



3

Workers in Contract Factories

Key Targets by FY11:

- ▶ **Eliminate excessive overtime in our contract factories.**
- ▶ **Implement tailored human resource management systems and educational training for workers in our focus factories.**
- ▶ **Implement Freedom of Association Educational Program in 100 percent of focus factories.**
- ▶ **Lead multi-brand collaboration on compliance issues in 30 percent of our supply chain.**

When we look at our overall footprint in the world, the needs of the almost 800,000 workers in our contract supply chain overshadow any other direct constituency.

We estimate that 80 percent of these workers are women aged 18 to 24, many of whom are the first women in their families to work in the formal economy. They have the potential to be significant agents of change within their families and their communities, both today and in the future. Yet they are typically poorly educated, living against a precarious backdrop of poverty and insecurity, within emerging economies, all of which leaves them particularly vulnerable to infringement of their rights.

Consequently we believe the most fundamental impact we can have in the world today is to impact positively the working conditions in our global supply chain and the industry as a whole.

The challenge we have set for ourselves is to play a role in bringing about positive systemic change for workers' rights within our supply chain and the industry at large.

Nike's evolving approach to tackling working conditions within our supply chain mirrors the evolution within a broader change movement. With the benefit of hindsight, we now define a number of different generations of approaches that evolved within Nike and are mirrored in the broader labor discussion.

We see the evolution of our approach in terms of generations. In Generation I we set standards. In Generation II we developed tools and methods to monitor those standards. Each generation was a stepping stone to the next and delivered vital learning and experience for all stakeholders.

Both generations held promise of change that, to date, has been only partially realized. While we see on-the-ground improvements — examples of best practice and enduring work in the industry that changes conditions on a daily basis for workers — the promised systemic change has not yet occurred. Across the industry we continue to see systemic issues affecting workers’ rights.

This insight led to our FY04 report, a watershed for us. We consolidated and shared our data. Industry data solidified our assessment that Generations I and II were not yielding the anticipated systemic change. This signaled the evolution of our Generation III approach, which we have implemented during the past two years.

Generation III is what we call responsible competitiveness. While monitoring continues to be a cornerstone of our approach, we are taking a broader, more holistic look at our supply chain, focusing on

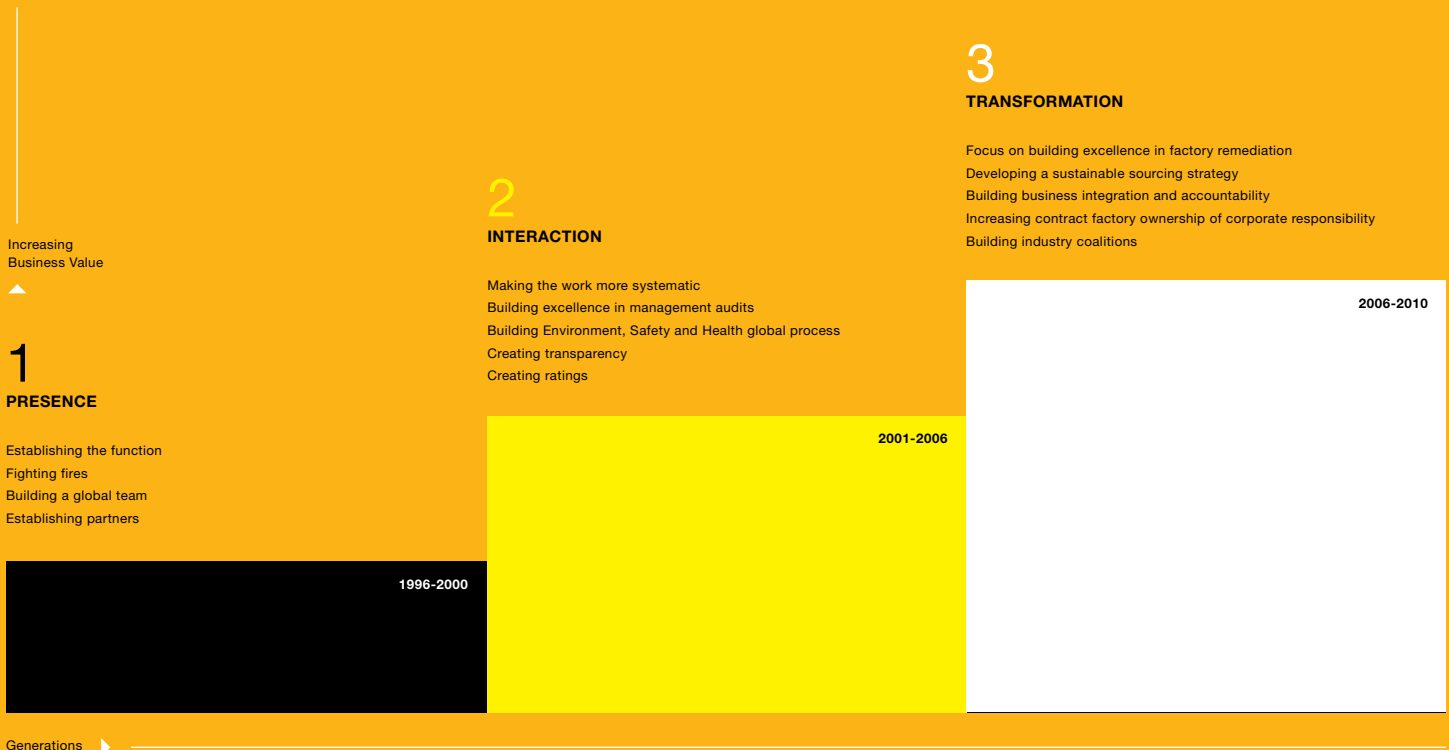
root cause identification and solutions that will drive systemic change. This evolution in our approach is the result of key learnings, some of which we outlined in our FY04 report. First, we know that monitoring by itself is not the answer. Monitoring sheds light on the issues, but not show how to solve them. It gave us a look back at incidents, but didn’t inform us of real-time system failures. Traditional monitoring audits the symptoms, not the causes.

Comprehensive monitoring in and of itself will not result in sustainable improvements for workers.

Second, secrecy around contract factory locations in supply chains — an inherited wisdom within the industry that locations are competitive information — led to a lack of cooperation between buyers and was responsible for massive wasted resources across the industry. The brands risked becoming caught in a never-ending cycle: placing all resources into monitoring supply chains would not allow them to focus resources on systemic change approaches.

We’d all be too busy monitoring the issues to actually solve the problems.

Chart 3
Compliance Generations at Nike



To counter that situation and enable greater cooperation and collaboration, we broke ranks with the industry model and disclosed our contract factory locations. Some have since joined us in publicly or privately sharing their locations. We are seeing successes as a result of collaboration – shared information, shared best practices, leveraged resources and more effective coverage of supply chains within our industry. By FY11 we expect to leverage multi-brand collaboration in 30 percent of our contract factories to share best practices and maximize resources.

We continue to advocate for transparency and encourage all companies in our industry to disclose publicly their supply chains. We have realized no competitive disadvantage from bringing greater transparency to our supply chain. In fact, many of our suppliers have welcomed it for leading to streamlining and harmonization of monitoring approaches, reducing the burden on them, and allowing partners to collectively focus resources and energy on more than just policing.

Monitoring is a cornerstone of Generation III and will continue to deliver extremely useful information. Monitoring fuels our ability to assess contract factory performance and to consider their performance as part of the overall assessment that Nike buyers use in establishing and evaluating business partnerships.

In Generation III we have shifted our approach to monitoring, and shifted resources to enable us to focus on root causes and permanent systemic change. Based on the hundreds of monitoring events we detailed in our FY04 report, in FY05-06 we documented the work done to focus on five major areas where non-compliance occurs within the apparel, equipment and footwear industries:

- ☉ Absence of freedom of association and collective bargaining
- ☉ Harassment and abuse of workers
- ☉ Excessive overtime work hours
- ☉ Inaccurate or nonpayment of wages
- ☉ Environment, health and safety issues

Our responsible competitiveness approach to tackling these problems is based on the belief that:

- 1 We need to go beyond the issue and understand the root cause.
- 2 We need to aim for systemic change, not just the resolution of incidents.
- 3 We need to foster systemic change by building responsible competitiveness into our entire business model and enabling a win-win for workers' rights and for growth and profitability across our supply chain.

Our transition to Generation III is still in progress. We have achieved a great deal already, but impacts will be slower and sometimes more difficult to document. We believe that more work is needed to quantify direct workplace improvements. Systemic change takes time. We believe that no one – in our industry, trade unions or non-governmental organizations – has yet found a way to demonstrate measurable impact from our collective work with enough evidence, enough scale, enough neutrality or enough transparency to prove large-scale systemic change.

Most of us have become experts in seeking out and documenting the bad, but few have described the vision of success that meets the interests of all parties.

In the past, good performance meant the absence of bad. We are now focusing our efforts on determining and describing what we think good looks like. From this, we are able to model efforts on bringing about measurable change.

Generation III

From policing and firefighting to coaching and capacity building.

We are building the skill sets and strategies to address corporate responsibility issues at the point of origin rather than where they surface. Coaching means sharing the knowledge we've gained and guiding and encouraging the way forward, not softening our approach or relaxing our standards. Experience, dialogue and partnership with stakeholders give us a roadmap for how to approach these issues.

From informing business units to engaging them.

Business units are seen as partners in the conversation, accountable for driving change. Rather than highlighting what was wrong in our business units and handling issues in terms of risk and reputation management, we are engaging the business and integrating compliance policy and process into business practices and performance measures.

From a focus on issues to a focus on systems and root causes.

We now focus on understanding root causes, creating approaches to drive systemic change across the supply chain rather than solely monitoring the appearance of those issues.

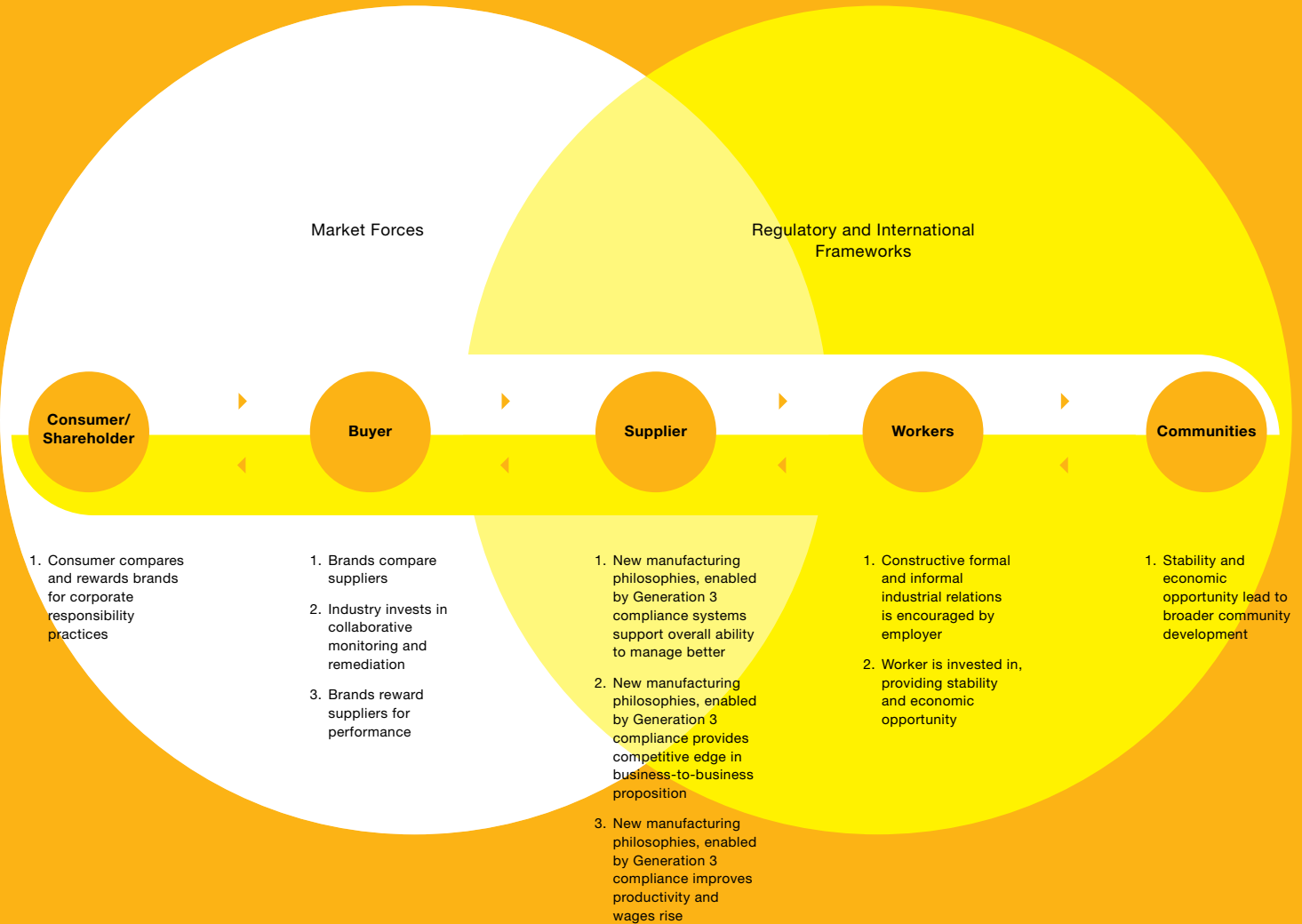
This is what we believe **good** looks like for our supply chain.

