

ETI Forum



Getting smarter at auditing

Tackling the growing crisis in ethical trade auditing

Report from ETI members' meeting, 16 November 2006

About ETI

The Ethical Trading Initiative (ETI) was established in 1998 to improve the lives of workers and their families in global supply chains. We believe that companies producing, supplying and selling goods for consumer markets should observe national and international labour laws. Our purpose is to identify and promote responsible corporate practice that will help make this a reality. Our tripartite membership of companies, trade unions and NGOs lends unique credibility to our work. See www.ethicaltrade.org for further information about ETI, including a list of our members.

About ETI Forum

ETI Forum reports on the key issues discussed at one of our events. ETI events – members' roundtables, public seminars and conferences – focus on ethical trade issues of topical interest or which have proved to be particularly challenging to our members. For example, we have held events on corporate social responsibility, homeworkers, corrective actions in code compliance, HIV/AIDS in the workplace and the role of gangmasters in the food and agricultural industry. These events give members and others the opportunity to learn from guest speakers and from each other, and to debate and identify practical responses to the issues raised.

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Summary

On 16 November 2006, members of the Ethical Trading Initiative (ETI) – including **Debenhams, Marks and Spencer, Asda, Tesco and Next** – met to discuss what could be done about the growing crisis in ethical trade auditing.

The meeting drew attention to the limited effectiveness of most ethical trade audits commissioned and/or undertaken by UK high street companies, highlighting the particularly questionable quality of the majority of audits conducted by third party commercial auditing companies. Members argued that audits tend to: be ineffective at identifying many of the most serious labour problems; be poor value for money; and generate multiple audits of the same supplier, leading to inconsistent corrective action plans that confuse the supplier. Perhaps most worryingly, members' experience shows an alarming rise in "audit fraud": suppliers in key sourcing countries are increasingly adopting a raft of fraudulent practices that are designed to hide the truth about labour practices from auditors' eyes. Many corporate ethical trade teams recognise the problems, but face serious constraints to addressing them.

The meeting highlighted the urgent need to improve auditing practices, and identified actions that could be taken both by individual companies, as well as longer-term actions that required collaborative action. Participants called on individual companies to: employ in-house auditing teams – including local staff based in key sourcing countries; review purchasing practices (eg, short lead times) that conflict with good labour standards – and therefore encourage audit fraud; and share audit reports and corrective action plans with other retailers and brands. Participants also urged ETI and other multi-stakeholder initiatives to engage more proactively with the commercial auditing companies to try and bring about systematic improvements in third party auditing, and in the longer term, to work together to develop common standards and protocols for auditing practice – and an effective system to enforce them.

The full report (below) provides a more detailed account of the key issues presented and discussed at this event, including what goes wrong in auditing, an analysis of why it goes wrong, and short and long term recommendations for improving auditing practice. It includes many corporate good practice case studies, as well as real-life examples of how auditing goes wrong.

About this report

Part of the *ETI Forum* series, this document reports on the key issues presented and discussed at the ETI members' meeting *Getting smarter at auditing*, held at CCT Venues Barbican, Aldersgate House in London on 16 November 2006. This report aims to serve both as an *aide memoire* for those who attended the event, and also as a stand-alone briefing for others with an interest in improving the quality of ethical trade auditing.

Who is this report for?

This report is aimed specifically at:

- ETI member companies and other brands and retailers with ethical trade programmes
- Ethical trade auditors and others who wish to see improvements in current auditing practice.

Purpose of this report

This report is intended to provide:

- A succinct and convincing synopsis of what goes wrong in current auditing practice, and an analysis of *why* it goes wrong;
- Short and long term recommendations on how to improve auditing practice, including good practice examples; and
- A springboard for concerted and collective action to tackle the root causes of poor auditing practices.

Background and purpose of the event

There has been growing concern, both within the ETI membership and beyond, about the yawning gap between recognised good practice in ethical trade auditing – and actual auditing practice on the ground. There are undoubtedly many examples of high quality auditing supported by comprehensive corporate ethical trade programmes. For most however, the world of auditing is dominated by poor quality auditing, poor value for money, unnecessary duplication of audits, inconsistent corrective action plans – and perhaps most worryingly, a rapid growth in “audit fraud”.

Many corporate ethical trade managers recognise the flaws in current auditing practices, but for various reasons feel powerless to change them. A key contributing factor is that many of these managers are forced to rely on third party auditing companies who deliver highly unreliable audit quality.

This event was organised to shine a spotlight on the problems with current auditing practice, and to move us a few steps closer to solving the growing auditing “crisis”. Specifically, the event aimed to:

- Bring the key problems out into the open
- Identify the main reasons why companies are finding it difficult to implement good practice
- Identify good practice examples and strategies for overcoming the barriers to change.

