



# Attacking the Roots: Shiraishi Garments Company and an Evolving Thicket of Business Ethics in China

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**Abstract.** This case examines management underpinnings of conducting socially purposeful business in contexts where the labor conditions and ethics are questionable. Shiraishi Garments Company was a Japanese entrepreneurial venture in the clothing industry that evolved into a highly successful multinational company. After its supply chain had extended into China, some ethical labor issues emerged. The decision point is focused squarely on the company's CEO, who must deal with conflicting forces stemming from his personal values and professional responsibilities. In exploring the issues, the case illustrates business risks of superficial standards auditing of international operations. The case also describes how multinational firms are often part of the problem and the solution when it comes to ethical labor issues. On these grounds, the case study reveals some alternative approaches to the audit model based on more meaningful partnerships. Implications pertain to successful and ethical supply chain relationships between foreign entrepreneurial firms and the developing economic systems they enter.

**Keywords:** operations, entrepreneurship, supply chain, international, China, labor conditions, safety.

## 1. Introduction

Takashi Shiraishi stared out his office window, watching reflections of a hazy afternoon sun shining on Tokyo Bay. The date was February 9, 2005. Since early the year prior, Shiraishi Garments Co. (SGC) had begun outsourcing its whole production capacity to China in order to dramatically increase its profit margins. As SGC's President, Takashi saw the immediate benefit of such outsourcing to his bottom line. But operations were vastly different in China. Some ethical issues had emerged related to the health and safety of Chinese workers. Some disturbing accidents had occurred in the manufacturing facilities. These events had long concerned Takashi for reasons that were personal. But now the reasons were also becoming business-related. As a consumer products company dealing in clothing and apparel, SGC needed to maintain its positive reputation: business success depended on its brand. Takashi was increasingly certain he was going to have to make a tough strategic management decision to resolve the tradeoff between ethical business operations and being a highly profitable multinational company.

Japanese firms had wrestled with public trust for several years, especially since the Snow Brand milk poisoning episode in 2000. That was when over 13,000 consumers became seriously ill. Cheap labor, albeit domestic, was reported as the reason. Yet, Japanese companies were still moving operations into other countries for more cheap labor, which was also increasing the level of domestic Japanese unemployment. Some of these companies were taking steps to demonstrate concern for international employees with a strong commitment to corporate citizenship. SGC also worked hard to improve labor conditions in its Chinese supply chain. For instance, when local suppliers were reluctant to make the financial investments for first aid training in factories, SGC paid for the initial sessions. Soon thereafter, the Chinese partners saw less time lost due to injuries and began to embrace first aid training. Later, two major suppliers also began to use the same first aid training and noted the same benefits. Although the direct costs were absorbed by SGC's bottom line, Takashi undertook additional similar initiatives, such as the production of a first aid handbook and posters with information about hazardous substances. But it never seemed to be enough. The entire issue was like an evolving thicket of conflicting forces. Takashi realized he was going have to do more than just trim the branches.

## **2. Finding the Roots**

As Takashi gazed at the setting sun, he pondered some more ideas to boost healthier workplace practices. For example, reducing the long working hours and increasing worker compensation throughout its Chinese operations. But such an initiative would seriously affect SGC's bottom line. Quite simply, outputs would reduce drastically because less hours were worked per employee. Although focusing on health and safety might help SGC's reputation, lower revenues did not make business sense, especially in the short term. But accepting the status quo was not necessarily less risky either: SGC's supply chain was showing cracks due to Chinese labor force dynamics. For example, he considered the Chinese workers churning out lady's brassieres for Ginza, the famous shopping district in Tokyo. Those employees were growing miserable while working in factories where security guards kept them behind locked gates and taking a bathroom break for longer than a minute was fineable offense. Employee turnover rates in two of these particular suppliers exceeded 100%. It was becoming impossible to recruit enough employees to maintain production. As a result, SGC orders were increasingly not being filled on time. Takashi found it unbelievable that production demands were so great that a labor shortage was emerging in the world's most populous nation.