Chart 4
Nike Supply Chain Vision



This is what we believe **good** looks like for the industry.

Chart 5
Industry Supply Chain Vision



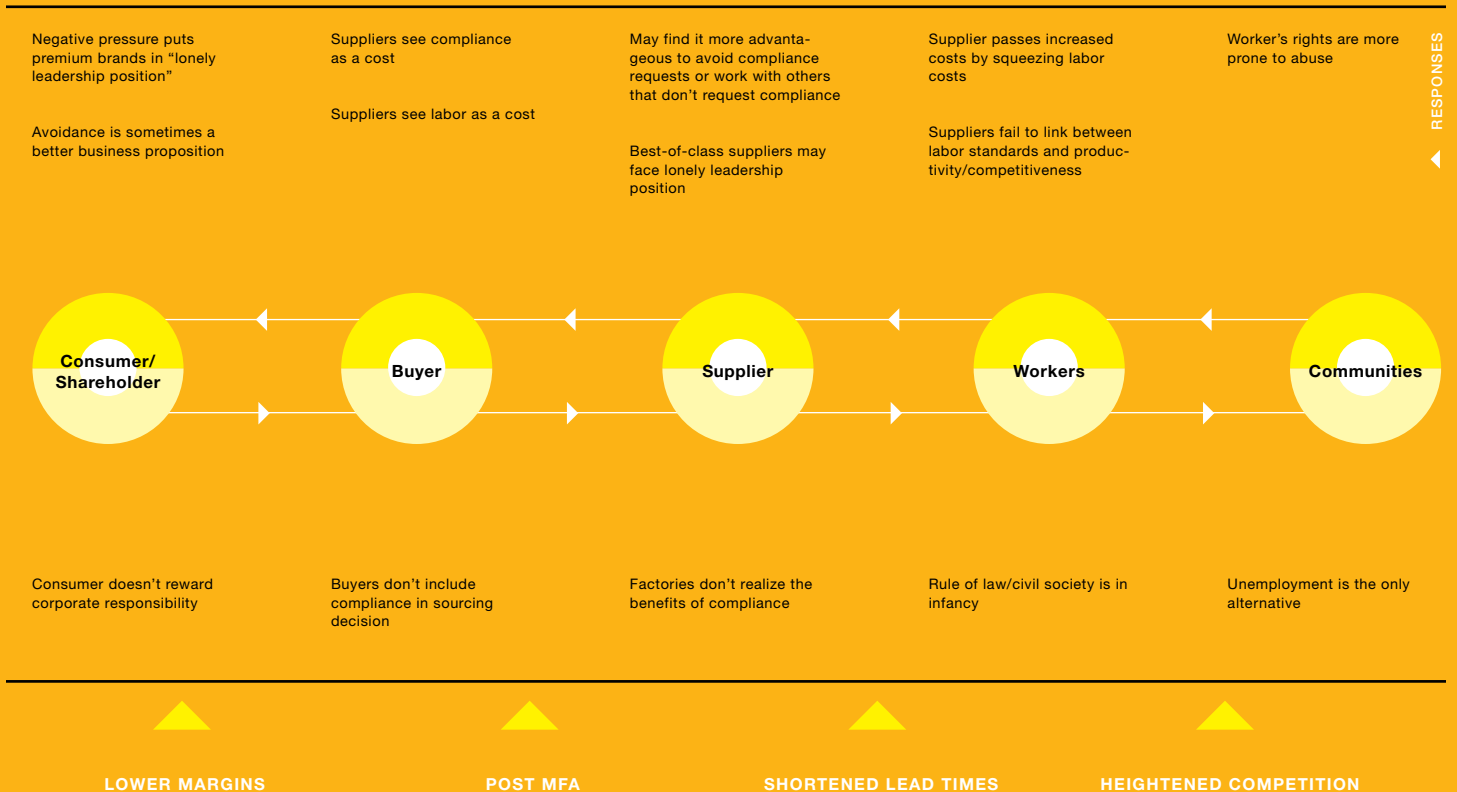
Root Causes of Non-Compliance:

Within this gloomy but often-realistic picture of our industry, we see three core areas in which key drivers of non-compliance emerge:

- 🕒 National and international socio-political-economic conditions
- 🕒 Factory management
- 🕒 Buyers

We developed our own vision of good for our supply chain and our industry. We also have a vision of bad – the combination of factors that can lead to a worst-case scenario. This helps identify where the root causes of non-compliance lie.

Chart 6
Worst-Case Scenario



National and international socio-political economic conditions

Our research and experience demonstrate that where there is poor enforcement of rule of law, low purchasing parity, poor transparency and weak civil society, contract factories show a greater risk of non-compliance. Independent research reflects this as well.

On the other hand, where International Labor Organization Conventions have been ratified and are being enforced, and where civil society is vibrant and government is open, the risk decreases. We believe these linkages – between good governance, open societies and their impact on working conditions – are keys to creating the environment for improvements on the factory floor.

The very nature of the traditional model for our industry means the majority of suppliers operate in emerging economies. Emerging economies frequently display the socio-political economic conditions we now know have the potential to inhibit good working conditions. Some argue that we shouldn't source in such countries. Others argue that by sourcing there we can wield some influence. Still others argue that by sourcing from such countries we help stimulate change, evidenced by the correlation between economic growth (to which our industry contributes) and the strengthening of social and political reform movements.

We think the answer is much more nuanced, probably a mix of all positions. We strongly believe in the power of change from the inside, through engagement and economic growth. There are countries, however, that we don't source from because of issues including enforcement of law and government infrastructure. We have developed our own country risk assessment tool, based on indicators from the [World Bank](#) and other such organizations as part of our new source approval process to help identify appropriate countries in which to work.

When in a country, Nike's ability to influence government policy or investment strategies is varied. We can be a force for change when we work with others, sometimes in unexpected alliances, and strategically engage and use our voice. We seek to do so where we can. Usually the most effective tool is one or a combination of the levers below:

- ☉ Industry collaboration

- ☉ Multi-stakeholder initiatives

- ☉ A strong voice from national and international civil society

- ☉ Incentives through international trade agreements

- ☉ Consumer interest

Factory management

Over the past 40 years, the apparel, footwear and equipment industries have remained fairly low tech, leveraging low-skilled labor in emerging markets. Increasingly, this model is being challenged to its core, given the evolving global marketplace and trading systems. One legacy of this model is that a majority of suppliers have immature local management systems, with poor human resources policies. In addition, due to traditional tariff and quota systems, many in the industry had a short-term view of relationships with buyers and, consequently, a short-term view of their relationships with workers.

We believe the predominant industry model of the past viewed workers as a commodity that were readily replaceable given the labor markets in emerging economies.

Today, that view is going through a fundamental shift in Nike's supply chain and business model.

External factors (including changing labor patterns, new risks, new costs, new market pressures, new competitive landscapes and new trade agreements) and internal drivers (including innovations, research and development, new business modeling and concepts of responsible competitiveness) are now helping Nike and our partners to radically rethink the traditional model.

Our core focus within apparel and footwear is to move toward fewer strong, long-term, strategic partnerships and a manufacturing model that drives efficiency and productivity and creates opportunities for workers. Called lean manufacturing, this model is discussed later in this chapter. We think that done well, with the right systems in place, the new models can alter – for the good – the way workers are treated and compensated.

Buyer

Since FY05 Nike has focused significant energy on understanding the impact of our business processes and purchasing practices on non-compliance on the contract factory floor. That work has been revelatory, a key pillar of our Generation III strategy. Through this work, we have been able to identify the drivers of non-compliance and demonstrate how addressing them both improves working conditions and has the potential to improve our business. It shifts the dialogue from that of trade-offs to win-wins, or, as we say, return on investment²-squared, or ROI² (see discussion on page 9).

For example, in examining the root causes of excessive overtime, (serious widespread issue in the industry) we found these issues in our own supply chain: poor application of laws, flawed factory management approaches and upstream practices that may have had unintended consequences at the contract factory.

This analysis helped us understand how often these buyer-related causes drive pressure on workers to put in excessive overtime and allowed us to shift our dialogue with contract factories from policing to one of solutions and business excellence. Investing in workplaces in which workers rights are central to the business proposition often leads to greater ROI to the business.

Overall, because of our work to understand root causes of non-compliance, the conversation both within Nike and with our factory partners has fundamentally changed. Today we see that compliance on the factory floor is a barometer for business excellence both within Nike and for our factory partners. This then becomes a business discussion rather than a question of compliance or policing, changing the nature of the dialogue considerably.

Because of this shift, we continue to evolve our approach to building Nike business accountability and visibility into compliance. Whereas before we focused only on ratings of our contract factories, today we also track the measures identified as ROI2 (drivers of business excellence and compliance) using a balanced scorecard that places corporate responsibility compliance alongside other important measures such as quality, planning and costing.

Chart 7
Footwear Sample Scorecard



Notes

This scorecard is for illustrative purposes only and does not reflect current scores. These targets are owned and driven by a cross-functional team of performance influencers inside the company. Compliance is now a part of this integrated team, supporting business improvements as part of its mandate is a significant shift in focus, expertise and energy.

Footwear Quality

A combination of factory inspections to measure finished product quality; engineering audits to measure product, tooling and chemical process quality; and problems found with finished product.

Delivery/Planning

Measures what percentage of product was delivered on time. A combination of several factors including how well the factory meets its delivery plans, how well these delivery plans were communicated and how successfully the factories met the consumer need dates.

NOS

The percentage of shoes built on Lean lines, as defined by the Nike's Lean Enterprise team.

CR – Compliance

A monthly snapshot of the distribution of Compliance ratings throughout the footwear factory base.

Product Readiness

Measures what percentage of products are on time for the reported season.

Costing

Measures how well factories are delivering, on average, against Nike's target freight on board (FOB). FOB is Nike's way of referring to the price we pay the factory for a product.

Our Vision of Success:

Key to our working toward systemic change as the definition of success is recognizing where Nike has direct control over change as opposed to the ability only to influence change.

Our vision of success takes account of the role of each stakeholder. Our definition of success is deliberately holistic, one that seeks to define whole system success.

Government

Influence, no control (Nike)

Invest in strong decent work programs and robust labor inspectorates, with clear rule of law around decent work.

Encourage responsible competitiveness within policies at national, regional and international levels.

Industry

Influence, no control (Nike)

Industry moves, with stakeholders, to a single industry code.

Industry moves, with stakeholders, to cooperative and collaborative monitoring programs, and an open source approach to investing in systems with factories.

Civil Society

Influence, no control (Nike)

Civil society builds the capacity of local workers to own their voice and to build networks and organizations, including trade unions that lead to constructive industrial relations, and a strong and open dialogue in communities and across stakeholder groups.

Consumer

Influence, no control

As brands move toward more transparency around their commitment to corporate responsibility goals the consumer will be better able to make more informed choices on a broad range of products.

Factory Management

Significant influence, no control

Workers are recognized as craftspeople, not commodities. Compensation and worker treatment reflects this shift.

