Analysis - Accounting risk clouds big U.S. business bets in China

By Dena Aubin and Lawrence White
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Tales of shady business practices abound in China - fake revenues, phony invoices, sham factories - but until recently, the problem seemed confined mostly to Chinese companies.

No longer.

Concern is growing about risks to U.S.-based multinationals in a country where American audit regulators are locked out by the Chinese government and bribery and fraud are routine.

Questions about transparency and integrity weigh heavily on China, the world's second-largest economy, as it assumes greater economic leadership and responsibility. These doubts test its ability to adhere to international standards.

Stories of business deception - confirmed by corporate sleuths, former business executives, court filings and experts on accounting in China - are commonplace.

There was the Chinese company that billed itself as a high-tech television screen manufacturer, but had a factory that turned out to be a man selling fireworks from a shack.

Or there was the Chinese biodiesel plant that sat idle for months, then sprang to life one day - when investors showed up for a tour - only to fall silent again.

Last month, there was the scandal at a Chinese unit of Caterpillar Inc , the world's largest construction equipment manufacturer, based in Peoria, Illinois.

On January 18, Caterpillar disclosed "deliberate, multi-year, coordinated accounting misconduct" at the Siwei unit of ERA Mining Machinery. Caterpillar said it would write off most of the $654 million it had paid to acquire ERA only months earlier.

Caterpillar's Siwei stumble was not the first for a U.S. multinational in China, but the scope of the problem stood out.

Caterpillar has provided few details, but it has disclosed inventory discrepancies, inflated profits and improperly recorded costs and revenue at Siwei.

Caterpillar declined further comment.

Part of Caterpillar's problem may have been inadequate due diligence work prior to the ERA acquisition. Companies often try to keep fees down for this type of work, but in China that may be asking for trouble, says Paul Gillis, an accounting professor at Peking University in Beijing.

Acquiring firms typically do some of their own due diligence while also relying on deal advisers, legal experts and auditors. Due to the risks in China, efforts should be beefed up to uncover fraud, Gillis said. "When you start cutting corners on audits ... you're enabling those who commit fraud."

GOING FOR GROWTH

Of course, it is not as if the United States has not had its own share of egregious accounting frauds over the years. In 2001-2002, a series of major scandals involving the likes of Enron, WorldCom and Tyco shook the U.S. economy.

Legislation followed that strengthened oversight of auditing and accountability of companies' top officers. That has not stopped U.S. accounting fraud, but it has made it easier to identify and deter some of the most egregious behavior.

In China, where large U.S. corporations are making some very big bets, a new frontier of accounting risk is opening up.

Lured by an economy growing much more quickly than the United States, U.S. companies have directly invested $54 billion in Chinese businesses, factories and property, most of it in the past decade, according to U.S. Department of Commerce data.

Despite a cooling off of China's growth last year, demand from its massive consumer class is still lifting revenues at companies that range from coffee seller Starbucks Corp to casino operator Wynn Resorts .

The Caterpillar experience and the growing catalog of smaller instances of deception and abuse have some experts wondering if U.S. companies' Chinese results can be trusted.

Though China is shifting to a market economy, much business is still done on a handshake, China experts say. State secret laws hinder investigations by outsiders. Audits done in China of U.S. corporate units there cannot be inspected by U.S. regulators because the Chinese government refuses to allow them.

A former executive at a large, U.S.-based multinational active in China recalled the firm's auditor being fired for trying to correct improper accounting at a joint venture in China. Managers there were trying to book sales early, sometimes for unassembled products, to avoid a coming tax increase, said the executive, who asked not to be named. He said he had the auditor reinstated and the accounting changed.

Dealings with a Chinese joint venture did not end well for California-based RAE Systems Inc, which makes chemical detection monitors. It had to pay nearly $3 million to the U.S. government to settle complaints in 2010 that it did too little to stop bribery at a Chinese joint venture.

'RED FERRARI' TEST

Despite well-known risks in China, auditors there often are not inquisitive enough or alert to possible fraud, some experts say.

Auditors in China may pore tirelessly over documents and yet "fail to spot the red Ferrari parked on the doorstep and fail to ask who it belongs to, how it was paid for," said Peter Humphrey, founder of ChinaWhys, a Shanghai-based anti-fraud consultancy that has investigated white-collar crime and fraud at scores of multinational firms in China.

China experts said it is difficult to do business there without encountering demands for gifts or kickbacks.

Transparency International, a corruption watchdog, surveyed business executives who said Chinese firms in 2011 were second only to Russian companies in being most likely to pay bribes abroad.

But six U.S. companies, including technology group IBM and drugmaker Pfizer Inc , were charged by the U.S. Securities and Exchange Commission over the past two years for improper payments or gifts in China.

Retailer Wal-Mart Stores has said it is investigating allegations of bribery in China, among other countries, and cosmetics group Avon Products Inc is dealing with probes of possible bribery in China.

There have been plenty of other red flags. For example, U.S. regulators have deregistered dozens of Chinese companies listed on U.S. exchanges after fraud probes, and some major U.S. investors have been caught flat-footed.

Billionaire hedge fund manager John Paulson suffered big losses after a disastrous bet on Chinese forestry company Sino Forest. Sino Forest was rocked by allegations in 2011 that it falsified its timber assets and later filed for bankruptcy.

Chinese software company Longtop Financial Technologies was accused of seizing audit documents when its auditor, Shanghai-based Deloitte Touche Tohmatsu, tried to double-check cash amounts at the company's bank. Longtop admitted cash had been faked. It was deregistered by the SEC.

The U.S. Public Company Accounting Oversight Board, which is responsible for regulating auditors of U.S.-listed companies, has been trying to get access to China to inspect audits there. But China has resisted because of sovereignty concerns.

Being unable to inspect in China "continues to create a gaping hole in investor protection," James Doty, chairman of the Washington, D.C.-based PCAOB, said in a statement.

The PCAOB recently reached deals with France and Finland to inspect in those countries, adding to its growing list of cooperation agreements with 16 nations.

The SEC has hit a wall trying to get documents out of China to investigate fraud. In December the commission began legal proceedings against the Chinese affiliates of five of the world's biggest audit firms - Deloitte , Ernst & Young , KPMG BDO and PricewaterhouseCoopers - over their refusal to turn over audit papers for fear of violating state secrets laws.

Meanwhile, investment in China continues. Over the past five years, U.S. companies and investment groups have announced or completed about $25 billion of whole or partial acquisitions in China, according to Thomson Reuters data.

(Additional reporting by Lisa Baertlein in Los Angeles, Ernest Scheyder in New York, Clare Baldwin in Hong Kong; Editing by Kevin Drawbaugh and Dan Grebler)