Buying your way into trouble?

The challenge of responsible supply chain management

Insight INVESTMENT

HBOS plc

Produced in conjunction with Acona

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About Insight

Insight Investment is the asset management of UK financial services company HBOS. It currently manages £67.8 billion (as at September 30 2003). These funds represent the assets of millions of people in the form of their pensions, life insurance and other stock market based investments. Insight has an explicit commitment to act as a responsible investor on behalf of its clients, principally by engaging proactively with the companies in which we invest to promote high standards of governance, ethics and social and environmental performance. For further information, see Insight's Investor Responsibility Policy, available online at www.insightinvestment.com/corporate/responsibility.

There are two principal reasons why Insight pursues a policy of engaging with companies in which it invests.

First, Insight believes that it is in our clients' long-term financial interests that the companies in which we invest behave responsibly. Failure to do so typically provokes government and societal sanctions such as fines, litigation, new regulation and taxes, consumer boycotts and damage to reputation, all of which create material risks to long-term shareholder value. Insight therefore analyses and engages with companies in its portfolios to encourage them to operate according to best practice standards on a range of issues pertinent to their business.

Second, Insight accepts that investors, as shareholders, have some moral responsibility for what is done in their name by the companies in which they invest. Shareholders have a key role to play in the governance of companies. It is therefore reasonable to expect them (particularly large investors like Insight) to provide company managers with support and encouragement in their efforts to ensure that their companies conduct their business in a responsible manner.

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About Acona

This report was written by Acona for Insight Investment. Acona is an international consulting group focused on understanding risk and improving performance. Acona has three business areas: business risk management, safety and environment and sustainable business.

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Executive summary

Insight has significant holdings in many companies that source the products they sell from the developing world. These companies do so primarily because of the cost advantage those countries offer at present over more developed countries. In principle, this is a business strategy that Insight supports. It can reduce costs, enhance margins and, ultimately, profitability and returns for shareholders. Moreover, the expansion of manufacturing and agricultural production capability in developing countries can bring much-needed economic and social development and help to raise their populations out of poverty.

However, companies face real ethical challenges associated with using supply chains in these countries, particularly with respect to labour standards abuses in suppliers' operations. As many companies have recognised, failure to respond effectively to these challenges as they move into less developed markets can give rise to significant operational and reputational risks that can threaten to undermine any potential gains from doing so.

Managing supply chains so as to maximise buying power, flexibility and efficiency, while at the same time upholding any commitments to responsible supply chain management that companies may have made can, therefore, be a substantial challenge.

Many companies have acknowledged that they have a responsibility to play a part in trying to stamp out labour standards abuses in their supply chains. To this end, they have begun to map out their supply chains and to identify the countries or suppliers that pose the greatest risk. In addition, they have set up auditing systems, underpinned by policies and codes of conduct, to try to identify and, if required, to rectify those abuses.

However, few companies seem to look at the supply chain as an *integrated* system and most importantly, at how their own buying practices affect suppliers' ability to meet their own commitments to uphold international labour standards.

This report, prepared by independent specialist consulting company Acona for Insight Investment, is intended principally to stimulate discussion among senior executives with responsibility for two areas: purchasing and responsible sourcing.

The principal issues this report sets out to explore are:

- Do current supply chain management practices and the drive for ever-greater efficiency put pressure on suppliers' factories or farms, essentially forcing them to contravene some of the ethical standards in order to meet the buyer's requirements?
- In order to find practical ways to improve labour standards in suppliers' businesses, do we need to look at the very nature of corporate buying practice?

Current thinking on best practice in these aspects of supply chain management is summarised in this report, with a particular focus on understanding how companies seek to improve and refine their approach. Three elements of modern supply chain management that seem to have a considerable impact on suppliers' ability to uphold labour standards emerge:

- The need to produce quickly and at low cost: **time and speed.**
- Issues around **flexibility and seasonality.**
- The search for lower prices and better deals: **cost and risk.**

This report explores how each of these characteristics links to, and may undermine, commitments in typical supply chain labour standards codes of practice. For example, the need for flexibility - responding quickly to changes in demand from customers – can lead to high levels of compulsory overtime, which is often discouraged within most ethical trading codes; seasonality - the demand for certain products all year round and the need for high volumes at peak times - can raise the demand for contract and temporary employment, and undermine suppliers' ability to provide secure and regular employment; and constant price pressure can feed through into pressure for suppliers to reduce wages below levels defined by legislation or companies' own ethics codes.

The research leads us to the tentative conclusion that some companies may be inadvertently pursuing a buying strategy that creates tension, or in some cases directly conflicts, with their commitments to ethical sourcing. Ironically, it also indicates that pressures of this kind of are quite often placed on suppliers needlessly. They result simply from bad buying practices - inefficiencies, indecision, badly designed incentives and a lack of trusting business relationships. Such failures are therefore doubly undesirable: they cost companies money and undermine their commitments to source responsibly.

It appears that companies may benefit from taking a more integrated approach to the challenge of maintaining a competitive, low-cost supply base, while at the same time upholding their commitments to trade ethically.

Important elements to consider, which emerged from the research, are:

- Improving critical path management – minimising slippage and improving communication among all those involved in the buying process.
- Improving the accuracy of forecasting to reduce last-minute demands on suppliers.
- Better understanding of the costs of failure in the supply chain.
- Reviewing management and appraisal frameworks for buyers.
- Creating a buying culture in the company that supports the achievement of ethical standards and reduces consequent negative effects on suppliers.

Insight believes that these issues should be examined closely by the senior management of the companies for which they are relevant – particularly those with extensive, high risk, developing country supply chains. We encourage those executives to review whether their purchasing and pricing practices support or undermine their commitments to uphold supply chain labour standards and how improvements could be made to better align their commercial interests and ethical commitments.

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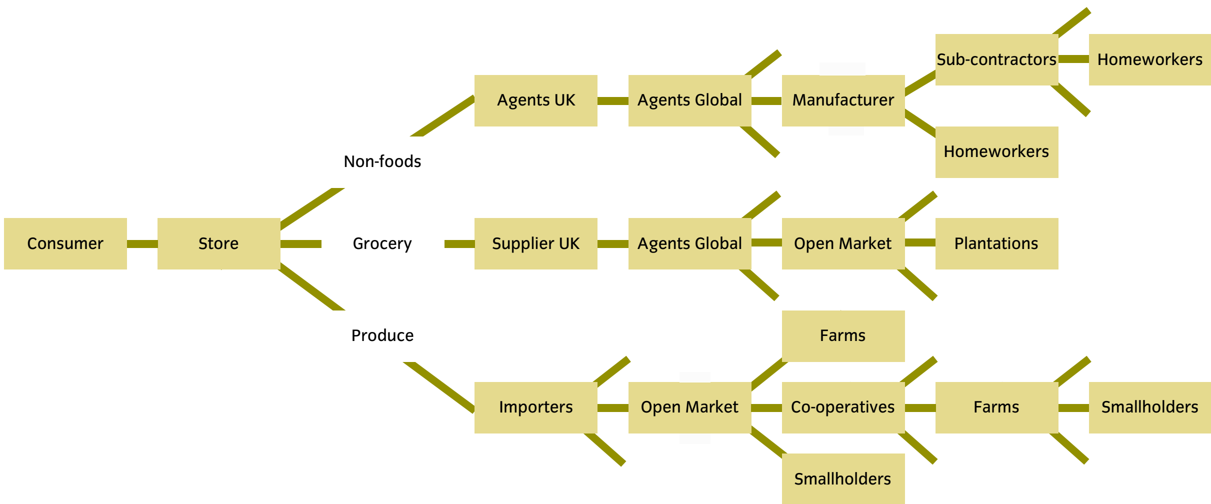
1. Introduction

Many companies in which Insight has a significant holding increasingly source the products they sell from the developing world, principally because of the cost advantage those countries offer at present over developed countries. In principle, this is a business strategy that Insight supports. It can reduce costs, enhance margins and, ultimately, profitability and returns for shareholders. Moreover, the expansion of manufacturing and agricultural production capability in developing countries can bring much-needed economic and social development and help to raise their populations out of poverty.

However, shifting supply chains in this way can also give rise to significant operational and reputational risks that may undermine the potential gains, as well as potentially impact negatively on the welfare of suppliers' workers. Thus, for many companies, managing supply chains so as to maximise financial advantage, while at the same time upholding any commitments to ethical trading they may have made, can be a substantial challenge.

Companies' supply chains are generally long and complex. A large general retailer in the UK may have in excess of 20,000 suppliers in a hundred countries. A multinational food producer may rely on hundreds of thousands of farmers. Other firms consolidate their buying, dealing directly with a handful of wholesalers or agents in London or Hong Kong, for example. However, those companies, in turn, deal with thousands of factories and farms that rely on subcontractors and home-based workers to fulfil orders. Supply chains for surgical instruments, footballs and apparel have been traced back to workers' homes in villages in Pakistan, Bangladesh and Morocco. Operating in these countries can therefore pose new and difficult cultural, operational, logistical and ethical challenges for companies.

