Deloitte.

Heads Up

November 29, 2011
Volume 18, Issue 38

In This Issue:

Conflict Minerals — The Supply Chain's Weakest Link?

by Joe DiLeo, Tim Kolber, and Beth Young, Deloitte & Touche LLP

Introduction

On October 18, 2011, the SEC hosted a roundtable to gather additional input on its December 2010 proposed rule on conflict minerals,[1] which was issued in response to a mandate of Section 1502[2] of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"). The roundtable was being held, in part, to address the significant feedback the SEC received on the proposal. This feedback consisted of more than 250 individual comment letters and over 60 documented meetings with the SEC's commissioners and staff. Respondents generally expressed their support for the intent behind Section 1502; however, many also voiced concerns about the timing and implementation of the proposed requirements.

Roundtable panelists included humanitarian groups, investors, issuers (i.e., registrants), and auditors. While no formal decisions were made at the roundtable, panelists' views were consistent with those previously expressed in comment letters and other venues. In responding to the staff's questions, panelists discussed the merits of Section 1502 but also described challenges that could arise as a result of the current complexity in companies' supply chains and product offerings, particularly at global organizations.

This *Heads Up* highlights the requirements of Section 1502 as well as key points for issuers and auditors to consider when implementing the proposed rule.

Respondents generally expressed their support for the intent behind Section 1502; however, many also voiced concerns about the timing and implementation of the proposed requirements.

The Bottom Line

Key topics addressed at the roundtable included scope, determination of the reasonable country of origin, due-diligence considerations, and reporting and auditing requirements (these topics are discussed in more detail below). The following list is a summary of some important considerations related to conflict minerals:

- Section 1502 applies to both domestic registrants and foreign private issuers.
- Footnote 13 of the proposed rule states that "conflict minerals" are defined as "columbite-tantalite, also known as coltan (the metal ore from which **tantalum** is extracted); cassiterite (the metal ore from which **tin** is extracted); **gold**; wolframite (the metal ore from which **tungsten** is extracted); or their derivatives" (emphasis added). Tin, tantalum, tungsten, and gold are often referred to as "3Ts+G." In addition, any other mineral or its derivatives could be included in this definition if the Secretary of State determines it to be financing conflict in the Democratic Republic of Congo (DRC) or an adjoining country.

[1] SEC Proposed Rule Release No. 34-63547, *Conflict Minerals*.

[2] Section 1502 amends Section 13 of the Securities Exchange Act of 1934 to impose a new disclosure requirement on publicly traded companies that manufacture products for which "conflict minerals" are "necessary to the functionality or production."

- Section 1502 instructs the SEC to promulgate regulations that require issuers to annually disclose a description of the measures they took to "exercise due diligence on the source and chain of custody of their conflict minerals." The SEC estimates that approximately 6,000 out of 13,000 issuers will be subject to the disclosure requirement. However, this estimate does not reflect the "trickle down" effect on the issuers' suppliers and vendors that are not regulated by the SEC but that would be required to provide information to their customers.
- Common applications of these materials include solder, electronic devices and related on/off switches, sheet metal, carbide tools, automotive parts, aircraft parts, wires, electrodes, capacitors, medical devices, dental fillings and tin fluoride, tin-plated containers, jewelry, glass, vacuum tubes, pesticides, fishing lures, and batteries.
- Common industries in which conflict minerals are used include aerospace, automotive, consumer packaging, defense, technology, electronics and communications, retail, jewelry, and medical device manufacturing.
- Section 1502 does not impose any penalty on registrants that determine they use conflict minerals. Rather, the objective of the provisions is to increase transparency and accountability related to conflict mineral reports by using legislative and regulatory mandates to pressure manufacturers and suppliers into "ethical sourcing."
- Section 1502 does not expand existing U.S. trade sanctions that already prohibit doing business with specified DRC individuals and entities; however, the U.S. Department of State and Department of Treasury are reportedly examining possible sanctions that might apply to U.S. companies that use conflict minerals.
- Some states are also attempting to effect change through legislative and regulatory mandates. In October 2011, California passed legislation that prevents an organization from entering into state procurement contracts that are in violation of Section 1502's reporting requirements. The effective date of this legislation is the later of January 1, 2012, or the date on which the SEC finalizes its proposed rulemaking on conflict minerals.[3]
- The original deadline for the SEC to finalize Section 1502 rulemaking was April 15, 2011. The SEC is therefore facing tremendous pressure to finalize the conflict minerals rule by the end of the calendar year. However, the SEC has acknowledged the view held by many constituents that because of the challenges associated with adopting this rule, an issuer's initial implementation should be a good-faith effort but should not be expected to be "perfect." Therefore, it is more likely that the SEC, rather than delaying a final rule to address all constituent concerns, will look for post-adoption improvements in reporting as registrants continue to develop their conflict minerals due-diligence inquiry processes and infrastructure.