Another option, suggested by SGC's Board of Directors, was to withdraw operations from China. SGC could enter other Southeast Asian countries such as Vietnam and Laos, where more cheap labor was available and there was not a

growing emphasis on labor conditions. Takashi rejected that option. He was a staunch proponent of the Japanese ideal of *Kyosei*, which had been embraced by international bodies such as the Caux Roundtable.<sup>1</sup> Just as the *Kyosei* ideal emphasizes economic and social development, Takashi believed economic survival was not the true goal of SGC. Rather, he wanted SGC to play a role in improving the lives of its customers, shareholders, and employees. In the case of China, therefore, he wanted SGC to contribute to the human rights, welfare, and education of Chinese people.

It was now past dusk. The running lights of cargo ships headed out to sea through the Uraga Channel were visible, and the Tokyo Aqua-line bridge was illuminated. Takashi resolved to make the right strategic decision for SGC before the month of March, in just 19 days. But he did not know where to start. He did not want to lose the competitive advantage of outsourcing to China, and he refused to exploit the labor force. He wanted SGC to maintain the reputation of a company that cared about its employees. This puzzle of how to keep making money in China while emphasizing more ethical business operations was driving him mad. Takashi knew he was not going to solve this puzzle by looking out the window. He vowed to act as quickly as possible. He strode to his desk and picked up the telephone.

### **3. SGC's Background**

Japan has one of the biggest and most sophisticated apparel industries. When it comes to fashion, the Japanese taste in clothing is among the most particular in the world. For centuries, the most cherished possessions of Japanese women have not been silver, gold or any kinds of precious stones. Instead, it has always been the lush rich colors and the perfect fit of their kimonos. Much more than other cultures, clothing signifies worldviews, personal tastes, and sensibilities in Japan. Although many contemporary Japanese live in plain apartments, most have a strong willingness to spend considerable sums of money on fashionable, stylish clothing. This aspect of the market environment underlies SGC's niche.

Takashi Shiraishi established SGC in 1978 after watching a news report on television. The oil crisis was hitting the economy hard that year, leading the Japanese government to announce and publicize the "energy suit". The energy suit was a short-sleeved safari outfit designed to allow companies to save expenses on air conditioning. The idea was a total failure however, because although a few ministers wore energy suits for a week or two, nobody would dare to wear one to the office. Takashi's recognized his entrepreneurial opportunity when the news reporter said,

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1. The Caux Roundtable Principles were developed in 1994 by business leaders interested in ethical and responsible corporate behavior as a foundation for business worldwide. See [www.cauxroundtable.org](http://www.cauxroundtable.org)

The businessman puts on the darkest suit he owns, a white shirt, sober tie, and *that is what he wears* in Japan, no matter what the temperature is outside. The Japanese find this rigidity comforting, as it eliminates the nerve-racking necessity of making choices.

A recent art school graduate, Takashi believed such conservative dressing habits created a real venture opportunity: introducing customization into the drab business attire market. He believed differences in taste, preference, and lifestyle mattered significantly to customers, even to those in the same age demographic. Thus, the purchasing patterns were diversified. He eventually opened a men's clothing shop in a Tokyo department store. Even though the small shop offered products in conservative colors such blue, gray, brown and black, there were other options besides drab suits and neckties. Based on skin color, hair style, and other characteristics, Takashi helped customers select colors, accessories, styles, and shapes for tie knots. He became a master at making customers feel special and important. Such personal attention made all the difference. Customers absolutely enjoyed that SGC took such interest in their appearance.

#### **4. The Growth of SGC**

As SGC grew, the clothing designs were transferred to sewing subcontractors in the Tokyo suburbs. SGC usually ordered smaller quantities with more designs whereas other retailers ordered larger quantities and fewer designs. Although it was easier to fill orders for other retailers, the subcontractors were more interested in SGC. As all the retailers wanted low prices and high quality from sewers, business relationships changed frequently because of price wars. Yet, the relation SGC had with its sewing subcontractors remained strong. SGC made detailed reports on defects and also gave advice about how to improve quality and production. SGC shared customer comments and fashion forecasts, too, so subcontractors and suppliers could keep pace with the market.

On average, within two weeks of an order customers would receive customized garments from SGC. The clothes arrived at the customer's home, and sometimes delivery personnel even showed customers how to wear the clothing correctly. Then they would visit the customer ten days later to see if everything was going well. Customers thus felt sense of obligation to SGC, which would always be there should the clothing require service or repair.