Figure 1: The structure of typical supply chains



Source: ETI Annual Report 2002-2003

In recent years, research by NGOs and unions has brought to light widespread violations in western companies' supply chains of international labour standards, often, they allege, in contravention of local law too. These cases include thousands of cases of discrimination, physical and verbal abuse, excessive hours and overtime, inadequate wages, non-payment of overtime, lack of access to trade unions, high rates of injury and death. According to the International Confederation of Free Trade Unions, 213 trade union activists were assassinated or disappeared worldwide in 2002. In addition, 1,000 were attacked and beaten, 2,562 were detained, 89 received prison sentences, 30,000 were fired and some 20,000 were victims of harassment.

There is a growing belief among Western consumers, NGOs, unions and other stakeholders that companies that source from developing countries bear some responsibility for abuses of workers in their supply chains, particularly when they are in a position to exert direct control over the actions of their suppliers. They therefore increasingly expect companies to accept some of the responsibility and to be proactive in addressing abuses. Although more work is needed to clarify the specific nature of this responsibility, many of the companies concerned accept the view that they bear some responsibility.

From an investor's perspective, problems related to supply chains can raise significant business risks and threaten shareholder value. In today's global markets, intangible assets such as brands are more important than ever. Damage to a brand can be particularly destructive of shareholder value, as scandals related to Nestle, Shell and Nike, to name but a few, have demonstrated in recent years. Complex and highly sensitive ethical situations therefore pose potentially serious reputational risks to companies, particularly those in sectors with the most extensive overseas supply chains - typically general retail, food retail, food production, telecommunications and IT, and tobacco.

Most companies have recognised that they face risks if labour standards abuses are discovered in their supply chains; some have acknowledged that they have a responsibility to stamp them out. As a starting point, they have begun to map out their supply chains and to identify the countries and/or suppliers in which they believe the risk to be greatest of labour standards abuses occurring. They have set up auditing systems to try to identify and (in the some cases) rectify those problems. These monitoring systems are often underpinned by state-of-the-art policies, codes of conduct and management systems. Insight strongly welcomes and encourages these commitments.

However, Insight believes that there is another extremely important dimension to this issue that is beginning to gain prominence. Up to now, western companies that source from developing countries have been considered to be passive bystanders whose failure has been merely to turn a blind-eye to abuses perpetrated by 'ignorant' or 'unprincipled' suppliers in developing countries. However, new allegations are emerging that suggest that companies' own buying practices may be playing some part in causing those abuses.

Oxfam and CAFOD - influential pressure groups on these issues - have recently published new reports[1] that suggest that corporate buyers' increasing price pressure, their demands for ever greater flexibility and faster product delivery from suppliers may be exacerbating labour standards problems and undermining their suppliers' ability to comply with buying companies' own ethical trading codes. If these allegations prove to be correct, companies will have to work even harder to manage labour standards issues – and start to look inwards, rather than just outwards, for solutions.

In the hope of facilitating a debate on this difficult issue, Insight commissioned Acona, a consulting company specialising in risk and sustainable development, to assess the ways in which companies could respond to these challenges. We hope that this report will contribute to the emerging debate on this important topic. We will also use it to inform our dialogue with companies in which we invest.

[1] 'Trading Away Our Rights - women working in global supply chains'; Oxfam International, February 2004; 'Clean up your computer: working conditions in the electronics sector; a CAFOD report', January 2004.

2. The issue: buying practice and ethical trade

A company's management of its supply chain is widely acknowledged to have an important influence on its competitiveness and, hence, its profitability. Most large organisations are constantly engaged in trying to improve their buying practices, either with a view to increasing efficiency, gaining extra buying power or strengthening supplier relationships.

In recent years, responding primarily to perceived risk to their brand and reputation, many companies have adopted an ethical trading policy and now aspire to meet recognised labour and welfare standards within their own organisation and their suppliers' operations. Discussions with such companies suggest that many find these standards hard to achieve. The typical approach has been to adopt a code of conduct on labour standards and to audit suppliers' performance against this code. In most cases, this seems to have led to only limited improvement in certain areas (such as health and safety) and to have had relatively little impact in others (such as regular employment, hours and overtime, harsh treatment of employees, etc).

This begs the question: in order to find a practical way to improve certain ethical standards in suppliers' operations, do we need to look at the very nature of corporate buying practices? Do current supply chain management practices, and particularly the drive for ever-greater efficiency, put pressure on the factories and farms that supply major corporate customers, essentially forcing them to contravene some of their customers' ethical standards in order to meet their commercial requirements?

This report investigates to what extent companies' failure to meet ethical standards in their supply chain results from other 'mainstream' aspects of their buying practices. It:

- Outlines factors influencing companies and current thinking on best buying practice in both consumer merchandise and business-to-business supply chains *(sections 4, 5 and 6).*
- Discusses the impact these practices have on attempts to implement ethical trade programmes in the supply chain *(sections 7-11).*
- Considers and analyses some issues arising from the separation of 'mainstream' and 'ethical' buying *(section 12).*

3. The project and its stakeholders

This report was prepared by independent consulting company Acona. It was prepared between September 2003 and January 2004, based on:

- A thorough literature review focussing on supply chain management and corporate purchasing.
- Acona's own experience working with ethical issues in corporate supply chains.
- Thirteen interviews with a wide range of individuals and organisations, including:
    - eight companies in which Insight Investment has a shareholding
    - two suppliers to those companies
    - one purchasing specialist, and
    - one ethical trading specialist.
- Two 'validation workshops' with approximately 20 invited representatives from companies, held to discuss the early draft and explore possible solutions.

The dominant stakeholder has therefore been the business world, with the contacts being roughly divided between ethical trading teams and mainstream buyers, with some input from supply companies. One business-led NGO has been directly involved.

A total of 23 separate organisations (including 18 companies) provided evidence and suggestions for this report. Insight and Acona thank all involved for their candid and thoughtful input.

4. Overview of corporate buying

Definition of ‘supply chain’

In its broadest sense, the term ‘supply chain’ refers to all stages of the business process from sourcing raw materials to delivering the completed good or service to the customer. As a consequence of this broad definition, businesses at different stages in the process often use the term slightly differently:

- In businesses where logistical accuracy is an important driver of profitability (for example in food retailing) the ‘supply chain’ may be used to describe the warehousing and distribution of product to the stores.
- Those manufacturing branded goods (for example cigarettes, branded soft drinks, branded household products, etc.) sometimes use the term ‘supply chain’ to refer to the downstream part of the process: the mechanisms and partnerships by which the products are stored, transported, marketed and sold to the consumer.
- However, the most common use of the term usually refers upstream, to the company’s suppliers, their suppliers and so on.

It is in this last sense that the term is used throughout this report.

The buying process

In general outline, the key elements of the buying process are common across the vast majority of industries and sectors. In retail sectors, the process is more complex and has more stages, but it is, in essence, the same. The ‘retail’ process typically applies to any product that is supplied to the consumer (e.g. buying stock for high-street stores) or the components/ingredients of consumer products (e.g. manufacturing of food and beverage), where predicting consumer tastes is an important element. Procurement of products and services for companies’ own use and business-to-business sales tend to have a different set of characteristics.

Despite many similarities in the buying processes, the way in which they are managed and implemented by companies varies considerably. This variation will be the subject of much of this report, but in this section we will outline the buying process in general. The following table illustrates the key stages of buying, for consumer and business-to-business sectors.

Table 1: The key stages of the buying process

Consumer	Business-to-Business
1. Decide what products or services are needed	
■ Design criteria (full brief or general guidelines) ■ Sales analysis ■ Market trend analysis ■ Price point analysis ■ ‘Range review’	■ Internal needs analysis ■ Product or service specification
2. Decide how much product is needed	
■ ‘Forecasting’	
3. Search for appropriate products or services	
■ Put out product brief to existing suppliers ■ Search for new suppliers ■ Visit trade shows ■ Online auctions ■ ‘Sourcing’	■ Bids and tenders ■ Search for new suppliers ■ Online auctions
4. Select products or services	
■ Evaluate product search results against key criteria ■ Negotiate terms (including price, volume, lead time, quality specification, phasing, rebates, etc)	■ Evaluate search results against key criteria ■ Negotiate terms (including price, volume, lead time, quality specification, etc.)
5. Ensure product is ‘just right’	
■ Ensure design criteria are exactly met ■ Check safety, quality and other technical matters ■ Go through a number of samples until the product is ‘just right’. ■ ‘Sampling’ and ‘sealing’.	
6. Look at onward sale factors	
■ Packaging design ■ Bar codes ■ Store placement ideas	
7. Place order	
8. Supplier plans production and orders components and materials	
9. Production or service preparation	
10. Delivery of product or service	
■ Delivery to warehouse ■ Delivery to store ■ ‘Logistics’	■ Delivery to final location ■ Installation or implementation of service

Differences between consumer and business-to-business buying

Consumer and business-to-business buying differs significantly. Companies quoted examples of retail buyers, who are strongly consumer-driven:

- Taking longer to finalise product design and specification and being more likely to then vary specifications (as consumer tastes and fashion change rapidly).
- Being less clear on how much of the product they require, because they are working from sales estimates or forecasts rather than from an analysis of their own procurement needs.
- Being more exacting about design and technical criteria, because offering high quality products to their own customers has high strategic priority in their business.
- Managing a much more complex and time-critical logistical process because just-in-time production and delivery are key to cost saving and business success.

