Supply Chain Fraud: Managing the Risks Dealing with the Fallout
Supply chain fraud – Managing the risks, dealing with the fallout

**Agenda:**

1. Introduction to the session
2. What is the supply chain
3. Quick fraud refresher & what it means in context of supply chain
4. Leading practices in supply chain fraud risk management
5. Fraud origins, incentives and risk factors
6. Internal vs. external stakeholders and collusion
7. Elements of the supply chain: Procurement cycle
8. Fraud risks and mitigation strategies in the procurement cycle
9. Elements of the supply chain: Production operation
10. Fraud risks and mitigation strategies in the production operation
11. Elements of the supply chain: Distribution
12. Fraud risks and mitigation strategies in the distribution operation
13. Supply chain levers to drive improvement
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 organization's 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.
- The importance of the supply chain in today's organizations cannot be underestimated. Many entities have achieved significant cost reductions and increased efficiency as a result of improving their supply chain. From ISO initiatives through to Six Sigma initiatives and the “perfect order,” there have been a multitude of efforts to increase supply chain efficiency.
- Some efficiency increases have inherent risks attached to them - a major one being fraud risk.
- This session will look at where the risks exist in the supply chain, how to devise tools and strategies to help prevent and detect problems and how to investigate those problems.
Budgeting for fraud risk management vs. fraud repercussions

- Organizations not budgeting for fraud detection, prevention, and reduction, are assuming risk. In much the same way as supply chain fraud cuts across enterprise operations, the repercussions from supply chain fraud are equally far-reaching (if not more so), and far more damaging and costly. Some examples are:
  - Manufacturing Downtime
  - Machinery Flush/Clean/Repair
  - Sourcing Replacement Suppliers
  - Customer Credits (Distributor, Wholesaler, Retailer)
  - Consumer Lawsuits (from injury or death)
  - Delayed New Products To Market
  - Delayed Advertising Campaigns
  - Damage-Control Advertising Costs
  - Vendor Compliance Chargebacks
  - Product Recall Costs (shipping, handling, destruction)
  - Loss Of Brand Trust
  - Loss Of Market Share To Competition
  - Regulatory Investigations & Audits (costs & disruptions)


- The ramifications and costs of supply chain fraud can leave your organization severely impacted and having to manage the fallout and costs over time.
What is a supply chain?

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? (continued)

Each of these touch points presents an opportunity for an individual predisposed to perpetrating an act of dishonesty.
What is fraud in the context of the supply chain? A quick refresher…

Fraud: “A representation about a material point, which is false and made intentionally or recklessly and believed by the victim, resulting in damage to the victim.”

There are six key elements contained in this short definition which must be present for fraud to exist:

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

Clearly these elements can and do occur at the various points in all supply chain operations. Think of the following areas such as purchasing, distribution, manufacturing and the various external touch points. Some area of concern for the supply chain;

- Piracy
- Theft
- Child Labor
- Bid Rigging
- Bribery and Corruption
- Product tampering
- Food fraud
- Gray market product etc. etc…..
Entity-wide fraud risk factors – Elevated risk vs. reduced risk impacting supply chain operations

- Geographically Distributed vs. Centralized
- Weak Internal Audit Function vs. Strong Internal Audit Function
- No Whistleblower Hotline vs. Publicized Whistleblower Hotline
- Poor/Weak Management Focus on Ethics vs. Strong Focus on Ethics
- Weak HR/Compensation Function vs. Strong HR/Compensation Function
- Weak Internal Controls vs. Strong Internal Controls
Enablers of Fraud and Misconduct in the supply chain

- Inadequate internal controls or compliance programs: 66%
- Management override of internal controls: 47%
- Inadequate oversight by directors over management: 44%
- Collusion between employees and third parties: 43%
- Collusion between management and third parties: 32%
- Collusion between employees and management: 27%
- Other factors: 4%

