KPMG
cutting through complexity

Conflict Minerals Provision of Dodd-Frank

Immediate implications and long-term opportunities for companies

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Section 1: Summary

Even as the "conflict minerals" provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or the Act) slowly garners attention in board rooms, C-suites, and among the rank and file of companies around the world, questions abound regarding the provision's scope, impact, reporting, and auditing requirements.

The conflict minerals provision, contained in Section 1502 of the Act, has a direct bearing on reporting requirements on about half (at least 6,000) of all publicly traded companies in the United States. The Act directs the Securities and Exchange Commission (SEC) to issue rules requiring companies to disclose in 10-K, 20-F, and 40-F filings whether they manufacture products containing certain minerals mined from the Democratic Republic of Congo (DRC) or certain neighboring countries in Central Africa, where proceeds of the mining activities have been used to finance armed militias committing atrocities in those war-torn countries.

For many—if not most—businesses, the most daunting aspects of the provision will involve complying with the requirement to conduct due diligence on the origin of the conflict minerals, which include gold, wolframite, casserite, columbite-tantalite, and their derivative metals, which include tin, tungsten, and tantalum.

In today's global economy, where businesses utilize numerous vendors, contract manufacturers, and strategic-alliance partners, knowing simply how to develop a strategy to determine the source of minerals will be the first major hurdle to clear.

A small number of companies already have begun the work of performing supply chain due diligence, some even before Dodd-Frank was enacted; and, a few industry groups have been instrumental in formulating industry-wide solutions, with the high-tech industry taking the lead. However, the majority of companies have not yet taken any action to formulate a strategy, according to a recent KPMG survey on the topic. In fact, it appears that general awareness of the conflict minerals provision continues to be low. Corporate counsel and auditors report that they have had to inform senior executives at their affiliated companies about the conflict minerals provision, its broad implications, and the reporting deadlines. The final rules, which were expected in April, are now anticipated to be released before the end of 2011.

KPMG has developed a practical approach for conducting due diligence on conflict minerals—an approach that is in conformance with the Organisation for Economic Co-operation and Development (OECD) guidelines, and works well with tools and programs endorsed by two electronics industry associations—Electronic Industry Citizenship Coalition (EICC) and Global e-Sustainability Initiative (GeSI).

While a number of organizations and specific businesses have raised a great deal of criticism about the complexity and ambiguity of the rules, a number of organizations that already have undertaken a supply-chain due diligence program have reported benefits beyond pure compliance of the rule requirements, not the least of which is supply-chain transparency.

KPMG issued a recent Public Policy Alert addressing the impact conflict minerals provisions may have on strategic business planning such as supply chain optimization particularly during global expansion.

Section 2: The law and its requirements

Introduction

The term "conflict minerals" is used to describe certain minerals such as gold, wolframite, casserite, columbite-tantalite and their derivative metals, which include tin, tungsten, and tantalum that are mined in the DRC or its adjoining countries.[1]

The United Nations has been raising awareness of mining of conflict minerals as a source of revenue for armed militias committing atrocities in the DRC for at least the past 10 years.[2] Over the last several years, Non-Governmental Organization (NGO) groups, such as the Enough Project[3] and Global Witness,[4] have championed the cause and lobbied Congress and several major electronics corporations to take action.

Attempts to legislate controls around the use of these minerals began in 2009[5] and culminated with the U.S. Congress passing the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. Included in the Act was the little-known—and even less-understood —"Section 1502," dealing with conflict minerals.

In enacting Section 1502, Congress hoped to remedy what it perceived as the exploitation and trade of conflict minerals originating in the DRC. Trade of these minerals help finance armed conflict, characterized by extreme levels of violence.[1] The purpose of Section 1502 is to promote transparency and consumer awareness regarding the use of conflict minerals and ultimately to discourage the use of conflict minerals by manufacturing and processing companies.

