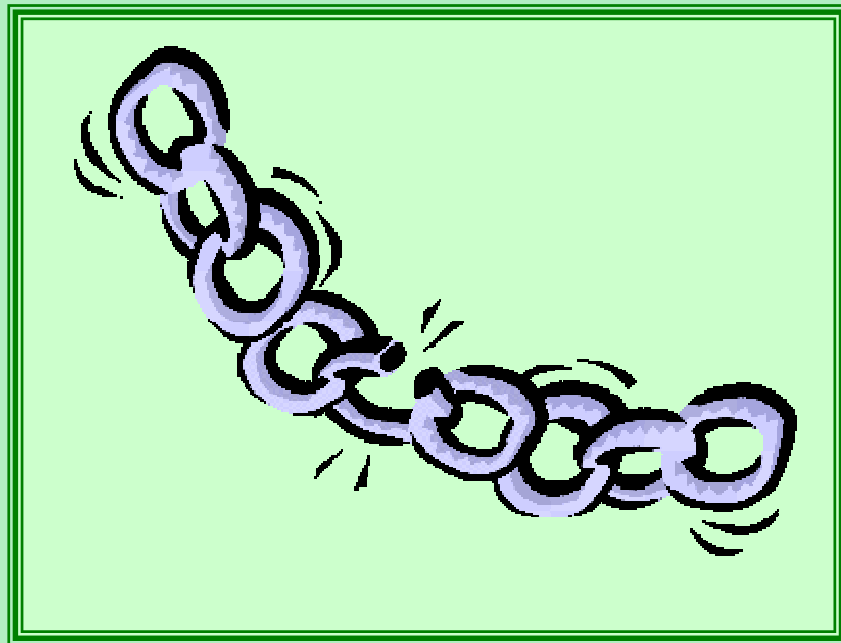




ETHICAL INVESTMENT ADVISORY GROUP



Company supply chains:  
The issues for responsible investors

January 2007

## **The growth of supply and demand**

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Historically, consumers were largely unaware of how goods were produced or how they ended up on a shop's shelf. The industrial revolution and the rise in real consumerism began in Britain in the late 18<sup>th</sup> and early 19<sup>th</sup> centuries, and has subsequently spread throughout the world. The invention of machinery and advancement in technology enabled an economy, once based on pure manual labour, to grow rapidly under an efficient production capacity. Railways and steam powered ships opened up the channels of distribution and began a process that has eventually led to many consumers (particularly those in the developed world) having access to any affordable product from across the globe, creating a worldwide capitalist society.

Although the introduction of the factory and mass production brought strong growth in real income per person, there is much debate about how this new age changed the lives of the "ordinary" worker. Many perceive authors such as Charles Dickens or Blake's well known "dark, satanic mills" as accurately describing the life of the working classes during the early years of English industrialisation. Many believe that the industrial revolution and capitalism are responsible for the degradation of the working class, through the industrialists exploitation of human capital in the mass production of food and products.

Although labour conditions and direct environmental and social impacts in the Western world have improved dramatically, the poor practices that were once evident in Victorian Britain appear to have been exported to developing countries.

## **Supply chains, an important issue to consider for shareholders**

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As responsible investors, the Church of England's investment bodies take an interest in the integrity of the supply chains of the companies in which they invest. Supply chains form an integral part of everyday life, and as such all companies will have some degree of exposure to supply chains.

In today's society where consumer demand is continuously growing, pressure on natural resources is intense. If those further up the supply chain want to continue making and selling their goods and services, it is imperative that the supply remains in place and is sustainable. Being responsible makes good business sense for companies, and ultimately for shareholders.

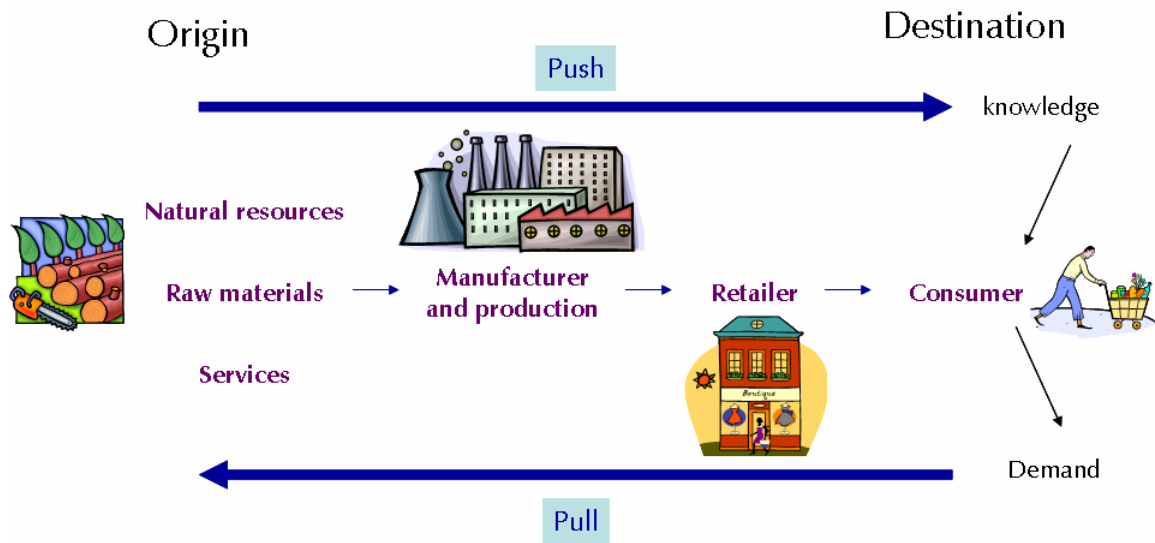
## **The complexities of supplying goods**

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Supply chains remain complex involving those providing the raw materials for goods, through to their manufacture, distribution and onward sale. Beyond this, there is also the end of life of goods to consider. The consumer also plays a role through the demand of cheap goods and services, resulting in the providers seeking the best way to meet this perceived need. However, what's good for the consumer may not necessarily be beneficial for those at the beginning of the chain, nor an effective driver of the economy. Consumer education is therefore key in eliciting any change in the supply chain that may benefit those sourcing the goods and services.