Some of the major types of fraud and where these might occur in the supply chain

<table>
<thead>
<tr>
<th>Asset Misappropriation</th>
<th>Financial Misrepresentation</th>
<th>Bribery/Corruption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forgery</td>
<td>Revenue Recognition</td>
<td>Bribery of Government Officials</td>
</tr>
<tr>
<td>Cash Theft</td>
<td>Expense Recognition</td>
<td>Commercial Bribery</td>
</tr>
<tr>
<td>Merchandise Theft</td>
<td>Asset Inflation</td>
<td>Insider Trading</td>
</tr>
<tr>
<td>Unpaid Services</td>
<td>Channel Stuffing</td>
<td>Kickbacks</td>
</tr>
<tr>
<td>Billing Schemes</td>
<td>Earnings Manipulation</td>
<td>Contract Manipulation</td>
</tr>
<tr>
<td>Payroll Schemes</td>
<td>Cookie-Jar Accounting</td>
<td>Poor Decision-making</td>
</tr>
</tbody>
</table>

Any and all of these can occur within each stage of the supply chain
Fraud and the supply chain are inextricably linked

In today’s business environment both the terms “supply chain” and “fraud” should be on the minds of business leaders. Individually, these two terms are a reflection of the evolving business world around us. At the risk of over using the term, the supply chain in today’s world is truly global in nature, and it seems that fraud is being committed in both the public and private sector at increasing rates and with increasing monetary impacts, each event more clever and audacious than the last.
Supply chain improvement must be holistic and consider all the risks

- As noted earlier, organizations have worked very hard to increase efficiencies and reduce costs in the supply chain arena but have not always considered the cost and risks of fraud as part of this process. Nor are they always aware of potential risks of fraud, waste, and abuse in the supply chain. As with other business processes, people play a key part in this critical business process and accordingly, this brings with it the traditional risks of fraud, waste, and abuse.
Supply chain risks

- There are many steps in the supply chain process where employees, vendors, regulators, service providers and others can and do identify weaknesses and susceptibility to fraud in the supply chain that can be exploited by those involved in or with an organization’s supply chain at its various stages and steps.

- Manifestations of fraud in this context can range from kickbacks on raw material purchases through to improper rebates on finished goods and everything in between. It could also appear as FCPA issues to misappropriation of scrap, raw materials, fixed assets used in the supply chain. It could involve issues surrounding certificates of origin of products, improper use of free trade zones, use of conflict minerals in production to OFAC issues. In short the supply chain is also subject to significant issues from a regulatory perspective.

- 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

- As supply chains have become more and more complex to meet the needs of global organizations in achieving their success we have seen a drop off in the ability to control and have internal controls in place in the supply chain context. The more complex the system the more players and countries involved and the more susceptible to extraneous systemic shocks the greater the risk for fraud.

- The recent Kroll report claims that “…the benefits, in terms of greater flexibility and efficiency in sales and production, have been great. But the costs, in terms of fraud, theft and other losses, are also sizeable.”
### Leading practices in supply chain fraud risk management