The emphasis was not on pointing fingers and laying blame, but on identifying the constraints faced by corporate ethical trade managers in implementing good practice – and finding ways to get around these constraints.

Who participated

The event included a short video (*Secrets and Lies* – see **section 6: further information**), workshop discussions, and **presentations from Marks & Spencer, Debenhams Retail, the International Textile, Garment and Leather Workers' Federation (ITGLWF), Women Working Worldwide and ETI.**

Overall, over 45 participants (all ETI members) took part in this event, including representatives from **20 member companies** including **Asda, Tesco, Sainsbury's, Levi Straus & Co, Next Retail, Boots, Monsoon, The Body Shop, New Look and WH Smith**; seven member NGOs; and three trade union organisations.

1. Setting the scene – what's good about auditing

In the last two to three years, ETI and others have emphasised that auditing – even if it is done well – is not enough in itself to guarantee results. An effective corporate ethical trade programme also requires effective communication about ethical trade within the company and supply chain; supporting suppliers to change; and integrating ethical trade into core business practices.

While recognising the need to set auditing within this broader context, two of the speakers were keen to point out that auditing remains a crucial part of any ethical trade programme. They emphasised that, firstly, auditing *does* have its uses, and secondly, that we do know what good practice looks like.

1.1 Auditing *does* have its uses...

One of the corporate speakers reminded participants that, despite the serious flaws in current practice, auditing does have its uses. The aim should be to fix what is wrong with auditing, rather than stop auditing altogether. In the speaker's view, auditing helps to:

- Get baseline information on working conditions, both in individual factories (workplaces), and in the wider supply base
- Screen new/potential suppliers – identify whether they meet the buying company's minimum labour standards as a basis for approving or rejecting the supplier
- Establish a starting point for discussion with suppliers about any labour problems, and determining necessary and appropriate corrective actions. Concrete evidence of poor labour practices generated by (good) audits can be crucial in convincing suppliers that problems really exist in their factories.
- Monitor progress over time – regular audits are a way of checking whether improvements are made over time.

The speaker also emphasised that auditing *has* brought concrete benefits to workers, albeit not to all types of workers nor in all areas of the Base Code. The ETI Impact Assessment findings (see www.ethicaltrade.org/d/impactreport) showed that auditing has contributed to widespread improvements in health and safety, extending payment of the minimum wage and legally correct overtime premiums to more workers, and a reduction in working hours.

1.2 ...and we know what good auditing looks like

As highlighted by one speaker, ETI has invested 10 years in working out what good auditing look like, and converting this knowledge into practical resources and training for companies. Most of us know the key ingredients of good auditing:

- Audit teams need to have relevant local expertise, and have the trust of all stakeholders (management, workers, supervisors)
- Open-ended questioning techniques need to be used
- Off-site, confidential worker interviews should be considered
- All types of workers, including contract, migrant and female workers, should be interviewed
- All Base Code principles should be covered, including special attention to freedom of association and discrimination
- Comprehensive feedback of audit findings needs to be given to management and workers, and
- Robust corrective action plans need to be agreed and followed up.

The problem of course is that while we know what it looks like, good practice is, in general, not implemented on the ground. But we mustn't forget that the "technical know how" and tools exist, if the political and resource constraints can be overcome.

2. What goes wrong

Speakers and participants identified a number of common ways in which ethical trade auditing currently goes wrong. These included:

- Unreliability of third party commercial auditing companies
- Poor value for money
- Multiple audits of the same supplier
- Inconsistent corrective action plans
- Failure to identify/report serious labour problems
- Prevalence of fraudulent practices.

Each of these problem areas are explained below, illustrated where available with specific examples of poor practice.

2.1 Unreliability of third party commercial auditing companies

When ETI was established, the jury was still out on whether it was better for retailers/brands to conduct their own audits, or for retailers to commission third party commercial auditing companies to carry them out. A decade later, participants at this event appeared to have reached a clear verdict: in-house auditing is preferable.

Speakers were keen to point out that in-house auditing is not perfect, and indeed that there is huge variation in the quality of audits conducted by different retailers and brands. As one participant commented, in-house auditing includes "good auditing, bad auditing – and everything in between".

"In-house auditing includes good auditing, bad auditing...and everything in between"

“Third party commercial auditing companies? It’s money for old rope”

However, there seemed to be widespread agreement that the auditing practices of commercial auditing companies were by and large considerably worse, characterised by lack of evidence or proof, failure to identify the real issues, and poor value for money – in the words of one participant, “Third party commercial auditing companies? It’s money for old rope”.

