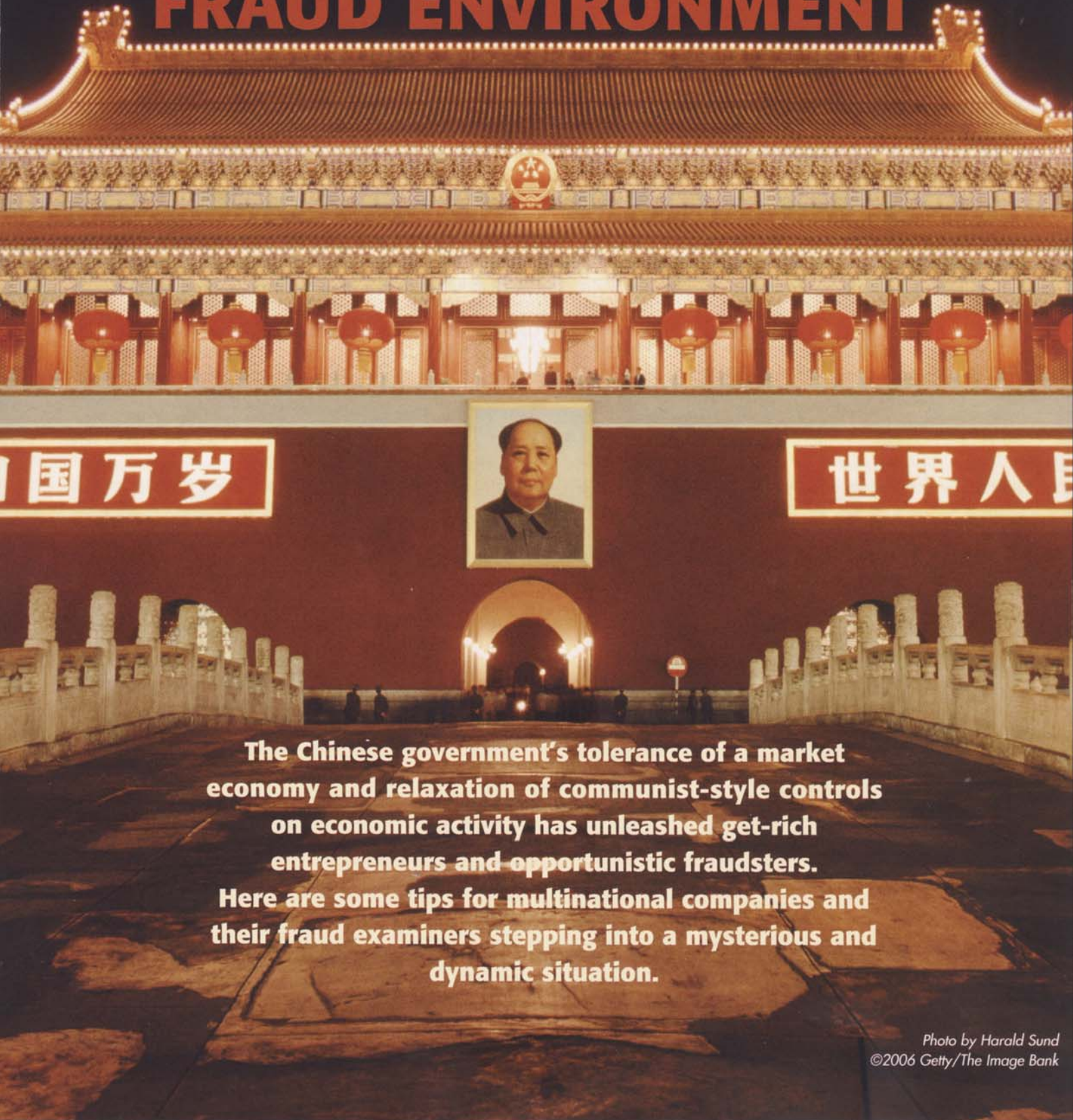


Booming fraud in China

# DECODING CHINESE FRAUD ENVIRONMENT



**The Chinese government's tolerance of a market economy and relaxation of communist-style controls on economic activity has unleashed get-rich entrepreneurs and opportunistic fraudsters. Here are some tips for multinational companies and their fraud examiners stepping into a mysterious and dynamic situation.**

