

Procurement fraud and corruption Sourcing from Asia



With the number of companies using suppliers based in Asia growing, instances of fraud and corruption in the procurement cycle are increasing. While cost savings can be attractive, the financial risks can be bigger and a company's reputation and brands may be put at stake. What companies may not realize is managing procurement fraud and corruption risks in Asia may require a distinctly different approach

With more countries stepping up enforcement of local anticorruption laws and U.S. enforcement of the Foreign Corrupt Practices Act leading to record fines and penalties, the risk of significant financial and reputational damage from procurement fraud and corruption may now be greater than ever.

Illicit rebates, kickbacks and dubious vendor relationships are all too common. While these risks can never be fully eliminated, organizations can implement controls to mitigate the likelihood of such risks occurring and to help detect them if earlier if they do occur.

China calling

Specific procurement fraud and corruption risks in China include instances where business professionals new to the country are exposed to longer procurement chains, a different economic climate, unfamiliar trade practices, language and cultural barriers, among others. This is further complicated by the effects of China's one-child policy, where many people have no siblings, but instead create an intricate network of friends and alumni. This can make conflicts of interest harder to identify. Business success in China is often due to contacts ("guanxi"), but what may be regarded as an acceptable business practice in Asia, could be illegal elsewhere.

In this article, we highlight an approach organizations can take to help mitigate these risks.

The procurement fraud challenge

Instances of fraud and corruption in the procurement cycle are typically difficult to detect, prove or prosecute. They are often dealt with internally and implicated employees allowed to "resign" with their reputations intact, increasing the likelihood of there being unprosecuted fraudsters among a company's experienced hires.

A high-risk fraud environment is typified by heightened pressure, opportunity and rationalization – the three sides of the "fraud triangle." These factors could be exacerbated by an economic downturn, leading to damage that may only be revealed sometimes years later, after economic recovery is under way.

Employees put in a position where they are requested to pay or are offered a bribe, and who have not already rejected both scenarios, will often ask themselves three questions:

- Will I get caught?
- Is it more than my job is worth?
- Is it right or wrong?

They may rationalize paying a relatively modest bribe on a big contract as not a significant risk. And if they do decide to pay a bribe, they will use the company's money. This typically means two things: first, there will likely be an incidence of fraud in order to create or hide the payments; and second, they may need to get others involved to help circumvent internal controls.

From procurement to distribution, employees and external parties, such as suppliers, distributors and competitors, all have opportunities to commit procurement fraud. This can range from false invoicing, bribery and kickback schemes to inventory theft and substandard goods.

Some red flags to look for include:

- Poor or non-existent record keeping
- Higher price/lower quality goods
- Excessive entertaining of procurement staff by suppliers
- Deviations in communications between procurement staff and suppliers, such as calls or text messaging to mobile phones
- Procurement staff demanding extended periods of notice before they allow an audit to take place

- Inexperienced buyers dealing with overbearing suppliers — especially when conducting business in Asia

While the risk of fraud cannot normally be eliminated entirely, it can be greatly reduced with a combination of company-level anti-fraud controls and risk-specific anti-fraud controls.

Knowing your supplier

Performing background checks and integrity due diligence can help determine whether your suppliers are of reputable standing as well as highlighting the manufacturer's interests, associations, related parties and possible conflicts of interest.

Given recent events in China, where factory managers as well as government officials have been investigated over a number of industrial pollution incidents, which in one case resulted in the lead poisoning of over 1,000 children in the summer of 2009, organizations should consider assessing their manufacturers' adherence to laws and regulations, whether environmental or employee related.

Checking on the financial stability of suppliers is also important. Ideally, this should include an analysis of the supplier's financial records to help determine whether it is in a stable financial position and is able to fulfil its contractual commitments. Reports of suppliers taking orders and deposits from foreign buyers and then not fulfilling the contract are not uncommon.

Additionally, analyzing both payroll costs and employee numbers may highlight problems of underpayments, overstaffing, illegal overtime or child labor.

Once selected, a supplier can be subjected to regular due diligence checks to help assess whether it is complying with its legal and regulatory requirements.

In the Deloitte Touche Tohmatsu Global Manufacturing Industry Group's *Innovation in Emerging Markets 2008 Annual Study*, it was found that only 35 percent of developed market manufacturers conducted "extensive monitoring" of their suppliers' subcontractors, while 49 percent performed "some monitoring" and 16 percent only performed "little monitoring."