The customer-oriented strategy combined with supplier relationship management were successful and good for business. SGC's garments were only 15% higher than ready-made ones, but with SGC consumers were able to choose from more than 10,000 unique style permutations. The SGC brand quickly became synonymous with quality and prestige. During the 1980s, when the Japanese economy was booming, SGC was a medium-sized but prestigious brand.

However, by 1991, its annual sales for eleven retail outlets had skyrocketed to exceed 22 billion yen.

## 5. SGC Tightens Its Belt

As the 1990s progressed, economic globalization and an aging population dramatically changed the Japanese apparel industry. Rather than purchasing completely designed garments, the new generation purchased items from several different shops, mixing them freely to match their flighty sensitivities. Young shoppers displayed a strong tendency to buy clothes at select shops near railway stations and fashion-specific commercial districts rather than conventional department stores, which were more sophisticated but also more traditional. There was also a new casual style trend for male consumers. Perhaps a general disillusionment with the “salary man” lifestyle made a more laid-back attitude seem attractive. Simultaneously, the Japanese economy entered its “ten lost years” once the real estate and stock market bubbles burst in 1990. Japanese consumers lowered spending on clothing by making fewer purchases and preferring lower-priced items. As such, from 1991 to 2004 the percentage of household clothing expenditures decreased every single year.

The Japanese male clothing market was becoming more fashion-oriented but commodity-driven. SGC’s customized business attire did not meet this trend well. Since the late 1990s SGC had been struggling with shrinking sales and profit margins, as shown in Table 1. At some point, Takashi recognized that he had to cut costs to survive. That point, in 2004, was when Takashi took steps to outsource SGC’s sewing operations to Chinese companies.

Table 1: Shiraishi Garments Company. Financial Highlights (yen, in millions)

<b>March 31year-end</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Sales	236,225	232,819	221,781	215,822	189,313
Operating income	17,661	14,032	15,275	12,910	12,872
Net income	7,266	6,026	5,049	4,567	4,347

Source: SGC internal documents

## **6. Chinese Allures and Challenges**

In 2004 the whole business world was already watching the Chinese economy. The reality of 1.3 billion potential consumers and low labor costs were attractive to American, European, and Japanese companies. Shelves around the world were stacked with low-cost goods churned out by China: the world's workshop and fourth largest economy. Its highest volume products were clothes, toys, and technology appliances (e.g., DVD players). The national minimum wage had increased by 30%. In the poor inland areas, where most migrant laborers come from, more young people could find jobs near their hometowns. As a result, when exporters near the coast had poor working conditions, migrant laborers would be less likely to go there for work. Unbeknownst to foreign companies, labor conditions were emerging as an important factor in the national labor market. Once China joined the World Trade Organization (WTO) in 2001, its attractiveness as a manufacturing center increased further. The World Bank then estimated that China would account for half of world textile manufacturing by 2010.

Takashi had conducted his own research in China as a production solution for his business. Table 2 shows Takashi's 2004 data, which revealed that China was not the cheapest place to outsource. However, Takashi believed personally that the criteria for the best place to manufacture were not so straightforward. Right now, the place was China because of low labor costs as well as the tremendous foreign direct investments in its textile and apparel manufacturing industries. Indeed, those industries were growing fast, and the rising productivity of Chinese high-tech sewing facilities were outpacing anything else the world had ever seen. Takashi visited several "supply chain cities" and was utterly impressed that everything needed to manufacture garments existed in a single location. Many Chinese vendors were located within the supply chain cities. Factories were located near textile mills and other suppliers of various components. From a business perspective, when considering the factories, political climate, time, fabric availability, human resources, infrastructure and speed to the Japanese market, Takashi was sure China was preferable to other Asian countries. He wanted to play a role in the positive development of China. From a personal perspective, and based on the historical context of Japanese and Chinese culture in southeast Asia, he saw a particular opportunity with China. His personal interest in making a contribution to innovation, trust, and world community called for him to embrace an ethical leadership role that might be especially appreciated by Chinese manufacturers.

