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# Guide on supply chain due diligence for companies trading, importing, processing, transporting or manufacturing forest products

This is a guide for Chinese companies that are investing in, trading, importing, processing, transporting or manufacturing using timber sourced from overseas.[1] It is designed to complement and support the forthcoming State Forest Administration (SFA) Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises.

This guide lays out a due diligence process that companies should use to ensure that they exclude from their supply chains any illegal timber. This due diligence standard is adapted from the existing UN Security Council due diligence standard for companies trading, importing, processing, transporting or manufacturing using certain minerals and metals.[2] The Chinese government, as a Permanent Member of the UN Security Council, was involved both in commissioning and in endorsing this due diligence standard for minerals supply chains.

This due diligence guide for companies investing in, trading, importing, processing, transporting or manufacturing using timber from overseas follows the five steps laid out in the UN Security Council due diligence standard for minerals. These steps are as follows:

- Strengthening company management systems
- Identifying and assessing risks in the timber supply chain and in forestry investments
- Designing and implementing a strategy to respond to identified risks
- Ensuring independent third-party audits
- Publicly disclosing due diligence and findings

Like the UN Security Council guideline, the five steps in this guide for the timber industry apply to all companies in the supply chain. However, as with the UN standard, there are distinctions in the extent and nature of the due diligence responsibilities of what we term 'upstream' companies and 'downstream' companies. This distinction is particularly relevant to the due diligence component on risk assessment (Step 2) and auditing (Step 4).

For the purposes of this guide, 'upstream' company means any company in the supply chain handling unprocessed, round, logs. So, 'upstream' companies include, for example, logging companies that cut trees and timber traders that buy and sell or import round logs. 'Downstream' company refers to any

[1] This guide assumes that all forest products covered by the State Forest Administration Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises contain timber. For sake of simplicity, it refers to the material under discussion as 'timber', rather than 'forest product'.

[2] UN Security Council, 'Security Council Committee established pursuant to resolution 1533 (2004) concerning the Democratic Republic of the Congo' http://www.un.org/chinese/sc/committees/1533/diligence.shtml; UN Security Council, 'Due diligence guidelines for the responsible supply chain of minerals from red flag locations to mitigate the risk of providing direct or indirect support for conflict in the eastern part of the Democratic Republic of the Congo', http://www.un.org/chinese/sc/committees/1533/diligence_guidelines.shtml. For English version, see http://www.un.org/News/dh/infocus/drc/Consolidated_guidelines.pdf.

company in the supply chain that is handling timber that has already been processed in some way, such as traders of sawn timber or manufacturers of wooden furniture. 'Log processor' means a company which transforms round logs into processed wood products. Examples of 'log processors' include producers of veneer or sawn timber.

The reason for this making this distinction is that, once a round log is processed, it becomes more difficult to trace to the point of origin – the forest that the trees were growing in. 'Upstream' companies find it easier to carry out due diligence on the exact origin of the timber and the conditions in which the trees were harvested and exported. It is 'upstream' companies, therefore, that are required to carry out the most rigorous elements of the due diligence process, such as on the ground risk assessments described under Step 2.

'Downstream' companies do not have to carry out full on the ground risk assessments. Instead, they are required to identify the last company in their supply chain to be handling round logs before the point of first transformation – the 'log processor' – and to make a thorough assessment of this 'log processor's' due diligence and whether it conforms with the standards set out in this guide.

This distinction between the responsibilities of 'upstream' and 'downstream' companies is a simple and practical way of reducing the burden on 'downstream' processors of timber products. It has the effect of placing particular significance on the role of 'log processors' in the supply chain.

**Should my company be undertaking due diligence on its supply chain?**

The first question that any company investing in, trading, importing, processing, transporting or manufacturing using timber needs to answer is whether it needs to undertake due diligence on its supply chain as detailed in this guide. The core principle of the UN due diligence standard is that companies should take a risk-based approach. This means that, if there is no risk of the company investing in illegal activities or of illegal timber entering its supply chain, then it need take no action. However, if there is a risk, the company must address it. If that risk is low, then the steps the company needs to take may be limited. But if it is high, the company's due diligence will need to be comprehensive.

