



DIAMOND IN THE ROUGH

Maximizing Synergies of Global
Governance and Investigation

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CLIENT PROFILE

ABOUT THE CLIENT

- ▶ Private company
- ▶ Chemical manufacturer
- ▶ Annual sales of more than \$100M
- ▶ Manufacturing facilities in multiple international locations
- ▶ Competitive advantage: Superior product performance



SITUATION

DRIVERS FOR THE PROJECT

Concerns from the board, ownership and corporate management about the health and condition of the China business



Board's recent notification of significant mislabeling problems

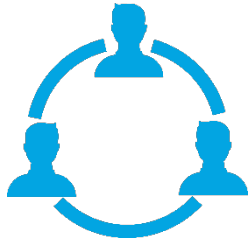
ELABORATING ON THE CLIENT'S CONCERNS



- ▶ Declining profits
- ▶ Questions about quality of the products
- ▶ Suspected process failures
- ▶ Lack of effective oversight by U.S. management team

ADDRESSING THE SITUATION

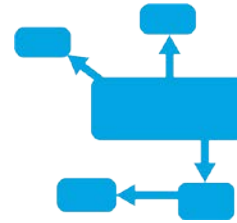
APPROACH



Formed a cross-functional team from RAS/Assurance/Global Forensics



Held interactive planning sessions with Board members



Developed a flexible work plan



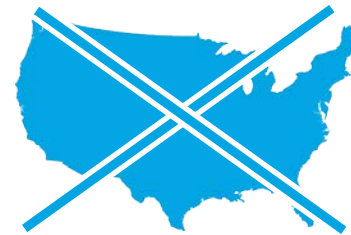
Integrated client personnel who also happens to be an owner



Collaborated with BDO China



8 team members onsite in Shanghai for 3 weeks



Significant complication: No access to the U.S. management team

SCOPE AREAS

Comprehensive assessment of the main business processes, including:

- ▶ Strategy, policy deployment and controls
- ▶ Technical services
- ▶ Sales
- ▶ New product development
- ▶ Operations
- ▶ Health, safety & environmental
- ▶ Quality



KEY ISSUE: MISLABELING OF DRUMS

WHAT IS MISLABELING?