*Photo by Harald Sund  
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hina is booming and so is its fraud. And it's not so much the headline-grabbing stories that foreign investors have to worry about. Fraud has infected the supply chain – the nation's business and their vendors, distributors, and employees. As multinationals shift their supply chain bases to China, these companies need to know that fraud in distribution and purchasing systems is burgeoning. And they need to know the unique factors that are driving it.

The Bank of China recently revealed it was working with U.S. authorities to recover half a billion dollars embezzled by branch managers who had fled to America. Official government sources reported 72,000 of what China euphemistically calls "economic crimes" in China in 2005 – up from 9.7 percent in 2004 costing US\$18 billion. They say that 61,000 cases were solved and US\$1.8 billion was recovered. But, of course, fraud statistics often can't be accurate. We're probably only seeing the tip of the iceberg of a large-scale problem.

There are some who don't take the situation seriously. The president of a U.S. manufacturing firm with a substantial China operation recently was asked whether his firm has a hotline to manage ethics complaints in China. "Oh, no, I don't take any of that nonsense seriously," he replied. "If I get any of those anonymous letters, I throw them straight in the bin." Well, take a look at these cases, Mr. President.

### CASE ONE: DR. ARTHUR AND HIS MANY RELATIVES

A European construction machinery manufacturer with offices and manufacturing facilities at multiple locations in China (we'll call it XYZ Corp.) employed a Chinese national with a Ph.D. (let him be known as Arthur) at its head office for several years. The company then sent him back to China as country manager on generous expatriate terms. For some years, XYZ distributed its products in China through multiple local dealerships. Then, suddenly, Arthur announced that the main dealers had formed a new joint company (let's call it Superdealer Ltd), inserting a new tier between the multinational and the existing dealerships. Arthur had presented the effective change to the board without prior notice. A year or so later, XYZ received an anonymous tip-off alleging Arthur might have illicit interests such as shareholdings or kickbacks in Superdealer Ltd. or its dealerships.

Even before these allegations were made, XYZ had grown frustrated with Arthur's poor performance in sales and distribution. He was uncooperative and had behaved in a dictatorial and eccentric manner toward local staff. Therefore, XYZ had hired an additional Chinese senior manager as a counterbalance. Evidently unsettled by this move, Arthur resigned about the same time as the anonymous tip-off.

XYZ, which naturally felt its business was seriously jeopardized, initiated a discreet probe to try to uncover

**By Peter Humphrey, Associate Member,  
and Yingzeng Yu, Associate Member**

the facts, identify problems in its distribution network, and make the operation more transparent. An internal audit uncovered little. The European auditors couldn't understand much of the chaotic paperwork, which was written in Chinese, and local employees were mostly unhelpful. So the company engaged Chinese external auditors to conduct a discreet investigation into Arthur and the distributors.

A detailed one-month examination of Arthur, Superdealer Ltd, and three of the original dealers (Dealer 1, Dealer 2, and Dealer 3) proved that Arthur had taken illicit gains out of the business and seriously undermined the distribution network and XYZ's prospects in China. The company would have to spend a great deal of time and money to repair the damage and prevent a recurrence.

The external auditors showed that Arthur had planted his wife as a 20 percent shareholder in the most important dealership, Dealer 1, and hired his childhood friend to manage Superdealer. Arthur concealed his actions from XYZ while enriching his family.

Meanwhile, Superdealer was sidelining some of the old dealerships in which Arthur had no personal stake. They were angry and possibly the source of the tip-off.

The examination of the dealers that were part of Arthur's shadow business showed a noteworthy chronological pattern of incorporation involving identical amounts of capitalization for each company. The external auditors found that one firm's registered capital was taken out and used to incorporate the next entity after the required period for keeping the cash in the bank.