Supply chains may be simple, with just one or two parties involved such as a farmer growing vegetables, which are then sold by a small shop to the consumer; or they may be more complex. Mobile phones, for instance, are made up from a myriad of components. Each of these components may have associated ethical dilemmas, some of which are covered later.

The diagram below attempts to provide a simple breakdown of the supply chain and the tensions that exist along the chain, from origin to destination.



Source: CCLA Investment Management

## Manufacturers and producers

Producers are both reliant on a good supply of resources, as well as on a retailer to deliver their products effectively into the market place, taking the role of a sort of middle-man along the chain. They are beholden to some extent upon retailers, but less so than those producing the goods or supplying the raw materials further down the chain. This is because food producers market and promote their own brands which have a certain following and demand in their own right. So although reliant on the physical deliverance of goods to the market place, the establishment of the brand is more important and with this, the reputational risk attached to the brands is high.

## Retailers

The ability for retailers, both food and retail, to meet growing customer demand for cheap goods is dependent on sourcing these goods from suppliers at a quality and cost acceptable to the company. But the larger the retailer, the larger the pressure it is able to assert on suppliers as the balance of power shifts in order to maintain contracts with large stores. Although suppliers and producers are not tied to retailers and have the ability to walk away from an unfavourable contract, the growth in the number of factories and suppliers means competition for retailers' business is strong. However, should a retailer put too much pressure on their suppliers, they risk losing their source of goods. Yet, the consolidation of purchasing power that has occurred through the emergence of just a few major retailers in the European and US markets has created demand for higher quality goods at lower prices from the suppliers, creating the strongest tension along the supply chain.

## Consumer

Consumer behaviour changes over times. The current trend is the demand for cheap and readily accessible products. Five years ago, it was very unlikely that style-conscious teenagers would ever buy their clothes from a supermarket or low-price store. Now the high street is awash with cheap clothing outlets. Buying jeans along with the evening meal has become quite acceptable. With a new top for less than £5, clothes have become almost disposable. It has almost become part of fashion to have the knowledge and ability to find the cheapest and best bargains, cheap is the new black, evidenced through the huge number of cheap items of clothing sold per week. However, consumers ought to think about the consequences of their purchasing decisions and their desire to have cheaper and cheaper products and the latest fashions as quickly as possible.

But it does appear that another type of consumer is emerging, that of the ethical consumer. Greater media scrutiny and an increase in awareness of how one's purchasing decisions have a wider impact on the world has shifted many to change the way they buy goods and services. However, these tend to be more costly, one is paying for a social conscience, so whilst a bargain is still to be had, even at an ethical cost, the rise in ethical consumerism will probably remain a niche market.

Adam Smith (an opponent of monopolistic practices) in the "Wealth of Nations" purports that monopolies not only led to higher prices for consumers and lower prices for suppliers, but were also "a great enemy to good management". With out consumer choice, a monopoly has to make no effort to keep its customers. However, consumers to a large degree do have choice and with this still hold a key role in how companies source their goods and how suppliers are treated.

## **Five ethical areas of the supply chain**

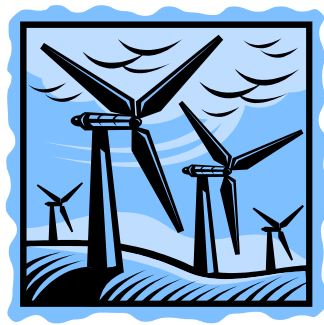
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Ethical issues of the supply chain are extensive encompassing the environment, human rights, employment, communities and business ethics. Companies with high exposure to supply chains fit neatly into the "positive" ethical criteria used to assess companies as outlined in the EIAG's Statement of Ethical Investment Policy. The degree of importance each of these issues holds within a supply chain is correlated to the geographic region in which the supplier operates. It tends to be the developing countries which have little or no regulation and hence where the opportunity to exploit both resource and human capital is greatest.

This paper will not look at *direct* company impacts, such as environmental footprint of an extractive company, but the *indirect* impacts companies have as a result of their business operations, i.e. at least one removed from a company. In addition, the paper will look at the payment terms within a supply chain as an issue of Business Ethics. It must be considered that, whilst we have separated various issues into five different areas, it is often a case that an issue may fall into more than one area.

These issues are fluid and constantly changing, but this paper aims to highlight some of the relevant ethical, social and environmental issues facing companies and their supply chains.

# ENVIRONMENT



## Outline

Natural resources form the basis of most supply chains, through industries such as mining, fishing, forestry and oil extraction. As long as they are not over harvested, *renewable* natural resources can restock themselves (such as fish, coffee, cotton and forests), whereas natural resources unable to reform at a rate that makes them sustainable (such as petroleum, metals and minerals) are non-renewable. The way that natural resources are obtained, used and then disposed of is of concern to industries that require a sustainable source of products; for once resources are consumed faster than a rate that exceeds their natural rate of replacement, the standing stock will diminish and eventually dry out.

