

Case Study

IP, Factory Monitoring, and Supply Chain Control

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Factory audits are well and good, but covert monitoring and other complimentary tools can help uncover hidden costs.

Anyone who has bought a pair of sneakers in the past 20 years knows that most of the world's athletic shoes are produced in China. And if China is the capital of shoe production, then Fujian Province in the South is the global epicenter.

Alongside the incredibly high concentration of authorized factories and suppliers, a wide array of businesses pump out knock-offs of major brands, ranging from cheap imitations to near-identical copies.

There are also a number of businesses that operate in the gray area between licensed production and counterfeiting.

In late 2007, CBI discovered a factory in South China making what seemed to be high-quality copies of our clients' athletic shoes. This, in and of itself, is not an unusual incident by any means. Our client is a large sportswear manufacturer and brand owner. Their trademarks are not as widely counterfeited as, say, the world-famous Swoosh, but they are counterfeited nonetheless.

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Our client confirmed that this factory was not a licensed supplier. CBI received authorization from our client to conduct a raid on the shoe factory and ensure that the relevant government authorities seize and destroy the counterfeit shoes.

During the raid, the factory owner presented TSB officials (Quality and Technical Supervision Bureau) with a signed Power of Attorney from our

client's Korean subsidiary, stipulating that the Chinese factory was a *licensed* subcontractor. The shoes being produced at the Chinese factory even utilized our client's authentic security labels! There was, in fact, no physical difference between these shoes and the genuine product, except that this factory was not really authorized to produce them, in spite of the PoA from the Korean licensee.

In reality, the Korean subsidiary was *never* authorized to subcontract to Chinese manufacturers, but that did not prevent them from doing so. Furthermore, the Korean subsidiary's contract with our client had expired months earlier, further rendering their PoA obsolete.

As far as the Chinese factory owner was concerned, he had no idea his production was unauthorized. He had stacks of documents written in Korean licensing his factory. But not one of those documents was valid according to the brand owner, our client.

Now, you may be reading this and thinking, “My company has third party auditors. I make trips to Shanghai every 6 months. My managers speak Chinese. This can’t happen to us.”

Think again.

Of course, our client has factory auditing procedures set up and trusted Asian managers in place. But these procedures are not perfect. There are many great, trustworthy suppliers in China. They are, in fact, the majority. This particular supplier in Fujian was not intentionally breaching contract—the factory owner was being misled. The Korean subsidiary wanted to cut costs, so it moved manufacturing to China. Factory auditors and managers in Korea never knew that the Korean subsidiary was subcontracting to China, regardless of express contractual terms against such activity. Some of the Chinese shoes were being sold directly to wholesalers, the rest were going to the Korean subsidiary. *The brand owner never saw the profit and sales were unaccounted for.*

Full Spectrum Supply Chain Monitoring

In spite of best practices, products made at an Asian supplier may end up on the gray market. Your supplier may run a “third shift” and produce “extra” products to sell out the backdoor; they may continue producing after their license expires; they may subcontract way down the line without your knowledge.

With apparel and sporting goods, this means a loss of revenue and a lack of control. It also might mean that your genuine products are on the market, competing with cheaper versions of....your genuine products.

In other industries, these sorts of supply chain failures have more extreme consequences. In the past several years, the American media has been filled with news items about inert or deadly medication, lead paint in toys, and so on. Such stories should serve as warning that supply chain oversight can never be taken for granted.

It is absolutely critical to generate real-time intelligence about your suppliers and subcontractors. In the case of sensitive industries such as pharmaceuticals, health and beauty, and food and beverage, it is vital to know where raw materials are coming from. If the key ingredient for your blockbuster drug is coming from family-owned pig farmers, are you relying on government authorities to monitor them, or investigators?

We encourage all of our clients to conduct in-depth audits and put in place extensive contractual controls. Additionally, CBI offers a range of complimentary tools to help control your supply chain. Diligent investigations, intelligence gathering, and covert factory monitoring help keep you informed of the real conditions at your factories.

Surveillance programs and supply chain investigations can help uncover diversion problems or unauthorized subcontracting. Placing informants into factories will shine light on “third shift” issues, and has the added benefit of helping you enforce CSR policies.

As long as consumers want to buy branded goods, factories will churn out knock-offs, both high-quality and poor. And as long as unscrupulous businessmen, flexible legal controls, and tough price pressures come together in Asia, suppliers will cut corners. Nevertheless, there are a number of ways to minimize risk and make sure that your product and your supply chain are completely within your control.