The Beat

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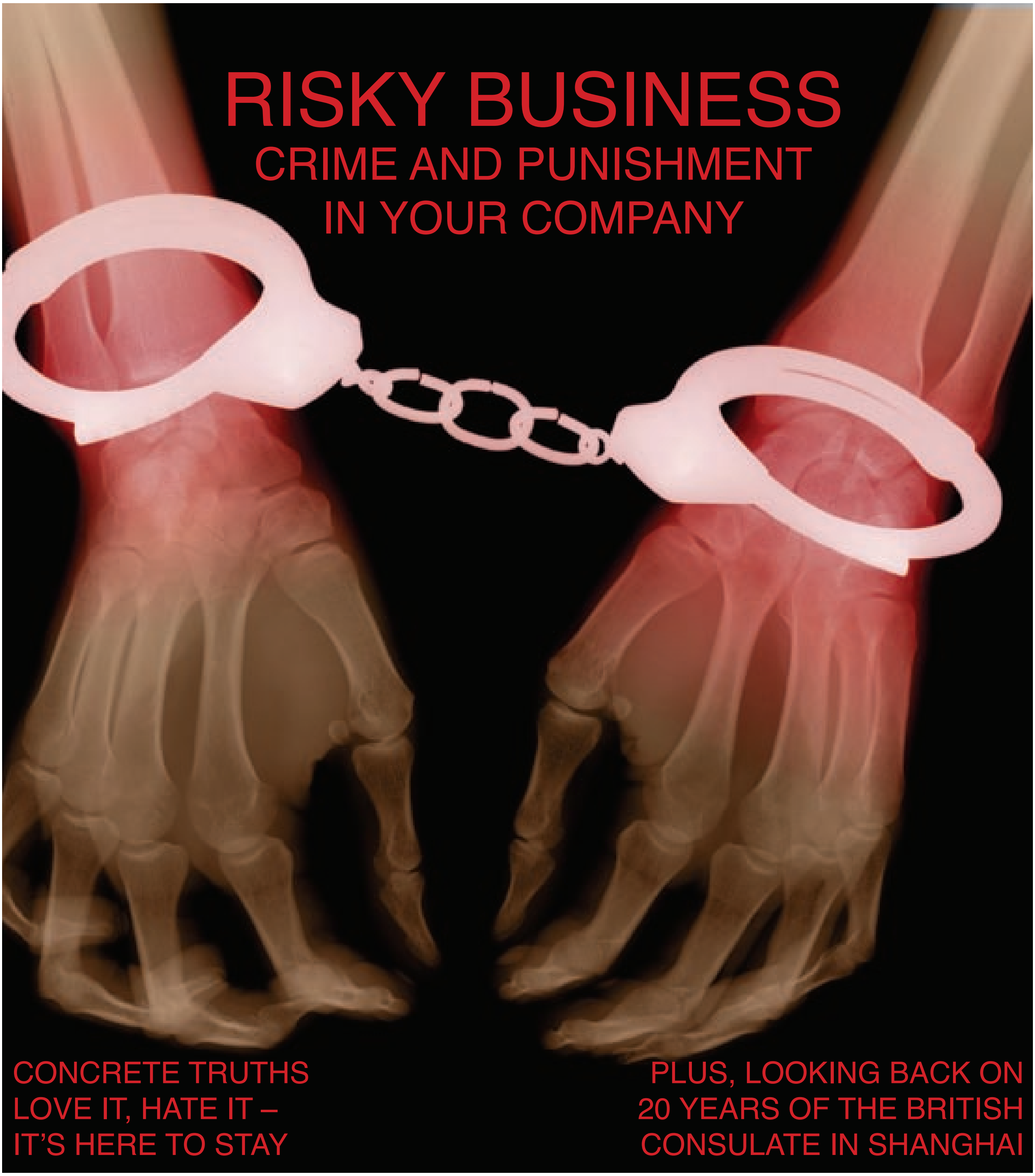

RISKY BUSINESS

CRIME AND PUNISHMENT IN YOUR COMPANY

CONCRETE TRUTHS
LOVE IT, HATE IT –
IT'S HERE TO STAY

PLUS, LOOKING BACK ON
20 YEARS OF THE BRITISH
CONSULATE IN SHANGHAI

Risky Business

We all know the horror stories – tales of foreign companies brought down by corruption, kick-backs and IP theft, perpetrated from the inside. Peter Humphrey shows that white collar crime can be tackled.

The global supply chain is undergoing a massive change and you are right in the centre of this shift. China's opening to the world, its reform and its joining the WTO have opened a floodtide of business into and out of China and confirmed it as centre-piece of the twenty-first century's world supply chain. Cost-benefit logic appears to make the trend unstoppable. Companies believe they can make immense savings and gains and remain competitive by relocating their manufacturing and sourcing to China to feed their global needs. Now, increasingly, they are focusing also on the vast domestic market. But the investment opportunity presents not only rewards, but also dangers.

The superlatives read like a dream. Call them the "wow" factor. China accounts for 13% of world output, is the third biggest exporter after America and Germany, holder of the second largest forex reserves after Japan and the largest recipient of foreign direct investment. Two thirds of all photocopiers and microwave ovens, DVD players and shoes are made in China, as are over half of all digital cameras and 40% of all personal computers. But there is a "but" factor, too, that should balance all this and inject a little sobriety into the current stampede.

