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SUNSHINE FASHION: FRAUD, THEFT AND MISBEHAVIOUR AMONG EMPLOYEES

Shenzhen-based Sunshine Fashion Co. Ltd (“Sunshine”) was a Sino-Japanese venture whose operations had grown from mere original equipment manufacturing (“OEM”) of cashmere sweaters for export to include retailing, with a chain of 220 retail points throughout China in 2010. In order to manage its retail operations, it had set up both regional and branch offices to handle stock and to support and monitor its retail points. However, fraudulent behaviour among employees had cost the retail chain almost 5% of its domestic sales revenues. The implementation of an ERP system for tracking goods and sales had improved the situation somewhat. What were the challenges that Sunshine faced in trying to control fraudulent behaviour among its staff? What additional measures could the management pursue and how could the remedial measures be implemented to achieve its target?

Company Background

Sunshine had been founded in 1993, starting out as an OEM export manufacturer of cashmere sweaters and eventually growing into an integrated manufacturer and retailer whose activities included material sourcing, spinning, dyeing, design, distribution, marketing and retailing. By 2010, it had three factories (located in Shenzhen, Shanghai, and Taiyuan in Shanxi province), 220 sales counters in department stores throughout the country, and a workforce of more than 1,000 employees.

Sunshine produced some 300,000 pieces per year for domestic sales, a segment that enjoyed a considerably higher profit margin than its export business. With a turnover of Rmb 150 million, domestic sales made up more than two-thirds of Sunshine’s business. Sunshine was positioned as a high-end fashion brand in the domestic market, with design being the leading factor in determining the sales of its goods. At Rmb 3,000¹ apiece, Sunshine’s cashmere sweaters were considered a luxury item in China.²

¹ US\$1 = Rmb 6.65. (11 November, 2010).

² China’s national average GDP per capita in 2007 was Rmb 18,665. Source: Men, Kepei; Jiang, Liangyu; Men, Xinfan (August 2008): China’s Macroeconomy forecasting research during 2008-2012, in: Asian Social Science, Vol. 4, No. pp. 64..

Grace Loo prepared this case under the supervision of Professor Neale O’Connor for class discussion. This case is not intended to show effective or ineffective handling of decision or business processes.

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We are concerned with the price at which we sell, not how many garments we sell. Volume is nothing for us. If we sell a lot of garments but at a very low price, there is no profit.

- Kitty Li, sales manager of Sunshine

Because the customers of Sunshine were fashion-conscious, the value of an out-of-season item could fall to as low as one-third its original price. Sunshine's vertically integrated organisation gave it a competitive edge over its competitors. It could complete the product cycle from design to distribution within 20 days, while its major competitor Edor took three months.

Retail Operations

Sunshine's 220 retail counters in department stores throughout the country were managed by 14 branch offices that reported to three regional offices in Beijing, Chongqing and Nanjing. The three regional offices were all former branch offices that had been promoted to regional offices.

Before the head office controlled almost everything, the price, the quantity, which branch office was to be allocated how much goods ... These decisions and coordination was concentrated with one person. With three regional companies, [the work] can be separated and it reduces the load on this one person.

- Kitty Li, sales manager of Sunshine

Sunshine had franchised some retail points outside of the major cities but remained cautious about expanding its franchise network out of concern for operational control and brand integrity.

Stock

At the beginning of each season, Sunshine's head office would prepare the stock, tagging the items with barcodes and prices and sending them to the branch offices. The branch offices were responsible for distributing the sweaters to the 220 retail counters and for replenishing the stock at each counter throughout the season. The head office sent the goods to the branch offices by air and sometimes by courier. Roughly 3% of goods were lost during the transportation process. At the end of each season, the branch offices were required to return all leftover stock to the head office and would be refunded the cost of the returned goods. Over a two-month period each year, the head office would put 10 people to work counting and inspecting the returned items, repackaging them, and changing the barcodes to a new price if necessary so they would be ready for sale the following season [see **Exhibit 1**].