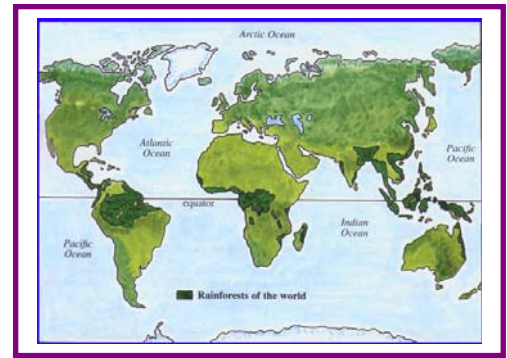
# Timber

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## Introduction

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Many companies sell products that are timber based and as such need to consider the type of timber used, where it originates and the sustainability of its source. Timber is used in furniture manufacture, window sills, sea defences, flooring, kitchen utensils, paper production, plywood and toys, as well as a source of fuel for many developing countries.



## What are the issues?

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### Rainforests

As the world's oldest living ecosystem, rainforests hold most of the world's biodiversity but are also the source for certain timbers such as mahogany, sapele, teak, greenheart and ramin which are used for a variety of purposes as already mentioned. In many of the countries exporting rainforest timber, such as in Indonesia and Brazil, the logging is done illegally. Rainforests are the home to over half of all plants and animals of the world. With rainforests once covering 14% of the earth's surface but now only covering 6%, this is endangering much of the world's biodiversity. 6,000 acres, the size of 4,000 football fields, of rainforest are estimated to be lost to logging and deforestation in an hour. The dark green map taking from "Learning about rainforest" above currently shows the world's rainforests.

### Climate change

In addition to biodiversity concern, the destruction of virgin rainforest is also contributing to global warming. Rainforests are generally carbon neutral but play a role in the global carbon cycle as a stable carbon pool; deforestation has been estimated by the World Bank to contribute 20% of global emissions as carbon dioxide is emitted through the burning of fossil fuels. Deforestation also leads to an increase in the levels of atmospheric carbon dioxide. It is also thought that rainforests play a role in cooling air that passes through them, an important role in climate systems.

### Corporate engagement

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Responsible shareholders can contact construction companies for example over their timber sourcing policies and monitoring systems. Company audits have proved useful showing that, despite the apparent correct documentation in Indonesia, in particular, there was evidence to suggest that documentation was often faked and no controls are in place to ensure that timber was not taken from pristine rainforest illegally. Certain companies have chosen to stop buying Indonesian timber until the situation improved.

A number of organisations now offer a certification scheme. One system for companies to use is certification from the Forest Stewardship Council (FSC). This is an international organisation that brings together concerned parties to find solutions which promote responsible stewardship of the world's forests. They are able to certify whether timber is sourced from sustainable forest systems, and not virgin rainforest.

The NGO, Friends of the Earth, believes that there are two basic features required of a credible certification and labelling scheme: first that the certification should be conducted by independent organisations operating to globally agreed principles and criteria; secondly, it should receive some form of official backing, as is now occurring under European Community eco-labelling rules, such as the FSC scheme.

# Palm oil

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## Introduction

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Another issue linked to the destruction of timber and rainforests is palm oil. Palm oil is an important vegetable oil found in many food and non food products from cooking oil, margarine and processed foods to commodities such as shampoo. It is estimated that palm oil can be found in one in 10 products sold in supermarkets. It is also used as a biofuel. The world's largest producer of palm oil is Malaysia, producing around 46% of global supply, with Indonesia in close second producing around another 36%. Both countries continue to expand their palm oil operations as its use and demand grows across the globe.

## What are the issues?

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### Biodiversity

The demand for land in tropical climates to grow cash rich crops such as palm oil and soy is driving illegal logging in order to clear land for crop growth. Certain species are under threat of extinction through this activity, such as the Orangutan. This species is now only found in Indonesian rainforests, spending most of their lives in trees and playing a vital role in rainforest habitat. The Orangutan population has fallen an estimated 91% in the past 100 years owing to the destruction of its habitat driven by illegal logging, forest fires, illegal gold mining and palm oil plantations. The species is the slowest breeding of all primates, and females have the longest inter-birth period (of around 8 years) of any land mammal. They reach maturity at 12 years, living for around 45 years. This results on average in three infants per breeding female during her lifetime.

### Renewable fuel

Palm oil is also used as a biodiesel, a popular “environmentally friendly” example of a renewable energy in regions such as Europe as global warming drives the need for greener energy alternatives. The Malaysian and Indonesian Governments, in recognising this, have focused the use of its palm oil into biodiesel production and government plans are underway in joint ventures to grow more palm oil plantations.

## Corporate engagement

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Supermarkets, food producers, non-food retailers and energy companies could be facing a knock to reputation if found to be sourcing these ingredients from unsustainable sources. Dialogue focuses on palm oil sourcing policies and assurance systems.

### Roundtable on Sustainable Palm Oil (RSPO)

Many multinationals are being encouraged to join the RSPO. This group was formally established under Article 60 of the Swiss Civil Code on 8 April 2004. It is a global multi-stakeholder initiative representing major players along the palm oil supply chain from the growers, processors, traders, consumer goods manufacturers, retailers, banks, investors and NGOs. The association was created by organisations carrying out their activities in and around the whole supply chain for palm oil in order to promote the growth and use of sustainable palm oil through working together within the supply chain.

Currently, the main UK food retailers are the first in Europe to join up, with major European retailers not appearing on the list of membership, although some of the major European Food Producers, such as Nestlé, have done so. Many energy companies have yet to consider the risk of palm oil in the renewable energy mix.



