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June 25, 2007

HAND DELIVERY

The Honorable David Spooner
Assistant Secretary for Import Administration
U.S. Department of Commerce
Central Records Unit, Room 1870
U.S. Department of Commerce
Pennsylvania Avenue and 14th Street, N.W.
Washington, DC 20230

PUBLIC DOCUMENT

**Re: Comments Regarding Antidumping Methodologies In Proceedings
Involving Certain Non-Market Economies: Market Oriented
Enterprise**

Dear Mr. Spooner:

These comments are being filed in response to the Department's May 25, 2007 request for comments on its proposal to grant market-oriented status to individual companies, as opposed to industries, in non-market economy ("NME") antidumping proceedings. *Antidumping Methodologies In Proceedings Involving Non-Market Economy Countries: Market-Oriented Enterprise*, 72 Fed. Reg. 29302 (May 25, 2007) ("Request For Comments"). These comments are filed by King & Spalding LLP on behalf of the American Furniture Manufacturers Committee For Legal Trade, the John Maneely Company; New Page Corporation; the Polyethylene Retail Carrier Bag Committee; and the Southern Tier Cement Committee.

In its Request For Comments, the Department asked parties to comment on (1) the conditions and factors that would guide the Department's assessment of the market-orientation of individual enterprises, (2) whether and how a market-oriented enterprise should be identified, and (3) the extent to which the Department should rely on a market-oriented enterprise's prices and costs, particularly for those inputs that are inextricably linked to the broader operating economic environment, *i.e.*, labor, land, and capital. *Id.* at 29303.

The creation of a wholesale exception to the application of the non-market economy for an individual enterprise contravenes U.S. and WTO law and weakens the trade laws to the detriment of U.S. domestic industries. For the reasons explained below, the clients that we represent oppose the Department's proposal to grant market-oriented enterprise status to individual companies within a non-market economy country.

I. THE DEPARTMENT DOES NOT HAVE LEGAL AUTHORITY TO DESIGNATE MARKET-ORIENTED ENTERPRISES

There is no legal basis to support the Department's proposal to designate individual entities as market-oriented enterprises. In fact, such a proposal is contrary to the express statutory scheme enacted by Congress regarding non-market economies. No provision in the statute grants the authority to the Department to grant market-oriented status to an individual enterprise within a country designated as a non-market economy under the statute. *See* 19 U.S.C. §§ 1677(18) and 1677b(c). The statutory language states that, if the exporting country is a non-market economy, "the valuation of the factors of production *shall* be based on the best available information regarding the values of such factors in a market economy country or countries considered to be appropriate by the administering authority." 19 U.S.C. § 1677b(c)(1)

(emphasis added). Accordingly, the Congressional intent is clear that when the exporting country is designated a non-market economy country, the Department must use the non-market economy methodology. Where Congressional intent is clear on the issue in question, an agency may not “fill in the blanks.” Chevron, U.S.A., Inc. v. NRDC, Inc., 467 US 837, 843 (1984). The Department’s regulations relating to the non-market economy methodology also do not permit the designation of individual enterprises as market-oriented. *See* 19 C.F.R. 351.408.

Moreover, the institution of a wholesale exception to non-market economy treatment for an individual enterprise contravenes the express terms of China’s accession protocol at the WTO, which calls for China to be treated as a non-market economy for 15 years (or until 2014). *See Accession Of The People’s Republic of China*, WT/L/432, 10 November 2001, at para. 15(a) and (d) available at http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm. China’s accession protocol only permits the abandonment of the non-market economy provisions when market economy conditions prevail in a particular “*industry or sector.*” *Id.* at para. 15(d). Thus, the accession agreement does not contemplate an exception to the application of the non-market economy provisions for market-oriented enterprises. The creation of such an exception, therefore, would violate China’s accession protocol, which was carefully negotiated by WTO Member states.

Accordingly, the Department should not create an exception to the non-market economy methodology for individual companies, because it violates U.S. and international law.