Alternate label put on drum

Actual formula used in drum

Ship To Product Cross-reference

Customer	CDGJMVJK01
Ship To	CDGJMVJK01
Product	A
Ship To Part Number	A-1

Send Electronically

Details | QC Specification

EXAMPLE OF HOW MISLABELING AFFECTS GROSS MARGIN

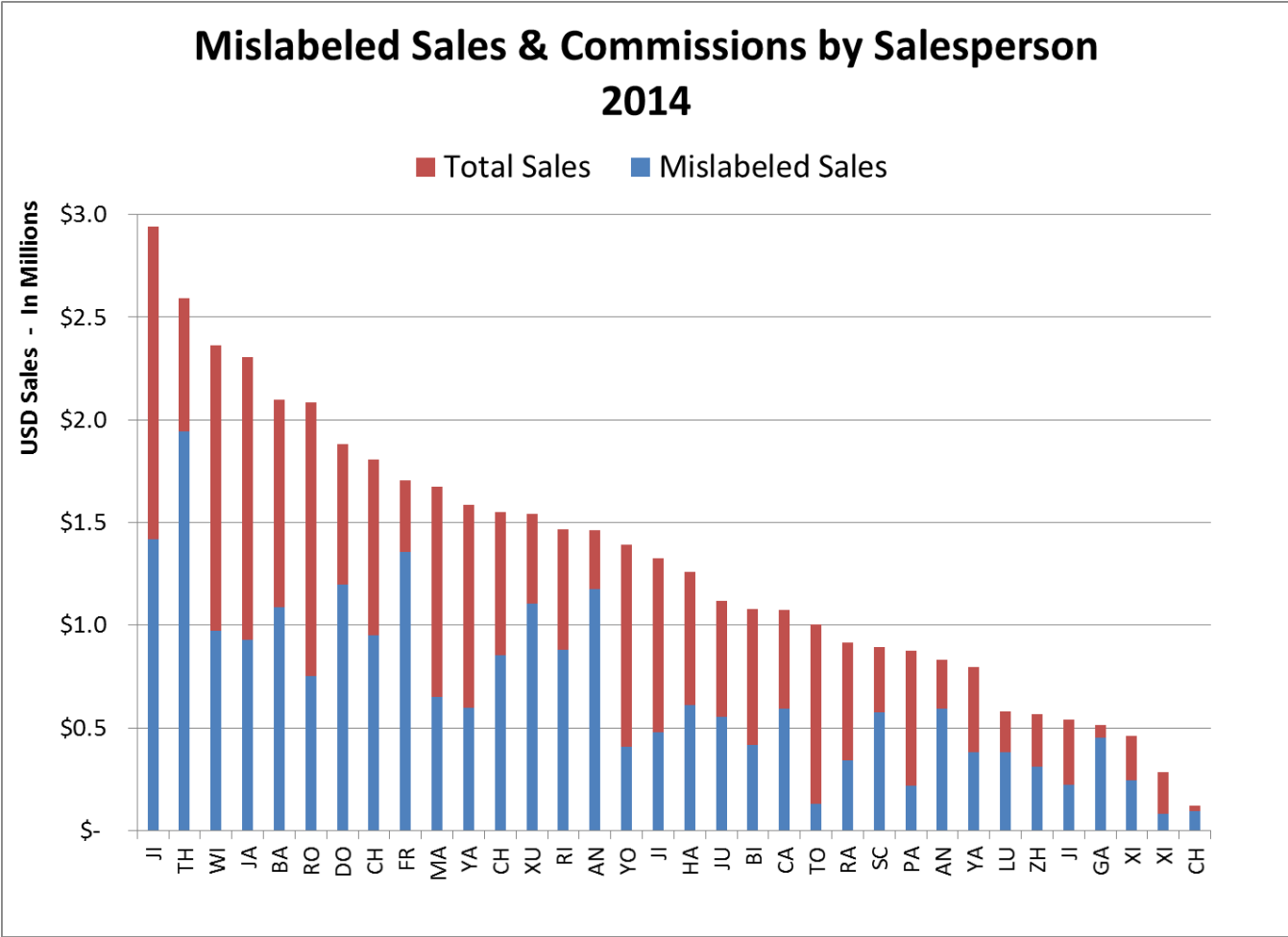


2014

Avg Sales Price/Drum	\$896	
Avg Cost/Drum	\$401	\$483
Avg Margin/Drum	\$495 55%	\$413 46%

Difference in Margin	\$82
Drums Sold in 2014	721
Additional Margin from Mislabeling	<u>\$59,122</u>

WHY MISLABEL?



Mislabeling has ended...



but was it executed the way
that the Board expected?

MISLABELING: CONCERNS WITH MANAGEMENT'S RESPONSE

- ▶ The organization decided in February/March 2015 to end mislabeling by April 1, 2015

- ▶ The response by management was alarming:
 - Unrealistic deadline for change - April 1
 - Letter sent to customers was misleading
 - The decision making process did not appear to produce a well-designed execution plan
 - Lacked robust analysis to understand and manage risk in the following areas:
 - Potential financial impact (i.e., lost sales, reduced gross margin, employee attrition, etc.)
 - Legal risks (i.e., compliance with laws, contracts, etc.)
 - Potential reputational damage

KEY ISSUE: SALES

ALARMING COMMENTS FROM SALESMEN

"I'm responsible for fixing customer complaints"

"30% of my customers have issues with the product"

"Big issue is skin rash for factory workers"

"We pay workers so they won't tell their boss about issues"

"I pay for medicine or take workers to hospital"

"Client may stop using our product if they know about issues"

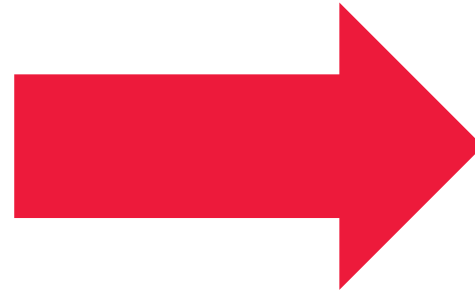
"My payments to workers are around \$5,000 a year"

"Competitor has quality product and commands a higher price"