2.2 Poor value for money

Whether spent on in-house or third party auditors, there was a general feeling that auditing provided poor value for money. Typically, companies spend something like 80% of their ethical trade budget on audits. Yet many felt that this was achieving little impact where it counts, ie, in improving conditions for workers. Too much of this money is being spent on worthless audits that miss the real problems, audits of factories that have already been audited before, or audits that cannot be followed up due to lack of resources.

2.3 Multiple audits of the same supplier

Five years ago, many suppliers were already complaining about too many/unnecessary duplication of audits. Since then, some individual companies have made efforts to collaborate with other companies on auditing, and there has also been the emergence of industry-wide collaborative initiatives such as SEDEX (Suppliers Ethical Data Exchange – see www.sedex.org.uk). But despite these efforts, the problem seems to be getting worse, not better. As well as the obvious waste of time and resources this involves for both suppliers and buying companies, multiple audits and audit approaches confuse factories. Moreover, for those factories that are particularly “well-audited”, a large number of bad audits gives them extra justification to keep double books and implement other fraudulent practices to hoodwink the auditors.

2.4 Inconsistent corrective action plans

Multiple audits and audit approaches also lead to multiple corrective action plans, which can often be inconsistent, creating obvious difficulties for the supplier in question.

2.5 Failure to identify/report serious labour problems

On the whole, audits still fail to identify breaches of certain aspects of the ETI Base Code, in particular discrimination and violation of trade union rights. Yet as the *ETI Impact Assessment* findings show, non-compliances with both these aspects of the Base Code are widespread.

Moreover, with “double book-keeping” becoming the norm in some regions, the failure of many audits to get beyond the fake records and figures means that even the previously more “visible” non-compliances, such as excessive working hours and poor wages, are escaping the auditors’ eyes.

And even where non-compliances are being identified, for example, lack of freedom of association, excessive overtime, women being paid lower rates than men, often these are not reported as non-compliances because they are judged to be the “industry norm”.

REAL LIFE EXAMPLE: FAILING TO IDENTIFY THE REAL PROBLEMS

One member company commissioned an external commercial auditing company to conduct an audit of one of their factories in China. The audit report they received showed that the factory had **no non-compliances** with any of the ETI Base Code principles. However, they subsequently received allegations of poor working conditions in this factory, so they decided to commission further investigation of the factory using a different auditing company/organisation and different methods.

These **further investigations found serious labour problems** in a number of areas, including:

- Suspected child labour and common use of fake ID papers
- Double books and coaching of workers
- Excessive overtime
- No legal overtime premiums, and high possibility that some workers do not get local legal minimum wage for standard time work
- Suspected sub-contracting of the company's orders.

*“The good news is:
we have helped.
We’ve created jobs –
for teams of
consultants employed
to help cover up the
truth from auditors”*

2.6 The prevalence of fraudulent practices

A particularly serious concern is the increasing prevalence of “audit fraud”. Suppliers are developing an ever more sophisticated and wide range of practices which have the sole aim of hiding the truth and presenting an “alternative reality” to auditors – while actual labour practices remain unchanged. There is also growing evidence that others are getting in on the act: the proliferation of poor auditing has spawned an alternative industry that specialises in making audit fraud easier for suppliers. As one participant ironically claimed: “The good news is: we **have** helped. We’ve created jobs – for teams of consultants employed to help cover up the truth from auditors”.

The types of fraudulent practices raised and discussed during the event included the following:

2.6.1 Keeping false documentation and records

Keeping false documentation and records is becoming common place in many key sourcing areas, particularly in China. So much so that there are specially designed software packages and training courses available in China to help fool the auditors “convincingly”, including software specifically designed to help you keep multiple sets of wage and other records.

REAL LIFE EXAMPLE: FALSE DOCUMENTATION

The *Secrets and Lies* video (see **section 6.2**) opens with photographs of a fake ID card for an underage worker, fake working hours records, fake wage records with workers’ signatures (the papers are folded so workers can’t see what they are signing), and a computer screen showing an electronic folder called “wage record for audit”.

2.6.2 Coaching workers to give false information to auditors

Many suppliers are deliberately coaching their workers to provide the “correct” answers to auditors. One of the speakers had come across factories which had hired outside professionals specifically to coach workers to lie convincingly to auditors.

REAL LIFE EXAMPLE: COACHING WORKERS TO LIE

In the *Secrets and Lies* video, one worker interviewed reported of being coached by his supervisor to say that he was being paid the minimum wage and the correct overtime premium (150%), and to lie about when he had started working at the factory. In another Chinese factory, typed briefing notes were found telling workers how to answer typical audit questions. An extract from these briefing notes says:

“Question 20: Is there any wage slip provided by the factory? Could you show it to us?

