MANUFACTURER

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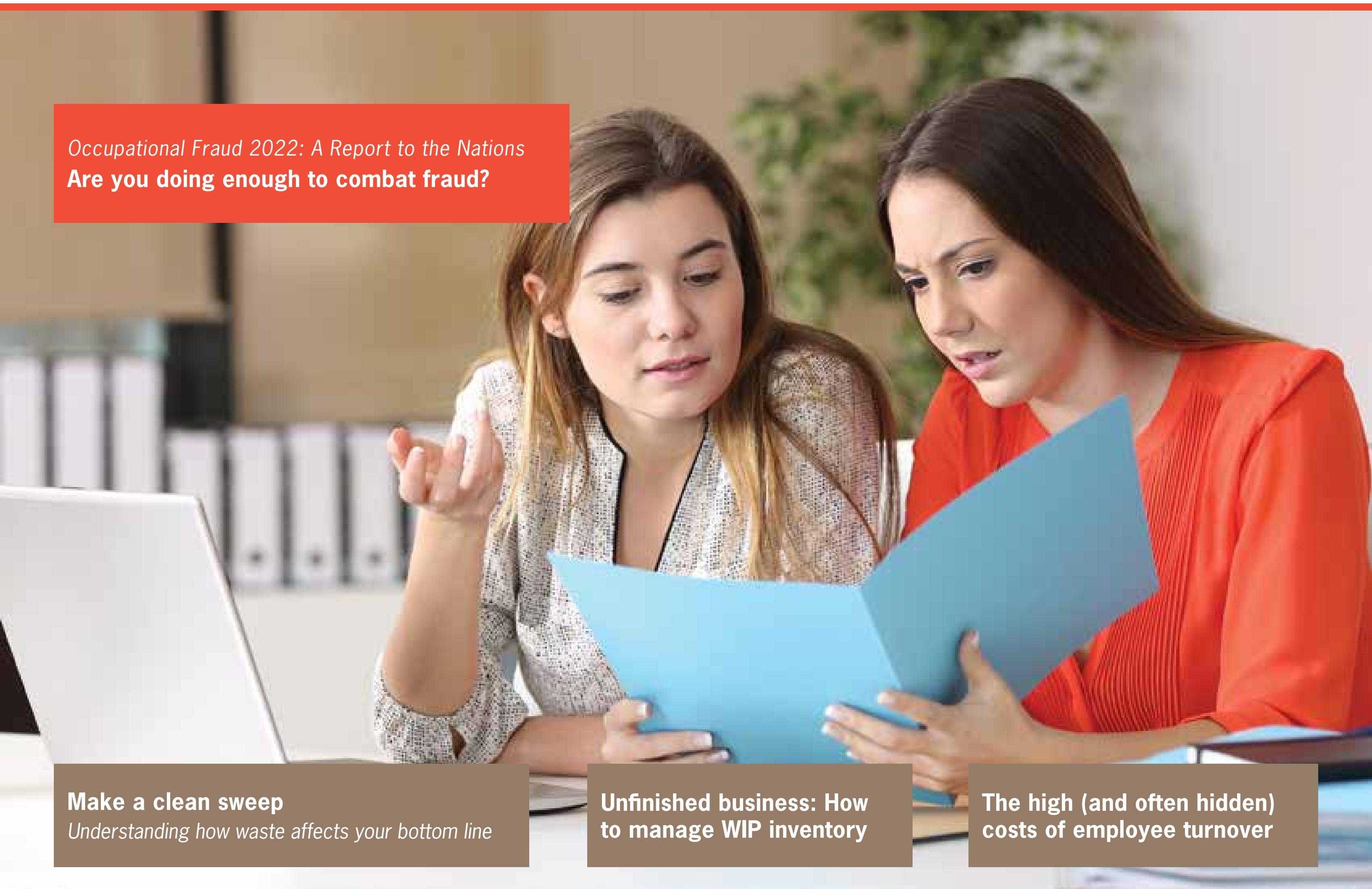

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Occupational Fraud 2022: A Report to the Nations

Are you doing enough to combat fraud?

Occupational fraud — that is, fraud committed by employees — is a significant problem for all businesses. According to the Association of Certified Fraud Examiners (ACFE), organizations lose 5% of their revenue to fraud every year, and manufacturing is among the most frequently hit industries.

