

ICCA REPORT
FOLLOW-UP AUDIT OF
MATTEL'S CHINA VENDOR OPERATIONS
Conducted in July 28 – August 2, 2004

I. Short Summary of the Original Audit Report

On January 27, 2004, ICCA published its first-ever formal audit report of its findings of 12 supplier factories in China. The audited facilities represented among the largest and most important of Mattel's vendors in China. The objective of the audit was to independently evaluate and verify the compliance of these vendors with Mattel's Global Manufacturing Principles (GMP). This was the first audit undertaken by any company of its suppliers where audit findings were to be made public without prior censorship either by Mattel or the vendors involved.

Mattel out-sources approximately one-half of its production needs to about 40 major vendors in China. Approximately 75% of Mattel's Chinese vendor operations, by dollar volume, involve 20 vendors operating 22 plants. This report covered twelve (12) plants – all of them located in the Guangdong Province of China. The audit was conducted in two phases: August 2002 (4 plants), and January 2003 (8 plants). These plants constitute approximately 50% of Mattel's total vendor business in China in terms of U.S. dollars. At the time of the audit,

these plants employed over 53,000 workers and represented almost 43% of the workforce employed by Mattel vendors in China.¹

GMP and its accompanying quantitative measures comprise a comprehensive set of outcome-oriented standards that cover almost all aspects of a plant's operations that affect workers' living and working conditions. The issues covered by the GMP audit include, among others, wages, normal and overtime working hours; job-related skill training; worker health and safety; safe operating conditions; freedom of association; and protection from harassment. GMP also has standards pertaining to macro environmental issues, e.g., waste water treatment, air emission, and storage and disposal of hazardous materials.

The field audit is comprised of four parallel activities. The first is an audit of a randomly selected sample of the personnel files and payroll data of a group of workers representing the plant's entire workforce. Auditors supervised by ICCA conduct this audit. The intent of this audit is to ensure that all workers receive wages for regular and overtime work as mandated by law; operate within legal and GMP standards as to regular and overtime hours; and receive benefits as mandated by law and GMP standards. The second element of the audit involves confidential, one-on-one interviews with the same group of workers who were previously selected for the payroll and personnel file audit. This allows for comparison of the information contained in the plant's payroll records and personnel files and the information elicited from the workers through confidential, one-on-one interviews. The third element of the audit is a thorough examination

¹ For complete details of these issue, please see ICCA's 2004 Mattel Vendor Audit Report by visiting our website www.ICCA-CorporateAccountability.org

of the plant's practices and policies with regard to environment, health and safety issues. Independent professional environmental experts accompanied by an ICCA professional engineer carry out this examination. The final element of the ICCA audit is a series of individual and group meetings between ICCA's audit team members and various plant managers responsible for different aspects of a plant's operational facilities, employee supervision and other human resource management activities, dormitories and canteen facilities and operations, and plant and dormitory security functions, to name a few.

The enormity and complexity of data analysis and clarification of issues through follow-up inquiries took a great deal more time than was originally anticipated. Hence the large time gap between the completion of the field audit and the publication of the formal report.

In one sense, this report reflected a certain level of progress in the treatment of factory workers in the Guangdong province in South China, which has been the center of "manufacturing for growth" in China. It is also a microcosm of the challenges that confront all multinational companies in conducting their business in China in a socially responsible manner.

Prior to the current formal audit, ICCA had visited a number of these plants about two years ago with a view toward developing a better understanding of the prevailing operating conditions in vendor plants and their impact on employees' working and living conditions. Vendor plants audited by ICCA have since shown significant improvements in a number of areas, which were considered "critical" non-compliance issues only a few years ago. These

subsequent formal audits also indicated that Mattel had committed considerable resources to advise and assist its vendors in order to improve their level of compliance with Mattel's GMP.

I. 1. Findings of the First Formal Audit

The findings provided a mixed picture of the vendors' performance. In some sense, this was to be expected. Mattel had urged its vendors to move beyond the current practices, which would affect all other customers of their plants. And both the vendors and Mattel were working together to create a new operational environment and to breakaway from the notion of "business as usual." Therefore, the process of continuous improvement has been started.

