

# DEPARTMENT OF COMMERCE'S OBLIGATIONS FOR INDEPENDENT PRIVATE SECTOR AUDITS: COMMERCE DESERVES A BREAK



**A White Paper by**  
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**OCTOBER 2016**



The GAO's third annual report, (Aug. 2016) came down hard on Commerce for not fulfilling a statutory requirement pertaining to the Independent Private Sector Audit (IPSA) provision of the SEC Rule.

DHC believes there are valid reasons that Commerce's delay has served the best interests of stakeholders.

This white paper outlines three of these reasons, and provides insights into how Commerce may forge a path forward.



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# Department of Commerce Must Fulfill Statutory Obligations for Conflict Minerals: But How? And When?

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## 1.0 INTRODUCTION

Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Conflict Minerals”) instructed the Securities and Exchange Commission (SEC), Department of Commerce (“Commerce”) and the Government Accountability Office (“GAO”) to take specified actions<sup>1</sup>. The GAO’s third annual report, published in August 2016, came down hard on Commerce for not fulfilling a statutory requirement pertaining to the Independent Private Sector Audit (IPSA) provision of the SEC Rule.



INTERNATIONAL  
**T R A D E**  
ADMINISTRATION

Douglas Hileman Consulting LLC (DHC) believes that Commerce really had no choice. DHC has no insights into the usual government machinery behind the scenes, such as budgeting, resources, priorities, competing interests, or politics. These have undoubtedly contributed to delays. Even without these, DHC believes that Commerce has been acting responsibly by not taking actions to date.

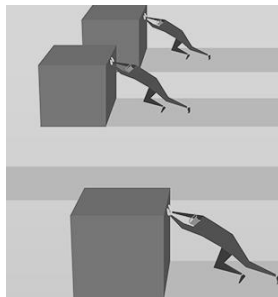
DHC believes there are many valid reasons that Commerce’s delay has served the best interests of many stakeholders, including auditors, the regulated community, the subcommittees of Congress to which they will report, interested stakeholders (Non-Governmental Organizations, etc.), and the taxpayers who will ultimately foot the bill for Commerce’s efforts. We outline three in this white paper, and provide some considerations that Commerce may be facing in forging their path forward.

<sup>1</sup> See GAO’s Report entitled “Companies Face Continuing Challenges...”, released in August 2016; Available at <http://www.gao.gov/products/GAO-16-805>



## 2.0 THREE REASONS DEPARTMENT OF COMMERCE DESERVES A BREAK

After learning that the Department of Commerce was seeking to learn more about Independent Private Sector Audits (IPSAs) as it pertains to companies subject to Section 1502 of The Dodd-Frank Wall Street Reform and Consumer Protection Act, DHC took a fresh look at the Department of Commerce's mandate in the statute. The Government Accountability Office (GAO) published their third annual report on conflict minerals shortly thereafter, calling out Commerce in no uncertain terms for failing to fulfill their statutory obligations. This prompted DHC to dig even deeper for valid reasons – independent of government bureaucracy – for the delay.



After considering the background of the many moving parts that contribute to compliance and risk management of conflict minerals, DHC identified many valid reasons for Commerce's delay. In fact, DHC maintains that the delay will ultimately prove to be beneficial to stakeholders interested in the issue, regardless of their viewpoint. DHC provides three of those reasons in this white paper, including background, our analysis, and perspectives on options available to Commerce at this time.

### 2.1 Awkward Statutory Instructions

#### **Reason #1**

DHC believes the statute uses terms in ways that are not the norm in the auditing community; as a result, it is not apparent how Commerce would fulfill them.

#### **Background**

The statute instructs the Secretary of Commerce, not later than 30 months after the date of enactment of this Act<sup>2</sup>, to “submit to the appropriate congressional committees a report that includes the following:

- (A) An assessment of the accuracy of the independent private sector audits and other due diligence processes described under section 13(p) of the Securities and Exchange Act of 1934.
- (B) Recommendations for the processes used to carry out such audits, including ways to
  - I. Improve the accuracy of such audits; and
  - II. Establish standards of best practices
- (C) A listing of all known conflict minerals processing facilities worldwide.