II. A COMPANY OPERATING WITHIN A NON-MARKET COUNTRY AND NON-MARKET INDUSTRY CANNOT BE MARKET-ORIENTED

As the Department recently concluded in an 80-page memorandum, China's economy has not yet attained market-economy status for purposes of the U.S. antidumping law. *Certain Lined Paper from the People's Republic of China - China's Status As A Non-Market Economy* ("NME"), Memorandum from Office of Policy for David M. Spooner (Aug. 30, 2006). In particular, the Department stated that "market forces in China are not yet sufficiently developed to permit the use of prices and costs in that country for purposes of the Department's dumping analysis." *Id.* at 4 ("*China's NME Status Memo*"). Furthermore, although the Department has employed a market-oriented industry ("MOI") test for the last 15 years, it has never found an industry to satisfy the MOI criteria. An individual company operating within an economy and, more importantly, industry that are defined by non-market conditions cannot be considered to be market-oriented. For example, in order for an entity to operate as a market-oriented enterprise within an industry marked by non-market conditions, it would have to source its inputs, which are likely the same inputs used by other entities in the industry from the same sources, outside of the industry's supply chain, and it could not use any inputs that are tied to the general economy, e.g., land, labor, and energy. Moreover, it is unclear how the Department could reconcile its recent, exhaustive analysis determining that the Chinese economy is still subject to pervasive non-market conditions that distort the production experience in China with a policy based on the claim that an entity, operating in that environment, can remain untouched by such distortions.

Accordingly, an entity operating in an economy and industry that is not subject to market conditions cannot be considered a market-oriented entity, because the non-market conditions within the industry and the economy as whole inescapably affect the individual entities within.

III. THERE ARE SIGNIFICANT PROBLEMS WITH RESPECT TO THE DESIGNATION OF MARKET-ORIENTED ENTERPRISES

A. The Department Cannot Rely On Prices And Costs In China

The Department cannot rely on prices and costs in China because it has been determined that they are not market-based. The Department has stated that

prices and costs are central to the Department's dumping analysis and calculation of normal value. Therefore, the prices and costs that the Department uses must be meaningful measures of value. NME prices cannot be relied upon as meaningful measures of value because they do not, as a general rule, reflect the relative scarcity of resources used in production.

China's NME Status Memo. at 6. The Department also found in its analysis of the Chinese economy that the government, at all levels, remains "deeply entrenched in resource allocation" and, in particular, the allocation of financial resources. *China's NME Status Memo* at 77. The government's interference distorts financial resources, but also distorts the allocation of other resources, *e.g.*, labor, material inputs, capital, and energy. *Id.* Moreover, as the Department correctly noted, certain factors of production that are used by virtually all manufacturers, *e.g.*, labor, land, capital, and energy, are indisputably "linked to the broader operating economic environment." *Request For Comments*, 72 Fed. Reg. at 29303. No Chinese company is insulated from the pervasive non-market conditions that affect the prices and costs of material inputs in China.

For example, the government continues to provide assistance to manufacturers in the form of grants relating to the purchase of major material inputs. With respect to labor, the Department found that “there are a number of important institutional constraints on the extent to which market forces can act upon the formation of wages.” *China's NME Status Memo*. at 22. In particular, the legal relationship between the government and trade unions “signals a significant reluctance on the part of the PRC government to allow the worker’s collective strength to come to bear on the negotiation of wages and working conditions. In addition, the restrictions on labor mobility serve to inhibit and guide workforce flows and seriously distort the supply side of the labor market.” *Id.* Furthermore, as the attached *Business Week* article explains, many Chinese companies maintain multiple sets of books or falsify records relating to labor and wage issues.

The Department also noted that private land ownership is prohibited in China and that only land use rights can be owned by individuals and firms. *Id.* at 41 (citing to Article 9 of the *Constitution*). The Department found that

laws and regulations are regularly violated by individuals and local governments. While the private market for land-use rights has grown, SOEs own a significant amount of land-use rights that they received free of charge. Also, commercial land sales are often conducted illegally. In short, property rights remain poorly defined and weakly enforced.

Id. at 46. Furthermore, the Chinese government continues to provide land grants at fractions of market value.