They proved that Arthur's wife was an active school teacher, not a businesswoman, and there was no possibility that she was an active participant in the dealership business.

They also discovered that Arthur had bought real estate with his ill-gotten gains and – as part of his expatriate package – he had also deceived the company into paying rent for a house that was actually his own by inventing a fictitious landlord and fabricating a lease.

The external auditors also calculated that through these various schemes Arthur had extracted millions for himself from the XYZ business over several years.

When the auditors discovered Arthur's transgressions, he still hadn't formally left the company and was on "gardening leave" – that is, he was still on the payroll prior to formal departure, still subject to the company's rules, and hadn't yet received his severance payments. The company's legal counsel advised that Arthur be summoned to a meeting with a head office auditor and the company's external lawyer "to discuss his departure terms" and be confronted with the proof. At this meeting, the interviewers gave Arthur several opportunities to lie. They then presented documents that proved he was lying, and he admitted his guilt. They rejected his resignation, terminated him with cause, and withheld all his severance payments.

Unravelling and unveiling this kind of mess is like peeling the many layers of an onion. The case raised by these types of allegations can rarely be solved by internal audit and transaction

reviews alone, although these may be part of the process. Fraud examiners in China will need to be backed up by external investigation methods and private investigators who have strong local knowledge and contacts.

Solving the Arthur case required a variety of methods. Investigators scrutinized HR and suppliers' files from the victim company to comb for vital personal data in the Chinese language about suspect employees, which provided vital identifiers and clues for the external inquiries.

Investigators also scoured e-mails for clues and leads, which obviously required the use of both Chinese and English language skills.

Most importantly, they analyzed company returns and personnel data from local authorities such as incorporation files and annual returns submitted to the bureaucracy in charge of registering and inspecting companies. After examining such data of the related companies in this case, they could flesh out inter-company relationships in more detail. Also, they could glean personal information about individual shareholders including identity numbers and home addresses. It was necessary to identify relatives and their workplaces and career histories. This analysis enabled them to prove in many cases that a certain shareholder of a certain company is, in fact, a certain person's wife, father, in-law, or old school buddy.

Names – both surnames and first names – are surprisingly few in this land of 1.3 billion people. Many people share the same name. Just imagine 10 million people named John Smith. So a critical component of fraud examination in China is to link together company names, shareholder names, ID numbers, and other personal identification data.

These methods can be reinforced by a careful analysis of call records on mobile telephone accounts. The company has paid for these accounts and so has a right to review the calling lists. In Arthur's case, investigators also analyzed real estate records, which included documentation on the ways he purchased his houses – in cash lump sums without mortgages!

Investigators conducted undercover telephone inquiries with related parties including the distributors and certain individuals within those firms. Investigators conducted undercover site visits to the companies to identify the actual persons running them. Investigators also visited the home addresses of those involved and spoke to individuals in real estate management offices and neighborhood organizations.

Only through this combination of methods was it possible to close the loop, connect the dots, and unmask Arthur's fraudulent and corrupt schemes.

#### **CASE TWO: THE DIVERTING, DISLOYAL EMPLOYEE**

An American multinational company (we'll call it "Office 123 Inc."), which manufactured office products and had a sales office and factory in Eastern China, received an anonymous letter alleging that an employee of the company in China, Buyer X, held shares in one of the main Chinese suppliers, Supplier Y.

Office 123 had obtained a corporate registration document on Supplier Y, but Buyer X wasn't listed as a shareholder or officer. Interestingly, at the same time Office 123 discovered that immediately after it had amended its business license to give it rights to manufacture a new product line in China, Supplier Y also changed its license to do the same, which indicated a conspiracy and a deliberate attempt to replicate Office 123's business.

Bilingual investigators discovered in corporate registration documents that Supplier Y had registered two different addresses. An investigator discreetly visited the two addresses and found that Supplier Y was indeed located at one of the two addresses where it presented itself as a trading company. At the second address, however, the investigator found a different company – a manufacturer – Company Z.