The SEC has acknowledged the view held by many constituents that because of the challenges associated with adopting this rule, an issuer's initial implementation should be a good-faith effort but should not be expected to be "perfect."

[3] The California Transparency in Supply Chains Act will also become effective on January 1, 2012 (and was signed into law in September 2010). Although not related to conflict minerals, this act is analogous in that it requires certain companies that conduct business in California to disclose the efforts they have made to eliminate human trafficking and slavery from their supply chains.

Key Definitions

Conflict Minerals — The metal ores from which tin, tantalum, tungsten, and gold (often referred to as "3Ts+G") are extracted and their derivatives.

DRC Conflict-Free — Products that either (1) do not contain conflict minerals or (2) in which conflict minerals are used but the source of these minerals is not the DRC or adjoining countries.

Disclosure Only — An issuer's conclusion, based on a "reasonable country of origin inquiry," that conflict minerals **do not** originate from DRC countries would have to be disclosed in the issuer's annual report only.

Disclosure and Conflict Minerals Report — An issuer's conclusions, each based on a "reasonable country of origin inquiry," that conflict minerals **do** originate from DRC countries; have an indeterminable origin; or come from **recycled or scrap sources** would necessitate (1) disclosure of the conclusion in the annual report **and** (2) "furnishing" of a Conflict Minerals Report, as an exhibit to the annual report, that describes the due-diligence measures undertaken to determine whether the conflict minerals used are DRC conflict-free.

If an issuer asserts that conflict minerals are used in, or are necessary to the functionality or production of, any of its products, the issuer would be required to disclose in the body of its annual report on Form 10-K, Form 20-F, or Form 40-F (the "annual report") whether its conflict minerals originated in the DRC or an adjoining country.

Background

In July 2010, President Obama signed the Dodd-Frank Act into law as part of Congress's response to the financial crisis. The Act also includes certain provisions that are unrelated to the crisis, including Section 1502, which addresses exploitation and trade of conflict minerals originating in the DRC that are used to "finance conflict characterized by extreme levels of violence in the eastern [DRC], particularly sexual- and gender-based violence, and contributing to an emergency humanitarian situation."

In response to the Act's mandate, the SEC issued a proposed rule on conflict minerals on December 15, 2010. The proposal would change "the annual reporting requirements of issuers that file reports pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934" (the "Exchange Act"). Under the new requirements, issuers, including foreign private issuers, would be required to perform a reasonable[4] due-diligence process (or reasonable country-of-origin process) to ascertain whether conflict minerals are necessary to the functionality or production of (1) any of their manufactured products or (2) those that they have contracted to be manufactured. If an issuer asserts that conflict minerals are used in, or are necessary to the functionality or production of, any of its products, the issuer would be required to disclose in the body of its annual report on Form 10-K, Form 20-F, or Form 40-F (the "annual report") whether its conflict minerals originated in the DRC or an adjoining country. The SEC notes that a "reasonable country of origin inquiry could be less exhaustive than the due diligence [process]."

