Decoding frauds in the manufacturing sector
Overview of some fraud risks

The manufacturing sector is often one of the most vulnerable sectors which is exposed to the risk of fraud and corruption. Some of the most recent frauds in the manufacturing sector that have caused significant losses to companies have been due to inferior product quality triggering product recalls, warranty claims fraud and IP infringement. In some cases, these have also resulted in criminal/civil actions due to regulatory and statutory violations. Additionally, in our experience, one of the most common frauds in this sector is inventory fraud, which continues to be a cause of concern.

In the recent past, manufacturing companies have been daunted by some of the typical frauds listed below:

**Product quality frauds**

Frauds owing to inferior product quality usually involve the use of substandard materials in production or in the assembly line for manufacturing of finished products. These can also include manipulating of records to meet certain tests or regulatory requirements (like emission norms), purchasing poor-quality materials from vendors who also pose to be potential conflicts of interest. Some of these vendors might also be returning undue favours or a kickback for inferior quality material.

Additionally, there are cases where a manufacturer’s internal quality control may not be able to detect poor-quality material, as control procedures can pick defects only after the complete manufacturing process is over. As margins get squeezed, manufacturers tend to subcontract critical and non-critical production processes to third parties. If sub-contractors are used without proper due diligence, manufacturers tend to become vulnerable to issues related to product counterfeiting or substitution.

Implementing proactive measures within an anti-counterfeiting programme (which includes conducting third-party due diligence and performing a fraud risk assessment at the procurement, manufacturing and supply-chain processes level) can help to identify leakages, if any, and significantly help to deter counterfeiting or substitution.
Warranty claims fraud

Warranty claims amount to huge costs for manufacturing companies and can have a direct impact on product quality and customer satisfaction. It has become quite simple to circumvent, whether a product is filed for a basic product warranty or an extended warranty period. Hence, being able to identify questionable or suspicious patterns of warranty claims is gradually becoming the focus. This can be done by analysing the warranty claims using forensic data analytics tools. Such an analysis can also help to provide early warning signs on any quality issues and focus on the main problem areas.

Counterfeit products also find their way into warranty claims. These are filed by service providers through the use of genuine serial numbers on counterfeit units/parts. This is done with the intention of defrauding the manufacturing company and thus stealing genuine or refurbished parts by making false warranty claims. By performing a proactive forensic data analytics exercise on warranty claims filed by customers, fraudulent claims (if any) can be identified, and eventually significant amounts of fraud loss can be prevented in the future.

IP infringement

Intellectual Property (IP) has become highly valuable and of fundamental importance to the sustainability of businesses, while also becoming more difficult to protect over a period. The theft of IP (such as trade secrets, patents, drawings and designs, trademarks or technology) is quite common in the manufacturing sector. This infringement of patent/intellectual property rights can result in the company’s products finding their way into the counterfeit/grey market. Not only can this cause substantial damage to the sales and revenue, but it can also lower customers’ confidence and the manufacturer’s reputation. Therefore, conducting third-party and senior management integrity due diligence should be the first key step to address this issue.

Inventory frauds

Inventory frauds usually involve the theft of goods or materials from a company. The perpetrator may try to cover up the theft by falsifying computer system records related to quantities in-hand or may knowingly allow losses to occur (in the case of a collusion). Some preventive measures that can help to detect inventory frauds are regular counting cycles, organised warehouses, strong inventory record-keeping, along with good picking/packing/receiving and stocking procedures supported by related technologies (such as bar code scanning, radio frequency identification and GPS tracking for stocks in-transit). Decoding frauds to improve product quality and prevent loss
Decoding frauds to improve product quality and prevent loss

The success of a fraud prevention programme can increase if people feel that their wrongdoing can be detected. However, this success also depends upon the actual mechanisms implemented and their ability to detect frauds.

Manufacturing companies should have a robust fraud risk management framework. The framework should ideally continuously improve the fraud risk management strategy while regularly measuring the current and desired state of the business, in terms of effectively preventing, detecting and deterring fraud utilising the techniques of fraud risk management and forensic data analytics. We call this approach Managed Forensics, which encapsulates the Detection, Response and Prevention strategy.

By conducting a periodic fraud risk assessment and identifying the specific fraud schemes that can pose the greatest threat to the business (particularly in the areas vulnerable to frauds, as mentioned above), categorising those areas that merit additional investment in targeted anti-fraud controls is important. Management should continually assess the organisation’s specific fraud risks and evaluate its fraud prevention programmes in light of those risks.

Companies can also prevent fraud losses by proactively using forensic data analytics to detect, prevent and control fraud and corruption issues. This can be done by performing analytics on a periodic basis on high-risk transactions or areas of business that can identify and isolate suspicious financial transactions within the vast data fields that hum away in the course of everyday business. This, in turn, can (for example) help manufacturers to identify areas for improvement in product quality and/or yield substantial warranty cost reductions. Therefore, manufacturing companies need to proactively carry out periodic analytics of relevant data to stop fraud, identify emerging issues related to product quality as well as get to the root-cause faster.

A timely detection of fraud incidents can go a long way in containing the loss and improving the chances of recovering any loss an organisation may suffer due to fraud. It is time for organisations to ensure that their current fraud risk management strategies are revised to be in line with current fraud trends and adequate to take care of future growth. In addition, increasing ways of preventing and detecting frauds proactively by using forensic data analytics and performing third-party due diligence that include background checks of individuals and/or entities can help organisations to mitigate fraud risk.
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