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Brian W. Johnson, CPA, CFE, CCIFP

Fraud Considerations for Vendor and Supply Chain Management

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Agenda

- Introduction
- What is the supply chain?
- Fraud & what it means in context of supply chain
- Fraud origins, incentives and risk factors
- Procurement cycle, fraud risks and mitigation strategies
- Production operation, fraud risks and mitigation strategies
- Distribution, fraud risks and mitigation strategies
- Supply chain levers to drive improvement
- Questions & Answers

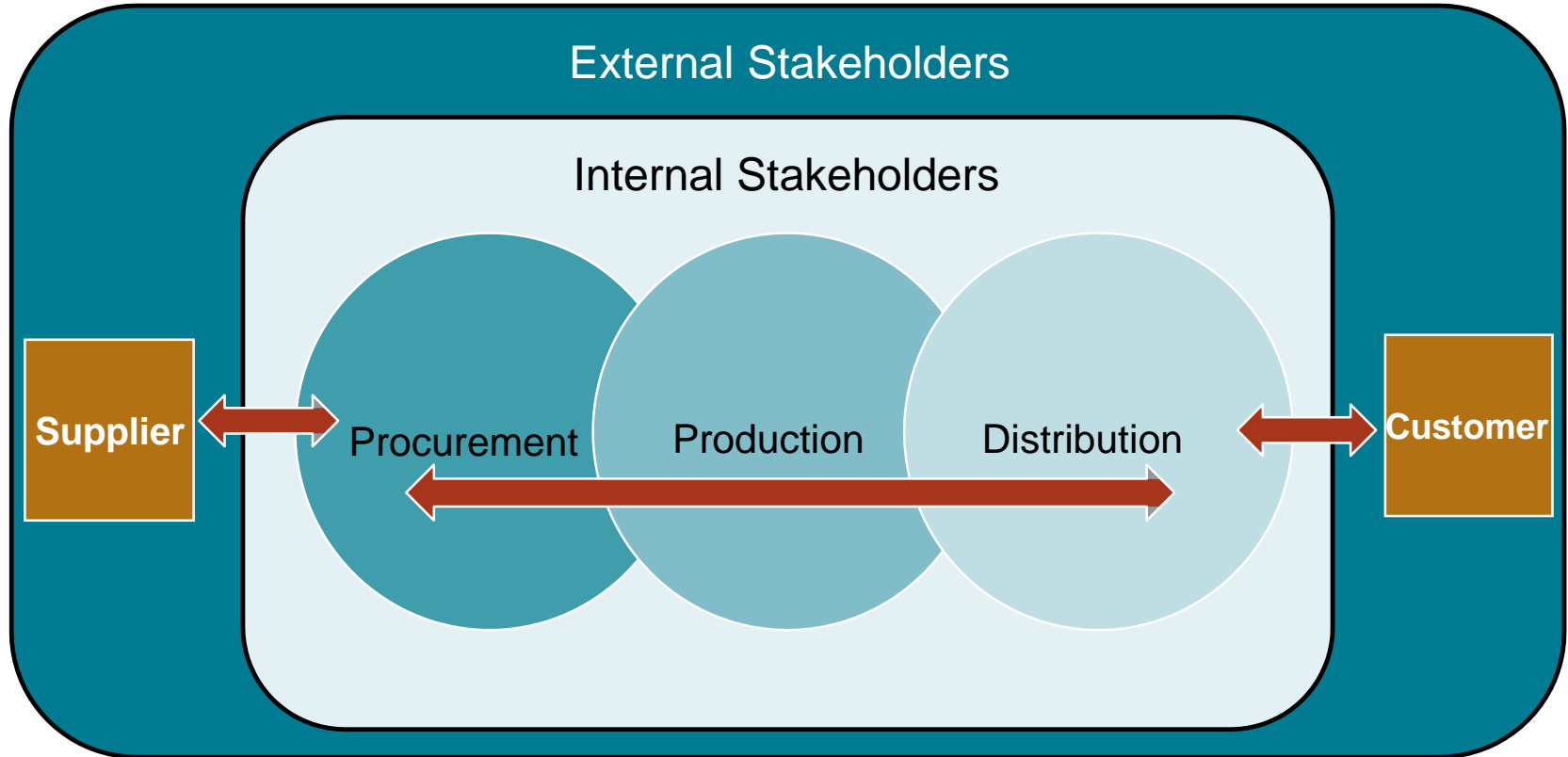
The Supply Chain and a Holistic Approach to Fraud Prevention, Detection and Response

- In organizations today the supply chain is in many cases the backbone of an organizations operations.
- Many organizations have worked very hard to increase efficiencies and reduce costs in the supply chain arena but have not considered the cost and risks of fraud as part of this process.
- Many entities have achieved significant cost reductions and increased efficiency as a result of improving their supply chain. Some efficiency increases have inherent risks attached to them, a major one being fraud risk.

What is a Supply Chain?

“A system of organizations, people, technology, activities, information and resources involved in moving a product or service from the supplier to customer. For example, supply chain activities transform natural resources, raw materials and components into a finished product that is delivered to the end customer.”

What is a Supply Chain?



What is Fraud in the Context of the Supply Chain?

Fraud:

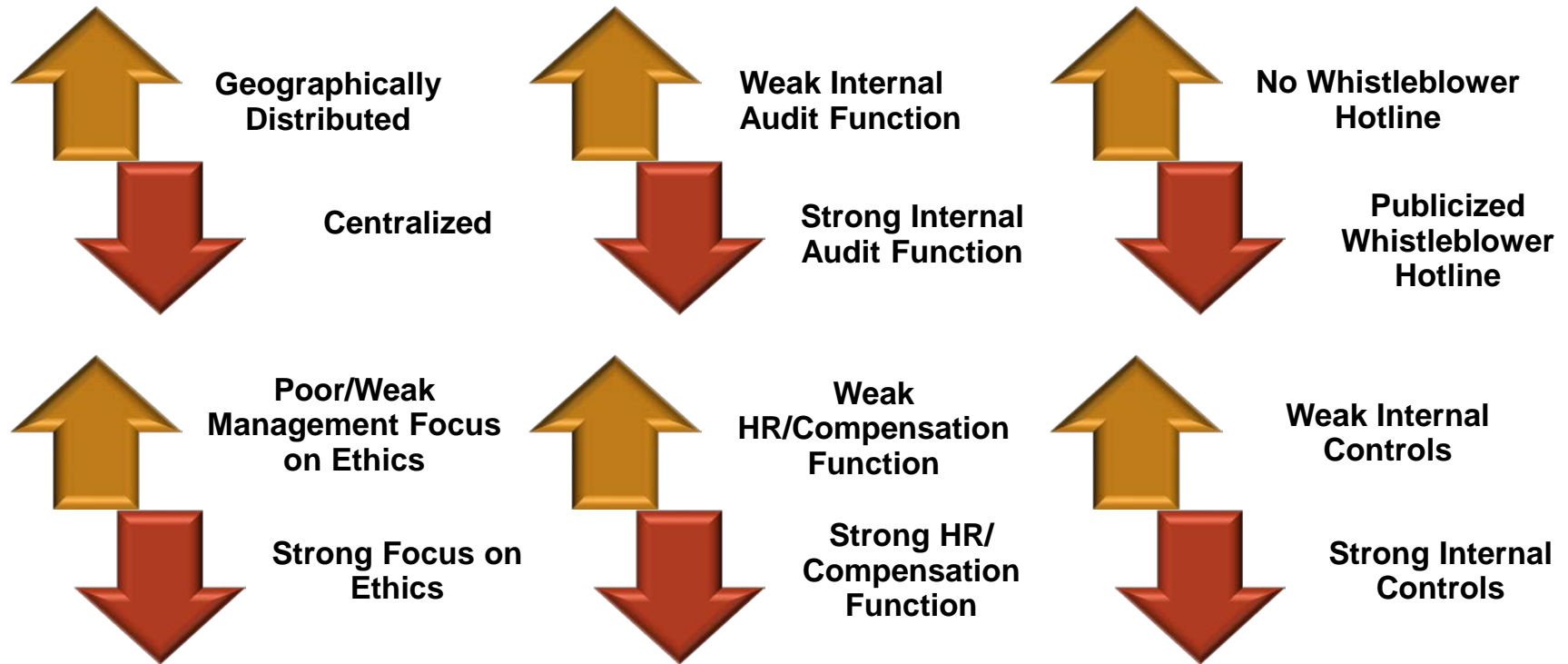
- A representation...
- About a material point...
- Which is false...
- And intentionally or recklessly made...
- Which is believed...
- To the damage of the victim.

