

BusinessWeek Online

November 27, 2006

Secrets, Lies, And Sweatshops

American importers have long answered criticism of conditions at their Chinese suppliers with labor rules and inspections. But many factories have just gotten better at concealing abuses.

Tang Yinghong was caught in an impossible squeeze. For years, his employer, Ningbo Beifa Group, had prospered as a top supplier of pens, mechanical pencils, and highlighters to Wal-Mart Stores ([WMT](#)) and other major retailers. But late last year, Tang learned that auditors from Wal-Mart, Beifa's biggest customer, were about to inspect labor conditions at the factory in the Chinese coastal city of Ningbo where he worked as an administrator. Wal-Mart had already on three occasions caught Beifa paying its 3,000 workers less than China's minimum wage and violating overtime rules, Tang says. Under the U.S. chain's labor rules, a fourth offense would end the relationship.

Help arrived suddenly in the form of an unexpected phone call from a man calling himself Lai Mingwei. The caller said he was with Shanghai Corporate Responsibility Management & Consulting Co., and for a \$5,000 fee, he'd take care of Tang's Wal-Mart problem. "He promised us he could definitely get us a pass for the audit," Tang says.

Lai provided advice on how to create fake but authentic-looking records and suggested that Beifa hustle any workers with grievances out of the factory on the day of the audit, Tang recounts. The consultant also coached Beifa managers on what questions they could expect from Wal-Mart's inspectors, says Tang. After following much of Lai's advice, the Beifa factory in Ningbo passed the audit earlier this year, Tang says, even though the company didn't change any of its practices.

For more than a decade, major American retailers and name brands have answered accusations that they exploit "sweatshop" labor with elaborate codes of conduct and on-site monitoring. But in China many factories have just gotten better at concealing abuses. Internal industry documents reviewed by BusinessWeek reveal that numerous Chinese factories keep double sets of books to fool auditors and distribute scripts for employees to recite if they are questioned. And a new breed of Chinese consultant has sprung up to assist companies like Beifa in evading audits. "Tutoring and helping factories deal with audits has become an industry in China," says Tang, 34, who recently left Beifa of his own volition to start a Web site for workers.

A lawyer for Beifa, Zhou Jie, confirms that the company employed the Shanghai consulting firm but denies any dishonesty related to wages, hours, or outside monitoring. Past audits had "disclosed some problems, and we took necessary measures correspondingly," he explains in a letter responding to questions. The lawyer adds that Beifa has "become the target of accusations" by former employees "whose unreasonable

demands have not been satisfied." Reached by cell phone, a man identifying himself as Lai says that the Shanghai consulting firm helps suppliers pass audits, but he declines to comment on his work for Beifa.

Wal-Mart spokeswoman Amy Wyatt says the giant retailer will investigate the allegations about Beifa brought to its attention by BusinessWeek. Wal-Mart has stepped up factory inspections, she adds, but it acknowledges that some suppliers are trying to undermine monitoring: "We recognize there is a problem. There are always improvements that need to be made, but we are confident that new procedures are improving conditions."

CHINESE EXPORT manufacturing is rife with tales of deception. The largest single source of American imports, China's factories this year are expected to ship goods to the U.S. worth \$280 billion. American companies continually demand lower prices from their Chinese suppliers, allowing American consumers to enjoy inexpensive clothes, sneakers, and electronics. But factory managers in China complain in interviews that U.S. price pressure creates a powerful incentive to cheat on labor standards that American companies promote as a badge of responsible capitalism. These standards generally incorporate the official minimum wage, which is set by local or provincial governments and ranges from \$45 to \$101 a month. American companies also typically say they hew to the government-mandated workweek of 40 to 44 hours, beyond which higher overtime pay is required. These figures can be misleading, however, as the Beijing government has had only limited success in pushing local authorities to enforce Chinese labor laws. That's another reason abuses persist and factory oversight frequently fails.