<table>
<thead>
<tr>
<th>Practice</th>
<th>Description</th>
<th>Description</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Create a “Cash Culture” focused on releasing cash trapped in business and balance cash impacts on RONA and ROS</td>
<td>Balance view of operating costs and working capital considerations</td>
<td>Balance view of operating costs and working capital considerations</td>
<td></td>
</tr>
<tr>
<td>Focus on optimizing DWC, DSO, DOH, and DPO</td>
<td>Improve visibility to impact of industry and external regulations changes</td>
<td>Improve visibility to impact of industry and external regulations changes</td>
<td></td>
</tr>
<tr>
<td>Utilize analytics to benchmark and compare corporate and business-level working capital</td>
<td>Implement specific initiatives for improvements (not one initiative across many process areas)</td>
<td>Implement specific initiatives for improvements (not one initiative across many process areas)</td>
<td></td>
</tr>
<tr>
<td>Update operating models at core functional and process levels to provide transparency, focus and oversee cash performance</td>
<td>Maximize velocity of product flow to customers aligned with the cash flow between AR and AP</td>
<td>Maximize velocity of product flow to customers aligned with the cash flow between AR and AP</td>
<td></td>
</tr>
<tr>
<td>Revise metrics, controls and accountabilities for cross-functional hierarchal accountabilities &amp; oversight</td>
<td>Document risks and opportunities documented and discuss monthly</td>
<td>Document risks and opportunities documented and discuss monthly</td>
<td></td>
</tr>
<tr>
<td>Institutionalize working capital process improvements for long-term sustainability &amp; renewal</td>
<td>Adequately scope and manage change</td>
<td>Adequately scope and manage change</td>
<td></td>
</tr>
<tr>
<td>Analyze time-based core material and financial flows to identify and rank DWC, DSO, DIO, and DPO drivers</td>
<td>Time based process to quantify excess cash after each phase milestone</td>
<td>Time based process to quantify excess cash after each phase milestone</td>
<td></td>
</tr>
<tr>
<td>Quantify Working Capital Dollar day impact</td>
<td>Utilize standardized tools and checklists to drive out process inefficiencies</td>
<td>Utilize standardized tools and checklists to drive out process inefficiencies</td>
<td></td>
</tr>
</tbody>
</table>

© 2011 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. 20961SEA
Origin of fraud and some supply chain examples

- Incentive/Pressure
  - Cost savings
  - Quality issues
  - Time to market

- Opportunity
- Rationalization
Incentive to commit fraud

Incentive: Motivation, pressure, “need” to commit a certain 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

Individual

What do I or the organization stand to gain?

Why do I need to commit this act?

Incentive/Pressure

Assets (Directly)

Bonus

Stock Price

Cash

Achieving Goals

Status

College Tuition

Medical Bills

Gambling Addiction

Means < Wants

Resentment

Lifestyle

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

© 2011 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. 20961SEA
Opportunity to commit fraud

Opportunities to commit fraud can be found anywhere controls or segregation of duties are lacking, employees have substantial access to assets or records, or more broadly 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.
Rationalization to commit fraud

Rationalization: Reconciling behavior with social norms and personal convictions

Rationalizing a fraud entails deciding that the incentives or other motivating factors are compelling enough to make the fraud permissible, especially considering the relative importance of amounts involved.

Rationalizing a fraud usually requires a motivating factor to assist. Examples include financial pressures at home, grudges about compensation or promotion, or fear of being left behind in career advancement.

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

Is this wrong?

Why do I deserve this advantage?

Individual
Framework of fraud risk management – Prevention, detection, response

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

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

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.

Prevention is proactive and a cost inhibitor

Response is a REACTIVE strategy – Costs are HIGH

Detection is a REAL-TIME strategy – Costs are MEDIUM
Fraud risk management framework – Flow of events

Prevention

Detection

Response

$\text{T}$
Supply chain stakeholders and collusion in fraud

External Fraud:
Vendors, Suppliers or Customers achieving inappropriate compensation or advantages, third party independent operators

Collusion: Inappropriate relationship or activity between stakeholders

Internal Fraud:
Employees using Procurement processes for personal gain or inappropriate purposes
What is collusion? What is the impact on the supply chain?