Supply Chain Fraud Schemes:

- Piracy
- Theft
- Child Labor
- Bid Rigging
- Bribery and Corruption
- Product tampering
- Gray market products

Entity-Wide Fraud Risk Factors

Elevated Risk vs. Reduced Risk Impacting Supply Chain Operations



Enablers of Fraud and Misconduct in the Supply Chain



Source: Fraudulent Financial Reporting 1987 - 1997: An Analysis of U.S. Public Companies, (COSO Study)

Major Types of Fraud and Where They Might Occur in the Supply Chain

Asset Misappropriation

- Forgery
- Cash Theft
- Merchandise Theft
- Unpaid Services
- Billing Schemes
- Payroll Schemes

Financial Misrepresentation

- Revenue Recognition
- Expense Recognition
- Asset Inflation
- Channel Stuffing
- Earnings Manipulation
- Cookie-Jar Accounting
- Insider Trading

Bribery/Corruption

- Bribery of Government Officials
- Commercial Bribery
- Insider Trading
- Kickbacks
- Contract Manipulation
- Poor Decision-making

Any and all of these can occur within each stage of the supply chain

Fraud and the Supply Chain - Inextricably Linked

The terms “supply chain” and “fraud” should be on the minds of business leaders:

- Supply chain in today’s world is truly global in nature
- Fraud is being committed in both the public and private sector
- Thefts are at increasing rates and with increasing monetary impact each year

Supply Chain Improvement Must be Holistic and Consider all the Risks

Organizations have not always considered the cost and risks of fraud:

- Not always aware of potential risks of fraud waste and abuse in the supply chain
- Business processes and people bring the traditional risks of fraud waste and abuse

Supply Chain Risks

Steps in the supply chain process where weaknesses and susceptibility to fraud in the supply chain that can be exploited:

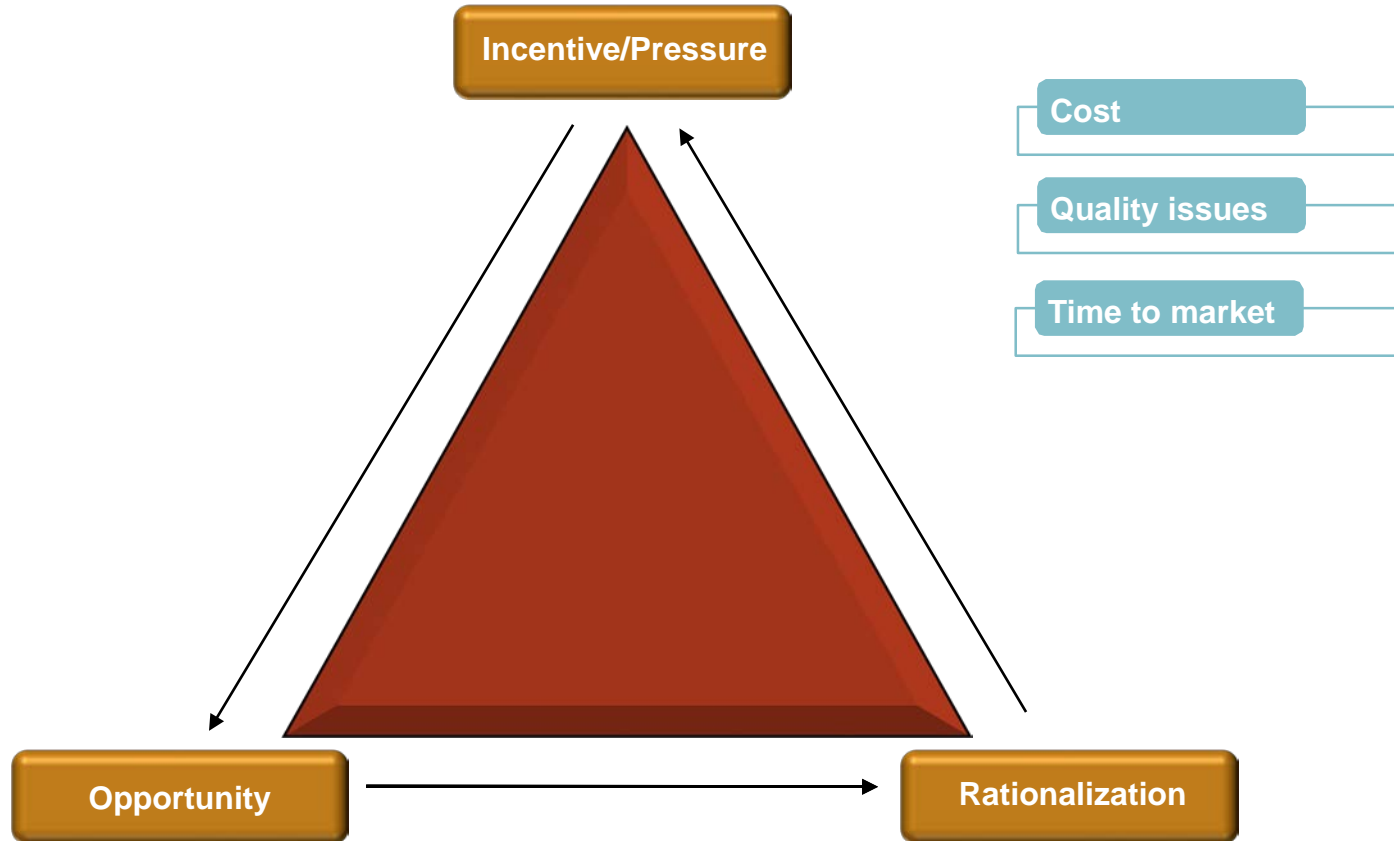
- Kickbacks on raw material purchases through improper rebates on finished goods
- Issues to misappropriation of scrap, raw materials, fixed assets used in the supply chain
- Issues surrounding certificates of origin of products

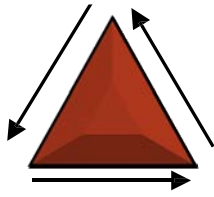
The more complex the supply chain the more complex the risks and the greater opportunity for fraud.

What Creates the Fraud Risk in the Supply Chain

- Supply chains have become more and more complex to meet the needs of global organizations
- Drop off in the ability to control and have internal controls in place
- The more complex the system the greater the risk for fraud

Origin of Fraud and Some Supply Chain Examples





Incentive to Commit Fraud

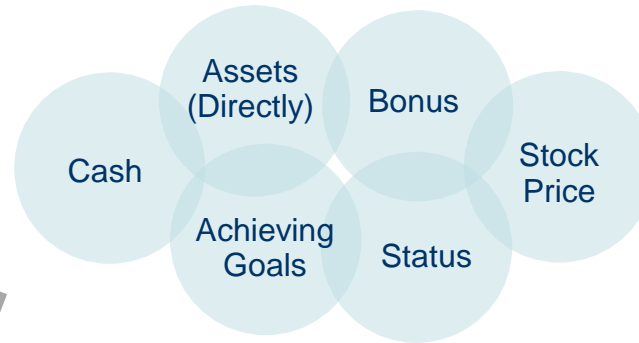
Motivation, pressure, “need” to commit a certain act



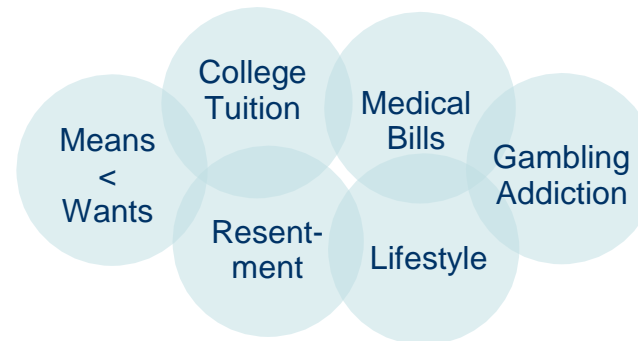
Individual

What do I or the organization stand to gain?

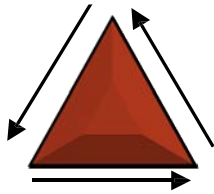
Why do I need to commit this act?



Incentives can be financial, status-based, or rooted in other personal issues



Incentives can be personal or professional, and rooted in the past, present or future



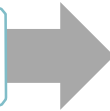
Opportunity to Commit Fraud

Ability, capacity, occasion, favorable condition

- Opportunities to commit fraud can be found whenever a corporate culture is conducive to circumventing policies and procedures
- Companies with a culture of “it couldn’t happen here” or “we just do things the easiest, most efficient way” are particularly at-risk



Will I get caught?

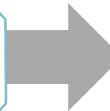


Detection

Segregation
of Duties

IT/Systems
Controls

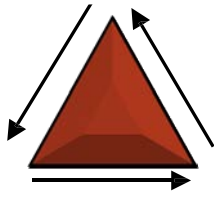
How do I do it?



IT/Systems
Controls

Access to
Assets

Access to
Records



Rationalization to Commit Fraud

Reconciling behavior with social norms and personal convictions



Individual

Is this wrong?

Why do I deserve this advantage?

