Managing Corruption Risks among Suppliers and Distributors*
The Problem of Corruption

Corruption – broadly defined as the misuse of entrusted power for private gain – has brought economic and social devastation to millions. In so much of the world, corrupt governments and private actors siphon resources, undermine the rule of law, inhibit economic growth, and preclude basic safety and security infrastructure. The World Bank estimated in 2004 that the cost of public corruption totals more than 5% of global GDP, with more than U.S. $1 trillion paid in bribes each year. A 2009 United Nations estimate puts the number closer to $1.6 trillion.
Increasingly, companies—particularly large multinational companies—are being held responsible, both legally and in the court of public opinion, for the corrupt activities of their suppliers and distributors.

But the costs of corruption go well beyond bribery of public officials. Fraud, embezzlement and commercial bribery add extraordinary burdens to business independent of any connection to governments. Corruption makes business far more costly by imposing huge inefficiencies and obstacles to growth.

Understandably, the pervasiveness and staggering impact of corruption have been the increasing focus of national governments and international institutions. Enforcement of anti-corruption and financial crime laws has risen sharply, with improved cooperation among various governments, and, in some cases, the imposition of massive fines against companies and prison sentences for offending corporate executives. In addition, international financial institutions and export credit agencies increasingly are barring or penalizing companies that participate in corruption.

The financial hardship and inefficiencies, the threat of serious legal sanctions, and the growing pressure of public opinion give businesses ample reason to fight corruption.

**Corruption among Suppliers and Distributors**

For any business, the problem of corruption extends well beyond the four walls of the enterprise and its employees. Global business is accomplished through the elaborate networks of the supply and distribution chain—the persons, entities and infrastructure that transform materials and human capital to intermediate and finished products and services and then sell and deliver them to customers and consumers. And the problems that affect business are multiplied throughout these networks.

Increasingly, companies—particularly large multinational companies (MNCs)—are being held responsible, both legally and in the court of public opinion, for the corrupt activities of their suppliers and distributors. As the news media regularly details, the misdeeds of suppliers can directly affect product quality. And misconduct by distributors, who generally carry the manufacturer’s brand, transfers directly to the manufacturer in the minds of the consuming public. At the same time, suppliers and distributors—who themselves may be large MNCs—must attune themselves to the problems of corruption, for the protection of their own products, services, and reputations.

One significant category of corruption risk—resulting in billions of dollars in direct loss to firms each year—is procurement fraud perpetrated by suppliers, often in league with the customer’s own employees. This includes kickbacks, fraudulent billing, and various purchasing and sales schemes. Those businesses that engage distributors face similar risks downstream. A 2009 survey of 729 senior executives from a variety of companies around the world found an average loss due to fraud of $8.8 million over three years, with 20% reporting losses due to vendor and procurement fraud and 19% with losses due to corruption and bribery.1

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Moreover, businesses confront extraordinary additional risks in many parts of the world where suppliers and distributors engage in corrupt practices involving governments and other public actors. Suppliers who corruptly bypass health and safety requirements, avoid necessary licensing, or otherwise evade legitimate law enforcement, create enormous risks to product quality. Recent years have seen numerous examples of widespread corruption-related health and safety scares from imported products.

Similarly, distributors who earn a reputation for corrupt practices with local governments pass those reputations on to manufacturers. And suppliers engaged to assist customers with government agencies create acute risks, both in reputation and liability, if they pay bribes on the customer’s behalf to customs officials or licensing authorities. These problems are magnified with that species of supplier – agents and consultants – whose job it is to help secure government contracts or lobby for legislative or tax changes, and with distributors who are selling a manufacturer’s products to the government.

It is worth emphasizing the reputational damage. As significant as the direct monetary costs of corruption may be, they are often are dwarfed by the indirect costs related to management time and resources dealing with the issues, legal liability, and reputational losses. Reputational losses in particular can dramatically affect the value of the brand, relationships with business partners, and share price.

For MNCs doing business in the developing world, these risks are severe. In countries with a high degree of corruption, suppliers and distributors for MNCs very often consists of small and medium size local businesses. These businesses typically have more contact with corruption they face more temptation and more opportunity. As local entities, they may lack a global perspective and have less discomfort in participating in corruption in a culture where such activity is the norm. And as smaller businesses, they may lack the leverage to resist corruption and influence local institutions for change.

