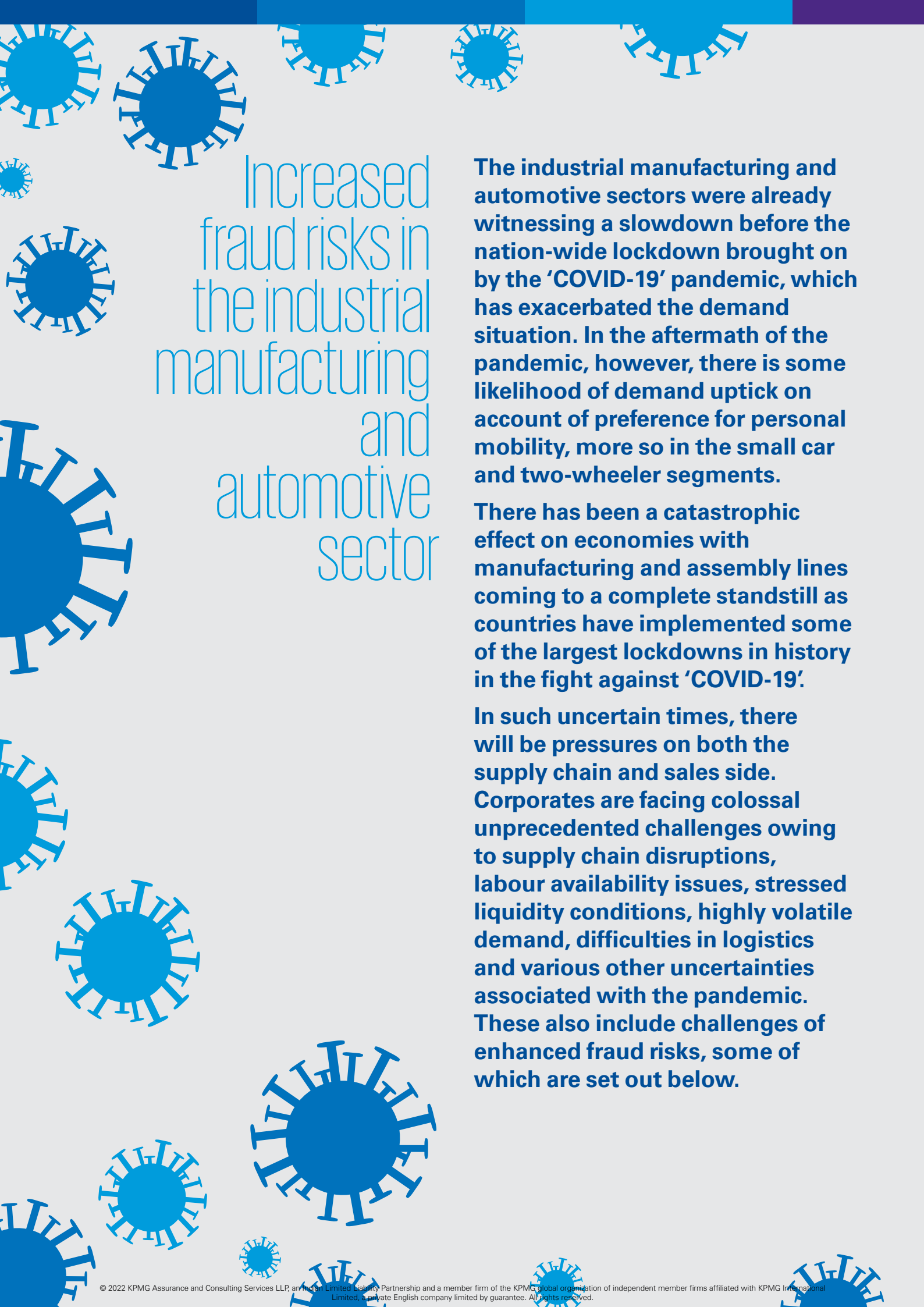




COVID-19: Increased fraud risks in the industrial manufacturing and automotive sector

home.kpmg/in/COVID-19





Increased fraud risks in the industrial manufacturing and automotive sector

The industrial manufacturing and automotive sectors were already witnessing a slowdown before the nation-wide lockdown brought on by the 'COVID-19' pandemic, which has exacerbated the demand situation. In the aftermath of the pandemic, however, there is some likelihood of demand uptick on account of preference for personal mobility, more so in the small car and two-wheeler segments.

There has been a catastrophic effect on economies with manufacturing and assembly lines coming to a complete standstill as countries have implemented some of the largest lockdowns in history in the fight against 'COVID-19'.