The ACFE's *Occupational Fraud 2022: A Report to the Nations* is based on data supplied by certified fraud examiners around the world. The report examined 2,110 fraud cases in 133 countries, with a median loss per case of $117,000. Manufacturers were involved in 194 cases, with a median loss of $177,000 — significantly higher than the overall median loss.

Know the common schemes

The ACFE has identified three common categories of occupational fraud:

Asset misappropriation (86% of cases). This occurs when an employee steals or misuses the employer's resources. Examples include billing schemes, inventory theft and payroll fraud.

Corruption (50% of cases). Bribery, conflicts of interest and extortion are common examples.

Financial statement fraud (9% of cases). In these scenarios, an employee intentionally causes a material misstatement or omission in the organization's financial statements.

Note that these numbers total more than 100% because many cases involve more than one type of fraud. In the manufacturing industry, the most common fraud schemes are corruption, billing schemes and noncash misappropriations.

The presence of antifraud controls is associated with lower fraud losses *and* quicker detection.

In a billing scheme, the perpetrator causes the employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases. For example, a fraudster might create a shell company and bill the employer for services not actually rendered.

Noncash misappropriation involves stealing or misusing the employer's noncash assets. Examples include stealing or misusing inventory, equipment or confidential customer information.

Stay in control

Implementing antifraud controls is an effective way to combat fraud. Indeed, nearly half of the cases in the ACFE's report were attributable to either lack of internal controls or management override of existing controls. Generally, the presence of antifraud controls is associated with lower fraud losses *and* quicker detection.

The ACFE evaluated the effectiveness of different antifraud controls. In terms of reducing losses, the following controls reduced losses by 50% or more:

- Job rotation/mandatory vacation,
- An employee hotline, and
- Surprise audits.

Other effective measures include proactive data monitoring/analysis, an antifraud policy, fraud training for employees, formal fraud risk assessments and an employee code of conduct.

As for shortening the duration of fraud schemes, proactive data monitoring/analysis, surprise audits and job rotation/mandatory vacation were the most effective controls. These measures helped lower the duration of fraud schemes by 50% or more. Conducting formal fraud risk assessments, as well as creating a dedicated fraud department, function or team, were slightly less effective at reducing fraud duration.

Recognize fraud warning signs

To effectively detect fraud and minimize your losses, it's important to recognize certain employee behaviors that can be a red flag for fraud. According to *Occupational Fraud 2022: A Report to the Nations*, a biennial report published by the Association of Certified Fraud Examiners, the eight most common red flags are:

1. Living beyond one's means,
2. Financial difficulties,
3. Unusually close association with a vendor or customer,
4. Control issues and unwillingness to share duties,
5. Irritability, suspiciousness or defensiveness,
6. Bullying or intimidation,
7. Divorce and/or family problems, and
8. "Wheeler-dealer" attitude.

Background checks can be an important tool for combating fraud. However, most frauds are committed by first-time offenders, often motivated by desperate circumstances. According to the 2022 report, 83% of the fraud perpetrators had no prior disciplinary record for fraud-related conduct.

Use effective precautions

Notably, some of the most effective controls are underutilized. For example, job rotation/mandatory vacation and surprise audits were each associated with at least 50% reductions in both median fraud loss *and* median fraud duration. But the ACFE found that they're among the least commonly implemented controls. Surprise audits were used by just 42% of the victimized organizations in the ACFE's report, while only 25% of the organizations had job rotation or mandatory vacation policies in place.

The ACFE found that tips from employees or outside parties were the detection method in 42% of the cases in the report. Consistent with previous ACFE studies, tips are by far the most common way that frauds are discovered, underscoring the importance of hotlines for reporting fraud and other violations.

The ACFE reported that fraud losses were two times higher at organizations without hotlines. Email and web-based reporting both surpassed telephone hotlines, so it's best to provide multiple reporting channels. The report also found that reports of fraud are more likely to be submitted via hotlines if employees receive fraud awareness and reporting training.

It *can* happen to you

Many manufacturers, especially smaller ones, view antifraud controls as unnecessary. You may feel that you know and trust your employees, and it can't happen to your company. But there may be motivations outside of your control, such as personal financial distress or gambling addictions, that can lead good employees to make bad decisions. By implementing antifraud controls, you can minimize the opportunities for fraud to happen at your company.