Collusion: “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

External Stakeholders

Internal Stakeholders

Supplier

Procurement

Production

Distribution

Customer
**The procurement cycle... What is procurement?**

**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.”

<table>
<thead>
<tr>
<th>Direct</th>
<th>Indirect</th>
<th>Other/Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw Materials</td>
<td>Maintenance</td>
<td>Capital Goods</td>
</tr>
<tr>
<td>Purchased Goods</td>
<td>Repair</td>
<td>Capital Services</td>
</tr>
<tr>
<td></td>
<td>Operating Supplies</td>
<td>Other</td>
</tr>
</tbody>
</table>

The procurement cycle is well known as a high risk area from a fraud waste and abuse perspective; however, are we considering it holistically in the context...
The procurement cycle

Under-pay/Over-pay

Performance Management

Identify Opportunities

Value Creation

Negotiate

Request Proposals

Catalogue

Contract

Requisition

Purchase Order

Receipt/Pay

Purchasing

Value Management

Cash Performance Quality

Sourcing

Is it needed

False Jobs

Change Order

Bid Rigging

Kick-back

Entertainment

Vague

Procurement
The procurement cycle – Opportunities for fraud

- Purchase Orders
  - Items for personal use
  - Vendor selection
  - Overbuying
  - Fictitious vendors

- Suppliers & Vendors
  - Goods and Services
    - Pricing
    - Quality
    - Quantity
    - Veracity

- Procurement Department
  - False Vendors
  - Collusion
  - Nepotism
  - Kickbacks
  - Waste
  - Bribery

- Invoices
  - Overbilling
  - Double Invoices
  - Price fixing
  - Phantom vendors

© 2011 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. 20961SEA
Know your suppliers

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

This due diligence should ensure that the supplier has systems in place that promote compliance with all applicable legislation and environmental requirements. In an era of increasing investor sensitivity and consumers expectations of ethical business conduct, entering into business relationships with suppliers who are subsequently found to have skeletons in the closet, for example associations with criminals or involved in serious unethical conduct, can have serious financial and reputational implications.
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
  
- FBI investigates $1.8M fraud scheme by employees for checks cut to fake vendors

- 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.


## Common fraud risks in procurement operations

<table>
<thead>
<tr>
<th>Procurement</th>
<th>Purchase Order</th>
<th>Receiving</th>
</tr>
</thead>
</table>
| - 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 | - Employees in Receiving might misappropriate assets and falsify records to avoid detection |
# Procurement – Core and leading practices

<table>
<thead>
<tr>
<th>Core Practices</th>
<th>Leading Practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval limits</td>
<td>Vendor Reviews/Audits</td>
</tr>
<tr>
<td>Standardized policies</td>
<td>Due diligence</td>
</tr>
<tr>
<td>Segregation of duties</td>
<td>Competitive, public bidding</td>
</tr>
<tr>
<td>Vendor database</td>
<td>Forecasting</td>
</tr>
<tr>
<td>Rotations</td>
<td>Publicized Hotline</td>
</tr>
<tr>
<td>Contact limits</td>
<td>Inspections</td>
</tr>
<tr>
<td>Short contracts</td>
<td>Spec Reviews</td>
</tr>
<tr>
<td>Consolidated reporting</td>
<td>Employee/Vendor database</td>
</tr>
</tbody>
</table>

- **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
Optimal procurement practices depend on the size, nature and complexity of organization as well as the organization’s tolerance for risk.
A company had observed that when one of its buyers was moved to a different product category as part of a planned move, a number of the suppliers appeared to move with him. This was peculiar and was raised as a red flag since the categories of goods were very different. One would expect that if the category of goods is very different, so too would be the appropriate suppliers. It was ultimately discovered through investigation that some of the suppliers were nothing more than middlemen sourcing product for the buyer. At a minimum, the company incurred costs that it should not have incurred, and at worst, the company was defrauded. In this example, moving the buyer and effectively monitoring the spend paid dividends.
Procurement case study

Prevent

- Rotation of procurement personnel
- ERP system and vendor relationship management

Detect

- Internal Audit function
- Monitoring spend

Respond

- Investigation
- Updating of policies and procedures
Overview of the supply chain…… Production

![Diagram showing the flow of supply chain with External Stakeholders, Internal Stakeholders, Procurement, Production, and Distribution with Supplier and Customer connections.]