Management understands the benefits of building strong human resource management systems that support the factory's journey to effective implementation of lean enterprise.

Waste is minimized and leveraged as a source of income and innovation for the manufacturer.

Buyer (Nike)

Control

Upstream business processes enable compliance in the factory.

Rules of the game are clear and adhered to. Business units make compliance one of their guiding principles and are accountable for compliance and incentivized around it.

An internal marketplace builds up where business is flowing to best-of-class suppliers because of their price, quality, on-time delivery and corporate responsibility.

Business Strategy:

Supply chain footprint

As of FY06, Nike's three main product engines - footwear, apparel and equipment - used almost 700 contract factories in 52 countries to manufacture all Nike products. Through annual reviews of Nike's supply chain needs, we may add or change contract factories based on product sourcing requirements, changing business and fashion trends, and/or general factory performance. Should a factory be dropped from the supply chain and not receive an order for more than 12 months, it must go through the new source approval process we require of all new contract factories that join our supply chain.

Although the workforce profile varies by country and region, the vast majority of the almost 800,000 workers in Nike contract factories are women who are 18 and above. This is the first job for many of these workers, requiring low skills. In many cases, it is also their first introduction to the formal workforce. Even as the industry matures, many of the manufacturing roles remain entry level and require low skill sets. Others require broader skill sets as we continue to implement lean manufacturing principles throughout our supply chain.

At the end of FY06, footwear contract manufacturers in China, Vietnam, Indonesia and Thailand manufactured 35 percent, 29 percent, 21 percent and 13 percent of total Nike-brand footwear, respectively. The vast majority of Nike-brand apparel was manufactured outside of the United States by independent contract manufacturers in 49 countries. Most of this apparel production occurred in China, Malaysia, Thailand and Turkey.

Contract factory disclosure

As part of our FY04 reporting, Nike became the first company in our industry to expand transparency by publishing online the names and addresses of all contract factories making Nike-brand product.*

We have updated this list and have published all contract factories currently approved to manufacture Nike-brand products as of February 28, 2007, including those that are inactive. We plan to update the [factory disclosure list](#) at least once each year.

Chart 8

Contract Factories and Contract Factory Employees
(as of May 31, 2006)

Contract Factories by Global Region/Operating Segment				
Region	Global	Apparel	Equipment	Footwear
Americas*	126	85	30	11
EMEA	81	59	18	4
N Asia	285	138	108	39
S Asia	195	155	21	19
Total	687	437	177	73

* Includes the United States

Total Contract Factory Employees by Global Region/Operating Segment				
Region	Global	Apparel	Equipment	Footwear
Americas*	49,734	30,692	8,620	10,422
EMEA	29,858	25,766	3,287	805
N Asia	422,255	122,236	57,552	242,467
S Asia	270,254	165,539	14,246	90,469
Total	772,101	344,233	83,705	344,163

* Includes the United States

*Due to confidentiality agreements there are a small percentage of subcontract factories for which Nike is not permitted to disclose names and locations.


Lean manufacturing


In the last two years, we've begun to explore the impact of lean manufacturing. Lean is an approach to manufacturing most often associated with the automotive industry. It's a philosophy of delivering the most value to the customer while consuming the fewest resources. Techniques concentrate on the product's end-to-end value stream rather than traditional functions and organizations. It focuses on the goal of creating the highest-quality product while eliminating all types of waste, including lost time and material.


In traditional manufacturing environments, workers typically are trained on one task, and represent one step in the process. In a lean environment, workers produce in teams, where they are cross-trained in different skill sets and are more empowered to manage the production process and immediately address quality and other issues.


Historically, the footwear and apparel industries have operated a "push" system, focused on economies of scale, with large batches and long assembly lines. This system relies on labor-intensive manufacturing processes that incentivize manufacturing in low-cost countries. But this model doesn't translate directly to the new environment, where customers increasingly demand greater variety, more frequent deliveries and smaller order quantities, all at a lower cost.

Lean differs from traditional manufacturing by incorporating new, key elements:

-  Focusing on each product and its value stream rather than organizations, functions, assets and technologies

-  Asking which activities are waste and which create value

-  Enhancing the value and eliminating the waste to optimize the whole

-  Empowering the workforce

Taking Nike's global supply chain into a lean manufacturing model takes time, partnership, investment and a tolerance for experimentation and failure.

Our goal is to have 90 percent of our footwear production come from lean lines by the end of FY11. We have key milestones to get there. By the end of FY07, roughly 40 percent of our Nike-brand footwear will be produced on lean lines. We also have begun implementing lean manufacturing techniques with key factory partners in apparel production. So far 18 of our contract factories – comprising nearly half the volume of our worldwide apparel production – have begun lean training and another six are set to follow in FY08. It will take time to realize the long-term benefits that will come with full implementation of lean. We believe lean holds great promise for worker empowerment and the ability to build a higher-skilled, higher-paid workforce. A good pointer to this can be found in documentation on lean manufacturing systems and in the Massachusetts Institute of Technology's "[Tale of Two Factories](#)" which documents two Nike suppliers, one traditional and one lean.

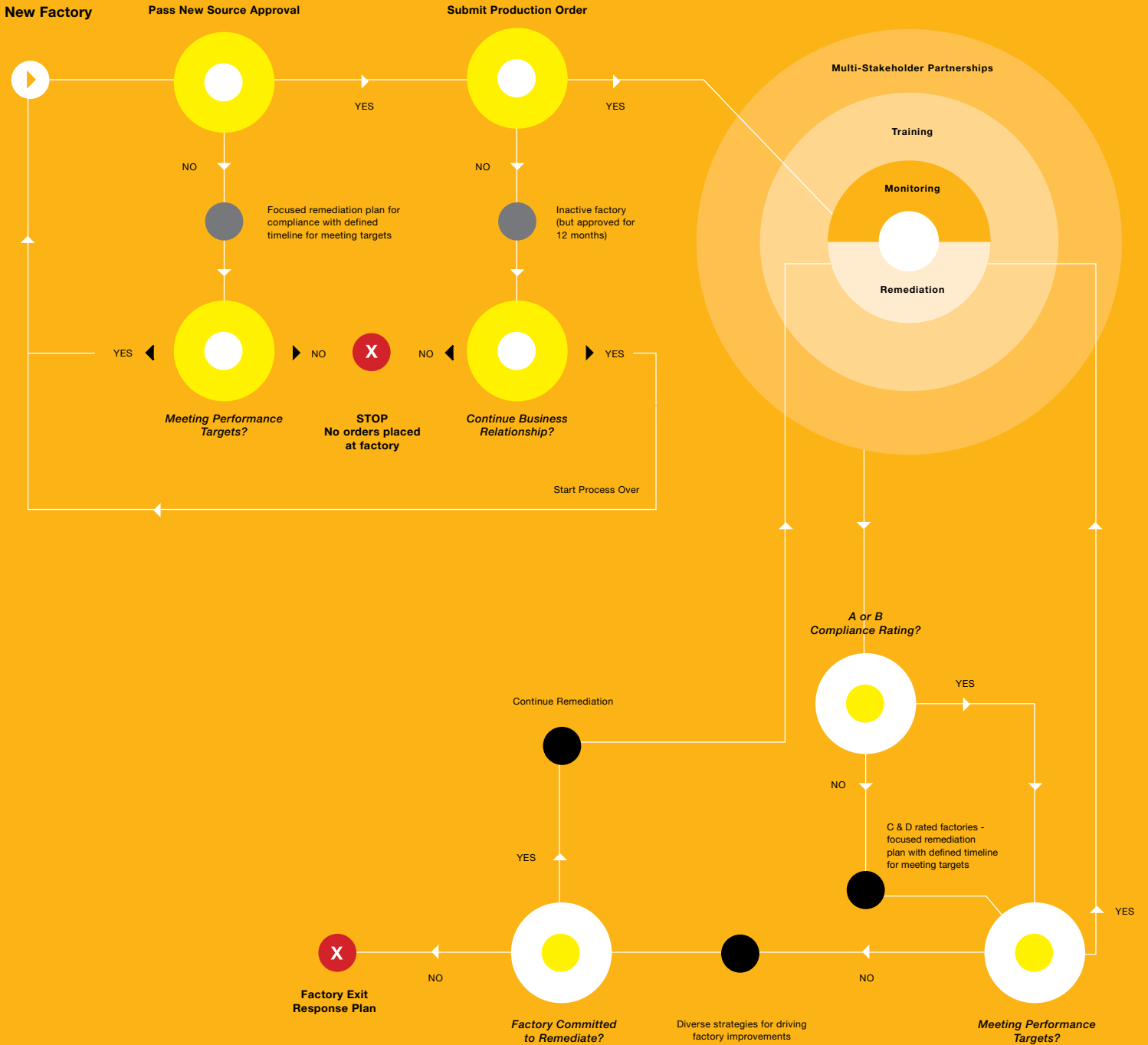
Policies, processes

We described the compliance life cycle of our work in our FY04 report. Against the backdrop of our focus on Nike's upstream business processes, we have also refined our corporate responsibility policies and processes across the entire product life cycle. This next section documents the shifts, progress and challenges across that life cycle.

The compliance life cycle

In FY04 we documented the compliance life cycle that begins when a factory came on board Nike's supply chain. In the subsequent years we have both refined that part of the process (we call it the downstream process) and added visibility into processes upstream in Nike's own business model. In the future we anticipate being able to document how responsible competitiveness is woven into both upstream and downstream strategies, policies, processes and programs.

Chart 9
The Contract Factory Compliance Life cycle



Weaving Responsible Competitiveness into Nike's Supply Chain Operations:

We discuss our processes and policies in contract manufacturing and highlight the increasing work being done to build responsible competitiveness policies and programs within Nike's own commercialization processes.

Adding new factories to our supply chain base

When we make decisions whether to add a contract manufacturer into our supply chain, we consider the entire compliance life cycle, beginning with a proposal for a new country or new source. Once we approve a contractor, it becomes our partner in internal and external capacity building, monitoring and remediation. Monitoring and remediation result in our compliance ratings, which we consider as part of our business evaluation and decision-making processes through the balanced scorecard.

Our compliance team, the business unit and contract manufacturers all play key roles in the success and failure of this life cycle, which depends on our ability to execute and measure our strategy and our ability to react with real-time information.

Sourcing and new source approval process

As we noted in our FY04 Report, the first step in our supply chain life cycle is the decision to source product at a particular factory. Our new source approval process includes compliance by conducting a pre-sourcing labor audit and an environmental, health and safety assessment that requires the factory to meet minimum standards. Once we bring a new factory on board, it is subject to our ongoing monitoring process. A more detailed description of this process can be found in our FY04 Report.

In FY06, Nike approved 81 new contract factories for the Nike brand, down from 83 in FY05 and 122 in FY04. Of the new contract factories, 11 were in the Americas, six in EMEA, 44 in Northern Asia and 20 in Southern Asia.

The majority of new contract factories are located in Asia. Apparel was the most active, with 56 new factories, including local production and agents and licensees, as well as the global product division. Footwear factory additions have been modest, at 17, reflecting the historically more stable nature of the sourcing base in that sector of our business. We approved another eight factories in footwear.

In FY07, we began redesigning our approval process to better coordinate both compliance and business needs and to focus our pre-sourcing audit on keeping the lowest-rated contract factories out of our supply chain. As part of the redesign, we also clarified the factors to assess when considering sourcing in a new country. We now look at a broad spectrum of issues including infrastructure, legal (rule of law), human rights, economic and political environments.

In FY05-06 Nike and several contract factories opened their doors to research teams from the Sloan School of Management at the Massachusetts Institute of Technology. Among various topics, the teams sought to understand the range of working conditions found in Nike contract factories. A working paper from this study suggests that at the macro level, country characteristics – such as labor standards

and the local government's ability to enforce them – are among key determinants of working conditions.

According to the research, the nationality of factory ownership is not correlated with working conditions. While the research validates much of Nike's long-term sourcing strategies and principles, we recognize the opportunity to further study this area. To see a full version of the MIT studies, please go to:

 [Beyond Corporate Codes of Conduct: Work Organization and Labor Standards in Two Mexican Factories](#)

 [Does Monitoring Improve Labor Standards?: Lessons from Nike](#)

Monitoring and factory remediation

Nike's monitoring program has two main parts: Management Audit Verification (MAV) and Environment, Safety and Health (ESH) audits.