The most effective controls for your company depend on a number of factors and can vary by industry. It's a good idea to benchmark your company's antifraud controls against those of your peers. Contact your CPA for help fortifying your defenses. ■

Make a clean sweep

Understanding how waste affects your bottom line

The goal of profitable manufacturers is to make as many products with as few resources as possible. With the economy continuing its uncertain path, getting ahead of cost savings is important. One way for manufacturers to save is to rein in waste at their facilities. But waste is much more than just scrap materials that pile up on shop floors. Let's take a look at how efficient production is the start to reducing waste.

Operating more efficiently

Preventive maintenance, routine physical inspections and effective quality control are the keys to operational efficiency. For example, do you conduct ongoing maintenance on equipment? Doing so can ensure that each machine is properly calibrated and running smoothly. Maintenance schedules can prevent unexpected breakdowns and leaks that drain electricity, gas, oil, coolants and so on.

Another part of preventive maintenance is replacing equipment on a regular basis. No machine lasts forever. New equipment can help speed up production, minimize defects and lower energy costs.

Finding solutions

Efficient production starts with waste reduction efforts. Besides preventive maintenance, other ways to help reduce waste include:

Managing inventory. Having the right amount of inventory can help reduce waste through risk of loss, decay and damage. You should order only the materials needed for production for a specific period. This will require you to review past years' sales data to estimate how much you need to produce. Now is the time to stop manufacturing less profitable products.

Scheduling walkthroughs. On the first workday of the month, get into the habit of walking the plant floor and pausing to observe the production process.

Look for such issues as how much time machines and employees sit idle and whether workflow seems to be organized. Examine the flow of materials. Revising the flow to be more linear and moving raw materials closer to the production line are simple ways to minimize idle time and transport.

Updating workspaces. Pay attention to whether locations are clearly delineated. You may occasionally need to update signage or repaint lines on the floor to help employees function more efficiently. Likewise, look for broken, dusty or expired inventory items. Slow-moving inventory is a waste of working capital.

Determining defect causes. Always look for the underlying cause of quality issues and fix it. For example, link defects to a specific employee (who may simply need better training) or a machine (that may need to be repaired or replaced).

Recycling when possible. Consider recycling opportunities. To illustrate, you may reuse rinse water in the cooling system. Or metal scrap can be melted and returned to raw materials — or sold to a recycling yard — rather than thrown in the trash.

Tracking waste. Most manufacturers already track energy and water use at their facilities. Tracking waste isn't so different. Start by creating a team — include representatives from all levels of your company — that gathers, analyzes and implements waste-reduction goals. The team then monitors the waste-reduction progress and reports back to employees. You can promote the goals to employees, even offering monetary incentives or noncash awards.

Conducting a professional waste audit. Every manufacturer needs quality inspections to detect waste and prevent defects from recurring. It may make sense to hire a professional to conduct a waste audit. This person can help review your waste streams and provide guidance on ways to reduce waste. Consider conducting the audit just after your year-end inventory count: You'll have your inventory organized and can see where you may have waste.

Time for a fresh start

Excess scrap can lead to safety issues, cleanup costs and diminished profit margins. However, waste extends beyond trash in a manufacturing context. Now may be the time to look for fresh perspectives on waste reduction and ways to boost your bottom line. Contact your CPA to review your manufacturing processes and schedule a professional waste audit if necessary. ■

Unfinished business: How to manage WIP inventory

Work-in-process (WIP) inventory is an important entry on a manufacturer's balance sheet. Monitoring WIP is critical not only to ensure that your financial statements are accurate, but also because it serves as a useful metric for tracking your company's performance.

What's WIP?

Simply put, the term "WIP" refers to all inventory in the stage between raw materials and finished-product inventory. Any time direct labor is applied to raw materials that aren't yet ready to be sold to customers, their production costs (raw materials, direct labor and factory overhead) are reported in WIP.