Table 2: Hourly rates for sewing laborers in Asian urban regions

Country	Rate (\$/hr)
Laos	0.04
China (mainland / inner)	0.12
Vietnam	0.12
Sri Lanka	0.14
Bangladesh	0.19
Pakistan	0.23
India	0.25
Indonesia	0.42
China (coastal)	0.48
Japan	10.5

Source: Cal Safety Compliance Corporation (CSCC)

## 7. Chinese Manufacturing Practices

Takashi noticed the salary rate in Chinese coastal areas was four times higher than in China western regions. Many labors thus had left rural poverty in the countryside for the new factories along the coast. As the 2004 Chinese New Year approached, Takashi was surprised to see that up to 120 million migrant laborers filled roads and railways to reunite with families in countryside. This large migration helped keep wages low. Migrant laborers were a cheap and compliant work force who had attracted much foreign direct investment and ensured the viability of millions of domestic businesses. However, Chinese prosperity had been achieved through their exploitation. In the Pearl River Delta, for example, one local vendor in SGC's new supply chain told Takashi, "There are many girls with good eyes and strong hands. If we run out of workers who will accept our current wages, we will go deeper into the hinterland and recruit new workers." In that vendor's factory workers were earning basic monthly wages of \$37 and worked 16 hours per day, seven days per week. These realities troubled Takashi.

Low wages and poor labor conditions were the dark side of cheap labor costs. Domestic China policy had not yet addressed them effectively as of 2004. Takashi saw that state-owned enterprises, although not productive or profitable, treated workers fairly well. At the same time, private sector companies were exploiting migrant labor, mostly young females. At the very root of the problem was the failure of local government to address the issue. He recounted in his journal, "The local authority's priority is to attract foreign direct investment, and

labor law enforcement is a selling point when trying to attract foreign inward investment. But the big problem is that local authorities are flexible in interpreting the law and have scarce resources.”

Clothing companies had been a focus of non-governmental organization (NGO) campaigns criticizing low pay, overtime, safety problems and child labor in Chinese supply chains. NGO criticisms could lead to significant damages to a company’s reputation. Thus, to operate in China, SGC had to face the problem of labor conditions. Other risks associated with poor labor conditions included quality problems, low productivity, and high employee turnover. Takashi summarized two principal risks associated with operating in China. Reputation, as poor labor conditions created negative publicity damaged the brand value. Also, operational risks were important and stemmed from poor productivity and high employee turnover (due to poor labor conditions).

Foreign companies with factories in China were less exposed to those risks than companies outsourcing production. Control was limited when outsourcing. Companies actual factories in China had implemented occupational health and safety programs. They paid basic wages above the legal minimum. Their social security payments and working hours complied with regulations. Some provided extra benefits, such as housing subsidies and holidays. These factories required a minimum volume of business and had to reinvest continually to update their technology. The overhead costs of an outsourced vendor, on the other hand, were spread over a couple hundred clients. Takashi thought it would take years for a new factory to achieve the best practices, platforms, and intellectual property on par with a third party. So he decided to use Chinese suppliers instead of establishing an SGC factory in China.

## 8. Potential Suppliers in China

In China, Shiraishi Garments Company had two major suppliers. The first one produced accessory goods (supplier 1) and the second one sewed garments (supplier 2).

**Supplier 1.** Located on the outskirts of the city of Wenzhou in Zhejiang province, supplier 1 employed 1,500 laborers. Its number of overtime hours were problematic, as 78% of employees worked at least 132 hours of overtime per month. Most workers arrived at this factory unskilled. Because they were often paid piecemeal, and never for overtime, there was no incentive for the factory to cutback hours. Workers built skills on the job. The factory did not pay for training, carrying hidden costs of low productivity and quality and factory overhead. Although the factory incurred warnings and fines, supplier 1 did not provide any sort of bonus to employees at all. A rule book issued to workers instructed them on every aspect of factory life. The harsh penalty system included



finer for any violation of the rules, including (a) arriving late, (b) talking during work, (c) leaving the workplace, or (d) spitting. Supervisors and middle managers spoke rudely and shouted at workers when production goals were not met.

Employees were despondent about the long hours and low pay. The fines and poor quality food exacerbated their unhappiness. Workers reported that there were few ways to communicate at all with managers. Most had no desire to do so. Relationships between workers and supervisors were strained. Employees frequently suspected supervisors of not accurately recording the number of pieces they produced and of extending working hours further than what management had scheduled.

It seemed health and safety management was good. Accidents were recorded by the medical center and minor injuries were dealt with in the first aid room in each production unit. Takashi still had concerns about ergonomic issues such as congested facility layouts, bad lighting, and poor ventilation. Problems also included inappropriate storage and handling of toxic chemicals, improper protection equipment for workers, and the lack of chemical safety training.