The buying team

These differences tend to lead to consumer and business-to-business buying being managed quite differently. The greater complexity of consumer buying typically requires more tasks and is generally managed by a larger team with a variety of different roles. A small team typically manages business-to-business buying, with one individual overseeing the purchase of a particular item from beginning to end.

For a more detailed description of how the buying function is organised in consumer and business-to-business orientated procurement, see Appendix 1.

5. External factors influencing buying practice

Geographical and consumer trends

Companies must respond constantly to changes in the market. Consumer behaviours, societal trends, new regulations and developing technology all influence how companies buy products. During the course of the project, we identified a number of broad trends that form an important backdrop to companies' approaches to their buying practices.

- **The effect of global trade:** Supply chains that were once concentrated in the UK and Western Europe now extend into North Africa, Central and Eastern Europe and the Far East. Companies are increasingly realising the benefits of manufacturing in these lower-wage economies. Simultaneously, quality and productivity in these countries is improving rapidly. This has led to explosive growth in overseas sourcing, with associated difficulties of extended logistics chains, language and cultural barriers and the potential for difficulties with labour standards. Many companies are increasing their purchasing representation and competence in these important new markets. UK companies taking part in the project are beginning to experiment with overseas warehousing, enabling them to hold goods close to the point of manufacture and do much of the initial picking and sorting using lower-cost employees.
- **The role of agents:** Overseas sourcing was traditionally the preserve of import agents, whose particular expertise was to find appropriate products in these 'difficult' markets. As companies develop their ability to source directly, the role of the agent is less clear. In the experience of some companies, agents have proved to be useful strategic partners, helping to deliver the quality and service requirements of the procuring company. However, at worst, companies say these middlemen reduce clarity and visibility in the supply chain and add costs. This appears to be leading to tensions and mistrust, as agents apparently fear they will be bypassed once they reveal their sources.
- **Consumer demands on seasonality:** In our '24/7' society, consumers increasing expect certain products, all year round (for example, fresh produce, core clothing essentials, books and CDs), placing heavy demands on retailers to find and hold the appropriate stock. In addition, the shop-front is becoming ever more seasonal (particularly in the apparel sector), with some operators now planning for six or even twelve seasons per year, rather than the traditional four.
- **Quality demands:** The success of high-volume, value-based retailers, particularly supermarkets, has blurred the traditional views of price and quality. Where once consumers perceived that they must pay more for a higher-quality product, this no longer appears to be the case, with retailers reporting that consumers search out the lowest price without compromising their quality expectations. Therefore many buyers are constantly aiming to increase quality standards while simultaneously driving down prices: many retail buyers will seek to negotiate annual price *reductions*, inflation notwithstanding.
- **Structural Change:** A number of sector-specific factors are driving structural changes in some supplier sectors. These include moves to vertical integration by buying companies (either merging or forming joint ventures with principal suppliers), increasing capital investment to bring greater productivity, major technological change (e.g. the computer controlled assembly of footwear) or major geographic change (e.g. the rapid growth in the East African supply of fresh produce).

Buying tools and techniques

In recent years, best buying practice has been influenced by the development of a number of IT-based tools and techniques.

- **Internal information systems**: Tools are now available to centralise data on a company's supply base, holding supplier information, contact details, past history and commercial terms and conditions. These tools allow all parts of a large organisation to share a supply base and are an essential component of the move to category management. At higher levels of evolution, the systems link to sales information, forecasts, and warehousing and logistics data, providing visibility of the entire supply chain.
- **Shared information systems:** The systems described above can be extended (often through the use of internet hosting) to become available to suppliers, who can use them to check information on logistics, demand, sales and forecasts. In turn, this allows suppliers to take a more active part in meeting their customers' demands.
- **Shared design systems (e-Showrooms):** Similar technology is being employed to simplify the design process with online showrooms for suppliers to demonstrate products and facilities for online design and collaboration (e.g. the ability for buyers to view swatches, colours, dimensional information, etc.). Once the design has been finalised, the systems then allow orders to be placed electronically.
- **On-line auctions:** These are real time processes, using the internet to attract the widest possible range of bids for the supply of a particular product. The technique is most appropriate where product specifications can be clearly and unambiguously provided (such as lower value and bulk supplies). Internet auctions provide a powerful way for companies to identify the lowest price for a product in a market, but are usually followed by a more conventional process of negotiation and discussion with one or two preferred bidders.

6. Current thinking on best buying practice

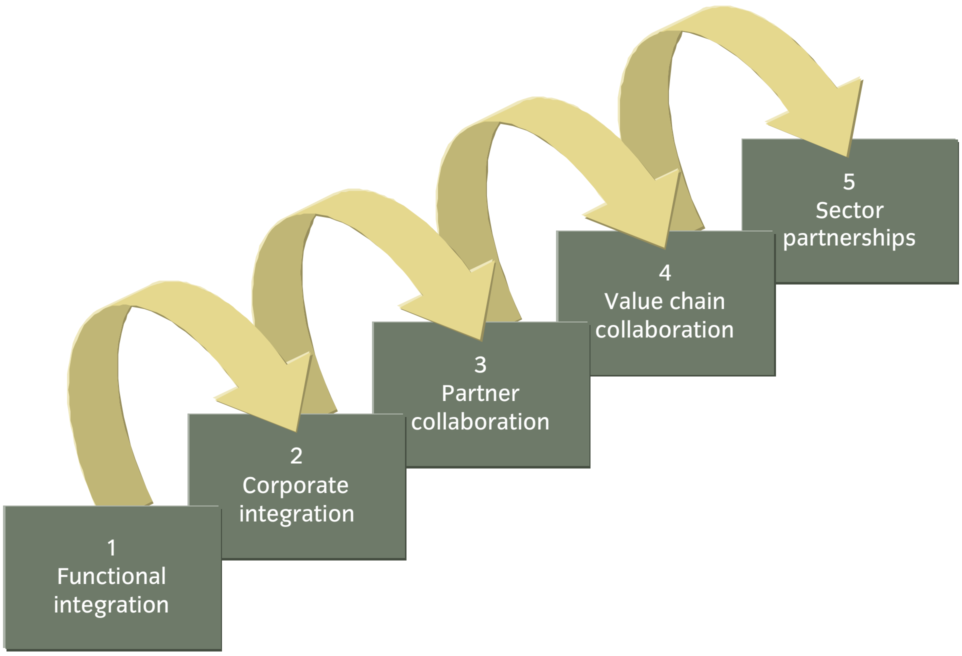
Overview

The supply chain was recognised as in important influence on product quality and price during the quality revolution of the 1980s. The concept was formalised in Michael Porter's 'Theory of Competitive Advantage' (see the book of the same name) in 1985, which postulated that a company's relative power in the supply chain (one of Porter's 'five forces') was an important influence on the competitiveness and, hence, its profitability.

Since then, the topic has consistently occupied the pages of management journals and has been the subject of dozens of conferences. Most large organisations are engaged in a programme to continually improve their buying practices. Some are simply aiming to gain control over a fragmented and inefficient process, others are seeking greater buying power through focussed procurement, and the most accomplished are looking for ways to harness the creativity and energy of their suppliers to support their own objectives.

Many models have been developed to illustrate these different stages in 'supply chain evolution'.

Figure 2: Levels of supply chain evolution



Adapted from Poirier and Quinn 2003

Table 2: Progression in supply chain evolution

Level 1: Functional Integration. Each functional area or business unit of a company focuses on procurement separately. Sourcing decisions tend to be 'tactical' (identify the required product, find the cheapest price, then purchase).
Level 2: Corporate Integration ('Category Management'). Companies begin to centralise procurement across the whole business and take advantage of the greater buying power this offers them. Sourcing becomes more strategic with buyers identifying 'key suppliers' in strategically important categories.
Level 3: Partner Collaboration. Procurement activities begin to extend beyond the confines of the company and key suppliers are invited to become involved, for example in design ideas and collaborating to find solutions to match supply more closely with demand. The process of supply chain consolidation is continued, with the company seeking fewer, longer-term relationships.
Level 4: Value Chain Collaboration. The relationship between the procuring company and the supplier becomes even more developed with design, marketing and sales data becoming visible to suppliers. Commercial risk is shared through open-book accounting and other pricing mechanisms.
Level 5: Sector Partnership. The procuring company and suppliers work together to provide an integrated approach to an entire sector. It becomes increasingly difficult to identify which company is the supplier and which the buyer: High levels of mutual dependency exist.

