

Sourcing Overseas for the Retail sector*

CSR and The Ethical Supply Chain



Part 2 in a four part series of analysis, comments and opinions by PricewaterhouseCoopers UK Retail and Consumer group

*connectedthinking

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Sourcing Overseas

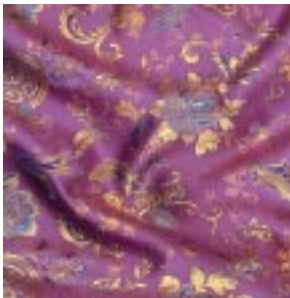
This is the second of a series of strategy papers on Sourcing Overseas by PricewaterhouseCoopers UK Retail and Consumer group.

It follows an earlier paper in which we examined the abolition of trade barriers in a key sector – textiles and clothing, and the implications this has for retailers, both in the UK and further afield.

Future papers in this series will examine licensing as a management opportunity; and the essential elements of brand protection and risk.

Executive Overview

Over the past ten years, a wide range of stakeholders have taken an increasing interest in the social, ethical and environmental performance of the retail industry's supply chain. This interest has resulted in many high profile campaigns targeting individual companies or whole industry sectors. This interest by the media, investors, consumers, employees, the Government and NGOs has led companies to explore how they can best control and manage the ethical implications of increased sourcing from overseas markets.



The traditional approach to ethical supply chain management has been the social compliance model, where manufacturers' facilities are assessed to ensure they are compliant with applicable local laws and/or companies' own supplier codes of conduct. Such monitoring has traditionally been carried out by external agencies, although some companies are increasingly employing their own full-time specialist monitors or training existing buyers to monitor performance in this area.

Many NGOs and trade unions have started to question the effectiveness of the social compliance model, citing poor levels of rectification in terms of supplier performance. PwC's monitoring experience suggests that poor rectification is usually due to a combination of:

- Weak internal processes and controls in following up identified non-compliances;
- A lack of leadership from senior management;
- Conflicts between buying teams' targets and systems;
- A lack of influence or leverage with suppliers; and
- A lack of supplier awareness/worker empowerment.

However, it is our opinion that monitoring is still vital for successful responsible supply chain management because it is essential for assessing a company's baseline position and developing rectification plans.

The issue is, rather, how to conduct monitoring in the most efficient and effective manner.

Looking to the future, the most forward looking companies are now starting to work collaboratively with others in their sector to manage responsible supply chain issues and are also integrating their responsible supply chain management programmes within wider business objectives. This involves:

- Integrating social compliance within the context of broader supply chain issues such as brand impact, intellectual property, quality issues such as product safety, product traceability and financial security, and
- Ensuring that wider business objectives, targets and systems are aligned with ethical sourcing principles.

It is this collaboration and integration which will be critical to developing meaningful, long-term and successful sourcing strategies that will support brands over the long term.

Introduction

The trend for large UK retailers to source goods from overseas has been coupled with increased attention from a variety of stakeholders on how companies manage social, ethical and environmental risks along their supply chains.

This article explores why companies are looking ever more closely at the wider Corporate Social Responsibility (CSR) implications of their sourcing practices which are often driven by cost controls, how companies are responding to the ethical supply chain agenda and the future of ethical sourcing.

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The Rising Trend for Overseas Sourcing

The volume of goods that UK firms source from overseas markets where the costs of production are lower has been steadily increasing for many years, now accounting for a significant proportion of the value of many products sold in the UK.

For example, in 2002 the volume of global garment trading was valued at \$500 billion, with developing countries being responsible for 70% of global garment exports. Of this \$500 billion total, the UK was responsible for \$16 billion imports of which \$3 billion were imported from China.¹ The trend for UK firms to buy in garments from the developing world is set to escalate following the cessation of the World Trade Organisation's Agreement on Textiles and Clothing on 1 January 2005. Even with the previous quota restrictions, in 2003 China exported an estimated 20% of the world's textile and clothing products. It is now widely believed that the majority of garment production will shift to Asian countries with some describing China as the future 'factory of the world'.

