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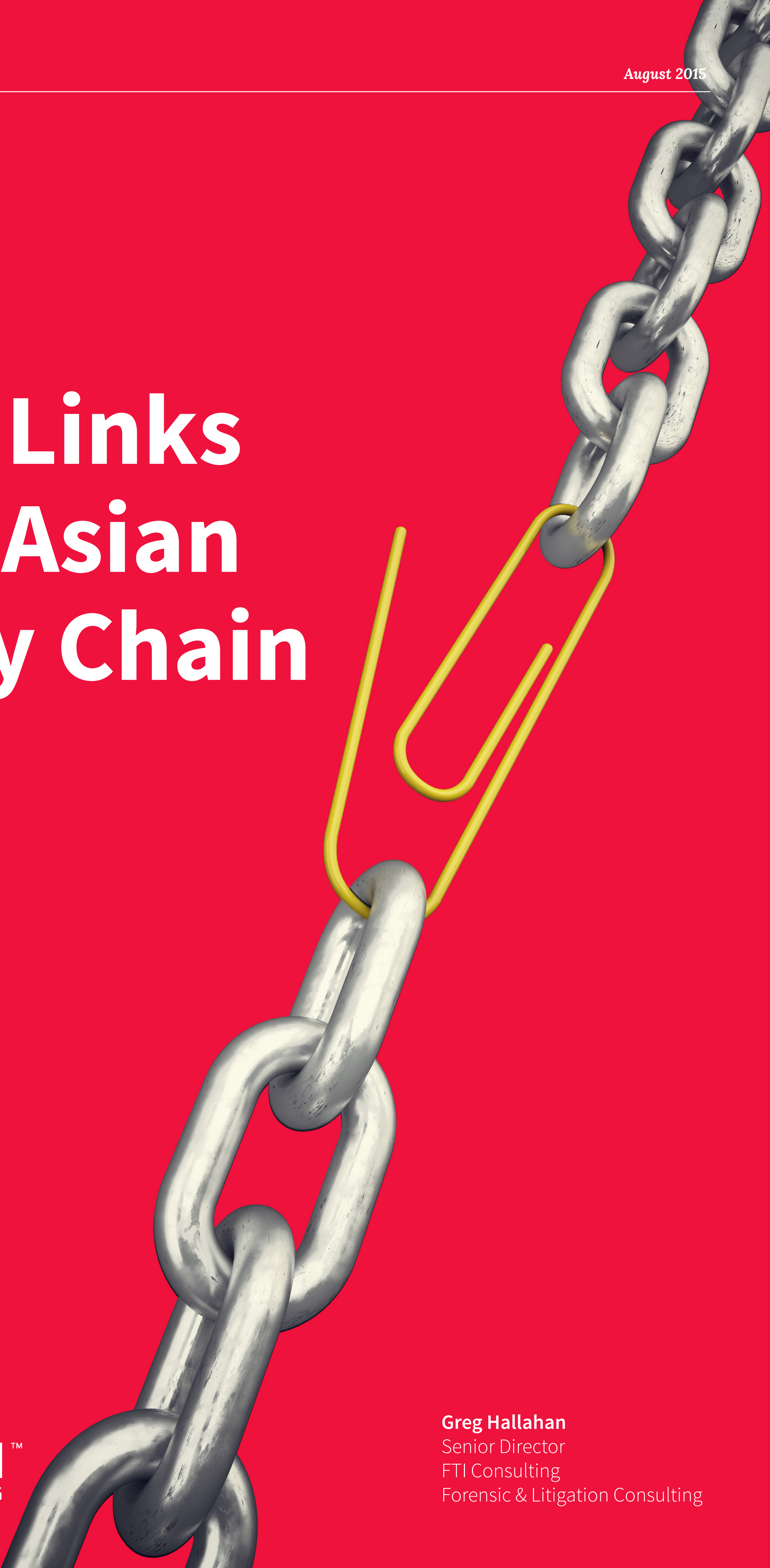
Loose Links in the Asian Supply Chain



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A few years ago, an Oregon woman bought a $29.99 Halloween decoration kit at a local Kmart. As she opened the box, a handwritten note from a Chinese prison inmate fell out. Scribbled in broken English, the writer implored anyone who had bought the product — or seen the note — to help expose the conditions under which it was made: forced labor in a Chinese prison.