A full explanation of these terms is included in Appendix 2 and a summary is presented above.

Sophisticated companies may operate at multiple levels within this model. For example, the merchandise supply chain of many retailers shows the characteristics of Levels 3 or 4, but few report having applied the same attention to all their non-merchandise purchases, which are typically managed at Level 2.

Power balance: the relative strength of buyer and supplier

Progress through the stages described above is often characterised by the procuring company increasing its buying power, and hence its influence, over the supplier. This is often done with the full co-operation of the supplier, which in return gains larger orders, better collaboration and increased security.

The logical consequence of Porter's 'five forces' theory is that companies are more competitive if they are able to increase their leverage and control over suppliers. Based on discussions with companies in the supply chain, it appears that the amount of leverage is typically greater when the buyer:

- Takes a very high percentage of the supplier's output.
- Controls the only route to market for the supplier.
- Sources 'own-brand' products.

Increasing their power and thus, control, over suppliers is implicit in many strategies for supply chain improvement, although at the more evolved levels of supplier management, this is redressed by higher levels of openness, risk sharing and mutual dependency. However, there are many cases where the power balance between supplier and purchaser appears very one sided to the detriment of the supplier: these are often characteristics of companies at Levels 3 and below in the model above.

In cases where companies are buying from major brands (for example, distributing global apparel, jewellery or mobile phones), the power balance can be completely reversed. The manufacturers of these 'must-have' items typically set the agenda, dictating how many the retailer should take, how they are to be displayed and at what price they are to be sold.

Asymmetry in the power balance produces the most conspicuous effects during commercial negotiations when, unsurprisingly, buyers use this leverage to their advantage. This manifests itself not just in lower prices, but also in other areas:

Table 3: Relationship between elements of buying process and negotiating points

Area of negotiation	Typical negotiating points
Cost	▪ Price reductions ▪ Reducing flexibility through pricing mechanisms like open-book accounting
Speed	▪ Shortening lead times ▪ Requiring just-in-time delivery ▪ Imposing fines for late delivery
Flexibility	▪ Making last minute order changes ▪ Ensuring that there is always the option to reduce or cancel an order
Risk	▪ Using 'sale or return' terms ▪ Negotiating rebates and profit contribution based on sales volume ▪ Encouraging suppliers to reduce cost price on promotions to help drive volume
Quality	▪ Tightening quality specifications ▪ Imposing fines for non-conforming products
Added extras	▪ Negotiating 'extra for free' ▪ Requesting that suppliers take responsibility for delivery to store not warehouse ▪ Requiring suppliers to contribute to the cost of product advertising

These tactics may deliver benefits, but throughout this project we uncovered examples of undesirable side effects. Excessive pressure was reported to drive unwanted behaviours in suppliers (encouraging dishonesty, corner-cutting and generally reducing trust) and, in extreme cases, can lead to business failure with its consequent impacts. Later sections of this report suggest mechanisms by which obstacles to ethical trading arise from power imbalances in the supplier-purchaser relationship.

7. How are supply chain labour standards typically managed?

A company's brand and reputation are critically important. Most major companies have recognised that ethical risk management is an important part of brand management. Although specific policies and procedures regarding ethical standards in the supply chain vary across companies and across sectors, the general approach to the management of labour standards is shared by most. In outline, it is as follows:

1. **Devise a code of conduct:** Codes of conduct set out what the company believes are acceptable minimum standards. A company may devise its own codes or may implement a code that has been developed by an external organisation, such as a trade association or the Ethical Trading Initiative (ETI). Most codes are based on the set of internationally recognised labour standards enshrined in the International Labour Organisation (ILO) conventions. Most codes cover the issues shown in Box 1.
2. **Carry out a risk assessment:** This is generally a desk-based assessment to determine which suppliers are most likely to contravene any of these standards.
3. **Train staff:** To ensure that buyers are familiar with the issues, that employees directly involved in the buying process have the skills they need and that the relevant managers in supplier companies understand the requirements, extensive and ongoing training programmes are offered.
4. **Carry out ethical audits:** This involves visiting suppliers' production facilities, interviewing management and workers and assessing their compliance with the code of conduct. Audits can either be done by internal staff (typically product technologists or quality representatives, occasionally buyers) or by external specialists.
5. **Draw up improvement plans:** On the basis of the audit results, a list of suggested improvements is drawn up for the supplier to implement in order to meet the required ethical standard. Ideally the buying company works with the suppliers to help them achieve the required standards.
6. **Report / disclose:** Companies tend to place their supply chain policies and general information about the progress of their compliance programme into the public domain.

The approach is very much one of the buyer finding a problem with the supplier, pointing it out to them and telling them to rectify it, or, in a best case scenario, working with them to do so. This approach does not look at the supply chain as an *integrated* system and most importantly, does not look at how buying practices actually affect suppliers' ability to meet these standards.

Box 1: Issues typically included in corporate codes of conduct

- ***Employment is freely chosen:*** Employers should not use prison labour or any other form of bonded labour. Workers should be free to leave when they please (after appropriate notice) and should not be 'tied in' by having to lodge their passports or ID cards.

- ***Freedom of association:*** Workers should have the right to form and join trade unions and to bargain collectively.

- ***Safe and healthy working conditions:*** Working environments and materials meet appropriate health and safety standards.

- ***No child labour:*** Children should not be employed below the legal minimum age and appropriate steps should be put in place to remove children from employment and guide them towards education.

- ***Payment of a living wage:*** Workers should be paid at least the national minimum wage in their country, but preferably a wage that is enough for them to live on. Workers should also receive a payslip and breakdown of their payment.

- ***Non-excessive working hours:*** Working hours should comply with national laws and in any case not be more than 48 hours per week plus a maximum of 12 hours overtime. Overtime should be voluntary and agreed in advance.

- ***No discrimination:*** Employers should not discriminate against workers on any grounds including race, ethnicity, gender, caste, union membership, with regard to recruitment, promotion, training or any other matter.

- ***Regular employment:*** As far as possible, workers should be given proper employment contracts and full-time employment. Employers should not try to avoid payment of social security, sick leave and maternity and other benefits through sub-contracting or labour-only contracting arrangements.

- ***No harsh or inhumane treatment of workers:*** There should be no physical, verbal or sexual abuse of workers.

8. How can buying practice affect suppliers?

Large western retail companies make desirable customers for smaller suppliers (particularly those in developing countries), either because they make major purchases for their own use or because they offer an excellent route to huge consumer markets. These suppliers therefore compete hard for the levels of business and recognition that arise from securing a major supply contract.

As large companies centralise procurement, the rewards become even greater, offering suppliers an outlet for 30, 50 or even 100% of their capacity. The move towards overseas sourcing further implies that these benefits are spreading to other economies; investment and wages are flowing into developing regions of the world as global trade patterns change.

As we explored these questions with project participants, it became clear that the buying practices described in the preceding sections had a number of impacts on suppliers. Some of these effects are positive, some less so:

- **Increased power of buyers:** As buyers work to increase their power and leverage over their suppliers, suppliers conversely find themselves increasingly disempowered and find their negotiating positions eroded. This is more pronounced in some sectors than others, the most extreme example being food retailing by supermarkets.
- **Longer term relationships:** Suppliers that have been chosen as ‘strategic suppliers’ by one or more of their customers can increasingly predict their future work load and turnover. This increased security can enable them to plan and invest in the future. On the other hand, dependence on key customers can reduce a supplier’s negotiating power. Almost all suppliers report that they do not have enforceable contracts with retailers, particularly in the matter of guaranteed supply volumes. Even where such contracts exist, many smaller suppliers are wary of confronting large retailers, who have more legal muscle, and may bring their business back again at some stage in the future. The effect of this factor, illustrated by concrete examples unearthed during our research, is that in the continual push to reduce prices, a key customer may *at any time* decide to pull out and move production to a supplier with lower labour costs.
- **Improved communications:** The use of new computer and web-based technologies is significantly improving buyer-supplier communications. As more information is shared, suppliers are becoming increasingly able to plan ahead. This technology, being deployed initially by larger more advanced supply companies, is largely web-hosted and accessed via PC and internet. As internet use spreads, it should, become more widely accessible, at least to larger, more sophisticated suppliers.
- **Higher quality standards:** As retailers strive to please consumers with ever-increasing quality standards, suppliers find themselves being asked to meet higher specifications. Cost pressures means that these extra standards are often not accompanied by a rise in prices.
- **Faster production:** The demand for shorter lead times requires suppliers to gear up their business to produce quickly. This can be positive – supplier and buyer work together to plan investment in mechanisation and infrastructure – or negative - when suppliers rely heavily on casual labour, extended overtime or place unrealistic pressure on employees.
- **Increased flexibility:** As retailers work towards just-in-time delivery and seek to reduce their risk of over- or under-buying, suppliers need to become more and more flexible and responsive. In practice, they must respond quickly to order changes, increasing or decreasing production levels, and be on-call all day, every day.
- **Importance of seasonality:** The increasing seasonality of retailing has significant impacts for suppliers, who must reduce and expand their production throughout the year

in line with the requirements of the retailer. Peak periods such as Christmas put extreme pressures on suppliers to produce large volumes in a very concentrated period of time.