Furthermore, issuers that determine conflict minerals to be necessary to the functionality or production of their manufactured products (and those contracted to be manufactured) would be required to furnish a separate report (the "Conflict Minerals Report") as an exhibit to the annual report when such issuers (1) conclude that any of their conflict minerals originate from the DRC or adjoining countries or (2) are unable to conclude that conflict minerals did not originate from the DRC or adjoining countries. An issuer would also be required to post the Conflict Minerals Report to its Internet Web site.[5]

The Conflict Minerals Report should include a "description of the measures taken by the [issuer] to exercise due diligence on [identifying] the source and chain of custody of [its] conflict minerals." These due-diligence measures would include an independent private-sector audit (IPSA) of the issuer's Conflict Minerals Report that is conducted in accordance

[4] As further described in the proposed rule.

[5] The proposed rule indicates that an issuer that does not meet these conditions would not be required to furnish a Conflict Minerals Report and thus would not be required to obtain an independent private-sector audit (IPSA); however, such an issuer would nonetheless be required to disclose in the body of its annual report and on its Internet Web site that (1) conflict minerals did not originate from the DRC or adjoining countries and (2) the reasonable country-of-origin inquiry undertaken to draw such a conclusion.

with standards established by the U.S. Comptroller General.[6] Further, any issuer furnishing a Conflict Minerals Report as an exhibit to its annual report would be required to (1) certify, in its Conflict Minerals Report, that it obtained an IPSA of its Conflict Minerals Report; (2) provide the independent private-sector auditor's report as an exhibit to its annual report; and (3) make the independent private-sector auditor's report, in addition to the Conflict Minerals Report, publicly available on the issuer's Internet Web site.

Roundtable Discussions

Scope

Participants expressed concerns that the scope and complexity of the proposed rule would make it challenging for issuers to achieve "mine to end product" mineral tracking. In addition, most panelists (with an emphasis from certain issuer panelists, speaking in their capacity as preparers of annual reports) argued for limiting the proposed rule's scope to 3Ts+G as the most efficient solution because these are the minerals or metals that have the highest economic value and are directly responsible for fueling the conflict in the DRC and surrounding areas. However, one panelist who represented a human rights advocacy group believed that the final rule should apply to all derivative minerals of the named metal ores detailed in Section 1502. Another panelist proposed that gold be excluded from the proposed rule's scope because of certain unique challenges, such as the significant use of recycled gold, the greater difficulty in observing the source and chain of custody, and the fact that due-diligence guidance on gold is still under development.

Most panelists argued for limiting the proposed rule's scope to 3Ts+G as the most efficient solution because these are the minerals or metals that have the highest economic value and are directly responsible for fueling the conflict in the DRC and surrounding areas.

Editor's Note: While certain panelists called for limiting the minerals within the proposal's scope, the legislative language in Section 1502 is broader than what these panelists have suggested. Therefore, such a change is unlikely because it would necessitate an amendment to Section 1502.

Definition of Necessary to Functionality or Production

The proposed rule provides guidelines for, but does not define, what would be "necessary to the functionality" or "necessary to the production" of a manufactured product. When asked whether these terms should be defined, panelists responded that they thought a definition would be helpful as long as it is not too complex. In seeking feedback, the SEC cited the example of conflict minerals included in decorative embellishments (e.g., used in packaging). In this context, the panelists' consensus regarding "necessary" centered on whether the use of a conflict mineral is intentional, regardless of whether the conflict mineral is included in the final product. In other words, if packaging was intentionally designed for use of a conflict mineral (e.g., when the packaging is "required for the financial success or marketability of the product"), its use was not "accidental" and the conflict mineral should be considered "necessary."

Another much-discussed aspect of this topic was whether conflict minerals used in items that build a product (e.g., tools and machinery) should be considered necessary to the production or functionality of that product. Currently, machinery and tools used in the production process are outside the scope of the proposed rule. Panelists offered various views on whether tools and machinery should be included within the final rule's scope.

Editor's Note: Panelists focused on the challenges associated with identifying conflict minerals that are used in machinery and tools as part of the production process. If machinery and tools used in the production process are within the scope of the final rule, many more issuers would be within the scope of the rule's requirements.