Supplier 1 had headaches managing its own suppliers. Low quality and late delivery of raw materials delayed production and squeezed the window of time for jobs and orders. They undertook used purchasing from multiple-source, buying from a list of potential suppliers to avoid getting locked into a sole source.

**Supplier 2.** A small factory in the city of Dongguan in Guangdong province, employing around 400 workers, sewed garments for SGC and a few other foreign retailers. The managers described relations with foreign purchasers as uncomfortable in terms of tight lead times, late sample approval, and last minute changes to product specifications. All these problems put increased pressure on supplier 2 to deliver orders, which were sometimes not filled. It also led poor communication between merchandisers, factory management, and production.

Insufficient communication about changes to product specification led to more reworking and, therefore, overtime. The reworking time averaged 7% during production and 10% after final inspection. On some production lines with particularly difficult styles, reworking could reach levels of more than 50%. As the piece rate compensation system did not cover reworking, a significant proportion of time was not only utterly unproductive, it was also unpaid. Very few workers knew there was a legal minimum wage. But all were aware they were not compensated for overtime and believed their wages were unfair. Two-way communication between workers and management was poor, so changes in pay or hours were not understood and on occasion resented by workers. There were few effective channels for workers to raise concerns with management, and managers usually did not respond to worker concerns or suggestions. Although the factory levied fines for 18 different kinds of offences, workers did not receive any training.

Supplier 2 had other areas of concern. Takaishi saw there were inadequate escape routes and locked or blocked emergency exits. Systems for tracking and improving productivity and quality were poor or nonexistent. There was no formal production line quality control system and no records of reworking rates during the production process. The piecemeal workers were given daily productivity targets and supervisors made daily estimates of how many pieces each worker made. Those records were not kept for more than a few days.

Supplier 2 estimated that 70% of its fabric supplies necessary for production were delivered at least one week late. Worker annual turnover at supplier 2 was extremely high, 140%. Most workers left because of the overtime hours and management had no apparent concern for their well-being.

## **9. Auditing**

Factory auditing by the government was not the best tool for tackling the problem of Chinese labor standards in supply chains but, at the time, it was the only way. Independent auditing is a critical factor that a company can use to maintain its reputation and achieve ethical behavior. But auditing alone, especially if superficial, is not enough to drive positive change. It was easy to audit financial conditions, but difficult to audit a supplier for social conditions related to labor, community, and the environment. Health and safety audits were also difficult. For instance, Takaishi noted one audit checklist item, which stated, “The supplier has a fire alarm.” Further questions not considered were, “does it work?” “Do workers know what it is?” “Do workers have the right or the will to use it?” “Would they know what to do in an emergency?” “Can everyone in the factory hear it?”

A black-and-white audit approach could not solve these kinds problems. Even if short timeframes to prepare and improve to pass an audit were granted, the fundamental problem was still poor labor conditions. Post-audit follow-up from the auditors was poor and resulted in few improvements actually being implemented.

Audits even could drive dishonesty, lack of openness, and fraud. Suppliers felt forced to provide the “right” answer or face penalties. Chinese factory managers were becoming skillful faking records and coaching workers to give acceptable responses during interviews. This trend towards concealment was a barrier to improving labor conditions because it wasted time and money without making any change in the workplace.

Whereas workers did not want to work the excessive hours demanded of them, they were willing to work more than the low limits set by Chinese law to increase their pay. They knew that if a factory reduced hours to legal limits as a result of an audit, without some commensurate effort to increase productivity, wages would decrease dramatically.

## **10. Attacking the Roots**

The sun was low and darkness was now descending over the Tokyo Bay's man-made islands. Takashi walked back to the window. His mind was clearer now. He believed that the current approach, dependent on compliance-focused audits, had made little progress in tackling poor labor conditions in SGC's Chinese operations. The days of sweatshop labor might be numbered because the business environment was changing in China. Workers had mobile telephones and word of worker mistreatment spread fast. International purchasers could no longer rely on profits earned by exploiting Chinese workers.

Takashi thought he needed to focus more on continuous improvement and capacity building activity. But a new approach to finding a sustainable solution was needed. If such an approach was impossible, he was prepared to seriously consider getting out of China.