

Who's minding the store?

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By Wong Joon-san (HK Edition)



Distribution of goods requires close supervision to prevent fraud. Wong Joon-San / For China Daily

Supply chain operations and procurement functions are susceptible to fraud owing to their nature. The situation is made more complex in today's global trading environment. Organizations can become victims of fraudulent activities, including theft, counterfeiting of food and consumer products, as well as adulteration, at every step in their supply chains, both internally and externally, and through internal-external collusion. Wong Joon-san reports.

The failure to detect and reduce fraud at the source can lead to huge financial losses, consumer injury and even death, such as revealed by the 2008 milk scandal spread over the mainland, involving melamine adulteration. There were an estimated 300,000 victims of that fraud. Six infants died and 860 babies required hospitalization.

A World Health Organization spokesman says the scale of the problem proved it was "clearly not an isolated incident, but a large-scale intentional fraud aimed at deceiving consumers for simple, basic, short-term profits".

"Good governance demands a thorough risk analysis, which includes an organization's susceptibility to fraud. Supply chain fraud detection and reduction requires a new examination of an organization's activities starting at the end: the financial statements. Minor fraudulent activity can turn into larger events leading to a hard impact, as the fraudster gains more confidence with increasing non-detection," says Norman Katz, president of Katzscan Inc.

When fraud strikes, the integrity and operations of the whole organization will be at stake, and no matter how good the management is at handling the crisis, it will still be a costly one to repair and regain its shattered image and reputation.

A leading fraud investigator in Hong Kong, who declined to be named, says among the reasons that led to fraud in some organizations was the lack of background checks on employees, vendors and distributors. "Poor due diligence on joint venture partners, high staff turnover, poor staff retention and weak internal controls of standard operating procedures also led to fraud," he explains.

Another finding concerning a fraud case in China, headquartered in Hong Kong, was that the organization had formal and informal chains of command as well as a similar communications structure.

That led to "hidden channels of command and communications", making it



very difficult to know what was truly going on. The problem was exacerbated by the fact that the company had several high-ranking managers with their own "pockets of power" within the organization. In one case, nine executives were brought to book after a long, difficult and extensive investigation into supply chain fraud involving losses of millions of dollars.

The cost of economic adulteration and counterfeiting of food and consumer products - fraud committed along the supply chain - for such industries may range from \$10-15 billion per year globally, according to a research study report by A.T. Kearney. The consequences of fraudulent adulteration, from lost sales and bankruptcies to adverse health consequences and, possibly, even fatalities for consumers, are alarming.

After reviewing the study's findings, A.T. Kearney says it became clear that even the best companies could find opportunities to improve their food safety and quality programs. The report says the keys to doing so lie in companies gaining a better understanding of their supply chains' vulnerabilities and in strengthening their existing deterrence strategies.

"Yet industry cannot be expected to solve this global problem on its own. If we are to prevent economic adulteration, manufacturers, governments, and other relevant institutions will need to share pertinent information that will enable them to take concrete action," the report says.

Associate Professor Hani El-Nezami at the School of Biological Sciences of the University of Hong Kong says the present controls in the city, especially with the introduction of the new food safety bill, are quite sufficient to protect Hong Kong residents from the risk of exposure to food contaminants.

"If any such (food contamination) outbreaks occur in Hong Kong, my advice to consumers is to read and understand what the scare is all about, find out more about the kinds of food that are affected, determine the extent of the problem and listen to the authorities," he says.

When looking at supply chain fraud, it may just involve small payments made by suppliers to company staff in the range of a few dollars to a few hundred dollars as payment to show their "appreciation of the business", but it is not necessarily given because any specific action is expected, says Paul Aram, supply chain director of ITT, which supplies, among other products, air-operated pumps and diesel and oil-driven systems to Hong Kong.

In some cases, small or medium-size payments are made by the supplier to company staff for a specified benefit. It may be for getting information about a competitor's suppliers pricing data, contract end dates and supplier metrics.

Payments maybe made in cash, or some other hard-to-trace method (such as supermarket shopping cards). Payments are normally made frequently but in small amounts, and they are paid whenever staff visit the supplier, or during holiday periods.