Level of tolerance for dishonesty

Strength of incentives/pressures

Likelihood of discovery

Materiality of impact

Passed over for promotion

Going to be laid off or suffer

Under-compensated

Overwhelming need for money

Rationalizing a fraud:

- Incentives or other motivating factors
- Consideration of the relative importance of amounts

Rationalizing a fraud, motivating factors:

- Financial pressures at home
- Grudges about compensation or promotion
- Fear of being left behind in career advancement

Framework of Fraud Risk Management – Prevention, Detection, Response

Prevention is proactive and a cost inhibitor

Prevention: Controls, processes, corporate culture, other measures designed to prevent misconduct from occurring, or deter employees from committing fraud.

Prevention

Response: Policies, procedures, infrastructure, relationships, and other measures designed to help a company react appropriately when fraud is discovered to minimize damage, then find and eliminate root causes of the fraud.

Response

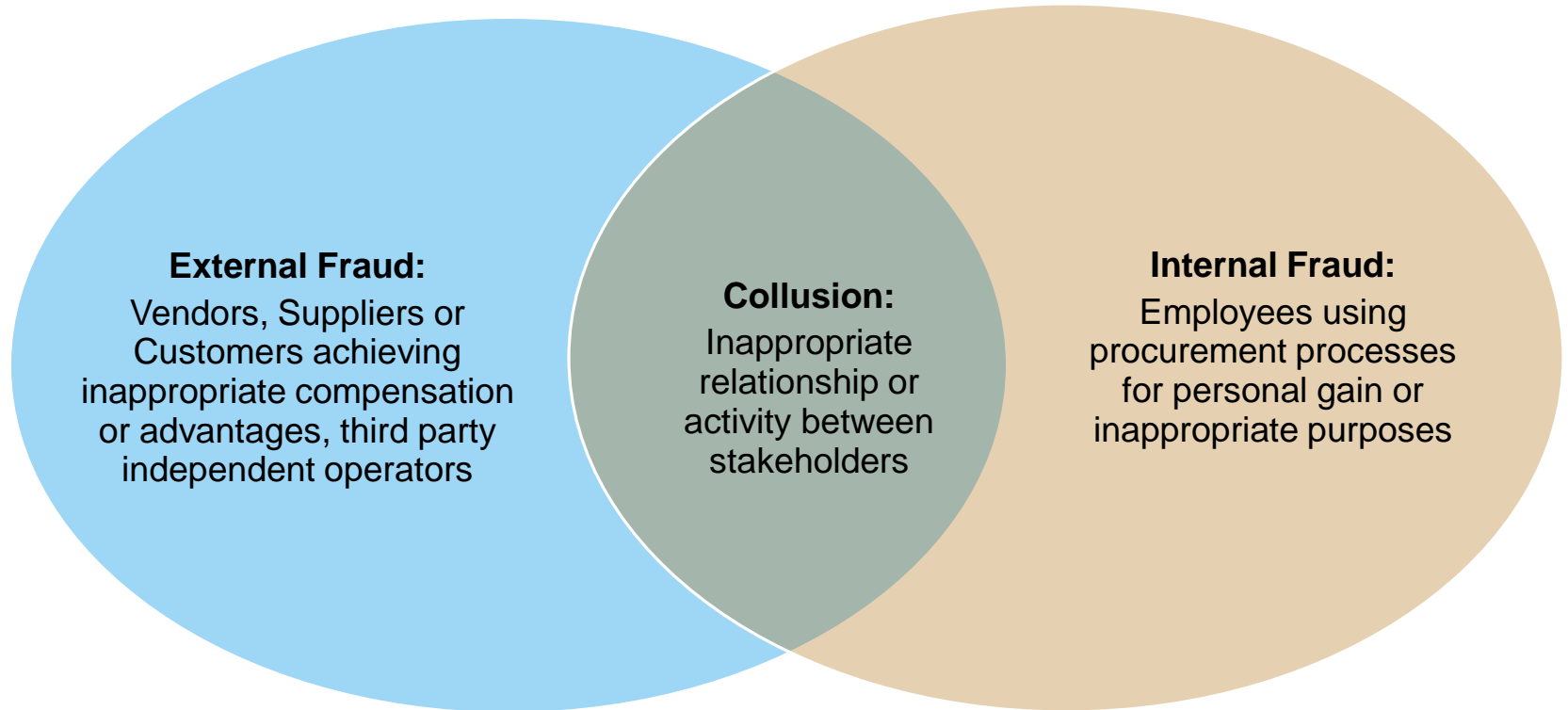
Detection: Controls, processes, and other measures designed to bring to light instances of fraudulent behavior or activity outside of policy as they occur.

Detection

Response is a REACTIVE strategy – Costs are HIGH

Detection is a REAL-TIME strategy – Costs are MEDIUM

Supply Chain Stakeholders and Collusion in Fraud

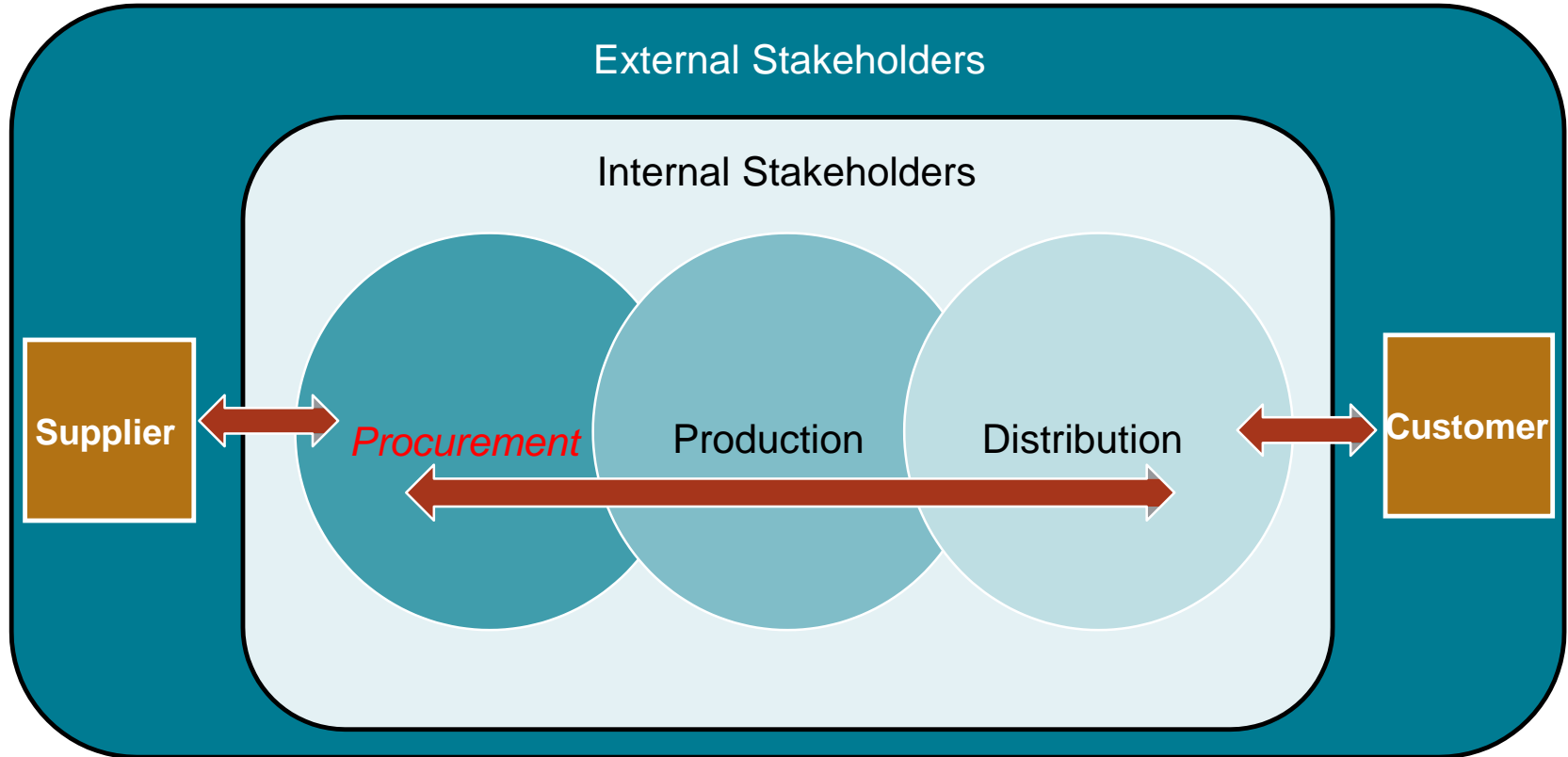


What is Collusion? What is the Impact on the Supply Chain?

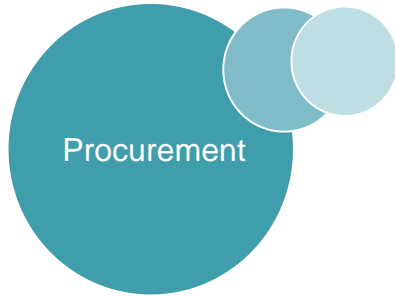
“Agreement between two or more persons, sometimes illegal and therefore secretive, to limit open competition by deceiving, misleading, or defrauding others of their legal rights, or to obtain an objective forbidden by law typically by defrauding or gaining an unfair advantage.”