# Fish

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## Introduction

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Fish forms a staple part of a human diet. Fish are sold directly to the consumer through food retailers and independent fish mongers, but also to food producers who use fish as a main ingredient in its meals and other processed food.



## What are the issues?

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Currently the world is on the verge of taking more fish from the sea than it is able to replace, owing to poor fisheries management and wasteful destructive fishing practices. With more than 100 million tonnes of fish consumed each year and demand growing, the seas are being depleted of wild life in a race to meet the demand. 76% of the world's fisheries are already overfished. Poor fisheries management is the largest threat to ocean life and habitats, having a knock on effect on livelihoods and food security of millions of people. There are differences between the way wild fish are caught, such as whether it is line fished or trawled. Line-caught methods are more selective and allow selection based on quality, size and breed. Trawled fishing often damages parts of its catch, owing to crushing in the net. There are some methods of trawling that do allow higher levels of escape of undersized fish, and smooth netting which allows reduction in the damage to a catch.

### Species under threat

There are sustainability issues and concerns over declining stocks of fish, such as North Sea Atlantic cod, common skate, marlin, wild Atlantic salmon, blue fin and big eye tuna, sturgeon products, shark, ling, dogfish and Chilean sea bass.

## Corporate engagement

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Many food retailers are now being asked to consider the issue, with commitments only to stock fish caught from sustainable fishing practices, and banning certain fish stocks which are considered over fished within their stores and in their products now being made. Companies have a key role to play through their sourcing policies. Ultimately, the bigger the player, the more pressure they

"Environmental problems are our problems. The supply of natural products (fish, food, water) can only be sustained if the ecosystems that provide them are sustained and protected"  
**CEO, Major multinational Retailer**

can place on their competitors to follow suit. One major retailer recently pledged to increase its supply of food from sustainable food sources. It announced that it would purchase all of its wild-caught seafood from fisheries that have been certified as sustainable by an independent non-profit organisation called the Marine Stewardship Council

(MSC) within three to five years. A sustainable fisher takes no more fish out of the ocean than are born each year, ensuring the survival of the fishing population. This decision sets a precedent for its competitors and positively plays a role through the education of consumers. The company is working with current suppliers to obtain the right certification.

### Marine Stewardship Council

The MSC supports equal access to its certification programme irrespective of the size, scale, type, location or intensity of the fishery. It recognises the need to observe and respect the long term interests of people dependent on fishing for food and livelihood. The council currently reports that 42% of the global wild salmon catch, 32% of the prime whitefish catch (includes cod, Pollock, hake, haddock, ling and saith) and 18% of the spiny lobster catch are part of its programme. About 6% of the global edible wild capture fisheries are engaged in the programme.



# Coltan

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## Introduction

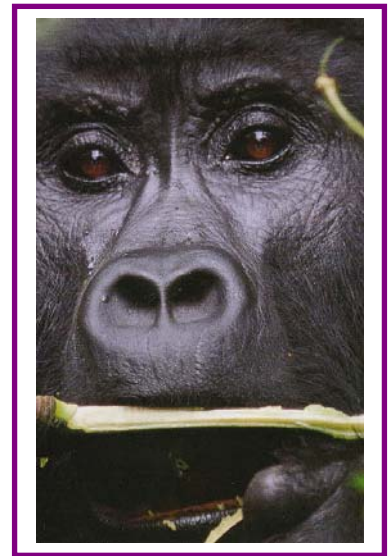
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Coltan, the colloquial name for columbite-tantalite, is a metallic ore that is used in consumer electronics such as mobile telephones, dvd players, computers and games consoles. It is popular for its refined product, a heat resistant powder, metallic tantalum which has unique properties for storing electrical charge. It is estimated that 80% of the world coltan supply comes from the eastern regions of the Democratic Republic of the Congo.

## What are the issues?

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The mountain gorilla is a threatened species now only found in the mountain jungles of Rwanda, Zaire and the Congo. The eastern lowland gorilla, a subset of the species, is only found in the forests of Eastern Congo. This is also the main region for coltan mining. There are allegations that this industry activity is having severe environmental repercussions on the forests and wildlife in the area, and in particular this largest living primate. Gorillas are facing problems in the Congo where not only are they hunted for lucrative bushmeat, but habitat destruction is caused by subsistence farming, and mining of coltan. Ground is often cleared to make the mining of coltan easier, reducing the available food for the Gorilla and the displacement of local populations by the miners has lead to Gorillas being killed and their meat sold as "bush meat" to the miners and rebel armies controlling the area. The UN Environment Programme reported the number of eastern lowland gorillas has declined by 90% during the five years of the dot com boom, with only 3,000 remaining.



At one point in the late 1990s, during the dotcom boom, prices spiked at \$600 a kilogram. It was estimated that the Rwandan Army was making around US\$20 a month from mining coltan and a coltan miner is able to earn as much as US\$200 per month, compared to a typical salary of US\$10 per month for the average Congolese worker. This all adds to the attractiveness of the product.

## Corporate engagement

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Coltan is not a visible component of cellphones but forms an integral part of the working mechanisms. Shareholders can question makers of mobile handsets and other electronic goods over the sourcing and use of coltan within their products, to ensure that the mineral comes from legitimate sources. Companies should also ensure that products now longer in use are recycled so that these minerals can be reused in new products. With over 2 billion mobile phone users now in the world, each having had at least (if not more) than one handset since mobile phones first came to the market, the retailers and makers of this equipment need to be acutely aware of the biodiversity issues that are associated with them.

