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Keeping Clean in China

By K.C. Swanson

Companies expanding into China have learned to expect a wide range of problems symptomatic of the vast social and economic changes under way in the country. The hurdles range from immature legal and regulatory systems to widespread theft of intellectual property. On any such list are the instances of corruption, ranging from the petty to the truly appalling, that often occur in business there.

In recent years, corruption has crept up the list of worries — but the reasons may have as much to do with events outside China as inside it. An emphasis on better corporate governance in the U.S. and Europe, manifested in newer laws (such as Sarbanes-Oxley) and increased emphasis on older ones (mainly the Foreign Corrupt Practices Act, passed in 1977), has made it more urgent than ever for multinationals operating in China to keep clean.
"Multinationals are getting more concerned about corporate governance … because of the fiascoes in the U.S. like Enron and WorldCom," says Clement Ngai, the Singapore-based Asia Pacific legal counsel for software maker Autodesk Inc. "That's filtered down to the [Asia] region as well."

That puts the spotlight on the preventive measures the multinationals have put in place. Over the years, many have implemented codes of conduct for local employees, suppliers, and distributors that leave no doubt about which business practices are acceptable and which are not. French telecom-gear maker Alcatel SA has such a code. So do U.S.-based earth-moving equipment maker Caterpillar Inc., chipmaker Texas Instruments Inc., delivery giant United Parcel Service of America Inc., and Autodesk.

Such measures are important, but as the companies will admit, the challenge is great. Nepotism, for example, is a deep-seated tradition in the Middle Kingdom. Deals sealed by connections and bribery are common. And as companies deepen their presence in China, they inevitably increase their exposure to these and other problems.

On one hand, foreign firms face the risk of becoming victims of corruption themselves by getting ripped off by local hires who siphon off funds to "dummy" companies or business to friends. More serious is the risk of corruption taking place inside Chinese subsidiaries or partners. Foreign-based companies whose employees are caught bribing Chinese officials or manipulating financial statements, both of which are forbidden under the Foreign Corrupt Practices Act (see sidebar, page 33), face penalties from the Department of Justice and the Securities and Exchange Commission — even if corporate executives in the U.S. are unaware of the illegal activity.

Just ask these multinationals, which have recently been embarrassed by revelations of graft in their China operations:

• In May 2005, medical-device maker Diagnostic Products Corp. admitted its Chinese subsidiary had violated the FCPA and agreed to pay fines of $4.8 million to the DOJ and SEC. The U.S. government says the firm forked over bribes to doctors in charge of purchasing at state-run hospitals and recorded the payments as legitimate sales expenses.

• In February 2005, airport security vendor InVision Technologies Inc. (which General Electric Co. acquired in December 2004) agreed to pay a $1.1 million SEC fine and an $800,000 DOJ fine for bribery and improper record-keeping that took place in China, the Philippines and Thailand.

• In April 2004, Lucent Technologies Inc. fired four of its top employees in China, including the president and chief operating officer, and reported to the DOJ and the SEC that an audit had turned up potential violations of the FCPA. Lucent says it's cooperating with those agencies but declines further comment.

The number of companies drawn to China will only increase. Already, many leading multinationals make more than 10% of their global sales there. The good news is companies can take steps to protect themselves from fraud. Among the leading recommendations: Promote codes of conduct, establish clear reporting lines for China branches, spot check suppliers to make sure they exist, and do background checks on new hires and potential business partners. Above all, don't look for shortcuts.

Action items

• Create a code of conduct that states acceptable and unacceptable business practices.
• Establish clear reporting lines for managers in China and in the U.S.
• Put expatriate managers—permanently or temporarily—in key management and financial positions.
• Spot check suppliers and joint venture partners to be sure they follow Chinese and American law.
• Conduct thorough background checks on new hires, suppliers and joint venture partners.
• React quickly to potential violations, alerting senior managers and the board.

Source: The Deal

To understand the corruption level in China, consider the results of a survey by Transparency International, an organization dedicated to combating corruption. According to TI's 2005 corruption ranking — based on input from country analysts, risk agencies and resident and nonresident business people — where 0 is highly corrupt and 10 is clean, China ranks 3.2. Other Asian nations fared worse, with Indonesia ranking 2.2 and Vietnam 2.6, but the corruption problem in China is still far more serious than in the United States, which ranked 7.6.

Beijing has made progress with its anti-corruption campaign, with nearly 50,000 officials punished for misbehavior during the past two years. Authorities have also been promoting stricter enforcement of laws, which among other things forbid officials from accepting gifts with a value more than roughly $24. Though this regulation is still widely flouted, the government has sought to make examples of high-level offenders by sentencing them to jail time and, in the most extreme cases, to death.

"I think the stereotyped idea of government officials taking bribes has changed in the last five, 10 years," says Autodesk's Ngai. "Maybe in the fairly small areas or third- or fourth-tier cities this could happen. But I don't think, in the major cities where multinationals are operating, this is the case." Still, few would argue that modest levels of corruption don't carry the same stigma in China as in the West. A quiet bribe from a supplier may not be seen as dirty money, but rather as fair compensation for a low salary.