- **Lower prices:** The continual downward pressure on prices driven by fierce retail competition leads suppliers to continually seek ways to cut costs.

The question then becomes: which of these commercial factors might affect suppliers' ability to meet required ethical standards?

Identifying and unravelling the full causes of poor labour standards is an immensely complex and subtle task, which is well beyond the scope of this research. However, three characteristics of modern supply chains that emerge from the preceding sections that merit further attention:

- The need to produce quickly and at low cost: **time and speed.**
- Issues around **flexibility and seasonality.**
- The search for lower prices and better deals: **cost and risk.**

In each case, a direct link may be postulated with labour standards.

Table 4: Potential link between buying trends and labour standards

Trend	Link to labour standards
Time and speed	Short lead times can lead directly to excessive working hours in an attempt to meet demand. The pressure to work quickly can also lead to unacceptable workplace cultures, although the quality and approach of local management probably have a strong influence on this aspect of worker welfare.
Flexibility and seasonality	This issue directly affects the supplier's ability to provide secure and regular employment. It also may influence levels of overtime and may force suppliers into using particularly vulnerable worker groups (e.g. migrants) to meet short-term demands.
Cost and risk	The strongest linkage is in the area of wages: cost pressures force manufacturers to cut wages, perhaps below acceptable levels. Additionally, overtime may not be remunerated at premium rates. Less obviously, cost pressures may lead directly to cutting corners in health and safety, and the use of vulnerable worker groups (although both of these elements are strongly influenced by management competence and approach).

The following sections will explain in more detail at how suppliers are affected by demands around time and speed (section 9), demands around flexibility and seasonality (section 10) and demands around cost and risk (section 11).

9. Time and speed

Almost all supply chains seem to be under continual pressure to produce goods faster. In some cases, this is to enable design decisions to be taken as near to product launch dates as possible and so that product volumes can be altered at short notice in accordance with up-to-date stock and sales data. This tendency is particularly pronounced in manufacturing and retailing apparel, footwear, home-ware and gifts, and in other sectors that produce for markets driven by rapidly changing consumer trends. In other sectors – for example automotive and electronics – this pressure is a consequence of ever-shorter product development cycles. Similar effects are also observed in fresh produce, but in this case, shortening the time between farm and plate is related principally to retailers' attempts to deliver higher standards of quality and freshness.

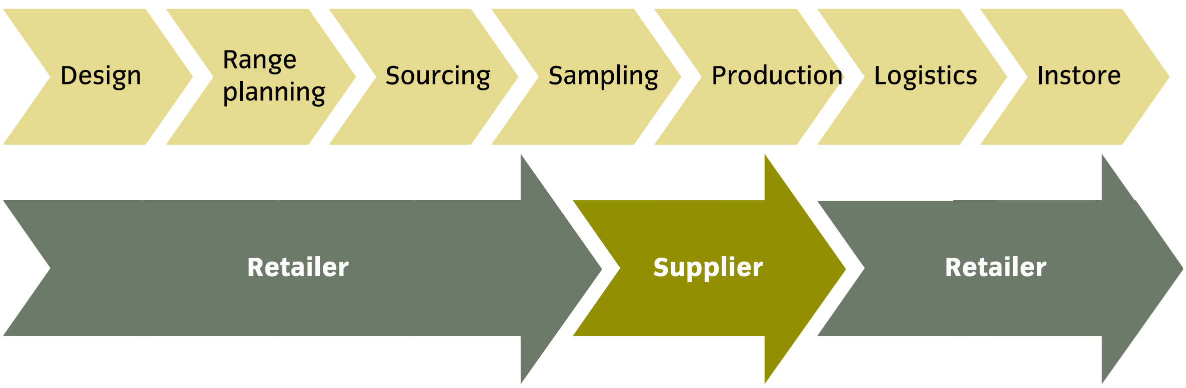
There are strong business reasons for companies to try to compress the buying process so that the time between product inception or it being picked and arriving in store is shorter. However, in practice, because of the way retail buying teams work (which will be described further below), the suppliers' stages in that process are typically compressed, without similar efficiencies being achieved in the other stages. This puts extreme pressure on suppliers who may not succeed in delivering the optimum performance as a result.

In order to understand the time pressures being put on suppliers, and to find viable solutions, it is necessary to look in some detail at critical path management in retail buying.

The critical path

The critical path is the series of inter-linked, time-critical tasks that must be performed in order for the buying process to proceed. The tasks in a typical critical path are shown in the following diagram (and were previously discussed in section 4):

Figure 3: The critical path



The length and importance of each task differs among sectors. For example, design is an extremely important part of the retailer's critical path in own-brand fashion clothing, but much less important in branded DIY goods. Similarly, sampling is more important for fashion goods (design) and electrical goods (safety) than it is for fresh produce.

The diagram shows how most of the critical path is, in fact, managed by the retailer. The supplier's involvement in sampling and production takes up only a relatively small part. This seems to indicate that if companies want to find ways to compress the critical path, they should focus on their role within it.

Retail critical path management

Critical path management has always been important in retail buying, but due to the recent trend towards overseas production it has become much more complex. Suppliers tend to be further away (making it harder to meet regularly face-to-face), more dispersed and live and work in different socio-cultural contexts. According to the project participants, this has lead to:

- Longer lead times.
- Communication problems.
- Lower levels of trust.
- More logistical complexity.

Efficient critical path management has therefore become even more central to business success.

What goes wrong?

Many companies report that they find critical path management difficult. Although this varies between sectors, it seems fairly typical that slippages, particularly in the early stages of the process, lead to orders being placed late. Since final delivery dates can rarely be moved, this results in the supplier's production time being dramatically squeezed. This situation can lead to suppliers hiring in short term labour, working excessive hours, enforcing mandatory overtime and/or outsourcing. All of these practices can reduce ethical and quality standards and increase risk to the retailer.

This research has revealed a number of factors that lead to late order placement and late production.

- **Inefficient decision-making:** Getting internal sign-off for buying decisions can be a lengthy procedure particularly when many individuals and/or committees are involved. Key individuals often travel extensively, and if a decision slips by a few days, it may then be weeks for the responsible person to be back in the UK. This can be especially difficult where creative design decisions are involved and can be further exacerbated by new and inexperienced buyers. The problems are often then repeated with decisions regarding packaging design.
- **Holding back decisions:** Buyers often deliberately defer a decision until the last possible minute in order to understand better what their competitors might do and to reflect exactly current consumer demands, either in terms of volume or product specification. This manifests as a constant drive for 'perfection'. Participants quoting many examples of final samples of products being subject to revisions, even after production is underway or (in one case) entirely complete.
- **Focus on only certain dates in the critical path:** Some of the deadlines in the critical path are truly immovable – typically the shipping date for overseas products and the in-store launch. Others are typically seen as internal milestones that can be safely disregarded. This can lead to a compression of the final stages of the critical path. The extension of critical paths, which seems to be increasingly common, may compound this effect. Retailers report starting range reviews fifteen months or more before the product is due in store, perhaps leading to a perception that there is plenty of time to spare, and consequent slippage in the early stages of the process.
- **Poor communication between buyers and suppliers:** Accurately communicating a precise product specification can be challenging. This is particularly so in the case of

fashion items and clothing, where the design needs to be followed exactly and where the designer may change their mind during the communication process. The desire to say 'yes' means that suppliers often do not ask for the clarification they need. The result is often that a very high number of samples is produced before the final product is agreed. These problems can be acute in countries such as China, where is it culturally inappropriate to refuse a request from a customer, but the agreement that the western buyer thinks she has secured may be impossible to achieve.

- **Poor information sharing about the critical path:** Most companies attempt to share some information about the critical path with suppliers, but this is often fairly rudimentary, thus making it difficult for the supplier to plan production. Sharing this information in a way that is useful for factory managers in other cultures is a further challenge.
- **Lack of trust between buyers and suppliers:** The greater distance between buyers and suppliers seems to lead to deteriorating levels of trust between them. One example quoted was that overseas suppliers are reluctant to order components until they have a formal order from the buyer. In contrast, buyers explained that tried and tested local suppliers may take a risk and start preparing for production if informally told that they will get the order, thus giving them more time.