When the investigators examined Buyer X's e-mail traffic, they discovered that this suspect had recently diverted orders from Company Z to company Y because Company Z was unable to meet the quality requirements. In a different e-mail, Buyer X also confided to one of his contacts that he and his friends had recently acquired a piece of land and were preparing to build a factory on it. In the same e-mail, Buyer X asked that all the e-mail correspondence be sent to his private e-mail address, not to his company e-mail box.

An investigator visited Company Z under a trade pretext. There he learned that senior executives of Company Z had been diverting business from their employers to their own company. The investigator followed the lead to the location of the new firm where he learned that the senior executives had recently bought a piece of land on which they were building a large factory. The investigator discovered the name of the new firm, retrieved and carefully examined its corporate registration documents, and found the name of Buyer X listed on some of the records as deputy general manager.

Consequently, Buyer X was fired for his role in diverting business and for acting in conflict with the company's interests.

### CASE THREE: CRONYISM AND LOAN SIPHONING

A multinational company managed a chemical joint venture in China's Hebei Province, which it had acquired from a Chinese state-owned enter-

## IMPORTANT CONSIDERATIONS FOR NON-CHINESE FRAUD EXAMINERS

- *What's in a name?* Chinese surnames and personal names are in short supply. Many people have same or similar names. Just imagine 10 million John Smiths! Catching a fraudster can involve matching a name to a person's unique ID number, identifying relatives, and then matching this data to corporate or other records.
- *Analysis of records.* Gaining access to records and conducting an intelligent analysis of the data is vital to solve frauds in China. Reviewing corporate filings, property records, tax returns, transaction data, expense claims and receipts requires strong Chinese language skills. China will need bilingual CFEs.
- *Kickbacks widespread.* In China a purchasing career offers the most lucrative opportunity. Buyers become de facto salesmen for suppliers. Kickbacks can come as cash, cars, holiday trips, and real estate often given via relatives of the employee.
- *Conflicts of interest.* Mid-level managers often run sideline businesses. They create firms under their names or under the names of family members or proxies, push buying or sales through these firms to the detriment of their employers, and fund their operations with employers' money through false expense claims.
- *Phantom companies.* Bogus suppliers and distributors in which employees have an interest often have no physical existence but are mere paper companies. This can be verified by local private investigators.
- *IP theft and business replication.* Theft of intellectual property and commercial secrets is widespread. Purchasing and distribution frauds are often interwoven with the theft of secrets and efforts to replicate a multinational's business.
- *Expenses and receipts.* False expense claiming is rampant. Official receipts are often coupons without descriptions. Employees often charge personal items to employers through fake receipts. Salesmen use false receipts to disguise slush funds created to bribe customers including state-owned entities.
- *Company search limitations.* There's no publicly accessible nationwide data pool of company registration and property ownership. Data is kept in hard copy at local government level. Manual searches are necessary using reliable contacts.
- *Real estate.* Chinese are obsessed with real estate ownership and fraudsters often put their money into property. Owning real estate beyond their means and having paid for it by lump sum cash can be a sign of fraudulent activity.
- *Asset searching.* The paucity of personal names hinders asset searching. The fragmented data situation makes it worse. Assets can easily be moved to a new firm in a new locality or switched to different family members.
- *Quantification of IP losses.* Government agencies such as the police or the courts aren't capable of quantifying losses of commercial secrets or intellectual assets. A case needs to be argued in persuasive detail before they will take it seriously.
- *Legal limits.* It's hard to prosecute. Unless it can be proved that a white-collar crime caused a loss of above US\$60,000 or bankruptcy, legal action is futile. It's also hard to prosecute for possession of assets obtained through illegal means. Such income is often cash under the table and the people holding these assets never file tax returns. Chinese laws don't offer the same level of protection to foreign and private business as they do to state-owned enterprises.
- *Local protectionism.* Stakeholders, including local government, regulators, and law enforcement, often protect local fraudsters or IP thieves and obstruct litigation or prosecution because the perpetrator provides local jobs and pays taxes or bribes.
- *Police limitations.* Law enforcement is often inadequately resourced or trained to cope with sophisticated commercial crime so police are often reluctant to investigate a case and need to be spoon-fed with information and evidence.