Standard answer: Yes I have wage slips, but I have thrown it away after I looked at it”

2.6.3 Workers offered bribes for lying to auditors

It also appears that many suppliers are offering bribes to workers to encourage them to lie to auditors. One speaker mentioned concert tickets being offered to workers in return for “good performance” during audits.

2.6.4 Putting on an act for auditors

Many factories have a well-rehearsed routine or “act” which is put on when auditors are visiting. The “play” might include tidying up work areas, putting on personal protective equipment which is normally not worn, and underage and contract workers leaving the factory so that auditors cannot see or interview them.

REAL LIFE EXAMPLE: PUTTING ON AN ACT FOR AUDITORS

In the *Secrets and Lies* video, a group of young workers at a Chinese factory said that if a particular piece of music was played, this meant that auditors were visiting the factory. The music was a signal for all “summer job students” to leave the factory immediately by the back gate.

2.6.5 ...and clients/auditing companies getting in on the act

There was also evidence of some clients or auditing companies playing an active role in encouraging and helping factories to falsify records. So while it is easy to point the finger at suppliers, clearly some auditors and possibly clients are also culpable.

REAL LIFE EXAMPLE: AUDITORS HELPING FACTORY MANAGERS TO PREPARE FALSE RECORDS

In the *Secrets and Lies* video, a factory manager talks of her initial experience of auditing. When the manager presented the true wage records etc., the auditor asked her why she wasn't providing false records that showed compliance with the relevant labour standards. The auditor encouraged the factory manager to prepare false records for the next audit, saying that this is what other factories do. The auditor even offered assistance in preparing the false records.

3. Why does it go wrong?

Many of the problems covered in **section 2** will not be new to those involved with ethical trade. But *why* do they occur? In the workshop sessions, participants – particularly corporate ethical trade teams – were asked to identify the drivers behind poor auditing practices and the constraints to improvement. These are summarised below.

3.1 Why auditing practices in general remain mediocre-to-poor**3.1.1 Resource constraints and the continuing importance of risk assessment**

Corporate representatives present pointed to limited funds as a key constraint to good auditing practice. They know what good auditing looks like, and can put it into practice in some cases, but to do this across their entire supply chain would be prohibitively expensive. While some

companies had taken the step of trading off quantity for quality, ie, doing fewer, better quality audits, other companies said that it was still imperative to get an overview of non-compliance risks in their entire supply base. Resources were therefore spread too thinly to allow good quality auditing throughout their supply chain.

The need to get an overview of the supply chain was also a reason given for continuing to spend 80% of ethical trade funds on auditing, despite recognising the importance of other areas of activity, eg, capacity building: you need to know your supply base, and since your supply base keeps changing you need to keep on auditing.

3.1.2 Limited auditor skills, lack of professional regulation

Participants generally felt there was a very limited supply of high calibre, qualified auditors with the right philosophy and working practices and a commitment to change – and demand far outstrips this limited supply. This lack of skills is exacerbated by limited availability of appropriate training, and the lack of professional standards and regulation of ethical trade auditors.

3.1.3 Conspiracy of silence between companies and auditors

One participant felt that a conspiracy of silence between auditors and companies had developed in the 1990s when companies didn't actually want to know about the problems. The legacy of this remains, contributing to the tendency for audits and audit reports to skirt over any real problems.

3.2 Why commercial auditing companies are particularly problematic

3.2.1 Ethical trade auditing is a sideline activity

For commercial auditing companies, ethical trade auditing tends to be either a top-up skill area for auditors trained in financial auditing or quality control – with accompanying philosophies and established practices, or a side-line activity for corporate social responsibility (CSR) consultancy firms. Either way, you end up with social auditors who do not see ethical trade auditing as their day-job. As one speaker commented, “Most social auditors don't like doing social audits!!”

3.2.2 Lack of bargaining power

As mentioned in **section 3.1.2** above, ethical trade auditing teams in commercial auditing companies appear to be characterised by a minority of good quality auditors amongst a poorly skilled and unmotivated majority. And while experienced corporate ethical trade managers are all too aware of these skills gaps, they lack the bargaining power to (a) ensure they get the individuals they want, and (b) insist on improved auditing practices overall. The underlying reality is that there are few alternatives – they can threaten to withdraw business, but both the client and the auditing company know that they don't have anywhere better to go. The lack of professional standards/regulation of ethical trade auditors makes it even more difficult to hold them to account.