Apart from action on tin, tantalum, tungsten and gold (commonly referred to as 3TG), Section 1502 leaves the door open for the U.S. Secretary of State to classify other metals/minerals as conflict minerals. Congress left the task of formulating guidelines and implementing the rules to the SEC.

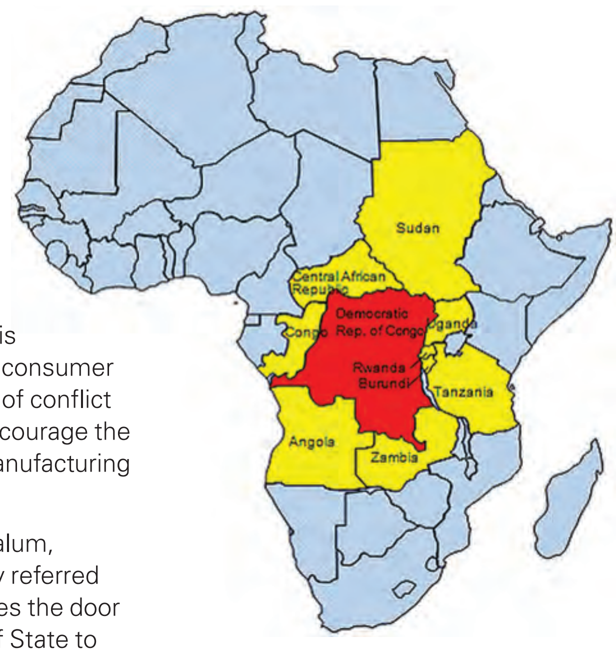


Figure 1: DRC and adjoining countries

Table 1: Uses of 3TG and % from DRC[1, 6]

Metal	Industries Using the Metal	Common Applications	Commercial Ores*	% World-Supply from DRC
Tin	■ Electronics ■ Automotive ■ Industrial equipment ■ Construction	■ Solders for joining pipes and circuits ■ Tin plating of steel ■ Alloys (bronze, brass, pewter)	Cassiterite	5%
Tantalum	■ Electronics ■ Medical equipment ■ Industrial tools and equipment ■ Aerospace	■ Capacitors (in most electronics), ■ Carbide tools ■ Jet engine components	Coltan (columbite-tantalite)	15-20%
Tungsten	■ Electronics ■ Lighting ■ Industrial machinery	■ Metal wires, electrodes, electrical contacts ■ Heating, and welding applications	Wolframite, Scheelite, Ferberite, hübnerite	0.60%
Gold	■ Jewelry ■ Electronics ■ Aerospace	■ Jewelry ■ Electric plating and IC wiring	Various free and combined forms	0.5-2%

Applicability

The section requires that companies that file 10-K, 20-F, or 40-F annual reports with the SEC, and use conflict minerals in their manufacturing processes and supply chain, disclose in the reports whether the minerals came from the DRC or an adjoining country.

The disclosure requirements will impact myriad industries, from makers of earrings, to cell phones, to combat jet fighters, to auto parts, and many more. The SEC estimates the law may directly impact as many as half (roughly 6,000) of all U.S. publically traded companies and perhaps thousands more suppliers.[1]

The rule affects:

- Publicly listed companies that manufacture products utilizing conflict minerals.
- Publicly listed retailers that carry private-label products or contracted with another party to have a product specifically made for them; however, retailers that only sell other companies' branded products are not required to report.
- Certain private or foreign corporations that operate in the supply chain of a publicly listed U.S. customer. While they do not have SEC reporting obligations, it is likely that many will need to provide documentation to their customers.
- Certain public/private distributors with no product specifically made for them. Similar to private corporations, while they are not covered by the new regulations, they may need to conduct due diligence to provide information to their public customers.

Law's requirement

All SEC-listed companies that use conflict minerals in the "functionality or production" of a manufactured product must comply with the Act, including companies that used a product made from a conflict mineral to make another product. In other words, the conflict mineral need not appear in the final product to require reporting compliance.