The positive changes included an emphasis on hiring workers 18 years or older, and universal compliance with regard to payment of accurate wages for regular and overtime hours. Areas showing significant improvement included safety of workplace, dormitories and canteens, workers' access to all levels of management, lack of discrimination in promotion based on sex, race or ethnic origins, and, significant reduction in poor treatment of workers.

Areas needing substantial further improvement included poor record keeping with regard to rest days and the requirement of paying double overtime or compensatory day off for work done on Sundays or other rest days; inconsistent application of regulations with regard to fringe benefits, e.g. maternity leave, annual leave, and use of cash fines; worker training with regard to safety; and, inadequate use of personal protective equipment.

There was also inadequate attention to macro environmental issues, e.g., treatment and disposal of waste-water, air and water quality, and a culture of inadequate attention to general plant maintenance and operations. Most factories were found to be inadequate in varying degrees of GMP pertaining to environmental issues. These included: disposal of wastewater, frayed electrical insulation and inadequate ventilation in areas with painting fumes and soldering processes.

The worst area of non-compliance pertained to excessive overtime hours. This practice has been particularly pervasive even in the case of the “Consolidated Work Hours,” where factories are allowed to condense their total allowable yearly overtime hours into a shorter-time span to meet peak season production requirements.²

II. Mattel’s Response to ICCA’s Audit Report

Mattel’s immediate response to ICCA’s findings was both positive and constructive. The company was gratified with the progress that had been made and vowed to increase efforts to effect changes in the areas that needed improvement. Tom Debrowski, Mattel’s Executive Vice President of Worldwide Operations stated: “We strive to continually improve our facilities, both Mattel-owned and supplier-owned, and for our actions and results to be transparent. In

² It should be noted here that consolidated work hours are widely practiced in the region, and even otherwise, most plants routinely exceed the maximum overtime hours permitted under China’s labor laws. ICCA questions the legality of both these practices. Notwithstanding, local authorities accept these practices to be the norm and give wide leeway to plants to design consolidated work hours to meet their production needs, which are routinely approved by the local authorities. Therefore, in practice, consolidated working hours do not conform to any type of overall industry framework or regional considerations. Instead, they are permitted by local authorities to suit the needs of individual factories

this way we uphold our commitment to Mattel's GMP and to fully responsible corporate conduct." The company promised to "work with suppliers, and in consultation with ICCA, design and implement an action plan to correct deficiencies and set the stage for continuous improvements in all of its overseas facilities and operations." This plan was to be finalized within the next 90 days.

On May 18, 2004 Mattel provided ICCA with details of its remedial action. In developing its plan, Mattel took a more forward looking approach and rather than simply fixing existing problems, it would work with vendors to create management systems that would greatly reduce, if not completely eliminate, occurrence of similar problems in the future.

The company's internal auditors analyzed over 300 specific findings in ICCA's report pertaining to the 12 plants. They worked with individual vendors to develop corrective plans that addressed the initial audit findings. The company provided ICCA with a detailed report of over 200 pages showing how each and every change was organized and implemented with record of verification and, where appropriate, provided for ICCA's review, copies of proper certification from appropriate government agencies and professional bodies. The company also provided photographic evidence of new and repaired installations indicating the extent and scope of corrective measures taken by the vendors in cooperation with Mattel.

III. ICCA's Follow-up Action

A detailed analysis of the report provided ICCA with a large measure of assurance that most of the changes recommended had indeed been made and that no further action was needed. It was a significant effort on the part of Mattel and its vendors and indicated considerable amount of human and monetary resources.

Of the 12 plants in the original audit, ICCA determined that in the case four plants (identified as Plant # 4, # 5, # 8 and # 11 in the original audit report of January 27, 2004) information submitted by Mattel was quite satisfactory and, therefore, no further action was necessary. ICCA decided to undertake a follow-up audit of the seven plants to personally verify the adequacy of compliance efforts. These plants employed approximately 28,400 workers representing 53% of the 53,300 workers covered in the original audit. (These plants were identified as Plant # 1, # 2, # 3, # 6, # 9, # 10 and # 12 in the original audit report of January 27, 2004.)

The Case of the Plant # 7

At the time of the original audit, this plant (identified as Plant # 7 in the original ICCA audit report of January 27, 2004) employed approximately 7,800 workers. During the initial audit, the plant was found to have significant non-compliance issues in the areas of payment of regular and overtime wages, excessive overtime hours, and poor record keeping with regard to working hours and wage payments to workers. Mattel informed ICCA that it had decided to

discontinue its business relationship with this vendor. Mattel's internal audit had concluded that this vendor could not be counted on to implement the changes called for in the ICCA audit report. Consequently, ICCA decided to eliminate this plant from the follow-up schedule.

