

Tackling Retail Fraud Risks in China

Fraud prevention in China's fastest growing consumer market

By Peter Humphrey



While the rest of the world has been on a big downer, retail has remained an attractive arena for expansion in China. But retail is not only pulling in the mall developers and the retailers, it is also

a magnet for fraudsters. The retail sector in China attracts all kinds of rackets like flies on meat, and foreign invested retail chains are especially vulnerable due to the cultural and language gap. Foreign-funded enterprises have opened tens of thousands of square metres of new stores

and malls in Beijing alone over the past year or so—such as the popular new H&M on Beijing's now-pedestrianized historical Qianmen shopping street. Similar stories are unfolding in China's other large cities. But are the retailers ready to tackle the fraud risks?

I led an investigation in Shanghai into a procurement fraud case involving a leading European multinational hypermarket chain. A new general manager had recently received a series of anonymous letters alleging that various purchasers were operating fraudulent or corrupt schemes—causing losses to the company.

The allegations named a number of people in various sub-departments of the buying operation, as well as a number of suppliers whom they allegedly had improper relationships. We began by investigating these companies' ownership and physical operations, checking for conflicts of interest and looking into the suspects' lifestyles and affiliations.

We uncovered a number of conflicts of interest. Shareholdings owned by my client's employees, for example, plus the lack of any physical existence of the suppliers (i.e., they were phantom vendors). Other unethical arrangements included kickbacks, commissions, goods rebate scams and manipulation of the hypermarket's electronic transaction system.

External inquiries were reinforced by an internal investigation, including workstation searches, computer forensics, monitoring and a series of interviews with suspects and witnesses. Conclusive evidence obtained that four senior buyers had led various fraudulent schemes. An expatriate, who oversaw the buying operation, turned a blind eye in exchange for sexual favours. All of these staff were interviewed and dismissed, and their suppliers were terminated.

A decisive breakthrough in this case came in connection with one of the ring-leaders, a young woman who headed the sub-department buying in high-margin foods and alcohol. From interviews, we learned that one of her main collaborators outside the firm (who was operating some suppliers) was her boyfriend, and he was a married man. The man's wife was identified, interviewed and provided significant information that helped resolve the case. Close associates and subordinates of the dismissed senior buyers were gradually removed from the company, and business controls were strengthened, including the introduction of a code of conduct, personnel vetting and vendor screening.

An analysis to quantify the losses suggested that the company had been paying 30 percent more than it needed to in some instances for the goods procured by the


crooked buyers, thus eroding the true potential profit margins and causing millions of dollars in annual losses.

Then there was Jenny. She was a merchandiser for 10 years with a multinational fashion chain that has shops and sourcing operations across China. She bilked millions of dollars from their Shanghai sourcing operation. Jenny was responsible for all the purchasing decisions and controlled the relationships with suppliers and subcontractors. Other staff, such as quality controllers, did not dare to challenge her judgments. The head office—legally responsible for all the contracts that she negotiated—was blind to what was happening. Jenny pocketed several million dollars in kickbacks before she was rumbled. Our investigation uncovered evidence of her unethical conduct and she was dismissed along with half a dozen associates.

Unfortunately, she managed to get another almost identical job at a similar foreign fashion chain—they evidently did not bother to check her background and track record. She is still working there today.

There was also Johnny, who was responsible for finding suitable new locations for a well-known European ware-

house retail chain. He negotiated private side deals with the real estate vendors and significantly ramped-up the price of land obtained for his company to build new stores. He was investigated and circumstantial evidence was uncovered—but thus far, the company has hesitated to take action against him. Johnny has close ties to local officials with the power to issue approvals and he is also connected to local gangsters who can cause problems to this retail chain's physical operations.

With China's retail sales growing by about 15 percent annually, analysts predict the country's consumer market is likely to surpass the US in the next decade. As top American retailers rush to enter China's fastest growing consumer market, these cases, and hundreds more, could have been avoided if firms were more serious about risk management. 

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To prevent fraud from happening to your company, firms should have a robust and comprehensive program of fraud risk management measures:

- Enforce rigorous background screenings of all staff and buyers
- Screen all suppliers of goods and services, distributors and resellers
- Partner due diligence must go beyond the balance sheet—check the people
- Conduct third-party investigations into property deals—the people, the legal docs and the value
- Impose a code of ethics (COE) and bind it into all contractual relationships
- Hold ethics trainings to drill the code into staff and partners
- Strengthen internal controls and monitoring
- Introduce maximum transparency into the procurement process
- Conduct internal compliance audits, fraud risk assessments and process reviews
- Use checks and balances to prevent cross-departmental collusion
- Use a whistle-blowing hotline, treat complaints (even anonymous ones) seriously
- Show a hands-on management style, don't appear aloof
- Use clear and visible deterrents, punish violators
- Guard against alternative loyalties based on cliques
- Manage cultural differences well, avoid “them and us” syndrome