Some of the corporate ethical trade managers present said they had put considerable effort into negotiating with the auditing companies to improve the quality of their audits, eg, asking them to include worker interviews in all audits. However, most had found that the auditing companies were unwilling to change their practices, for example insisting that all their other clients were happy with their services and no-one else was complaining. Ultimately, this demonstrates the limitation of a single company/client tackling large global auditing companies on their own.

“Are we expecting too much of auditors? A good auditor needs to be a lawyer, economist, accountant, OHS specialist...and a detective!”

“Most social auditors don't like doing social audits!!”

3.3 Why many retailers/brands continue to use third party auditors

As noted in **section 2.1** above, many corporate ethical trade managers now believe that in-house auditing is better than using third party commercial auditing companies. Yet such third party audits continue to form the backbone of many corporate ethical trade audit programmes – why is this the case?

Many of the corporate ethical trade managers present said that there was strong pressure from the company's institutional investors to use external auditors: external was seen as synonymous with "independent", and therefore more credible than any audits done by internal company staff. As a result, often ethical trade managers are not given the option of in-house auditing, regardless of their views about which produces better quality audits – and which is better value for money.

Indeed, one corporate participant said that he was told which specific auditing company to use when he took up his post as ethical trade manager. And despite the fact that the audits carried out by this firm were clearly of very poor quality, it took him several years to convince his company to switch to another auditing firm.

Some participants said that NGOs and the media, as well as investors, also created a pressure for use of external auditors, since once again external was seen as more independent, and therefore more credible.

Audit for audit, in-house auditing can work out cheaper than using a third party commercial company. However, it is important to remember that many brands and retailers who use third party auditing companies are not paying for it themselves: they pass the cost of the audit onto their suppliers. Such companies therefore have little financial incentive to shift from third party to in-house auditing.

3.4 Why the prevalence of audit fraud?

The workshops also sought to identify why "audit fraud" has become so widespread. Participants highlighted the following drivers:

3.4.1 Inappropriate purchasing practices

Purchasing practices that undermine ethical trade standards, eg, short lead times that make it difficult to comply with overtime standards – are a key contributor to audit fraud. Faced with conflicting pressures from clients' buyers and ethical trade teams, suppliers recognise that the buyers' requirements hold more weight. So they meet the buyers' demands for high quality and short lead times through getting workers to work excessive overtime, then develop a set of false timesheets showing working hours that comply with the company's labour code – thus satisfying the ethical trade teams' requirements. Until buying practices are brought in line with ethical trade standards, the pressure for suppliers to keep double books will always be there.

3.4.2 Reliance on pre-announced audits

Most companies continue to rely on announced audits, ie, where suppliers are informed about audits prior to the visit. They prefer this approach because it saves time, allows relevant information to be collected beforehand, and does not threaten the relationship with the supplier. However, pre-announcing visits also gives the supplier time to prepare false wage records, get children on the roof, send contract workers home etc. etc. In other words, pre-announcing audits makes audit fraud a lot easier.

3.4.3 Zero tolerance approach of most US companies

Many corporate representatives felt that the “Zero tolerance” approach of most US brands and retailers has been a key driver behind the growth in double-book keeping and other fraudulent practices. Member companies generally detect a difference in approach between UK and US companies in terms of how they deal with non-compliances. British companies tend to focus on “continuous improvement”, accepting that suppliers will have non-compliances – as long as they agree to make improvements over time. In contrast, US companies tend to take a pass/fail approach: they won’t buy from suppliers who are found to have non-compliances.

Faced with the dominance of the US market and this zero tolerance approach, it is no wonder that a culture of double-book keeping has developed. If a factory is faced with a 100 audits per year, most done by or on behalf of US companies, it is hard for an ETI member company to break the supplier’s mindset and encourage them to reveal the truth, even if the member company is genuinely committed to working with the supplier to address any non-compliances.

3.5 Why do multiple audits continue?

Most member companies are frustrated by multiple audits – and want to see fewer audits. At the same time, many continue to conduct or commission their own audits because they feel they cannot rely on the quality of audits done by many other brands/retailers or auditing companies. This is exacerbated by the differences between company codes and what they require of suppliers. So until the quality of audits overall becomes more reliable, and there is greater code harmonisation, the drive for companies to do their own auditing – and therefore the multiplicity of audits – is likely to continue.