However, Mattel has since informed ICCA that for business reasons, Mattel has continued its contractual relations with this vendor and currently has no plans to terminate this relationship. Therefore in the case of Plant # 7, compliance with GMP standards – many of which fall in the zone of “highly critical” standards – remains unresolved.

Follow-up Audit Schedule

The follow-up audit was to be scheduled on a relatively short notice to ensure that all plants would be in operation and that responsible personnel from Mattel and vendors would be available during ICCA's visit. Mattel immediately agreed to such an action and ICCA scheduled the follow-up audit of 7 plants during the period of July 27 – August 3, 2004.

IV. Organization of the Follow-up Audit

The follow-up audit was organized to focus on four groups of activities for compliance verification in the seven plants.

1. Policies and practices with regard to total work hours scheduled by the plants during normal and peak production periods. This would also include scheduling of work on Sundays or other rest days, and the payment of overtime wages or compensatory time-off for such work within a reasonable period of time.

ICCA's focus would be to ensure that new payroll record-keeping and payment systems had been put in place and satisfactorily implemented to comply with Mattel's GMP standards with regard to maximum hours worked during normal and peak production periods.

2. To ensure that new policies have been put in place and corrective action taken with regard to probationary period, maternity leave, and annual leave that are consistent with China's national labor law and GMP standards. Another issue to be examined pertained to the vendor policies with regard to imposition of cash fines. A third issue had to do with different vendors' policies with regard to the workers' use of bathroom facilities and drinking water during work on the assembly line. A fourth issue pertained to certain mandatory requirements imposed by some vendors that workers live and eat in the company provided facilities and the reasonableness of such charges in accordance with GMP standards.

3. The third group of actions covered all environment, health and safety related issues that directly affect individual workers. These included, among others, training and proper use of personal protective equipment (PPE) by all workers, housekeeping, noise contamination, maintaining proper air quality standards in areas such as soldering, tempo-printing, spray painting and injection molding, safe operating conditions and good electrical and mechanical maintenance practices in all areas to ensure worker safety.

4. The fourth group pertained to the macro-environmental aspects of a plant's operations. These included, among others, waste and process water

treatment, storage and disposal of hazardous materials, soil contamination and external air pollution.

V. Findings of the Follow-up Audit

V. 1. Regular and Overtime Hours

GMP standard prevailing at the time of the original audit (August 2002 – January 2004) provided for a maximum of 60 hours/week over a six-day period comprising of 40 regularly paid hours and 20.0 overtime hours for a theoretical maximum number of 3030 hours per year. This standard, however, exceeded the relevant provisions of the China's national labor law, which provided a maximum of 2440 work hours per year, including a monthly maximum of 36, or a total of 432 overtime hours per year.

Notwithstanding, the more liberal GMP standard faced two problems.

a) Local area practices almost always exceeded the GMP standard with the result that all vendors were found to be in violation of the GMP standard by wide margins. Some vendors were also suspected of keeping double sets of books and thereby apparently meeting the GMP standards while in practice violating them.

b) The GMP standard did not provide for excess overtime hours during peak production periods. Vendors routinely resorted to the practice of seeking exceptions to the national law from their local labor bureaus, which were only too willing to provide such exceptions. The result has been widespread

abuse of overtime limits where individual plants located next to each other in a community had widely different types of permissions. Some plants also had permissions whose authenticity was questionable, while many others exceeded the limits provided under these permits with impunity.

ICCA has determined that the legality of these local bureau permits to be highly questionable. However, Mattel and most other foreign multinational companies have chosen to accept the validity of these permits and allow for the higher overtime limits provided in them.

Following ICCA's report, Mattel revised its GMP standard with regard to overtime hours. This was an attempt to find a middle ground whereby vendors could operate their plants and also provide workers with greater opportunities to earn additional overtime wages during peak production periods.