Sales

The branch offices and retail points had been reporting information about stock and sales to the head office manually until 1998, when Sunshine implemented an RFID/ERP system. The system networked the branch offices and the head office, and allowed the head office to receive updates on sales at all the retail points every four hours. Sunshine's RFID/ERP system also stored information about inventory at the branch offices and retail counters, but the information had to be entered manually by staff.

Theft and Fraud by Employees

In 2008, Sunshine faced serious fraud and misbehaviour problems among its employees, with losses estimated at between Rmb 9.3 million and Rmb 10.5 million, equivalent to more than 5% of Sunshine's total domestic sales. Though Sunshine's RFID/ERP system provided the head office with updates on the point-of-sale situation every four hours, managers who wanted to cheat took advantage of the inability of the head office to control discounts and stock at the local level. Sunshine's head

office was responsible for setting prices and determining promotional timeframes, but these timeframes were not necessarily followed by all the branch managers. Some branch managers postponed the start dates of promotional periods without informing the head office, enabling them to sell sweaters at the original prices and pocket the difference. Other branch managers would report a higher discount rate to the head office than was actually the case and pocket the difference. The situation was further complicated by the fact that the market situation varied greatly throughout China and each department store had its own policy with regard to the timing of sales promotions.

It depends on the different department stores. They each have different sales and celebrations and other things. It's hard to control from the head office, they are far away from the office.

- Kitty Li, sales manager of Sunshine

Sunshine had no choice but to allow some autonomy in decision-making with regard to promotions and discount rates at the local level, a practice that increased the risk of managers engaging in fraudulent behaviour. The branch offices also engaged in a small amount of cash sales and there was no way for the head office to control such sales. The branch managers had total discretion over how much of a discount they wanted to give in such instances.

Fraudulent behaviour was also facilitated by the fact that Sunshine had no mechanism in place to control stock at the local level. While the head office knew how many pieces it sent out to each branch office at the beginning of the season, it had no information regarding how many of those pieces were at the branch office and how many had been distributed to each retail point at any point in time. The branch office sent pieces to the retail points almost every day, depending on their need. This made it difficult for the head office to control promotions.

To check the stock before each promotion is impossible. The promotion each time depends on the different holidays and the policy of each departmental store ... It's hard to take stock before each promotion. We only control the inventory.

- Kitty Li, sales manager of Sunshine

Sunshine's ERP system could not update stock information automatically. It stored stock information, but that information had to be entered and updated manually. This meant that staff could enter the stock information only after a promotion started, giving them a window in which to sell the sweaters at the original price and pocket the difference. Loss arising from such misbehaviour was estimated to cost Sunshine Rmb 3 million.

While barcoding the sweaters helped Sunshine to track its products, it had found that the barcodes on some of the sweaters had been changed—revising the price upwards by as much as 50%—when the unsold goods were returned to the head office at the end of the season.

For example, given two garments priced at 1000 yuan and 500 yuan, respectively, the salesman might sell one piece of 1000 yuan, and return 500 yuan piece to the head office at the end of the season. The head office knows that the salesman has 1000 yuan earning. But, if the salesman changes the barcode of the 500 yuan garment to the 1000 yuan barcode, then on returning the garment and barcode to the head office, the head office thinks that the salesman has only 500 yuan earning (cash). When auditing at the end of the season, the total quantity is not less, but the amount difference who knows???

Every year we have a big quantity and amount of sale, and the price changes all the time (because of festivals, shop anniversary, discount season ...) it's a huge workload to check every barcode, or the boss thinks that is it worth to do so? It's another big cost.

- Kitty Li, sales manager of Sunshine

Loss due to changed barcodes was estimated at Rmb 1.5 million. Sunshine's accounting department visited the branch offices once or twice per year during the sales season to check their stock and accounts, and the head office arranged random visits to the retail counters, but to little avail.

Another example of misbehaviour that Sunshine encountered was managers who used the relationships they had built with department stores in order to sell their own goods or brands.

[T]hese managers, they use their own relationship with the department store manager to begin their own brand and business. Maybe they give money to the manager every year, but this money is from Sunshine, you know, so they use the company's money to set up their own relationship. That's the problem.