[6] Under the standards established by the U.S. Comptroller General, the IPSA may consist of either a performance audit or an attestation engagement. While performance audits may be performed by both certified public accountants and other parties, attestation engagements may only be performed by certified public accountants.

De Minimis Threshold

Panelists were asked whether the SEC should provide a de minimis threshold and, if so, how such a threshold might be applied. One panelist discussed the use of gold in cell phones, indicating that because of the trace amounts of gold used in such phones, it would be doubtful that the threshold would ever be more than de minimis if significance is assessed in relation to the product itself (i.e., one cell phone). However, the panelist continued by stating that the use of gold would quickly become significant when considered in the aggregate (i.e., with respect to all cell phones in use globally).

Editor's Note: Panelists were concerned about how a minimum acceptable threshold for the use of conflict minerals could be established when the use of any amount of conflict minerals could fund human rights abuses.

Products Contracted to Be Manufactured and Consideration of Mining

The conflict minerals rule would also apply to situations in which a product is contracted to be manufactured, but only when the issuer has influence over the manufacturing process (e.g., a retailer selling company-label generic products). Some panelists indicated that the proposed rule should take into account products that are contracted to be manufactured because the issuer has a vested interest in the product — effectively through influence exerted over the product's manufacturing process. Other panelists suggested that for contracted products to be within the proposal's scope for this reason (i.e., because of influence exerted), the level of influence should be "significant." Proponents of this view argued that because there are inherent limitations with looking into many contractual manufacturing relationships, a higher threshold of influence over the manufacturing process is needed so that companies can avoid expending resources on potentially insignificant relationships. However, such proponents also believed that "significant" in this context would need to be defined.

Most panelists believed that all levels of the supply chain, beginning with the mining of a conflict mineral, should be within the scope of the proposed rule.

Panelists were asked whether mining should be included in the supply chain and whether it should be considered "manufacturing." Most panelists believed that all levels of the supply chain, beginning with the mining of a conflict mineral, should be within the scope of the proposed rule. Views differed, however, on whether mining should be considered manufacturing. While some panelists argued that mining should be considered manufacturing or part of the manufacturing process, others contested that it should be excluded because it only represents the extraction of ore and is therefore unlike a manufacturing process, which is transformative in nature.

Impact on Recycled and Scrap Minerals

The proposed rule describes recycled or scrap minerals as derived from products recycled or reclaimed from end-user or post-consumer products but excludes partially processed and unprocessed minerals and products, as well as mineral by-products, from this definition. The proposed rule acknowledges the "difficulty of looking through the recycling or scrap process" and allows issuers that obtain conflict minerals from a recycled or scrap source to consider those minerals "DRC conflict-free." However, issuers would be required to report on the due diligence they performed to ensure that these conflict minerals were indeed recycled or scrapped.

The panelists generally agreed that the SEC should reconsider treatment of "recycled and scrap minerals" and should continue to incentivize the use of scrap and recycled materials as a responsible sourcing practice by requiring a less rigorous reasonable country-of-origin inquiry process. In addition, some panelists believed that, rather being required to document their due diligence for ensuring that conflict minerals were recycled or scrapped, which would be subject to the audit requirements,[7] issuers should only need to validate that the minerals are recycled or scrap and should not be subject to any additional reporting requirements.

[7] While the proposed rule does not explicitly state that an audit is required when minerals are obtained from recycled or scrapped materials, this requirement can be inferred from Question 68 of the proposed rule's "Request for Comment."

Reasonable Country-of-Origin Inquiry

The proposed rule does not define the phrase "reasonable country-of-origin inquiry." Panelists generally believed that such a definition would be critical to understanding whether their procedures are sufficient to meet the proposed rule's requirements. Because infrastructure limitations are likely to exist as of the required implementation date, reasonable country-of-origin inquiries would rely on direct or indirect representations from refining facilities, smelters, and suppliers. Participants also identified additional complicating factors, such as (1) the difficulty of tracing conflict mineral origins to smelters, especially when relationships with smelters do not exist; (2) the ability to identify all suppliers, since companies often regularly change their suppliers; and (3) the ability to obtain representations from suppliers (or other appropriate evidence) in a timely manner so that the reasonable country of origin can be determined. Because of such potential challenges, it is important for issuers to understand whether such representations would be acceptable.