Companies whose supply chains are at greatest risk are those that are investing in, or buying timber produced in, a country where law enforcement is weak and illegal activities are known to occur. These firms will need to undertake detailed due diligence on their investments and supply chains.

**Using red flags to detect risk of illegal timber in the supply chain**

To make that initial assessment of risk, the UN due diligence standard calls on companies to look for 'red flags' – indicators of risk – in their supply chains. For Chinese companies investing in, trading, importing, processing, transporting or manufacturing using timber, these 'red flags' should include the following:

- The country from which the company's timber originates or where its investments are located is known to be experiencing problems relating to conflict, illegality, corruption, and unclear or disputed forest and land tenure.
- The sub-national region from which the company's timber originates or where its investments are located is close to the border with a country which is known to have problems of illegality,

corruption, unclear or disputed land tenure and weak law enforcement. (This is to address the common problem of illegal timber trade across international boundaries.)
- The particular species of timber the company is using is protected by national laws or international conventions; for instance the species is CITES listed.
- The particular species of timber the company is buying is labelled as originating from a country or sub-national region that has limited or no known forests containing this kind of tree.
- The timber is labelled as originating from a country or sub-national region where illegal timber is known to transit and where there is therefore a risk of supplies of local and transited timber being mixed together.
- The company's immediate or indirect suppliers or its investment partners have invested in or sourced timber within the past 12 months in a way that raises one of the above 'red flags'.
- The company's immediate or indirect suppliers or its investment partners have shareholder or other interests in businesses that invest or source timber in a way that raises one of the above 'red flags'.

If companies can demonstrate that they are not using any timber originating from places or in situations that raise any of these 'red flags', then their supply chain due diligence need go no further. However, if they are investing in, trading, importing, processing, transporting or manufacturing timber that originates from a region, or is produced in a set of circumstances, that falls into one of the 'red flag' categories identified above, then they should undertake the five step due diligence measures detailed below.

## 1. Strengthening company management systems

As set out in the UN due diligence standard, there four elements in particular that are crucial to strengthening company management systems:

**Devising, communicating to suppliers and investment partners, and publishing a company policy on timber purchases and forestry investments** – this company policy should be fully in line with the SFA's Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises; so setting out a clear and unambiguous commitment that the company will **ensure that the activities being invested in are legal and that all timber is legally harvested and traded**. The company should use this policy as a basis for assessing its own investments and purchasing practices and those of its investment partners and suppliers of timber.

**Structuring internal company management systems to meet the aims of the guidelines and carry out effective due diligence** – in practice this means appointing a senior member of staff, preferably a director, to take responsibility for overseeing the due diligence, assigning sufficient budgetary and other resources, and disseminating the company's policy across all departments. It also requires the creation of a system of internal accountability by which the company can ensure that the due diligence is properly carried out.

**Putting in place a chain of custody system for the company's timber supplies** – this entails measures that will enable the company to obtain, on a consistent basis, the following types of data on the precise nature and origin of the materials and the complete supply chain: the species of timber; the exact cutting site, down to the level of harvesting coupe, block and concession and proof of legal right to harvest; the identity of the company carrying out the harvesting; the transportation route; the point of export from the country of origin and the identity of all intermediary companies that have transported, traded or processed the timber.

**Introducing a system by which 'whistle-blowers' with information about any risks or actual problems in the supply chain, or relating to investments, can contact the company** – this requires having a designated person within the company who is accountable for receiving, and responding to any such information. The company should establish a set of protocols for handling any such data so that whistle-blowers' identity and security are protected. The company should also ensure there is a means by which people can easily provide information, for instance by setting up a mechanism for receiving communications through the company's website, or by creating a special 'hotline' phone number.

## 2. Identifying and assessing risks in the supply chain and in forestry investments

Having established the controls systems set out in step 1, the company will need to identify and assess the particular risks that its timber purchases or forestry investments entail.

Upstream companies should carry out a risk assessment following measures (i) to (iv) below.