<sup>2</sup> See <https://www.congress.gov/bill/111th-congress/house-bill/4173/text>



### DHC Analysis

President Obama signed Dodd-Frank into law on July 21, 2010. Thirty months from enactment of the [Dodd-Frank... Act] would have been approximately February 2013. The SEC did not publish the final conflict minerals rule until August 2012 (“SEC Rule” or “the Rule”). Even giving Commerce 30 months from publication of the SEC Rule, they should have submitted their report by March 2015 or shortly thereafter.



However, auditors do not generally refer to audits as being “accurate.” Auditors commonly describe their audits as being performed according to specific criteria; or as using specified auditing frameworks, standards, or methodologies.

Audits are often done to ensure [more] accurate reporting as done by the audited entity (“auditee”). An auditor may be expected to accurately communicate the audit objectives and conclusions. But the audit itself is not generally described as “accurate.”

Similarly, processes are not generally described as being “accurate.” A process should be designed and implemented to achieve an objective or goal. Think about a business process you have done, such as completing paperwork on your first day of a new job. The process’s objectives could be to gather all information required to ensure timely and accurate pay, appropriate access (and limitations) to building areas and IT systems, and to enroll you in all benefits you are entitled to or opt to take. The intake *process* could be described as cumbersome, smooth, efficient, comprehensive, clear, confusing, slow, or many other ways. The IT systems you encounter may not be intuitive, or allow for options you wish. Some people involved may not know how to administer some aspects of the process. These are a matter of proper design or implementation of the process, in order to meet organizational objectives. An objective may be to obtain an accurate profile of you and the expectations for your new job – but the process itself isn’t “accurate”.



Since the statutory instructions do not align with common terminology or concepts in the auditing community, Commerce could encounter problems in being responsive to these aspects of their mandate.



### Options for Commerce

DHC suggests that Commerce has two options with regard to this aspect of their mandate:

1. Proceed to answer the questions as asked, or
2. Answer a similar question that addresses an underlying concern.

## 2.2 Few IPSAs

### Reason #2

DHC believes that the number of IPSAs submitted to the SEC is insufficient to provide for analysis that would support a meaningful conclusion, with respect to the influence of IPSAs on due diligence conducted across regulated companies.

### Background

SEC's final rule for conflict minerals was published August 22, 2012<sup>3</sup>. The SEC Rule sets forth a three step approach:

- 1) Determine applicability
- 2) Conduct a Reasonable Country of Origin Inquiry (RCOI), and (depending upon ability to draw certain conclusions),
- 3) Proceed with additional due diligence.

The Rule requires all regulated companies to submit a Form SD annually. Companies that performed due diligence are also required to submit a Conflict Minerals Report (CMR). The SEC Rule included two objectives for the IPSA, following the statute's mandate to the SEC as to an Independent Private Sector Audit (IPSA). After a two year transition period, the Rule requires some assurance, in that all issuers submitting a CMR would be required to obtain and submit an IPSA<sup>4</sup>.



<sup>3</sup> See <https://www.sec.gov/rules/final/2012/34-67716.pdf>

<sup>4</sup> This is, of course, a significant simplification of the Rule. Readers are encouraged to read the entire 356 pages of it, as well as subsequent SEC guidance for a better understanding.



In the Rule, the SEC indicated that one consultant estimated that 6,000 companies would be regulated, and the SEC used 5,994<sup>5</sup> as the basis for the number of affected public issuers. The SEC included data provided by a manufacturing industry, using a basis of 4,500 issuers affected by the IPSA requirements<sup>6</sup>.

### DHC Analysis

There were other early estimates that variously estimated the number of companies that would be subject to the SEC Conflict Minerals Rule within a range of approximately 5,000 to 8,000 companies. The manufacturing industry's estimate suggests that approximately 75% of regulated companies would procure an IPSA. The GAO's report on the third reporting year used a basis of 80% for the number of regulated companies that would submit a CMR. (page 21)



Several aspects of the SEC Rule have not turned out as expected, including those listed below.

- **Estimates of regulated community:** The initial estimates for the number of companies submitting filings were very high. For the Reporting Year (RY) 2014, 1,321 companies submitted filings. For RY 2015, the number was 1,283<sup>7</sup>. This is only 20 to 30% of the number initially estimated.
- **Legal challenges:** As a result of legal challenges, many aspects of the SEC Conflict Minerals Rule have been deferred. Notable among them is that, until further guidance, public issuers are required to procure and submit an IPSA only if they elect to conclude (and report) that they manufacture or contract to manufacture at least one product that is "DRC Conflict Free" – and use those specific words. As a result, few companies have done so.