"The fraud can easily be perpetrated by a staff member signing for the receipt of a certain number of components, when in reality he had received only half the amount stated on paper," he says, adding that this may also extend to acceptance of defective products or parts, or inclusion of delivery charges that are small initially and increasing to huge amounts subsequently.

Often, the purchases of indirect items, such as equipment for warehousing facilities, are put out to tender. The successful bidder is picked after comparing quotations from three independent suppliers.

"In a fraud case, the supplier manages to win the sale by rigging the tender by putting in three bids, while making sure one of his bids get the job," Aram says. Other examples of this type of legerdemain are network cabling, fire extinguishers and even transportation.

He points out that most often the fraud is committed to defraud the company such as changing the pricing in the enterprise resource planning (ERP) system as most companies' weakness is in direct purchases or project purchases.

According to a Tsinghua University research, an estimated 16 percent of China's GDP is lost to fraud annually via embezzlement and other forms of fraud involving distribution, purchasing, combination of distribution and marketing, product alterations and so on.

In a case on the mainland, investigated by Hong Kong-based ITT, the "kick-back" to a staff member for awarding the supplier with a \$1 million contract was 10 percent, or \$100,000, reflecting the magnitude of corruption involved. In other cases, the size of the supply chain fraud varied, and the amount of "kick-back" to company staff also depended on the seniority of the staff.

"On the mainland, managers cannot be linear in resolving (supply chain) fraud cases because there are too many moving parts," says Edward Epstein, managing partner of international law firm Troutman Sanders, in charge of Shanghai operations. The firm's Hong Kong office, established in 1997, also assists with investigations with the mainland when necessary.

Epstein says the reason people commit fraud is complex and rooted in history. "Fraud may not just be a mechanism for employees to steal from their employer, but may also be a symptom of underlying corruption in the supply chain," he adds. Epstein says this was revealed in one of the probes carried out by his company on behalf of a client. "In this case, the fraud was also part of a scheme to fund corrupt payments of employees of customers," he reveals.

Fraud is frequently revealed by anonymous whistle-blowers. It is essential to maintain "hotlines" to facilitate whistle-blowing. "Hotlines" do not just refer to a telephone number or e-mail address. But Epstein says these hotlines should be made very accessible and simple, and not making the e-mail complicated, while citing a Bank of China e-mail hotline. There may be a system for channeling and handling all reports concerning compliance issues, whether they are submitted anonymously or not. It may be a bulletin board and handling all reports exclusively by the compliance officer or an e-mail or telephone reporting system to channel reports made anywhere in the company.

Epstein says his company held an investigation after the whistle was blown by an anonymous e-mail sent to regional headquarters management and which was then forwarded to headquarters.



The implementation of a code of conduct, financial controls and monitoring of relationships with third parties in the supply chain must be treated as a complete package to prevent fraud. In addition, the company hiring staff should carefully carry out an employee's background screening, which is the same as that applied to screening the backgrounds of vendors and distributors.

Due diligence imposed with an anti-corruption element while employee and vendor integrity programs should be implemented. Staff should be trained on best practices and ethics. Contingency plans should be set up on what lines of action to take when such a crisis develops.

"You cannot just rely on one spoke in the wheel or the wheel will fall off. In a case investigated by Troutman Sanders, code of conduct training was inadequate while financial controls were submissive to management and not skeptical and there was no third-party due diligence," Epstein adds.

An investigation and the implementation of its findings must be a single and integrated objective. Investigators and lawyers bring different but complementary skills and experience to the table. "It's therefore essential for the investigator and the company's legal counsel to respect each other and work as one team.

"Typical types of implementation of findings will include the discipline of employees, including termination, strengthening the code of conduct and training and/or fraud controls and monitoring processes."

He points out that these cannot be done without a clear understanding of behavior and where and how the machine broke down, which means legal counsel must be involved in the investigation and not just reading the findings' report.

Good investigators bring thinking skills and forensic techniques that most lawyers do not have. The investigators also understand human nature and predict behavior better than lawyers and are able to think laterally and follow up leads rather than checking boxes.

Good lawyers are able to distill findings into an essence for implementation of a variety of remedial measures and communicate all this succinctly and effectively. Legal advice to clients is protected by attorney client privilege (legal professional privilege).



Moving goods along supply chain from the mainland to Hong Kong. Wong Joon-San / For China Daily

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