

# Brands in the Boardroom 2010

**Product warranty and support abuse: saving companies' financial health and brand**  
PricewaterhouseCoopers LLP

# Product warranty and support abuse: saving companies' financial health and brand

Warranty service abuse can damage brands, increase costs and lead to revenue losses. However, appropriate vigilance and controls can significantly curtail this type of entitlement abuse

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You know the routine. You excitedly open your new software, technology or other gadget, load it onto your computer or server and then see this message:

*Register your product now (preferred)  
Register your product later (NOT  
recommended)*

Many start to register a product, get frustrated with all the information required and then defer registration indefinitely. Others defer without hesitation.

Either way, you may be contributing to a multibillion-dollar threat that manufacturers or original equipment manufacturers are beginning to recognise: abuse of warranty and product support entitlements ("warranty service abuse" or "entitlement abuse"). This issue affects all major brands around the world; while prevalent in the technology industry, it also occurs in other major sectors. Globally known brands experience revenue loss, increased expenses and a negative customer experience from these activities – culminating in a lessening of the brand's value.

PricewaterhouseCoopers (PwC) research and surveys indicate that technology and original equipment manufacturers and other manufacturers are implementing controls to prevent this abuse, which is estimated to cost companies between 3% and 5% in lost revenues alone. However, its implications

are even more widespread and extensive than these figures suggest, according to PwC's study entitled "Service Blues: Effectively managing the multibillion dollar threat from product warranty and support abuse", a collaboration with the Alliance for Gray Market and Counterfeit Abatement. For example, beyond the costs and lost revenues associated with servicing invalid claims or sending replacement products and fuelling the grey market, additional damage can be done to a company's reputation and brand. Likewise, relationships can sour with business partners which are effectively penalised for "doing the right thing" with regard to warranty and service programmes, as they can be at a disadvantage against unethical opportunists who may have profited from fraudulent schemes.

However, our experience and industry research suggest that the frequency of this type of entitlement abuse and its effects can be significantly reduced with appropriate vigilance and controls, from front-end manufacturing, contracting, sales and claims-processing activities to back-end coverage through contract compliance reviews, internal audit coverage and sophisticated monitoring techniques.

Few companies can afford to overlook this pervasive and growing threat to their success, especially in the current economic climate. As such, it is critical to expose entitlement abuse and, more importantly, to leverage tools and insights to help manufacturers to implement practical mechanisms for the prevention and detection of fraud, while maintaining the level of service delivery that customers demand.

## What is warranty service abuse?

Warranty service is post-sale support delivered (over a defined period of time) by a manufacturer to an end customer to



enhance or provide added value on products purchased. Warranty service abuse refers to use of services or replacement products to which the customer or recipient is not entitled. For example, acquiring a service contract for products and using that service contract to request and receive service on a product not covered by the contract constitutes warranty service abuse. Likewise, requesting a replacement for a product not owned or not returned by the claimant is a form of warranty service abuse.

The abuse can be as simple as a customer requesting warranty service on an expired service plan; other abuses are more sinister and complex. Consider Apple's recent US\$2.5 million loss, in which it alleged that a reseller group charged its customers a fee for replacing products not covered by warranty or service agreements. The resellers then submitted those damaged products for replacement to Apple, using serial numbers for different products known to be covered under valid warranty or service agreements (source: [www.channelnews.com.au/Hardware/Mobility/M9Q4F7K5](http://www.channelnews.com.au/Hardware/Mobility/M9Q4F7K5)).

For purposes of simplicity, we do not differentiate between warranty abuse and service abuse, which differ in timing and application, because the fraudulent activities are often similar, as are the control solutions employed to curb them.

#### Who commits these abuses?

Our research reveals that business partners, including third-party service organisations and distributors/resellers, are perceived to be the most likely to abuse the entitlement process. They typically have access to valuable information such as service contract numbers and product serial numbers, which can be used to exploit control weaknesses.