**Fighting Supplier and Distributor Corruption**

Despite these obvious dangers, many companies are not prepared to deal with them. Virtually all large MNCs have sophisticated supply chain management processes focused on supplier identification, cost control, logistics, and supply quality. There are similar processes in place for sales and distribution management to ensure that a manufacturer’s products are marketed and sold in a consistent and value-added way. Unfortunately, few concentrate on supply chain and distributor corruption with the same intensity, despite the extraordinary potential costs from corruption. Dealing with corruption should be part of good supply chain and distribution management generally.

Fighting corruption among suppliers and distributors also must be part of a larger anti-corruption program that addresses corruption risks throughout the firm. This includes...
assessing corruption risks, establishing policies and procedures to control corruption, educating the workforce and business partners on the risks of corruption, and monitoring and auditing for compliance. And it means promoting a culture where corruption is simply unacceptable. Efforts to eliminate corruption among suppliers and distributors are but one, albeit important, element of this larger concern.

There is much that businesses can do to reduce these corruption risks. Many MNCs engage their suppliers in the areas of human rights, labor and the environment. These customers often have sophisticated programs, involving supplier principles, contract enforcement, supplier education and auditing, to ensure, for example, that suppliers are not using child labor or abusing their employees, or dumping toxic waste. Such programs are a key element of good corporate citizenship and enhance the reputations of those companies that devote appropriate resources to these activities.

Engaging suppliers and distributors in a similar fashion on issues of corruption can reap even greater benefits. Firms that engage suppliers and distributors through meaningful anti-corruption programs can:

- improve product quality
- reduce fraud and related costs
- enhance their reputations for honest business
- improve the environment for business
- create a more sustainable platform for future growth.

Assessing Risks

Preventing corruption requires a clear-headed view of the hazards, and a strategic approach to engaging suppliers and distributors. Customer-supplier and manufacturer-distributor interaction comes in myriad forms, and varies widely along numerous dimensions relevant to the risk of corruption. Preventing corruption among suppliers and distributors is not a homogeneous exercise.

At the same time, resources available to fight corruption are limited. Anti-corruption programs will include many elements — codes of conduct, employee training and certain financial controls, for example — that will affect all customer-supplier and manufacturer-distributor relations, but no business can afford to employ gold-standard anti-corruption efforts in relation to all its suppliers and distributors. Nor would such massive efforts be cost effective. Buying office supplies from a large office supply chain in a developed country presents very different risks and necessitates a different level of controls than the purchase of key food ingredients from a medium-sized supplier in a developing country. Fighting corruption among suppliers and distributors, like any business decision, requires an assessment of risks, a balancing of costs and benefits, and tailoring the program to fit the risk profile.

To assess these risks, a business must ask a series of questions about its own operations and about the nature of its suppliers and distributors. Although many companies address
some of these issues, few consider the full range of questions relevant to the corruption risk. Moreover, assessment of corruption risks in relation to suppliers and distributors should be part of a more general assessment of corruption and ethics and compliance risks generally. (See LRN White Paper, *Ethics & Compliance Risk Assessment as a Strategic Driver: Integrating with Business Decision-Making* for an excellent discussion of these issues.) The answers will help direct anti-corruption resources to their most value-added objectives.

**QUESTIONS ABOUT THE CUSTOMER OR MANUFACTURER’S BUSINESS**

The assessment begins with an appraisal of what the business already has in place internally to fight corruption. A business that does not take adequate care to prevent corruption is in a poor position to make such demands of its suppliers and distributors.

**What controls do you have in place to prevent, detect, and respond to internal fraud?**

Program elements to consider here include the existence, and effectiveness, of such controls as:

- Written standards of conduct
- Employee training and communications
- Reporting mechanisms
- Mechanisms to investigate, deter and sanction employee misconduct
- Spending controls, including multiple levels of review, spending limits, and documentation requirements

**What controls do you have in place to prevent, detect, and respond to supplier and distributor fraud?**

Companies also must consider, specifically, the controls they have in place in relation to supplier and distributor engagement. These include:

- The evaluation process
- Contract terms
- Training
- The contract management process, including mechanisms for measuring and monitoring the quality of products or services provided by suppliers and distributor performance.