The provision specifically mandates three steps for companies to follow:

1. Determine if tin, tungsten, tantalum and gold are used to make its products.
2. Determine if the metals they use originated in the DRC or neighboring countries. If the metals did not originate in affected nations, companies must report how the company determined the metals' origins.
3. If the metals were from DRC or adjoining countries—or the source is unknown—companies must trace the supply chain for the source and furnish an independently audited report on those due-diligence efforts.

The SEC mandate is expected to require the first and second steps of the process described, regardless of the origin of these metals. The third step—disclosure of the products manufactured, facilities where DRC materials may have been used, etc.—must be completed only if the DRC is identified as a source or if the source is not identifiable. Companies must make specific disclosures in their annual report, and if applicable, furnish a conflict mineral report as an exhibit, and on their Web site whether they use conflict minerals in a product they manufacture, or in products contracted to be manufactured on their behalf.

Federal law does not prohibit companies from sourcing conflict minerals, nor impose a penalty for doing so. However, the intent is to rely on public pressure to dissuade U.S. companies from indirectly sourcing conflict minerals, and hence fund the armed groups in the DRC.

Current time line

On December 23, 2010, the SEC proposed rules governing specialized disclosure relating to conflict minerals and opened a period for receiving public comments. Final rules were due to be issued by April 15, 2011, but the release date was later delayed until sometime between August and December of 2011.[7]

For now, it is understood that the final rules will apply beginning with the annual report for the first full fiscal year after the enactment of the final rules (i.e., for a calendar-year company, the annual report for 2012 to be filed early in 2013).

Action by state and local governments

On April 12, 2011, a California State Senate committee passed a bill that would curb the use of conflict minerals from Congo.[8] If passed, the bill would prohibit the state government from contracting with companies that fail to comply with federal regulations on conflict minerals. In addition, two cities, Pittsburgh, PA; and St. Petersburg FL, have taken steps toward becoming conflict-free cities, and NGOs have been lobbying other cities in the United States and Canada to follow suit.[9]

Section 3: Analysis of industry action and challenges

Challenges to implementation

There are many reasons why implementing Section 1502 could be challenging for companies. Its mandate to companies is extremely complex and it has been criticized in many quarters as being vague and open to wide interpretation. Even though the SEC is expected to issue further details later in 2011, implementation may be challenging for the following reasons:

1. **Uncertainties regarding the scope of the requirement.** Terms such as "reasonable country of origin search" and "substantial to the functionality" have caused a great deal of debate. Also, the implications to retailers are unclear, as is the extent to which due diligence will be required for recycled materials.
2. **Mapping the supply chain is expected to be an arduous task.** Today's supply chains are global and highly complex. Between the ore and the final use, materials frequently change hands 10 or more times. The dynamic nature of sourcing of parts and commodities that have yielded lower costs for companies have also made the supply chains less transparent. Complexity can magnify when companies use distributors or multiple suppliers for the same component. As a result, even large companies with substantial clout over suppliers and extensive resources face significant challenges to map their entire supply chain.
3. **Uncertainties regarding audit standards.** Companies are finding it difficult to reach a conclusion about how the audit will be conducted. The proposed rule does not clearly state the type of conclusion sought and related objective of the audit of the conflict minerals report; but leaves it to the Government Accountability Office (GAO) to provide guidelines.

Uncertainties include:

- Nature and objective of audit:
  - Conformity with a recognized standard
  - Whether the issuer performed the due-diligence procedures
  - Origin of the conflict minerals
- Applicable professional standards for audit: Choice between attestation or performance audit
- Independence requirement: Standards set by the SEC, the Public Company Accounting Oversight Board (PCAOB), or the GAO

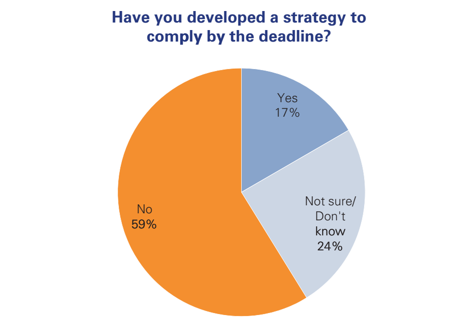
While the comments to the SEC[10] overwhelmingly supported the implementation of the new law, the challenges were apparent in some of the comments from companies, trade groups, and service providers, including KPMG. However, it is unrealistic to expect that the SEC will be able to clarify every requirement. In fact, requirements are expected to evolve over time, and it will be up to the industries to find acceptable solutions.