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prise two years before. The previous general manager, who was well connected locally, installed many of his cronies in key management positions, and many of his relatives and friends owned the suppliers. He also set up a rival company making the same products. Veteran employees who knew the history had long been forced out of the company. Suppliers owned or affiliated with the ex-general manager had been selling inferior products to the company at inflated prices, and salespeople had deliberately locked contracts into low prices to miss the opportunity of the peak season. As a result the company had been losing money since the acquisition. The new shareholder hired a new general manager and was determined to seek evidence that would root out the cronies of the ex-general manager from the company.

With the support of the new management, fraud investigators conducted individual interviews in Chinese with most senior executives of the company, sales and purchasing staff, and some veteran employees who had been forced out of the company. Their knowledge of the history provided important intelligence and investigative clues. The investigators analyzed and distilled information from these interviews and pinpointed leads for further inquiry. They left the main suspects for last so they could collect enough information to confront them. After the interviews, the investigators focused their audit on purchasing, sales contracts, and accounting records. They discovered on the payable list that layers of middlemen, whose names didn't appear on the supplier list nor in any of the purchasing contracts, had been inserted between the real suppliers and the company. A large amount of money had also been siphoned out without any authorization as loans to companies linked with the ex-general manager. As a result of the investigation, the finance and purchasing manager were confronted with the findings and

their employment was promptly terminated.

#### FACTORS IN THE CHINA FRAUD ENVIRONMENT

These cases are among many hundreds that we've investigated in China over the past decade. They typify problems that many multinationals face with their China operations. Often, multinational victims neglect the basic "best practice" prophylactic measures because, for some reason, they were persuaded by somebody that these couldn't be implemented in China. Later they pay the price for this misplaced view.

Corporate governance in China falls well below international standards. A survey by the Hong Kong City University & Institute of Directors gives China extremely low marks for corporate governance. Chinese firms listed on the Hong Kong stock exchange score 44 out of 100 (average) for corporate governance practices. This includes China's leading listed companies, known as Red Chips, and the overseas-listed arms of Chinese state-owned firms, listed in places like Hong Kong and known as H-Shares. The criteria included disclosure, shareholder rights, directors' responsibility, and compliance, among other factors.

The most common triggers for a fraud investigation, like the Arthur case, include anonymous letters, tip-offs from stakeholders in the business such as an aggrieved vendor or distributor, or an internal audit that raises suspicions that the auditor can't resolve. Internal audits have increased in the past year or so in the China operations of multinationals registered with the U.S. Securities and Exchange Commission (SEC). The

increase is mainly due to concerns over Sarbanes-Oxley governance requirements, the SEC's crackdown on U.S. firms, and the risk of prosecution under the Foreign Corrupt Practices Act and the Act's European counterparts. Also, there have been audits for makeovers within multinationals that were restructur-

### SEAH SPEAKS AT CHINESE CONFERENCE ON CORPORATE COMPLIANCE

Tommy Seah, CFE, CMC, FAIA, ASCA, ACIB, MIIA, vice chairman of the ACFE Board of Regents, recently gave the welcoming address and moderated panels at a two-day conference that billed itself as "China's first summit to discuss the issues of transparency, corporate governance, and compliance."

Most of the speakers at The Internal Audit, Corporate Governance & Compliance (IACC) World 2006 Summit, April 26 and 27 in Shanghai, stressed the need for the application of the principles of Section 404 of the U.S. Sarbanes Oxley Act to create accountability at all levels, Seah said.

"The common understanding in plain language [at the conference] was that 'nobody dies alone' in matters of failure in internal controls," Seah said. "They have a Chinese saying, 'If the beam is not leveled, the pillars will not be straight.' That is the literal translation. But I think what is meant is that the tone at the top must be right."