Examples include price fixing, kickbacks, bribery, or misrepresenting the independence of the relationship between the colluding parties.

Overview of the Supply Chain: Procurement



What is Procurement?



“Acquisition of appropriate goods and/or services at the best possible cost to meet the needs of the purchaser in terms of quality and quantity, time, and location.”

Direct

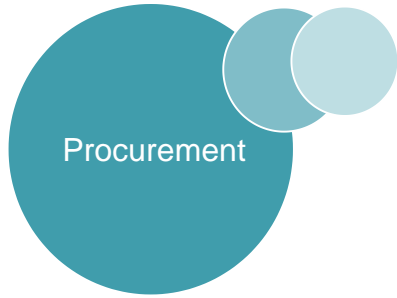
- Raw Materials
- Purchased Goods

Indirect

- Maintenance
- Repair
- Operating Supplies

Other/Capital

- Capital Goods
- Capital Services
- Other



The Procurement Cycle... Opportunities for Fraud

Purchase Orders

Items for personal use
Vendor selection
Overbuying
Fictitious vendors

Cash

False Vendors
Collusion
Nepotism
Kickbacks
Waste
Bribery

Suppliers &
Vendors

Procurement
Department

Goods and Services

Pricing
Quality
Quantity
Veracity

Invoices

Overbilling
Double Invoices
Price Fixing
Phantom Vendors

Know Your Suppliers

Appropriate supplier due diligence should be conducted prior to entering into a business relationship:

- Ensure that the supplier has systems in place that promote compliance
- Take care to not to enter into business relationships with suppliers with questionable integrity issues
- Be sensitive to any past history of unethical conduct

Why Analyze Procurement Data?

Examples of procurement in the news include:

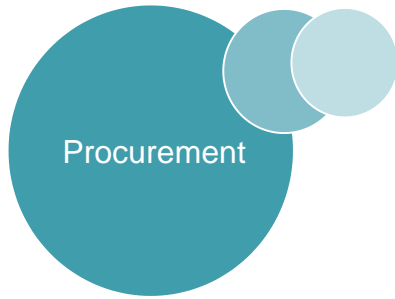
- Three employees indicted in large school district bilking \$39 million in computer payments allegedly steered to vendor.¹
- FBI investigates \$1.8M fraud scheme by employees for checks cut to fake vendors.²
- A top exec was arrested for creating kickbacks from vendors and potentially defrauding the company of over \$65 million (used to pay off gambling debts). He is accused of funneling exorbitant commissions and kickbacks from vendors to a separate front company.³

1. Source: *The Dallas Morning News* on the web, May 30, 2007, "Three indicted in DISD bilking \$39 million in computer payments allegedly steered to vendor", by Kent Fischer.

2. Source: North Jersey Media Group, "FBI alleges Elmwood Pk. pair behind \$1.8M fraud scheme", by Peter J. Sampson.

3. Source: *The Sacramento Bee* (sacbee.com), December 30, 2008, "IRS: Fry's exec stole \$65M to pay gambling debts", by Jordan Robertson.

Common Fraud Risks in Procurement Operations

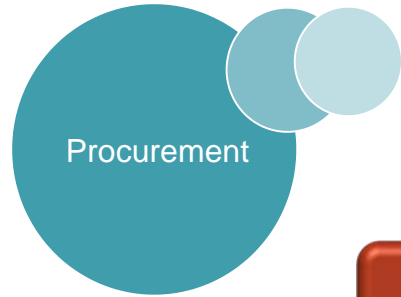


Purchase Order

- Purchasing employees might accept concessions such as sports tickets, merchandise, or entertainment to improperly influence purchasing decisions
- Kickback schemes related to vendor selection, pricing, or other critical business decisions
- Collusion with vendors or other employees in channel stuffing or other types of revenue recognition or expense manipulation schemes
- Falsified or manipulated purchase order fraud by employees as a method of misappropriating cash
- Purchasing employees use non-approved vendors or fail to achieve less-than-optimal pricing, possibly to benefit themselves, family members, or other related parties

Receiving

- Employees in Receiving might misappropriate assets and falsify records to avoid detection



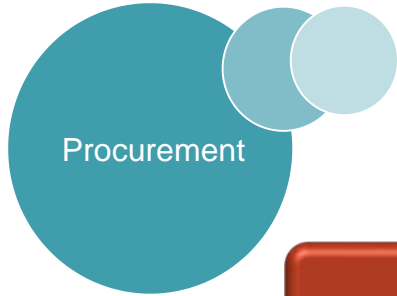
Procurement – Core and Leading Practices

Core Practices

- Approval limits
- Standardized policies
- Segregation of duties
- Vendor database
- Rotations
- Contact limits
- Short contracts
- Consolidated reporting

Leading Practices

- Vendor Reviews/Audits
- Due diligence
- Competitive, public bidding
- Forecasting
- Publicized Hotline
- Inspections
- Spec Reviews
- Employee/Vendor database analysis
- Electronic procurement
- Purchasing cards
- Commodity spend analysis
- Process automation
- Workflow management
- ERP integration
- Management by exception



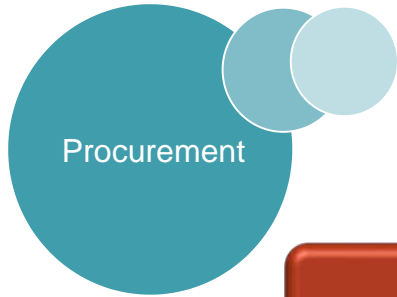
Procurement – Red Flags

Red Flags

- Mistakes in bids
- Cost variances
- Unusual or varying number of bidders
- Frequent change orders
- Complaints or reluctance from other vendors
- Government officials

- Contracts just below thresholds
- Unknown job numbers
- Odd bid due dates
- Mixed contract types
- Patterns of awards
- PO Boxes

- Product failures
- Vague or restrictive specifications
- Teamed vendors or hiring of losing vendors
- Odd bids or evaluations
- Unnecessary middlemen

