

## CONTRIBUTING ARTICLE

By Peter Humphrey

The global rush to invest in China reflects the enormous potential rewards that multinationals sense can be earned in China. With the potential rewards come risks, and perhaps the most potent threat foreign investors face in China is the perceived difference in the local business culture. A pervading attitude is that best international business practices cannot be followed in China because they go against the grain of Chinese culture. Foreign investors speak of doing things the "Chinese way" - which usually implies tolerating corruption. For a multinational company, it is a dangerously erroneous stance to regard corruption, fraud, and kickbacks as par for the course here.

Corruption in business does exist, and the way to combat it is not acceptance but prevention. The China exceptionalism approach will only result in compliance failures and corporate governance disasters. Multinationals have corporate governance responsibilities towards their home constituency, head office, and their increasingly graft-weary shareholders. As one US high-tech corporation, forced to purge its senior China management due to rampant bribery practices, recently found, the permissive mindset comes at a hefty price.

## Case Study

Consider the case of Frankie Wang (not his real name). He is from a generation in China which began their working lives during a period when it was acceptable to take shortcuts to get rich quickly. A capable man, he won a private scholarship to study in the United States. After earning a PhD in law at an Ivy League university, he began working at an international law firm, specializing, among other things, in tax law and corporate structuring. Some years later, Frankie returned to Shanghai and took a senior management position at a well-known European manufacturing company. A charismatic man, he developed an entourage of loyal cronies and proceeded to collude with them to steal from the company via a variety of scams involving its investments and its advertising expenditure. A growing atmosphere of suspicion about his integrity eventually led to his opportune resignation.

His entourage quickly followed his lead, joining him at another multinational - this time, a consumer hardware producer. Frankie was appointed country manager. His position enabled

him to collude with trusted associates in senior positions in development, marketing, sales, finance, human resources, and friends working in government, state-owned enterprises (SOEs), and in financial institutions outside of China. He conducted investment deals, joint ventures, contract manufacturing, and distribution arrangements - often with family members - that severely disadvantaged the company. He signed off on deals beyond the limits of his authority, misrepresenting the Chinese-language small print on contracts to head office. He wired millions of dollars to dubious offshore third parties. He negotiated manufacturing deals with unachievable targets on the sales side, with early exit from these contracts carrying heavy financial penalties.

Supplier companies in which Frankie either surreptitiously owned shares, or which he owned outright through nominee shareholders, were overpaid. He also worked with corrupt SOE managers, bribing them to transfer state assets to the multinational - thus exposing the company to potential corruption charges in China and back home.

Frankie also invited his cronies to weekends at luxury resorts and golf courses for shadow "board meetings", while the real board of the company were sorely unaware of the real activities of the multinational in China.

It took the company years to grow suspicious of Frankie's independent activities. Then, he promptly resigned. He had, in the meantime, formed his own company in the same line of business, injecting it with ill-gotten capital, and attaching to it the various entities that had been the multinational's suppliers. The multinational began being hit by writs from manufacturers from which it had failed to buy contracted quantities, and from distributors that had paid for as-yet-undelivered goods. During the investigations into Frankie's activities, the forensic accountants and private investigators discovered many, if not all, of his frauds. They uncovered a situation so embarrassing that the firm, fearing the negative publicity that would likely ensue, decided not to pursue Frankie through the courts. Instead, they launched into damage cleanup and a restructuring program to mitigate future risks. Their losses amounted to many millions of dollars.




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## Steps for Prevention

The company in this case clearly failed to conduct best business practices and sensible risk mitigation measures to protect its assets, its bottom line, and its reputation. There are measures that can be taken to avoid a similar situation.

**Reference checks.** The company in question did not conduct reference checks on its management hires. At 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 any of their credentials forged, or personal history faked? Discreetly verify past jobs they claim to have held. Establish the real reason why 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.

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**Due diligence.** In a country where transparency is lacking, and companies tend to have patriarchal leadership structures, and where corporate governance standards are low, due diligence on a joint venture (JV) partner or on an acquisition target must go beyond the balance sheet and into the realm of business intelligence. Solely examining the numbers is insufficient (even when you think you have all versions of the accounts.)

More important is the people factor. Who actually controls or owns the firm? What is their background, track record, and reputation for integrity? What are their true levels of competence and influence? What happened to the last deals

they made? These questions can be answered in China through discreet and lawful investigative channels.

**Integrated risk management policy.** All of these procedures interlock and mutually reinforce each other. They should form 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.

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

**Hiring restrictions.** Place a complete restriction on the hiring of relatives, and on conducting business with close relatives of staff and managers. Collusion between employees 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 their cultural environment. Favor trading and collusion across departmental barriers often defeat conventional business controls in China. Rigorous operating procedures are required to defeat control breakers. Place effective limits on the authority of any single individual, and regularly inspect their use thereof.

This is of particular salience in the use of chops, a device of great significance in Chinese business life, but one that can cause enormous problems when abused.

CONTINUED ON PAGE 8

## CONTINUED FROM PAGE 7

Signatory powers bestowed upon 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 point the finger of blame at 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 relation policies should encourage mutual understanding.

Ultimately, the lesson in all fraud cases is that it could have been prevented by best business practices. Managers of MNCs 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.

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