To see our MAV and ESH audit tools, please [click here](#).

The MAV is a labor assessment tool designed to audit performance through root-cause analysis in five key areas: hours of work, wages, benefits, grievance systems and freedom of association. The audit focuses on the factory's people management systems and practices and is performed by Nike's compliance staff. We use the Code Leadership Standards related to management subjects (M-CLS) or local labor laws as benchmarks, whichever are stricter. Our first version of the MAV tool does not directly address freedom of association, as we sought additional external expertise in developing this aspect of the audit process. Future versions will include this essential area. The Code Leadership Standards (CLS) expand on Nike's [Code of Conduct](#) and cover 51 standards, 13 for management and 38 for environment, safety and health.

ESH audits provide a baseline assessment of non-compliance incidents and management system performance. The audit focuses on environment, health and safety and is organized according to each key area and the supporting ESH subjects. The benchmarks for this audit are based on the Code Leadership Standards related to ESH subjects (ESH-CLS).

Given our Generation III approach, we now prioritize monitoring by focusing on key contract partners, of which there are approximately 130. We focus our oversight and capacity-building efforts on the 20 percent of suppliers that account for 80 percent of the long-term, strategic impact to Nike. We rate each factory using five primary risk factors:

-  The country in which the factory is located
-  Factory worker population
-  The type of factory operation
-  Manufacturing process
-  Past compliance performance history

Due to the inherent differences between ESH and labor, we apply different filters depending on the type of manufacturing process and strategic partnership and/or worker population.

Strategic planners and senior managers within manufacturing, operations and corporate responsibility developed and now contribute corporate responsibility scores to existing balanced scorecards that record corporate responsibility performance alongside other business-pertinent issues including quality, price and delivery.

We spent FY06 building capacity at key contract factories and using our root-cause analysis tools to gain a better understanding of the drivers of non-compliance. We also convened a global team to build the Generation III labor oversight tools. Contract manufacturers conducted Safety, Health, Attitude, People and Environment (SHAPE) assessments while Nike staff focused on conducting in-depth ESH and MAV audits. In addition, we are disclosing our [ESH](#), [SHAPE](#) and [MAV](#) audit tools with the publishing of this report with the hope that this will stimulate dialogue, input and collaboration. Generation III strategy changes our monitoring coverage. Our monitoring focuses in on fewer contract factories with more thorough audits. We are also building brand collaboration and partnerships with organizations such as the Fair Labor Association (FLA) to achieve more complete coverage of our contract factory base and the industry as a whole.

We provide a complete list of our finished goods contractors to the FLA each year for audits as part of the association's independent external monitoring visits. Our participation in this monitoring provides additional expertise gained through collaboration in a pilot project on joint monitoring and remediation. We also have sought to expand the scale of collaboration by sharing information with other brands in the industry. This work is easiest where brands have joined us in transparency. But identifying shared contract factories is only the first step. More fruitful results will come from sharing differences in code application standards, audit tools and audit methodologies, through which we all gain confidence in the quality of factory performance information.

Monitoring Results:

In the last three years, Nike conducted 810 M-audits in contract factories around the world. Initially, M-audits were designed to find incidents of non-compliance against our Management Code Leadership Standards which identified more than 80 individual non-compliance issues. While the audit helped identify non-compliance issues against our standards, it did not focus on finding root causes of those issues.

Beginning in FY06, we decided to focus our audit resources on finding root causes of the non-compliance issues that have the greatest impact on workers, including work hours, wages/benefits, grievance systems and freedom of association. We believe identifying root causes will enable us to identify, along with the contract factories, areas where we can together build capacity and expertise, focused in the areas best suited for sustainable remediation.

In FY06 we implemented a new Management Audit verification tool, the MAV Audit. Forty-two were completed through FY06.

Chart 10
% Management Audit Compliance Score

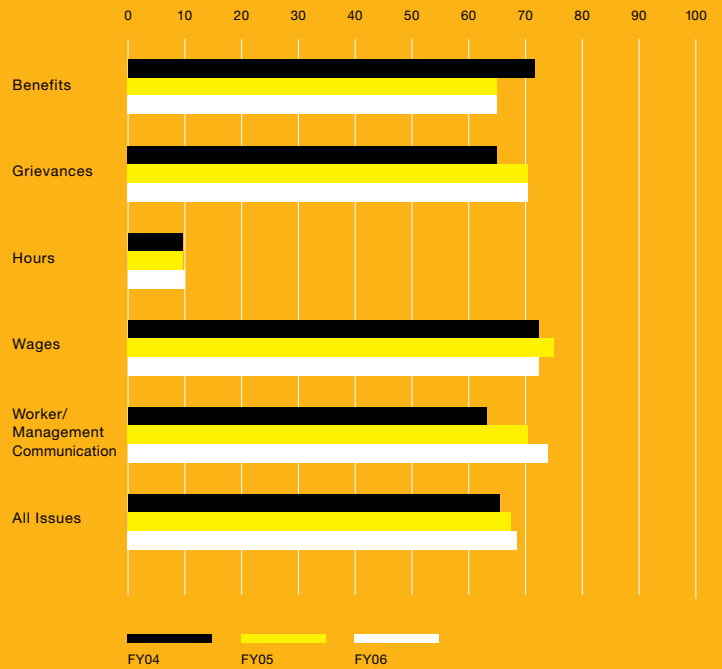


Chart 11
% Non-Compliance Management Audit Findings



* Overwhelming verbal, not physical findings.

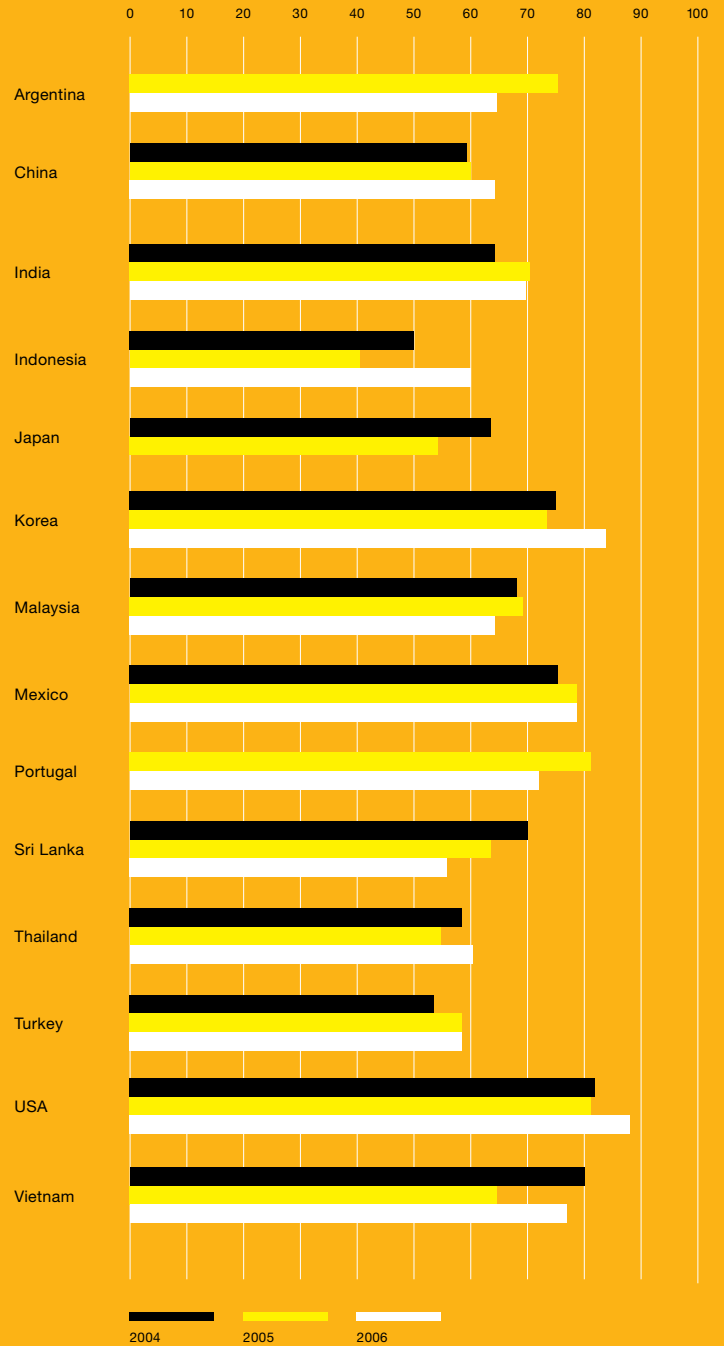
Monitoring Results:

Management Audit Verification (MAV) Audits

Of 42 MAV audits completed in FY06, seven contract factories received an A rating and 13 contract factories received a D rating, the lowest rating we assign to a factory. Ignorance of the law or the Nike standard is a primary driver of non-compliance. The second-leading issue was a lack of systems to manage people and processes.

By assessing factory performance through a root-cause approach, we are better able to identify upstream contributors to problems and drive remediation efforts at the source. Our work in FY05-06 went deep into two topics – wages and hours – and closely examined root causes.

Chart 12
% Management Audit Results by Top Production Countries



Monitoring Results:

Management Audit Verification

With two years of MAV audits we now have a better in-depth understanding of non-compliance. We better understand upstream drivers, critical for a balanced sourcing approach. This approach is crucial in elevating contract factories from a D rating and preventing contract factories from falling into D status. These audits have helped us improve our work with contract factories, elevating their human resources systems so they can better manage compliance. The MAV and subsequent work ahead will continue to rely on keen measurement and adequate assessment tools.

Chart 13

% Management Audit Verification (MAV) Results FY05-06
Top 3 Issues By Region

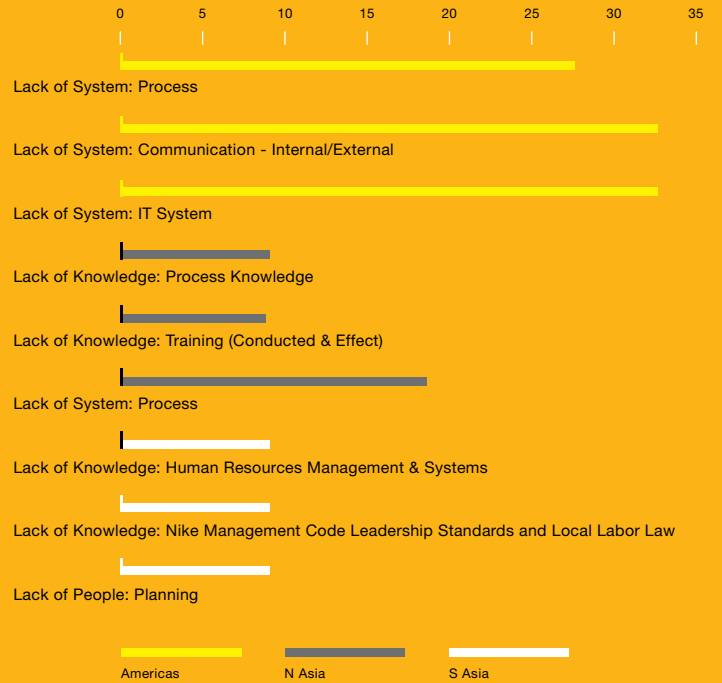
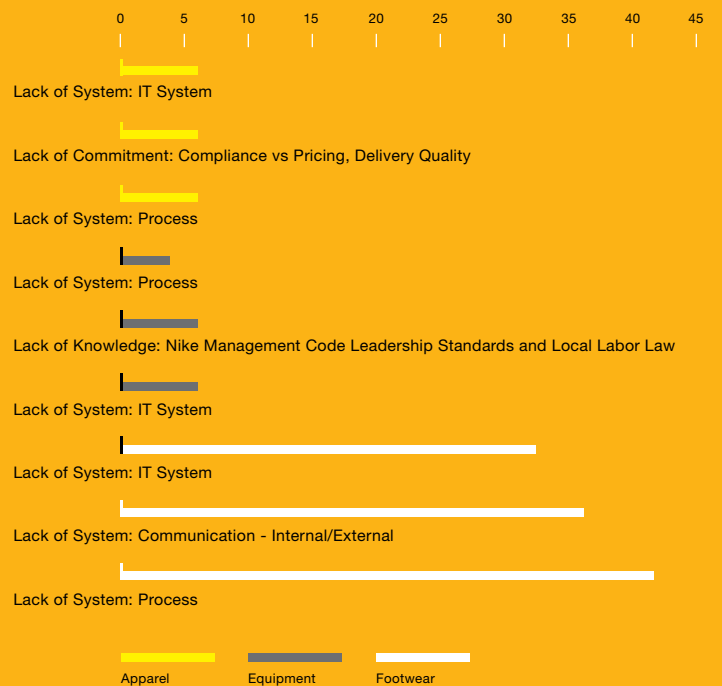