Possible improvements

Almost all participants in the project agreed that improving critical path management could yield both commercial and social benefits. Many of the possible improvements that we unearthed are unremarkable examples of simply getting the basics right, but there are also several other more specific suggestions.

- **Better definition of roles and responsibilities**: Most participants suggested that the roles in critical path management are still not well understood in their own organisation, despite appearances to the contrary. High levels of staff mobility and turnover, coupled with very specific incentivisation of buyers (see section 12) lead to a constant need to communicate, explain and reinforce the basics of the buying process both within and outside an organisation. The conclusion: many people don't stick to the critical path because they simply do not know what it is.
- **Simplify decision making:** Decision-making is apparently often very hierarchical. For example, a buyer might agree a range with a supplier, but this is then passed to a category controller for final sign off. This is then collated with other ranges and may be taken to a trading director for final approval. The technical/quality team all need to agree, as might the merchandising, logistics and other teams. All it takes is for one or more of these individuals to be unavailable and decisions slip. Companies might wish to look at ways of simplifying the process, or making it more generally robust in the absence of certain individuals.
- **Segmentation:** It is much easier to make last minute amendments with suppliers who are only an hour's drive away than with those on the other side of the world. Some retailers are building this type of sophisticated thinking into their management, taking basic items from Far East suppliers and reserving complex, risky or fast turnaround merchandise for more local suppliers. Another element of segmentation that is practised is to reserve complicated or risky products for tried and tested suppliers with established relationships and only trial new suppliers for simpler lines.
- **More active enquiry from suppliers:** All participants agreed that suppliers must share some of the responsibility for improving communication by seeking to clarify details that they require. Many suppliers (particularly new suppliers) are so keen to maintain relationships that they are not assertive enough in asking questions. Retailers in general say that they find it useful for suppliers' to offer them examples of good quality product briefs that have worked in the past.

- **Cultural training:** It can be hard to communicate with suppliers from other cultures, where even 'yes' and 'no' might have subtly different meanings. Some project participants cited examples of successful training provided to help buyers understand and work with these issues.

Box 2: Critical path management case study: it *can* be done

One of the companies involved in the project has a vertically-integrated supply chain and did not report the same problems with critical path management. Orders tend to be placed at the agreed time, forecasting is better and communication seems to work well. A number of factors seem to contribute to this more efficient and effective supply chain operation, including sharing a common language and company culture, and having facilities that are located relatively close together. As we explored this case, it became clear that the biggest single influence was the fact that both buyer and supplier knew that the whole company would ultimately suffer as a result of poor critical path management, leading to a shared incentive to get it right. This case seems to suggest that most of the difficulties arise from buyers applying pressure to suppliers 'because they can', i.e. the buying company knows that it can change the order at the last minute and that the supplier will silently carry the cost. The buyer thus gains a useful option without cost. In the vertically-integrated case, this cost affects the final performance of the group, and there is not the same incentive.

10. Flexibility and seasonality

Flexibility

Retailers rely on forecasting to predict how much of the product they will sell and thus how much they need to buy. Because forecasting is not an exact science, it is to the retailer's advantage to have a flexible supply base so that they can change orders, increase or decrease volumes and change delivery phasing as appropriate to keep their buying in line with their stock and sales.

What goes wrong?

Forecasting is notoriously difficult and is never 100% accurate. In some sectors, such as fashion retailing, initial forecasting accuracy can be as low as 50%. Retailers understandably do not want to carry the risk of forecasting inaccuracies. They thus encourage suppliers to become more flexible and responsive, delivering small quantities of product more frequently and being able to respond to order changes at very short notice.

The two principal unknowns in forecasting are the weather (which can increase demand for key lines enormously or depress sales of certain items) and the behaviour of competitors. Last minute price promotions, often undertaken to respond to competitor action, can lead to initial forecasts being hopelessly wrong. This has a number of impacts on suppliers:

- **Suppliers need to keep a flexible workforce:** In order to be able to respond to last minute changes suppliers may keep their workforce on flexible terms, impose mandatory overtime and use casual labour.
- **Increase cost to suppliers:** Just-in-time production and delivery can increase suppliers' costs if they have to pay for the delivery of higher numbers of smaller loads. In one example the supplier had to deliver twice as many half pallet loads instead of full pallets. Moreover, in some highly competitive sectors such as food retailing, supermarkets want suppliers to deliver products seven days a week. This has severe cost implications for the suppliers, as they need to extend their operating times and pay staff for the extra time.

Seasonality

Seasonal changes in fashion and fluctuations in sales lead to dramatic variation in demand for goods throughout the year. Even when these fluctuations can be easily predicted, it is often not viable to carry out advance production due to the cost implications of storing the finished product or the perishable nature of the good involved.

What goes wrong?

- **Suppliers need to produce high volumes over a short period:** There are times of the year when the sheer volume of goods required puts pressure on the productive capacity of suppliers. Production for Christmas is the most obvious example, but in certain sectors there are other peak times including Easter and Valentine's Day.
- **Suppliers do not receive continuous orders throughout the year:** Suppliers who produce summer goods for example often find themselves with no work during the winter

goods production months. They thus have to either temporarily 'un-employ' their workers or shift to production for the local market.

Possible Improvements

Forecasting was generally acknowledged to be a difficult area and a critical driver of profitability. Surplus stock is expensive to transport and store (even if it can be returned to the supplier) and empty shelves damage reputation and reduce sales intensity. Many participants agreed that forecasting was good for 'bread and butter' lines, but could be wrong by a factor of three for new or fashion items.

- **Increased sophistication in forecasting:** Many companies are working hard to improve forecasting - taking account of price trends, fashion and increasingly liasing with media and press to anticipate the impact from celebrity endorsements (the 'Delia effect') or product placement. This attention pays commercial dividends, but also improves the ability of suppliers to plan ahead.
- **Separate forecasting from buying:** Common practice is now to separate the forecasting from the buying teams, since the latter may have other incentives to artificially pitch too high (perhaps to get a new marginal range approved) or too low (to guarantee a soft target and an easy bonus). This would seem to be best practice, leading to significant improvements in accuracy.
- **WIGIG:** Retailers are making a feature of '*When it's gone, it's gone*' promotions, either to drive early sales or to emphasise the one-off or exclusive nature of a particular product. While not generally applicable across all ranges, this niche strategy can reduce commercial risk and assist supplier planning.
- **Manage production outside supplier peak periods:** Suppliers of seasonal products obviously have peak manufacturing periods, during which their prices tend to be higher. Placing orders outside these periods can enable buyers to benefit from lower prices and also help maintain continuous employment for suppliers' staff. However, this strategy carries with it greater risks associated with forecasting, the possibility of misinterpreting customer fashion and significant problems with warehousing the products until they are required. These factors must be balanced, but many participants felt there could be real benefits from exploring this area more thoroughly.
- **IT tools:** Almost all participants have invested in IT systems for forecasting and stock management, with most preferring to develop a bespoke customisation of one of the standard platforms.

11. Price and commercial terms

"It is unwise to pay too much, but it's worse to pay too little. When you pay too much you lose a little money - that is all. When you pay too little, you sometimes lose everything, because the thing you bought was incapable of doing the thing it was bought to do".

"The common law of business balance prohibits paying a little and getting a lot - it can't be done. If you deal with the lowest bidder, it is well to add something for the risk you run. And if you do that, you will have enough to pay for something better."

John Ruskin 1819-1900

Another aspect of purchasing that impacts ethical standards is perhaps the most difficult to deal with - pricing. Any purchaser will of course attempt to obtain the lowest price for a product and no vendor is obliged to sell, but it is clear that the almost continual downward pressure on price that is prevalent in retailing today does have an impact on the conditions of many workers.

What generates price pressure?

The UK economy has experienced a long period of low inflation, typically below 3% per annum (p.a.). Once the effect of certain sectors has been accounted for, analysis shows that in many parts of the economy, prices have been rising by typically only 1-2% p.a. It is common practice in the retail sector to use 'price points' – keeping the retail price of products at certain psychologically significant levels (e.g. £1.99, or £99.99), which makes it extremely difficult for retailers to pass these small, inflation-driven percentage increases on to consumers without suffering a significant commercial disadvantage. This effect is compounded by the common practice of price benchmarking by retailers and consumer groups alike. The net result is that many products have been held at the same price for two or even three years.

Profits, however, must continue to rise if shareholders are to be satisfied. In mature markets, where volumes are rising only slowly (if at all), the only place to look is at costs. Given that the bulk of the costs are in the purchase price, this naturally leads to a constant downward pressure on suppliers' prices.

A second effect is the rise of huge international retailers whose scale allows them to take the entire output from supplier factories and drive prices downwards. Other retailers are then forced to compete with these companies' consumer prices, but without the benefits of scale in the supply chain.