Some American companies now concede that the cheating is far more pervasive than they had imagined. "We've come to realize that, while monitoring is crucial to measuring the performance of our suppliers, it doesn't per se lead to sustainable improvements," says Hannah Jones, Nike Inc.'s (NKE) vice-president for corporate responsibility. "We still have the same core problems."

This raises disturbing questions. Guarantees by multi-nationals that offshore suppliers are meeting widely accepted codes of conduct have been important to maintaining political support in the U.S. for growing trade ties with China, especially in the wake of protests by unions and antiglobalization activists. "For many retailers, audits are a way of covering themselves," says Aurret van Heerden, chief executive of the Fair Labor Assn., a coalition of 20 apparel and sporting goods makers and retailers, including Nike, Adidas Group, Eddie Bauer, and Nordstrom (JWN). But can corporations successfully impose Western labor standards on a nation that lacks real unions and a meaningful rule of law?

Historically associated with sweatshop abuses but now trying to reform its suppliers, Nike says that one factory it caught falsifying records several years ago is the Zhi Qiao Garments Co. The dingy concrete-walled facility set near mango groves and rice paddies in the steamy southern city of Panyu employs 600 workers, most in their early 20s. They wear blue smocks and lean over stitching machines and large steam-blasting irons. Today the factory complies with labor-law requirements, Nike says, but Zhi Qiao's general manager, Peter Wang, says it's not easy. "Before, we all played the cat-and-mouse game,"

but that has ended, he claims. "Any improvement you make costs more money." Providing for overtime wages is his biggest challenge, he says. By law, he is supposed to provide time-and-a-half pay after eight hours on weekdays and between double and triple pay for Saturdays, Sundays, and holidays. "The price [Nike pays] never increases one penny," Wang complains, "but compliance with labor codes definitely raises costs."

A Nike spokesman says in a written statement that the company, based in Beaverton, Ore., "believes wages are best set by the local marketplace in which a contract factory competes for its workforce." One way Nike and several other companies are seeking to improve labor conditions is teaching their suppliers more efficient production methods that reduce the need for overtime.

The problems in China aren't limited to garment factories, where labor activists have documented sweatshop conditions since the early 1990s. Widespread violations of Chinese labor laws are also surfacing in factories supplying everything from furniture and household appliances to electronics and computers. Hewlett-Packard, (HPQ) Dell (DELL), and other companies that rely heavily on contractors in China to supply notebook PCs, digital cameras, and handheld devices have formed an industry alliance to combat the abuses.

A compliance manager for a major multinational company who has overseen many factory audits says that the percentage of Chinese suppliers caught submitting false payroll records has risen from 46% to 75% in the past four years. This manager, who requested anonymity, estimates that only 20% of Chinese suppliers comply with wage rules, while just 5% obey hour limitations.

A RECENT VISIT by the compliance manager to a toy manufacturer in Shenzhen illustrated the crude ways that some suppliers conceal mistreatment. The manager recalls smelling strong paint fumes in the poorly ventilated and aging factory building. Young women employees were hunched over die-injection molds, using spray guns to paint storybook figurines. The compliance manager discovered a second workshop behind a locked door that a factory official initially refused to open but eventually did. In the back room, a young woman, who appeared to be under the legal working age of 16, tried to hide behind her co-workers on the production line, the visiting compliance manager says. The Chinese factory official admitted he was violating various work rules.

The situation in China is hard to keep in perspective. For all the shortcomings in factory conditions and oversight, even some critics say that workers' circumstances are improving overall. However compromised, pressure from multinationals has curbed some of the most egregious abuses by outside suppliers. Factories owned directly by such corporations as Motorola Inc (MOT). and General Electric Co. (GE) generally haven't been accused of mistreating their employees. And a booming economy and tightening labor supply in China have emboldened workers in some areas to demand better wages, frequently with success. Even so, many Chinese laborers, especially migrants from poor rural regions, still seek to work as many hours as possible, regardless of whether they are properly paid.

