Don't jump in without testing the water

China seems to offer a panacea for the problems of international business: low labour costs, an opening environment and a potentially vast market. But, as Peter Humphrey warns, plenty of businesses have had their fingers burned, by not carrying out due diligence.

THE GLOBAL supply chain is undergoing an undeniable quantum shift. China's opening to the world, its economic reform and its entry into the World Trade Organisation have confirmed it as the new centrepiece in the world supply chain of the 21st century. Cost-benefit logic appears to make the trend unstoppable. Companies believe they can make immense cost savings and thereby remain competitive by relocating their manufacturing and sourcing to China to supply their global needs, not to mention the alluring domestic market of 1.3bn people.

You name it, they are all doing it: the auto industry, the computer industry, the pharmaceutical industry, chemicals, consumer goods - the list will be endless. But are they addressing the downside risks of this change? In many cases, not. Too often companies abandon best business practice on the doorstep of China. But there is no such thing as a free lunch. So, beware. Companies can make money in China, but only by protecting their businesses against the traps and pitfalls that have snared many an unwary investor.

Counting the risks

Within the shift to China there are several highly risky trends: outsourcing, localisation and technology transfer. Multinationals are increasingly localising their China operations for the sake of economies and what might be termed political correctness. The HR consultants have been telling them that local hires will cost them less than expatriates or head office staff, and some companies want to be seen as empowering their local people with equal opportunities. So the top management jobs have been shifting from expatriates to local people. There are immediate savings and gains from a reduced payroll, impacting overall costs - for a while. But the ultimate cost can be bigger than imagined.

The world's top manufacturers are outsourcing production not only of components but also finished goods to local suppliers and contract manufacturers, and thereby becoming mere brand managers of products with their well known label. These companies see huge potential cost savings, better margins and competitiveness by outsourcing production to local firms in China. They reduce the risks associated with carrying huge overheads.

At the same time, there is a massive transfer of know-how and technology underway. This is partly an inevitable trend when firms are shifting their production base and localising operations. Technology is thus revealed to staff, partners, suppliers, distributors and regulators.

There is an almost suicidal rush now to transfer research and development operations to China lock, stock and barrel. Financial consultants have advised firms about the tax advantages of relocating R&D to China; you can hire researchers with PhDs very cheaply compared to the more advanced countries. All this raises the risk of loss and abuse of intellectual assets in a country where copycatting and intellectual property piracy have long been a national sport.

Small and medium-sized enterprises new to China are getting in on the act. Many of them think they can do it without their own presence on the ground in China. American companies, in particular, who want to source their products in China think they can do it by finding a few local factories, handing over their drawings and leaving them to get on with it. Many others live to regret living with such gay abandon. Others should heed the lessons and hard experience of their forerunners.

A survey last year showed more than half of the manufacturers of consumer goods in China claimed they were not making money. The losses were attributed to various factors: over-extending into unfamiliar provincial locations not yet suitable for such operations; fragmented and chaotic local markets with huge differences from one place to another; price differences outside urban centres in rural locations where incomes and purchasing power were significantly different; and variations in competition in different regions of the country.

A darker side

To anybody who has been on the ground in China for many years, all those factors seem plausible. But risk management analysis of the situation throws up another reason for the losses, or for the failure to make significant profits. Fraud, corruption and white-collar crime play a big role in eroding the margins.

It does not take a Westerner to invent this sort of story; you only have to read the official press to know fraud and corruption are rife in China. The country is undergoing a get-rich-quick social revolution, a smash-and-grab phase of development. The late reformist leader Deng Xiaoping 20 years ago told the Chinese nation "to get rich is glorious" and set the country on a new path. That's exactly what people are doing - getting rich by every short cut they can think of. China has become a kickback culture again.

Fraud and embezzlement are pervasive in both the public and private sectors, both in domestic enterprises and foreign-invested business operations. The equivalent of around 16 per cent of GDP is lost to fraud and embezzlement in the public sector, according to Professor Hu Angang of Tsinghua University. People in the risk management business estimate similar, if not higher, leakage in the private sector, especially in foreign-invested enterprises blind to what is going on inside their own operations.

