

The ABC's of SCM Fundamentals of Supply Chain Management – *Fraud*

Introduction

Our friend Whitney Massengill has observed, “A gang armed with guns can easily steal thousands. A gang armed with pens can just as easily steal millions - and the prison terms are shorter.” Enron may provide the ultimate proof of concept, but the supply chain world has been plagued by fraud and deceit since long before it was known as supply chain. And, the manifestations, while often physical, are also found in the (cooked) books.

Time was, that it was stunningly easy to put an extra case – or an extra pallet – on a truck for the driver to sell, splitting the take with the inside man. Today's systems may make that simple fraud a little more difficult to get rich with, although a little collusion still goes a long way. But, modern fraud is often complex – even elegant – in design and execution.

The management of fraud (and other) risks is more fully discussed in Supply Chain Risk Management, as well as being briefly touched on below.

The Classics Of A Golden Age

Some would cite Homer's Trojan Horse as an early logistics fraud, illustrating the need for inbound inspection. Maybe the good ol' days weren't that good, after all.

The Teapot Dome scandal that engulfed the Harding administration involved shady doings around oil reserves.

Product adulteration, or dilution, has been practiced since the earliest times; it is not a modern phenomenon limited to the narcotics trade. Back in the day, it might involve such commodities as sugar, coffee, flour, liquor, wine – oops, that's happened in modern times, too.

The substitution of inferior goods for what was actually purchased was a time-honored practice in times of old, and may have had its origins in the Biblical story of Jacob, Leah, and Rachel. It certainly gave rise to the expression, “a pig in a poke.”

In addition to the extra case/extra pallet outbound scenario, outright theft on the inbound side was once rife, especially in port operations. And, the opportunity for Traffic Managers and Purchasing Agents to live above their means, thanks to the generosity of favored carriers and suppliers, was the stuff of business legend until quite recent times.

Outright theft, of course, remains a staple occupation in some locales within our globalized supply chains. Some shippers deliberately send extra truckloads of product into known high-theft areas, knowing that, on average, they will lose a predictable percentage of the total to hijackers.

An interesting variant of the extra case scam involved unscrupulous suppliers who would ingeniously stack pallets with a case or a bag missing from the inside of the stack. The omission is not visible



until or unless the pallet is broken down, but by then the goods have typically been paid for, and the missing case has disappeared into someone's personal supply chain.

Truth is, some of the more spectacular frauds in business history have had a supply chain management flavor.

In More Recent Times

Enron has dwarfed other business scandals, and, of course, had nothing to do with failures in the supply chain. But, what about McKesson & Robbins? In 1938, the giant wholesale distributor got caught up in accounting fraud that created – out of thin air – a non-existent \$10 million inventory in Canadian warehouses that didn't exist. \$10 million was more than pocket change in the Great Depression years. While considered at the time to be an accounting fraud, it illustrates the marriage of physical supply chain operations and accounting in perpetuating fraud. In the '80's a large public accounting firm was brought down – foreshadowing Arthur Andersen's collapse – when entire manufacturing and storage facilities were belatedly discovered not to exist.

The '60's were a hot time, too. Billy Sol Estes, politically connected with Lyndon Johnson, managed a double whammy in the first half of the decade. First came the improper purchase of cotton allotments, aided by payoffs to Agricultural Adjustment Administration minions, and complicated by the suicide of a principal antagonist, who reportedly shot himself five times. Then, in a notorious exit from the public arena, Billy Sol was found to have extracted enough money to fund the illegal allotment transfers by using phantom fertilizer tanks as collateral. He was released from prison in 1983.

In 1963, in news largely overshadowed by the Kennedy assassination, Tino De Angelis, principally financed from loans guaranteed by American Express, was found to have storage tanks full of water. No crime, except that they were supposed to be full of salad oil. AmEx was not pleased. Nor were Manufacturers Hanover Bank (among about four dozen), Bunge Corporation, Williston and Beane, and Ira Haupt Brokerage Company, who all got taken – or got taken out of the play, in the case of the brokerages. A major public accounting firm was accused of negligence, initiating a practice that became increasingly popular as the 21st century arrived.

It seems that De Angelis couldn't help himself. His early career triumphs were grounded in selling bad shortening to post-war Europe and spoiled meat to US school lunch programs. Encouraged, he had put together an ultimately failed plan to corner the world market in soybean oil.

Tino, only momentarily the pride of the Bronx, himself got taken, but to the pokey, for several years. Upon release, he attempted to recover his lost fortune with a Ponzi scheme, which required more credibility than Tino possessed to pull off. The price tag on this oil escapade was a trifling \$175 million, which would approach \$2 billion today.

Where Were The Auditors?

Umm, well, this arena is not one in which the mild-mannered Certified Public Accountant has typically excelled. It's not that they're naïve or feeble-minded, but these aren't really the things they've been traditionally good at finding. The auditing firms have been generally more concerned with matters with material impact on the balance sheet or income statement – *known* material impact.

There's loads that could fly under their radar. And, they most often were not operations people, so could be easily flummoxed even when involved in physical inventories. When the fraud is intentional, with wide-spread collusion, their normal processes didn't stand a chance of breaking the case open.

No pun intended here, but in one celebrated case, the fraud was so extensive that the company in question loaded bricks of approximately the right weight into sealed cartons ostensibly containing technological equipment. The physical inventory disclosed the right number of cases, but did not ever contemplate that something else might be in them.