Nineteen companies submitted IPSAs for the reporting year (RY) 2015. This is a jump over the six and four companies that submitted IPSAs for RY 2014 and RY 2013, respectively. Still, it makes for a very small data set – and much less than anticipated when SEC published the final rule.

<sup>5</sup> Ibid., p. 262

<sup>6</sup> Ibid., page 250

<sup>7</sup> See GAO's Report entitles "Companies Face Continuing Challenges....", released in August 2016; Available at <http://www.gao.gov/products/GAO-16-805>





**Table 1, Number of IPSAs for the 2015 Reporting Year, Compared to Estimates at Time of Publication of SEC Rule**

Many companies have procured other independent reviews of various aspects of their conflict minerals programs. These have included IPSA Readiness Assessments,

Parameter	Expectation at Publication of SEC Rule (August 2012)	Situation after 2015 Reporting Year (RY) (at June 2016)
Number of filers	~5,000 to 8,000	~1,300
Number of IPSAs Submitted for RY 2015	~4,500 to 6,400	19

conflict minerals program reviews, or other types of service offerings. In some cases, customers have conducted these reviews as part of their own conflict minerals programs or corporate risk management efforts. Some companies have indicated this in their CMRs, but they are not obliged to do so. These companies have had a preview of what an IPSA would be like, and have had the opportunity to improve their programs (including due diligence efforts).

#### Options for Commerce

DHC suggests that options available to Commerce include:

1. Compare CMRs submitted by companies that procured IPSAs with companies that did not.
2. Consider other ways to assess the effect of IPSAs – whether they were conducted or not – on due diligence practices.

*Either approach has advantages and limitations. In either case, DHC suggests that Commerce (or resource(s) they engage) approach the effort with the same degree of diligence as they would a performance audit.*

## 2.3 Content of IPSA Reports

### Reason #3

DHC notes that Independent Private Sector Audit (IPSA) reports do not include enough information to enable meaningful analysis; nor do the filer's Conflict Minerals Report (CMR) that has been subject to the IPSA.





## Background

There are two objectives for the IPSA, namely for the auditor to express an opinion or conclusion as to whether:



- 1) the design of the issuer’s due diligence measures as set forth in the Conflict Minerals Report, with respect to the period covered by the report, is in conformity with, in all material respects, the criteria set forth in the nationally or internationally recognized due diligence framework used by the issuer, and
- 2) the issuer’s description of the due diligence measures it performed as set forth in the Conflict Minerals Report, with respect to the period covered by the report, is consistent with the due diligence process that the issuer undertook<sup>8</sup>.

IPSA’s must be done using Generally Accepted Government Auditing Standards (GAGAS)<sup>9</sup> - “Yellow Book” – with CPAs using attestation standards and non-CPA auditors using performance audit standards.

## DHC Analysis

Objective 1 incorporates the concept of materiality. Materiality has been used in financial reporting for decades. The Global Reporting Initiative’s (GRI) G4 guidelines<sup>10</sup> is GRI’s first version to incorporate materiality into Sustainability (non-financial) reporting.



Materiality remains a matter of professional judgment. Auditors (and/ or the companies themselves) must consider various scenarios, the likelihood they will occur, and the potential impact (either without or with controls). Auditors must ask themselves, “Material to whom? Based upon what evidence or support?”

The IPSA Auditor fulfills Objective 2 by reviewing what the issuer has elected to say about its “steps taken” for due diligence. This is far from the complete content in the CMR. Indeed, the issuer is under no obligation to provide a complete description of the steps they took for due diligence; they can drive the scope of the IPSA Audit by how much they provide, and how they describe it.

<sup>8</sup> SEC Final Rule, p. 217

<sup>9</sup> Available at: <http://www.gao.gov/products/GAO-12-331G>

<sup>10</sup> See [www.globalreporting.org](http://www.globalreporting.org)



IPSA Audit reports are brief. Indeed, most audit reports are brief. Attestation audit reports follow an outline and format that is familiar to anyone who reads financial auditor's assurance in company financial filings. IPSAs done to performance standards are a bit more descriptive, but still generally two pages or less. The filers' CMRs are brief, with most CMRs at seven pages or less. The portions of the filer's CMR that discuss due diligence (and are within scope of the IPSA) could be as little as one page – and this is for effort that required considerable time and resources for the reporting period.



