Preventing procurement fraud and corruption

All organisations are prone to fraud and corruption in their procurement cycles. The fallout from a reputational perspective as well as a financial one can be disastrous. With the growing number of companies using suppliers based in Asia, the instances of fraud and corruption in the procurement cycle are increasing.

Illicit rebates, kickbacks and dubious vendor relationships are all too common. Whilst a company can implement or have controls in place to reduce the likelihood of these occurring, the risk can never be fully eliminated.

Instances of fraud and corruption in the procurement cycle are not easy to detect, prove or prosecute. They are often dealt with internally and implicated employees allowed to ‘resign’ with their reputations intact.

During a normal business cycle a high risk fraud environment is typified by pressure, rationalisation and opportunity. These factors are exacerbated with an economic meltdown. The global financial tsunami appears to be both unveiling more fraud and increasing the pressure on individuals to meet and maintain double digit growth previously experienced. It is this type of mindset in slower economic times that can contribute to increased fraudulent activity.

Employees put in a position where they are requested to pay or are offered a bribe will often ask themselves three questions:

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

And if they do decide to pay a bribe they won’t use their own money - they will use yours. This typically means two things: firstly, there will be an incidence of fraud in order to create or hide the payments; and secondly, they will need to get someone else involved to circumvent internal controls.

There are specific fraud risks in China, where investors new to the country are exposed to longer supply chains, a different economic climate, unfamiliar trade practices, language and cultural barriers.

In this article, we highlight an approach that organisations can take to manage these risks. This is done, not least, by having the appropriate corporate governance in place.

Throughout the supply chain, there are many opportunities for numerous people to commit procurement fraud. From procurement to distribution, both employees and external parties, such as suppliers, distributors and competitors, all have opportunities. These range from false invoicing, bribery and kickback schemes to inventory theft and substandard goods.
Some of the red flags to look out 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; and
- Inexperienced buyers - especially in conducting business in Asia - dealing with overbearing suppliers.

Whilst the risk of fraud cannot be eliminated entirely, it can be greatly reduced with the right approach:

**Establish the right culture**

While paying bribes may be part of the business culture in some parts of Asia, an organisation that condones bribes will at some stage find itself in the regulatory or investor spotlight.

Setting the right ethical tone within the organisation is therefore vital. So too is communicating this tone to business partners. Country-specific codes of conduct and ethics policies are a must. They should be practical, easy to understand and easily accessible to every employee. The proactive development and promulgation of these policies by senior management will set the tone for what is deemed fraudulent or unethical behaviour, thereby facilitating the disciplinary process.

**Hire 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 fraudulent behaviour.

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

Hiring the right staff and providing suitable training is therefore imperative if processes are to work correctly.

**Assess internal controls**

To mitigate the risk of fraud, existing controls, thresholds and procedures should be questioned, since all too often foreign managers are simply told “this is the way it’s done in this part of the world”. They 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. However, even the most carefully designed and tightly controlled system can be circumvented. Fraud in the procurement process commonly occurs when controls are deliberately overridden, by either the individual who knows he will not be challenged, or a collusive group able to use its knowledge to hide fraudulent activity.
**Actively monitor controls**
Having reviewed and enhanced internal controls there is little point in ignoring them. As business processes develop, so too should the systems that control them. An established control review procedure, which tests accuracy and functionality, is a must.

**Develop a fraud response plan**
The timing of a fraud cannot be predicted. It can rear its head at the most inconvenient times. Organisations should expect the unexpected and have a fraud response plan in place.

**Know your supplier**
Performing background checks and integrity due diligence can ensure that the manufacturers are of reputable standing as well as highlighting the manufacturer’s interests, associations, related parties and possible conflicts of interest.

Checking on the financial stability of each of the suppliers is also important, especially in the current economic climate. Ideally, this should include an examination of the supplier’s financial records to ensure it is in a stable financial position and is able to fulfil its contractual commitments.

Ensuring that the supplier has the required capacity is also crucial. In many instances in China, subcontractors are used - and even subcontractors of subcontractors - all without the buyer’s knowledge. In a recent study performed by Deloitte, it was found that only 35 percent of manufacturers conducted ‘extensive monitoring’ of subcontractors, while 49 percent performed ‘some monitoring’ and 16 percent only performed ‘little monitoring’.

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

Once selected, a supplier must be subjected to regular due diligence checks to ensure that it is complying with all its legal and regulatory requirements.

**Manage your sub-contractors**
As supply chains extend and margins are squeezed suppliers are often driven to more and more sub-contracting. Recent manufacturing scandals and the resulting mass product recalls demonstrate that unless an organisation has visibility and control over this process the risks are enormous, with branded product liable to appear in the worst production facilities or substandard materials included in the production process.

**Monitor the procurement process**
Regular checks on quality are a must - unannounced visits can often throw up a few surprises. Examining the number of rejections attributed to poor quality by each quality assurance supervisor and factory can often highlight strange patterns with particular employees.
All too often the saying in China “heaven is high and the emperor is far away” is a reality. If a supplier is based in China, and is responsible for providing finished goods to a corporation based outside of the country, the supplier may be able to operate with little or no oversight, taking advantage of various schemes that may be contrary to the interests of the buyer such as:

- Production of counterfeit goods
- Selling finished goods at reduced prices
- Outsourcing manufacturing to third parties
- Offering bribes to government officials to avoid being sanctioned for non-compliance with regulatory requirements
- Producing fraudulent financial statements and
- Tax evasion

Ensuring appropriate storage and distribution centres have been set up is also important. By performing regular stock counts, there is less opportunity for theft.

If appropriate prevention and detection methods are not implemented, organisations may suffer loss of revenue and profit. Routine checks for non-deliveries, repeat deliveries for the same order and discrepancies between purchase orders and delivery are a few of the procedures needed to reduce fraud risks.

Prevention is always better than cure. The amounts paid to settle any claims resulting from exposed fraud will always be secondary to the loss of reputation and integrity that companies may suffer for being associated with such claims.

Asia’s trading environment provides many business opportunities. In order for these to be fully exploited, investors must exercise a degree of caution and approach each one with scepticism.
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HK-040-10

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