By Peter Humphrey

CHINA'S BOOMING FRAUD INDUSTRY

Due diligence, background vetting, robust responses to violations of internal controls or to unethical conduct, and the provision of early warning mechanisms to detect or avert fraud, are being embraced in a more integrated way

There is one industry that is booming in China like everything else but doesn't often get written about – it's called fraud. It can be in your supply chain, among vendors, distributors, employees and joint venture partners. Or it can be among the people who you use to transact an acquisition or a new partnership or a securities deal. Management fraud, distribution and purchasing system fraud, and fraud in M&A and securities transactions, have become a major headache to avoid in China. Multinationals shifting more and more core operations to China are highly vulnerable targets for unscrupulous people. And those attempting to execute complex transnational deals in a country with so little transparency face great risks.

Over the past 10 years I have advised in around 1,200 investigations of various sizes and types in China comprising fraud investigations, fraud-prevention due diligence investigations, anti-bribery investigations, forensic audits, investigations of intellectual property violations, extortion cases such as kidnap and product contamination, as well as internal operational reviews. More than half of these investigations tackled acts of white-collar crime committed by employees and business partners of western multinational corporations.

The victims were mostly American or European companies with business operations in China where a fraud had been alleged, suspected or committed, or where there was a desire to plug loopholes and prevent fraud from occurring. Most of the frauds were "supply chain frauds" involving distribution or procurement rackets, unauthorised production of goods or replication of businesses. We have also conducted investigations into financial fraud, construction fraud, securities fraud, inventory fraud, real estate fraud, and cash theft. You name it, it all happens. The amounts involved have ranged from tens of thousands of dollars to tens of millions of dollars.

In China it is rare for a multinational to litigate or prosecute a case of white-collar crime in the courts due to the rather unlevel playing field that you face in the pursuit of justice here and due to a desire to avoid offending the Chinese authorities. Although I have seen some cases litigated or prosecuted with the support of our evidence, more commonly multinationals here opt to limit their countermeasures to the termination of staff, suppliers, distributors or business partners, i.e. they conduct a house-cleaning and then rebuild their internal controls and defenses against fraud.

One substantial case with mixed elements of distribution and procurement fraud and the counterfeiting of fast moving packaged consumer goods involved the widespread and complex collusion of multiple parties. The victim was a leading multinational manufacturer of personal hygiene and household hygiene products. After a seizure of fakes in a wholesale market, rumours arose within the firm that insiders were involved. Inquiries confirmed the activities and interactions of several preliminary suspects inside and outside the company. We involved Chinese police, who detained several suspects and questioned them. Police seized a laptop from one of the suspects and we helped to unlock two important documents that were found on it, the counterfeit syndicate's business plan year and their secret shareholding agreement, which differed markedly from the registered shareholding structure of their company which we had already examined. On the secret shareholding agreement, a number of the multinational's employees were listed together with their percentage shares. Consequently, the police made further arrests of these employees as members of the counterfeit syndicate.

The investigation was continued internally within the multinational using interviews, desk searches, computer forensics, and reviews of files on personnel, suppliers and distributors, as well as external field inquiries including company record searches, personal record searches, factory and company visits, undercover interviews, and monitoring. In this way it was possible to map out further elements of the syndicate including additional employees and corporate entities, collusive suppliers who had provided materials and packaging, collusive distributors who had distributed the fakes alongside real product, and tacitly complicit JV partners of the multinational. As a result, a dozen people went to jail, more than 150 staff were removed over the subsequent 12 months, the number of distributors nationwide was consolidated to around 40 from 250, the number of suppliers was reduced to dozens from hundreds, the company gradually terminated some of its partnerships and radically restructured its manufacturing operations.

Before they were caught the syndicate had conducted several million dollars worth of business in counterfeit personal hygiene products. The business plan that was thwarted was valued at US$10 million over the next year and foresaw substantial further growth thereafter. But the business was nipped in the bud and stopped as a result of the investigation and the crackdown.

Another case involving procurement fraud ensnared a European multinational hypermarket chain. A new general manager who had recently taken up his position received a series of anonymous letters alleging that various buyers were operating fraudulent or corrupt schemes and causing losses to the company. The allegations named quite a few people in various sub-departments of the buying operation as well as some suppliers with which they allegedly had unethical relations. We checked these companies' ownership and physical operations, we checked for conflicts of interest, and we looked into the lifestyles and affiliations of the suspects. A number of shareholdings owned by employees were uncovered, and many of the suppliers were found to have no physical existence at all, i.e. they were phantom vendors. Other unethical schemes that were uncovered included kickbacks, goods rebate scams and manipulation of the hypermarket chains' electronic transaction system.