In such uncertain times, there will be pressures on both the supply chain and sales side. Corporates are facing colossal unprecedented challenges owing to supply chain disruptions, labour availability issues, stressed liquidity conditions, highly volatile demand, difficulties in logistics and various other uncertainties associated with the pandemic. These also include challenges of enhanced fraud risks, some of which are set out below.

Areas impacted by COVID-19 and of potentially enhanced frauds risks

1

Cyber fraud-related risks

Due to the adoption of work from home for business continuity, the dependence on technology is more than ever before. Remote access to corporate servers, new devices being allowed to connect, digitalisation and use of new applications/tools are amongst some of the reasons for enhanced risk of cyber fraud. Existing controls may not be adequate for prevention and response to cyber-fraud threats from both insiders and others and organisations can get caught off-guard. Following are some examples.

a. Phishing scams

Impostors claim to be customers/senior officials/dealers/suppliers and target victims with disguised emails, including malicious attachments and links. Such attachment/links, if accessed by the recipient, may infect the computer/phone device with malware, which can result in stealing of funds, identity theft, unauthorised purchases and transmission of the data to the hacker

b. Ransomware attacks

Ransomware is a type of software designed to compromise and encrypt a victim's computer. The files become inaccessible until a ransom is paid to the attacker. As remote access becomes a norm for work from home, a spike in ransomware attacks is expected globally

c. Other malware, business email compromise and mobile application scams

Once accessed or installed these genuine looking emails/applications infects the user's device

d. Data leakage and data-privacy

Issues increasing the risk of exposing confidential and sensitive information that may result in reputational and financial loss to the corporates.



2

Asset misappropriation risks

There are enhanced risks of asset misappropriation as the sense of insecurity regarding the possibility of lay-offs or pay cuts set in. Such frauds can particularly occur in the following areas.

a. Occupational frauds

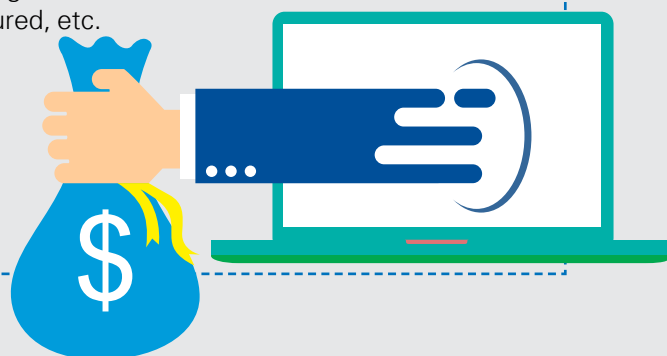
Occupational frauds include larceny, theft/misuse of confidential data, collusion with third parties, over-payment, etc. Such frauds can especially happen in the business functions tasked with invoice approvals and processing, payroll, administration, sub-contract management and scrap disposal

b. Unauthorised transactions and alterations in the accounting system

Unauthorised alterations may be made to the master databases in accounting systems in order to make fictitious payments and to siphon off funds

c. Misappropriation of charity funds

In times of crises, large corporations have set up charities to help reduce the impact on communities and the poor. Fraudsters can misappropriate these funds using various modus operandi such as donations to non-existent charities, investing/donating for COVID-19 related products/services not actually getting manufactured/procured, etc.



3

Fraud risks in procurement and supply chain

The strain and disruption in the supply chain across geographies have created the need to identify alternative procurement channels/business partners as domestic and/or international component manufacturers, sub-contractors and other third parties get impacted. This coupled with the shifting goal posts of restrictions due to change in the red, amber/orange and green zones enhance the possibility of the following risks, which, in turn, create reputation/financial/quality risks for companies.

a. Inadequate screening and due diligence

Before onboarding of third parties, the involvement of which in illegal activities might go unidentified

b. Quality checks

Ineffective or subdued effort around buying price discovery and quality checks due to lack of available supply options

c. Collusion between vendors and employees

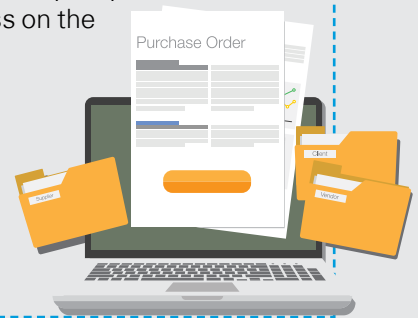
Collusion between vendors and employees and urgency of requirement could potentially lead to supply of substandard material/services by vendors/third parties at higher prices

d. Impact on subcontractors

Financial/operational impact on subcontractors may lead to situations wherein they may cut corners and try to pass on the loss to manufacturers

e. Inferior/counterfeit products

Causes product discrepancies, further impacting future warranty claims.