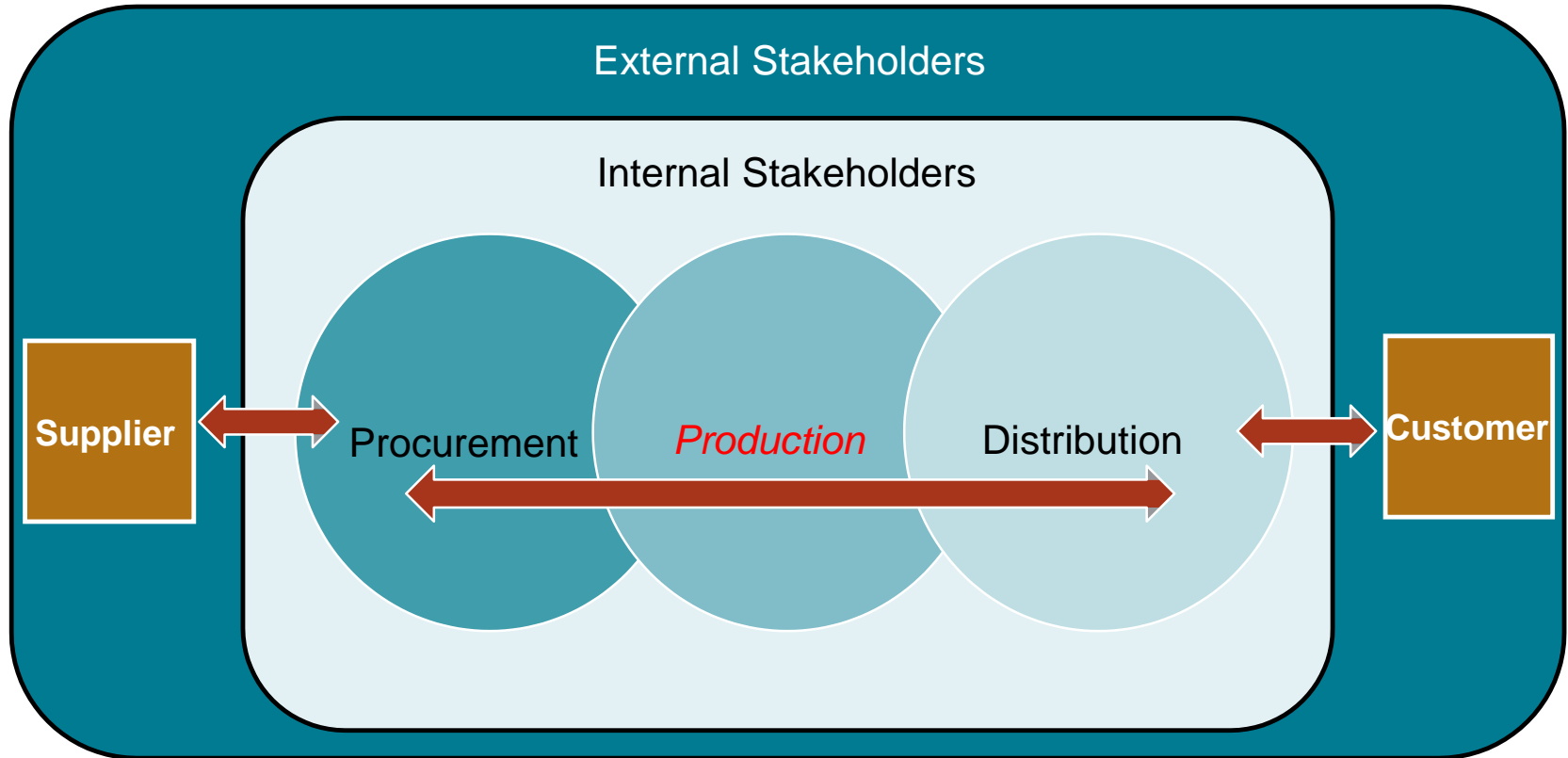


Procurement – Schemes

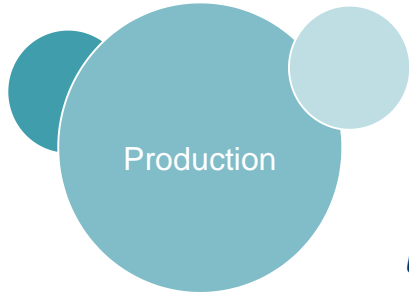
Procurement Schemes

- Bribes, Gratuities, Kickbacks
 - Collusion between buyer and vendors
 - Teaming or price fixing
 - Bid rigging or suppression
 - Shell companies
 - Illegal vendors
- Related parties
 - Leak of selection criteria
 - Cost mischarging or inflation
 - Selective information dispersal
 - False statements
- Product substitution or “bait and switch”
 - Improper sole sourcing
 - Requirement splitting
 - Specifications developed by a vendor

Overview of the Supply Chain: Production

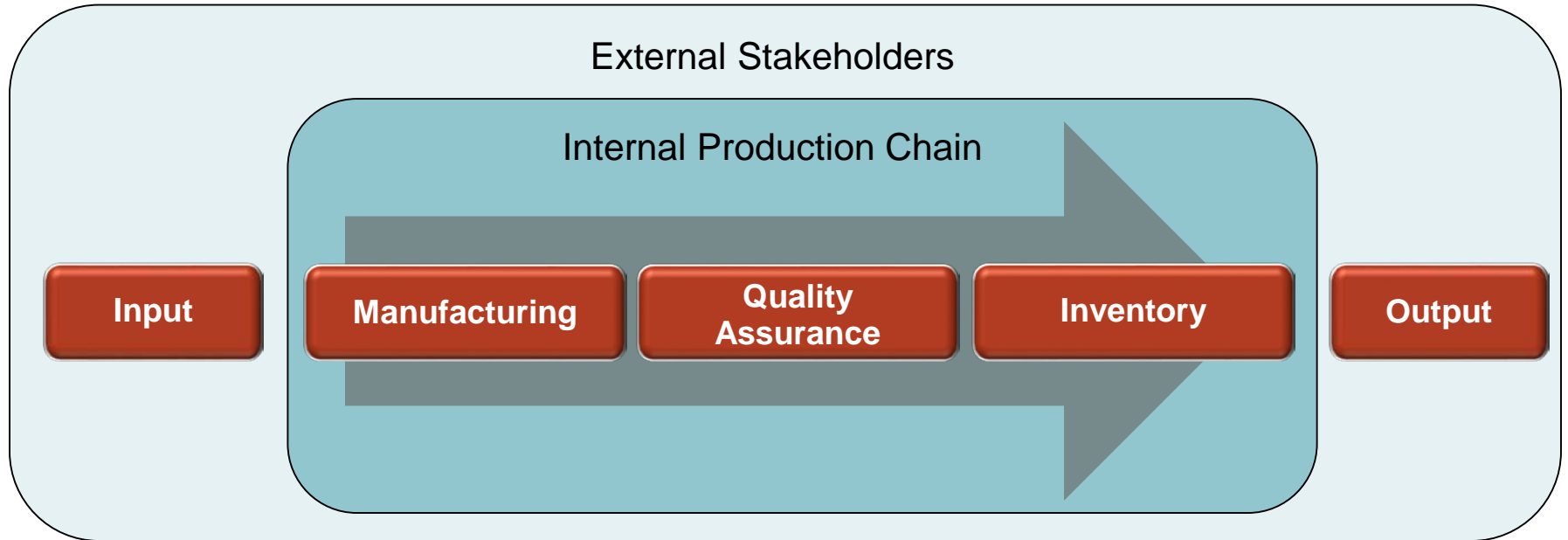
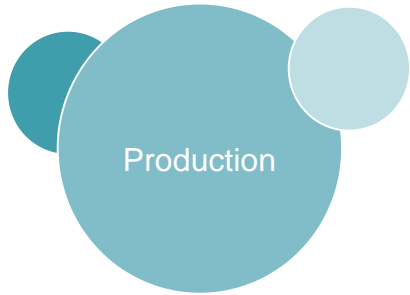


What is Production?

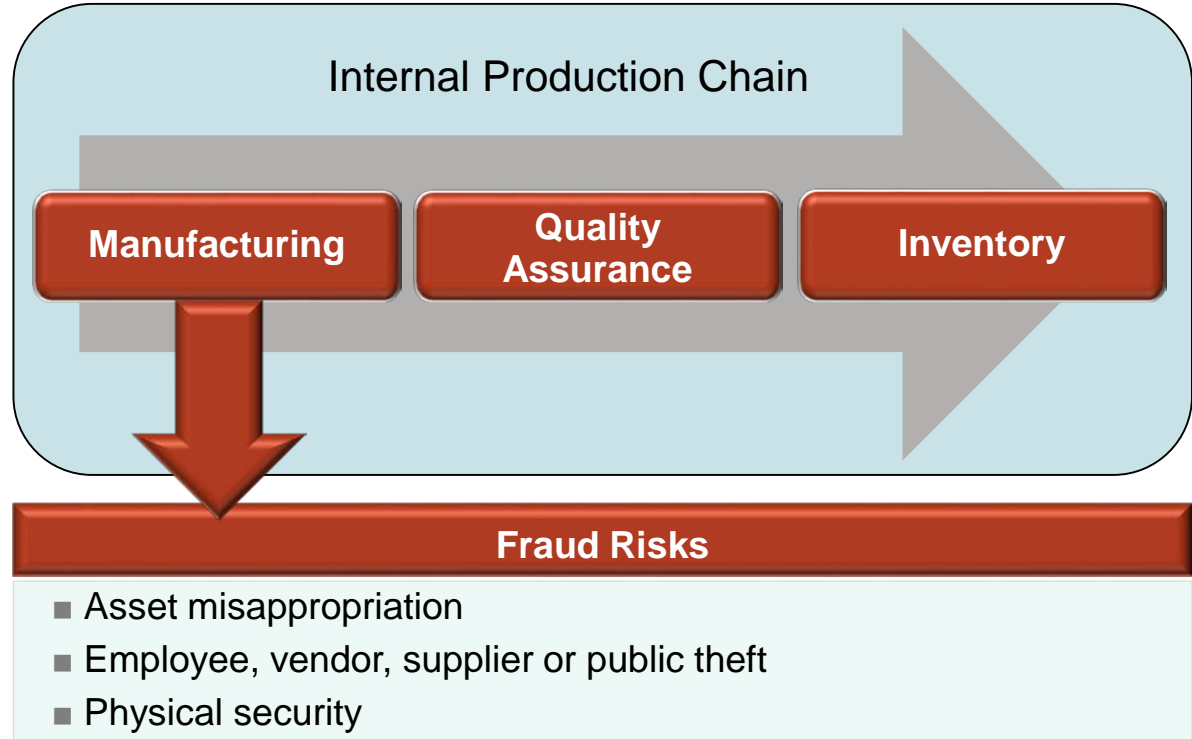
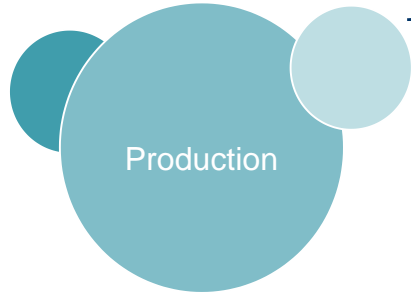


“The process of converting of inputs into outputs. Production uses resources to create a good or service that is suitable for exchange. Examples of processes integral to production: manufacturing, storing, shipping, and packaging. Production generally results in a good or service with an exchange value, which in response to a perceived economic demand.”