Half of all coltan is now mined in Western Australia, however there is yet to be a cast-iron certification scheme to guarantee these claims and therefore shareholders have little way of knowing for sure that the coltan used by companies is not fuelling this issue.

## Further ESG issues

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There are also human rights issues to consider here, as Coltan is seen to be financing conflict in politically unstable areas such Congo, Rwanda, Uganda and Burundi, discussed further under Human Rights.

# Beyond the supply chain

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## Introduction

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A new product progresses through a sequence of stages, from introduction, growth, maturity and finally to decline. This is referred to as the product life cycle. The responsible practices of a supply chain are not entirely focused on the source and use of a product, but should also consider the decline, disposal or end life beyond the use of the consumer or customer.



## What are the issues?

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There are huge environmental consequences at the end of the supply chain. Waste materials have historically gone to land fill, but as a small island, Britain has a limited amount of space to dispose of waste. Around two thirds of waste is biodegradable, however figures for 2004/05 show that 20m tonnes of waste were sent to landfill, which leaves just under 7m tonnes that is unable to be broken down in landfill. The biodegradable waste itself has environmental consequences, producing landfill gas as it breaks down, contributing to nearly 2% of all of the UK's greenhouse gas emissions. Thankfully around one third of sites now have gas controls and many sites are able to extract the gas for energy recovery.

Environmental pollution results when waste by-products pollute water tables and soil. Certainly minerals, metals and materials originate from the non-renewable natural resources and in order to maintain a supply of these resources, recycling is essential.

## Corporate engagement

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The end of life cycle of product responsibility is essential for listed companies to consider, particularly with governments placing greater responsibility for this area on corporates. Those addressing these issues will be better placed to take financial and reputational advantage over competitors. Legislation has, and is, coming into force that will drive this. A few are outlined below.

### Waste Electrical and Electronic Equipment Directive (WEEE)

This directive aims to have 4kg of electrical goods recycled per person per year. Manufacturers must take more responsibility for recycling and providing information to consumers. Also separate collection services need to be put in place by the manufacturers of electrical goods.

### End of Life Vehicle (ELV) Directive (2000/53/E)

This directive has set a target for 95% of vehicles by weight to be reused or recovered (including energy recovery) by 2015.

### EC Directive on Packaging and Packaging Waste

The directive aims to reduce the amount of packaging used, to encourage its reuse, enhance recycling and recovery and divert waste from landfill. The UK met these targets by 2002 and the amount of packaging we recycle continues to increase.

Shareholders can encourage, where possible, take back, donation, re-sale, trade-in or recycling options to its consumers to ensure that the products it sells, whether they have been directly created by the company or not, end life in a sustainable fashion.

# HUMAN RIGHTS



## Outline

Most companies now declare that they follow the UN Universal Declaration of Human Rights, however human rights abuses still occur across the world. Indigenous people's rights are often an area for the extractive industries, as well as those sourcing produce from countries with dubious human rights records. Human Rights focuses on humans having natural rights regardless of ethnicity, religion or gender.

# Oppressive regimes

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## Introduction

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An oppressive regime may be defined as one in which the fundamental human rights of its citizens as set out in the United Nations Universal Declaration of Human Rights (1948) are widely denied or are systematically abused over time. The former might include the denial or restriction of freedom of expression and worship, or the denial of civil rights based on ethnic or tribal origin. In many cases there will not be a free press and the rule of law will be absent. The latter may include imprisonment without trial, torture, disappearance and state sponsored killing. Today there are more democratic countries in the world than ever, however as part of its own human rights policy, for instance, the Co-operative Bank names 59 regimes that it classifies as 'oppressive'.



## What are the issues?

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### Sudan

The three year conflict in Darfur, Southern Sudan has resulted in a human rights catastrophe that has claimed the lives of 400,000 people and displaced 2.5m more. Despite a UN led peace deal, government forces have continued to bomb and “ethnically cleanse” rural communities in Darfur. Rape has been used systemically as a weapon of war by the armed forces and militia groups.

### Myanmar

Burma (Myanmar) is one of the world’s most oppressive and secretive regimes, run by a military government since 1962. Free elections held in 1990 were won overwhelmingly by the National League for Democracy, but the military government refused to acknowledge the result, which continues its harsh rule and systematic human rights abuses. There is no freedom of expression and torture is endemic. The government continues to systematically persecute ethnic groups such as the Karen.

### Democratic Republic of Congo

Civil war has raged in DRC for many years, and government control over vast swathes of the country is non-existent. Ethnic tension and guerrilla activity has led to unlawful killings, systemic rape, torture and the use of child soldiers. The UN estimates that up to 31,000 people a month are killed through civil violence.

### Other Oppressive Regimes

Freedom House’s 2006 Annual Report on the state of democracy and freedom in the world reports 89 countries as free, 45 as unfree and 58 as partly free. Countries where human rights are severely limited or in peril include China, Pakistan, Zimbabwe, North Korea, Libya, Saudi Arabia, Turkmenistan, Uzbekistan, Somalia, Nigeria and Belarus.

## Corporate engagement

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Military conflicts disrupt food production and distribution. Moreover increased global military spending diverts spending from social and economic development. Oppressive regimes and corruption can also cause hunger, by draining scarce funds away from those most in need. Companies operating in countries where freedom is severely restricted may incur reputational risk if they become tainted by association with particularly oppressive administrations, or perpetuate abuses themselves as part of the cost of doing business.

