

# Check Before You Go

## Managing Fraud Risks in China Business Operations

Peter Humphrey | ChinaWhys

Good ethics management can make a substantial impact on your bottom line. German companies operating in China should strive to keep unethical elements out of their business. Otherwise, they can incur substantial losses. The global supply chain shift of the past 25 years which has pushed so much manufacturing and R&D into China has been accompanied by increased outsourcing, localisation and technology transfers. All this is driven by commercial, cost-benefit logic, but it changes the risk profile of companies because commercial fraud and corruption, according to Western and Chinese watchdogs, is at least four times more prevalent in China than it is in more advanced industrial nations, such as Germany or the United States.

I have spent the last 15 years investigating cases of fraud and corruption in multinational operations in China and across Asia. I see clear and ever-present dangers challenging companies that do not take adequate preventive measures. German Mittelstand companies, or small and medium-sized enterprise (SMEs), with their precious niche technologies, are particularly vulnerable.

The high incidence of fraud in China, although this is not the only country where it happens, is set amid a get-rich-quick social revolution and economic development phase that has spawned a high rate of graft in both the public and private sectors. Also, because of the culture gap between many multinationals and their China operations, it is often hard to detect and respond to the challenges of white-collar crime.

The above-mentioned gap is one of the single most important factors. No foreign culture and language

can be more remote and more difficult to grasp for western multinationals than the Chinese culture. Multinational head offices and their representatives are often blind to what is happening inside their China operations. This blind spot creates opportunity and temptation for dishonest people to commit fraud, as they think, often correctly, that they will go undetected. Very few multinationals bridge this gap well. Chinese companies also suffer from these frauds, but they can handle it better because they do not have to cope with this gap.

Very often, head office or a senior expatriate manager fails to show a hands-on stance. They do not visibly show that they care about their operation. They are also unable to reach out to all levels of employees, and, finally, they over-depend on a single point of reporting – usually a local hire with good English skills – to provide them with information about the operation. This person accumulates too much power and controls the whole business: language, connections to government, internal network, external social network, direct contact with suppliers, direct contact with distributors, and loyalty from other staff within the firm. In return, junior staff with ethical complaints often have no channel to communicate with head office or with the senior expatriate managers even if they want to report problems. This creates fertile ground for deception and fraud. Companies must tackle this risk through a healthy and balanced approach towards local vs. expat ratio, HR management, screening, training, checks and balances, and internal controls.

Add to this “gap problem” the mentality that has seized many people in this society in recent times and the enormous social pressure felt by many

people in China, especially the young ones. Money brings prestige, and many people are prepared to take shortcuts to own houses, cars and luxury goods. Scholars at Beijing's prestigious Tsinghua University have estimated that the equivalent of 16% of China's GDP is lost to fraud and corruption each year, compared with an estimated 4% fraud rate in the United States.

Faced by such challenges, more companies have recently been adopting broad-based ethics control programs to pre-screen employees, vendors, distributors and prospective JV partners or acquisition targets. We have also seen a significant rise in compliance audits. In short, due diligence, background vetting, robust responses to violations of internal controls or to unethical conduct, and the provision of early warning mechanisms to detect or avert fraud, are being embraced in a more integrated way.

Greater efforts are visible among many companies to introduce or strengthen a Code of Conduct or Code of Ethics by tying it into employment contracts as well as contracts with suppliers and distributors, to outlaw unethical behaviour, especially collusive activity between staff and business counterparties. The more advanced companies are drilling the Code of Ethics into their workforce, the more firms may associate with ethical awareness and compliance training.

Whistle-blowing hotlines, usually established by big firms on a global basis, are often inadequate to deal with China operations due to cultural and language differences. A global ombudsman sitting across the world fails to understand the special traits of China. But there needs to be a reliable channel for staff, suppliers, dealers, partners, customers and other stakeholders in order to report ethics concerns to appropriate people in the organisation. Some firms are now, therefore, setting up special channels to exclusively handle China complaints. All these are welcome developments.

### Case study 1

One case that I handled involved a packaged consumer goods manufacturer where staff in almost every

department colluded with a counterfeit syndicate to produce fake products and inject them back into the firm's distribution channels alongside genuine product. People in procurement, packaging, sales and distribution, in the warehouses and in trucking, and even in the R&D department, were in on the act. They even had a business plan with annual production and sales targets. The entire racket was masterminded by the firm's former HR manager. This explosive mix of faking, supplier-purchaser scams, distribution fraud, and technology theft forced the firm, at great cost, to restructure its China business, terminate agreements with crooked suppliers, staff, and distributors and end numerous partnerships. Needless to say, it was a painful episode.