What's more, the trend for increased global sourcing extends beyond the textile and clothing sector. Statistics for the Information and Communication Technology (ICT) sector

reveal that electronic and electrical products accounted for 60% of total exports from the Philippines and two-thirds of exports from Singapore.² Electronic products are also a significant industry in China with exports valued at US\$62.6 billion in 2003, an increase of 72.9% from 2002.³

A 2004 survey by The Grocer found that buyers across the industry expect their businesses to increase the amount of food and non-food they source overseas in response to rising competitive pressures. Specifically, nearly two-thirds of buyers on the magazine's Reader Panel expected their firms would increase sourcing from overseas in the future. At the same time many of these same businesses are also concerned with the sustainability implications of this drive for overseas sourcing and competition, with 40% stating that overseas sourcing could overshadow issues such as health and sustainability performance records due to less visibility with suppliers and reliance on agents and middlemen.

It is now widely believed that the majority of garment production will shift to Asian countries with some describing China as the future 'factory of the world'

¹ Source: Hong Kong Trade Development Council

² HSBC Business Profiles, Philippines and Singapore, September 2003

³ HSBC Business Profiles, China, August 2004

The Importance of Ethical Supply Chain Management

Over the past few years, a wide range of stakeholders have taken an interest in the social, ethical and environmental performance of the retail industry's supply chain, including the media, investors and rating agencies, consumers, employees, the Government and NGOs:

“The effective management of supply chain dynamics has for some time held the key to a successful business model. With this environment changing considerably over recent years retailers have been faced with a new set of issues that require greater understanding and sensitivity than ever before. The principle driver in this change has been a move from domestic to global sourcing practices, as emerging markets offer new opportunities. Global sourcing will continue to offer the basis for a diverse product range and with consumers becoming more exotic in their tastes the buying community will be pushed to every corner of the world. Coupled with this, a highly competitive market has inevitably led to fierce price competition with retailers exploring alternative markets to reduce costs and where possible differentiate themselves from competitors.

These changes have resulted in retailers adopting increased levels of accountability in managing the complexities associated with supplier relations. The dynamics between supplier and retailer have escalated further down the supply chain as businesses strive for improved levels of transparency from cradle to grave. Successful supply chain management now emphasises a working relationship with the supply chain to understand the breadth and depth of supply chain issues and the management of potential business risks. Management that makes good CSR reading but above all sound business sense.”

Nigel Smith, CSR Policy Director, British Retail Consortium

The Media

The media has devoted considerable attention to such issues, with headlines on alleged ‘sweatshop labour’ affecting many prominent global brands. This media attention has amplified the need for companies to not only establish systems and controls to monitor supplier performance but also to develop reporting mechanisms to demonstrate to external audiences what actions they are undertaking to ensure high standards.

Government

The UK Government is taking an increasing interest in CSR and ethical supply chain management. In the UK, the Operating and Financial Review (OFR) comes into effect for financial years after 1 April 2005, requiring companies to report on a wide range of issues to the extent information is necessary for an assessment of the company, with suppliers being highlighted specifically as one of these potential areas for reporting. Additionally, the Government, through its own direct procurement is increasingly looking at broader sustainability issues in awarding tenders and contracts. At the EU level, the European Commission's recent White Paper on CSR contains guidance on labour standards.

Investors and rating agencies

Many corporate investment companies are now screening their investments according to a range of social and environmental criteria, including a company's efforts in addressing supply chain labour conditions. For example, Insight Investment, the asset management arm of HBOS, worked with AccountAbility last year to develop the Gradient Index, an index that compares the performance of major FTSE listed companies on supply chain labour issues management (see Table 1). Insight Investment is now engaging with the poorer performers in the Index to encourage them to manage the sustainability impacts of their supply chain. Additionally, the FTSE4Good index introduced labour standards into their annual Corporate Social Responsibility (CSR) index for the first time in November 2004.