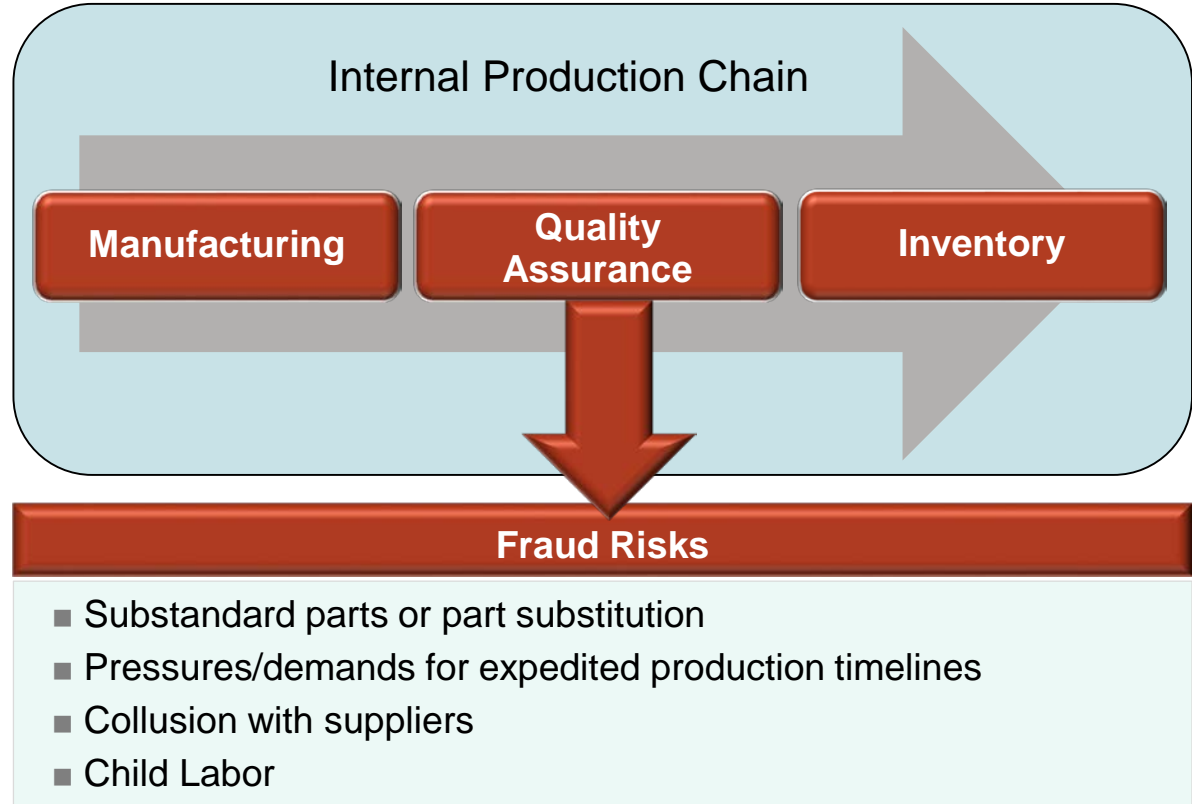
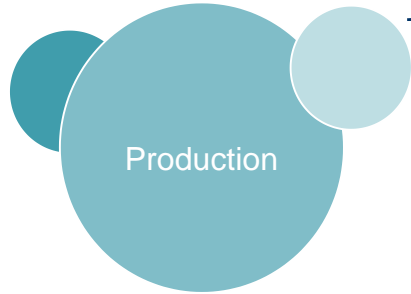
What is Production?



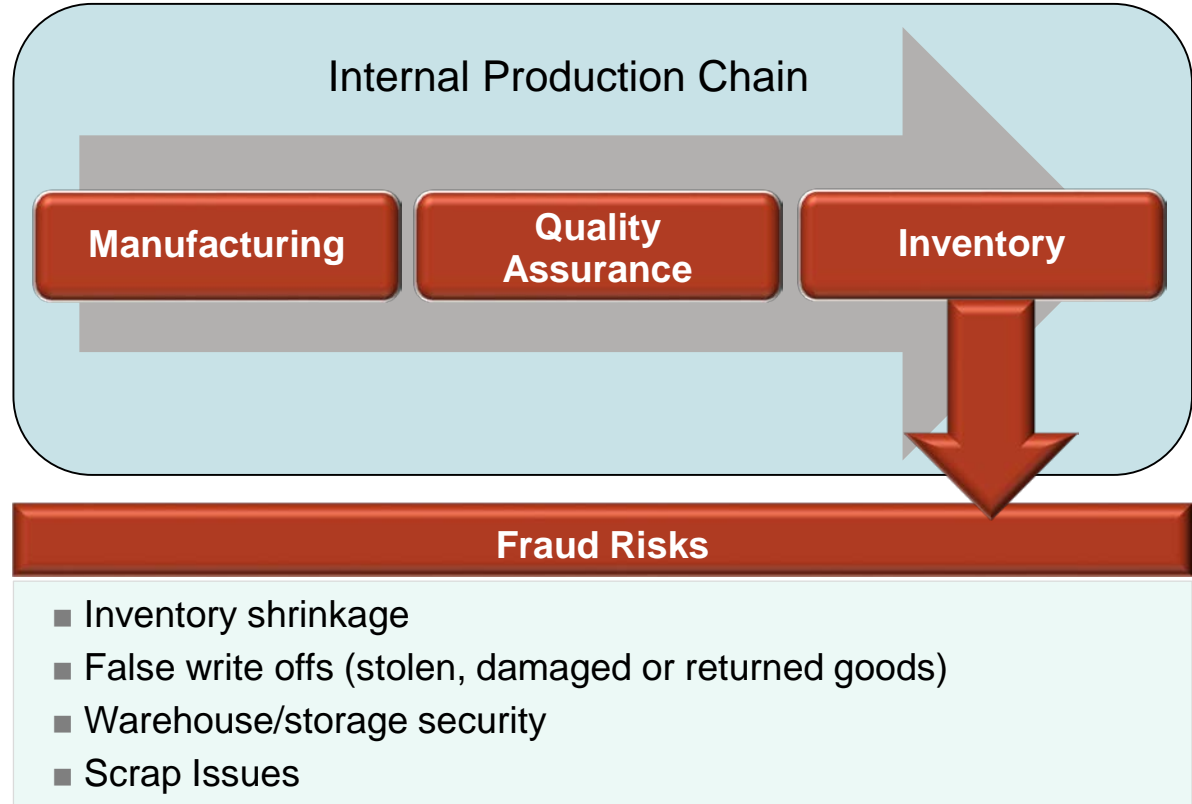
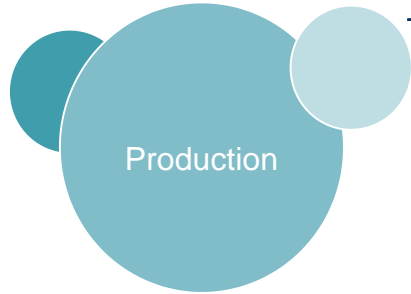
Production – Opportunities for Fraud



Production – Opportunities for Fraud

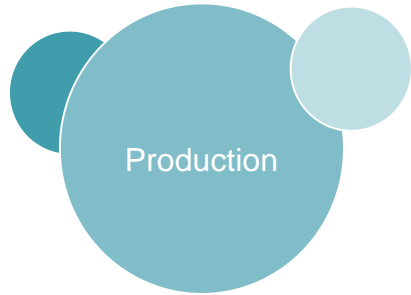


Production – Opportunities for Fraud



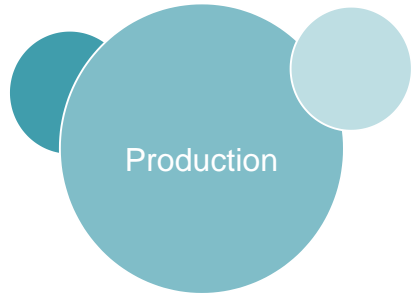
Inventory

Fraud Schemes	Detection Methods	Preventative Methods
<ul style="list-style-type: none">■ Appropriating inventory for personal use (theft)■ Theft of scrap proceeds■ Misclassification of prime material as off-grade■ Charging embezzlements to inventory■ Using R&M accounts to circumvent the capital allocation process to build new facilities	<ul style="list-style-type: none">■ Statistical sampling■ Receiving reports■ Perpetual inventory records■ Raw material requisitions■ Shipping documents■ Job cost sheets■ Physical inventory counts■ Analytical review■ Computer – generated travel analysis	<ul style="list-style-type: none">■ Proper documentation■ Segregation of duties■ Stress importance of strong internal controls■ Independent checks■ Physical safeguards■ Regular inventory counts



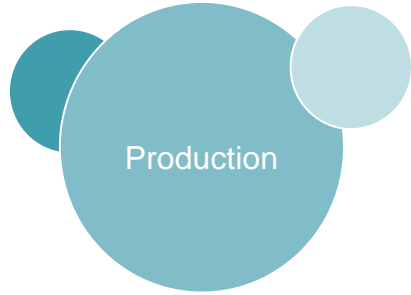
Common Fraud Risks in Production Operations