In this shifting, often murky environment, labor auditing has mushroomed into a multimillion-dollar industry. Internal corporate investigators and such global auditing agencies as Cal Safety Compliance, sgs of Switzerland, and Bureau Veritas of France operate a convoluted and uncoordinated oversight system. They follow varying corporate codes of conduct, resulting in some big Chinese factories having to post seven or eight different sets of rules. Some factories receive almost daily visits from inspection teams demanding payroll and production records, facility tours, and interviews with managers and workers. "McDonald's (MCD), Walt Disney, (DIS) and Wal-Mart are doing thousands of audits a year that are not harmonized," says van Heerden of Fair Labor. Among factory managers, "audit fatigue sets in," he says.

Some companies that thought they were making dramatic progress are discovering otherwise. A study commissioned by Nike last year covered 569 factories it uses in China and around the world that employ more than 300,000 workers. It found labor-code violations in every single one. Some factories "hide their work practices by maintaining two or even three sets of books," by coaching workers to "mislead auditors about their work hours, and by sending portions of production to unauthorized contractors where we have no oversight," the Nike study found.

THE FAIR LABOR ASSN. released its own study last November based on unannounced audits of 88 of its members' supplier factories in 18 countries. It found an average of 18 violations per factory, including excessive hours, underpayment of wages, health and safety problems, and worker harassment. The actual violation rate is probably higher, the fla said, because "factory personnel have become sophisticated in concealing noncompliance related to wages. They often hide original documents and show monitors falsified books."

While recently auditing an apparel manufacturer in Dongguan that supplies American importers, the corporate compliance manager says he discussed wage levels with the factory's Hong Kong-based owner. The 2,000 employees who operate sewing and stitching machines in the multi-story complex often put in overtime but earn an average of only \$125 a month, an amount the owner grudgingly acknowledged to the compliance manager doesn't meet Chinese overtime-pay requirements or corporate labor codes. "These goals are a fantasy," the owner said. "Maybe in two or three decades we can meet them."

Pinning down what Chinese production workers are paid can be tricky. Based on Chinese government figures, the average manufacturing wage in China is 64 cents an hour, according to the U.S. Bureau of Labor Statistics and demographer Judith Banister of Javelin Investments, a consulting firm in Beijing. That rate assumes a 40-hour week. In fact, 60- to 100-hour weeks are common in China, meaning that the real manufacturing wage is far less. Based on his own calculations from plant inspections, the veteran compliance manager estimates that employees at garment, electronics, and other export factories typically work more than 80 hours a week and make only 42 cents an hour.

BusinessWeek reviewed summaries of 28 recent industry audits of Chinese factories serving U.S. customers. A few factories supplying Black & Decker, (BDK) Williams-

Sonoma, and other well-known brands turned up clean, the summaries show. But these facilities were the exceptions.

At most of the factories, auditors discovered records apparently meant to falsify payrolls and time sheets. One typical report concerns Zhongshan Tat Shing Toys Factory, which employs 650 people in the southern city of Zhongshan. The factory's main customers are Wal-Mart and Target. (TGT) When an American-sponsored inspection team showed up this spring, factory managers produced time sheets showing each worker put in eight hours a day, Monday through Friday, and was paid double the local minimum wage of 43 cents per hour for eight hours on Saturday, according to an audit report.

But when auditors interviewed workers in one section, some said that they were paid less than the minimum wage and that most of them were obliged to work an extra three to five hours a day, without overtime pay, the report shows. Most toiled an entire month without a day off. Workers told auditors that the factory had a different set of records showing actual overtime hours, the report says. Factory officials claimed that some of the papers had been destroyed by fire.

Wal-Mart's Wyatt doesn't dispute the discrepancies but stresses that the company is getting more aggressive overall in its monitoring. Wal-Mart says it does more audits than any other company--13,600 reviews of 7,200 factories last year alone--and permanently banned 141 factories in 2005 as a result of serious infractions, such as using child labor. In a written statement, Target doesn't respond to the allegations but says that it "takes very seriously" the fair treatment of factory workers. It adds that it "is committed to taking corrective action--up to and including termination of the relationship for vendors" that violate local labor law or Target's code of conduct. The Zhongshan factory didn't respond to repeated requests for comment.