Consumers

Consumers are becoming more and more active in directing their spending towards goods that meet their ethical expectations and boycotting companies and brands that are seen as exploiting suppliers. Environics International's latest Annual CSR Monitor reported that 27% of consumers across 25 countries have punished companies for being socially irresponsible and another 21% have considered doing so. Additionally, a recent survey by the Co-Operative Bank found that 30% of consumers believed that they could best influence the corporate responsibility of business through 'boycotting companies that I feel are unethical'.

Table 1: The Gradient Index

The Gradient Index	
<p>The Gradient Index is a benchmark of 35 FTSE350 companies, taken from 6 sectors. The index scores companies on a range of supply chain management issues, covering:</p> <ul style="list-style-type: none"> • Governance and risk management • Policy • Management • Stakeholder engagement • Auditing and reporting. 	<p>Key findings from the index indicate that:</p> <ul style="list-style-type: none"> • 31 of the 35 companies have publicly recognised the importance of social, environmental and ethical issues to their business; • 14 companies surveyed do not disclose a supply chain labour standard code or policy, or have a weak code that does not reference core ILO conventions; • Only 1 company aligned performance in this area with staff incentives; • 26 of the companies have committed themselves to auditing performance in their supply chain, although only 8 cover their entire supply chain; • Member companies of the ethical trading group, Ethical Trading Initiative (ETI), that took part in the Gradient Index scored higher on average than non-member companies.

27% of consumers across 25 countries have punished companies for being socially irresponsible and another 21% have considered doing so.

Employees

Employees are demanding reassurances of their employers regarding the management of a broad range of corporate responsibility issues, including management of suppliers in overseas territories. For example, employee interest and pressures is the most commonly cited reason for companies producing CSR reports. This is supported by a recent survey by the Work Foundation, ‘Corporate Nirvana’, which found that 80% of employees would not work for an organisation with values they did not believe in.

NGOs

NGOs have for a number of years campaigned for companies to monitor and manage the ethical performance of their suppliers. It is important to note that NGOs have not only multiplied in numbers in recent years but also become increasingly more active, establishing a local presence in countries such as China, to focus on conditions in the factories that UK companies are increasingly sourcing from. Larger NGOs are also now starting to target companies beyond the retail sector, for example in telecommunications and electronics.

Responding to the pressure of these stakeholders and recognising that enforcement of labour and environment related legislation is typically more lax in many developing countries, many in the private sector have taken it upon themselves to manage the reputational risks presented in sourcing from developing markets. However, as well as managing the downside highlighted by various stakeholders, there are also many business benefits to be gained from increased focus on social compliance within supply chains. For example, companies with successful ethical monitoring programmes have reported resulting beneficial impacts in terms of increased knowledge about their suppliers, better relationships with suppliers and benefits from product differentiation. All these factors ultimately help to build stronger supply chains that support the brand and protect against reputational damage. The following diagram (Figure 1) traces the evolution of ethical supply chain management, highlighting the influence of different stakeholder groups.

Figure 1: The evolution of ethical supply chain management

	1990/95	1996/97	1998/99	2000/02	2003/04
Drivers	NGO Campaigns and awareness raising	Development of corporate response	Establishment of recognised standards: <ul style="list-style-type: none"> • SA8000 • Ethical Trading Initiative 	Investor and Governmental pressure: <ul style="list-style-type: none"> • Pensions Amendment Act • ABI Guidelines • Socially Responsible Investment 	Move towards understanding the impacts of responsible supplier management programmes
Corporate Challenges		<ul style="list-style-type: none"> • Should a corporate code be adopted? • What would such a code contain? • Codes varied in coverage and quality 	<ul style="list-style-type: none"> • Adoption of standards • Debates on need to monitor and audit compliance 	<ul style="list-style-type: none"> • Continued debates on need to monitor and audit compliance 	<ul style="list-style-type: none"> • How can companies measure impacts? • How can activities be integrated with broader supplier management objectives? • Capacity building

Defining Ethical Supply Chain Management

The exact definition of ethical supply chain management will vary between stakeholders and individual companies. Many companies have based their codes on the principles set out in the International Labour Organisation (ILO) Conventions and United Nations (UN) Universal Declaration of Human Rights. Others have also included environmental and broader economic development considerations in mind when defining what ethical supply management means to them.