The revised GMP standard allows vendors to schedule a maximum of 72 hours per week during peak periods and other extraordinary situations, provided that the total number of weeks covered under this provision cannot exceed 17 weeks in a year. For the remainder 35 weeks of the year, the weekly schedule cannot exceed 60 hours per week. Under Mattel's new guidelines the maximum hours that a worker may be required to work is approximately 3200 total hours per year, comprised of 2008 regular hours and 1192 of overtime hours.³

The revised GMP standard also attempts to eliminate most of the abuses associated with local authorization permits. Under the current system, manufacturers are generally able to obtain waivers from local authorities allowing

³ The variation may stem from the specific dates of the stated peak period, and the dates on which national holidays fall.

working hours in excess of the national law. These waivers can often reach unacceptable limits and may allow vendors to engage in other practices with regard to payment of wages for normal and overtime work which are in violation of China labor laws and GMP standards.

The new GMP standard also provides that:

- Except for extraordinary situations, the peak production period shall be defined in consecutive weeks. It will be announced to the employees at the beginning of each year.
- Mattel will not accept any local bureau authorization that would allow a vendor to exceed these limits.
- All overtime work must be voluntary and that appropriate wage rates must apply to overtime work.
- Workers must receive one day off per week except during times of extraordinary circumstances, where a worker is allowed to work seventh day but cannot work more than 13 days consecutively.
- In order to monitor compliance with this standard, Mattel requires that all vendors develop a management system, which clearly documents instances when workers exceed the 60-hour workweek as well as work on the seventh day. Furthermore, if the vendor gives workers time off in lieu of double pay, it must be given within the next pay cycle and documented in a system that is easily understandable and verifiable.

Our follow-up audit indicated that with the exception of two plants (Plant # 1 and # 12), all plants (Plant # 2, # 3, # 6, # 9 and # 10) were in full compliance with the revised standard, i.e., the systems were in place to ensure that:

- Work hours during normal week and peak production period could not exceed 60.0 and 72.0 hours respectively. A review of payroll data and time sheets indicated that all plants were in compliance with the new standards.
- All overtime work was voluntary and that workers received correct wages for regular and overtime work.
- Workers also received requisite compensatory day-off or double wages for work done on Sundays or other normal rest days.

Plant #1 employing 3,700 workers had not implemented the new GMP standard and, at the time of the follow-up audit, indicated no definite plans as to when it might comply with the revised GMP standard. Plant #1 currently operates on the basis that any employee can be scheduled to work at the rate of 72.0 hours per week on the basis of 12.0 hours/day, 6.0 days per week. Moreover, a worker could be asked to work 12.0 hours on any single day of the week, or a full week during any time of the year. The practical impact of this policy is that plant #1 can schedule its entire workforce for 72.0 hours/week for the entire year to a theoretical maximum of 3636 hours per year.

Plant #12, employing 4,500 workers, has accepted the new GMP standard in principle. It currently operates on the basis of 60.0 hours/week. However, it has not yet determined as to how it would implement the GMP standard for

defining peak production period in terms of its timing and duration. Plant #12 has already implemented all other provisions of the revised GMP standard, i.e., overtime pay, a maximum limit of 13 days of work without a day off, and timely payment of overtime wages or compensatory day off for work on Sunday or other normal rest day.

ICCA views this situation with considerable alarm. As we have noted in an earlier part of this report, Mattel's revised GMP standard provides far more flexibility to its vendors both as to scheduling and maximum allowable overtime hours per week and the entire year than the original GMP standard. The revised standard also leaves additional room for manipulating GMP standards through creative interpretation of terms like "extraordinary situation."

ICCA believes that any further adjustment of this standard would make it practically ineffective in protecting workers from doing excessive overtime hours. We await Mattel's response toward making this standard more explicit and enforceable, and how Mattel plans to make Plant # 1 and Plant # 12 adhere to the new GMP standard with regard to overtime hours.

IV. 2. Employee Benefits

ICCA's audit confirmed that all vendor plants included in the follow-up audit were in full compliance with GMP standards with regard to probationary period, maternity leave, and paid annual leave. All plants have instituted policies and procedures to ensure that all eligible workers receive such benefits. Furthermore, these policies are being communicated to all workers through

revised orientation programs, employee handbooks, and notices posted in common areas.

Imposition of Cash Fines

Mattel has revised its GMP standards to limit the imposition of cash fines to only those employee actions, which create safety hazards to themselves and their fellow workers. Henceforth, plants would also emphasize greater training and better supervision to reduce the need for such fines.