Within a few months, the incident had captured headlines around the world. Sears Holdings Corporation, owner of Kmart, found itself scrambling to answer media inquiries. How could such a thing have happened? Sears officials said the company had found no evidence that its Asian supplier had subcontracted the production of the Halloween decorations to a Chinese prison but that Sears no longer was sourcing from that original supplier. The company stressed that its contracts demanded strict adherence to safety and human rights standards, and it issued a statement that its own investigation had uncovered no violations.

But the damage was done. And, in fact, as dramatic as the Kmart story is, it's not uncommon. When companies establish a supply chain in emerging Asian markets, they generally focus the bulk of their attention on first-tier suppliers.

But a bevy of risks lurk below that tier.

Asian supply chains are multi-tiered and fraught with conflicts of interest. Many Asian suppliers are owned by entrepreneurs who frequently have a financial interest in multiple businesses. These multiple business interests can lead to rigged tendering processes. They also can involve hard-to-understand conflicts of interest, and disputes can bring a supply chain to a grinding and often inexplicable (to the contracting business) halt. Unauthorized subcontracting is common and can cause significant quality problems and bring unknown, potentially unscrupulous players into the mix.

The dangers particularly are acute for companies that produce basic products like toys and apparel, where a large number of suppliers may do the work. In this article, we trace the supply chain route of such products to reveal where the risks lie and discuss how companies can avoid them. Only when businesses gain clearer visibility into their entire supply chain and identify the loose links can they begin to breathe more easily.

Follow the Risks

Trouble can start even before suppliers are selected. A procurement team seeking a provider in the Asian market usually will identify three or four primary candidates and request a bid from each. At this stage, the procurement team rarely probes the business interests of these competing suppliers. But often unbeknownst to the team, the owner of one of the candidate suppliers may have a financial tie to one or all of the others.

Conflicting Interests

When suppliers have an overlapping interest in more than one company, the tendering process can be easily rigged and frequently is. Since the bidding companies, for all practical purposes, are jointly or cooperatively owned and managed, they can coordinate their proposals and also agree to share in the spoils no matter which company wins the bid. Rigged bidding processes can inflate buyer costs and diminish profit margins for years. In addition, such processes can thwart a company's ability to control the quality of its products. If a company has issues with the work of a given supplier, the company may threaten to terminate the relationship and use another. But that new supplier may be owned by the old one, and, therefore, there's no reason the provider should care about quality, as the threat of losing the business is hollow.

Members of the procurement team may have their own conflicts of interest. Regional procurement teams typically include a manager from the region because that person will know the local language, as well as the suppliers in the area. Some procurement managers take advantage of their position. For example, if one's employer announces the need to ramp up production for a new product, a member of the company's local procurement team may take this information to a provider. This provider, in turn, could establish a completely different entity — in which the procurement team member has an interest (sometimes through a friend or family member) — expressly designed and promoted to supply the corresponding requirements. So what appears to be a legitimate company, in fact, has been created through inside information to secure this particular contract, whether or not it actually has the capability to do so. The team member then steers work to the entity in which he or she has an interest.

Undetected conflicts of interest can stop a supply chain in its tracks. A large U.S. consumer products company experienced the consequences of such conflicts when it tried to withhold payment for a large volume of goods that failed to meet contractually agreed-to quality standards.

What the consumer goods company's executives did not know was that the product supplier also owned the trucking company with which the organization had contracted to deliver its goods to port. Not surprisingly, in retaliation for the company refusing to pay for the substandard goods, the product supplier ordered its trucks to block the consumer products company's local warehouses. This prevented the consumer goods company's employees from entering and its products from being shipped — in effect, holding the company and its supply chain hostage.

Operations ceased. Revenues dried up. Business stopped.

The local police did very little, as it viewed the issue as a purely commercial conflict and outside its purview. Held for ransom by a key supply chain provider, the company had to make a quick financial settlement in order to restore operations.

Unauthorized Subcontracting

Although most contracts with suppliers prohibit unauthorized subcontracting, the practice is common. Local suppliers can find themselves overbooked and unable to take on a new project or order. Because the competition in the Asian market is fierce, local suppliers fear that a client may never return if a supplier turns down work and the client is forced to go to another supplier. To maintain the relationship, the local provider will subcontract the work without informing its client.