The following list details the areas covered by the Ethical Trading Initiative's base code. The ETI was established in 1998 to bring the combined knowledge and influence of relevant NGOs and the international trade union movement to work alongside companies in identifying and promoting good practice in the implementation of ethical trade codes. The organisation now has 36 corporate members, working with representatives from 16 NGOs and 4 international trade unions.

- Employment is freely chosen
- Freedom of association and the right to collective bargaining are respected
- Working conditions are safe and hygienic
- Child labour shall not be used

- Living wages are paid
- Working hours are not excessive
- No discrimination is practised
- Regular employment is provided
- No harsh or inhumane treatment is allowed.

It is worth noting that environmental impacts are also a key component of ethical supply chain management for many companies, and that there are a number of sector specific issues, e.g. management of conflict diamonds for the jewellery sector. Additionally, some companies are also looking at the economic development impacts of their sourcing impacts, e.g. local procurement policies. However, this paper focuses on the more 'social/ethical' implications of sourcing activities.

Focus on China



Chinese textile factory monitored by PwC Hong Kong

The move towards increased sourcing from China brings with it significant ethical supply chain risks. PwC's social compliance team in China have been conducting social compliance visits across the region for companies since 1997. During 2004, PwC visited 1,500 factories in one region of China to conduct social compliance audits. Their work has identified 4 areas of common non-compliance:

- Barriers to freedom of association;
- Insufficient wages and compensation;
- Excessive working hours; and
- Poor health and safety standards.

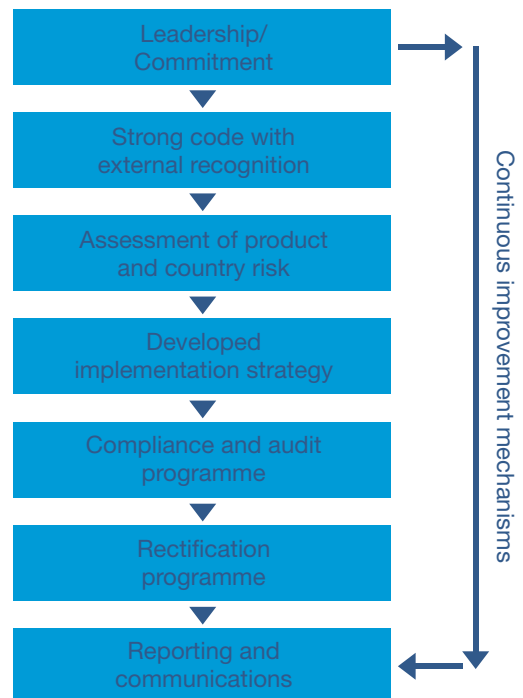
On a more positive note, they have found that in recent years the incidence of child labour (defined as workers under the age of 16 in China) has become less common and health and safety performance has improved.

Managing Supply Chain Risks

The traditional approach to ethical supply chain management has been the social compliance model. This has involved assessing manufacturing facilities to ensure that they are compliant with applicable local laws and regulations, plus companies own codes of conduct including areas covered within the ETI's base code.

Many companies initially choose to use external providers to conduct such monitoring programmes. For example, PwC's Hong Kong social compliance team have estimated that in 2003 in the region of 30,000 third-party social compliance monitoring visits took place in China from a variety of providers. The diagram opposite (figure 2) details the key elements that are needed for successful social compliance programmes. In addition, there follows a case study of a luxury retailer's approach to the traditional social compliance model.