# Child labour

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## Introduction

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The International Labour Organization (ILO) has estimated that 250 million children between the ages of five and fourteen work in developing countries. Many do light or part-time work that can be fitted in around their schooling to help support their families. However, many others are involved in dangerous or exploitative labour that harms their development, wrecks their health and denies them a right to education.

## What are the issues?

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### Domestic employment

A recent Delhi study revealed shockingly high levels of emotional, physical and sexual abuse among children working as domestic helpers in other people's homes in Calcutta. With more than 50,000 children employed in this form of work, it has become a cultural norm to employ young children. The current law in India allows domestic employment of children as young as 14.

### Mining

In both Mali and Burkina Faso, it is common for children to leave their homes to find work, in some cases children are trafficked and forced into labour. Many children end in the Sahel region of Burkina Faso to mine gold, often working long hours in dangerous conditions.

### Cocoa

One of the more current issues is the use of children in the cocoa trade. Chocolate manufacturers and retailers came under scrutiny following reports that children were being shipped from west African countries to work on Cote d'Ivoire cocoa plantations. There have been reports of young boys aged 12 to 16 being sold into slave labour and forced to work on one of the 600,000 cocoa plantations harvesting beans from which chocolate is made. Some estimate that there are as many as 15,000 children being forced to work on the farms under terrible conditions and abuse.

### Asia

Many children in Asia are trapped in servitude, and have been found to work in factories and workshops for no pay and, as reports suggest, receive constant beatings. Carpet factories need small nimble fingers to work on their products, fitting a child perfectly. Other accusations of footballs being stitched and clothes made in factory sweatshop conditions, still abound.

## Corporate engagement

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Any company sourcing goods with poor labour standards and inadequate government policies, particularly relating to children, are at risk of exposing themselves to reputational damage. Tarnished reputations take years to recover, and in extreme cases some never do. A major sporting company still suffers from being accused of having its footballs stitched by children in Asia. This in turn can have a major knock on effect on company sales, revenues and future growth prospect. This is clearly a concern for shareholders, and engagement over policies and audit trails is essential to understand how they are dealing with these issues.

### International Cocoa Initiative

This initiative was set up to eliminate child labour from cocoa plantations when allegations of child trafficking occurred. Members have worked together in order to protect the reputation of the cocoa industry which supplies one of their main ingredients. Modern slavery and child labour are often hidden from view and partnerships like this help provide consumers with more confidence that the products they are buying are not fuelling human rights abuses.

# Blood diamonds

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## Introduction

The term blood diamonds was coined from diamonds that were being mined in war zones in Africa, often by illegal miners including children and then sold, usually clandestinely, through militants and oppressive regimes to finance an insurgent or invading army's war efforts. Countries in central and western Africa are the main players in blood, or conflict diamonds.



## What are the issues?

In the 1990s, approximately 4% of the world's diamonds were classed as blood diamonds. This issue was first highlighted in the brutal conflict in Sierra Leone, although blood diamonds have been evident in the funding of conflict in Angola, Liberia, Ivory Coast, the Democratic Republic of Congo and the Republic of Congo, even if not mined directly in some of these regions.

Lack of traceability of these diamonds results in these stones ending up as pieces of jewellery in the west and consumer concern that diamonds are not from reliable sources may result in consumer boycotts.

## Corporate engagement

Shareholder engagement has occurred, and still occurs, with the mining industry in particular over the associated reputational risks. The supply chain issue for those who buy diamonds for industrial or retail businesses focuses on how a business ensures the source of their diamonds traceable and reputable. This is where certification comes into its own.

### Kimberley Process Certification System,

In 2000, a cross sector coalition of governments, non-governmental organizations and the diamond industry worked together to address this issue resulting in the Kimberley Process Certification System, being formulated in 2002. This UN-backed process has significantly reduced the trade in conflict diamonds although this trade is still evident and some countries are still "black-listed".

This voluntary certification scheme imposes extensive requirements on participants to certify that shipments of rough diamonds are free from conflict diamonds. There are around 45 Participants of this scheme, including the European Community.

## Further ESG issues

Conflict diamonds have environmental impacts as the operations used to mine diamonds are often destructive and have no remediation processes in place to return areas to their original form. Illegal miners also end up surviving on bush meat and living in ecologically sensitive areas (see coltan).



# EMPLOYMENT



## Outline

Suppliers in a competing world have had to become much more flexible and responsive to their buyers. Human capital has become cheaper off-shore and much of our supply chain now originates from other parts of the world, largely the developing world. Companies sourcing human capital off-shore for goods and services, such as call centres, face employment issues that need to be managed and audited, particularly as these countries from which they are sourcing tend to have weaker employment legislation than the Western world. Subcontracting of suppliers makes this issue even harder to audit and trail.

# Freedom of association

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## Introduction

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Freedom of association is the right of free adults to mutually choose their associates for whatever purpose they see fit. Freedom of Association has been included in several national constitutions.

Collective bargaining is a specific labour issue, a contract between an employer and one or more worker unions, allowing negotiation around working terms and conditions.

## What are the issues?

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Most of the world accepts freedom of association as a right under any normal labour conditions and allow workers the ability to belong to a group or union which represents a common interest, normally in the right of the employee. However issues in factories, for example include long working hours, poor benefits, low and steadily declining salaries, poor health and safety conditions and the prevention from joining unions and other workers' rights groups. Evidence suggests that in order to meet retailing demand, workers are pushed harder with an increase in shifts and weekend work, with reports of no guarantee of overtime, breaks and a limit to an individual's working day. Factories may also choose to subcontract which makes the supply chain even more complex. Without freedom of association or collective bargaining, abuses in factory working conditions can occur.