Chart 14

% Management Audit Verification (MAV) Results FY05-06
Top 3 Issues by Product Engine



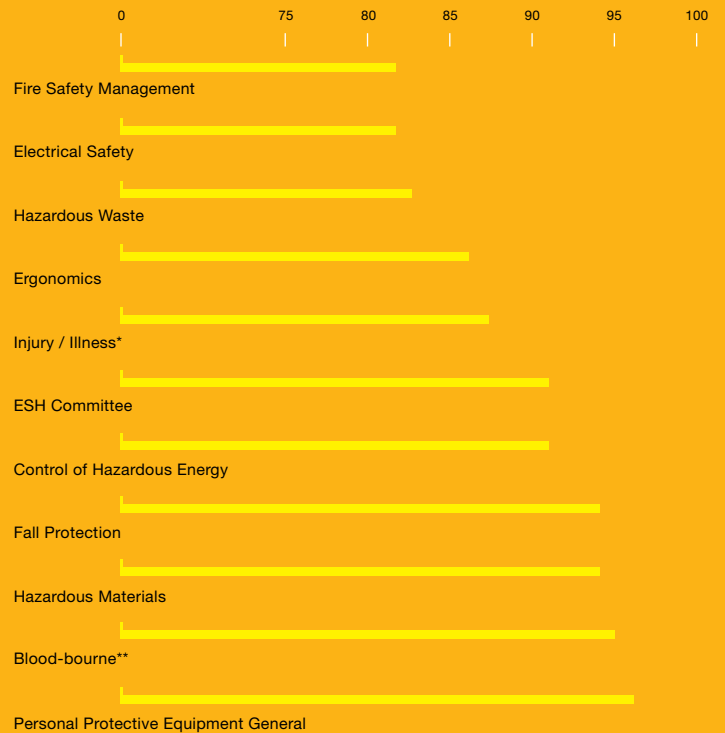
Environment, Safety and Health (ESH):

In FY05, we began collecting baseline data on more than 650 contract factories in 52 countries, conducting 65 audits and 15 in-depth root cause assessments. The results told us the greatest ESH issues are in specific factory types (footwear, vertical apparel and inflatable facilities which make products such as basketballs, volleyballs and soccer balls) and the majority of those contract factories are in 10 countries – Bangladesh, Brazil, China, Honduras, India, Indonesia, Mexico, Thailand, Turkey and Vietnam. We then used factory type and country filters to focus our ESH efforts on about 70 contract factories that employ about half of the contract factory workers around the world.

Chemical exposure, worker protection, fire safety and maintenance-related safety are the most significant ESH issues in contract factories. We focus on the key drivers of non-compliance-related findings and how to build factory capacity to manage these issues. We use a risk-based approach to focus our efforts on factory type, factory population and geographic filters.

Both upstream and downstream factors impact ESH issues. While we strive to solve potential problems through the choices we make in the design process, we do not fully control the factory environment. To that end, we are working to improve worker health in contract factories through auditing and analysis, training and factory capacity building, integrating factory management systems, and reducing solvents.

Chart 15
% ESH Audit Results, FY05-06
Top Non-Compliance Issues



Notes

* Injury & Illness: Incident reporting; injury and illness management

** Blood-bourne: Risk of occupational exposure to bloodborne pathogens

We partnered with outside environmental, safety and health consultants to conduct the assessments. The project identified four key drivers of non-compliance: chemicals, worker protection, fire safety and maintenance-related safety. Understanding these drivers has helped us focus our efforts and measure and build factory capacity to manage these issues.

Overall, we found that the factory-level understanding and performance of ESH came within industry standards in their respective countries. While understanding was generally high, performance against the Nike ESH Code Leadership Standards was, on average, less than 60 percent compliant.

Equipment contract factories typically demonstrated poorer standards of ESH understanding and performance than footwear and apparel. Also, many of the equipment processes require chemical use and related manufacturing techniques not required in footwear and apparel. ESH management representatives at the contract equipment factories were generally less knowledgeable of Nike ESH requirements and the ESH risks associated with certain practices and materials.

We found that solvent-related risks were dominant in footwear and equipment and that water/wastewater management and related dye house exposure risks were dominant in apparel.

Building on that work, in FY06 we designated contract factories to receive baseline ESH audits. To date we have conducted similar audits in the 97 contract factories with the greatest potential. Initial audit results indicate generally better performance among contract footwear factories than equipment and apparel. We believe this is because our ESH and engineering staff have invested considerable amount of attention in contract footwear factories. As we move into FY08 we will increasingly focus on equipment and apparel.

ESH looking ahead

ESH audits provide baseline assessment of both non-compliance incidents and management system performance. Along with these audits, we are looking at targeted programs and projects that can drive a deeper understanding of issues and their solutions. Among these are projects that evaluate hazardous waste disposal, targeted evaluation of industrial hygiene to quantify opportunities for improvement of processes or chemistries, and projects to measure the return on investment for contract factories with regard to ESH issues.

Chart 16
% ESH Audit Scores by Region, FY05-06

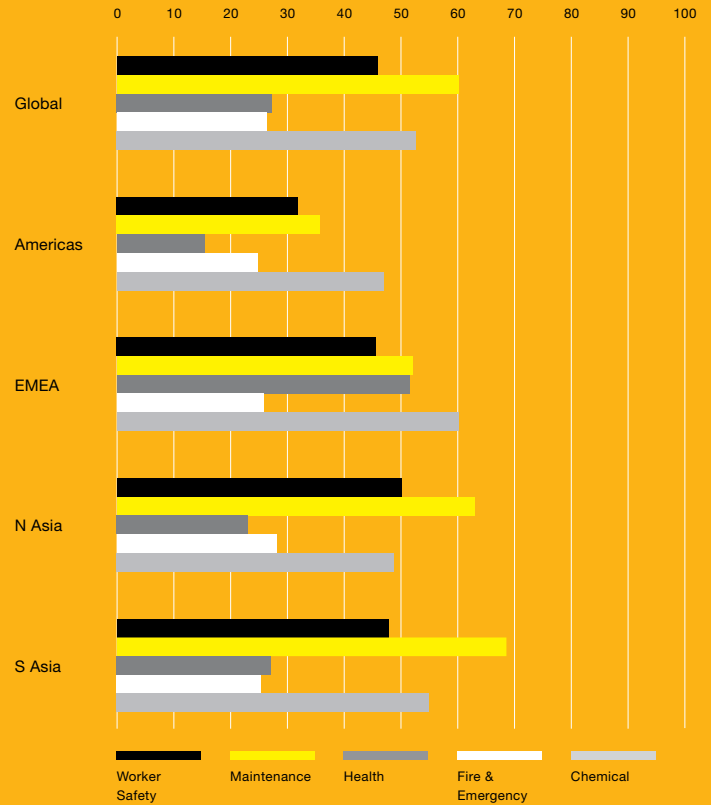
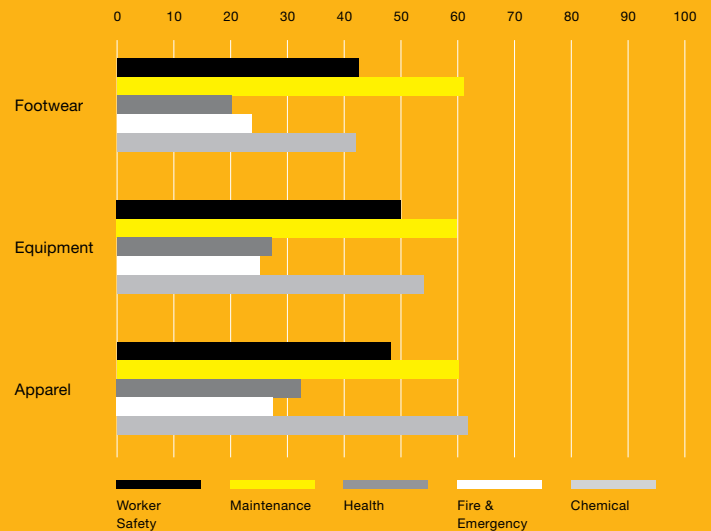


Chart 17
% ESH Audit Scores by Business Unit, FY05-06



Overall Compliance Results— Factory Ratings:

As we shared in our FY04 report, we must first be able to assess the extent to which a contract factory is compliant with our code and local laws before integrating either incentives or sanctions into our sourcing and production.

We have developed a grading system to facilitate this process. We assign a letter grade at the field level that is reviewed by the regional director. This grade reflects all of our relevant information about a factory's compliance performance, taking account of the number and nature of non-compliance issues discovered by various forms of monitoring and oversight as well as the factory's progress in resolving items identified for remediation.

We take these ratings seriously. We aim to see contract factories with a C or D compliance rating move to a higher rating. When a C or D-rated supplier is not making adequate progress in meeting its remediation targets within a set timeline, we elevate these concerns as a part of reassessing our business relationship.

The Ratings Process

No rating system is perfect. As we noted in our FY04 report, some inconsistency remains in our ratings. Today we better understand both the assignment of ratings and the leverage those ratings have with sourcing decision makers. We have made incremental steps in improving rating consistency and measurement, including developing criteria that are aligned with evaluating systems performance. In FY08 we will work to merge ESH and human resources management evaluations into our overall factory performance assessments.

We developed our ESH rating system using a topical weighting scheme based on internal research. Our ratings capture 38 code leadership standards in six summarized categories reflecting the highest level of inherent risks in the supply chain: chemical management, worker protection, maintenance safety, fire/emergency action, health and ESH support. This breakdown helps us evaluate a factory's progress against the greatest ESH risks. Before assigning a final rating, we analyze the ratings and undergo a series of checks and balances.

We developed the M-rating system by identifying minor, serious and critical issues based on Nike's Management Code Leadership Standards, which includes age verification, employee training, forced labor, freedom of association, harassment and abuse, hours of work, leave policies, licensee-agent, migrant employees, non-discrimination, security, wages and women's rights. We typically assign standards based on risk, severity and frequency.

We updated our ratings criteria and no longer apply the percentage of past due Master Action Plan items as an indication of compliance performance. Our focus on serious, material issues and the factory's commitment to long-term improvement helps us evaluate a factory's progress against management issues/risks. In FY08, we will update the M-ratings criteria further into a common framework that can better measure system versus incident-based compliance and improves awareness of real-time risk.

Compliance Rating Criteria:

We conduct both Environment, Safety and Health (ESH) and Management audits and assign letter grades to contract factories, based on their performance against standard measures.