"You have a situation where some people don't know the difference between right and wrong," says Peter Humphrey, head of Shanghai-based ChinaWhys, a risk management firm helping multinationals tackle white-collar crime. "It will only be solved through education. You won't see this problem disappearing for any big company in the next 10 or 20 years."

Kickbacks are common scams in China. In the classic case, an employee takes bribes from suppliers in exchange for awarding business. Depending on the product, the margins on kickbacks could range from 1% to 30%.

There's reason to believe companies can discourage bribe-taking by setting high standards for business conduct. Consider Caterpillar's experience. Early in the 10-year history of the firm's 1,000-person manufacturing plant in Xuzhou, some employees were caught taking kickbacks in exchange for awarding contracts, and were fired. But no one has had to be sacked for a similar offense during the past few years, which general manager Marvin Rosser credits partly to the introduction in 1998 of a code of values that says under-the-table deals won't be tolerated. The code stresses the values of excellence, teamwork and commitment, adopted from Caterpillar's Peoria, Ill., factory. A fourth, integrity, was added after executives decided plant managers needed to discuss it in-depth with employees in China.

Caterpillar's manufacturing facility is a joint venture with a state-owned enterprise, meaning many of its employees are government officials and most of its suppliers are SOEs. Rosser believes this makes the code of conduct even more critical. "There are some people from SOEs where the opportunity for promotion or compensation increases might be tied to new business deals," says Rosser, "where at Cat there will obviously be no compensation exchange for such favoritism."

In a similar position is Alcatel, which in 2002 folded its China businesses into Shanghai Bell and took a majority stake in the new entity, renamed Alcatel Shanghai Bell. As Alcatel (New York Stock Exchange-listed, via American Depositary Shares) has upgraded Shanghai Bell's internal controls to align with international practice, it's also been making progress toward Sarbanes-Oxley compliance by the end of 2006, says Christian Reinaudo, president of Alcatel Asia-Pacific activities. Alcatel's China office requires employees who deal with suppliers or customers to sign a letter agreeing to abide by its ethical code.

Major suppliers also sign a document promising to follow fair business practices.

In fact, most major U.S. companies include contract language requesting that their partners and suppliers around the world — not just in China — act in a manner that won't get American firms in trouble with the FCPA. The trouble is that Chinese firms sometimes sign the contract and simply ignore it because contracts don't carry the same weight as in the U.S. But at least if a problem crops up later, American firms can make the case that they tried to encourage good governance. Employees awarding contracts to family or friends is another common problem. Sometimes the contracts are given in exchange for payment; other times no money changes hands. The latter situation can be tricky to address because employees in many countries may see nothing wrong with favoring friends and relatives.

David Reid, vice president and director of worldwide ethics for chipmaker Texas Instruments recalls one question-and-answer session when a procurement staffer in South Korea wanted to know why he couldn't simply buy supplies from his brother-in-law's store. "I remember responding, 'Why would you do that?' " recalls Reid, "and the person said, 'Because I know my brother-in-law won't rip me off.' In Asia in general, that relationship — guanxi — is something that is traditional and in many situations honorable. It seems counterintuitive when we tell people no, we have a process [for procurement]."

But other times, conflicts of interest clearly reflect less honorable intentions. Case in point: Texas Instruments discovered that a sales employee in China had teamed with some of his old college roommates to set up a distributorship, then began selling to his own firm. "The entrepreneurial spirit is alive and well in China," says Reid. When an investigator confronted him, the employee quit.

At Alcatel, according to Reinaudo, "The first request [for employees involved in procurement] is to exit from ownership in any company that poses a conflict of interest with the job."

Fraudulent employees have also been known to set up dummy companies registered in the name friends, relatives or, occasionally, in the employee's own name that takes a cut of revenue from the supply chain without providing a service or even having a physical presence at all. In an even bolder gambit, employees may spend years quietly building up rival businesses to compete with their own employers.

"They get their relatives and friends involved and gradually expand," explains Humphrey. "They develop a whole value chain, and when they finish, they abandon their employer." Humphrey says he recently investigated a scheme in the chemicals industry in which employees stole technology and industrial processes, resulting in millions of dollars in losses to the company.

Among the tip-offs to potential problems with employees: customers complaining about inaccurate invoices or accountants apparently unwilling to investigate a pile of fishy-looking receivables. A common method of exposing wrongdoers is through anonymous letters, which have a long history in China. Expatriate managers may be tempted to dismiss letters that seem outlandish or that are written in poor English. But fraud investigators say such letters are often valid.