Freedom of association and the right to collective bargaining is not an issue limited to retailers and factory supply chain, but will affect all supply chains with large work forces, such as mining industry, farming, transport, and more or less any manufacturing industry. Poor workers rights and industrial relations have the ability to bring business to a standstill. One example may be a large airline which faces a food shortage owing to its catering company falling victim to major strikes as a result of poor industrial relations.

## Corporate engagement

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As multinationals put pressure on the supply chain to deliver cheap and timely goods, factories and other suppliers put pressure on their work force. For example, the fall in prices on the high street, it has been said, has been passed on to the buyers, the suppliers, and ultimately the workers. This can be seen by the average garment export prices in China falling 30% between 1997 and 2000, at the same cost with production costs rising 10%.

## Further ESG issues

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Not only is freedom of association a labour issue, but it is recognised as a fundamental human right within many human rights documents and by many organisations, such as the Universal Declaration of Human Rights and the International Labour Organization Conventions C87 and C98.

# Bangladesh and other countries factory conditions

## Introduction

Bangladesh is one of the poorest regions of the world, as well as one of the most densely populated. With over 50% of the population living in abject poverty, work is hard to come by and ensuring job security is key to providing for one's family. In Bangladesh, as in other developing countries with growing supply economies, this gives great power to these regions employers (i.e. factory owners).



## What are the issues?

The abuse of power is the main concern. Many retailers and other major global companies are now sourcing their goods and services, such as call centres, from across the developing world. Bangladesh has become a very popular place for retailers to obtain goods, particular cheap clothing. The food retailing industry's main driver recently has been its growth of non-food items with sales worth £13.5bn to supermarkets in 2004.

In 2001, the general clothing industry in Bangladesh accounted for 86% of the country's exports. Reports from NGOs working in Bangladesh, as well as those on the ground are not good. Wages and working conditions have not improved but worsened with the minimum wage having halved in real terms over the past 10 years, now worth £7 a month. There have been reported problems of factory workers walking out over decline in pay that resulted in clashes with police, injuries to workers and fatalities. This also resulted in a disruption to the supply of goods to retailers sourcing goods from these factories.

Western companies often require high standards of their factories, but managers have become very adept at pulling the wool over the eyes of its customers with evidence of double book keeping, manipulating worker interviews, bullying tactics and changing factory working practices and conditions for the short time audit visits take place.

## Corporate engagement

With a high demand for cheap almost disposable clothes, the low cost clothing retailer has grown substantially over the past few years; four major players in the UK market now make up the majority of today's clothing sales in this country. Shareholders need to be concerned with increase in the number of accusations of companies treating suppliers unfairly, which ultimately may result in harm to reputation and potentially loss of business as consumers boycott the retailer or company.

Engagement can focus on the implementation of ethical sourcing policies, audit trails, the allowing and encouragement of basic human rights, such as freedom of association. Those companies with an good policies in place and robust audit trails will ultimately be at an economic advantage.

### The "look behind the label" campaign

Labour Behind the Label works to support the garment workers' efforts worldwide to improve their working conditions through educating consumers and lobbying companies and governments. It aims to raise awareness and encourage international solidarity with workers, ultimately to improve working conditions within the garment industry worldwide. Shareholders can ask companies whether they are working with these sorts of groups to ensure good audit processes and decent working conditions are in place within the factories from which they source.

# COMMUNITY



## Outline

A supplier's impact upon communities may have a reputational risk for any company sourcing from the related supplier. Many community issues overlap with other areas of concern, such as environmental impacts upon a community, local employment opportunities, employment practices, etc. Positives can include an increase in economic opportunity for communities, access to affordable goods and a building of brand awareness and a good reputation.

# Business and communities

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## Introduction

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All business has some bearing, and is reliant to some extent upon the communities in which they operate. This also applies to relationships down the supply chain. Community issues in a supply chain can be local or global.

## What are the issues?

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### Migrant workers

Many communities originate out of migrant workers moving to areas of industry. Companies dependent upon those industries have an impact on how these communities operate, and these in turn can help industry to be productive.

Retailers, for instance, may have a more physically visible presence within the countries in which they operate. Market towns have historically been the social and trading focal point for rural England. Retailers have moved out of high streets to provide large one-stop stores for customer convenience and the growth in the food retailers is evidence of how popular this is with the end of the supply chain. This business strategy has resulted in accusations against large retailers of:

- destroying the economic viability of town centres
- closing down local retailers
- destroying areas of countryside
- increasing traffic and therefore pollution

Superstores argue they are offering the customer, and hence the community, what it wants, providing more jobs for the local population, access to affordable goods otherwise unavailable and creating efficient market economies.

### Displacement of communities

As companies source their goods from far and wide, and growth in micro-economies in the developing world results, this in turn develops into growing communities around the economic opportunities on offer. However, there are occasions when a supplier moves into an area which results in the displacement of a local community, such as in the Indonesian rainforest as loggers move in, and certain crop plantations, such as palm oil are set up. The extractive industries, for instance, often operate or sourcing from sensitive areas, such as Colombia, Brazil, Africa, Russia and China where communities have been adversely affected by these activities.

