

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.



Contact details for Deloitte's China Practice

Beijing

Deloitte Touche Tohmatsu CPA Ltd.

Beijing Branch

8/F Deloitte Tower
The Towers, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, PRC
Tel: +86 10 8520 7788
Fax: +86 10 8518 1218

Chongqing

Deloitte & Touche Financial Advisory Services (China) Limited

Room 10-12
13/F International Trade Center
Chongqing
38 Qing Nian Road
Yu Zhong District
Chongqing 400010, PRC
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170

Dalian

Deloitte Touche Tohmatsu CPA Ltd.

Dalian Branch

Room 1503 Senmao Building
147 Zhongshan Road
Dalian 116011, PRC
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297

Guangzhou

Deloitte Touche Tohmatsu CPA Ltd.

Guangzhou Branch

26/F Teemtower
208 Tianhe Road
Guangzhou 510620, PRC
Tel: +86 20 8396 9228
Fax: +86 20 3888 0119 / 0121

Hangzhou

Deloitte Business Advisory Services (Hangzhou) Company Limited

Room 605, Partition A
EAC Corporate Office
18 Jiaogong Road
Hangzhou 310013, PRC
Tel: +86 571 2811 1900
Fax: +86 571 2811 1904

Hong Kong SAR

Deloitte Touche Tohmatsu

35/F One Pacific Place
88 Queensway
Hong Kong
Tel: +852 2852 1600
Fax: +852 2541 1911

Macau SAR

Deloitte Touche Tohmatsu

19/F The Macau Square Apartment H-N
43-53A Av. do Infante D. Henrique
Macau
Tel: +853 2871 2998
Fax: +853 2871 3033

Nanjing

Deloitte Touche Tohmatsu CPA Ltd.

Nanjing Branch

11/F Golden Eagle Plaza
89 Hanzhong Road
Nanjing 210029, PRC
Tel: +86 25 5790 8880
Fax: +86 25 8691 8776

Shanghai

Deloitte Touche Tohmatsu CPA Ltd.

30/F Bund Center
222 Yan An Road East
Shanghai 200002, PRC
Tel: +86 21 6141 8888
Fax: +86 21 6335 0003

Shenzhen

Deloitte Touche Tohmatsu CPA Ltd.

Shenzhen Branch

13/F China Resources Building
5001 Shennan Road East
Shenzhen 518010, PRC
Tel: +86 755 8246 3255
Fax: +86 755 8246 3186

Suzhou

Deloitte Business Advisory Services (Shanghai) Limited

Suzhou Branch

Suite 908, Century Financial Tower
1 Suhua Road, Industrial Park
Suzhou 215021, PRC
Tel: +86 512 6289 1238
Fax: +86 512 6762 3338

Tianjin

Deloitte Touche Tohmatsu CPA Ltd.

Tianjin Branch

30/F The Exchange North Tower
189 Nanjing Road
Heping District
Tianjin 300051, PRC
Tel: +86 22 2320 6688
Fax: +86 22 2320 6699

Xiamen

Deloitte & Touche Financial Advisory Services Limited

Xiamen Liaison Office

Unit E, 26/F International Plaza
8 Lujiang Road, Siming District
Xiamen 361001, PRC
Tel: +86 592 2107 298
Fax: +86 592 2107 259

Contacts

For more information, please contact:

Nick Robinson

Partner

Tel: +852 2238 7085

Email: nickrobinson@deloitte.com.hk

Yuk Lam Cheung

Partner

Tel: +852 2852 6775

Email: ylcheung@deloitte.com.hk

Emmanuel Vignal

Partner

Tel: +86 21 6141 2738

Email: emmivignal@deloitte.com.cn

For further information, visit our website at www.deloitte.com/cn

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 140 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's more than 168,000 professionals are committed to becoming the standard of excellence.

Deloitte's professionals are unified by a collaborative culture that fosters integrity, outstanding value to markets and clients, commitment to each other, and strength from cultural diversity. They enjoy an environment of continuous learning, challenging experiences, and enriching career opportunities. Deloitte's professionals are dedicated to strengthening corporate responsibility, building public trust, and making a positive impact in their communities.

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/cn/en/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms.

Deloitte's China practice provides services through a number of legal entities and those entities are members of Deloitte Touche Tohmatsu (Swiss Verein).

We are one of the leading professional services providers in the Chinese Mainland, Hong Kong SAR and Macau SAR. We have over 8,000 people in thirteen offices including Beijing, Chongqing, Dalian, Guangzhou, Hangzhou, Hong Kong, Macau, Nanjing, Shanghai, Shenzhen, Suzhou, Tianjin and Xiamen.

As early as 1917, we opened an office in Shanghai. Backed by our global network, we deliver a full range of audit, tax, consulting and financial advisory services to national, multinational and growth enterprise clients in China.

We have considerable experience in China and have been a significant contributor to the development of China's accounting standards, taxation system and local professional accountants. We also provide services to around one-third of all companies listed on the Stock Exchange of Hong Kong.

These materials and the information contained herein are provided by Deloitte Touche Tohmatsu and are intended to provide general information on a particular subject or subjects and are not an exhaustive treatment of such subject(s).

Accordingly, the information in these materials is not intended to constitute accounting, tax, legal, investment, consulting, or other professional advice or services. The information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser.

These materials and the information contained therein are provided as is, and Deloitte Touche Tohmatsu makes no express or implied representations or warranties regarding these materials or the information contained therein. Without limiting the foregoing, Deloitte Touche Tohmatsu does not warrant that the materials or information contained therein will be error-free or will meet any particular criteria of performance or quality. Deloitte Touche Tohmatsu expressly disclaims all implied warranties, including, without limitation, warranties of merchantability, title, fitness for a particular purpose, noninfringement, compatibility, security, and accuracy.

Your use of these materials and information contained therein is at your own risk, and you assume full responsibility and risk of loss resulting from the use thereof. Deloitte Touche Tohmatsu will not be liable for any special, indirect, incidental, consequential, or punitive damages or any other damages whatsoever, whether in an action of contract, statute, tort (including, without limitation, negligence), or otherwise, relating to the use of these materials or the information contained therein.

If any of the foregoing is not fully enforceable for any reason, the remainder shall nonetheless continue to apply.