Similarly, the Department found that the Chinese government determines electricity prices. The Department, quoting the WTO, stated that “there is no direct correlation between

electricity costs and prices; the latter are apparently determined as much by political and macroeconomic factors.” *China’s NME Status Memo* at 50.

Accordingly, the Department cannot use prices and costs reported in China.

B. The Department Cannot Use Chinese Respondents’ Financial Statements To Calculate Financial Ratios

Although China has made reforms to Chinese GAAP in an attempt to bring it into conformity with international accounting standards, this reform is in transition (the new standards were only introduced in February 2006). The announcement of new standards does not necessarily translate into practice absent strict enforcement of the standards and an independent audit environment. As reported in a recent *Business Week* article (**attached**), many Chinese companies maintain multiple books and records designed to evade audits. Thus, Chinese financial statements are not a reliable source for the calculation of financial ratios.

Accordingly, the Department cannot use the financial statements of Chinese respondents to calculate financial ratios.

C. Currency Manipulation In China Precludes The Treatment Of Individual Companies As Market-Oriented

Underlying distortions caused by the manipulation of the Chinese currency preclude a company in China from being market-oriented. In particular, China’s practice of pegging the *renminbi* to the dollar prevents exchange rate conversions from occurring at the market rate and impedes the efficient allocation of resources according to market principles. *See China’s NME Status Memo* at 11.

The statute recognizes that “the extent to which the currency of the foreign country is convertible into the currency of other countries” is a key element of a market economy. *See* 19 U.S.C. § 1677(18)(B)(i). Although the Department has noted that the *renminbi* is convertible into foreign currencies for trade purposes, it also concluded that China maintains restrictions on its currency that “interfere with the ability of market signals to impact the exchange rate” and that “reforms to date cannot ensure that the *renminbi* is market-based....” *China’s NME Status Memo* at 2.

Accordingly, a Chinese company operating in an economy marked by distortions caused by currency manipulation cannot be treated as a market-oriented entity.

D. The Designation Of Market-Oriented Enterprises Will Undermine The Department’s Current Practice Regarding Market Economy Inputs

Pursuant to the regulations, the Department may use the prices reported by respondents in a non-market economy if the input is purchased from a market economy supplier and paid for in a market economy currency. *See* 19 C.F.R. § 351.408(c)(1). If the Department were to use prices or costs reported in *renminbi* for market-oriented enterprises, as its Request For Comments suggests it might, it would nullify the central requirement for the use of reported prices under the current market economy input policy, *i.e.*, that inputs must be purchased from a market economy supplier and paid for in a market economy currency. As explained above, however, the Department cannot use domestic prices reported in *renminbi* due to the distortions caused by a non-market economy. Indeed, it will only be able to use reported prices for inputs sourced from a market economy and paid for in a market economy currency. In other words, the

market-oriented enterprise test would have the same result that is currently achieved by the market economy input policy.

Accordingly, there is no reason for the Department to institute the proposed market-oriented enterprise practice.

E. The Department Cannot Use Home Market Sales, And The Use Of Third Country Sales Would Permit Manipulation

The Department cannot use domestic sales/home market pricing, because domestic sales are distorted by the non-market conditions that pervade the economy.¹ Furthermore, automatic resort to third country sales is ripe for manipulation by respondents, who would have the opportunity to control the normal value by selling at a low price in a selected country. With knowledge of the market oriented enterprise analysis, a respondent could manipulate its sales data over multiple countries, permitting a respondent to cover the low sales prices in any one country.

F. The Designation Of Market-Oriented Enterprises Will Reduce Predictability In Antidumping Proceedings

Predictability is one of the Department's stated goals in administering the antidumping law and, more specifically, the non-market economy provisions. *See Antidumping Duties; Countervailing Duties; Preamble To The Proposed Rule*, 61 Fed. Reg. 7308, 7344 (Feb. 27, 1996); *Lasko Metal Prods. v. United States*, 43 F.3d 1442, 1446 (Fed. Cir. 1994); *Creatine Monohydrate From the People's Republic of China*, 64 Fed. Reg. 71104, 71106 (Dec. 20, 1999).