Companies leaping on to the global supply chain shift into China must learn to recognise and mitigate the risks, prevent and reduce the losses (*see box*). The threats to their new Sino-centric supply chain include a lack of transparency, weak legal protection, regulatory U-turns, embezzlement, fraud, kickbacks and official corruption. There are procurement rackets, distribution scams, risks arising from tax and duty evasion and messy legal disputes leading to costly protracted lawsuits and arbi-

trations. There is also unauthorised production of products, counterfeiting, a grey market, parallel exports, loss of technology, data theft, and product tampering. All these problems can drop a cold shower on those entranced by the China supply chain dream.

Take the case of a leading manufacturer of consumer electrical goods who grew suspicious about a string of investment and manufacturing deals set up by their China general manager. Intensive investigation and forensic analysis revealed a web of personal business interests and fraudulent joint venture and manufacturing deals, as well as business ties between the executive and relatives of his management team that would not escape visibility and sanction in more advanced countries. The man had stitched up his employer with onerous contracts that enabled him to siphon vast sums of money offshore, and from which the multinational could not easily exit without stinging penalties. Acting on the information uncovered, the company had to purge its operations of a syndicate of corrupt managers and staff and find ways out of the deals. The chief culprit got off the hook and is now producing competing goods with his former employer's technology.

Or take the case of a packaged consumer goods manufacturer that discovered there were staff in every department colluding with a counterfeit syndicate to produce fake product and inject it back into the firm's distribution channels alongside the genuine product. People in procurement, in packaging, in sales and distribution, in the warehouses and in trucking and in the R&D department were all in on the act. They even had a business plan with annual production and sales targets. This explosive mix of faking, supplier-purchaser scams, distribution fraud and technology theft forced the firm, at great cost, to restructure its China operation, terminate many staff, suppliers and distributors and end numerous partnerships.

> There is an almost suicidal rush now to transfer research and development operations to China

There are some shared features in the companies that got into this type of mess. Many had taken matrix management to such an extreme that effectively nobody was in charge. This provides an unscrupulous white-collar criminal with a golden opportunity. Very often a re-engineering had recently taken place and the firm had failed to match its risk management procedures with the new business structure. Remember, when you alter your business model, the risks you face may also change shape.

There was also a frequent rotation of senior management resulting in institutional memory loss and gaps in responsibility. Local staff turnover was high, due to a tight supply of properly qualified local personnel. There were weaknesses in internal controls, maladjusted to local cultural conditions. Employees and partners had not been vetted. New managers were allowed to bring in a clique of cronies that meant loyalty gravitated to a faction led by a charismatic patriarch and not to the corporation.

The internal audit department was too weak, unable to mount challenges to the improper behaviour of senior local managers. Previous signs of fraud had been papered over for office-political reasons. And finally there was low morale throughout the operation.

While all these factors are in play, fraudsters can have a field day. And that is what happened. Any company with more than three of these characteristics should take remedial measures.

You can add to all of this the fact that many multinational corporations in China suffer from a cultural and linguistic "gap". Localisation has both an upside and a downside; it is a sensitive and controversial issue. You cannot expect every expatriate manager to learn Chinese overnight and you cannot expect every Chinese employee to resist temptation, if head office does not seem to take much interest in what is going on. *[continued overleaf]*

Inlingual ad

In many operations with fraud problems the local staff talk about it among themselves but the HQ representative knows nothing about it. Naturally, there have also been dishonest expats who have screwed their companies, too; it is not only local people who do these things.

Chinese society thrives on favour trading. Within an operation there is constant favour trading, a quasi-bribery, between colleagues who will collude across departmental boundaries, defeat established business controls and will be reluctant to betray each other. There is an "us and them", "rich versus poor" syndrome between locals and foreigners. This makes a foreign company fair game for a bit of fleecing.

Companies riding the tide of the global supply chain shift need to address these risks and avoid a corporate disaster. Risk management is a cultural issue, a corporate governance issue, a profit issue and a business model issue. Companies owe it to shareholders to conduct effective detailed due diligence investigations on partners, suppliers, distributors and employees before handing over the crown jewels.

> Companies leaping on to the global supply chain shift into China must learn to recognise and mitigate the risks, [and] prevent and reduce the losses

A simple tick-the-box accounting approach won't work. They need to know the people they are dealing with. It is necessary to install business controls adapted to this operational environment, to react vigorously to any discovery of fraud or related problems and to signal a strong deterrent, in order to keep the business profitable, whole and healthy.