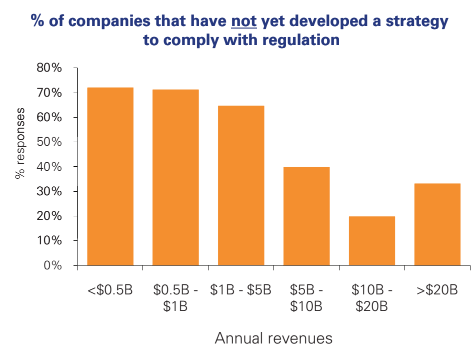
Individual company response and potential reasons

Even before the conflict minerals provision was signed into law, several high-tech companies had started work on the issue. According to the Enough Project, companies such as Intel, HP, Apple, Dell, Motorola, Microsoft, and Nokia have begun conducting due diligence to become "DRC conflict free."[12]

Despite these examples, and a looming reporting requirement about to become a reality, most companies have not acted. A survey conducted by KPMG's Americas' Financial Services Regulatory Center of Excellence (figure 2) indicated that only 17 percent of respondents in affected industries claim to have a strategy to comply by the reporting deadline. Smaller companies are even less likely to have developed a strategy.

Figure 2: Company strategy for conflict minerals



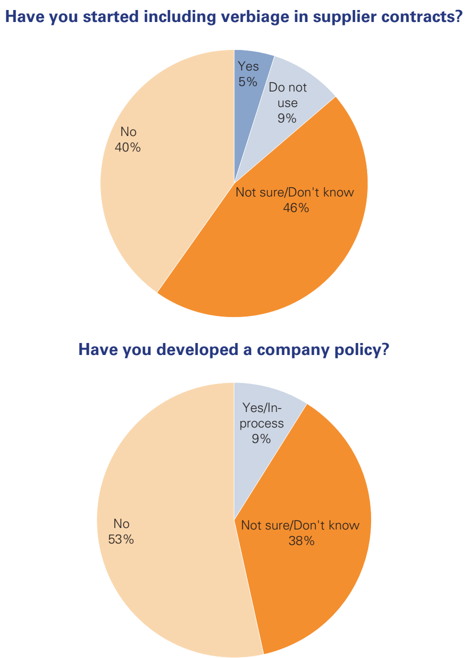


Source: KPMG Conflict Minerals Survey, 2011

One of the first steps in "DRC conflict free" status is to develop a company policy of not using conflict minerals and including appropriate language in supplier contracts. The KPMG survey found that fewer than 10 percent of respondents have even taken this step (figure 3). Not surprisingly, the majority of companies that have taken action are from the high-tech industry or are suppliers to the industry.

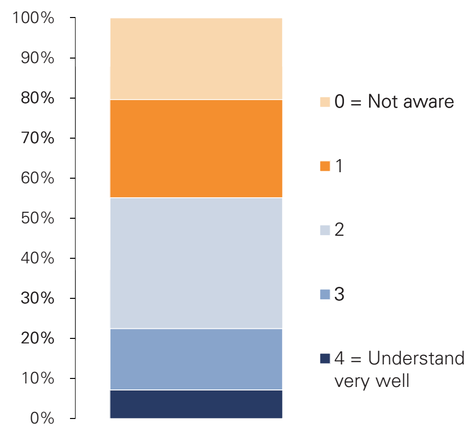
While there may be several reasons for the inaction, a lack of understanding of the act seems to be a strong contributor. Just over 50 percent of companies surveyed in the affected industries claim to have a good understanding (2 or higher on a scale of 0 through 4) of conflict minerals (see figure 4). In fact, only five percent of respondents said that they understood the provision very well.