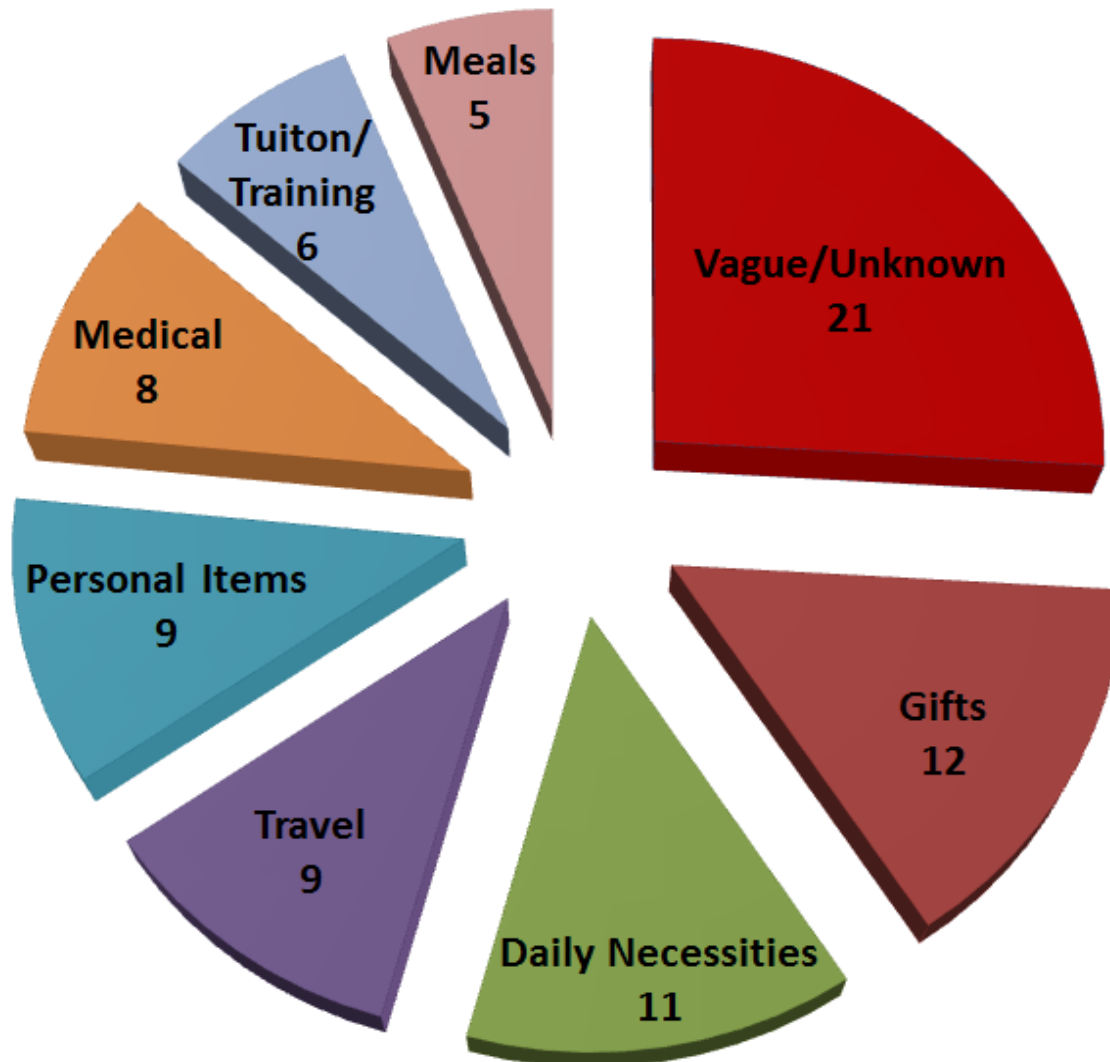
"For a little machine rust, I solve with additives"

"When rust is serious, I change product"

POOR QUALITY COSTS MONEY



SAMPLE TESTING OF EXPENSE REIMBURSEMENTS



SIGNIFICANT CORRUPTION RISK



Questionable support for expense reimbursements



Salesman dealing with state-owned customers



ADDITIONAL CONCERNS EMERGE

Interviews and transactional testing also identified other areas to explore:

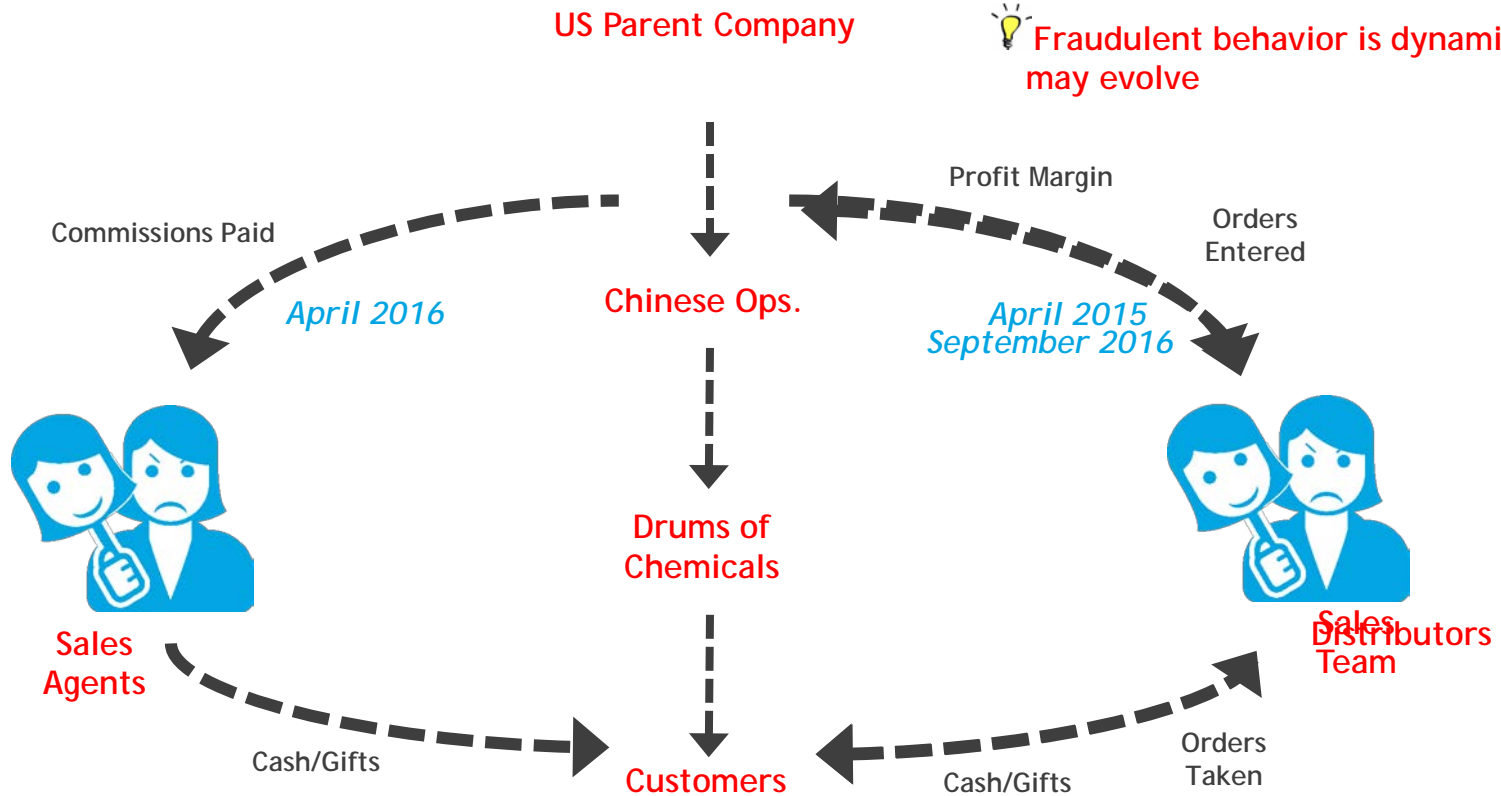
- ▶ Use of sales agents
- ▶ Use of distributors
- ▶ Purchases from customers

