Reducing the Fraud Risk Factor

By Peter Humphrey

MNCs operating in China should apply the same best practices for risk management and corporate governance here as in their home country. If not, the unwary and unwise could find themselves repeating the salutary experiences of executives who have had their fingers burned.

A QUANTUM supply chain shift is under way and you are right in the thick of it, keen to tap the immense savings and gains of locating your manufacturing and sourcing in China to feed your global needs. You are also dazzled by the potential of the domestic market. But this unprecedented opportunity brings with it unprecedented challenges to your business.

As a result of the investment stampede, you are outsourcing more, localizing more and transferring more and more of your know-how to third parties – your employees, JV partners, distributors, suppliers and government regulators. All of these trends seem both politically correct and commercially savvy. But they also raise the level of business risk in an environment that is highly prone to white-collar crime, counterfeiting and technology loss. Remember that you are operating a business in a country that consistently falls halfway down the world corruption index (China ranked 71st out of 145 in the 2004 Transparency International ranking, after Croatia and before Jamaica). Its listed firms score poorly for corporate governance and there is a high failure rate for JVs and acquisitions, with foreigners generally on the losing side. So take care.

Dodging the Pitfalls

Consider the case of Bill. He is handsome, bright, young and Chinese; a smart guy with a great knack for smoothing the way with suppliers, distributors, staff and local officials. An asset to any corporation. An overseas auto components maker thought so, too, and a decade ago hired him to head its sales operation in China.

But in the meantime, Bill had secretly started his own company, run by his brother Fred and other relatives. He began to transfer product technology and manufacturing know-how to the family firm. As Bill's company grew, he also passed on management know-how, as well as supplier and distributor connections.

After seven years, Bill nudged the multinational company to form a JV with his family firm, without ever telling them of his involvement, and he quietly continued to grow his business. He formed subsidiaries and inserted them into the chain as suppliers to his employer. He copied their products and then targeted their customers for OEM work. After 10 years, Bill's firm grew into a serious rival, the MNC started to grow suspicious, and Bill left them to concentrate on running his own company. It was only then that the foreign company checked and uncovered the large and complex business organization that Bill's family had developed – at the MNC's expense.

Bill's firm had achieved vertical integration of coating, components and finished goods. It then formed a holding company and is now aiming to list on China's stock market. Bill's products compete head-to-head with his former employer in the market with considerable cost advantages.

This is just one illustration of the pitfalls of not taking adequate risk management measures – up front. There are plenty of others. Jenny was the senior merchandiser who bilked millions of dollars from the Shanghai sourcing office of a famous apparel brand; Frankie, the country manager of a top electric appliances maker, saddled his employers with a string of fraudulent JV deals; Anita, the buyer at a supermarket chain, pocketed 30 percent of all deals via companies owned by her mother and her boyfriend.

In all these cases, the companies failed to uphold good corporate governance and business practices and to take sensible steps to protect their assets, bottom line and reputation. Many cases were aggravated by an MNC failing to understand its own people and its operations in China. In such cases, cultural blindness or an "us versus them" divide grew, caused by sending managers with insufficient experience to establish the China business or neglecting proper handover procedures between rotating senior management.

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Managing Risks

Ultimately, the lesson in all fraud cases like these – and there is potential for such cases at every major MNC in China – is that problems could have been prevented with best practices. Managers must learn to identify, manage and reduce the risks. Provide risk management resources from day one. Install strong controls and execute them rigorously. This will help to prevent huge additional costs and even failures.

Happily, there are measures that can be taken to avoid similar frauds occurring, including:

Reference checks. At a minimum, companies should independently check all references from applicants and solicit written references from confirmed referees. But do more than that.

Employee screening. When hiring, go beyond references and probe a candidate's background. Is he who he says he is? Are any of his credentials or personal history faked? Verify the jobs he has held. Find out why he really left each job. Check his character, track record and integrity.

Vendor screening. Pre-qualify distributors and vendors by checking their credentials and backgrounds. Make this your policy. So-called credit reports provide no real assurance in China. Inquiries to verify the existence, ownership and pedigree of a company are vital.

Due diligence. Due diligence must go beyond the balance sheet. Where transparency is lacking and firms have hierarchical leadership structures, and where governance is weak, due diligence on a JV or acquisition target must enter the realm of intelligence. Examining numbers is not enough, even when you think you have all four versions of the books. The key is the people. Who really controls the firm? What is their background, track record, reputation and integrity? What is their true competence and influence? What happened to their last deals? What other firms are they connected with? These questions can be answered through discreet – and lawful – investigative means.

Integrated risk management. Such procedures interlock and mutually reinforce each other. They should form part of an integrated risk management policy for China operations. They should be tied together as a coherent set of measures and linked to other important controls.

Code of ethics (COE). MNCs must have a clearly defined COE that is bound into contracts with employees, suppliers, distributors and JV partners. In some cases, the COE should be published, sent to clients and displayed prominently in reception lobbies and meeting rooms. The COE and all contracts must include strong language on bribery, kickbacks, money laundering, conflicts of interest, IPR abuses and confidentiality. It needs to be updated and signed again annually by all concerned. Reinforce it with annual ethics awareness training for all staff and managers.

Hiring restrictions. Ban the hiring of relatives and the conduct of business with relatives. Collusion between employees, their friends and relatives and the creation of phantom vendors, are the most common recurring factors in China frauds.

Internal controls. Internal controls must be robust and adjusted to their cultural surroundings. Favor-trading and collusion across departmental barriers undermine conventional business controls. Strict operating procedures are required to defeat control breakers. Limit and closely monitor the authority of any individual. A close watch is clearly necessary concerning the use of chops, a device of great significance in Chinese business life and one that can cause huge headaches if abused. In short, signatory powers vested in a single individual should be balanced.

Cultural communication. It is too easy to point the finger of blame at Chinese culture when you consider these issues. This misses the point. The MNC must proactively bridge language and cultural gaps. The gap itself is often exacerbates risk, as it fosters an "us and them" mindset that opens the door for abuse. Head office and its expat representatives should be encouraged to penetrate local culture, get to know the Chinese staff as individuals and understand the nuts and bolts of the business. Too many expats isolate themselves from local personnel, which alienates Chinese staff. A careful balance must be struck in the expat-local management mix. Staff-relations policies must encourage mutual understanding.

Continuity. Many companies rotate senior managers into China every few years. There must be a "red flag" handover between rotated managers. The outgoing manager must give his successor detailed knowledge of any potential risks of fraud.

Best people. Send only your very best people to China as expatriates. Maturity and experience are critical to the successful management of the operation. Otherwise you are just making China a paradise for fools.

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