External inquiries were reinforced by internal investigation including desk searches, computer forensics, monitoring and a wave of interviews with suspects and witnesses. Conclusive evidence was obtained that four senior buyers had led various fraudulent schemes and an expatriate who oversaw the buying operation had ignored their sins in exchange for sexual favors. All these staff were interviewed and dismissed, and their suppliers were terminated. A decisive breakthrough in this case came with regard to one of the ringleaders, a young woman who headed up the sub-department buying in dry foods and alcoholic beverages. From interviews, it was learned that one of her main collaborators outside the firm who was operating some suppliers was her boyfriend and that he was a married man. The man's wife was identified and interviewed and provided significant information and evidence to help resolve the case against the buyer. Close associates and subordinates of the dismissed senior buyers were also gradually removed from the company, and security and business controls were strengthened, including the introduction of a Code of Conduct, personnel vetting and vendor screening.

Analysis to quantify the losses suggested that the multinational had been paying up to 30% more than it should in some instances for the goods procured by the corrupt buyers, thus eroding the true potential profit margins and causing several millions of dollars in losses annually. But the multinational did not prosecute any of the culprits out of fear of embarrassing the JV partner, a Chinese SOE. The expatriate later sued for wrongful dismissal but lost the case.

In yet another fiasco, a multinational auto accessories maker hired a handsome and bright young man (let's call him Bill) to be its lead sales manager in China. Immediately, Bill secretly started a company run by his brother Fred, and Bill then transferred product know-how to this family firm. As Bill's company grew,

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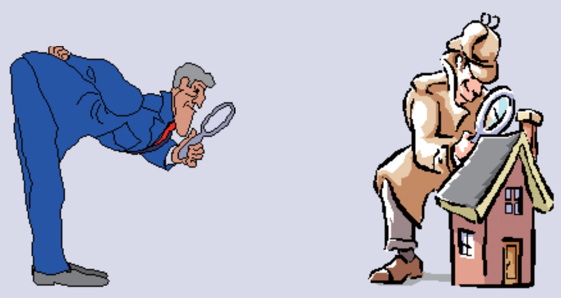

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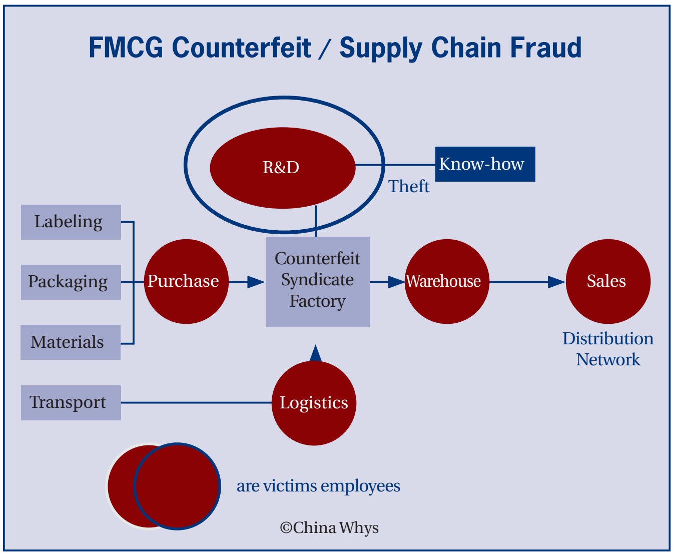
Bill also transferred management know-how. After about seven years, Bill persuaded his employer to form a joint venture with his family firm, while still not disclosing his interest in it. Thus he continued secretly to feed and grow his family firm. He set up subsidiaries and inserted them into the chain as suppliers of his employer. He copied the multinational's products, and targeted their customers for OEM work. After 10 years, his own firm had grown into a serious competitor. Bill then quit the multinational and began to run his firm openly. His firm had achieved vertical integration of coating, components and finished goods. It now formed a holding company in preparation for going public. Bill's products compete head-on with his ex-employer in the market with considerable cost advantages. For a decade, though, his employers did not know.