IACC speakers, mostly based in China, discussed anti-fraud and risk management efforts in the Chinese corporate world, creating an effective compliance culture in Asia, the need for standards and accreditation in the region, coping with SOX compliance, dealing sensitively with cultural issues, and several other topics.

"Needless to say, I took the opportunity to show the participants the strategic advantage of being certified by the ACFE and the many opportunities for those who attain the CFE status," Seah said. The Chinese government has invited him to speak on national television about anti-fraud principles later this year, he said.

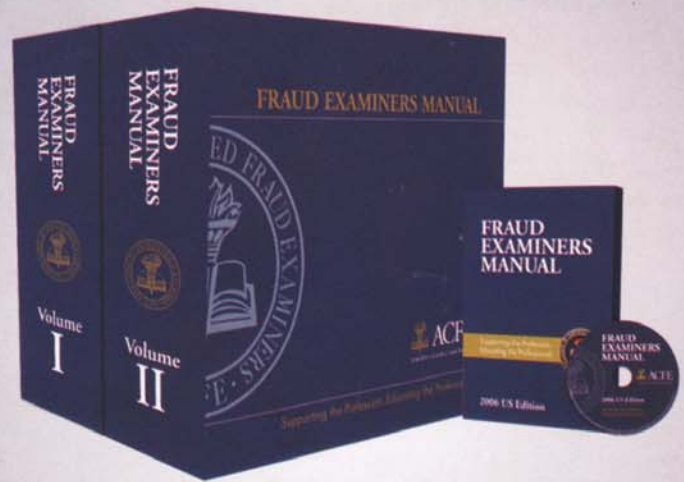
ing businesses to take advantage of deregulation in China following its entry into the World Trade Organization. Much of this activity has uncovered bad smells and led to many fraud investigations of the Arthur type.

Among the triggers, the anonymous letter has to be taken seriously in this country. The Chinese people have a long tradition of anonymous denunciation going back hundreds of years. In our experience, the content of an anonymous allegation letter in China turns out to be true nine cases out of 10. The motivation may vary – from the disgust of a genuinely honest employee or a wrongfully dismissed employee, to the anger of a jilted lover, or to turf warfare among competing corrupt factions within a company. But even if the motivation varies, the force of the facts doesn't; usually the allegations are true. Therefore, firms should have policies and procedures in place to handle whistle-blowing and should take complaints seriously.

The solution of the Arthur case might sound like good news. It might appear that it's easy to solve such cases in China. Unfortunately, it isn't. Many multinationals get wind of such crimes, but don't manage to peel the onion, never mind punish the culprits even when they're unmasked. There are a number of reasons for this.

One problem is that the language and culture barriers between a typical multinational and its China operations erects a formidable obstacle. Multinationals with large operations often fail to drill their codes of conduct, ethics practices, standard operational procedures, and internal controls into their China organizations. They often get the mix of expatriate and local staff wrong. They engender an "us and them" atmosphere due to pay differentials and communication failures. As a consequence, a gap emerges that in itself represents a serious risk. The culture gap is both an opportunity for, and a driver of, the unscrupulous individual to commit fraud. It also raises a penetration challenge to the internal auditor or fraud examiner. The non-Chinese investigator can often be overwhelmed by something as mundane as the maze of names of Chinese companies and organizations translated in a myriad different ways. It's also quite common during an inquiry for

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Chinese managers who are made privy to what's happening to leak information – accidentally or otherwise – to other employees and thus blow the investigation.

Such issues were also reflected in a recent crime survey by accounting firm PriceWaterhouse-Coopers, which found that 54 percent of the fraud cases in China were perpetrated by internal parties and that the most common denominators were different customs and business ethics. It also found that there's a lack of awareness about values or wrongdoing and that the perpetrator was easy to tempt.