Under the proposed rule, issuers must also conclude, through their reasonable country-of-origin inquiry, whether their conflict minerals are from the DRC. The reporting requirements for an issuer that is unable to determine the origin of its conflict minerals would be expected to be the same as those for an issuer that has confirmed that its conflict minerals are from the DRC. Some panelists strongly believed that the final rule should offer an additional disclosure option for companies that are unable to determine the origin of their conflict minerals. This additional option would require less robust disclosures, would not require an audit over a phase-in period, and would be considered when an issuer undertakes a good-faith effort to determine the countries of origin.

Panelists believed that to minimize financial reporting conflicts, all registrants should be given either the same due date for conflict minerals reporting or a due date that is outside of a registrant's required annual report filing deadlines.

Editor's Note: Panelists reiterated their belief that the rule's intent is to ensure that issuers undertake a reasonable inquiry process, not to provide absolute certainty regarding the origin of their conflict minerals. Such panelists also suggested that compliance would not be perfect in the year of implementation but would evolve and improve over time.

Due Diligence

Roundtable participants discussed concerns associated with the provisions related to supply chain due diligence. Several panelists indicated that they thought it would be challenging for the SEC to develop a final rule that balances prescriptive due-diligence guidance related to each level of the supply chain with a flexibility that allows for certain accommodations when warranted by an issuer's specific facts and circumstances.

Most panelists agreed that to meet the rule's requirements, they would need to develop an infrastructure that is supported by multiple stakeholders. Some have observed that companies would not be able to single-handedly trace supply chains because of their limited visibility beyond direct suppliers with whom they have a commercial relationship. One suggestion was that industry-coordinated initiatives (e.g., conflict-free smelter certification) should be a priority. Such prioritization would reduce the burden on individual registrants and allow them to contractually obligate direct suppliers.

Several panelists also asked what disclosures would be adequate for them to provide while they are further developing their certification and validation infrastructures. Panelists suggested various alternatives for this certification and validation "build-up" phase, including the creation of a safe harbor within which issuers could operate, establishing and disclosing conflict-free policies with suppliers, and performing and reporting on internal risk assessments. These panelists believed that in establishing such alternative certification and validation processes and providing related disclosures, registrants would not only be adequately informing investors about their good-faith efforts but would also have additional time to develop their due-diligence processes and procedures.

Editor's Note: The SEC has recommended the Organisation for Economic Co-operation and Development's (OECD's) *Due Diligence Guidance for Responsible Supply Chains of Minerals From Conflict-Affected and High-Risk Areas* as a good starting reference for companies to consult in performing due-diligence measures. Several panelists highlighted that the OECD recently initiated a pilot program to refine this guidance to facilitate more effective implementation and is expected to issue revised guidelines in June 2012. The fact that new or revised guidance is expected has been cited by some as further support for a phased-in approach to compliance.

Reporting Requirements

Panelists suggested alternative methods for furnishing the Conflict Minerals Report instead of as an exhibit to an issuer's annual report. These alternative methods included (1) a newly created separate form or (2) Form 8-K. Panelists were concerned that if the requirements were applied as proposed, there would be "continuous reporting" because of issuers' differing fiscal year-ends and that such reporting would most likely result in a lack of comparability. Therefore, panelists believed that to minimize financial reporting conflicts, all registrants should be given either the same due date for conflict minerals reporting or a due date that is outside of a registrant's required annual report filing deadlines.