Figure 3: Company policy and supplier contracts



Source: KPMG Conflict Minerals Survey, 2011

Figure 4: Awareness of Conflict Minerals Provision of Dodd-Frank



Source: KPMG Conflict Minerals Survey, 2011

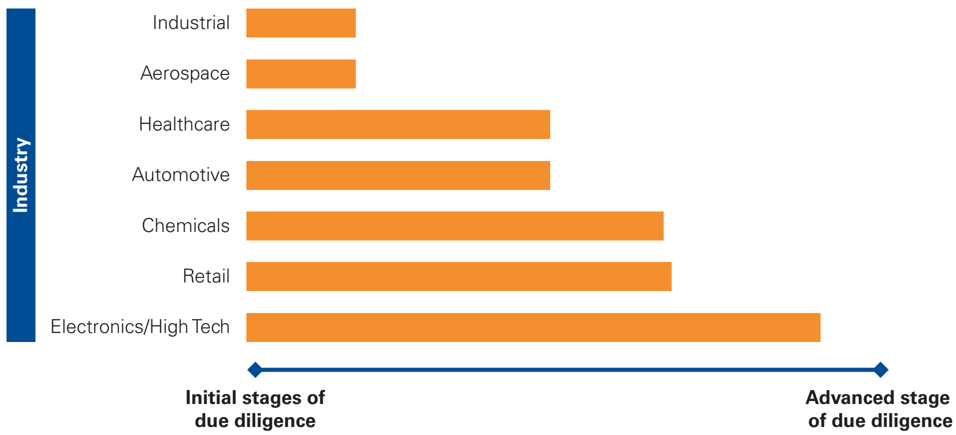
Industry-based Solutions

While individual companies have been slow to act, a few industry groups have taken the lead in formulating potential solutions. The OECD has developed standards that have been referenced[1] by the SEC as a good starting point for companies to base their policies for compliance with the Act. The OECD requirements[13] for risk-based due diligence in the conflict mineral supply chain include:

- Establish strong company management systems
- Identify and assess risks in the supply chain
- Design and implement a strategy to respond to identified risks
- Carry out independent third-party audit
- Report on supply chain due diligence

Even though OECD guidelines may be a good starting point, they do not outline how supply chain due diligence could be conducted. Two electronics industry associations, Electronic Industry Citizenship Coalition and Global e-Sustainability Initiative, which together represent a large group of high-tech companies, are in the process of developing a Conflict Free Smelter (CFS) program[14]. If successful, companies performing due diligence will only need to trace the 3TG supply chain down to smelters (see figure 6). The work of tracking the mines of origin and preventing "tainted" minerals from reaching the supply chain would then fall on the smelters. Lastly, on August 3, EICC and GeSi announced the release of the "Due Diligence Reporting Template and Dashboard" that companies can use as a standard questionnaire for conducting inquiries into supplier's sources of metals.[15]