The formula for estimating ending WIP in an accounting period is relatively simple:

> Beginning WIP + production costs – cost of goods manufactured (COGM) = ending WIP

Suppose, for example, that a manufacturer's WIP at the beginning of a quarter is $100,000. During the quarter, its production costs total $250,000. The manufacturer's COGM (the production costs for goods that are available for sale) is $200,000. It's ending WIP, therefore, is $150,000 ($100,000 plus $250,000 minus $200,000).

What are the benefits of tracking WIP?

Estimating and monitoring WIP provides several important benefits, including:

Reporting more accurate inventory values. Getting a handle on WIP helps ensure that your inventory is valued accurately on your balance sheet. If you undervalue WIP, you'll overstate your COGM, which can distort your financial performance.

Reducing reliance on physical counts. Assuming you have systems in place for tracking and estimating production costs, valuing WIP using the formula discussed above allows you to rely less on costly physical counts of WIP inventory at various stages of the manufacturing process. Physical counts provide important benefits — such as identifying damaged or stolen goods and revealing reporting errors — but properly tracking WIP allows you to reduce your reliance on them.

Identifying trends and red flags. WIP is a valuable metric that can reveal significant trends, helping you spot red flags and address them before they damage your profits. For example, excessive WIP can forewarn of bottlenecks in your supply

chain or manufacturing process. A large amount of WIP also means higher storage costs and a greater amount of capital tied up in nonsalable assets. And more WIP means more unfinished products, which present a greater risk of damage, loss, expiration or obsolescence while awaiting completion.

Is there an optimal level of WIP?

Generally speaking, in terms of cost and efficiency, the lower your WIP, the better. In some cases, however, a certain level of WIP can be a good thing. For example, having some WIP for employees to work on can minimize downtime when there are delays in the supply chain. And too little WIP can mean excessive completion times for finished products.

The optimal level of WIP varies from manufacturer to manufacturer. What's right for your business depends on several factors, including the number and types of products you manufacture, the nature of your supply chain and operations, and your inventory management strategies.

Getting help

To manage WIP effectively, you need to be able to measure it. That means you'll need to have the ability to track the costs of raw materials, direct labor and factory overhead at various stages of the manufacturing process. Your advisors can help ensure that you have systems in place for collecting the data needed to optimize your WIP. ■

The high (and often hidden) costs of employee turnover

Most businesses today are facing an unprecedented shortage of skilled labor, so it's more important than ever to hang on to the employees you have. Manufacturers have been hit particularly hard. One reason for this: When the COVID-19 pandemic caused most schools to shift to a remote model, enrollment in many vocational programs — where hands-on learning is essential — declined sharply.

Recognize the full cost

You may be reluctant to devote already scarce resources to employee retention, but it's important to consider how much it costs to lose employees. In a recent study, the Society for Human Resource Management estimated that the average replacement cost of a salaried employee is six to nine months' salary. That means, for example, that if you lose an employee earning $50,000 per year, the cost of replacing that person will be approximately $25,000 to $37,500. Other estimates are even higher, especially for executives or other highly paid employees.

Some of the costs of employee turnover are obvious, such as those associated with advertising a position, screening and interviewing applicants, and training and supervising new hires. Plus, you may temporarily lose productivity while a new employee gets up to speed. Others are less apparent, such as the cost of overtime or temporary help needed as a result of staff shortages or the negative impact on company culture or morale.

Stabilize your workforce

Employee turnover also can affect product quality — a significant hidden cost. A recent study titled "The Hidden Cost of Worker Turnover: Attributing Product Reliability to the Turnover of Factory Workers," found a direct link between worker turnover and product reliability. The authors of the study partnered with a major smartphone manufacturer, tracking failure rates for 50 million phones over a four-year period. They were given access to data that 1) allowed them to trace units that required replacement or repair back to their exact manufacturing dates and locations, and 2) provided staffing information for those dates and locations.

The authors found, among other things, that each 1% increase in the weekly turnover rate increased the product failure rate by 0.74% to 0.79%. This finding confirms that "products are more reliable when the workforce is more stable."

Make the investment

Given the shortage of skilled workers, and the steep cost of employee turnover, manufacturers can reap significant benefits by investing in their existing workers. This may include increasing salaries and bonuses, enhancing benefits, offering flexible schedules, or providing training and upskilling opportunities. In most cases, the benefits of a stable workforce will outweigh the cost of higher wages, better benefits and improved working conditions. ■

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