Fixed Assets	<ul style="list-style-type: none">■ Misappropriation, misuse, overuse, or other inappropriate activity involving companies' fixed assets can give rise to unintended financial, health and safety, or legal/regulatory consequences
Trigger Event	<ul style="list-style-type: none">■ Stakeholders might manipulate the parameters in which a Supply Chain operates causing possible financial consequences related to inventory, profitability, or external vendor commissions
Quality Assurance	<ul style="list-style-type: none">■ Modification or circumvention of quality assurance protocols, or ignore obvious safety concerns, under pressure for profitability or expedience – examples of this include recent issues with safety of consumer products■ Participation or complicity in bribe or kickback schemes related to their roles in quality assurance programs



Common Fraud Risks in Production Operations

Manufacturing	<ul style="list-style-type: none">■ Collusion with outside vendors or internal stakeholders to make decisions regarding product design or manufacture that have unintended or adverse consequences, such as impact on product quality
Inventory	<ul style="list-style-type: none">■ Theft of inventory, fail to report damaged/expired inventory, or otherwise allow company records to be falsified resulting in inaccurate statement of financial position, theft of intellectual property■ Failure to follow company protocols resulting in exposure to legal consequences or unnecessary operational expenses



Production – Leading Practices and Red Flags

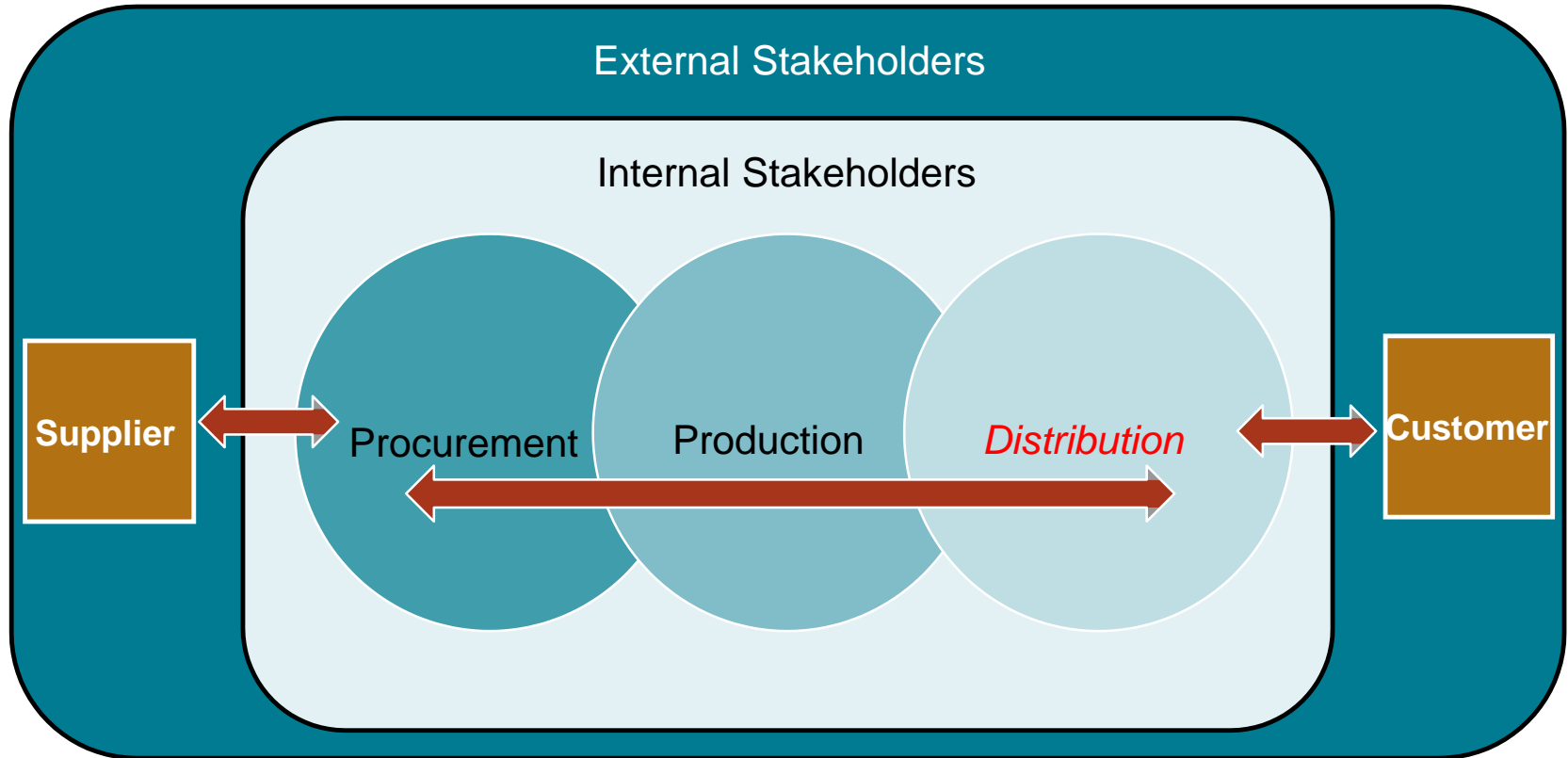
Leading Practices

- Delegation of Authority
- Approval limits
- Recordkeeping
- Segregation of duties
- Periodic vendor review
- Right-to-audit clauses
- Preferred vendor lists
- Mandatory competitive bidding

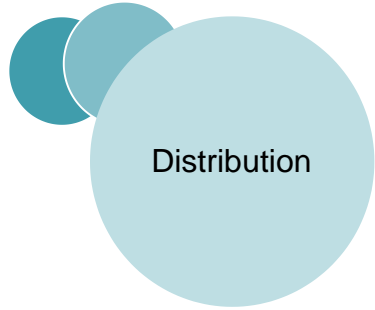
Red Flags

- Lack of visibility to customers/suppliers
- Large number of returns
- Pressure to accelerate or skip quality control steps
- Use of unusual/new vendors
- Large number of write offs due to damage
- Purchases that bypass the normal procedures

Overview of the Supply Chain: Distribution

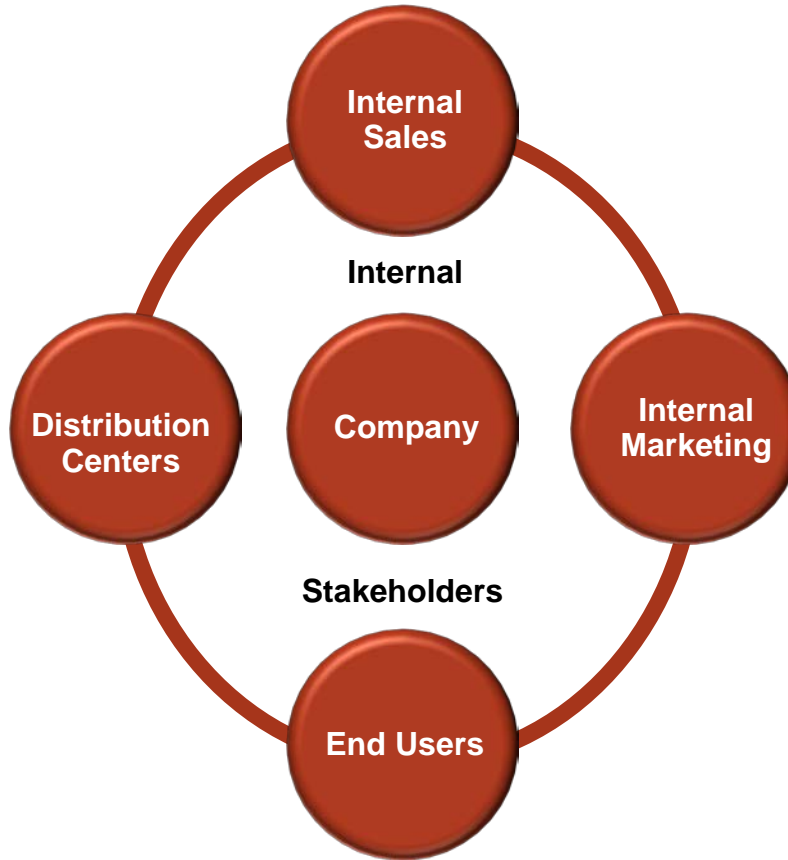
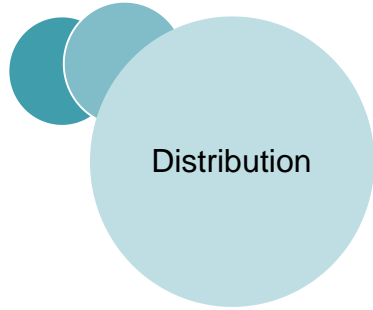


What is Distribution?



“The chain of intermediaries involved in transferring goods from producers to consumers or end-users. Distribution phases include factory to supplier, supplier to retailer and retailer to end customer.”