4. How do we move forward?

As noted above, one of the key aims of the event was to identify how to improve the quality of auditing and address some of the underlying causes of poor practice. Speakers and other participants identified a wide range of recommendations and good practice examples, which are reported in four sections below, as follows:

- **Recommendations for individual companies** – actions that can be taken by companies in the short to medium term, irrespective of what other companies or organisations decide to do. See **Sections 4.1 – 4.3** below, which also include good practice examples from a range of member companies.
- **Longer-term recommendations** – recommendations that require collaborative action by companies, ETI, the other multi-stakeholder initiatives, and other relevant actors – see **section 4.4** below.

In terms of recommendations for individual companies, **there was a clear call for brands and retailers to bring the auditing function in-house**. At the same time however, there was recognition that this is not always possible. The recommendations for individual companies are therefore further sub-divided into three sections, depending on whether a company has an in-house auditing team or relies on external auditing companies:

- Recommendations for all companies (regardless of how they manage their auditing) (**section 4.1**)
- Recommendations for companies with in-house auditing teams (**section 4.2**)
- Recommendations for companies using third party commercial auditors (**section 4.3**)

4.1 Recommendations for all companies (regardless of how they manage audits)

4.1.1 Create an environment that encourages honesty – and penalises dishonesty

Participants talked about the importance of how you approach suppliers, and ensuring that you create a context and environment that encourages the supplier to be honest and open about non-compliances – starting with the very first contact you have with the supplier. Conversely, **participants recommended a zero tolerance approach to suppliers who are dishonest** – an approach already adopted by several member companies.

4.1.2 Do fewer, better quality audits

Several member companies said they have moved towards doing fewer, but better quality, audits, allowing more resources to be spent on conducting and following up on each audit. Some talked about forgetting one-day audits altogether – they are not long enough to get to any of the real problems. While this approach clearly makes sense in terms of ensuring better quality auditing – and ultimately perhaps more impact in improving working conditions, the business imperative to “cover all bases” (see **section 3.1.1** above) makes this unrealistic for some companies.

4.1.3 Share audit reports and corrective action plans

Some participants recommended that companies who share the same suppliers should conduct joint audits and develop common corrective action plans. If this is not possible, they should at least share their audit reports and improvement plans with other companies, so that they know what other companies have done and do not ask for corrective actions that directly conflict with those requested by other companies. Some ETI member companies are already doing this.

4.1.4 Review purchasing practices

Participants recommended that companies review the purchasing practices that most effect suppliers’ ability to meet ethical trade standards. While it was recognised these issues cannot be solved overnight, the incentive to keep double books and lie to auditors will continue to exist as long as the demands of buyers conflict with the demands of ethical trade teams. Participants suggested that the positive link between good labour standards and good quality needs to be hammered home and used as a key argument in bringing about change on this issue.

GOOD PRACTICE EXAMPLES: INCENTIVISING BUYERS AND SUPPLIERS

Several member companies, including **Gap Inc.**, Inditex (owners of **Zara**) and **New Look**, have been exploring ways of integrating ethical trade considerations into buying decisions. Two specific examples highlighted at this event were:

- **Inditex** (owners of **Zara**) grade their suppliers according to their performance against their labour code, and in one part of their business (*Tempe* shoes) buyers’ bonuses are linked to the grading of suppliers they buy from.
- **New Look** are working with sourcing staff to concentrate production in factories who perform well on their ethical trade score – they believe there is a business case for doing so since better labour conditions means better quality products and on-time delivery.

4.1.5 Build capacity of suppliers – tackle the root causes of labour problems

Some participants recommended that companies should invest more in training factory managers on general management skills, and human resource management in particular. They felt that the root cause of many labour problems is that factory managers do not have the capacity or competence to run the factory properly.

GOOD PRACTICE EXAMPLE: DEVELOPING HR MANAGEMENT SKILLS AT FACTORY LEVEL

Pentland have been working with a Human Resources management association to develop a staff manual for factories they source from.

4.2 Recommendations for companies with in-house auditing teams

4.2.1 Employ local staff to carry out audits

Participants recommended that, where the auditing function is in-house, companies should employ local staff with relevant skills in key sourcing countries to carry out audits. Many member companies have already started going down this route (see box below).

GOOD PRACTICE EXAMPLES: EMPLOYING LOCAL STAFF

ETI member companies **Gap Inc.**, **Next**, **Monsoon**, **Pentland**, **WH Smith** and the **Ethical Tea Partnership** all employ local staff based in key sourcing countries, who are responsible for conducting audits and other ethical trade activities. The specific examples highlighted at this event were:

- **WH Smith** have 2 full-time ethical trade staff based in their Hong Kong office, both of whom are Chinese. They are responsible for auditing all their suppliers in China (as well as suppliers in other Asian sourcing countries).
- The **Ethical Tea Partnership** has employed a local representative in Kenya (responsible for the East Africa region), a regional manager based in Sri Lanka, and are now recruiting for a representative in China.