The vast majority of what an auditor does, and what the auditee does for the underlying subject matter, is not provided in reports generated by either entity. This makes it difficult to assess the quality of the audit from the published report.

#### Options for Commerce

*DHC suggests that Commerce has two options:*

1. *Rely on publicly-reported information (IPSA, CMR) to gather information on the nexus between IPSAs and due diligence; or*
2. *Take an alternative approach. Commerce could recognize that companies have considered IPSAs from a variety of perspectives, including:*
  - *Obtaining an IPSA*
  - *Obtaining an assessment of IPSA readiness or the conflict minerals program*
  - *Awareness, via discussion in industry associations*
  - *No consideration of IPSAs or their objectives.*



### 3.0 CONCLUDING REMARKS

The Independent Private Sector Audit is a construct of the Dodd-Frank statute. Congress did not mandate an “Independent Conflict Minerals Audit.” The two objectives in the SEC Rule make this IPSA applicable to conflict minerals.

Several factors have contributed to full adoption of the SEC Rule. As DHC has written elsewhere, Section 1502 is arguably the first requirement where an SEC disclosure has been required due to a driver that is primarily social (non-financial) in nature. Programs to engage with supply chains, exchange relevant and reliable information, and create appropriate systems for reporting took a few years to evolve.

Ongoing litigation has had the effect of deferring actions on key aspects of the SEC Rule, including the requirement for IPSAs. What’s more, the 2016 elections could play a role in the direction of the SEC Rule in the coming year.

Any approach Commerce takes poses challenges.

- If Commerce proceeds to answer the questions directly, they may compile data and information that does not lead to meaningful conclusions or insights.
- If Commerce elects to address issue(s) to meet the underlying intent of “audit [and due diligence process] accuracy”, there are risks it could focus on the wrong issues.

Either way, Commerce runs the risk of arousing the ire of Congressional sub-committees, and/or producing information of little use to the regulated community or other stakeholders.

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#### Questions? Comments? More Information?

I invite your questions, comments and insights. Contact DHC at [www.douglashileman.com](http://www.douglashileman.com) for information on IPSAs, the challenges posed by Department of Commerce, and insights on reasonable options for a path forward. Also, visit [www.DFCMAudit.com](http://www.DFCMAudit.com) for more information on IPSAs and related matters.



## About Douglas Hileman



One consultant that has done annual analyses of SEC conflict minerals filings each year rated the quality of IPSAs for the first time in their analysis of the 2015 filings. They rated Douglas Hileman Consulting LLC's IPSA as the best of all the firms providing IPSAs<sup>1</sup>, with a rating of 95%. Although DHC is gratified by the rating, it is also worth considering that this is based only on publicly-available information.

Douglas Hileman, CRMA, CPEA, P.E. has led his own firm for over seven years. He draws from over 35 years of experience in many aspects of operations, compliance, business strategy, enterprise risk management, non-financial reporting, audit readiness, and auditing. He worked at PricewaterhouseCoopers for six years, where he supported financial audits, internal audits, and other engagements involving governance, risk management, compliance. He also has nine years of experience in industry.

Douglas commented on the draft SEC Rule for conflict minerals. He has worked with clients in Advisory and Assurance roles for conflict minerals. As an advisor, he helped incorporate elements of other compliance and risk management frameworks into conflict minerals programs, anticipating inquiries from customers and senior management. His firm conducted one of the first four Independent Private Sector Audits (IPSAs), submitted for the 2013 reporting period. His firm has conducted an IPSA for each subsequent reporting period.

He is active in the Institute of Internal Auditors. He holds credentials as a Certified Risk Management Assurance professional (CRMA), Certified Professional Environmental/ Health & Safety Auditor (CPEA, Management Systems focus), Professional Engineer (chemical), and a Qualified Environmental Professional. He has submitted comments on the SEC's Concept Release on Regulation S-K, Integrated Reporting Framework (and its assurance), and numerous other standards and regulations. He has presented "Frameworks for Non-Financial Reporting" at several meetings of the Institute of Internal Auditors. His firm serves clients nationwide from Los Angeles.

See [www.DFCMAudit.com](http://www.DFCMAudit.com) for more resources on IPSAs and related aspects of conflict minerals.

See [www.douglashileman.com](http://www.douglashileman.com) for more resources on environmental, safety, non-financial reporting, compliance, and risk management.

Continue the conversation with Douglas Hileman on [LinkedIn](#).