4

Sales channel-related fraud risks

Misrepresentation by sales channels or dealer misconduct, with or without employee collusion in the process of ensuring work security and dealership existence.

a. Channel partner misconduct

Given the uncertainty about the ability to meet sales targets, storefront compliance, staffing requirements, meeting delivery timelines and loss of promotional material, the risk of misreporting, creation of fictitious customers, inflating sales, etc. exists. For instance, backdating or predating of vehicle sales. Such fraudulent activities may result in the wrongful claim of concessions or sales-related incentives measured against preset sales targets

b. Fraudulent warranty claims

The shutdown across market areas has caused

extension of near-term warranty expiries by most of the major automobile and industrial manufacturers. As dealers' service departments contribute the most to their bottom line due to high margins on repair work, they may submit false warranty claims

c. Deep discounts

Dealers may engage in providing deeper discounts in order to meet sales targets and claim various promotional/sales performance benefits from manufacturers. Discount leakage and the likelihood of these not reaching the end customer by an array of fraud schemes, including dealer collusion, non-reporting of exchange discounts etc. are some of the key fraud risks in this area.



5

Contractual obligations and disputes

a. Contractual obligations

The economic slowdown and the resultant drop in operations and sales is causing severe financial concerns, resulting in increase in non-compliance with various contractual obligations among dealers, customers, manufacturers, vendors and other stakeholders

b. Disputes

The ambiguity between the doctrine of frustration and force majeure is likely to result in legal disputes between manufacturers and parties to the contract because of failure in honouring contractual

obligations, including delivery, timely payment and uncontrollable delays resulting from the current situation

c. Intellectual property (IP) infringement risks faced by original equipment manufacturers (OEMs)

There is increased risk of the supply of inferior/counterfeit products, thereby causing possibility of IP infringement issues, such as theft of trade secrets, patent right breaches and duplication of manufacturing technologies, for OEMs.





6

Financial risks

Businesses in the industrial manufacturing and automotive sector are increasingly facing a severe liquidity crunch, which is consequentially impacting their working capital requirements.

a. Distress on loan repayments

The economic slowdown is bound to cause distress on loan repayments and manufacturers with an in-house financing (NBFC) arm are likely to face fraud risks in collections such as misappropriation, ever-greening, non-compliance to regulatory requirements, etc

b. M&A activities and due diligence

While the focus turns to survival, manufacturers, their suppliers/dealers/component manufacturers are likely to engage in different M&A activities like backward integration, consolidation, etc. This may have a negative impact in the absence of adequate due-diligence procedures

c. Window dressing

With companies facing increasing challenges of working capital requirements, the risk of window dressing of financial statements to obtain funds from financial institutions increases

d. Employ higher levels of scrutiny

With increasing focus on personal hygiene and health, shared mobility is likely to take a backseat and there is a possibility that consumers may return their focus to personal mobility. This might lead to increased demand for vehicle financing, considering the liquidity crunch. Given the increased risk of repayment defaults, the focus for financing arms should be to employ higher levels of scrutiny to mitigate such risks.



7

Non-Compliance with laws and regulations

a. Challenges in implementation of Bharat Stage (BS) VI norms

Before the lockdown, automobile manufacturers were gearing up for the production and sale of BS VI compliant vehicles from 1 April 2020 as per the mandate of the Government of India. Following the current lockdown, manufacturers are in an uncertain position as the Supreme Court announced an extended period of 10 days for the sale of BS IV compliant inventory from the day lockdown ends (except in the NCR), thereby necessitating carrying the huge value of unsold/unfinished inventory. While this is beneficial, the manufacturers and dealers need to keep track of such unsold BS IV inventory, to prevent and mitigate the enhanced risk of theft and/or misappropriation given the COVID-19 situation

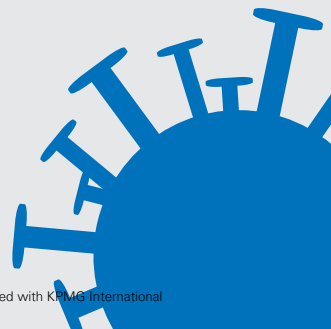
Additionally, there is a risk of such non-compliant vehicles flooding into the market through predated sales and misreported deliveries thereby increasing the risk of reputational damage to OEMs

b. Increased touchpoints and dealings with government officials

In cases, where irregular payments are being made and/or products provided free of cost by third parties to statutory authorities to ensure smooth clearance and transition of goods or obtaining various permits/licenses during the lockdown period. Such instances could lead to potential violation of the applicable anti-bribery and corruption laws and regulations

c. Prevention of sexual harassment (PoSH) complaints

Enhanced risk of sexual harassment due to blurry definition of the workplace and staff not trained/aware of the related sensitivities. Furthermore, committee members may not be aware of how to efficiently conduct investigation with remote access to information and employees.