4.2.2 Treat audits as a multi-staged process – and invest accordingly

Several corporate ethical trade managers present emphasised the importance of treating audits as a multi-staged process, allowing for proper planning and follow-up – and providing enough resources per audit to allow for all these steps.

GOOD PRACTICE EXAMPLE: INVESTING IN AUDITS

Pentland's audit programme is based on conducting 2-day audits, engaging with local organisations as part of the audit process, and allowing for return visits to tackle the bigger issues identified in the first audit, eg, discrimination.

4.2.3 Work with local TUs/NGOs to bring about better industrial relations

Some participants encouraged companies to work more closely with trade unions and relevant NGOs to build better industrial relations in their supply sites, as a more sustainable way of addressing entrenched labour problems. It was pointed out that leading companies like **Gap Inc** have recognised the limited impact of the current audit-heavy approach to ethical trade, and see the building of better industrial relations as a key strategy for achieving greater impact on the ground.

GOOD PRACTICE EXAMPLE: BUILDING BETTER INDUSTRIAL RELATIONS

Gap Inc have recently embarked on a joint programme with the ITGLWF aimed at promoting more mature systems of industrial relations in Gap's supply chain. To date, ITGLWF have conducted training on trade union rights for Gap's entire social compliance team, and engaged in discussions with regional teams in South and South East Asia on how to bring about better industrial relations at their supply sites.

4.3 Recommendations for companies using third party auditors

4.3.1 Use different companies for financial/quality and ethical trade audits

One speaker recommended that, where an external auditing company is used for ethical trade audits, this should never be the same company as the one who audits the business's financial accounts. This is important to avoid any conflict of interest.

4.3.2 Actively engage the auditors

Participants encouraged companies to engage the auditors they work with, taking a proactive stance in setting the agenda for their audits, and working with the auditors to develop an acceptable audit methodology and ensure decent follow-up.

GOOD PRACTICE EXAMPLE: SETTING THE AGENDA FOR AUDITORS

New Look works closely with their external auditors to develop the audit process. Every audit lasts at least 2 days, and is paid for by New Look.

4.3.3 Train and sign up auditors on an individual basis

Some participants recommended employing specific auditors on an individual basis, rather than contracting an auditing *company* and leaving them to select individual auditors. This was seen as a direct response to the huge variation in staff quality within each auditing company, and the lack of control over which auditor is allocated to the job. **Levi Strauss & Co** have developed a system for training, screening and contracting auditors on an individual basis – see box below. Interestingly, the UK Temporary Labour Working Group also came to the same conclusion: that the only way to guarantee the quality of auditors was to train and select them on an individual basis.

GOOD PRACTICE EXAMPLE: TRAINING AND SIGNING UP AUDITORS ON AN INDIVIDUAL BASIS

Faced with a freeze on internal recruitment, **Levi Strauss & Co** needed to bring in external auditors to supplement their over-stretched in-house ethical trade audit team. However, they were concerned about the inconsistent quality of auditors offered by commercial auditing companies, so they set up their External Monitoring System, which:

- Recruits auditors on an individual basis. Auditors from any background can apply – commercial, NGO or trade union.
- Applicants go through an initial interview, then they must attend a standard 5-day training programme
- All would-be monitors (auditors) then have to conduct an audit which is shadowed and assessed by Levi's staff
- If they pass, the monitor is given a one-year certificate.
- After one year is up, the monitor needs to undergo another shadow audit assessment before their certificate is renewed.

The Levi's representative present noted that the cost of running the system is not excessive, since the external auditing company fielding the auditor pays for their training. However, some of the audit companies have been resistant to this system since they feel it involves "excessive" training demands.

4.4 Longer term recommendations

Participants felt that while there is much that companies can do alone (see sections 4.1 – 4.3 above), systematic improvements in audit quality are only going to be made through a collaborative effort by companies and other key actors. ETI, the other multi-stakeholder initiatives (MSIs), their member companies, and possibly other code initiatives (eg, WRAP,

BSCI), need to join forces and develop common standards and protocols for auditing practice, and establish an effective system to enforce these standards. This section (4.4) elaborates on what participants believed needed to be done to make this a reality.

Some participants expressed the view that, in the long run, voluntary corporate codes and any amount of good auditing are not enough to address the underlying labour problems, and that ultimately codes and auditing cannot in themselves produce improvements in labour conditions on the scale or in the timeframe required. What is needed is a mature system of industrial relations, backed up by a slimmed down verification service, and that this should be the ultimate end goal that we should all work towards. Nevertheless, even if this is the long-term vision, there was recognition that in the medium term there will still be a need for commercial auditors, so it is still important to improve the current auditing system, however flawed it might be.