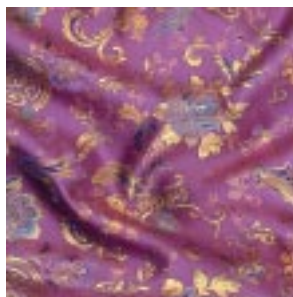
Figure 2: Best practice elements of social compliance model



Case Study 1: Luxury retailer – Protecting the Brand and Reputation through Ethical Supplier Management

PwC has worked with a luxury retailer who was concerned about potential reputational risks associated with their increased outsourcing of manufactured products outside Europe. PwC developed a risk assessment framework and applied it to over 1,000 suppliers / manufacturers under license to identify higher risk suppliers/manufacturers. Based on the results of this risk profile, we developed a strategy to implement a programme to monitor compliance of their supply base with their social and ethical code of conduct. A key element of the strategy was the execution of a pilot programme, assessing compliance of suppliers and manufacturers under license in Italy, UK, Japan, Hong Kong and China, using local PwC social compliance monitors in these countries. This pilot was rolled out to the remainder of the supply base and involved site visits to suppliers in approximately 15 countries including China, Thailand, the Philippines, Tunisia, Romania, Peru and Poland. We also conducted a review of a key licensee's own ethical sourcing programme to assess its alignment with our client's own programme.

The client has benefited from an increased and intimate knowledge of the conditions at several of their higher risk suppliers' sites. Working relationships have also improved with several suppliers and licensees. Finally, the client is now in a stronger position with respect to protecting its brand than it was when their code of conduct was initially drafted.



Many companies are increasingly using not only external monitors to conduct factory audits, but also investing in their own internal capability to conduct such monitoring programmes. For example, Gap has about 90 full-time employees worldwide who continually monitor factories for compliance issues and work with manufacturers, local NGOs, unions and other stakeholders to improve conditions. Similarly, PwC has worked

with IKEA to support them in developing their internal capacity to monitor supplier compliance with their code of conduct, covering performance regarding social and working conditions, child labour, environment and forestry. Further details of this work can be found in the following case study.

Case Study 2: IKEA – Developing Internal Capacity

Following work with IKEA to develop their supplier code of conduct, PwC has helped the company to develop an implementation programme to ensure compliance with the code. Our work has involved developing controls and reporting tools for IKEA's own internal social compliance monitors and developing training programmes for internal auditors in the conduct of social compliance audits.

One element of IKEA's approach has been the introduction of "calibration" visits to IKEA suppliers, whereby PwC monitors have conducted audits at the same sites as IKEA monitors to ensure the consistency of their findings. Our work has also included on-site training at the supplier's premises of IKEA's internal auditors. This has also been supported by third party monitoring visits to randomly selected IKEA suppliers to ensure suppliers' compliance to the IKEA Code of Conduct and also provide an overall evaluation of IKEA's internal compliance system.

The Future

Many NGOs and trade unions have started to question the effectiveness of the traditional social compliance model, citing poor levels of rectification in terms of supplier performance. Therefore, some industries and groups of companies are now taking a different and more collaborative approach to managing these risks. Looking to the future, it is anticipated that leading companies will further integrate ethical supply chain management issues within wider business objectives.

Is the compliance model working?

Many NGOs and trade unions have now started to question the effectiveness of the social compliance model, citing poor levels of rectification in terms of supplier performance. Partly in response to such criticisms, The World Bank commissioned PwC in 2003 to identify the key barriers to improved implementation of codes of conduct at the level of suppliers and develop potential options for addressing these barriers.

The report⁴ was written in conjunction with the Danish Institute for Human Rights and Business for Social Responsibility. The study involved consultations with nearly 200 workers and 200 representative groups and companies in China, Honduras, India, Kenya, the United States and Europe.