**What monitoring mechanisms are in place with suppliers and distributors?**

- Do you have contractual audit or inspection rights?
- Do you exercise them?

**QUESTIONS ABOUT THE SUPPLIER OR DISTRIBUTOR**

The need for, and benefit derived from, controls related to the supplier or distributor will vary with the nature of the engagement.

**How large is the supplier or distributor?**

- Is this a large, sophisticated MNC, a small local business, or something in between?
Where is the supplier or distributor located?
Where are the goods or services to be produced/delivered/sold?
What are the corruption risks in these locations?

Corruption control resources logically must be focused on contracts to be performed in countries with a higher risk for corruption.

What is the supplier’s or distributor’s reputation for integrity and ethical conduct?
Due diligence is key here. Inquiring about a supplier’s or distributor’s background and reputation will be critical where there are other risk factors for corruption, such as the nature of the services provided and the location of the supplier or distributor. The greater the potential risk, the more in depth the due diligence required.

- How was the supplier or distributor identified?
- Through a trusted source?
- Through use of a pre-qualification or certification service?
- Is the supplier or distributor a friend or relative of an employee?

The answer here can cut both ways, as employee referrals can indicate trustworthiness, but run the risk of conflicts of interest and kickbacks.

What controls does the supplier or distributor have in place to prevent corruption?

Does the supplier or distributor have:

- Standards of conduct
- Employee training and communications
- Reporting mechanisms
- Mechanisms to investigate, deter and sanction employee misconduct
- Other controls (e.g., spending controls, including multiple levels of review, spending limits, and documentation requirements)

QUESTIONS ABOUT THE ENGAGEMENT

What is the nature of the goods or services to be supplied or sold?

Corruption control resources logically must be focused on contracts to be performed within industry sectors with a higher risk for corruption.

What is the size of the contract?

The more at stake, the greater the risk of kickbacks and other forms of procurement fraud.

What are the possible points of contact with government corruption?

- Is the supplier or distributor subject to government inspection?
- Does the supplier or distributor require government licensing?
- Are the goods subject to VAT or other taxation?
• Is the supplier or distributor responsible for dealing with customs officials?

The more contact with government officials, the greater the risk for government-related corruption, particularly in high-risk countries.

Is the supplier being engaged as an agent specifically to deal with the government, for example, to obtain licenses or permits, or to deal with customs or tariffs?

If so, the risks for corruption and principal liability may be particularly high.

Does the distributor sell your products to the government?

Again, the liability and reputational risks to the manufacturer are especially high if the distributor pays a bribe to make the sale.

THE COSTS OF CORRUPTION IN THE ENGAGEMENT

In assessing the acceptability of risks, it will important to understand not only the chances that corruption may occur, which many of the previous questions address, but also the cost of corruption if it does occur.

How costly would the disruption be if the supplier or distributor engaged in corruption?

A customer should look closely at the nature of goods and services being supplied and the nature of its end product or service, and consider the possible consequences of corrupt supplier behavior, including worst-case scenarios. If a food supplier bribes a government inspector to ignore health code violations, the various risks are far more serious than if a supplier bribes a local police officer to allow parking of trucks in no parking zones. Similarly, manufacturers must consider the consequences of various forms of corruption among distributors who carry the manufacturer’s brand.

What are the operational risks of such disruption?

Is this a critical good or service? Is this a key market or distribution channel?

What are the reputational risks of such disruption?

Could supply chain corruption affect product quality, or the company’s reputation for honest business? What happens if it’s a corrupt distributor?

What are the possible remedies if there is a problem with the supplier or distributor?

Some remedies—such as bringing a lawsuit against a distant supplier or distributor in its
These are strategic relationships and must be viewed as such.

**Trust and cooperation are key.**

“Getting the best“ of your business partner is not in either party’s long-term interest, even if the immediate deal is attractive.

How will you control the damage in each case?

The greater the potential damage from an act of corruption, the more important it is to take additional precautions up front.