An audit late last year of Young Sun Lighting Co., a maker of lamps for Home Depot, (HD) Sears (SHLD), and other retailers, highlighted similar inconsistencies. Every employee was on the job five days a week from 8 a.m. to 5:30 p.m., with a lunch break and no overtime hours, according to interviews with managers, as well as time sheets and payroll records provided by the 300-worker factory in Dongguan, an industrial city in Guangdong Province. But other records auditors found at the site and elsewhere--backed up by auditor interviews with workers--revealed that laborers worked an extra three to five hours a day with only one or two days a month off during peak production periods. Workers said they received overtime pay, but the "auditor strongly felt that these workers were coached," the audit report states.

Young Sun denies ever violating the rules set by its Western customers. In written answers to questions, the lighting manufacturer says that it doesn't coach employees on how to respond to auditors and that "at present, there are no" workers who are putting in three to five extra hours a day and getting only one or two days off each month. Young Sun says that it follows all local Chinese overtime rules.

Home Depot doesn't contest the inconsistencies in the audit reports about Young Sun and three other factories in China. "There is no perfect factory, I can guarantee you," a

company spokeswoman says. Instead of cutting off wayward suppliers, Home Depot says that it works with factories on corrective actions. If the retailer becomes aware of severe offenses, such as the use of child labor, it terminates the supplier. A Sears spokesman declined to comment.

Coaching of workers and midlevel managers to mislead auditors is widespread, the auditing reports and BusinessWeek interviews show. A document obtained last year during an inspection at one Chinese fabric export factory in the southern city of Guangzhou instructed administrators to take these actions when faced with a surprise audit: "First notify underage trainees, underage full-time workers, and workers without identification to leave the manufacturing workshop through the back door. Order them not to loiter near the dormitory area. Secondly, immediately order the receptionist to gather all relevant documents and papers." Other pointers include instructing all workers to put on necessary protective equipment such as earplugs and face masks.

SOME U.S. RETAILERS SAY this evidence isn't representative and that their auditing efforts are working. BusinessWeek asked J.C. Penney Co. (JCP) about audit reports included among those the magazine reviewed that appear to show falsification of records to hide overtime and pay violations at two factories serving the large retailer. Penney spokeswoman Darcie M. Brossart says the company immediately investigated the factories, and its "auditors observed no evidence of any legal compliance issues."

In any case, the two factories are too small to be seen as typical, Penney executives argue. The chain has been consolidating its China supply base and says that 80% of its imports now come from factories with several thousand workers apiece, which are managed by large Hong Kong trading companies that employ their own auditors. Quality inspectors for Penney and other buyers are at their supplier sites constantly, so overtime violations are hard to hide, Brossart says.

Chinese factory officials say, however, that just because infractions are difficult to discern doesn't mean they're not occurring. "It's a challenge for us to meet these codes of conduct," says Ron Chang, the Taiwanese general manager of Nike supplier Shoetown Footwear Co., which employs 15,000 workers in Qingyuan, Guangdong. Given the fierce competition in China for foreign production work, "we can't ask Nike to increase our price," he says, so "how can we afford to pay the higher salary?" By reducing profit margins from 30% to 5% over the past 18 years, Shoetown has managed to stay in business and obey Nike's rules, he says.

But squeezing margins doesn't solve the larger social issue. Chang says he regularly loses skilled employees to rival factories that break the rules because many workers are eager to put in longer hours than he offers, regardless of whether they get paid overtime rates. Ultimately, the economics of global outsourcing may trump any system of oversight that Western companies attempt. And these harsh economic realities could make it exceedingly difficult to achieve both the low prices and the humane working conditions that U.S. consumers have been promised.

By Dexter Roberts & Pete Engardio, with Aaron Bernstein in Washington, Stanley Holmes in Seattle, and Xiang Ji in Beijing