Battling Fraud & Corruption in the Business

By Peter Humphrey

Fraud and corruption are a growing problem for many companies operating in China. The pressure has grown in recent years to police the problem in order to comply with tough new corporate governance and regulatory standards such as the American Sarbanes Oxley Act and international laws on bribery and money laundering. In this stringent environment companies would well be reminded of some of the dangers and pitfalls along with ways to tackle the risks.

Concerning Cases

In one recent case that we encountered, a multinational financial institution was considering an acquisition targeting a regional securities brokerage in southwest China, which we shall call Target P. Inquiries revealed a murky situation. It emerged that Target P had five shareholders who were all related to the local government and who were in fact a front outfit for Company T, which was controlled by Mr. X. Further inquiries discovered that Company T been invested in by many locally-listed companies. And Target P was one of the channels for Mr. X to raise funds to support his investments in the listed firms and boost their stock prices. The multinational met Target P's chairman Mr. W and its President Mr. L, who both were ex-government officials, to discuss their contemplated deal, not realizing that Target P was in fact controlled by Mr. M who was a close confidant of Mr. X. The due diligence inquiries discovered that local government officials were concerned that funds raised by Target P derived from risky loans and from shady stock trading. Due to these concerns regulatory authorities were launching an investigation and preparing to make arrests.

In another case, a multinational chemical company called in investigators to probe a joint venture where profits had dropped dramatically and suspiciously from a previous year's 35% to 0% this year. Reasons given were that expenses of the previous year had been booked to the current year in order to minimize income tax payments. However, an internal investigation revealed that a firm linked with the former general manager of the joint venture was in fact both a supplier and distributor at the same time, selling high to the joint venture buying cheap from it. It was discovered that the firm had not issued the required tax invoices (fapiao) for 10 million RMB to the joint

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venture, in order to avoid paying income tax. There was 5 million RMB that had not been booked at all, and another 5 million RMB that had been booked as advances to the supplier on the balance sheet. Both were charged to the present year, thereby wiping out most of the present year's profits. Inquiries revealed that the supplier-distributor was run by an ex-employee of the joint venture who had received repeated pay rises from the former general manager for running this side of the business for him.

A salesperson at a leading multinational pharmaceuticals company was literally caught "red-handed" by Chinese anti-corruption officers handing over a red envelope to a Chinese health official to facilitate medicine sales to public institutions. The arrest sparked a crisis in the implicated multinational that forced it to launch an in-depth investigation into the personnel and business practices of this particular division of the corporation. These inquiries revealed that a pervasive culture of bribery and fraud existed within the China operation. They showed that sales were being driven through the nationwide bribery of officials within the pharma bureaucracy, public hospitals and schools. Company staff were pocketing some of the bribe money themselves. And in an atmosphere where staff believed the firm was tolerant of corruption, they were conducting many other scams and frauds against their employers.

Shadow Business

Although there were expatriate representatives from head office at the senior management levels of the firm's China business, it emerged that the business was in fact being run by local senior management who were operating a "shadow business model" that was quite different from the official business model that the firm thought it had installed in China. The detention of the salesperson led to a wide range of discoveries showing that the company was highly exposed on compliance and corporate governance issues including a risk of prosecution both under Chinese anti-bribery laws and international laws such as the American FCPA and its equivalent laws in Europe. Under these international laws heavy fines can be imposed on companies and executives caught bribing overseas officials. Consequently, intense lobbying had to be carried out with local anti-corruption bureau to avert prosecution. A major clean-up also had to be conducted, many firings took place, the business unit was restructured and relocated, and almost one year's business was lost.

In addition to the bribery racket, other abuses were uncovered by this investigation. Staff had skipped tiers of wholesalers to sell directly to end-customers, "borrowing" goods from a distributor, then selling them to hospitals, then repaying the distributor at cost and pocketing the difference. Other staff had been using the company's distribution channels to sell rival products, some had colluded with certain suppliers to produce fakes and inject them into the same sales channels, and yet others colluded with distributors to sell what were supposed to be free promotional goods. There were also instances of staff owning distribution companies, and cases of colluding with hospital doctors to share kickback money.

The inquiries alluded to above make clear it is possible to peel the onion and connect the dots on pre-transactional risks and white collar crime mysteries in China if the effort is made. A recent fraud survey showed four in 10 firms suffered losses from their China operations due to fraud but only half investigated the malfeasance. It also showed only 25% of firms have a supply chain review program and only 31% have conducted due diligence on suppliers and business partners.

To prevent fraud, companies should have a robust and comprehensive program of fraud risk management measures. Here we present a number of key measures:

- Background screening of staff, vendors, distributors, resellers etc
- Due diligence beyond the balance sheet - check the people
- Strengthen internal controls & monitoring
- Check compliance with internal procedures
- Educate your staff in local and international laws; ensure compliance
- Conduct internal audits, fraud risk assessments, process reviews
- Impose a Code of Ethics (COE) and bind it into all contracts
- Hold ethics awareness training to drill the COE into staff and partners
- Use a whistle-blowing hotline and treat ethics complaints seriously
- Introduce checks and balances to prevent cross-departmental collusion
- Show a hands-on management style
- Use clear and visible deterrents, punish the violators
- Be on guard against alternative loyalties centering on cliques
- Cultural differences must be well managed, avoid them and us syndrome

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