'Downstream' companies should identify risks of illegal timber entering their supply chain by assessing the due diligence practices of the companies that transformed the raw logs into part-processed timber – the 'log processors' – against the steps 1-5 set out in this guide.

'Downstream' companies may cooperate with other firms to identify the 'log processors' in their supply chains and to carry out joint assessments of these 'log processors'' due diligence. 'Downstream' companies retain individual responsibility for carrying out due diligence to the standards set out in this guide, however.

Risk assessment by 'upstream' companies:

**(i) Identify main risks of illegality** – companies performing due diligence should use any information that they have gathered under step 1, for example through chain of custody documentation, to identify the main risks in their supply chains and investments with reference to the 'red flag' indicators suggested above. They should then proceed to carry out more detailed assessments, depending on the level of risk, as described below.

**(ii) Obtain and review further documentation** – Key documents to assist in identification of risks relating to legality include: evidence of consent to logging taking place by local people who have customary rights to forest land and resources; environmental and social impact assessments; forest management plans; annual operating plans; social agreements between companies and local communities; receipts for payments of relevant taxes and fees; permits for harvesting, processing, transporting or exporting timber. In the case of CITES-listed timber, the company should obtain CITES certificates and cross-check these with CITES conditions on trade regarding the species concerned.

Having obtained these and other documents, the company must make an assessment of their authenticity. Corruption is a serious problem in most timber-producing countries and document fraud is commonplace. Where the company finds indications that the documents are fraudulent or have been obtained in a fraudulent manner, it should disengage from the supplier or the investment concerned in line with Step 3 – Designing and implementing a strategy to respond to identified risks (below).

As well as obtaining and assessing documentation, companies should review independent third party assessments of the conditions in the countries where they are investing, or the countries from which the timber they are purchasing originates, in terms of levels of illegal logging and corruption. These should include reports by international organisations (e.g. UN and World Bank), researchers and scholars, international and local non-governmental organisations and the media. A good example of an authoritative resource on risks of illegality in the international timber trade is the website run by the think tank Chatham House, http://www.illegal-logging.info/. Companies should also consult recognised indices of corruption such as the Transparency International Corruption Perceptions Index.[3]

The company should seek to obtain information on the beneficial ownership (the identity of the ultimate owners), the corporate structures and principal officers of all those businesses that are involved in harvesting, trading, or transporting the timber that it is purchasing or those which are involved in, or providing services to, its investments. This will help the company detect risks of fraud or corruption and will, in turn, reduce the likelihood of it becoming implicated in illegal activities.

**(iii) Carry out on the ground assessments** – where the timber the company is buying is coming from, or investments are sited in, high risk areas of the kind defined under the 'red flag' indicators above, documentation cannot, on its own, provide a reliable basis for identifying risks and on the ground assessments are required. This is because in places where the rule of law is weak, the chances of documentation being incomplete, fraudulent or having been obtained through corruption are high. The on the ground assessment should go beyond review of documents and include first hand interviews with people living in and around forests from which the timber the company is using is being logged, as well as interviews with local and international civil society groups and with independent experts.

The UN Due Diligence Guidelines allow companies to undertake these kinds of on the ground assessments jointly, or commission third parties (along the lines of certification firms) to carry them out. An important qualification to this ability to enlist help from certifiers or other third parties is that the company retains full responsibility for gathering complete and accurate information on risks relevant to its own investments and timber supply chains. If, for instance, a timber trading company chooses to use data from a certification body which proves to be flawed, the company, rather than the certifier, must be held responsible for any resultant failure to exclude illegally harvested timber from its supply chain.

Equally, with regards to existing international timber certification schemes, such as the Forest Stewardship Council for example, the company can refer to the data contained within certifiers' assessments as part of its evaluation of risk. If the certification system is reputable and internationally recognised, then it may be able to provide the company with a good deal of the information it requires to carry out the risk assessment component of its due diligence. Simply obtaining a timber certificate is not a substitute, however, for the company undertaking its own on the ground risk assessment or other aspects of its due diligence. (It is worth noting that, for similar reasons, the EU Timber Regulation does not allow companies to offer certification as proof of legality.)