A key finding of the study was that developing codes of conduct were, on their own, not sufficient to achieve sustained improvements. Such improvements required the implementation of capacity building and worker empowerment programmes. For example, many workers interviewed in China were unaware of their rights under Chinese law. Additionally, the study concluded that suppliers currently have an insufficient understanding of the business benefits associated with making the required investments in CSR. For example, some businesses in China saw standards such as SA8000 as new forms of 'trade barriers' from the West.

Our experience shows that social compliance audits are fundamental to successful ethical supply chain management, as without auditing and monitoring performance it is not possible to know what issues exist within your supply chain

and therefore what areas rectification programmes should address. However, some audit and monitoring programmes are currently not achieving significant rectification and improvements. This is for a variety of reasons including:

- Weak internal processes and controls for following-up identified areas of non-compliance;
- Lack of leadership from senior management on the importance of social compliance;
- Conflicts between buying teams' targets and systems, for example contradictions between "just-in-time" delivery processes and the principles of ethical trade; and
- Lack of supplier awareness and knowledge in terms of company expectations on social labour issues or a lack of buy-in from producers as to the reasons for change.
- Insufficient leverage and influence over suppliers particularly when buyers purchase a small percentage of the suppliers total output

Looking forward, monitoring programmes need to be strengthened through strong executive endorsement, robust follow-up procedures and alignment with mainstream buyer's business objectives. Monitoring programmes should also extend beyond supplier compliance visits to include awareness raising initiatives both internally within the company's organisation and with the supply chain to demonstrate the benefits of improving the working conditions in supply chains. In addition, capacity building around relevant legislation, improved planning techniques and overall project management at supplier level is likely to reap greater improvements in working conditions.

⁴ Strengthening Implementation of Corporate Social Responsibility in Global Supply Chains, October 2003, The World Bank Group Corporate Social Responsibility Practice

What can be achieved in isolation?

From a business perspective, many companies are also questioning how much can be achieved by individual company action in isolation and also the cost of conducting monitoring programmes. These concerns have led some within industry to push for a 'supplier pays' approach to social compliance monitoring. However, shifting the cost of auditing to suppliers' could lead to significant independence issues and many have questioned the ethics of shifting this responsibility for compliance to suppliers themselves, particularly if they are being asked to pay for multiple audits for various customers.

Therefore, many companies within the retail and consumer goods sector are now starting to work in a more collaborative manner to share best practice and also share findings from site visits to suppliers to avoid duplication of effort and save resources. Anecdotal evidence suggests that this approach is also supported by supplier companies themselves as it minimises disruption. One example of such cross industry working is the Ethical Tea Partnership.



A weighing station on a tea field in Sri Lanka monitored by PwC

How can ethical supply chain management be integrated with wider management of supply chain issues?

As detailed above, integration of ethical supply chain management objectives within wider business objectives and planning is key to achieving performance improvements. In particular, integration within buyers' performance metrics and targets is needed to achieve lasting rectification.

Global procurement teams and local buying agents should be trained and conversant in ethical sourcing issues. For example, the contract tender process in each region should allow sufficient time to review the responses from potential suppliers with supporting evidence, where appropriate, in relation to social compliance issues. Additionally, the selection criteria for the award of supply contracts should clearly make reference to environment, health & safety

The Partnership was formed in April 1997 by a number of UK-based tea packing companies who believe that they have a shared responsibility for the social and ethical conditions involved in sourcing the tea they buy and that activities in this area should be non-competitive and apolitical.

In the UK, four leading retailers, Marks & Spencer, Safeway Stores plc, Tesco and Waitrose together with Northern Foods, Geest, RHM and Uniq have formed SEDEX. This is a secure, web-based system for companies to maintain data on labour standards at production sites and make it available to companies with which they are in a trading relationship, in order to drive and demonstrate improvements. This system is an important development in the quest to share best practice and avoid duplication of effort. However, a key challenge with this approach is ensuring consistency in auditing approaches and the quality of information provided as there are currently no standards for companies taking part in the programme and a variety of different monitoring providers. This is an important issue to address for companies to be able to place reliance on the findings of reports from this system.