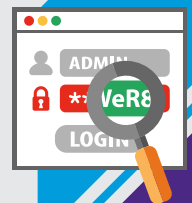


How can KPMG in India help?

Cyber investigation - assist in responding to cyber threats effectively and efficiently with our bouquet of services ranging from rapid cyber incident response, containment of threats, monitoring to training and capacity building and taking measures to mitigate such incidents in the future.



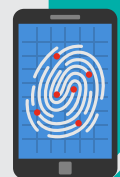
Investigation and assessment of impact - capabilities to investigate fraud and misconduct by remotely obtaining the required information and engage sector specialists. A specific focus to help organisations take timely corrective measures, thereby preventing financial and reputational loss.



Forensic review of the charity, donation and CSR expenditure - assist in proactive and reactive reviews of third parties, payments and utilisation of expenditure on charities, donations and expenditure under CSR.



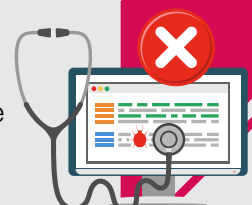
Control assessment and fraud risk management - existing controls and preventive and monitoring frameworks are likely to fall short of the changing requirements as the avenues for fraud and unethical activities increase. The idea of a fraud risk assessment is to conduct a thorough analysis into the effectiveness and completeness of the existing control framework and assist organisations in making them rigorous and resilient to the challenges of the changing environment.



Protective data analytics - provide proactive data analytics in high risk areas like unsold BS IV inventory, procurement analytics, analytics on payments, CSR expenditure, sales and distribution and warranty claims to identify the red flags of wrongdoing for a detailed review. 'KPMG in India' can develop customised offerings with the required inhouse tools and technology.



Contract compliance and dispute advisory services - assist in the resolution of commercial and contract disputes. We can support the office of general counsel by dissecting complex issues and providing compelling arguments on the financial, commercial, valuation and accounting aspects of disputes.



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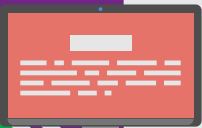
Third party risk assessment and counterparty due diligence - to check/validate the information provided by third parties. Given the current need of venturing into alternate supply chains and M&A activities, it is critical for businesses to shield themselves from the association to undesirable external parties by conducting proper due diligence.

8



Physical security assessment - assist organisations with an assessment of the existing safety and security infrastructure, keeping in mind the recent changes in the health and safety scenario; devising a return-to-business strategy and complying with the fast-evolving government rules and regulations while keeping in mind the safety of the workplace.

9



E-learning training and awareness - help provide trainings and awareness sessions on various regulatory compliances like anti-bribery and corruption regulations, PoSH and other areas, including risks and prevention of cyberattacks, fraud prevention and detection, reinforcement of zero tolerance to fraud and non-compliance.

10



Loan staff/forensic managed operations - all the above services can also be availed of by having KPMG in India professionals work as intrinsic members in your teams.

11



Intellectual property advisory - market intelligence support to track counterfeit products in the marketplace. Furthermore, our range of services include IP conflict check during M&As, IP policy and contracts review, damage assessment by expert witnesses and IP infringement conduct validation and analysis.

12



COVID-19 helpline - attend and respond to SOS calls, manage employee queries through toll-free phone numbers and email by referring to pre-agreed FAQs. Track the resolution process for queries outside the FAQs within defined timelines and coordinating with officials responsible to address such queries and assist in creating awareness through emails. Provide a dashboard and status update at a defined frequency on queries received.

KPMG in India contacts

Vijay Chawla**Partner and Head**

Risk Advisory

T: +91 80 6833 5509**E:** vschawla@kpmg.com**Jagvinder S. Brar****Partner and Head**

Forensic Services

T: +91 124 336 9469**E:** jsbrar@kpmg.com**Manoj Khanna****Partner**

Forensic Services

T: +91 80 6833 5519**E:** manojkhanna@kpmg.com**Sidhartha Gautam****Partner**

Forensic Services

T: +91 98991 83331**E:** sidhartha@kpmg.com**Deepti Singal****Director**

Forensic Services

T: +91 124 2549 191**Abhijit Agarwal**

Director

Forensic Services

T: +91 98209 03735**E:** abhijitpagarwal@kpmg.com**home.kpmg/in****Follow us on:****home.kpmg/in/socialmedia**

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KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000.

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