What goes wrong?

Buyers negotiate price in conjunction with a number of other issues (as described in section 6). The supplier must always make a judgement on whether the additional volume of the order in question justifies the price offered. If this judgement is wrong, the suppliers profit levels will be unacceptable.

Asymmetric power relations (such as those described in section 6), can lead to suppliers taking business at unsustainably low prices. They must then find ways to save costs that can have a direct impact on working conditions. There are a number of factors that make this scenario particularly likely:

- **Inappropriate incentives for sales teams:** The individual or team negotiating price on behalf of the supplier may be incentivised based on sales volume and not margins. Their interest therefore is to close the sale, regardless of the unit price and the impact on profitability. This can contribute to unsustainably low prices being agreed.
- **Poor understanding of manufacturing costs:** The likelihood of agreeing an unsustainably low price increases when suppliers do not have good management systems allowing them to correctly apportion labour and materials costs to each product (activity based costing).
- **The balance between labour and materials:** In sectors where labour is intensive and materials are cheap (e.g. toy manufacturing) the temptation seems to be to look for cost savings in the labour bill, rather than in materials. This effect is not as pronounced where materials are expensive and the labour component is lower (e.g. electronics, jewellery).
- **The availability and influence of workers**: Reducing wages and benefits is a more viable option in regions and sectors where there is an oversupply of labour (either for demographic or economic reasons or because the skill base is low) or where other circumstances make workers unable to withdraw their labour (e.g. in the case of home-workers or workforces with no collective representation).

Possible improvements

Project participants unanimously agreed that there is such a thing as ‘too cheap’. Most companies were able to cite examples of products that were eventually unfit for purpose and attracted public criticism, or that did damage to the supply base in another way (see the case study below). In hindsight, they agreed, it was easy to identify when the price paid had been too low, but the problem was generally acknowledged to be how to spot these cases in advance of making the deal.

- **Cost models (buyers):** Getting it wrong by driving price too low can lead to costs being displaced and borne by other parts of the company. There were only a few examples of true cost models being used properly to apportion these hidden costs back to products. For example, many retailers were able to apportion the costs of a product recall back to the buying department in question and most successfully assigned price rebates and import duty. However very few considered the costs of quality appraisal, product reworking, logistics, inventory, amendments to packaging and other differential overheads (for example, heavy demand on customer services teams) arising from cheap products that looked like a good deal at the time. The overall result is that companies are not able to learn from their mistakes, repeating decisions that depress overall profitability.
- **Cost models (suppliers):** The other facet of low prices is the impact on the supplier company. Some retailers had explored modelling supplier costs, enabling them to form an independent judgement on whether a supplier was pricing too low in a bid to gain business. These had been relatively successful in some bulk supply markets (e.g. food ingredients, fabric, timber etc.) and had provided useful insight. It is then possible to extend this thinking to explore whether the element of wage costs in the total was sufficient to meet workers’ needs, but this was generally agreed to be very complex and best undertaken in conjunction with an NGO partner.
- **Price engineering and open-book accounting:** Some very good examples were provided of buyers and suppliers working openly together to engineer cost out of a product, reducing non-essential elements to get something fit for purpose at the right price. Conversely, some reported cases border on abuse, with open-book accounting (where suppliers show buyers their full accounts) being used as just another tool to cut

suppliers' margins. In the extreme case this can remove all incentive for suppliers to reduce costs since any savings achieved are simply captured by the buying company. This is a powerful tool, but is critically dependent on the buying culture in which it is used (see section 12).

- **Getting the 'right' fraction of production capacity:** There was much debate around the 'right' fraction of a supplier's output for a buyer to take. Some buying strategies are based on offering huge volumes to a supplier, guaranteeing production, but at a very low cost and often with the result that the supplier can have no other significant customers. In other cases, retailers consciously limit themselves to being only one of a number of customers, forgoing a price advantage but reducing their responsibilities in the event that they wish to terminate supply. Both strategies can lead to poorer working conditions. In the former case, through downward price pressure; in the latter case, through buyers forgoing influence over their supply companies. This seems to be an area that all retailers would be well advised to keep under constant review at a strategic level.

- **Price or perception:** 'Customers want the lowest price' is the phrase used to explain cost cutting in the supply base, but in fact most participants confessed to a more sophisticated approach. On reflection, all agreed that the critical element is the customers' *perception* of price and that this is influenced mainly by key lines and may even be erroneous. It is usually important to have competitive prices at entry-level products in a range, but there is more flexibility for those with added value. There was, however, little evidence of this subtlety being applied in the sourcing of these products, which is an area for possible improvement.

Box 3: Cost and risk case study: slashing prices

A large manufacturing company passed into new (private) ownership, with a medium term strategy of improving profitability and flotation. One of the first acts of the new management team was to decree an immediate 15% reduction in all prices paid to suppliers, with no negotiation and even apply this to invoices that had already been received.

Predictably, suppliers responded with outrage. Many threatening to cease supply immediately but after a period the threats receded, the suppliers swallowed hard, and most accepted the new terms as a condition of supply. The immediate target cost savings were achieved.

After a number of months, some of the suppliers found that the prices were unsustainable and that they had to exit the business whatever the cost. They quietly courted new customers, reduced their own costs appropriately and then didn't seek to renew the contract. The manufacturing company found it difficult to source new suppliers, since word had spread around the industry of their pricing and buying strategy. Innovation stopped, production problems began to occur, and the rate of profit improvement stalled.

According to those in the industry and former employees, the company was eventually set back behind the point it started from. It took four years to return to acceptable levels of output and profitability, and the medium-term goal of flotation was not achieved.

12. The ‘Sales Prevention Team’

Buying culture

Some profound issues of culture and behaviour underlie many of the mechanistic analyses included in sections 6-11. We found a number of factors in a typical company that can lead to unhelpful behaviours among buyers, associated teams and suppliers. This section explores some of those factors. Its title is a phrase often used facetiously by buyers to describe those in their own companies who have responsibility for quality, ethics and even product safety. We have used it to highlight just how deep these cultural divides can be. The factors described below are clearly generalisations, but they were all raised by companies during the project interviews or workshops.

The buyer is king

Buying is critical to profitability in many sectors. Buyers are therefore very important people since their individual talent and ability directly affects the company’s bottom line. This has led, in some cases, to a culture where ‘the buyer is king’, with systems being geared constantly to optimise the buyers’ effectiveness. Interviewees told us that good buyers are often individualists, operating better on their own than as part of a team. In some cases, buyers can easily see other colleagues (for example, the quality assurance team), as simply putting hurdles in their way and many work to get around, or even subvert these systems, which have presumably been developed to reduce risk to the company. Even at its least extreme, this culture can make communication with buyers very difficult.

The deal is the thing

Buyers’ focus on the importance of the next deal can make buying culture very short-termist. In fact, many participants in the project reported that a crisis management and fire-fighting culture was systemic in their buying teams. Buyers also tend to move on quickly, rarely staying with a product range for more than a year or so and to move between employers frequently too. This suits many of the younger buyers, who are keen to prove themselves as quickly as possible and advance their career. This mitigates against a longer-term approach to developing relationships with suppliers and occasionally leads to buyers generating a lot of problems in a new product range, which only ‘come home to roost’ once they are safely in a new job.

It’s not my job ….

The individualistic culture and the focus on the deal means buyers have a very keen sense of what is and isn’t their job. They are quick to shed anything that they believe gets in the way of top performance and indeed many are actively incentivised to do so. Buyers tend to be appraised on price, buying margin (but without many of the true cost elements described in section 11), cost saving etc. They receive plaudits for introducing hot new ranges and exciting products at low cost. They are not encouraged to take a broader or longer view, to visit supplier factories or consider long-term intangibles, such as trust or company reputation.

… and I don’t want to know anyway.

In some cases, where they have taken an interest in ethical or quality issues, buyers have found themselves forced into a type of ‘doublethink’. They become aware of the problems in their supply companies, but they have little opportunity to do anything about it. In this case, knowledge becomes almost worse than ignorance, since it can lead to quite deep conflicts at a personal and motivational level.

Why is this important?

Is it not enough that someone in a company has responsibility for product quality, ethical standards and the like? Isn't there a strong argument for separating these elements from the buying function and leaving the buyers to concentrate on what they are good at? This has been the response from most companies to date, and it has resulted in the situations described in sections 4 and 6, namely that a technical or ethical team takes responsibility for those issues through a programme of compliance assurance. Companies are experiencing only limited success through this approach to implementing ethical trade programmes – and our researches suggest that there are direct commercial benefits that can be gained from improved critical path management and a more sophisticated understanding of price, cost and volume.