External Stakeholders

Internal Stakeholders

Procurement

Production

Distribution

Supplier

Customer
Production: “The process of converting 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? (continued)

External Stakeholders

Internal Production Chain

Input
Manufacturing
Quality Assurance
Inventory
Output
Production – Opportunities for fraud

Internal Production Chain

- Manufacturing
- Quality Assurance
- Inventory

Fraud Risks
- Asset misappropriation
- Employee, vendor, supplier or public theft
- Physical security
Production – Opportunities for fraud (continued)

**Internal Production Chain**

- Manufacturing
- Quality Assurance
- Inventory

**Fraud Risks**

- Substandard parts or part substitution
- Pressures/demands for expedited production timelines
- Collusion with suppliers
- Child Labor
Production – Opportunities for fraud (continued)

Internal Production Chain

- Manufacturing
- Quality Assurance
- Inventory

Fraud Risks
- Inventory shrinkage
- False write offs (stolen, damaged or returned goods)
- Warehouse/storage security
- Scrap Issues
## Inventory

<table>
<thead>
<tr>
<th>Fraud Schemes</th>
<th>Detection Methods</th>
<th>Preventative Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appropriating inventory for personal use (theft)</td>
<td>Statistical sampling</td>
<td>Proper documentation</td>
</tr>
<tr>
<td>Theft of scrap proceeds</td>
<td>Receiving reports</td>
<td>Segregation of duties</td>
</tr>
<tr>
<td>Misclassification of prime material as off-grade</td>
<td>Perpetual inventory records</td>
<td>Stress importance of strong internal controls</td>
</tr>
<tr>
<td>Charging embezzlements to inventory</td>
<td>Raw material requisitions</td>
<td>Independent checks</td>
</tr>
<tr>
<td>Using R&amp;M accounts to circumvent the capital allocation process to build new facilities</td>
<td>Shipping documents</td>
<td>Physical safeguards</td>
</tr>
<tr>
<td></td>
<td>Job cost sheets</td>
<td>Regular inventory counts</td>
</tr>
<tr>
<td></td>
<td>Physical inventory counts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Analytical review</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Computer – generated travel analysis</td>
<td></td>
</tr>
</tbody>
</table>
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
## Common fraud risks in production operations

### Fixed Assets
- 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
- 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
- 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 (continued)

#### Manufacturing
- 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
- 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
Overview of the supply chain distribution

- External Stakeholders
  - Supplier
  - Customer

- Internal Stakeholders
  - Procurement
  - Production
  - Distribution
What is distribution?

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 – Examples of internal and external stakeholders

- **External Stakeholders**
  - Sales Agents
  - Distributors/Resellers
  - End Users
  - Distribution Centers
  - Company
  - Internal Sales
  - Internal Marketing
  - FCPA minefield
  - Margin issues
  - OFAC issues
  - Money Laundering etc

- **Internal Stakeholders**
  - End Users
  - Distribution

- **Stakeholders**
  - End Users
Distribution – Opportunities for fraud

Internal Sales

Internal

Company

Internal Marketing

Distribution Centers

End Users

Stakeholders

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 etc. etc.
Distribution – Opportunities for fraud (continued)

Distribution

Internal Sales

Internal Marketing

Company

End Users

Distribution Centers

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 (continued)

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

Stakeholders:
- Internal Sales
- Internal
- Internal Marketing
- Company
- Distribution Centers
- End Users
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
## Accounts receivable