WARNING

RECAP OF SALES ISSUES

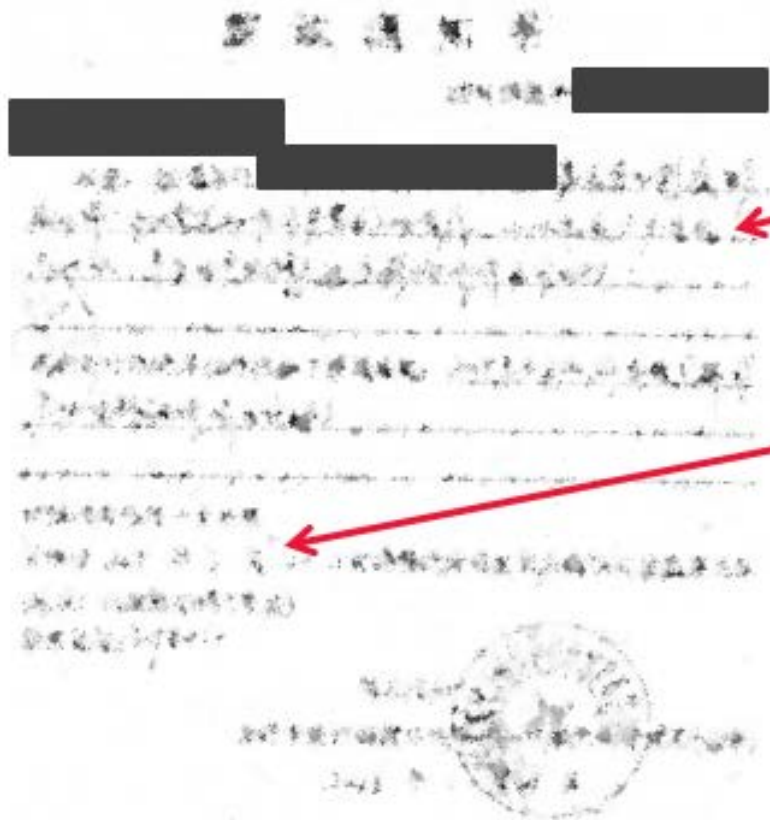
Lessons Learned

- 💡 Periodic site visits are critical
- 💡 The right data analytics are key
- 💡 Fraudulent behavior is dynamic and may evolve



KEY ISSUE: SHANGHAI ENVIRONMENTAL WASTE PERMIT

ENVIRONMENTAL WASTE NOTICE



Output far exceeds authorized amount

Response required within 60 days

UNDERSTANDING WHY THIS MATTERS

What is the potential impact? (as of April 15, 2015)

Plant forced to shut down near term

Impacts current and future value of the company

Impairment of assets (i.e. plant)

Reputation risk

Plant forced to shut down longer term (i.e. wind down to R&D facility within 2-3 years)

Alternatives for production in Shanghai (i.e. shift to another facility, build another plant in Shanghai)