Chart 18
Compliance Rating Criteria

Grade	Environment, Safety and Health	Management
A	<ul style="list-style-type: none"> Fully compliant Demonstrates best practice Considered a leader 	<ul style="list-style-type: none"> Isolated violations of M standards found, but none considered serious or critical. No more than five minor issues outstanding on the Master Action Plan (MAP).
B	<ul style="list-style-type: none"> Mostly compliant Minor system failures are found. Factory is making progress. 	<ul style="list-style-type: none"> Isolated violations of M standards found, but none considered serious or critical. More than five minor issues on the MAP, but none serious or critical.
C	<ul style="list-style-type: none"> Non-compliant Serious system failures Factory is making no progress 	<ul style="list-style-type: none"> Factory does not provide basic terms of employment (contracts, documented training on terms, equal pay, discriminatory employment screening). More than 10 percent of employees work between 60 and 72 hours each week. More than 10 percent of employees exceed annual legal limits. More than 10 percent of employees work seven or more consecutive days without a break. Factory violates local migrant labor laws. Non-income related benefits fall short of legal provisions. Some evidence of verbal or psychological harassment or abuse. One or more serious issues on MAP, but none considered critical.
D	<ul style="list-style-type: none"> Non-compliant Demonstrates general disregard for Nike Codes and Standards Unwilling or unable to drive important change Deliberately misleads auditors Audit shows critical systemic and repeated problems 	<ul style="list-style-type: none"> Management refuses or continues to demonstrate unwillingness to comply with Nike Standards. Management provides false information (statements, documents or demonstrates coaching). Factory fails to provide verifiable timekeeping system to accurately record work hours. Factory fails to pay legally mandated minimum wage. More than 10 percent of employees work more than 72 hours each week. More than 10 percent of employees exceed daily work hour limits. More than 10 percent of employees work 14 or more consecutive days without a break. Factory requires pregnancy testing as condition of employment. Factory uses workers under the minimum legal age. Factory uses bonded, indentured or prison labor. Factory uses force to compel illegal work hours. Audit finds confirmed evidence of physical or sexual abuse. Factory management denies access to authorized compliance inspectors. Factory denies freedom of association for workers, including demotion or dismissal of workers seeking to exercise their rights. Factory provides no benefits tied to security (workers' compensation, medical coverage, social security, retirement funds). Factory outsources to unauthorized facilities or issues homework to employees.
E	<ul style="list-style-type: none"> Not enough current information to measure compliance performance. 	<ul style="list-style-type: none"> Not enough current information to measure compliance performance.

Compliance Ratings:

Chart 19
Factory Rating Trends FY05

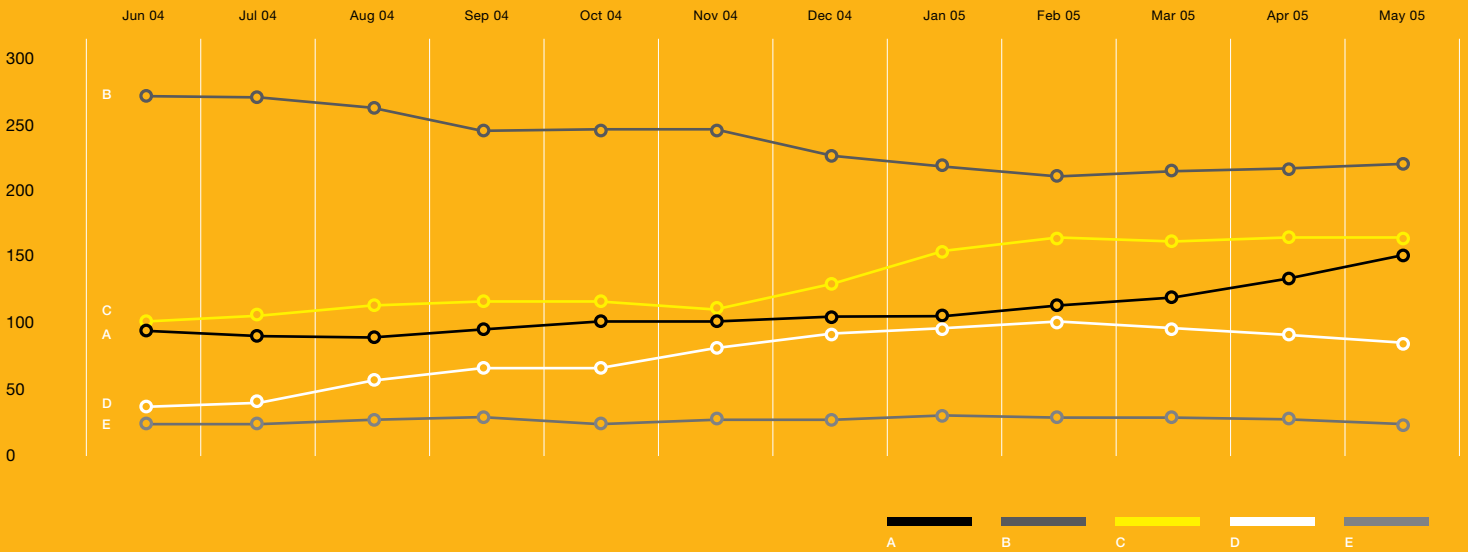
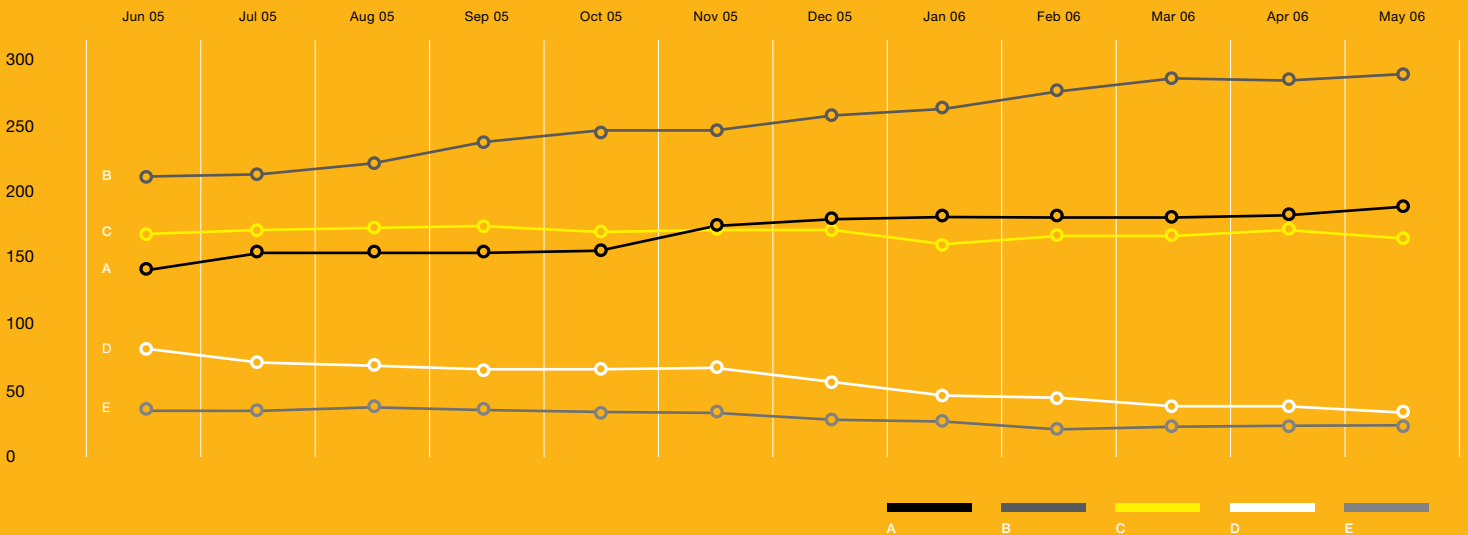


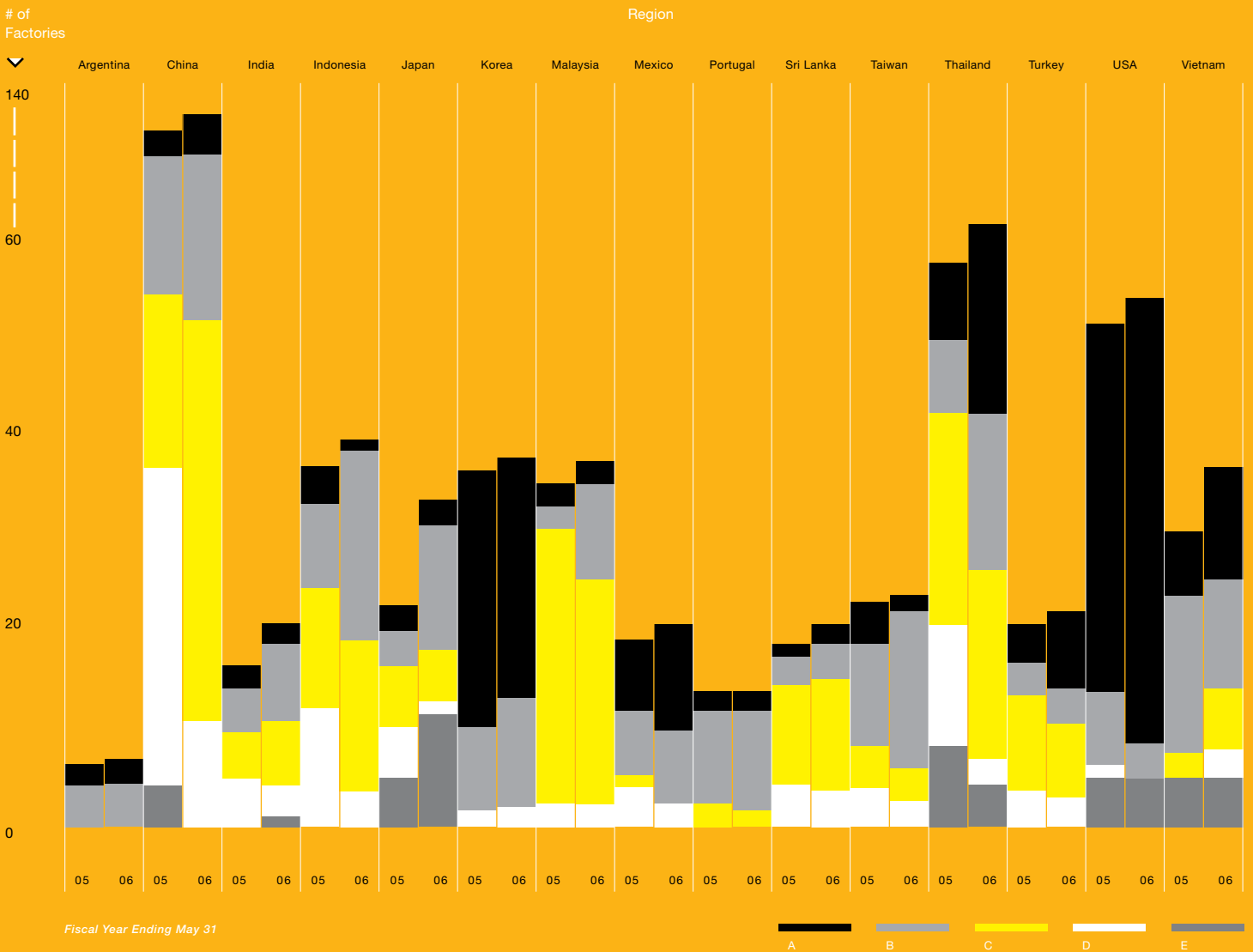
Chart 20
Factory Rating Trends FY06



Compliance Ratings:

Compliance ratings help us measure how contract manufacturers are performing against key benchmarks such as our Code Leadership Standards and local labor laws. We have found that contract manufacturers often respond to our audit results and remediation plans with quick fixes that can lead to rating fluctuation. Such fluctuations have made it challenging for us to recommend holding, ceasing or increasing production orders. We believe that changing our ratings criteria from focusing on incidents to systems will reflect the pace of sustained change at a factory more accurately and improve our ability to integrate compliance performance into production planning. We have made significant strides toward this end with ESH audits in FY06-07 and expect to begin refining the MAV audits FY08.