<table>
<thead>
<tr>
<th>Fraud Schemes</th>
<th>Detection Methods</th>
<th>Preventative Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lapping</td>
<td>Matching deposit dates</td>
<td>Segregation of duties</td>
</tr>
<tr>
<td>Old or written-off accounts receivable</td>
<td>Confirmations</td>
<td>Stress importance of strong internal controls</td>
</tr>
<tr>
<td>Fictitious product returns</td>
<td>Accounting cut-off analysis</td>
<td>Lock-box arrangements</td>
</tr>
<tr>
<td>After the fact price adjustments</td>
<td>Trend analysis on written-off accounts receivable</td>
<td>Objective sales – based compensation plans</td>
</tr>
<tr>
<td>Fictitious accounts receivable</td>
<td>Tracking system</td>
<td></td>
</tr>
<tr>
<td>– Meeting sales quotes</td>
<td>Timely reconciliations</td>
<td></td>
</tr>
<tr>
<td>– Receiving sales-based compensation</td>
<td>Monitoring of returns and allowances</td>
<td></td>
</tr>
<tr>
<td>– Borrowing against A/R</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: David Cotton, CPA, Cotton & Co.; AICPA 1997 National Fraud conference
Common fraud risks in distribution operations

<table>
<thead>
<tr>
<th>Distribution &amp; Shipping</th>
<th>Sales Commissions</th>
<th>Picking, Packing, and Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holding certain quantities of merchandise aside at the point of shipping/receiving for personal use or resale</td>
<td>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</td>
<td>Employees involved in picking frauds might intentionally pick too many of a particular item, holding some aside for personal use or sale</td>
</tr>
<tr>
<td>Maintaining inappropriate relationships with transportation or lading companies that include non-optimal costs, kickbacks, falsified documents, or other types of fraud</td>
<td></td>
<td>Collusion with customers to send too many of an item, an item other than what was ordered, or otherwise defraud the company</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Collusion with customers or vendors to permit inappropriate returns, or returns without proper transfer of merchandise back to the origination point</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Without segregation of duties, employees involved in these functions have increased opportunity to commit frauds without detection</td>
</tr>
</tbody>
</table>
## Supply chain levers to drive improvement

### Typical Change Areas in Supply Chain and Operational Functions

<table>
<thead>
<tr>
<th>Change Area</th>
<th>Key Causes of Cost Drivers</th>
<th>Attributes of Leading Supply Chain Organizations</th>
</tr>
</thead>
</table>
| Cost and Cash Optimization                       | - Too much focus on sales & not enough on RONA  
- Siloed processes & contradicting priorities  
- Excessive inventory padding & lead times  
- Excessive cross-product subsidization         | Operational efficiency aimed at adopting process improvements, deriving cost efficiencies through low cost sourcing, implementing improved planning and forecasting tools |
| Operational performance improvement              | - Lack of visibility into core process lead-time drivers  
- Ineffective capacity management processes  
- High product & process instability rates     | Enhanced visibility across supply chain with increased investments in technological solutions and platforms resulting in cost and process efficiencies for all value chain partners |
| Network & flow optimization                      | - Over-reliance on demand forecast accuracy  
- Push (utilization) rather than pull (lean) product flows  
- Inadequate buffer levels                     | Aligning supply chain design with environmental improvement opportunities and working cooperatively with suppliers to reduce environmental impact |
| Supply chain & operational governance            | - Lack of integrated target operating models & metrics  
- Non-standard processes  
- Inadequate process visibility                 | Value networks, comprising various upstream and downstream partners working in collaboration and adding value to the product/service as it passes various stages of manufacturing and distribution delivering superior customer value |
| Technology enabling global integration           | - Complex and global nature of supply chain and operations  
- High costs involved in infrastructure and integration issues  
- Disparate technology systems and tools in functional areas | All relevant processes and controls subject to continuous improvement and optimised from a cost and risk view point |
| Rising environmental consciousness               | - Regulatory requirements like REACH and ROHS  
- Usage of hazardous materials in end product consumption  
- Pull from suppliers & customers to ensure green compliance |                                                                                |
| Redefining Value Networks                        | - Higher competition, more information & demanding customer base  
- Lack of standardization, increased complexity and reduced transparency in the supply chain |                                                                                |
Thank you

Presenter:

Guido van Drunen
Guido van Drunen
KPMG Forensics
(206) 913-4208
gvandrunen@kpmg.com
www.kpmg.com