Do you have alternative sources of supply or distribution?

How many alternative suppliers or distributors are there?

Is this a “strategic supplier” or key distributor?

Who has the leverage in the relationship?

If commercial claims or regulatory investigations or charges are brought against the company because of its supplier’s or distributor’s corrupt activities, what are the other possible consequences that may be triggered by these disputes?

Each company’s facts and circumstances will govern whether any notices to third parties (such as commercial partners, lenders or regulators) or other actions are required.

There is no fixed formula for processing the answers to these questions, but performing this exercise will give the company a far better sense of risk and inform decisions about the level of control necessary in each case.

## Supplier and Distributor Engagement

**THE IMPORTANCE OF TRUST AND COOPERATION**

There is no single model for customer-supplier or manufacturer-distributor interaction. As with any business relationship, the leverage that either party holds will vary from party to party and over time. In some cases, a customer is looking for a one-off purchase and does not contemplate a continuing relationship, but in many customer-supplier situations, the parties will anticipate a long-term repetitive series of transactions. Distributor engagements typically are anticipated to be longer-term, but still vary significantly across markets and with the sophistication and capabilities of the parties.

These are strategic relationships and must be viewed as such. Trust and cooperation are key. “Getting the best“ of your business partner is not in either party’s long-term interest, even if the immediate deal is attractive.

In many instances, suppliers are as large as or larger than their customers, and equally or more sophisticated. Some distributors may be large companies as well. In other cases, particularly in the developing world, suppliers and distributors will be small and medium size local businesses that may either be unsophisticated about the expectations of MNCs, or
Managing Corruption
Risks among Suppliers and Distributors

Ideally, suppliers and distributors will adopt their own programs and systems for preventing corruption. These parties should come to understand, if they do not already, why preventing corruption and doing business with integrity is in their interest.

Companies may be operating with few resources and thin margins, or under various pressures or cultural norms that increase the risk of corruption.

In attempting to prevent corruption among suppliers and distributors, it is important to go beyond simply trying to dictate compliance, and move toward comprehension and capacity building. In many instances, the customer or manufacturer will not have the leverage to dictate compliance in any event. The key here is building trust and a common vision.

In any business relationship, the parties do not have the same incentives, but must find a way to work together toward commonly understood goals. Customers and suppliers, for example, will view the issues of cost and efficiency differently. Similarly, there is a natural tension between manufacturers and distributors, who often have different incentives regarding commitment of resources to distribution and quotas/sales targets. The best business relationships get past these tensions by collecting, managing and sharing information to maximize mutual business interests. This includes information about the costs of corruption and the actions necessary to prevent it.

Ideally, suppliers and distributors will adopt their own programs and systems for preventing corruption. These parties should come to understand, if they do not already, why preventing corruption and doing business with integrity is in their interest. Clean business is good business for suppliers and distributors—who must be concerned with their own reputations—not just a contract term that a particular customer or manufacturer is demanding.

Companies should expect continuous improvement from suppliers and distributors; they should educate supplier and distributor personnel and work with them to try to fix problems. At the same time, customers and manufacturers must be ready to terminate a relationship where necessary. It is worth noting again, to minimize the potential disruption from a termination decision, companies must assess their suppliers and distributors to the extent possible prior to entering into a relationship.

To be meaningful and effective, anti-corruption cannot simply be a throw-in or boilerplate in a contract. Where there is significant risk of corruption, doing business with integrity must be emphasized from the beginning of the relationship as critical to the engagement.

SUPPLIER EDUCATION
When dealing with suppliers or distributors who are unsophisticated on these issues, companies should consider training supplier and distributor personnel in much the same way that they train their own employees. Many MNCs have programs for preventing human rights and labor abuses in the supply chain, and train suppliers on program requirements. Most of these same companies have written policies against corruption in the supply chain, and may have supplier code of conduct, but few train their suppliers on corruption issues, despite the extraordinary risks. Similarly, companies that use distributors frequently devote significant resources to training distributor personnel on company products and sales practices, but rarely talk about corruption.
Supplier and distributor education can come in many forms, and will be dependent upon the risks and costs involved. Face-to-face interaction, with an opportunity for supplier or distributor personnel to ask questions and provide feedback, generally is preferable, but in-person training may not be cost effective or practical in many cases. Web-based courses are a valuable alternative. Leaflets and handouts may be appropriate in many cases. The important point is to increase understanding about the consequences of corruption.