Chart 21
Factory Rating Trends by Top Production Countries, FY05-FY06

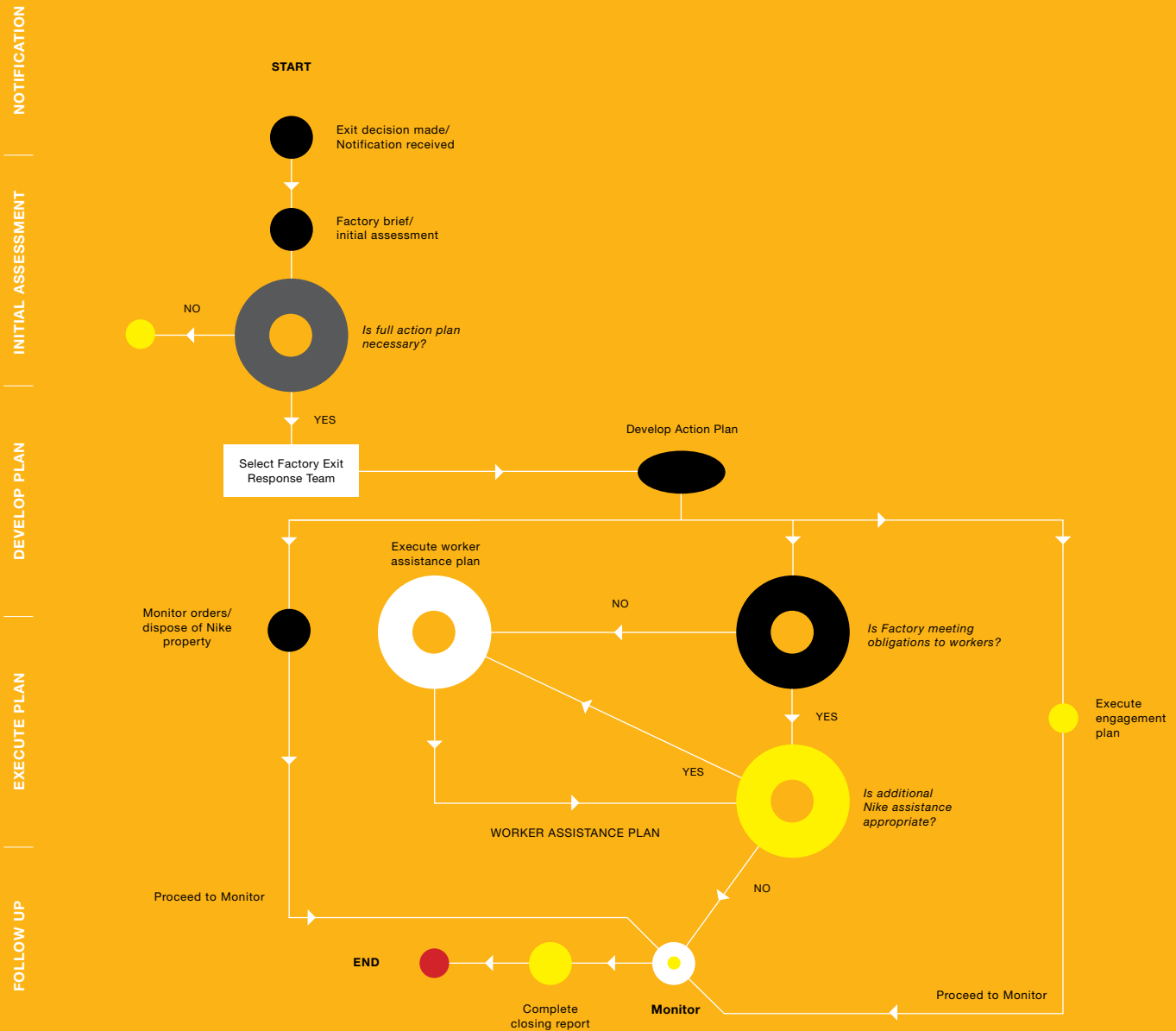


Factory Exits:

On the other end of the supply chain life cycle is the process of significantly reducing or ceasing orders to a factory. Such changes can come about for a variety of business reasons, such as the factory going out of business, Nike reducing or ceasing orders due to changing consumer demand, or where the factory fails to meet production or compliance requirements. No matter the reason, we are well aware that a reduction in orders or exiting a factory can impact workers at that factory and the surrounding community significantly.

FERT refers to Factory Exit Response Team and is an integrated team comprised of Compliance, Communications, the Business Unit, Sourcing, Government Relations and others as needed.

Chart 22
Factory Exit Process



We developed a standard exit process in FY04 based on our experience in departing the Doson, Indonesia, footwear factory.

In FY07, we refined our process to incorporate additional insight and to outline our exit response more clearly. The first step is to ensure that the compliance team and Nike business leaders are notified of a potential factory exit or significant reduction in orders.

The affected business unit then prepares a factory brief, providing key information including the extent of Nike's production in the factory and the number of potentially impacted workers. Based on that information, we assess whether to develop a full action plan. In some cases — such as where we are not currently sourcing at that factory based on seasonality or the factory has other major buyers and there will be little or no impact on workers — a Nike response may not be necessary or appropriate.


When necessary, we assemble an integrated response team composed of representatives from compliance, the applicable business unit sourcing team, communications, government relations and other relevant departments to develop a full action plan.


A critical element of this planning process is estimating the likely impact on workers, based on the factory's requirements under local law as well as any additional requirements under a collective bargaining agreement. We consider the factory's likelihood to meet its obligations fully, combined with macroeconomic elements such as government assistance through unemployment compensation and health benefits and the likelihood of worker reemployment in similar or better jobs.


While ongoing stakeholder engagement informs our strategy, in cases where we elect to reduce or cease orders, our first obligation for formal notification is to our business partner, the contract factory. We are hopeful that providing sufficient notice to factory management gives them time to secure orders from other buyers with minimal disruption to their business. We recognize that this is not likely possible in all situations. In some instances, factory management must take the lead in applying good industrial relations practices and work directly with worker representatives to mitigate negative impacts of our decisions.

Once factory management has been notified of our decision, we may also engage other stakeholders such as government, local trade unions and non-governmental organizations as well as members of the global community. In cases where we believe the factory will uphold its obligations, we focus on informing other stakeholders of the rationale for our decision. In other cases, where we are prepared to provide additional assistance to affected workers, we rely heavily on the expertise of stakeholders to develop relevant and effective programs.

Our basic operating principles regarding assistance to workers are:

-  We stand in support of workers receiving all of their legal entitlements.

-  We will not pay severance or unpaid wages in lieu of the factory owner. We will seek to influence the factory to fulfill its severance and other obligations under applicable law.

-  We will determine what additional support, if any, to provide in light of the circumstances of each case.

The Challenge of Managing Responsible Transitions:

While our factory exit process provides a template action plan, this aspect of the production life cycle contains many exceptions and unique circumstances. As we seek to mitigate negative impacts on workers, we consider engagement and collaboration with other stakeholders critical to our success. We had a number of examples of this work in FY05-06.

Outside the parameters: Hermosa

In May 2005, the owner of the Hermosa plant in El Salvador unilaterally closed the factory's doors, leaving its employees without final compensation. The issue was brought to Nike's attention through a third-party complaint to the Fair Labor Association in December 2005. Hermosa last supplied product to Nike as a subcontractor to another factory in spring 2003, giving us no direct visibility of the factory's performance at the time of its closure.

Hermosa did not meet our litmus test for engaging in worker assistance: We had not sourced directly from the factory for two years and when we had sourced from Hermosa, Nike product as an overall percentage of volume for the factory was relatively low.

This closure, however, represented an opportunity for several brands to work together to influence the government's response to an improper closure, and, through the Fair Labor Association, engage with other local stakeholders to determine collective approaches to address the pressing needs of workers who faced unemployment.

In December 2006 the FLA created an emergency fund to provide workers assistance in meeting basic needs around food, housing and medical care, while seeking alternate employment and fulfillment of their legal and economic rights under the law. Nike contributed to this fund. Although the fund was an unprecedented course of action by the industry — workers, non-governmental organizations and trade unions that supported the campaign were disappointed by its size. To promote learning from this experience and improve collaborative action by brands in addressing a factory closure, Maquila Solidarity Network has undertaken an assessment of the emergency fund process. We look forward to reading its report.

A turning point: Saga

Nike's difficult decision in November 2006 to cease placing orders of hand-stitched soccer balls with Saga Sports in Pakistan presented a very different set of challenges. We were Saga's dominant buyer. Furthermore, our decision to leave and our very public explanation of the compliance challenges we identified there were perceived as a threat to the entire regional industry.

While our decision to end our relationship with Saga was one we had to make on our own, we have continually engaged with local and global stakeholders to determine the best course of action for mitigating impacts on workers, and long-term options for strengthening the industry.

From a stakeholder engagement perspective, we have been greatly encouraged by what we see. The Government of Pakistan has taken a leadership role in evaluating the competitiveness of the industry and is a strong supporter of the review process led by the International Labor Organization. We engaged local organizations to assess the needs of workers most likely to be affected by this decision and developed assistance plans based on their input.

Even with a strong multi-stakeholder effort, challenges remain. It is not yet clear what steps are required for a traditional, hand-stitched industry to remain competitive in a market increasingly shifting toward machine-stitched balls. It's not even clear if such a path is viable. As we explore options for paid training programs for workers, we have to consider what jobs we are preparing them to do, work in a new industry or work in a more technically challenging soccer ball industry.

Key learnings from each case have influenced the protocols we use in our new country approval process, new source approval process and factory exit process. In addition, they have influenced our contract manufacturing processes and sourcing strategies.

Refining the process: Multi-Fibre Arrangement (MFA) Forum Responsible Transitions Working Group

As we evaluate our options for improving our factory exit process, we see areas for improvement, including:

- Evaluating the full cost of entering new contract factories, so that we consider the impact of exits when making new sourcing decisions, including greater evaluation of a factory's financial health before bringing it into the supply chain.
- Continuing to adhere to the established factory exit process, providing contract factories with the notice they need to make good business decisions in the absence of Nike orders.

At this stage we have more questions than answers. We recognize that more dialogue with stakeholders is needed to define good processes for mitigating worker impacts. To meet that goal, we are sponsoring the efforts of the Multi-Fibre Arrangement Forum's Responsible Transitions Committee, which is working to better define responsibilities and options for each stakeholder engaged in factory exits.

Major Issues:

The areas of focus we identified in our FY04 Corporate Responsibility Report continue to drive much of our work today.

> By FY11 we aim to have the Freedom of Association educational program implemented in 100 percent of our focus factories.

Freedom of Association (FOA)

Protecting the rights of workers to freely associate and collectively bargain remains a persistent and fundamental compliance challenge in the industry. We shared three components of our approach to strengthening industrial relations in our FY04 report: encouraging worker-management dialogue, sharing best practices to improve factory grievance systems and directly intervening where specific freedom of association issues arise. Although we have undertaken some specific actions over the past two years, we feel that much more needs to be done in this area.

Among various freedom of association initiatives, we participated in the Fair Labor Association's Central American Project, to counter the prevalent practice of blacklisting in Central America, particularly within Economic Processing Zones. The project attempted to address blacklisting by developing and providing training to factory management and government officials on human resources policies and practices around hiring, termination, disciplinary measures and grievance procedures.

In Vietnam, we are participating in the International Labor Organization's Factory Improvement Program alongside trade unions and factory management. The program is being implemented in collaboration with the Vietnam Chamber of Commerce and Industry in 12 contract factories around Ho Chi Minh City. It consists of seven training modules which, among other things, are designed to strengthen collaboration and worker-management communication.

In China, we continue to work with the Xiaochen Hotline Program to provide training on China labor laws, improved worker-management communication and more effective grievance systems. In 2007 we will focus on building these principles and promoting workers' access to the hotline.

More recently, we worked with SITEMEX, the trade union representing workers at MEXMODE in Mexico, and factory management to reach an innovative agreement to bring in an outside consultant to evaluate the factory's human resources management practices and make recommendations for increased productivity.

Despite these efforts, significant challenges remain. Many challenges are beyond our ability to impact significantly, but we continue to address when possible. These issues include:

• The complex and varied legal framework for freedom of association from country to country.

• The varying degrees of effectiveness, transparency and good governance within union representation, and a need for local unions to build capacity to be effective and constructive partners with management.

• The need to educate contract factories – to varying degrees – on the role of freedom of association and collective bargaining.

To address these issues, we have now adopted a work plan that includes several important new steps:

1 Clarify.

We are developing a deeper and more clearly defined Nike position on Freedom of Association and the broader topic of worker-management dialogue over conditions of work and worker grievances. For example, like others, we continue to grapple with the challenge of promoting free association in countries where legal or political constraints prohibit or limit such rights of workers, which is the case in several countries where our product is manufactured.

2 Train.

We have not done enough to systematically map legal requirements around free association in our key sourcing countries and train our compliance staff. We have started identifying key stakeholders, but have not yet integrated them into an overall understanding of the legal and broader worker association landscape. To address this gap we plan to develop country-specific profiles. These profiles will capture a summary of key legal requirements, concerns raised by trade unions and others regarding the country's practices, information on specific freedom of association issues within the Nike supply chain and a list of principle stakeholders. Based on this work and input from stakeholders, we plan to develop more systematic training for our compliance staff and identify mechanisms for delivering training to factories to facilitate good industrial relations.