ICCA has noted that the two plants imposing these fines, i.e., Plant #1 and Plant #12, have recorded a significant reduction in the fines during the first half of 2004 compared with the similar period in 2003.

Non-Payment of Overtime wages for Work on a National Holiday in Plant #12

One of ICCA's audit findings pertained to the non-payment of overtime wages for 2-days of work on a national holiday.⁴ Following investigation by Mattel and the vendor, it was agreed that all workers who worked during the national holiday period should be paid two days of extra wages at normal wage rates.

Unfortunately, a significant number of these workers are no longer in the employment of Plant #12 due to high turnover rates that are endemic to plant operations in Southern China. Therefore, Mattel and the vendor, in consultation with ICCA, have agreed to the following remediation plan.

⁴ For details of the incident and the reasons thereof, please see ICCA's 2004 Mattel Vendor Audit Report by visiting our website www.ICCA-CorporateAccountability.org

- a) Mattel and the vendor would jointly set up an Employee Welfare Fund with approximately RMB289,000 (US\$36,150) constituting 2 days wages of the plant's work of around 4,500 workers at the time of the incident.
- b) The vendor will place a notice on all factory notice boards announcing the plan and asking all currently employed workers who had worked during those two national holidays to report to the plant management. Notices will remain posted for a 30-day period.
- c) Vendor will also include a similar notice in each worker's pay-stub during the next pay period.
- d) Upon verification, all eligible workers will receive 2-days' extra wages added to their October, 2004 paychecks.
- e) All remaining unclaimed funds would be earmarked for employee welfare activities to be determined by a committee, which would also include employee representatives.
- f) Activities selected for funding under this program would be entirely new activities. In other words, these funds would not be used to pay for the programs, which are currently funded for by the vendor.
- g) ICCA will verify the implementation of this program through a visit to the vendor's plant in late November 2004.

IV. 3. Internal Environmental Health and Safety Issues

ICCA's follow-up audit confirmed that problems observed and documented during the initial visits to the subject seven vendor plants have been addressed

by plant management and have been mostly corrected. It has taken a major effort to bring the plants to their present state of compliance. The responsible parties deserve credit for an outstanding effort. With minor exceptions, exceptional progress has been made in areas of housekeeping, the proper use of PPE, electrical and mechanical equipment maintenance, grounds keeping, and in some instances proper ventilation. There remains a need for improvement in certain plants for drinking water purity, statutory inspections of cranes and hoists, material handling and stacking, internal noise monitoring, and additional ventilation equipment in some tampo-painting areas and soldering stations.

In one plant where ambient inside temperatures reach uncomfortably high levels, the plant has initiated a test program of coating a portion of the sheet metal roof with insulating compound. This coating helps to reduce the inside air temperature by approximately 5 degrees centigrade. The vendor plans to continue insulating the remainder of the sheet metal roofs with the same compound. This is a positive step. Should vendors maintain their current level of effort toward improving physical facilities, ICCA believes that the vast majority of existing problems will be eliminated in the foreseeable future.

IV. 4. Macro-Environment

The vendors have successfully addressed most of the external problems identified during the original audit. Dangerous goods storages have been improved and upgraded although some secondary containment areas need improvement. Integrity tests have been conducted to assure diesel tanks and underground pipelines are not leaking, potentially contaminating the soil. In most

cases applications have been submitted to the Environmental Protection Bureau for pollutant discharge permits but as of now have not been issued. The permit application process should be followed up to assure that the permits are issued in a timely manner. With the exception of one plant, monitoring applications for air emissions, wastewater and boundary noise permits have also been submitted to the Environmental Protection Bureau. These require follow-up to ensure their timely issuance. Exceptional progress has been made in clearing up external environmental issues and the efforts should continue until all major objectionable problem areas have been eliminated.

In general, the following issues need further attention in one or more plants information for which was communicated to the plants' management immediately upon completion of the plant visit during the follow-up audit:

- a) Air emission standards for the canteen in one plant
- b) Wastewater and boundary noise standards exceeding permissible limits pursuant to test by the local environmental station
- c) Previously many of the paint scrubbing systems were either partially inoperative or nonfunctioning, they had been improved and/or redesigned. Preventive maintenance systems should be instituted to assure the proper functioning of the paint scrubbing systems.