



Not In My Name: Assessing and managing third-party risk in global business

Global value chains are the new normal for many businesses. The actions of suppliers, agents or partners in a foreign jurisdiction can have a direct impact on corporate reputation and expose companies to a range of financial and legal risks. Knowing who you're doing business with and what actions they may be conducting in your name is the only effective means to assess and manage the risks.

In 2013 major grocery chains throughout Europe were swept up in what has been termed 'The Horsemeat Scandal' – the finding of horse meat rather than beef in the products of several major supermarket players resulted in financial and reputational damage to companies throughout the supply chain.

In the aftermath, what became apparent was the lack of knowledge about who actually made up the supply chains of such major businesses. In one study, it was shown that only 38% of companies had information on the identity of the suppliers to their suppliers (Tier 2) and none had information beyond those.¹

Food contamination is just one of a number of risks within global value chains. Tech giants, have been impacted by reports of unsafe and unethical labour practices and more locally, several fast-food chains have had to manage the fallout of the illegal labour practice of their franchisees.

Not knowing who you're really transacting with and what they may be doing is often most acute at the time of an acquisition as one major US Private Equity firm found out when they acquired a seemingly successful company in China. While the CEO seemed competent and clearly charismatic, six months following the

acquisition it was revealed he had convictions for embezzlement and strong ties to organised crime.

Community expectations are shifting

Regulators and consumers alike continue to place greater responsibility on companies for actions taken by representatives and partners.

In the area of corruption, both the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act allow for companies to be held liable for the actions of agents and partners. Failure to identify and remediate issues also increases liability.

Companies are also being held to greater account on issues such as human rights, environmental concerns and ethical practices which are gaining regulatory attention and influence the decisions consumers make about certain brands. Regulations in this space will likely place a greater responsibility on companies to both detect and prevent a broader range of ethical problems within their value chains.

In Australia, the next likely area for reform will be human rights with the government currently conducting an inquiry into introducing a modern slavery act in Australia and the issue now also being taken up by the Federal Opposition – upping the political stakes. While the eventual shape of legislation remains to be seen, submissions to the inquiry have called for a range of

¹ <https://www.cebglobal.com/blogs/supply-chain-lessons-from-the-horsemeat-scandal/>

measures from mandatory reporting, compulsory due diligence requirements, sanctions and the appointment of a special commissioner.

In other jurisdictions, legislation has remained at the lighter end. The UK Modern Slavery Act, for instance requires companies with annual revenues in excess of £36 million to make an annual disclosure of the steps they are undertaking to identify and prevent slavery and human rights abuses in their supply chains. The California Transparency in Supply Chains Act requires similar disclosure and the EU is in the process of introducing similar provisions.

While the eventual form of Australia's legislation will likely be close to these examples, it is safe to assume companies will be the subject of some form of regulation. For businesses already regulated by Australia's Anti-Money Laundering and Counter Terrorism Financing Act (2014) (AML/CTF), enhanced due diligence into customers and business partners is already a mandated requirement. The trend going forward will likely see more companies having to closely examine the identity, reputation and activities of those with whom they do business.

What is effective due diligence?

The term due diligence is a confusing one and often applied across numerous areas from financial, legal and operational issues.

The actions taken by a company to investigate corruption, bribery or other ethical issues is sometimes termed reputational or investigative due diligence and Know Your Customer/Supplier (KYC). The terms cover a range of activities from simply identifying a customer is a real person, as is common in the retail banking sector, through to more in-depth investigations and audits examining the identity, track record, reputation and activities of companies and individuals.

Deciding what level of inquiry is needed relies on a mature risk assessment which takes account of the general risks involved in doing business in different countries and the specific areas of the company's operations which may provide opportunities for bribery and corruption or give rise to other ethical issues. A risk based approach is already mandated under the FCPA and most AML/CTF regulations; however, many companies have a limited understanding of what and where the risks are.

Key warning signs of a potentially risky deal

While the actual third-party risks will vary from company to company and transaction to transaction, there are some key red-flags which should trigger a more cautious approach.

- **Complex corporate structures** – while there can be legitimate reasons for using multiple subsidiaries and off-shore business registration hubs, like the British Virgin Islands, many fraudulent and corrupt companies use these to hide the identity of the real owner or to make tracing revenues and asset ownership more difficult. Making sure you know who the actual beneficial owner of the company is can help avoid potential problems. In a recent case, FTI Consulting found the assets claimed as owned by a potential JV partner were actually owned by a different company. Had the transaction proceeded, our client would have been left with a shell company of very

limited value and a complex litigation across three jurisdictions in order to recover any funds.

- **Unknown relationships and companies** - in many parts of Asia successful business people have a network of overlapping financial interests which present risks of rigged tendering processes, collusion and complex conflicts of interest that can significantly hamper ongoing operations. Unauthorised subcontractors are also common in Asian value chains and can introduce unethical and unscrupulous links without the knowledge of the contracting business.
- **Above average revenues** – revenue and profits well above the industry norm should be a trigger for further investigation. In one case, FTI Consulting discovered a company had 'borrowed' an entire factory and employees for the purpose of fraudulently inflating assets and estimated revenues prior to the sale of the business.
- **Government linkages** – understanding a company's linkage with the local government is critical. In many locations close involvement with the government can increase the risks of bribery and corruption. It is also important to consider any licences or permits granted to the business or any subsidies they receive. FTI Consulting has noted numerous examples in Asia of key operating permits being revoked due to the discovery they were issued corruptly. With the original owners long gone, the current owners and investors have little hope of recouping their losses. Government linkages can also expose companies to breaches of international trade sanctions and to politically exposed persons – which can carry serious penalties including fines and imprisonment.
- **Government subsidies** - companies receiving government subsidies should also be looked at critically. On behalf of one client, FTI Consulting discovered the manufacturing business they were about to buy into made more money from government subsidies than they could make from selling their products.

What's involved and when?

The above list is by no means exhaustive and unfortunately there is no one size fits all approach to managing third-party risks. Different countries pose different profiles of reputational and ethical risk and a thorough risk assessment is essential.

Where higher risks are identified, there are a number of ways to obtain the right intelligence to assess, mitigate or even avoid becoming entangled in the issues of a potential business partner.

Corporate and public records can provide insight into ownership structures and financial track-records; a history of involvement in litigation or regulatory issues can point to the track record of compliance and ethical conduct of a business; and social media is often a good place to locate public comments about a company and to identify links which may pose a risk. When collected and analysed holistically, a rich picture of the companies' history can be developed.

In many parts of Asia, however, there is no substitute for direct observation and intelligence. Conducting discreet site visits and making inquiries through knowledgeable sources can reveal issues

that would otherwise go undetected. For instance, FTI Consulting was able to identify a company in China was engaged in illegal labour practices by interviewing former employees. Had these gone undiscovered, they would have caused a major US corporate significant financial and reputational damage.

Deciding when to undertake an investigation depends on the circumstances. However, the costs involved are often significantly less than the expenses of full financial and legal due diligence. A due diligence investigation can help avoid wasted time and money and often highlight issues that can inform contract negotiations.

Pulling back the curtain and examining the claims made by a potential business partner is essential. The process of due diligence needs to be approached as a critical review that questions the claims presented and seeks to identify any issues before a transaction proceeds. While no due diligence process is fool-proof, when exposing your reputation to the actions of another party, forewarned is forearmed.

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