But it's not only in the making and trading of goods that fraud happens. There can also be fraud in the new deals that you are doing. Evidence gathered for US stakeholders against a Chinese firm which was publicly listed in the USA showed it had defrauded its original Chinese shareholders and made false filings to the Securities and Exchange Commission. This inquiry uncovered conspiratorial insider trading frauds committed by various middlemen who assisted Chinese firms to list overseas, in default of original small shareholders, and who sold shares at the peak through anonymously established offshore vehicles. Another inquiry into a securities transaction helped a leading European investment bank better understand the three major shareholders of a target Chinese firm, when it was discovered that they were proxies brought in to disguise the true owners, whose political status in China prohibited them from owning a company. It was discovered that the three shareholders had engaged in a series of murky share transfers and insider deals to ramp up the share price of the target firm. Inquiries



for a multinational property investment group considering a partnership with a Chinese real estate developer for a new resort revealed that the target had obtained his seed capital some years ago through fraudulent and corrupt activity involving the local securities industry. Once again, inquiries for a global international investment bank into the principals of a Hong Kong-listed company with mainland China origins and exposed their high-level connections to a branch of government and the illegal co-mingling of personal and state interests for financial gain, giving rise to significant legal risks if the international investment bank proceeded to transact with these people.

In most of the fraud cases that I have seen in China the victims had neglected basic business controls and measures to reduce the risk of this type of disaster occurring, and they had been slow to react when the first signs of the problem became obvious.

The high incidence of fraud in China, roughly four times as high as the US, occurs against the background of a get-rich-quick social revolution and economic development phase that has spawned a high incidence of graft in both the public and private sectors. Not only that, due to the culture gap between many multinationals and their China operations, it is often hard to detect and respond to the challenges of white-collar crime.

That gap is one of the single most important factors. No foreign culture and language can be more remote and more difficult to grasp for western multinationals than the Chinese culture. Multinational head offices and their representatives are often blind to what is happening inside their own China operations. This blindness creates opportunity and temptation for unscrupulous individuals to commit fraud, thinking, often correctly, that they will go undetected. Very few multinationals bridge this gap well.

Very often head office or a senior expatriate manager fail to show an adequately hands-on posture, they do not show that they actually care about their operation, they are unable to reach out to all levels of employees, and they over-depend on a single point of reporting – usually a local hire with good English – to provide them with information about the operation. This person gathers too much unchecked power and controls the whole business: language, connections to government, internal network, external social network, direct contact with suppliers, direct contact with distributors, and loyalty from other staff within the company. Conversely, junior employees wishing to express ethical complaints often have no channel to communicate with head office or with the senior expatriate managers even if they want to report problems. This creates fertile ground for deception and fraud. Companies must tackle this risk through a healthy and balanced approach towards the local vs. expat ratio, HR management, screening, training, checks and balances, and internal controls.

Add to this “gap” problem the mentality that has seized many people in this society in recent times and the tremendous social pressure felt by many people here – especially the young. Money brings prestige, and many people are prepared to take shortcuts to own houses, cars and luxury goods. Scholars at Beijing’s prestigious Tsinghua University have estimated that the equivalent of 16% of China’s GDP is lost to fraud and corruption each year, compared with an estimated 4% fraud rate in the United States.

Faced by such challenges, more companies have recently been adopting broad-based ethics control programs to pre-screen employees, vendors, distributors and prospective JV partners or acquisition targets. We have also seen a significant rise in compliance audits. In short, due diligence, background vetting, robust responses to violations of internal controls or to unethical conduct, and the provision of early warning mechanisms to detect or avert fraud, are being embraced in a more integrated way.

Greater efforts are visible among many companies to introduce or strengthen a Code of Conduct by tying it into employment contracts as well as contracts with suppliers and distributors, to outlaw unethical behaviour, especially collusive activity between staff and business counterparties. The more advanced companies are drilling the code of ethics into their workforce and associated firms through ethical awareness and compliance training.

Whistle-blowing hotlines, usually established by big firms on a global basis, have been found inadequate to deal with operations in China due to cultural and language differences. A global ombudsman sitting half way round the world fails to understand the special traits of China. But there needs to be a reliable channel for staff, suppliers, dealers, partners, customers and other stakeholders to report ethics concerns to appropriate people in the organisation. Some firms are now therefore setting up special hotlines to exclusively handle China complaints. All these are welcome developments.

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 contractual relationships
- 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

Peter Humphrey is the founder of ChinaWhys, an advisory firm promoting business ethics and transparency. He is also President of the China chapter of the Association of Certified Fraud Examiners (ACFE). He is fluent in Chinese and has dealt with China and other Communist countries for more than 30 years. He can be contacted at peter.humphrey@chinawhys.com