**(iv) Assess risks in the supply chain** – the company should assess the information it gathers against the following standards:

[3] Transparency International, *Corruption Perceptions Index*, http://www.transparency.org/research/cpi/overview.

- The State Forest Administration Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises
- The State Forest Administration and Ministry of Commerce Guide on Sustainable Overseas Forests Management and Utilisation by Chinese Enterprises (2009)
- The State Forest Administration and Ministry of Commerce Guide on Sustainable Overseas Silviculture by Chinese Enterprises (2007)
- National laws of the countries where the timber originates or transits
- International standards, such as UN Security Council resolutions, the UN Declaration on the Rights of Indigenous Peoples and the International Labour Organisation conventions

On this basis, the company should determine whether it is meeting the SFA Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises objective of ensuring that the activities being invested in are legal and that all timber is legally harvested and traded. Any instances where this may not be the case should be considered risks that require disengagement or mitigation.

## 3. Designing and implementing a strategy to respond to identified risks

Having identified and assessed risks, the company should pursue an approach based either on disengagement or mitigation:

**Disengagement** – where the assessment described in Step 2 reveals <u>evidence</u> of illegal timber entering the company's supply chain or of illegal activities associated with its investments, then the company's response should be disengagement from the relevant suppliers and business ventures. Disengagement could be accompanied by mutual agreement between the company and its supplier or investment partners of the performance objectives they need to meet before a business relationship may resume.

**Time-bound risk mitigation plan** – where the assessment process reveals <u>risks</u> of illegal timber entering the company's supply chain or other illegal activities associated with its investments, then the company should work with its supplier or partners and put in place – and publish – a time-bound action plan to ensure that the risk is eliminated. The time frame, in such cases, for improving operations to a point where all risks of illegal activities are addressed, should be no longer than six months. If, after that time, there remains a risk of illegal activity, then the company should disengage from the investments or supply chain relationships concerned.

If a company is pursuing a risk mitigation plan, it should undertake regular reviews to ensure that it remains informed of any relevant developments and the progress of its suppliers or its investments towards eliminating all risks of illegality.

## 4. Ensuring independent third-party audits

Independent checks are required to ensure the integrity of the due diligence process. At a minimum, the companies that are the last link in the 'upstream' part of the supply chain – the 'log processors' should commission regular audits of their due diligence measures as follows:

**Selecting an auditor** – in accordance with international auditing standards (the UN encourages individuals and entities to consult ISO 19011:2002 for detailed audit requirements) audit organisations must be independent and must not have conflicts of interest with the companies they are auditing.

**Auditors' review of documentation** – this should examine samples of all documentation and other evidence compiled and produced through the company's due diligence on timber supply chains or investments that raise 'red flag' risk indicators. The document review should aim to determine whether the due diligence is sufficient to exclude illegally harvested timber from the supply chain and to ensure that the activities the company is investing in are entirely legal.

**Auditors' verification measures, including site visits** – auditors should cross-check and supplement the data obtained through the document review via interviews with company staff, suppliers and external observers. In its due diligence guidelines, the UN further recommends site visits to a sample of suppliers, all the way back to the original point of extraction if necessary.

**Auditors' report** – having completed their information gathering, auditors should report on the company's compliance with the SFA Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises. The auditors should also make recommendations to the company on how to improve its due diligence.

## 5. Publicly disclosing due diligence and findings

To ensure that the public can access data on what due diligence the company has undertaken, the company should publish this information on its website. There should be a clear link from the company's home page to the pages outlining its due diligence. Companies should publish this data not only in Chinese, but also in the main language of the country in which the timber they use is produced.

This reporting should encompass the following:

- The company's timber trade and investment policy (described in point 1, above, and which must be based on the SFA's Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises)
- Information on how the company controls its timber supply chain and investments, who is responsible for implementing them, and the data that these management systems have generated
- The company's risk assessments, including the on the ground investigations, and an outline of the methodology that the company has used
- The company's risk mitigation strategy – if it is pursuing one – and its implementation
- 'Log processors'' audit reports on their due diligence – these should be published. Information on pricing may be removed in order to maintain business confidentiality, if necessary.