The “gap” helps to foster the development of informal command and communication structures and rogue operations within a company's China organization, which soon amount to a shadow business. People may hold certain job titles, but what are they really doing? Who are they really taking orders from and giving orders to? The business model in action may be very different from the one that the corporate headquarters thinks it has on paper.

It's also important to understand the tremendous social pressure felt by today's Chinese, especially the young, to make money. China's recent tolerance of the market economy and the relaxation of communist-style controls on economic activity have unleashed a get-rich-quick revolution. More than two decades ago when he launched the reform, Chinese leader Deng Xiaoping cast aside the Maoist reverence for egalitarianism and told China that “to get rich is glorious.” Many Chinese have been doing just that. At the same time, the political upheaval of China's “Cultural Revolution” before the reform, had trashed traditional Chinese ethical values and created something of a moral vacuum. Many people no



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longer knew the difference between good and bad behavior. This has created a great deal of “values confusion.” The strong drivers for many Chinese – besides finding a spouse of good social standing – are accumulating money, cars, and houses that will help win respect from peers. Some have been tempted to take shortcuts by committing white-collar crime. It's no coincidence that many of the culprits in the fraud cases we've examined in China were under the age of 30. Even some Chinese corporations are starting to recognize this as a problem and are now looking to establish ethics programs.

Multinationals faced with difficult fraud situations often are unsure where to turn for succor and resolution. Should they go to their Big 4 accounting firms? To the lawyers? To the internal auditors? To CFEs? To security people? To specialized consulting firms? They often tend to swing between these various problem solvers. Very rarely do they manage to coordinate the resources of all of them in a cohesive and effective way. As a result, they sometimes get close to the truth but fail by a whisker to close the loop on an irritating mystery. Very often, internal and external approaches must be combined. Investigations, if successful, might at the least facilitate dismissing of culprits to purging the organization of corrupt elements, and they certainly will spur multinational executives to beef up defenses and controls and to reduce the risk of a recurrence.

However, even if the victims “solve the case,” regrettably they rarely win justice. This is primarily due to an inherent bias in Chinese law towards Chinese state-owned enterprises (SOEs) and against private and foreign-held businesses. China's Criminal Code does define certain white-collar crimes, such as fraud, embezzlement, and bribery, and it provides penalties for them. But private or foreign enterprises have little hope of getting a hearing,

never mind a fair one.

You've probably realized that nobody went to jail in the three cases we've described. The companies simply terminated the fraudsters and perhaps withheld some severance. Of course, such outcomes provide very little deterrence for this type of criminality. The heavy penalties seen in certain high-level corruption cases, such as life imprisonment and the death penalty, are rare and politically selective, and don't occur in private sector fraud cases. So companies must learn to police themselves with effective controls and inquiries and not count on the authorities to do it for them.

If Arthur had defrauded a SOE in the way that he cheated XYZ, he probably would have gone to prison. But judicial and enforcement agencies in China take little or no interest in private-sector cases of this type yet. The commercial crimes division of the Chinese police is still in its infancy. China's officials – including police – were raised in the Communist Party and state-ownership system. It will take a long time for their mindsets and training to change and for them to acquire the necessary fraud examination skills. Multinationals, therefore, may need to lobby the Beijing government together for better legal protection. Until they get it, the business of fraud investigators here – be they internal auditors, PIs, or CFEs – may be brisk. 🔍

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*Peter Humphrey, Associate Member, is the founder and managing director of ChinaWhys, a Shanghai-based advisory practice promoting business ethics and transparency in China. He's fluent in Chinese and has dealt with China and other communist countries for more than 30 years. His e-mail address is: [peter.humphrey@chinawhys.com](mailto:peter.humphrey@chinawhys.com).*

*Yingzeng Yu, MBA, Associate Member, is the general manager of ChinaWhys. Born in China, she was trained in financial management at the Anderson School of Management of UCLA, worked in financial control for a number of companies and has spent the last 10 years as a fraud investigator in China. Her e-mail address is: [ying.yu@chinawhys.com](mailto:ying.yu@chinawhys.com).*

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