SUMMARY OF FINDINGS

PRESENTATION TO THE BOARD

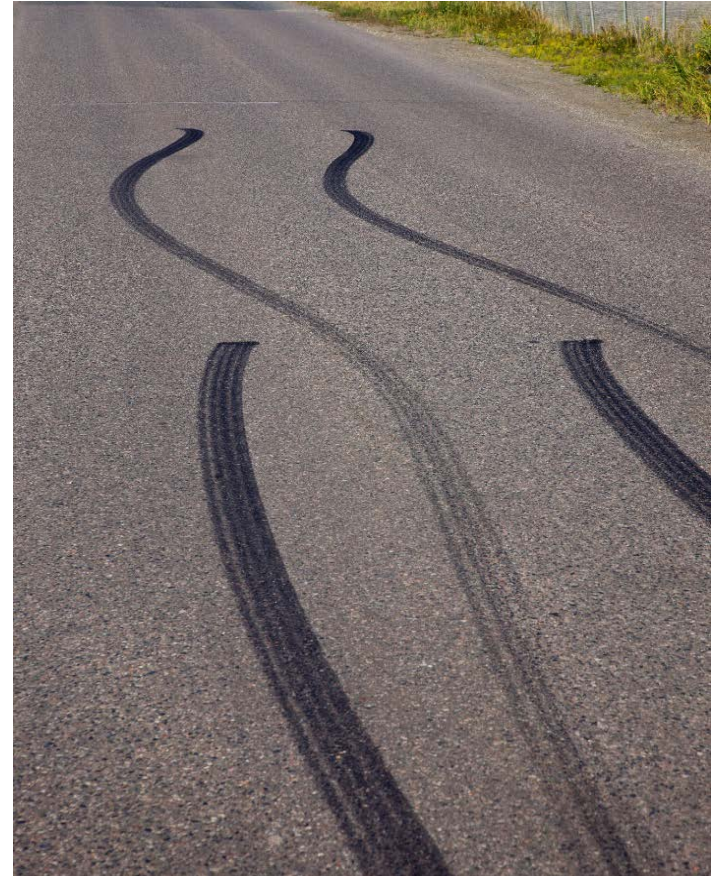
- ▶ 4 hour BDO presentation to the Board and U.S. management team
- ▶ Owners were appalled by the unethical behaviors, which was a key driver for the changes to come
- ▶ The defensiveness of U.S. management was overcome by the facts and data used to support our findings
- ▶ Resulted in follow up visits at the request of the Board - 12 months and 18 months after the first visit



CLIENT RESPONSE

THE FALLOUT

- ▶ CEO and CFO resign within 9 months of BDO report
- ▶ Significant customer loss
- ▶ Significant increase in cost to closely monitor China operations



INVESTMENTS IN CHINA

- ▶ Expats in key positions
- ▶ Hiring of key leaders in China
- ▶ Consultant hired to revamp sales process
- ▶ Office updates (fixing disrepair, painting, etc.)
- ▶ Emphasis on improving employee morale (lucky draw, meals, offsite gatherings, etc.)
- ▶ Follow up assessments by BDO



IMPACT OF INVESTMENTS IN CHINA

CHANGING CULTURE



Enhance business operating systems and communications channels



Core management team additions - Great people are for great business



Expat commitment & engagement



Enhancement of basic skills - Learning university program



Create great place to work - Broken windows theory



New expense policy - \$1M SG&A savings vs. AOP in Q1

DRIVING BUSINESS



Revitalize sales team to protect & grow



Eliminate product mislabeling



Product localization process



Global technical service process



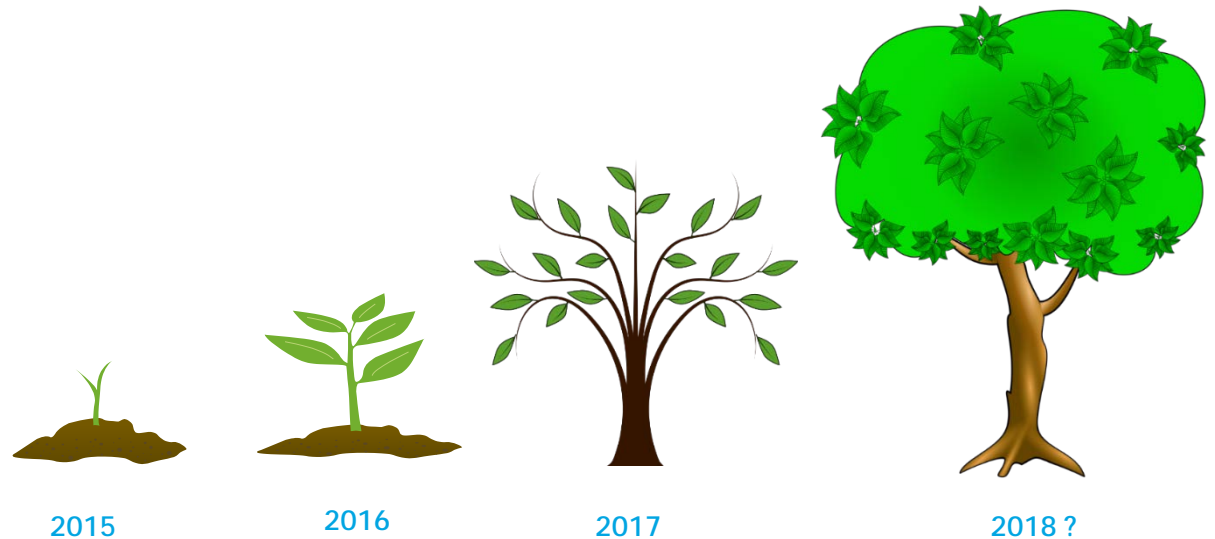
Global quality & manufacturing

KEY TAKEAWAYS

GAINING TRACTION ON CULTURE CHANGE



Culture change is
NOT like a
lightning strike



Culture change is more like planting a seed and nurturing it and watching it grow.