Surveys by international bodies show that multinationals still face daunting challenges from the lack of transparency, over-regulation, HR problems, problems with partners, corruption and fraud, counterfeits, poor auditing and accounting, and unfair competition. In such an atmosphere, fraudsters can flourish, taking advantage of the smoke and mirrors that surround the foreign business. Despite its rise, China still ranks only 46th in the world competitiveness league; it falls half way down the world corruption index; its listed firms score only 44 out of 100 for corporate governance; and there is a high failure rate for joint ventures and acquisitions, with foreigners generally on the losing side.

Take the story of Bill. He was a handsome and bright young Chinese man with the gift of the gab and a remarkable knack of smoothing the way with local suppliers, distributors, employees and government regulators. That was 10 years ago. A multinational automobile parts manufacturer saw Bill therefore as a great potential asset and hired him to lead its sales operation in China.

However, Bill immediately secretly started up a company of his own, which was initially run by his brother Fred and various other relatives, and he began to transfer product technology and manufacturing know-how to his family firm. As Bill's company grew over the following years, Bill also passed out management know-how, as well as supplier and distributor connections.

After seven years, Bill persuaded his employer to form a joint venture with his family firm, of course without disclosing that his family owned it, and secretly continued to grow this personal business. He set up subsidiaries of his family business and inserted them into the chain as suppliers of his employer. He copied the multinational's products, and then targeted their customers for OEM work. After 10 years, Bill's firm grew into a serious rival, the multinational grew suspicious and Bill quit the foreign employer to concentrate on running his own firm. It was only then that the foreign company checked and discovered the large and complex business organisation that Bill and his family had developed – at the multinational's expense.

Bill's firm had achieved vertical integration of coating, components and finished goods. It then formed a holding company and is now preparing to list on China's stock market. Bill's products compete head-to-head with his former employer in the market with considerable cost advantages.

Then there is Jenny. She was a merchandiser for 10 years with a multinational textile brand that has sourced vast quantities of goods in China. Hampered by the tight restrictions on import and export here, its China sourcing office had no rights of its own to export from China and it had to rely on Chinese firms to conduct the exports. The textile business was also heavily affected by the quota restrictions on textiles such as those in force in the United States and Europe. Getting part of that quota in China to export your goods has involved all kinds of trickery and corruption behind a murky veil that most foreign businessmen do not penetrate.

Through her 10-year career, Jenny was able to suck millions of dollars in kickbacks out of the business. These corrupt and fraudulent practices inevitably compromised the company in many areas: corporate social responsibility, tax and duty, anti-bribery laws, product quality, and morale.

So three key types of Chinese exporters emerged over the years while Jenny was a merchandiser: those that were both exporter and manufacturer; state-owned trading firms that bought products from subcontractor factories; and private trading firms that were owned by individuals who had previously worked at state-owned trading firms but who then hijacked the SOE business and made it their own, often through corrupt or fraudulent acts.

Over the years, the merchandisers of the multinational garment company's China buying office profited royally – and illegally of course – by developing intimate ties with the suppliers and taking huge kickbacks or even by secretly owning subcontractor factories. Ironically, the merchandisers in the multinational's rep office made all the purchasing decisions. Jenny and her clones were not responsible legally for any of the purchasing contracts, which were signed between the intermediary Chinese trading company and a "buyer" in the sourcing department of the multinational's headquarters, far away overseas. Through her 10-year career, Jenny was able to suck millions of dollars in kickbacks out of the business. These corrupt and fraudulent practices inevitably compromised the company in many areas: corporate social responsibility, tax and duty, anti-bribery laws, product quality, and morale.

The companies in these cases clearly failed to uphold the best business practices and to conduct sensible risk mitigation measures to protect their assets, bottom line and reputation. There are measures that can be taken to avoid similar situations occurring.

MEASURES YOU COULD TAKE TO PROTECT YOUR COMPANY…

Reference checks. These companies did not conduct reference checks on 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 big sums of money and precious intellectual assets, companies should go beyond mere references and delve into a candidate's background. Is he who he says he is? Are any of his credentials forged or personal history faked? Discreetly verify the past jobs he claims to have held. Establish the real reason why he 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 assurances in China. It must be augmented by discreet inquiries to verify the existence, ownership, and track record of a company.

Due diligence. Where transparency is lacking and companies tend to have patriarchal leadership structures, and where corporate governance is weak, due diligence on a JV partner or acquisition target must go beyond the balance sheet into the realm of intelligence. It is not enough to examine the numbers. The key is the people. Who really controls or owns the firm? What are their background, track record and reputation for integrity? What is their true competence and influence? What happened to their last deals? Do they have multiple structures and parallel firms that could harm the multinational? These questions can be answered in China through discreet and lawful investigative means.

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.

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

Hiring restrictions. Ban the hiring of relatives and the conduct of 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 robust and adjusted to their cultural environment. Favour trading and collusion across departmental barriers 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 of it. This is patently needed with the use of chops, a device of great significance in Chinese business life but one that can cause huge headaches when abused. Signatory powers vested in a single individual should be limited and balanced. All contracts should be reviewed by other executives.

Ultimately, the lesson in all fraud cases like those outlined above – and there is potentially one at every major multinational operating in China – is that they could have been prevented by best practices. Multinational managers must learn to identify, manage, and reduce the risks. It pays to provide resources for 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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