Subcontractor risks

As procurement chains extend and margins are squeezed, suppliers are often driven to more and more subcontracting. So determining that a supplier has the required capacity can be crucial. In many instances in China, subcontractors and even subcontractors of subcontractors are used without the buyer's knowledge.

China's manufacturing scandals over the past few years demonstrate the risks can be enormous unless an organization has visibility and control over the process. Branded products may be made in substandard facilities causing reputational harm to the buyer. Substandard or hazardous materials might be introduced during the production process, creating significant product liability exposure.

Procurement quality fraud: Buyer beware!

1. Economic losses from Chinese drywall could reach \$25 billion
2. Company launches biggest recall in its history — recalls 19 million toys made in China
3. Almost 300,000 babies taken ill with contaminated milk powder made in China

In addition to the externally focused activities described above, internal anti-fraud controls are also important in Asian procurement activities, but they may require customization to deal with regional or country-specific cultural and business practice issues.

Establishing the right culture

While paying bribes may be part of the business culture in some parts of Asia, an organization that condones bribes runs a high risk of finding itself in the regulatory or investor spotlight.

Setting the right ethical tone within the organization is therefore vital. As is communicating this tone to business partners. Region- or country-specific codes of conduct and ethics policies can help to address specific local risks and business practices. They should be practical, easy to understand and easily accessible in suitable local languages for every employee.

The proactive development and promulgation of these policies by senior management can help set the tone for what is deemed fraudulent or unethical behavior, thereby facilitating the disciplinary process.

Hiring the right people

Automated procurement and accounting systems produce information, but these processes are still driven by people. This is particularly the case in China where most data input is still done manually, providing an ideal environment for fraud.

Background checks on individuals with procurement responsibilities can be conducted before hiring and periodically thereafter. The scope of such checks can be tailored based on the potential risks to the company. The approach used for background checks can also be adjusted from country to country, depending on where the relevant information is more likely to be found.

In order to limit the amount of control each individual has over each business process, segregation of duties can be implemented so that no single individual is empowered to manage the whole transaction.

Assessing internal controls

To mitigate the risk of fraud, existing controls, thresholds and procedures can be assessed skeptically. All too often foreign managers are simply told “this is the way it’s done in this part of the world.” They may then leave it at that, until it goes wrong.

To identify fraud one must understand risk. By identifying the risks within a control system, areas susceptible to fraud can be highlighted and corrected.

A good question to consider is, “If someone in the procurement cycle wanted to commit fraud or bribery, would this control be likely to prevent it or promptly detect it and bring it to the attention of someone not involved in the fraud who would be likely to stop it?”

Fraud in the procurement process commonly occurs when controls are deliberately overridden, by either the individual who knows he or she will not be challenged (perhaps for cultural reasons), or a collusive group able to use its knowledge to hide fraudulent activity. So anti-fraud controls

“Sourcing product in China represents a significant opportunity, but its risks are often not properly assessed and can prove costly to manage.”

Nick Robinson
Partner, Deloitte China

desirably have multiple layers and include controls that are more resilient to attempted override.

Actively monitoring controls

Assessing and enhancing internal controls can make them strong at one point in time. You do not want someone to be able to change or dismantle those controls once your back is turned. Actively monitoring those controls and testing them regularly can help to keep them strong over an extended period.

Preparing a fraud response plan

The timing of a fraud cannot be predicted. It can arise at the most inconvenient times. Having a fraud response plan in place can help the organization to respond without delay. This is a key issue in today’s world for two main reasons. First, vital electronic evidence may be overwritten or discarded if it is not promptly captured forensically. Second, the media may be pressing senior executives for answers to allegations that may only just have surfaced on the other side of the world, yet are circulating widely on the Internet.

Conclusion

Asia’s trading environment provides many business opportunities, but also many risks.

The amounts paid to resolve claims resulting from procurement fraud and corruption can be high, but they are more likely secondary to the loss of reputation and damage to brands companies may suffer for being associated with such claims. In this context, fraud and corruption prevention activities may be the best investment of all.

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Bill Pollard is a partner in the Forensic & Dispute Services practice of Deloitte Financial Advisory Services LLP. Mr. Pollard can be reached at wpollard@deloitte.com.

Nick Robinson is a partner in the Forensic & Dispute Services practice of Deloitte China. Mr. Robinson can be reached at nickrobinson@deloitte.com.hk.

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