3 Build.

We plan to consult and work with stakeholders to include best practices around grievance systems and worker-management communication as part of our human resource management initiative. We plan to review and revise our MAV audit tool to improve the way we measure the effectiveness of worker management communication, including worker grievance processes and the ability of workers to exercise free association rights and collective bargaining within our contract factory base.

Excessive overtime:

By FY11 we aim to eliminate overtime identified in all contract factories.

In our FY04 report, we identified excessive overtime hours – hours worked beyond the limits of country rule of law or Nike’s Code of Conduct, whichever is more strict – as one of the most pressing and pervasive issues in Nike contract factories and in the industry at large.

The new audit tool we developed to identify root causes, the MAV, confirms what we suspected.

Late design changes and poor forecasting by buyers pressure factory management who may already have done a poor job of production planning or have accepted orders beyond their capacity as a means of managing risk in a fluctuating market. The pressure on contract factories is compounded by unexpected events such as power shortages or late material arrivals.

The pressure on the factory to deliver product on time often seems to outweigh concerns about legal compliance, code compliance and general good work practices. A negative reinforcing loop may occur: Excessive overtime can result in decreased quality or productivity, promoting further excess hours to meet production targets. Many in local industry also are able to circumvent or ignore legal compliance standards, which may reflect a more generalized lack of clarity about or enforcement of the law.

Upstream focus

While we cannot control all of the factors that lead to excessive overtime, we are determined to better manage the variables driven by our business processes.

In June 2005, we launched an Excessive Overtime Taskforce chaired by our CEO. The taskforce includes business leaders from each of our three product engines and senior leadership in corporate responsibility, including those focused on strategic planning, research and compliance. Tasked with examining the entire business cycle as it relates to overtime, the group identified several key areas where there is opportunity to provide benefit to both Nike and the contract factories’ efforts to control excessive overtime.

The goals identified were:

-  Increase productivity per product style – Fewer lines generate greater profitability, decreasing the complexity within the supply chain and potentially increasing the profitability.

-  Expect process discipline – Expect people and teams throughout the system adhere to the process.

-  Consolidate materials – Consolidating the use of materials eases pressure on the supply chain through less complexity and less volume of diverse materials.

-  Increase on-time commercialization – Hand off from the designer to factory must take place within our agreed upon time frame so that added pressure to deliver to market on time is not placed on the factory.

-  Increase forecast accuracy – If product forecasts are significantly off, this can cause significant and sudden increases or decreases in orders.

-  Reduce samples – The need for sales samples in the traditional business model places significant pressure on the supply chain. Samples frequently are asked for with much shorter deadlines and in small quantities. Reducing samples will not only positively impact the factory floor, but also significantly reduce the amount of waste generated in the overall supply chain.

Each goal is significant and complex. Certainly the Corporate Responsibility team alone is not able to bring about change on deep and widespread process improvement across the global supply chain. The goals demand significant process, cultural and behavioral change throughout the business.

Based on the task force's work, the Corporate Responsibility team is updating the balanced scorecard to include direct correlations between business processes and resulting excessive overtime on the factory floor.

This scorecard will provide an important check on Nike's delivered in full, on-time metric for evaluating business performance. We aim to achieve a balance between meeting expectations to remain competitive in the marketplace, while protecting the worker's right to a safe workplace, where there are reasonable hours of work that meet Nike's Code of Leadership Standards.

Eliminating excessive overtime: the business case for the factory

Ultimately, we aim to see contract factories take responsibility for compliance and better productivity. To accomplish this, we help them implement better business practices and well-developed human resources practices and factory management systems.

One of our leading suppliers in Turkey explained that it committed resources to address excessive overtime following Nike's D rating for the factory due to non-compliance in this area. In its words, "We were paying more money for a negative performance evaluation. Something had to change."

In general, the true cost of excessive overtime still goes unmeasured within most contract factories in the industry. Building the links between traditional areas of measurement in contract factories, such as quality and delivery, and the human element – turnover rates, costs of recruiting and training, time lost due to incidents and accidents – are crucial in establishing a business case for eliminating excessive overtime.

Without a clear business case, contract factories have a difficult time embracing investments in human resource management systems. External market pressures are simply too overwhelming and the rule of law generally too weak to create a level playing field at the regulatory level.

Looking ahead

Eliminating excessive overtime will require a cultural shift, both within Nike and our contract factory base. The keys to unlocking that change are similar:


- Measuring the right data to evaluate the business impact of our practices, upstream and on the factory floor.
- Creating incentives that reward the right behavior.


Wages:


Our ultimate goal is that equity runs across supply chains from start to finish and workers at every stage of a supply chain are rewarded with locally relevant fair, competitive wages.

We have two distinct approaches to wages:

- 1 To monitor that workers are paid wages owed them for the hours worked, at the rates agreed to, with base compensation at a level that reflects minimum wage or above and includes a number of benefits that are defined by factory, collective bargaining processes or country legislation. This is documented in our [Code of Conduct](#) and is a core component of our factory grading.
- 2 To explore and support the building of human capital (worker skills) coupled with increasing factory productivity as mechanisms that positively impact worker compensation levels while also assuring a competitive business model for factory, country and buyer. This is addressed through our targets for the next five years, namely to:

-  Provide tailored human resources management training and systems to all of our focus contract factories.

-  Roll out lean manufacturing across all of our focus contract factories.

-  Introduce freedom of association and collective bargaining training to all of our focus contract factories.

We believe that a responsibly competitive industry that invests in its workforce will result in sustainable, locally relevant wage increases for workers over the long term. We do not endorse artificial wage targets or increases based on arbitrary living wage definitions. Minimum wages should be determined by negotiations with workers and management and through public policy. As part of our lean manufacturing strategies, we are committed to educating managers and workers in our contract factories about freedom of association and collective bargaining, as well as helping factories implement strong human resources management systems and practices.

Across the industry

In an average garment, labor costs represent about 15 to 20 percent of the total per-unit price paid to the factory, with materials contributing approximately 60 percent of the product's on-board cost. In footwear, the average labor costs are 10 percent of the total per-unit price.

In the traditional business model of the apparel and footwear industry, where the key driver has been lowering the landed cost of goods, stakeholders have rightly expressed concern that a market-driven downward pressure on price can undermine efforts to improve working conditions. They're specifically concerned that downward pressures on pricing can be a factor in maintaining wages at artificially low levels.

Although a small fraction of the total cost of a product, wages have traditionally been one of the only parts of the manufacturing process with elasticity. Across the industry, we see contract factories closing, often blaming lower wages in other countries. For those that stay open, negotiations between management and worker representatives are often tough, with little room for bargaining in such a price-sensitive market.

In the past, tariffs and quotas created sourcing necessities based not on consumer demands but that could be accommodated because of the slower pace of change within the marketplace. Quotas and tariffs also created impacts to the unit price of goods – sometimes hidden, sometimes visible – and producers reacted by hunting to find the best freight on board (FOB) price in a very fragmented market.

Tariffs and quotas have been dismantled, allowing for more long-term partnerships with contract factories. Consumer expectations have changed. They expect more, sooner and with increasing customization. New markets emerge as economies develop. Success in the new global marketplace is based increasingly on time to market and product quality. This is changing the dynamic

On the factory floor: Measuring the true value of labor

The starting point for many contract factories remains basic compliance with local wage laws, including appropriate payment for overtime work. In FY05-06, Nike secured nearly \$1 million in back wages owed to factory workers, most of them in Asia. In some cases the unpaid wages reflected a lack of commitment to ethical behavior by contract factories. In many other cases they reflected poor systems for tracking wage payments or poor understanding of local law.

For nearly all contract factories, even those that manage their payroll appropriately, the true value of labor is highly underestimated. We believe that shifting the view of the workforce from cost to investment is a crucial component of supplier ownership of corporate responsibility and is a requirement for shifting the wages debate.

Some Nike contract factories manufacturing today reflect an ROI2 model: investing in workers and watching their investment reap returns

in efficiency and quality gains. So far, these contract factories number far too few across the industry, but increasing numbers of contract factories in our supply chain are shifting to new models, in part because they are rethinking their approach to manufacturing.

In the past five years, our footwear team has developed lean manufacturing processes with key suppliers. Lean manufacturing empowers and develops the workers' skill sets so that they can perform multiple tasks, facilitates the efficiency of the manufacturing process, and encourages workers to identify problems and solutions, positively impacting quality.

Greater efficiency and higher quality is related to productivity and profitability gains, all of which make a factory and its trained work force more competitive. We believe lean manufacturing has the potential to result in wage gains for workers as their skill sets and productivity improve and as the factory invests more in workers' development and retention.


As lean manufacturing creates productivity gains, many factors will influence the ultimate benefit to workers and how any profitability improvement is shared or reinvested across the supply chain. For example, a productivity gain may be offset by a long-term increase in fuel prices or raw materials, affecting both the factory and the buyer. Consumer demands may require that gains be reinvested in product improvements or retail prices. By the same token, a factory may need to reinvest gains in worker retention to keep the factory competitive.


It's unclear today how lean manufacturing will affect workers' wages. Measuring these impacts is challenging, and we are still exploring how to best quantify gains for workers through lean manufacturing.


A factory may be unwilling to share with us how all of their gains from lean manufacturing are being shared or reinvested. Because contract factories are separate companies, we do not have visibility to all aspects of their operations and financial business model. However, we are seeing gains to contract factories and to Nike from our initial work with lean manufacturing, and we believe the long-term savings can be significant for both factory and buyer. For fiscal 2007, Nike expects to see a \$0.15 cost reduction for each pair of shoes produced on lines that have been lean for at least 12 months. We are reinvesting these gains into our growth strategies. We believe contract factories are reinvesting

their initial gains into the investments required to implement lean manufacturing and the human resource management systems required to make lean manufacturing effective. We believe that the ultimate savings from lean manufacturing could be more than double the savings we've experienced so far. This would certainly be significant when applied to our current footwear production of more than 225 million pairs a year.

In FY08 we are committed to continuing work in this area, including:

-  Evaluating current wage levels at selected contract factories, including those implementing lean manufacturing, and determining the impact of productivity on labor rates.

-  Building a set of measures for factories to use in developing human resources management systems to properly value their investments in labor.

-  Identifying case studies and sharing them with a broader set of contract factories to promote ROI².

Hazardous waste:

We have broadened our perspective on our responsibility to include the environmental footprint of manufacturers, impacting both workers in contract factories and the environment. Specifically, we are tracking the final disposition of hazardous waste. In recent years we have come to understand that we needed to identify the compliance and technical capabilities of contract facilities to treat and dispose of the approximately 5 million kilograms of hazardous waste generated by Nike contract facilities.

In mid-2004 we joined [CHWMEG](#), a nonprofit trade association comprised of manufacturing and other industrial companies interested in efficiently managing the waste management aspects of their environmental stewardship programs. CHWMEG conducts comprehensive, independent reviews of commercial facilities that treat, store, dispose, recycle or transport waste based on a standard protocol and conducted by independent, experienced environmental firms. CHWMEG member companies share the cost of the facility review reports that are of interest to each member.

Since joining CHWMEG, we have invested in six such reviews at strategically selected sites, primarily based upon volume of hazardous waste generated, three in China, two in Thailand and one in Vietnam. These six facilities collectively receive more than 45 percent of the global volume of hazardous wastes generated by Nike contract factories and 65 percent of the global volume of our footwear wastes.

By the end of FY07 we aim to have completed audits at 10 facilities around the world, capturing 65 percent of the global volume of hazardous wastes generated and 90 percent of the footwear hazardous waste. We also aim to conduct facility reviews at key disposal facilities in Indonesia, Brazil, Mexico and Turkey.

Results to date have increased our awareness and knowledge regarding hazardous waste treatment service providers. We now are able to drive factory remediation and influence contract manufacturers' disposal facility selection process. Together with contract partners, we ultimately hope to reduce the risks associated with regulatory fines, clean up actions and brand image concerns, while improving working conditions. For more detail on our efforts around hazardous waste, [read](#) our Considered Design and the Environment section.

Helping to improve contract factory conditions and enhance protection of worker's rights continues to be one of Nike's most important corporate responsibility efforts. It is the combined efforts of corporations, government, trade unions and non-governmental organizations that will bring about systemic change.