Time is measured in years before you get a fully functional, aligned culture.

UNDERSTANDING CULTURAL DIFFERENCES IS PARAMOUNT

Top Featured Differences



1. Boss



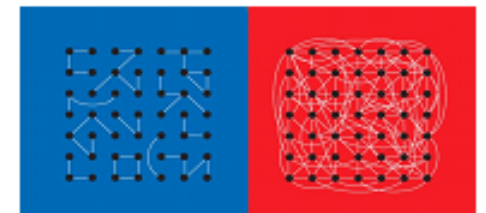
2. Punctuality



3. Way to Solve Problems



4. Way to Think



5. Connections

CHALLENGES & SOLUTIONS



Eliminate Learn/Forget Cycle – make change sticky



Drive and Manage Change via Corrective Action



Heart Transformation – people doing the right things for the right reasons



Structuring Very High Standard Internal and External Audits



Develop & Conduct Periodic & On-going Verifications



Instill within all employees on a daily basis the Organizational Vision

ADDITIONAL POINTS TO REMEMBER

- ▶ Local culture, talent and language fluency are critical
- ▶ Establish meaningful feed-back loops and key performance indicators for each process area
- ▶ Periodic in-person reviews are necessary
- ▶ Don't ignore the initial signs of trouble
- ▶ Dig deeper to connect the dots



Q & A



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TEAM BIOGRAPHIES



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EXPERIENCE SUMMARY

Dawn has over 15 years of internal audit, vendor construction audit and SOX compliance and other consulting experience. Prior to joining BDO, Dawn was at UHY Advisors TX, LLC for 11 years and before that, she was with PricewaterhouseCoopers. Dawn has managed a significant number of vendor and construction audits, and outsourced and co-sourced internal audit functions. She has also assisted newly public companies successfully achieve year one SOX compliance.

Dawn has managed large scale internal audit, internal controls, consulting and SOX engagements, with teams ranging in size from 3 to 15 resources. She has assisted clients with design and implementation of their internal controls framework, and led the team that developed the Risk Advisory COSO 2013 methodology. Dawn assists clients with the development of their internal audit department and serves as the Chief Audit Executive for her outsourced Internal Audit clients.

Dawn has managed a vendor construction audits for large energy companies. She has identified millions of dollars in cost recoveries for her clients, identified major control weaknesses, investigated allegations of fraud, and recommended and implemented appropriate action plans to strengthen internal controls.

PROFESSIONAL AFFILIATIONS

Certified Internal Auditor - CIA
Certification in Risk Management Assurance - CRMA
Institute of Internal Auditors
Association of Certified Fraud Examiners



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EXPERIENCE SUMMARY

Jesse Daves is a Managing Director in BDO Consulting's Global Forensics practice with over 20 years of experience providing audit, forensic accounting and investigative services to clients across a wide range of industries including, energy, retail, real estate and manufacturing.

Mr. Daves has conducted fraud-related investigations involving numerous issues, including alleged violations of the Foreign Corrupt Practices Act (FCPA), embezzlement, kickbacks, Ponzi schemes, conflicts of interest and diversion of assets.

He has worked directly with all levels of management, general and outside counsel as well as the Harris County District Attorney's Office, the United States Attorney's Office, the Federal Bureau of Investigation and the Securities and Exchange Commission. Mr. Daves has testified as an expert witness and has also assisted legal counsel before and during trials by planning and strategizing how to examine witnesses and present evidence.

PROFESSIONAL AFFILIATIONS

CPA licensed in the State of Texas
Certified in Financial Forensics
Certified Fraud Examiner
American Institute of Certified Public Accountants
Associate of Certified Fraud Examiners