¹ It is not clear from the Department's notice if it is considering doing so as the Request For Comments specifically asks for comments regarding prices and costs only.

The proposed market-oriented enterprise framework would reduce predictability in antidumping proceedings involving non-market economies. Respondents and petitioners will be unable to predict what treatment a respondents will receive or what methodology will be applied.

Furthermore, for petition purposes, the dumping calculation will become even more complex if petitioners have to guess which individual companies may be treated as market economies by the Department. Finally, it will lessen the predictability of the Department's selection of mandatory respondents and the calculation of the separate rates margin for all other respondents.

G. The Designation Of Market-Oriented Enterprises Strains The Department's Over-Extended resources

The proposed market-oriented enterprise framework would also create additional burdens that permeate the entire antidumping proceeding. The Department operates under strict, tight statutory and regulatory deadlines in antidumping proceedings. It simply does not have the time or resources to add a market-oriented enterprise analysis in the timeframe provided by the statute and regulations. The Department already has to consider large amounts of information at the outset of antidumping proceedings in the form of quantity and value questionnaires, separate rate applications, and comments on respondent selection. If the Department must analyze and determine whether each individual company that applies is a market-oriented enterprise, it will delay the selection of mandatory respondents in antidumping proceedings, which necessarily must occur at the outset of the proceedings.

Accordingly, the Department, which is already overburdened and bound by tight regulatory deadlines, should not institute a market-oriented enterprise policy in antidumping proceedings.

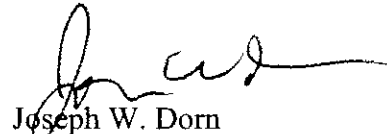
IV. CONCLUSION

For the reasons explained above, the clients represented by King & Spalding LLP oppose the Department's proposed market-oriented enterprise framework, because such a policy is contrary to the statute. Furthermore, China's economy is still marked by pervasive non-market economy conditions. An individual enterprise operating in that economic environment cannot shield itself from the distortions, and prices and costs in China continue to be unreliable as a basis to calculate normal value.

If, however, the Department nevertheless decides to institute its proposal, parties should have the opportunity to comment further on the specifics of the policy.

Please contact us if you have any questions about this submission.

Respectfully submitted,



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ATTACHMENT

11/27/06 Bus. Wk. 50
2006 WLNR 20258204

BusinessWeek
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November 27, 2006

Volume 4011

Section: Cover Story

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

By Dexter Roberts & Pete Engardio, with Aaron Bernstein in Washington, Stanley Holmes in Seat

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 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 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 Auret 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. 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 (page 56).

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, 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. and General Electric Co. 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, Walt Disney, 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, 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. 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, Sears, 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. 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.

Gaming The System

Some of the ways Chinese factories frustrate labor auditors sponsored by American retail chains and manufacturers:

DOUBLE BOOKS

Factories produce bogus payroll records and time sheets to show that workers are on the job 40 hours a week and receive proper overtime pay; the genuine books are kept secret.

SCRIPTED RESPONSES

Workers and managers are tutored on how to answer auditors' questions about hours, pay, and safety conditions; when interviewed off the premises, workers often give different answers.

HIDDEN PRODUCTION

Plants meet U.S. demands by secretly shifting work to subcontractors that violate pay or safety standards; some put workers in dangerous back rooms, hidden from auditors.

Data: BusinessWeek

---- INDEX REFERENCES ----

COMPANY: HOME DEPOT INC; GENERAL ELECTRIC CO; HEWLETT PACKARD (CANADA) CO; TARGET STORES; SEARS ROEBUCK AND CO; DISNEY (WALT); BLACK AND DECKER CORP (THE); WAL MART STORES INC; FAIR; DISNEY (WALT) CO; HEWLETT PACKARD CO; NOVADIGM INC; GENERAL ELECTRIC; WAL MART; BUREAU VERITAS; GENERAL ELECTRIC CO (EGYPT); NORDSTROM INC; HEWLETT PACKARD; MOTOROLA INC; JC PENNEY CO INC

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Word Count: 3973
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