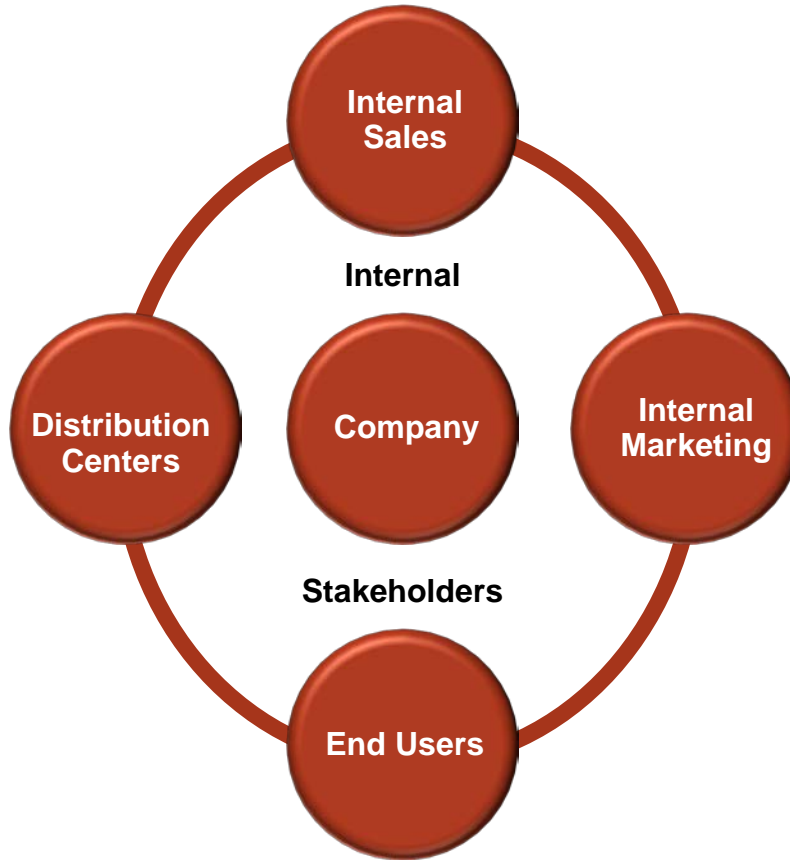
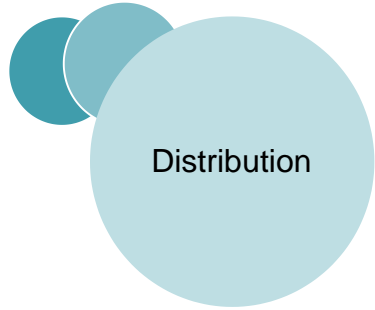
Distribution – Opportunities for Fraud



Internal Sales Fraud Risks

- Unprocessed credit claims
- Late-month invoicing of products due the following month (pre-booked sales)
- Ability of sales managers to overrule credit managers
- Overly aggressive sales targets
- Conflicts of interest
- Collusion with Distributors
- Grey market product
- Pricing manipulation
- Regional violations

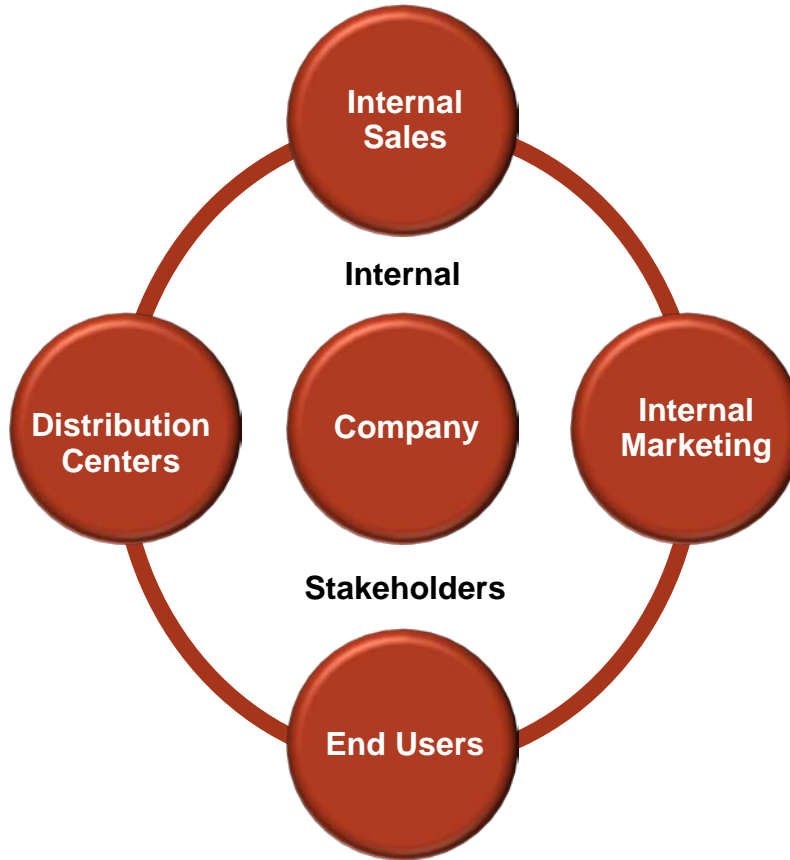
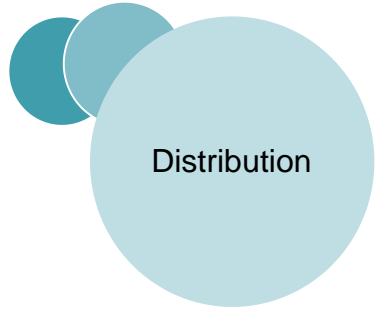
Distribution – Opportunities for Fraud



Internal Marketing Fraud Risks

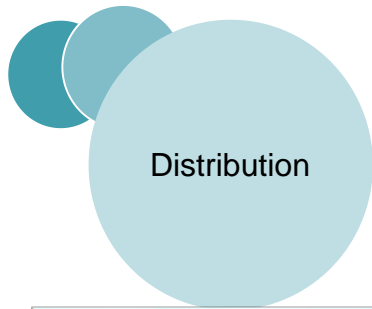
- Marketing substandard or imitation products
- Company goals that do not align with the marketing Key Performance Indicators (KPI's)

Distribution – Opportunities for Fraud



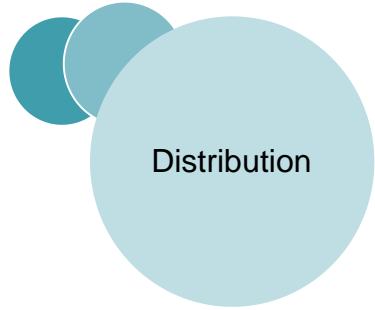
Distribution Fraud Risks

- Lack of background checks for distributors/warehouse locations/transportation vendors
- Lack of transparency in vendor selection
- Physical Security



Common Fraud Risks in Distribution Operations

Distribution & Shipping	<ul style="list-style-type: none">■ Holding certain quantities of merchandise aside at the point of shipping/receiving for personal use or resale■ Maintaining inappropriate relationships with transportation or lading companies that include non-optimal costs, kickbacks, falsified documents, or other types of fraud
Sales Commissions	<ul style="list-style-type: none">■ Collusion in, or singlehandedly undertake schemes regarding sales and/or commissions involving duplicative or false invoices, channel stuffing, or other inappropriate relationships within a company's sales mechanisms
Picking, Packing, and Returns	<ul style="list-style-type: none">■ Employees involved in picking frauds might intentionally pick too many of a particular item, holding some aside for personal use or sale■ Collusion with customers to send too many of an item, an item other than what was ordered, or otherwise defraud the company■ Collusion with customers or vendors to permit inappropriate returns, or returns without proper transfer of merchandise back to the origination point■ Without segregation of duties, employees involved in these functions have increased opportunity to commit frauds without detection



Distribution – Leading Practices and Red Flags

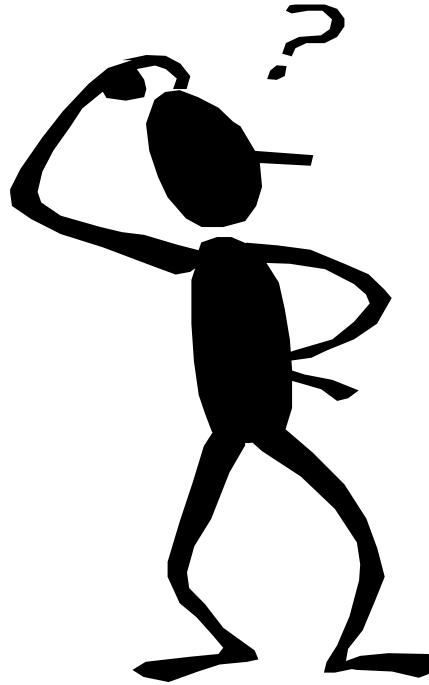
Leading Practices

- Delegation of Authority
- Segregation of duties
- Vendor compliance program
- Right-to-audit clauses
- Preferred vendor lists
- Mandatory competitive bidding
- Automatic data collection technology

Red Flags

- Lack of visibility to customers/suppliers
- Close relationships with vendors
- Large number of defective/damaged returns
- Falsified or double invoices

Questions



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