For example, Hewlett-Packard recently conducted a contract compliance assessment of a business partner and found audit evidence (source: <http://www.crn.com/it-channel/18831000>) confirming that:

- False or invalid warranty claims were submitted to obtain parts.
- False claims were submitted for labour not provided.
- False customer names or account information were provided.
- Customer satisfaction surveys were falsely completed on behalf of non-existent customers.
- Replacement parts were resold on the grey market.

However, as many manufacturers' primary point of contact with customers, third-party service organisations and distributors/resellers also can be one of the greatest allies in curbing abuses.

Other perpetrators include organised crime and career criminals who make a living from warranty service abuse, along with unethical or ill-informed end users who have not been educated or were misinformed about what constitutes valid service coverage. This is especially true in particular regional markets.

#### How are the scams perpetrated?

Many scams seek to exploit industry or manufacturer-specific control weaknesses; apparently, word travels fast among criminals. Below are general introductions to some of the more broadly perpetrated abuse schemes.

##### Under-coverage: "What's good for some is good for all"

Under-coverage occurs when a customer purchases a small number of (often premium) service contracts, or a contract that covers specific products, and attempts to overuse that service (or replacement offering) on products that do not carry the same level of coverage.

##### Non-returns or advance replacement exploitation: "You'll get it any day now..."

In this fraud, perpetrators submit requests for replacement products on a warranty or service contract but do not send back the covered product (instead sending scrap or counterfeit products, or sometimes nothing at all).

##### Just-in-time coverage: "Now I'd like to talk about that service contract..."

In this abuse scheme, the customer fails to purchase a service contract for the product at the time of purchase. Instead, the customer waits until a product breaks to purchase a service contract for it and submits a claim a short time later.

##### Buy one, sell several: "There's plenty to go around"

This abuse occurs when a service company buys a small number of valid service contracts and then resells its own service agreement to several customers. Knowledgeable of product serial numbers, the servicer submits claims to the manufacturers for service work actually done on products sold without valid service plans.

### **Fraudulent service claims: “You won’t even know we’re here”**

As described in the earlier Hewlett-Packard example, in this fraud a third-party servicer uses valid serial numbers and other customer information to submit claims/invoices for services not actually provided.

### **Simple service abuse: “Just an honest mistake”**

As the name implies, this technique simply involves a customer who submits a service request or requests a replacement for unentitled products; the request is fulfilled because of insufficient information to refute the claim or just to appease an upset customer.

### **Software download key abuse: “Our guests act like they own the place”**

Service abuse also affects software. Some customers or perpetrators take advantage of customer-centric but poorly controlled web-enabled services. For example, a company may purchase a software service agreement for one piece of software to gain system access and then download additional software for which no payment or licence fee has been made for personal use or resale.

### **How to fix the problem?**

Effectively reducing warranty service fraud requires patience, knowledge and deep commitment. A holistic, end-to-end approach that we have seen used successfully by leading companies is set out below.

### **Commit to change**

Company leadership should appoint a catalyst to lead the charge within the organisation. This person or group should first understand where the company is exposed, where and how abuse schemes have festered and how best to remedy those deficiencies. Next, working with management, the individual or group must take responsibility for developing warranty service policies and related programmes.

### **Communication policies**

Once a policy and related programme are developed, they should be communicated to stakeholders – executives and employees, and then externally. Business partners, third-party servicers and large customers should be advised of prohibited activities and required business practices.

### **Build a culture of compliance and risk management**

Executive buy-in is critical to set the tone at the top. It is also frequently the initial

and most significant hurdle for many organisations striving to add teeth to prevention efforts. The company should emphasise its commitment to an austere ethics policy and communicate its stance clearly at every level, including updates on the impact of current or anticipated abuses, efforts and successes.

David LaVoy, PwC internal audit services partner, recommends that management be actively engaged in driving change in the organisation, leveraging internal audit to provide risk assurance surrounding the change demanded. This can be done, for example, through enterprise risk management coverage, review and assessment of controls effectiveness, and the use of data analysis tools to identify control circumventions, unanticipated trends and potential perpetrators.