The Ethical Tea Partnership represents 17 companies responsible for 47 brands of tea sold in over 30 countries. The Partnership has commissioned PwC to assess compliance with local legislation and collective bargaining agreements for approximately 1,200 tea producers over a four year cycle. Collaborative working has been essential to the success of the programme and helps address the problem of multiple auditing programmes and stakeholder liaison.

performance, treatment of employees and other significant ethical issues. Here, the negotiated terms and conditions should include the provision for the company to terminate the contract with the overseas supplier for substandard performance in relation to these areas. As part of the company's supplier development programme, these ethical standards should be translated into local information and reinforced through planned communications.

At the same time as increased efforts to train procurement teams and buying agents on ethical sourcing issues, some companies are also now starting to take a more integrated approach to their social compliance programmes. This has involved integrating social compliance within the context of broader supply chain issues such as brand impact, intellectual property, royalties, quality issues such as product safety, counterfeiting and financial security.

Setting social compliance within the context of broader business issues is a crucial step forwards for companies to effectively engage in ethical supply chain issues and enable effective mapping and prioritisation of social and financial risks

Using RFID technology to improve traceability

The pharmaceutical sector is investigating the use of technological advances to increase traceability within the supply chain, by using Radio Frequency Identification (RFID) tags and bar code technologies. These tags will enable firms to help uncover fraudulent and counterfeit medicines and will be used to check quality.

Additionally, many worldwide food companies are considering the use of RFID to meet the requirements of food traceability regulations. Here, companies are required to trace the movement of materials and goods at least one stage forwards and one stage backwards at each step in the supply chain. The tags are planted in pallets and cases so that batches of product can be tracked. Applied in this way, the technology can be used to identify recalled and expired products in the supply chain.

Similarly, RFID tags could be used to detect other counterfeit products, particularly items made in the Far East and then introduced in the European supply chain (otherwise known as “grey imports”). Such counterfeit products tend to be made in conditions that contravene internationally recognised standards, as well as branded company’s own Corporate Social Responsibility policies. Also, RFID can be used to detect products that have been diverted for unauthorised sale, typically in developing countries at a lower price. Used in this way, RFID could support the ethical sourcing management programmes of branded companies by demonstrating that all reasonable and practical steps are taken to guarantee the authenticity of their products through a legitimate supply chain, as well as supporting wider objectives around quality control, product safety and counterfeiting.

Setting social compliance within the context of broader business issues is a crucial step forwards for companies to effectively engage in ethical supply chain issues and enable effective mapping and prioritisation of social and financial risks. It is also an important step to realise the many positive potential opportunities from ethical supply chain programmes, such as:

- Increased knowledge about suppliers;
- Better relationships with suppliers;
- Product differentiation;
- Support of brand values; and
- Basis for increased dialogue with consumers on corporate social responsibility.

These broader supply chain issues will be discussed in future papers in this series that will examine licensing as a management opportunity; and the essential elements of brand protection and risk.

In conclusion, the ethical supply chain agenda has developed considerably over the past few years. Past performance indicates that conducting social compliance audits in isolation may not lead to significant rectification. Rather, a combination of monitoring, senior level commitment, collaborative working, and alignment of wider business objectives, targets and systems with ethical sourcing principles is necessary to achieve lasting positive outcomes in terms of brand support and enhancing reputations. The most forward looking companies have already started to adopt this integrated approach, with the rest of the retail sector under increasing pressure to respond to this ever strengthening agenda.

For further information on PwC’s ethical supply chain work or wider sustainability services, please refer to our website, where you can also subscribe to PwC’s quarterly sustainability newsletter or contact a member of the Sustainable Business Solutions team:

<http://www.pwc.com/sustainability>

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