In another major event, the headquarters inventory was fine. But, no one deemed the relatively tiny store inventories worth examining. Regrettably, fictitious transactions had moved mountains of non-existent product into phantom local stocks, creating enormous, but false, sales volumes.

Prevention

Scattershot measures based on intuition or a persuasive salesperson's "hot" product don't git 'er done, as Larry The Cable Guy might say. We vividly remember the very large international technology distributor that invested a lot of money, and even more time, in screening devices through which each and every employee, visitor, vendor, contractor, and consultant was required to pass – at the beginning and completion of the shift, in and out for lunch, and in and out for breaks – any time the DC was entered or left for any purpose. Their concern was well-grounded, for their products were both valuable and highly desirable at the individual consumer level.

All the while the working associates were queuing up to pass through "security" in a process that would have made a TSA screener proud, two mid-managers were successfully conspiring – until they were caught – to move and sell truckloads of high-value product out of the distribution center and into what might be called alternative channels. Think Tony Soprano. With better paperwork.

So many times, it seems that the remedy relies on the crooks getting greedy or sloppy, with the thievery discovered only after huge losses have been incurred, over a long period of time. In another case we encountered, a chemical manufacturer for the automotive aftermarket became suspicious that product might be "leaking" out of its factory DC – but only after ownership changed hands, with a growing feeling that things just didn't add up.

Once again, collusion, abetted by good looking phony paperwork for phantom customers, was taking a truckload a day out of the DC and off the books. But, it took months of surreptitious observation and digging through paper and electronic files to conclusively prove the case and nail the individuals involved.

In another situation, the on-the-take Traffic Manager of some twenty years was not remotely suspected by a catalog retailer's senior management of shenanigans. But, a routine fact-finding analysis, with no agenda other than assessing potential improvements, found carrier selections that made no sense otherwise. He was allowed to resign, and keep the money, when at least a pistol-whipping seemed to be called for.

An Organized Approach

The Sarbanes-Oxley Act continues to have reverberations in the supply chain management arena, quietly requiring controls to prevent, identify, and detect fraud. PricewaterhouseCoopers (PwC), the public accounting and services giant has published a white paper devoted to fraud schemes in the transportation and logistics sector. It, in a significant departure, addresses risks beyond those in financial reporting, including reputation, legal, and strategic implications. Ken Evans, their US transportation and logistics leader, has asserted that 45% of all companies have been victims of economic crime.

In the interest of full disclosure and in the spirit of Sarbanes-Oxley, we confess to being PwC alumni, having a predecessor firm as our consulting *alma mater*.

Their five-step anti-fraud program is the usual straightforward, even dull, recitation, with the devil – as well as the excitement and the effectiveness – in the details:

1. Establish a baseline, preferably with a multi-disciplinary team, and including the development of remediation plans;
2. Conduct a risk assessment, which is not only an inventory but also a weighting of likelihood and seriousness;
3. Evaluate controls design and effectiveness, with major roles and responsibilities for operating management;
4. Assess residual financial reporting risks, which links fraud risks to internal audit weakness and ineffectiveness; and
5. Standardize incident investigation/remediation processes, which recognizes that fraud, in the real world, will occur, and demands that the gaps must continually be filled.

We have presented a few examples of fraudulent supply chain situations, with both physical and reporting elements. PwC's assembly of fraud and misconduct schemes presents six categories:

- Financial statement manipulation, sub-divided into improper revenue recognition, over/understatement of assets/liabilities, and other; this is really the mother lode, encompassing such things as: manipulation of estimates, over-accrual of rebates and receivables, understatement of liabilities, overstatement of receivables, sham transactions with related parties, overstating revenue, fictitious transactions, premature revenue recognition, revenue leakage, backdated and side agreements, and "round-tripping," transactions with no net economic benefit that can inflate earnings;
- Asset misappropriation, including cargo theft, fraudulent disbursements, cash skimming, industrial espionage, and "lapping," a theft of customer payments;
- Unauthorized receipts/expenditures, including bribery (both individual and commercial), tax evasion, improper labor practices, and fraud against employees (e.g., failure to fund pensions or pay insurance premiums);
- Aiding and abetting, helping a third party commit fraudulent acts;
- Senior management (or key financial operative) fraud, including, in addition to involvement in all the above, conflicts of interest and insider trading; and

- Disclosure fraud, intentional omission or misstatement of such items as channel stuffing, even if they conform to Generally Accepted Accounting Principles (GAAP), the usual gold standard for what practices are allowable.

We salute PwC – this could restore the accountants to relevance, maybe even to importance.

New Disciplines

We have reached a point of understanding the nature, variety, and scope of supply chain fraud, and the linkages between its physical and financial components. It's time, we think, for a couple of forces to join together in fighting against these crimes.

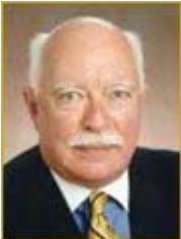
Forensic Accounting has been around for a long time, certainly since the days when Al Capone went to jail for tax evasion instead of for murder. A newer specialty may be Forensic Logistics, in which operations can be analyzed for evidence of – or the potential for – bad behavior.

Putting these two together might put real teeth in efforts to thwart supply chain fraud.



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