Figure 5: Stages of conflict minerals due diligence by industry

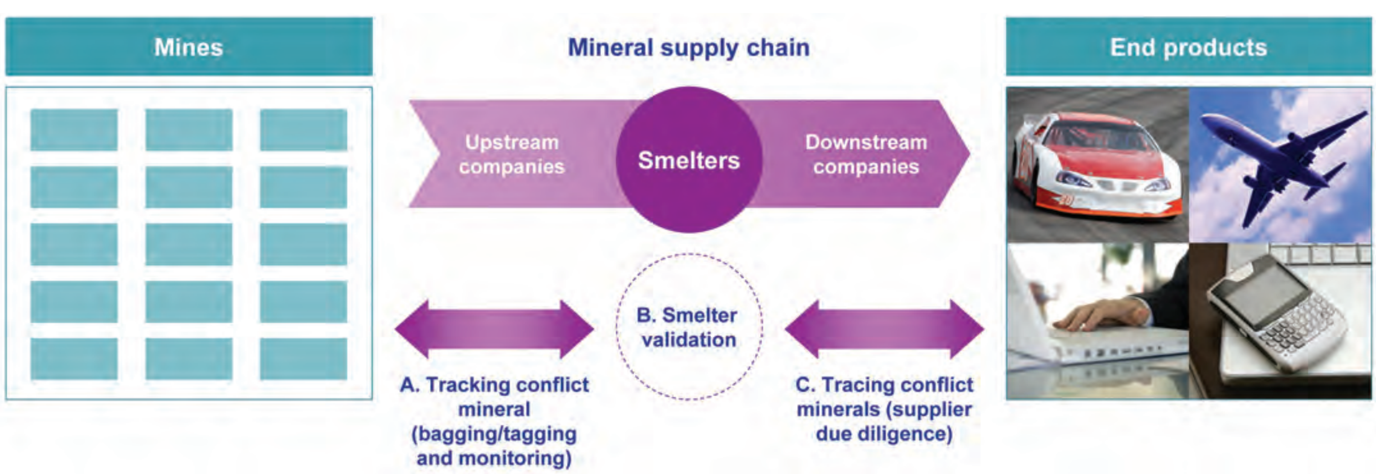


Source: KPMG Conflict Minerals Survey, 2011

While other industry groups have not made public any common solutions, the Automotive Industry Action Group (AIAG) and the Aerospace Industry Association (AIA) have sought to increase awareness among their members by holding seminars/Webinars. Through the AIAG, six auto makers—Chrysler, Ford, GM, Honda of America, Nissan North America, and Toyota North America—issued a letter dated April 19, 2011 to their suppliers alerting them of the new law.[16]

Figure 5 illustrates the progress made by various industries on addressing conflict minerals.

Figure 6: Proposed solution for end-to-end supply chain transparency



Source: KPMG LLP, 2011

Section 4: KPMG's recommended approach

Recommended steps

Based on extensive experience with past due diligence and reporting requirements, KPMG has developed a simple process that involves the following key steps:

- Identify use of 3TG conflict minerals in products manufactured or assembled
- Identify and survey suppliers of 3TG metals
- Perform a risk assessment using tools and OECD guidelines
- Prepare disclosure statements in accordance with SEC requirements
- Engage third party to perform an independent conflict minerals audit
- Institutionalize a process so to update with ease on an annual basis

KPMG successfully tested this approach with a U.S.-based electronics corporation with global operations, and thousands of worldwide suppliers. In the face of imperfect information and gaps in supplier data, KPMG worked with the company's procurement group that is leading the implementation of this initiative to drive towards meeting "significant and reasonable" due-diligence requirements.

Gaps in internal and external processes were identified and an action plan put in place to bridge the gaps by December, 2011.

OECD guidelines, industry best practices for supply chain due diligence, and questionnaires available from EICC-GeSi were referenced during the course of the project.

Case Study

KPMG recently assisted a U.S.-based, global manufacturer with more than 3,000 suppliers in instituting a rigorous "auditable" supply chain due diligence process to assess its risk exposure to conflict minerals. The ancillary objectives beyond the immediate compliance goal were to develop a process that could be extended to other corporate social responsibility initiatives in the future—one that would integrate with the company's overall risk process (both from an internal audit and external audit perspective) and drive vendor accountability while improving the stability of their own supply chain.

Getting started

The company established a multidisciplinary team to address business implications of the rigorous compliance process. The team included legal, investor relations, procurement, corporate social responsibility, supply chain, and others within the company who typically handle large change management exercises.

Compliance strategy

The team developed a process to identify, survey, and risk rate suppliers that use 3TG metals in the manufacture of components used by this company. This was done using, in part, a KPMG proprietary tool that provided the mechanism to collect and analyze the results. Supplier information was synthesized into information that will be used to complete and maintain the annual report disclosure on conflict minerals.