Independent Private-Sector Audit

The SEC is required to promulgate rules under which IPSAs are performed in accordance with standards established by the U.S. Comptroller General. Under such standards, known as Generally Accepted Government Auditing Standards (GAGAS), audit requirements may be met through either attestation engagements or performance audits. Some of the differences between attestation engagements and performance audits include that (1) the parties that may perform attestation engagements are more limited than those that may perform performance audits and (2) the level of information in performance audit reports is typically more detailed than that in reports for attestation engagements. Numerous concerns were expressed both in comment letters to the SEC and by panelists regarding the need for clarity regarding IPSAs.

Numerous concerns were expressed both in comment letters to the SEC and by panelists regarding the need for clarity regarding IPSAs.

Several panelists recognized that the term "audit" needs to be clarified in the context of conflict minerals. Panelists suggested that the term has been used to refer to (1) the IPSA of an issuer's Conflict Minerals Report, which is specifically cited in Section 1502, and (2) audits to be conducted for each level of the supply chain in the form of certifications to facilitate efficient execution of due diligence (i.e., the country-of-origin inquiry process). Examples of these certifications may include the Conflict-Free Smelter Program, code of practices, and mine-to-smelter.

Some aspects of this topic that are considered unclear include the pros and cons of performance audits and attestation engagements and whether one would result in "better" information. For example, because the reporting in performance audits may be more flexible than the more standardized audit reporting in attestation engagements, performance audits may yield additional information but may also lead to a lack of comparability in audit reporting among issuers. Another concern was whether the Conflict Minerals Report should focus on detailed quantity and location disclosures or on the supply chain country-of-origin inquiries process. These issues are important for registrants and independent private-sector auditors because they would greatly affect the information needed for reporting and the evidence required for the IPSA.

To promote discussion about many of the concerns raised by panelists and commenters, the SEC staff also asked panelists whether the final rule should specify which form of audit is acceptable and who may perform the audit. In posing this question, the SEC staff expressed its belief that the use of a performance audit model would promote competition by including a greater number of service providers (CPAs and non-CPAs) who can perform the IPSAs. Panelists indicated their desire for the most cost-effective form of audit.

Editor's Note: Comment letters on the proposed rule also identified other concerns, including the need for additional clarity regarding IPSA objectives, criteria, and evidence. Such comments pointed out that without such additional clarity, issuers' Conflict Minerals Reports could be inconsistent and lack comparability. Commenters recommended that the final rule provide the criteria needed for issuers to prepare their Conflict Minerals Reports and for independent private-sector auditors to perform the related IPSAs.

Under GAGAS, independent private-sector auditors would need to comply with GAGAS professional training and other requirements regardless of whether such auditors that perform the work are domiciled in the United States or abroad. As a result, IPSAs performed under GAGAS will introduce new complexities for independent private-sector auditors intending to perform IPSAs that do not have an already-established peer review program or whose personnel are not currently trained in GAGAS.

Next Steps

The SEC has indicated that it will complete a final rule by the end of 2011. Issuers should begin assessing the impacts of the proposed rule if they have not already begun this process and should continue to monitor the SEC's Web site for further developments.

For additional information, please contact our Conflict Minerals Advisory Team:

- Eric Hespenheide (ehespenheide@deloitte.com).
- Frank Oehl (foehl@deloitte.com).
- Kristen Sullivan (ksullivan@deloitte.com).
- Elise Gautier (elgautier@deloitte.com).

Subscriptions

If you wish to receive *Heads Up* and other accounting publications issued by Deloitte's Accounting Standards and Communications Group, please register at www.deloitte.com/us/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy & tax.
- Corporate governance.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Risk intelligence.
- Sustainability.
- Technology.
- Transactions & business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Join *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Registration is available for this upcoming *Dbriefs* webcast. Use the link below to register:

- The Postdigital Enterprise: Harnessing Change, Managing Disruption (December 1, 2 p.m. (EST)).

Technical Library: The Deloitte Accounting Research Tool

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking,* the weekly publication that highlights recent additions to the library.

In addition, Technical Library subscribers have access to *Deloitte Accounting Journal* entries, which briefly summarize the newest developments in accounting standard setting.

For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.