It seems clear that the key to unlocking many of these benefits is to involve the buyers. Some participants reported examples where this has been done successfully - getting buyers involved in new product development or major strategic projects right from the outset, integrating certain other functions closely with the buying team and so on. By and large, these approaches have tended to focus on *organisational* integration rather than on the subtler concept of *cultural* integration.

Underlying many of the possible improvements listed in the earlier sections is the concept of trust – trust between supplier and buyer and trust between colleagues in the buying company. It seems plausible that there has been an erosion of trust in the supply chain of many companies, driven by shifts overseas, moves away from traditional purchasing models, such as using agents extensively, strong buying pressure exerted by some major players and so on. The business benefits from reversing this situation may not be explicitly measurable in terms of this year's margin, but low levels of trust were cited sufficiently frequently as a barrier to improvement as to suggest that there is a strong business case for focussing on this rather old-fashioned area. It seems clear that short-term, narrowly focused buying behaviour destroys trust.

Possible improvements

Improvements in this area go right to the heart of a company's culture. Successful buyers are promoted and can eventually become Commercial Directors and even CEOs. Their behaviour provides the model for others to follow - so there may be tough questions to ask about leadership style.

- **Consider organisational integration for buying teams**: Several participants mentioned specific initiatives to involve buyers more closely in other aspects of the business, perhaps by seconding them into project teams or by restructuring the organisation. Where they have been tried they seem to have been productive. A concrete example might be to formation of a multi-disciplinary team to overhaul a key product range (involving buyer, merchandiser, designer, technical and ethical experts) rather than the traditional process-driven and function-based approach. Simple steps such as re-locating teams so that they work closer to each other and developing shared team meetings can also help.
- **Rethink buyer appraisal frameworks:** Most participants suggested that buyers should not be incentivised on margin alone and attempts should be made to reapportion other costs when calculating their contribution. Many participants strongly identified the need to include other elements in the buyer's appraisal: quality, ethical standards, team working, innovation and so on. There was a strong feeling that this need not be explicit in bonus arrangements (although that would be the ideal) but that it certainly should be recognised in appraisal and performance discussions.

- **Develop an approach to seeing value in supplier relationships:** The benefits of good, open long-term supplier relationships are difficult to value explicitly, but they are considerable. Risk is reduced when using tried and tested suppliers because communications can be simpler and less formal and problems can be identified and overcome much more quickly. However, these aspects are often lost in the drive for lower prices. We encourage companies to investigate other ways of considering and segmenting their supply base and developing non-financial metrics of the health of a supply relationship. As a hypothetical example, a company could begin to map supplier 'churn' rates: is it healthy to have 50% of a core product range supplied by companies that have only been a supplier for two years? Which suppliers have shown the best track-record in innovation or quality? Aren't these the first place to turn for critical new product development?
- **Take the lead on developing trust:** Developing trust is a virtuous circle – once one partner shows it, the other finds it easier to follow. But is has to start somewhere, and the current state of most supply chains suggests that the large buyers need to make the first move. There are excellent case studies (albeit in isolated examples) of companies being awarded a secure supply contract, enabling them to raise finance and invest, which in turn brings price and quality benefits to the purchaser. In most cases, these virtuous circles started with the purchaser offering a longer contract, or a higher margin than might have been strictly necessary, but this short-term cost produced long-term benefit for both parties.

13. Conclusions

Increasing buying power, thereby influence over suppliers, and striving for a diverse, flexible and highly responsive supply chain, are valid commercial goals of corporate buying strategy.

However, our research suggests that there are profound and complex connections between the normal commercial buying practice of a company and its suppliers' ability to meet required ethical standards. According to discussions with project participants, this can lead to a number of pressures being imposed on suppliers that, in turn, can have negative and unforeseen consequences for their workers.

In some cases, it may well prove that companies are inadvertently pursuing a buying strategy that creates tension, or in some cases directly conflicts, with their commitments to ethical trading. For example, if purchasers are too aggressive in demanding lower prices and shorter lead times, these demands may make it very difficult for suppliers to meet the required standards for workers' pay and working conditions.

Ironically, our research indicates that pressures of this kind of are quite often placed on suppliers needlessly, because of bad buying practices - inefficiencies, indecision, badly designed incentives, lack of trusting business relationships etc. Such failures are therefore doubly undesirable: they cost companies money and undermine ethical trading. Most companies seem to operate parallel programmes to try to deliver improvements in buying practices and in ethical trading.

This research indicates that companies may gain significant benefits from taking a more integrated approach to the challenge of maintaining a competitive, low-cost supply base, while at the same time upholding their commitments to trade ethically.

Insight believes that these issues should be examined closely by the senior management of the companies for which they are relevant – particularly those with extensive, high risk, developing country supply chains. We encourage those companies to begin to explore whether their purchasing and pricing practices support or undermine their ethical trading commitments and how improvements could be made to better align their commercial interests and their ethical commitments.

Appendix 1: Buying function organisation in consumer and business-to-business buying

Consumer buying

- Design*
- Sourcing
- Product development
- Initial forecasting
- Commercial negotiations

"buyer"
"trader"
"product developer"
"category manager"

- Merchandising
- Product planning
- Critical path management
- Sales analysis
- Chasing and adjusting orders
- Commercial

"merchandiser"
"supply chain manger"
"category manager"

- Technical
- Quality
- Safety
- Ethical

"technologist"
"quality assurance"

*In high fashion houses, this will generally be a separate design team.

In most UK retail operations, there are three major roles within a buying team. These roles are known by a variety of job titles and in some cases may even form two or three different, but collaborating departments. The exact composition of the roles varies, but broadly follows the pattern below:

Business-to-business

- Product specification
- Tender management
- Sourcing
- Commercial negotiations
- Chasing orders
- Logistics management

"procurement manager"
"supply chain manger"
"category manager"
"purchasing manger"

Because the buying process is relatively simpler in non-consumer sectors, it is common for there only to be one role within the buying team. This role, however, also goes by a number of different names.

Appendix 2: Levels of supply chain evolution

Level 1: Functional Integration	
Characteristics:	■ Companies focus on procurement separately in each functional area or business unit. ■ Sourcing decisions tend to be 'tactical' (identify the required product, find the cheapest price then purchase). ■ No centralised data is available on the company's supply base. ■ There tend to be many suppliers, each with low volumes of business. ■ The buying company may have multiple contacts with the same supplier, each operating with different terms and conditions.
Found in:	■ Companies that have not yet addressed the subject (e.g. those that have recently been the subject of rapid growth such as software and IT). ■ Companies recently reorganised or that have been created through merger, leading to fragmented procurement.
Level 2: Corporate Integration ('Category Management')	
Characteristics:	■ Companies begin to centralise procurement across the whole business and take advantage of the greater buying power this offers them. ■ Sourcing becomes more 'strategic' as procured items are organised into different categories and these categories are managed differently according to their strategic importance to the company. ■ The number of suppliers is reduced to decrease duplication and increase buying power. ■ For strategically important categories the buyer will begin to identify 'key suppliers' and develop special relationships with them. ■ For less important categories the company will attempt to bundle products and services together in order to achieve greater leverage (eg, instead of buying paper towels , they may bundle this with other related items and buy 'cleaning services' or even 'facilities management').
Found in:	■ The average organisation for which supply chain management is not a strategic imperative. ■ Examples include most non-retail, non-manufacturing organisations (e.g. service companies, financial services, some IT and telecoms companies).
Level 3: Partner Collaboration	
Characteristics:	■ Procurement activities begin to extend beyond the confines of the company and key suppliers are invited to become increasingly involved in the process. ■ Suppliers may be involved in design ideas and may collaborate with buyers to find solutions to match supply more closely with demand. ■ The process of supply chain consolidation continues, with the company seeking fewer, longer-term relationships. ■ Computer systems enable information on logistics and warehousing to become increasingly visible across the whole purchasing company.
Found in:	■ Retailers. ■ Component supply for many manufacturers.

Level 4: Value Chain Collaboration	
Characteristics:	▪ The relationship between the procuring company and the supplier becomes even more developed. ▪ The increased use of new computer technologies and web-based systems enable an even higher level of information sharing and collaboration. ▪ Design, marketing and sales data become visible to suppliers, enabling such techniques as collaborative design and manufacturing (CDM) and collaborative planning, forecasting and replenishment (CPFR). ▪ Commercial risk is shared through open-book accounting and other pricing mechanisms.
Found in:	▪ Leading retailers. ▪ Particular manufacturing sectors (e.g. automotive, electronics).
Level 5: Sector Partnership	
Characteristics:	▪ Procuring company and suppliers work together to provide an integrated approach to an entire sector. ▪ Major licensing agreements concluded at Board level. ▪ Increasingly difficult to identify which company is the supplier and which the buyer: high levels of mutual dependency. ▪ Business planning and management is seamlessly integrated.
Found in:	▪ Restricted to particular sectors, e.g. infrastructure suppliers for networks, publishing and distribution, licensees of high-profile brands.