## Corporate engagement

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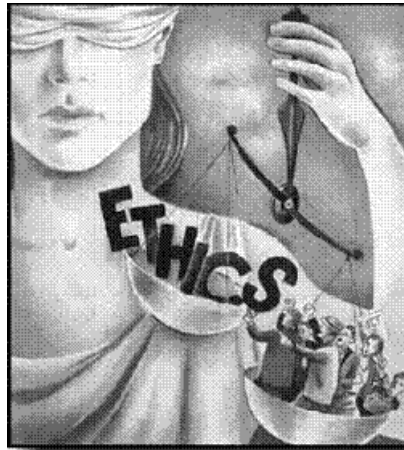
Shareholders should be concerned that supply chain audits and processes take community issues into consideration within any policies in place. Community consultation is vital and should be encouraged. With this, issues such as local peoples rights, cultures and traditions should be respected and observed. Economically, the positive benefits should be highlighted.

## Further ESG issues

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With community issues involving the developing world, environmental, human rights and labour issues will need to be considered and therefore cross many of the other areas of concern within a supply chain.

# BUSINESS ETHICS



## Outline

Although shareholders would like their companies to operate in an efficient and competitive manner, responsible investors also aim to invest in companies which operate with integrity. This includes areas such as bribery and corruption, supplier terms and conditions and how a company ensures that its suppliers are paid. Managing business ethics poorly may lead to reputational damage through association as well as placing suppliers on the edge of economic viability.



# Supplier payment practices

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## Introduction

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In an annual report, a listed company is obliged to disclose information on its creditor days; a ratio used to work out how many days on average it takes a company to pay its creditors. It is also a useful tool to decide whether a company that is very slow in paying its creditors (say 100 days plus) is having problems generating enough cash to pay them.



## What are the issues?

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The government recommends that suppliers are paid within 30 days, but it appears that companies are pushing beyond this limit and taking longer to pay their suppliers. The longer a company can hold off paying a supplier, the longer it has capital with which to work. However, a supplier, like most businesses is dependent on regular income from which to buy or source raw materials, pay its work force and its bills. For suppliers, the longer they have to wait for their payments, the more risk they face in terms of economic viability.

In the examination of debtor days, the average days it takes a company to get paid for what it sells, one is able to deduce the efficiencies of a company. Obviously, the lower the number of debtor days, the better. An abnormally high figure suggests inefficiency, potential bad debts, window-dressing of the sales figures, or deliberate bullying by large customers trying to improve their own cash management, not good news for shareholders. Cash businesses, including most retailers, should have very low debt collection multiples, because they get their money at the same time as they sell the goods, however this would not be the case for goods producers, normally in the middle of a supply chain, being reliant on retailers to pay them.

FTSE 350 companies from the three sectors highly influential within a supply chain, food retailers, food producers, general retailers, there is a definite trend over a ten year period to increase the number of trade credit days (this is the average days it takes to pay a supplier). The food producers (in the middle of the supply chain) have seen the largest increase over the past five years, in both creditor and the debtor days suggesting that as retailers are working favourable payment conditions for themselves, the food producers are passing these on to the suppliers further down the chain. In other words the longer food producers wait to get paid by the retailers, the longer they are waiting to pay their own suppliers. Those at the bottom of the chain fair the worst.

Further evidence of squeezing by retailers can be seen in research carried out by Accountancy Age which shows a trend that supermarkets are paying fewer small invoices to suppliers on time, evidenced by one retailer falling from paying 87% invoices below £5,000 within a timely manner to 67% in a one year time frame.

## Corporate engagement

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Engagement should focus on the relationship companies have with their suppliers, and the payment policies that have been agreed. Companies need to pay their suppliers in a timely fashion to ensure sustainable business relationships and not place smaller companies at the edge of economic viability. The bigger a company, the more pressure it can exert on favourable payment conditions. Companies also need to be cognisant of Government legislation and recommendation. Voluntary systems will ultimately result in regulation should companies fail to adhere, and countries with no regulation pose greater risks in this regard. Responsible payment practices result in growing economies and the assurance of sustainable supply.

# Bribery and corruption

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## Introduction

Bribery is a crime whereby an offer of something valuable, normally monetary is made to an official or person in discharge of public/legal duty, in order to influence the action of the other, such as a guarantee of a contract, and is normally the activity in which official of a corrupt regime participate.



## What are the issues

For companies, bribery is an illegal activity in the UK and is serious enough to be punishable by a prison sentence or large fine. This is therefore relevant for all UK plc. This creates a grey area over facilitation payments, which are the payments made to officials to ensure that business operates smoothly. This ethically questionable term that is generally used when businesses operate in countries where it is impossible to conduct business without some sort of bribe, such as Nigeria.

There are many countries across the world in which regimes are inherently corrupt (see oppressive regimes).

## Corporate engagement

It is vital that companies have good codes of business ethics which address the issue of bribery and corruption and that these policies are included in any supply chain contract a company may have. Shareholders should seek honest and transparent trading activities within the companies in which they invest and should encourage ownership of these issues at Board level. All companies should have an anti-bribery policy in supply chain contracts which might include guidance on business transaction procedures, prohibit the offer or acceptance of bribes, hospitality, gifts or expenses which may influence the outcome of a business transaction. In addition, companies may include prohibiting donations to political parties.

Scenario planning and education of staff is key and shareholders and enquire what processes are in place to educate staff of suppliers. Many companies have invested in whistleblowing lines and confidential hotlines to help report and eradicate bribery and corruption.

## Conclusion

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This paper on the issues of concern within a supply chain is intended to be both a set of engagement principles for responsible investors to use when examining company supply chains, as well as an educational guide for those with an interest in this area.

It is a working document, where changes will be made as new issues arise, and potentially old issues are resolved.

As a shareholder, the Church of England believes in corporate responsibility and uses its position to address these issues with the companies in which the three investment bodies invest.

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