It requires a special effort. But implementing effective risk controls is essential in this supply chain shift. It is one of the costs of making money in China.

The views expressed are those of the author and do not necessarily reflect those of CBBC. Peter Humphrey is the head of ChinaWhys, a private risk management consultancy based in China. Peter is an expert on risk control, supply chain fraud and white-collar crime investigations in the region. He can be contacted at phumphrey@chinawhys.com

Tips to reduce chances of disaster

THERE ARE a number of measures that can be taken to reduce the risks.

- **Reference checks.** As a bare minimum, companies should independently check all references provided by applicants and solicit written references from confirmed referees, even when assistance from executive search firms is available.

- **Personal background checks.** For senior hires responsible for large sums of money and precious intellectual property, companies should go beyond references and deeper into a prospective employee's background. Is he or she who they say they are? Are credentials forged? Is personal history faked? Discreetly verify past jobs they claim to have held. Establish the real reason they left each job. Check with past employers and associates on character, track record and integrity.

- **Supplier and distributor screening.** It should be a matter of policy to pre-qualify suppliers and distributors by checking their credentials and background. The credit report-style check used elsewhere in the world provides inadequate assurance in China. It must be augmented by discreet inquiries to physically verify the existence, ownership and track record of a company.

- **Due diligence.** In a place where transparency is lacking, and local firms tend to have patriarchal leadership structures, and where corporate governance standards are low, due diligence on a JV partner or acquisition target must go beyond the balance sheet into the realm of business intelligence. Solely studying the numbers is insufficient (even when you think you have all versions of the accounts). More important is the people factor. Who controls or owns the firm? What is their background, track record and integrity? What is their true competence and influence? What happened to the last deals they did? These questions can be answered through discreet and lawful investigative channels.

- **Integrated risk management policy.** All of these procedures mutually reinforce each other. They should be part of an integrated risk management policy for all operations in China. They should be tied together as a coherent set of measures and connected to other significant business controls.

- **Code of ethics (COE).** Multinationals should implement a clearly defined COE and tie it to all contracts with staff, suppliers, distributors and JV partners. The code should be published, provided to clients and displayed prominently in reception lobbies and meeting rooms. The code and all contracts must include strong language on bribery, kickbacks, money laundering, conflicts of interest, IPR protection and confidentiality. It must be updated and reconsidered at least annually by all concerned. Reinforce the COE with regular ethics awareness training for all staff and managers.

- **Hiring restrictions.** Ban the hiring of relatives and the conduct of business with close relatives of staff and managers. Collusion between staff and their friends and relatives, as well as the creation of phantom vendors, is the most common recurring factor in fraud cases in China.

- **Internal controls.** Internal controls must be strong and adjusted to the cultural environment. Favour trading and collusion across departmental barriers often defeat conventional business controls in China. Rigorous operating procedures are required to defeat control breakers. Effectively limit the authority of any individual and regulate their use of it. This is especially vital in the use of chops, a device of great significance in Chinese business life but one that can cause enormous problems when abused. Signatory powers given to a single individual should be limited and balanced. All contracts should be reviewed by other executives.

- **Inter-cultural communication.** It is all too easy to blame Chinese culture when considering these issues. This misses the point. The task of the multinational is to proactively bridge the language and culture gap. The gap itself is what constitutes the risk, as it fosters an "us and them" atmosphere and produces temptations and opportunities for abuse. The multinational's head office and its expatriate representatives should be encouraged to penetrate the local culture, get to know their Chinese staff as individuals and develop an understanding of the nuts and bolts of the business. Too many multinational expatriates segregate themselves from the locals. This alienates the Chinese staff. A careful balance must be struck in the expatriate-local management mix. Staff relations policies should encourage mutual understanding.

- **Resources.** Ultimately, the lesson in all fraud cases like those mentioned is that it could have been prevented by best business practices. Multinational managers must learn to identify, manage and reduce the risks. It pays to provide resources for preventive risk management from day one. Immediately installing strong controls and implementing them visibly will help prevent enormous potential costs and failures in the future.