This is where trouble can begin. Undisclosed subcontracting makes it more difficult to detect theft and counterfeiting, especially in logistics. Because of Asia's immense size and the extensive volume of goods manufactured there, logistics industries commonly are fragmented and poorly regulated. Under time and cost pressures, local manufacturers often will subcontract to small, unregulated and unauthorized storage and transportation providers. FTI Consulting has seen many instances of these transportation providers making products disappear in transit.

One high-end global apparel company was finding that a large quantity of products was vanishing before reaching port, replaced by counterfeits. The culprit turned out to be a small, unregistered trucking company to which the apparel company's factory had subcontracted without informing headquarters. The trucks were making frequent stops en route to port, and, at each stop, a counterfeiting syndicate switched the company's goods.

If a provider subcontracts without disclosure, the client company loses its ability to assure proper working conditions. Products manufactured in Chinese prisons are among the more recent examples of what a loss of supply chain visibility can lead to. The Chinese government requires that prisons fund themselves. They often do so through manufacturing work, reaping profits by paying miniscule wages while demanding excessive hours from a captive workforce. This practice is not secret. Prisons actively market themselves to local manufacturers through agents who have a prominent online presence.

Kmart is not the only company to have found itself embroiled in a prison labor scandal. Inmates released from Dongguan Prison in China reported in 2013 that they had been forced to manufacture headsets for British Airways and Qantas for $1.40 a month. Both airlines found themselves under fire and tried to understand how a passenger amenity ended up being made by forced prison labor.

Neither airline had contracted with Dongguan Prison to manufacture the headsets. Both airlines had contracted with a supplier that contracted with another supplier that contracted with the prison.

And so it goes.

How to Control the Supply Chain

To gain greater control over their supply chain, companies need to know the business interests and practices of their providers in emerging Asian markets. The good news is that the information, in many cases, is readily available. Today, data about corporations and their business interests are more publically accessible in many parts of Asia than ever before. Businesses can (and should) require that prospective suppliers provide information about their own directors, shareholders and business activities as part of the vetting process. Although suppliers may push back at first, requesting information on a regular basis soon becomes routine.

A thorough process of documenting suppliers should include these steps:

Audit for current quality and social compliance

The process should begin by identifying any information gaps in current audit processes. Has ownership of the supplier been verified? Is all business license and location information current? The audits should assess production capacity to gauge the likelihood of unauthorized subcontracting.

Check all available public records

Asian countries have greatly improved business and industry directories, and these reference materials sometimes contain a substantial amount of information. Businesses, therefore, should check local regulatory, litigation and bankruptcy records, as well as sanction and compliance databases. Companies also need to review reports from local environmental and worker safety organizations.

Include online research

Trading websites, industry forums, job postings and social media can be rich and powerful sources of information and provide clues about undisclosed conflicts of interest. These inquiries should be conducted by individuals thoroughly fluent in the local language.

Conduct discreet visits

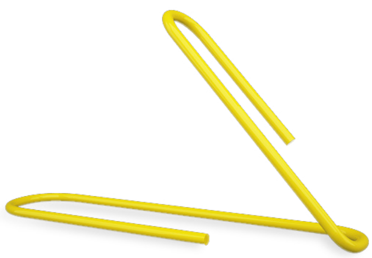
Unannounced visits can verify if the supplier exists in the shape and form it claims it is and if it operates at the stated address. Discreet visits can be used to fill in information gaps found during the verification process.

Incentivize procurement for more than cost reduction

Most companies recognize procurement professionals for reducing costs and gaining concessions from suppliers. But procurement employees rarely are praised or promoted for advocating new due diligence processes and systems. Company leaders should reward the procurement organization for thoroughly understanding the nature of its suppliers and the supply chain, not just for finding the lowest price.

Once this information is compiled, it should be put into an accessible database and regularly updated. Once installed, such a system offers compounded benefits over time and likely will surface important information. For example, if the database includes the cell phone numbers of procurement employees and suppliers, the company can see if there are any shared connections among them and be alerted to possible red flags. The ability to make these associations increases as more information is added to the system.

Companies that have invested smartly in Asian supply chains have made great strides in managing the quality of their first-tier suppliers and assuring that they meet international environmental and safety standards. However, companies often pay less attention to the deeper levels of their supply chain. Lack of visibility and oversight into the depths of the supply chain can put profit and reputation at considerable risk. Businesses can mitigate these risks by developing a disciplined process that delves into the business practices of their suppliers and the complex web of financial relationships common across much of Asia.



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