### **Enable enforcement**

Enforcement can take the form of forensic investigations of known or perceived fraud, as well as regular contract compliance audits of distributors, resellers, external or outsourced service providers and other third parties.

Perhaps the strongest deterrent to committing warranty service fraud is the fear of capture, prosecution and retribution. This can be accomplished with an active programme of investigation and prosecution, with great care taken to inform the public about these efforts and resolutions.

According to David Marston, PwC US leader for the licensing management and contract compliance practice, an active contract compliance programme, with both limited and full-scope audits, is critical not only in detecting non-compliance and billing errors, but also in sending a message that the company takes compliance seriously.

### **Implement controls to reduce vulnerabilities and limit implications**

Fraud perpetrators have grown increasingly savvy in capitalising on loopholes and other control weaknesses in the product sale-to-service lifecycle. Companies that effectively apply a portfolio of controls that prevent and detect service abuses will be better positioned to reduce fraud and deter exploitation.

Companies can focus on a few specific areas or controls, most notably in the capture and use of data, such as serial numbers. We see the greatest success where policies and expectations are communicated



clearly, where there is transparency with regard to claim requests and valid entitlements (and data is actually used), and where employees, customers and business partners are encouraged to root out abuses.

#### Continual improvement and monitoring

Effective monitoring techniques are critical and should be leveraged to drive continual improvement and reduce warranty service abuse. These techniques are most effective when they are applied in tiers, addressing reactive, proactive and predictive elements.

Computer-assisted auditing techniques, (CAATs) are one of the most successful methods of detecting and preventing entitlement abuses. Using CAATs, sales, claims and other data is analysed regularly for control or policy violations, circumventions or other red-flag warnings of potential abuses. Most importantly, the results should be reviewed, investigated and resolved in a timely fashion, with results fed back into the monitoring mechanisms.

#### Understand and navigate impediments to effective change

Ingrained and accepted practices that enable abuse, and lack of buy-in or change aversion from management and stakeholders, can impede the implementation of a prevention programme. Real or perceived strains on customer relationships also can hinder a prevention programme.

However, controls need not be overly burdensome. Our research suggests that customers will also likely benefit as the

cost and magnitude of the warranty service abuses subside.

#### Prevent abuse, protect revenue

Warranty service abuse affects businesses through lost revenue and increased costs, and contributes to the grey market, undermining the integrity of both individual businesses and entire industries. These consequences, along with other risks, will continue to threaten a company's brand, its operations and financial results unless threats are recognised and appropriate actions are taken to prevent continued fraud and abuse.

Sound risk management strategies can thwart abuse, improve the bottom line and protect a company's brand. Some companies may choose to write off the losses from warranty service abuse as a cost of doing business, unwilling to risk pushing away legitimate customers by addressing abusive activities. However, companies that address warranty service abuse can generate significant savings and create long-term value for their organisations, their investors and their customers, without compromising customer service and satisfaction. Getting a handle on prevention necessitates executive-level buy-in, enterprise-wide action and risk mitigation through practical controls, enforcement efforts and appropriate messaging.

Hopefully this message has resonated, and you will have more sympathy for product manufacturers the next time you get that annoying registration message. *iam*



David Marston, a partner with the firm since 1997, has a breadth and depth of international consulting experience. Mr Marston specialises in IP matters, including how to maximise IP monetisation, licensing compliance issues, contractual licence agreement issues, software asset management and IP risk assessments. He works primarily in the software and technology industry, and also serves clients in the telecommunications, life sciences and branded goods sectors. Mr Marston has served as a neutral arbitrator in numerous arbitrations.

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Jonathan Kurtz has over 12 years' experience providing internal audit and contract compliance services to a multitude of industries. He specialises in value-enhancing services for his clients, most notably risk and control consulting, and business partner compliance programmes. Mr Kurtz has helped to develop control enhancements and monitoring mechanisms to reduce revenue leakage, supplier overpayments and other enterprise risks. Further, he has worked with clients to mitigate the impact from ever-changing risks and challenges arising from business relationships, such as grey market and warranty service abuse schemes, often through the use of sophisticated data analytics/mining.

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