- Kitty Li, sales manager of Sunshine

To counter such misbehaviour, the president of Sunshine regularly visited department stores with Sunshine retail counters around the country to reinforce the Sunshine brand and to build up personal relationships with the department stores himself.

We don't want the branch managers to get too close to one store manager. Once they have good relationship [with the departmental store manager], even better relationship than the general managers from our head office ... they can begin their own brand easily, use this relationship to begin their own business may be at the same time.

- Kitty Li, sales manager of Sunshine

Sunshine rotated the branch managers among the different branches periodically to keep a check on their power.

A number of organisational factors also contributed to the rampant fraudulent misbehaviour among employees. *Guanxi*, or relationships of mutual favour, with department stores was critical for brands to be able to set up retail points within department stores in China, and Sunshine branch managers were often recruited based on the strength of their relationships with the department stores rather than their management ability or integrity. With branch managers having an average tenure of two years and a yearly turnover rate of 20%, their weak sense of belonging and loyalty to Sunshine engendered greed and opportunistic behaviour. Branch managers, leveraging the relationships they had built with department stores while working at Sunshine, often became agents of other brands when they left, becoming direct competitors of their former employer.

Branch managers received a fixed monthly salary of between Rmb 3,000 and Rmb 4,000 and a year-end bonus that was decided solely at the discretion of the general manager. While standards of living and wage levels varied greatly throughout China, the salary of Sunshine's branch managers was generally set on par with Shenzhen, where Sunshine's head office was located and which had one of the highest wage levels in China.³ Nonetheless, the year-end bonus was decided solely at the

³ According to the China Statistical Yearbook 2009, Shenzhen had the fifth-highest average wage and salary level among the major cities in China, after Shanghai, Beijing, Lhasa and Guanzhou. The average wage and salary of Shenzhen was Rmb 43,731, compared to Rmb 56,565 in Shanghai. Kunming, which ranked 36th, had an average wage and salary level of Rmb 22,432.

discretion of the general manager, and the lack of transparency in how decisions regarding how bonuses were made gave branch managers little motivation to act in the best interests of the company. To remedy the situation, Sunshine began setting sales targets for the branch managers each June based on the location, square footage and sales history of the retail points, and awarded year-end commissions to branch managers who could meet their sales target. Under the new system, branch managers could receive a commission that was as high as their annual salary if their sales performance was good.

Annual Review

Sunshine's management was due to meet soon for its annual review meeting, and employee fraud and misbehaviour was on the meeting's agenda. The chief executive had decided to set a target of reducing the costs of fraudulent behaviour to 2% of retail sales. The implementation of the ERP system had given the head office better control over its retail operations, but fraud and misbehaviour among employees continued. Kitty Li, Sunshine's sales manager, knew that it was impossible to control everything.

If the manager knows you are to come, he will do something about it. Everything we do is to reduce risk but we cannot control perfectly. If you control them perfectly, they will resign.

- Kitty Li, sales manager of Sunshine

But there had to be more that could be done to control such misbehaviour. What were the root causes of the staff's misbehaviour? What were the strengths and weaknesses of Sunshine's current internal control system and, more importantly, what could Li propose to the management to improve the situation? What measures should the management undertake and how should the remedial measures be implemented? In what order should the recommended actions for Sunshine be implemented?

EXHIBIT 1: SUNSHINE’S OPERATIONAL FLOW FOR ITS RETAIL BUSINESS

	Head Office		Regional Offices		Branch Offices		Retail Points
Flow of goods beginning of the season.	Prepare stock with bar codes and send out at the start of each season.	⇒		⇒	Branch office responsible for replenishing retail points throughout the season .	⇒	
Flow of goods not sold end of season.	Head office inspects, counts, and change barcodes if necessary after receiving goods returned.	←		←	Branch offices sent goods not sold back to head office at the end of the season.		
Flow of retail sales information	Receives information via ERP system.		Receives information via ERP system.		Receives information via ERP system.	←	ERP system records sales information. Inventory information has to be input/updated manually.
Discounts/promotions	Determines discounts and promotions.				Branch offices engage in some direct sales and branch managers has discretion in giving discounts in such sales.		Department stores in which retail points are located also make their own discounts/ promotion policies.