To achieve efficiency when dealing with many suppliers and distributors who may need such training, and to help level the playing field, companies may consider bringing key personnel from multiple suppliers or distributors together for joint education sessions. Ultimately, suppliers and distributors should run their own education programs for their employees.

DEALING WITH OBJECTIONS
Companies can expect a variety of responses from suppliers and distributors when confronted with expectations concerning control measures and education.

Some may see these efforts as too costly. This should be the easiest objection to deal with, given the cost of non-compliance in this area. This does not mean, however, that any cost imposed on a supplier or distributor to prevent corruption is reasonable. Companies must understand the true risks of corruption in each situation in considering the costs to impose on suppliers and distributors, and themselves.

Some suppliers and distributors may claim that such efforts are unnecessary, or even offensive, as they consider themselves to be above reproach. In some cases there will be some merit to these objections, as with large sophisticated suppliers, and fewer controls will be necessary. In other cases, the customer or manufacturer will have to explain that these efforts are not meant as an insult, that they are in place with other suppliers and distributors and, like any contractual provision, are intended for the protection of the parties. It may be helpful in these situations to explain the relevant legal and other risks applicable to the customer or manufacturer, so that the supplier or distributor is better able to appreciate the company’s position. Companies also must be sensitive to cultural differences, but still must establish baseline standards consistent with law and the company’s own values.

Many who provide goods and services to multiple large customers, or who act as distributors for many manufacturers, will have genuine difficulty with multiple standards and practices that may be inconsistent or, at a minimum, disruptive and redundant. They may object to having to sign on to several standards of conduct. They may be asked to attend training from multiple customers or manufacturers, or may face audits and other monitoring activities from many companies. These are legitimate concerns to which companies must be sensitive and willing to engage. Efficiencies can be achieved, for example, if companies are willing to accept training or auditing conducted by other customers or manufacturers, and if there is a standard code of conduct to which all customers and manufacturers agree. The path to this efficiency is collective action, particularly industry-specific and regional anti-corruption organizations. See the sidebar on the Value of Collective Action.
Supplier and distributor requests to modify, or be excused from, contractual terms and codes of conduct are among the most difficult decisions a company will face. There is great value to standard contract language for all suppliers and distributors, and it is generally inadvisable to negotiate over issues like corruption with each supplier or distributor. In addition, objection to anti-corruption contractual provisions may be a red flag that the supplier or distributor is a high risk for corruption. Nonetheless, many suppliers and distributors will have their own codes, and it may be possible to allow their language to stand in for the customer’s or manufacturer’s if the company otherwise can be sufficiently confident about the supplier or distributor.

In general, the extent to which a company can accede to supplier or distributor demands to relax anti-corruption controls will depend on the outcome of the risk assessment described earlier. Large, sophisticated suppliers and distributors may be treated differently than small local businesses, particularly in high-risk countries. Where there are greater risks for corruption, either because of the nature of the business, the reputation of the supplier or distributor or the geographic location, it will be necessary to address objections more forcefully and insist on full compliance with the company’s program.

Synergy: Integrating Corruption Controls with Existing Supply Chain and Distribution Controls

MNCs typically are quite sophisticated about supply chain and distribution management. This includes complex systems and programs for supplier and distributor selection, cost control/oversight, logistics management, inventory control, sales management and quality assurance. Many MNCs also have robust programs for dealing with human rights, labor and environmental issues among suppliers (though few extend these programs to distributors). And in many companies there are efforts to prevent corruption in the supply chain and among distributors, though these programs often are inadequate in light of the risks.

Unfortunately, in most organizations these supply and distribution management efforts are poorly coordinated. Rather, separate groups within the organizations, with little connection to one another, manage what should be a unified and integrated endeavor. Thus, Procurement typically deals with sourcing and vendor selection, and may handle contract management. Quality Assurance generally is a separate department. And so is Distribution or Sales Management. “Social compliance,” involving human rights and labor issues may reside in Human Resources, Legal, Communications or External Affairs. Environmental compliance usually will be handled elsewhere. And corruption prevention, or various aspects of the risk, may belong to Legal, Audit or a separate Ethics & Compliance function.