4.4.1 Agree common standards and guidelines for auditing

Participants requested that the MSIs work together to develop clear and common guidelines for auditing – this is urgently needed. One speaker suggested that these standards and guidelines should cover:

- The amount of time allocated to audits
- What preparation is required before an audit takes place
- Areas (issues) to be covered in an audit – these should include in particular freedom of association and the right to collective bargaining
- Inclusion of worker interviews as standard auditing practice, including specifying where, when and how these should be conducted
- The frequency of audits
- How the results will be published
- A recommended scale of audit fees.

4.4.2 Develop a common training and certification programme for auditors

Participants recommended that, having developed common auditing standards and guidelines (4.4.1), the MSIs then need to develop a joint training programme that trains would-be auditors on these standards and guidelines, and accredits trainees who have the skills and qualities necessary to deliver to the required standards. Some participants suggested that such a training programme and certification system could build on the External Monitoring System developed by Levi's (see 4.3.3 above). One speaker suggested that the training programme should have 3 levels – introductory, intermediate and advanced, with a professional qualification attached to the final, advanced level.

4.4.3 Develop a system for regulating auditor behaviour and performance

Participants also highlighted the need for a system to regulate auditors once they have been trained, to ensure they comply with the agreed standards and guidelines. One speaker proposed the establishment of a professional institute for auditors which would regulate their behaviour and performance.

4.4.4 Agree a common corporate code of labour practice

Participants also felt that a common code of conduct was urgently needed to avoid unnecessary multiple audits and duplication of effort. Some participants recognised that ETI has taken a lead here with the JO-IN project (Joint Initiative on Corporate Accountability and Workers' Rights – see www.jo-in.org), but must redouble its efforts to have everyone, and especially the other multi-stakeholder initiatives, marching in the same direction.

4.4.5 Build a network of local auditors

Some participants argued for ETI, other code initiatives and individual companies to work together in building up a network of local auditors in sourcing countries, and to provide capacity building to these local auditors/organisations where necessary. Participants mentioned the recently formed Local Resources Network as a possible forum for such work.

4.4.6 Engage investors and consumers

Some participants felt that while individual companies can certainly make a difference by rewarding their buyers and suppliers for good ethical trade practice (see **section 4.1.4** above), ultimately the rewards need to come from investors and consumers. They therefore recommended that ETI and other code initiatives, together with their members, should work together to influence investors and consumers and ensure they provide the right rewards and incentives for retailers and brands.

5. Next steps

In response to the concerns raised at this event, ETI will:

- Share this report with ETI members, relevant contacts in auditing companies, and others with a stake in improving ethical trade auditing;
- Organise a follow-on meeting with interested corporate members to identify specific actions they believe ETI can take to help address the problems outlined in this report; and
- Report back to all members on whether, and if so how and when ETI can take these actions forward.

ETI also encourages member companies to review the recommendations and good practice examples in **Section 4** of this report, and consider what else they can do within their own companies to address the auditing problems they face.

6. Further information

6.1 Good practice in auditing

ETI Workbook, 2nd Edition: Ethical trade – a comprehensive guide for companies (2006)

Developed by practitioners for practitioners, the ETI Workbook (2nd Edition) is a step-by-step guide for companies on developing and implementing an ethical trade strategy. It distils a decade of ETI experience on what constitutes “good practice” in ethical trade. It includes a comprehensive chapter on auditing, supplemented with a wide range of sample auditing tools and good practice case studies.

To order a copy of the ETI Workbook, please contact the ETI Secretariat at the address on Page 18.

6.2 Further evidence of poor auditing practices

Short film: “Secrets and Lies”, ETI, (2006)

This short film shows graphic examples and evidence of different types of audit fraud being practiced in Chinese factories. The film, which was commissioned by ETI, comprises real footage of interviews with factory managers and workers and other related informants in China in 2006. The factories featured supply to various European and US companies across a variety of industries.

To order a copy of “Secrets and Lies”, please contact the ETI Secretariat at the address on Page 18.

“Looking for a quick fix: how weak social auditing is keeping workers in sweatshops”, Clean Clothes Campaign (2006)

This document reports on findings from research conducted in nine countries by the Clean Clothes Campaign and local partner organisations. Based on interviews with 670 workers in 40 factories, as well as factory managers and social auditors, the report provides a comprehensive account of the problems with current auditing practice, including many specific examples and quotes from workers.

Copies of this report can be downloaded for free from: www.cleanclothes.org/ftp/05-quick_fix.pdf

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