

# China Supply Chain Fraud

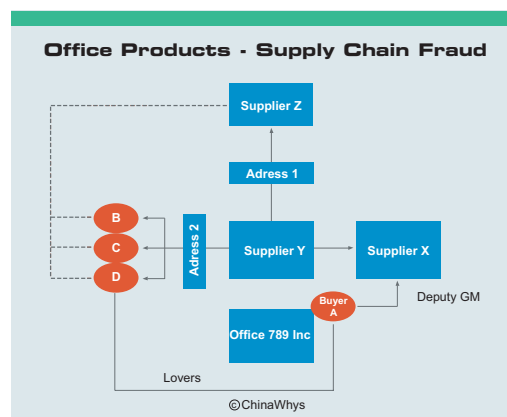
## A Risk to Watch Out For

**C**hina is booming but so is fraud. It is not so much the daily headline news about high level graft in SOEs or government agencies that foreign investors and outsourcers must worry about. It is in the supply chain, in their own midst, among vendors, distributors and staff. Management fraud, distribution and purchasing system fraud, have become rife; and multinationals shifting their core supply chain operations to China are highly vulnerable to fraudsters.

### False fronts

In one recent case that we investigated a US office products maker with a sales office and factory in eastern China (let's call it "Office 789 Inc"), received an anonymous email accusing one of its buyers of holding shares in an important supplier ("Supplier Y").

Office 789 had got hold of an incorporation record on Supplier Y but had not found the buyer listed as a shareholder. But of note, at the same time, Office 789 found out that right after it had amended its own business license to include manufacturing rights in China for a



new product line, Supplier Y had also changed its license to do exactly the same. This appeared to be a calculated attempt to imitate Office 789's business.

Close analysis of the corporate registration documents by bilingual forensic investigators showed that Supplier Y had registered two different addresses. An investigator visited both addresses and found that supplier Y was indeed located at one of the two, where it presented itself as a trading firm. At the second address, though, he found a different firm, a manufacturer ("Company Z").

By examining the buyer's company email backup, investigators learnt that he had recently diverted orders from company Z to company Y on grounds of quality. The buyer also confided in an email to one of his contacts that he and friends had recently got a piece of land and were going to build a plant there. In the same email he

asked that all future email correspondence be sent to his private address rather than his company email box.

An investigator visited company Z under a trading front. There he learned that senior executives of Z had been diverting business from their employers to their own firm. He followed this lead to the location of the new company. There he learned this new firm had recently bought some land where it was building a big factory. After obtaining the name of the new firm, we examined its incorporation records and found the name of the buyer listed as Deputy General Manager. As a result, Office 789 Inc fired Buyer X was fired for diverting business away and for acting in conflict with the company's interests.

### Supplier or Distributor -- or both?

In another situation, a multinational chemicals firm in Shanghai found that the profits of its JV with a Chinese partner had dropped dramatically from 35% of the previous year to 0%. Under cover of a process review we conducted a forensic audit and found that two suppliers had predominantly contributed to the profit drop, around RMB9 million, and one of them was, oddly, both a supplier and a distributor at the same time. Part of the payments to the suppliers was not booked at all, while part of it was booked as advance to supplier and was not reflected in P&L.

From discreet interviews we ascertained that the ex-GM had used a supplier's account to launder money, and the name of the supplier/distributor that we had spotted in the audit. Through external inquiries we also discovered that the chairman and legal representative of the supplier/distributor was an employee of the JV who had received many unusually generous pay rises from the ex-GM. Through further inquiries we learned that goods that appeared on the invoices from the suppliers were not what was actually purchased; product names and quantities recorded in the computer system for these transactions were fictitious. The products bought were finished goods but were recorded as raw materials.

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The management claimed that this cooked accounting was intended to distort the cost structure to win a US anti-dumping case. However, the warehouse supervisor was ordered by the ex-GM not to keep any records of




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goods received from the two suppliers; all information related to the anti-dumping case kept by the previous finance manager was nowhere to be found; and the GM's computer had vanished after he resigned. The evidence showed that the fall in profit was due to accounting and invoice manipulation by the previous GM in collusion with several staff in the company for personal gain.

### Stolen Intellectual Property

Another recent case involved a Chinese scientist working for a big life sciences multinational in an R&D team that had developed an innovative cost-saving industrial process. The firm had patents on the technology and expected to make hundreds of millions of dollars in profits by building

plants with this technology. Indeed the first contract had been signed. The scientist suddenly resigned and was later found to have copied all the related files from the IT system to CDs and was working with companies in China to build a business around this stolen technology.

The inquiries referred to above make clear that it is possible to peel the onion and connect the dots on white collar crime mysteries in China supply chain operations -- if the effort is made. A recent survey showed four in 10 firms suffered losses from their China operations due to fraud but only half investigated the malfeasance. It also showed only 25% of firms had a supply chain review program and only 31% had conducted due diligence on suppliers and business partners. 

# MAKING BUSINESS FLOW



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#### Key measures to prevent Supply Chain fraud :

- Background screening of staff, vendors, distributors, resellers etc
- Due diligence beyond the balance sheet – check the people
- Strengthen internal controls & monitoring
- Check compliance with internal procedures
- Educate your staff in local and international laws, ensure compliance
- Conduct internal audits, fraud risk assessments, process reviews
- Impose a Code of Ethics (COE) and bind it into all contractual relationships
- Hold ethics awareness training to drill the COE into staff and partners
- Use a whistle-blowing hotline and treat ethics complaints seriously
- Introduce checks and balances to prevent cross-departmental collusion
- Show a hands-on management style
- Use clear and visible deterrents, punish the violators
- Be on guard against alternative loyalties centering on cliques
- Cultural differences must be well managed, avoid "them and us" syndrome