This siloing leads to inefficiency, loss of critical information and, ultimately, inferior supplier and distributor performance and cost to the business. Coordinated supply chain and distribution management efforts, by contrast, can provide a clearer and more comprehensive understanding of the strengths and weaknesses of the supply chain and of distributors. Assessing suppliers and distributors outside of (or across) silos enables the organization
readily to identify those who, while excelling in particular areas, are failing to meet minimum standards across other monitored capabilities. Information sharing across the organization will ensure that each supplier and distributor is most efficiently managed for compliance against all applicable standards. MNCs that free themselves from the siloed management framework will realize the synergies of cost savings and improved supply chain and distributor performance as a result. In most organizations, efficiencies can be achieved in several aspects of supply chain and distribution management, including, for example, common risk assessment processes, common information systems, and the increasing use of automation.

Ensuring supply chain and distribution integrity is a commitment both cross-functional and cross-geography; integrity should be monitored through all aspects of a company’s supply chain and distributor relationship. In a typical MNC, supply chain professionals engage in evaluation and control at each stage of the supply chain process from initial sourcing through post-performance supplier evaluation, but often do not attend to the corruption risk inherent at various mileposts. Those who manage distributor relationships are generally laser-focused on maximizing sales and market share and understand the importance of reputation and brand image, but infrequently attend to corruption.

Corruption risks, including kickbacks and other forms of fraud, as well as bribery and other forms of government-related corruption, are particularly great:

- when companies are evaluating suppliers and distributors;
- when creating and managing contracts; and
- when evaluating contract and sales performance.

Suppliers will face heightened temptation and pressure to act corruptly:

- when responding to a tender;
- when sourcing materials; and
- in production.

Distributors will confront similar temptations:

- during initial contract formation:
- during the sales process; and
- in reporting sales.

A commitment to ensure the ethical practices of the supply chain and among distributors requires an enterprise wide effort to root out corruption at each of these stages.

Ultimately, companies need to see supply chain and distributor management as a unified whole, with a common set of policies and practices that include corruption prevention as well as the more traditional elements of cost control, quality monitoring, and logistics management.
Conclusion

The fight against corruption raises many thorny issues, particularly as it extends beyond the firm to its business partners. Establishing and maintaining effective and productive business relationships is difficult enough without adding elements of anti-corruption control and monitoring. Many suppliers and distributors may not fully understand the corruption risks, or believe that they cannot do much about them, or they may feel that, because of their leverage in the relationship or the environment in which they operate, they simply don’t have to. But the cost of not making the effort is extraordinarily high, both to the firms themselves and to the societies of which they are a part. Customers and suppliers, manufacturers and distributors, must engage on these issues, working together to build trust and a common understanding of the risks that everyone faces in the chain from initial sourcing to final sales.

* LRN is indebted to the United Nations Global Compact. Much of the content of this white paper derives from work Mark Snyderman, Senior Knowledge Leader at LRN, did with the UNGC as a Senior Advisor on Anti-Corruption. The UNGC will publish an expanded guide to fighting supply chain corruption in June 2010.

About LRN: Inspiring Principled Performance

Since 1994, LRN has helped 10 million people in over 400 companies worldwide simultaneously navigate complex legal and regulatory environments and foster ethical cultures. LRN’s combination of practical tools, education, and strategic advice helps companies translate their values into concrete corporate practices and leadership behaviors that create sustainable competitive advantage. In partnership with LRN, companies need not choose between living principles and maximizing profits, or between enhancing reputation and growing revenue: both are a product of principled performance. LRN is the trusted partner to leading businesses including Procter & Gamble, Apple, Pfizer, Johnson & Johnson, Viacom, DuPont, Rolls-Royce, 3M and The Dow Chemical Company. We help our partners engage their employees in over 100 countries, and have offices in Los Angeles, New York, London and Mumbai. For more information, visit www.lrn.com, follow @LRNinc on Twitter, or call: 800-529-6366 North America +1-310-209-5400 Global