To help prevent such goings-on from ever starting, companies can create a chain of people who sign off on purchases. Other anti-fraud measures: spot checks to make sure suppliers actually exist, and screening new suppliers and partners. A thorough investigation on a potential joint-venture partner, for example, might entail looking into the reputation of management as well as the company's handling of previous deals, its source of capital, associations with other firms or government agencies, industry reputation, labor or environmental problems, debt and any record of bribery. Unfavorable findings need not necessarily destroy a deal, especially if the partner proves willing to cooperate or work to improve the problem. The results of an investigation might even help a multinational renegotiate a deal on better terms.

One of the most common mistakes companies make in combating fraud is failing to do background checks on high-level employees. In some cases, employees sacked for corruption have later found work in the same industry with other multinationals. They may even land jobs through respected headhunters, though some headhunters have begun conducting their own background checks. That an employee has an advanced degree or overseas experience doesn't necessarily guarantee he or she is trustworthy.

Texas Instruments verifies the education and work history of new employees and also checks background references and ownership records of both customers and suppliers. Some of its products contain technologies that can only be used in non-military applications in China. If a customer's management or board had ties to the military, TI would have inadvertently shared the information with a non-commercial entity.

Other factors can also boost the risk of fraud. Companies that lack clear lines of reporting in China, or where different locations operate as independent fiefdoms, are more vulnerable to abuses. A culture gap between expatriate managers and local staff can compound corruption problems by fraying the lines of communication. Frequent turnover of foreign managers doesn't help, either. Outgoing managers should be questioned about potential fraud hot spots in the company.

There's no proven recipe for maintaining the right balance of foreign and local financial staff. Some big companies may bring in expatriate chief financial officers for the first few years of a China venture so they can train local staff in the company's procedures. At Alcatel Shanghai Bell, the chief financial officer, the management controller of the company and the management controllers of the major product lines all come from the Alcatel side, not from Shanghai Bell. The local head of procurement is Chinese, but he spent more than six months in a European posting to better acquaint himself with Western business practices.

Most companies eventually want to localize, though, both to save money and because Chinese staff better understand local needs. For example, as UPS expands globally, it usually tries to fill jobs with local or regional candidates. The company's current finance and accounting controller in China hails from Singapore. But Jeff Wilson, director of human resources for Asia-Pacific, says UPS "doesn't have a standard, cookie-cutter formula: 'If x, bring in y number of expats.' "

Occasionally, companies that have pursued localization in China back off that policy after running into problems. "I've seen companies where after going through a bruising experience, they reverse the pace of localization and bring back expats for a while — which suggests to me that nobody knows how to get it quite right," Humphrey says.

A written, comprehensive code of conduct reinforced with regular training may be the best approach to discouraging corruption and protecting the company from legal action. UPS has a committee review its code of conduct to be sure the translation is meaningful in terms of language and local customers, according to Wilson, and managers take part in biannual refresher sessions. And Reid of Texas Instruments makes trips to China to review the code of conduct with managers and factory employees, reminding them, for example, not to let trade secrets slip when they chat with their old professors.

Most companies agree, though, that even the most thorough anti-corruption plan may not eradicate the problem. "When you manage 6,000 people in China, you can never swear that there's nobody doing anything incorrect," Alcatel's Reinaudo admits.

But at least by setting high standards at the outset, companies may save themselves dollars, time and face in the future. CD

- SIDEBAR -

The long arm of the FCPA

The U.S. Foreign Corrupt Practices Act dates to 1977. But as U.S. companies accelerate their expansion in China, it has never seemed more relevant.

The law forbids American companies and their employees at home and abroad from offering bribes to foreign officials, a group that includes both employees of government agencies and those of state-owned enterprises. The latter accounts for many Chinese businesses, which means interactions the FCPA wouldn’t govern elsewhere are covered by it in China, according to Patrick Norton, a partner in the Washington-based office of O’Melveny & Myers LLP who until recently worked for the firm in Beijing. He says it’s not uncommon for Chinese officials to expect perks, such as travel to U.S. tourist sites, during overseas trips. They are often surprised to find that under FCPA, their American hosts aren’t allowed to foot the bill.

FCPA also requires U.S.-owned companies with operations in China, as in all overseas locations, to make sure their local agents and partners don’t offer bribes on their behalf. That requires careful oversight, which can be difficult in part because wholly foreign-owned enterprises often use local intermediaries to get government approvals, Norton says. Ideally, U.S. companies should request the performance records of agents and distributors to make sure they're clean, though that's often difficult in practice.

Penalties for making bribes include corporate criminal fines of up to $2 million for each violation and jail time of up to five years for wrongdoers. Further, the Securities and Exchange Commission can fine publicly listed U.S. companies caught disguising bribes directed at employees of government or private companies in their financial records.

A speedy response to suspected mischief can help a company avoid serious legal penalties. FCPA violations are often investigated by independent lawyers who work with in-house attorneys and auditors to resolve problems. Investigators report to a company's board of directors and recommend how to resolve the problem, which might include firing the responsible employee, cutting ties with suppliers implicated in the violation or requiring additional FCPA training.