Looking for opportunities beyond traditional compliance

In the end, the company used this project to gain other significant benefits such as future supplier certification and meet audit requirements, establishing a process to respond to customer requests to provide information on the use of conflict minerals in the products sold, identifying opportunities for consolidation and supply chain cost reduction, and preemptive identification of risk due to sole sourced suppliers. This company also saw value in positioning their market brand as conflict free.

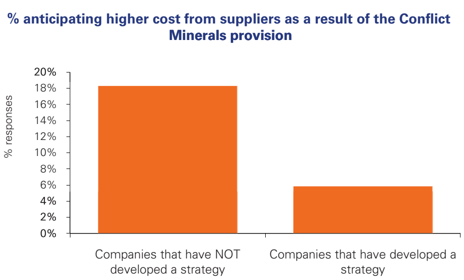
Source: KPMG Public Policy Alert, July 2011, "Legislative complexity challenges traditional business and compliance strategies."

Section 5: Long-term costs and benefits of implementing Section 1502

The fear of the unknown

Several comments to the SEC from industry groups have expressed concerns about the cost of implementing the provisions of the new law. KPMG's survey specifically asked respondents about the (perceived) impact of compliance. The surprising finding was that companies that had not already developed a conflict minerals strategy were three times more likely to anticipate higher costs from suppliers than companies that had developed a strategy (figure 7).

Figure 7: Anticipated impact of the Conflict Minerals provision

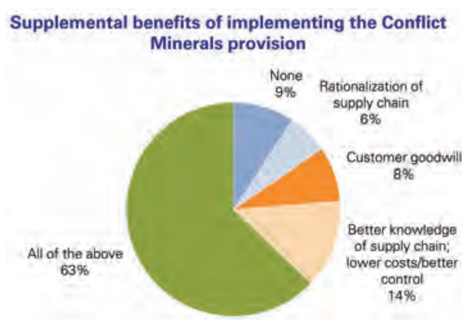


Source: KPMG Conflict Minerals Survey, 2011

Supplemental benefits of conducting supply chain due diligence

During a recent KPMG Webcast on conflict minerals, the audience, comprising representatives from more than 500 diverse organizations, was asked if they foresaw any supplemental benefits from implementing the conflict minerals provision. Only nine percent of respondents chose "none," viewing the effort as purely a reporting burden (figure 8). It appears that companies recognize that there could be other potential benefits of performing supply chain due diligence for conflict minerals, such as identification of opportunities for supply chain simplification/rationalization (6%) and cost reduction (14%), and improvement in customer goodwill/brand recognition (8%).

Figure 8: Long-term benefits of the Conflict Minerals provision



Source: KPMG Conflict Minerals Survey, 2011

Industry participants believe that this law may trigger similar regulations on other corporate social responsibility issues, such as environment/sustainability, labor standards, health and safety, and ethics. The California Transparency in Supply Chain Act,[17] which seeks to curb human trafficking and slave labor, is one such example. A strong process developed for conflict minerals may serve as a template to meet those regulations as well.

Section 6: Conclusion

The Conflict Minerals provision of Dodd-Frank places a new burden on SEC registered corporations to trace and report the source of 3TG metals. Requirements of the new law are far from clear, and many corporations are waiting for the SEC to issue clarifications before the end of the year.

However, several leading corporations and industry groups have begun to trace conflict minerals in their supply chain rather than wait for SEC's final ruling, due to the tight time line for implementation once the ruling is finalized. The generally positive experience of companies that have already begun work should spur other affected corporations to develop a conflict minerals strategy, and begin the due-diligence process sooner rather than later. This message has been reiterated by the U.S. State Department in a press release on July 15, 2011 that urges companies to begin to "…exercise due diligence immediately in order to ensure a viable and conflict free supply chain…"[18]

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