### Case study 2

Another case involved a well-known hypermarket chain's China operations. A senior buyer, who we shall codename Angie in this article, pocketed the equivalent of 30% of all the buying transactions that she handled. She controlled a valuable chunk of the buying operation in dry foods and alcoholic drinks. She collected kickbacks, gifts and allowances from vendors; she favoured companies that she had set up in the names of her mother and her boyfriend as her employer's suppliers, companies without any physical existence. She ran scams with rebated goods; she manipulated the electronic price system. In the end, she was caught and fired as a result of an investigation triggered by anonymous allegation letters. Her boyfriend's wife became a key witness in our inquiries!

### Case study 3

A medium-sized German construction machinery manufacturer (let's call it "XYZ Co") employed a Chinese ("Arthur") with a PhD at their head office for several years and 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 ("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 in Superdealer Ltd or the dealerships below it, such as shareholdings or kickbacks.

Even before this allegation was made, XYZ had grown frustrated with Arthur's "poor performance"

in sales and distribution. He had shown an uncooperative attitude and had behaved in a dictatorial and eccentric manner towards local staff. It had therefore installed an additional Chinese senior manager as a counterbalance. Evidently unsettled by this move, Arthur resigned, around the same time as the anonymous tip-off came in.

It was natural that XYZ felt its business was jeopardised and thus it initiated an investigation to try to uncover the facts, identify problems in its distribution network and make the operation more transparent. An internal audit uncovered very little of significance. The local paperwork was so chaotic that the auditors could not understand much of it. This was not helped by the fact they could not read Chinese. Local staff were mostly unhelpful during the interview process. So we were called in to conduct a discreet investigation.

During a detailed one-month inquiry into Arthur,

RECHTSANWÄLTE  
**SCHULZ NOACK BÄRWINKEL**  
HAMBURG • ROSTOCK • SHANGHAI • HO CHI MINH CITY

Legal Expertise for Business in China

[www.snb-law.de](http://www.snb-law.de)

### CORPORATE AND ARBITRATION

Unsere Mission ist rechtliche Beratung auf höchstem fachlichem Niveau mit einem praktischen, Problem lösenden Ansatz.

Seit der Gründung unseres Shanghaier Büros im Jahr 1994 haben wir eine Vielzahl ausländischer Investoren bei industriellen Projekten in verschiedensten Branchen an vielen Standorten in China umfassend beraten. Wir betreuen nicht nur bei Greenfield-Investitionen, sondern auch bei Akquisitionen und Restrukturierungen. Baurechtliche Expertise und die Einbeziehung von Aspekten des Gewerblichen Rechtsschutzes ergänzen dabei die gesellschaftsrechtliche Beratung. Über besondere Erfahrung verfügen wir bei der Akquisition chinesischer Privatunternehmen und Unternehmen mit technologischer Ausrichtung.

Bei vertraglichen Streitigkeiten zwischen unseren Mandanten und chinesischen Unternehmen vertreten wir insbesondere in Schiedsverfahren innerhalb und außerhalb Chinas. Unser Partner Rechtsanwalt Axel Neelmeier ist seit vielen Jahren Schiedsrichter der CIETAC und verfügt über umfangreiche Erfahrung als Parteivertreter und als Schiedsrichter in CIETAC-Verfahren.

Ansprechpartner in Shanghai:

Dr. Jörg-Michael Scheil  
Dr. Mario Feuerstein  
Suite 2302 International Trade Center  
2201 Yanan Road (West)  
Shanghai 200336, P.R. China  
Tel.: 0086 21 6219 8370  
Fax: 0086 21 6219 6849

Ansprechpartner in Hamburg:

Axel Neelmeier  
Dr. Mark-Alexander Huth  
Baumwall 7  
20459 Hamburg  
Germany  
Tel.: 0049 40 369 796 0  
Fax: 0049 40 362 088

Superdealer Ltd and three original dealers (Dealer 1, Dealer 2, and Dealer 3), it was proven that Arthur had been taking illicit gains out of the business and had seriously undermined the distribution network and XYZ's prospects in China. Major efforts would now be required to repair the damage and prevent a recurrence.

A childhood friend of Arthur headed Superdealer Ltd and Arthur had planted his wife as a 20% shareholder in the most crucial dealership. The wives or parents of friends had been installed in other firms as proxy shareholders. The large amount of money and transaction volume through these distributors with close family ties represented a serious conflict of interest, to say the least. Arthur deliberately hid this from XYZ while enriching his family via these arrangements. Some old dealerships where Arthur had no stake personally, were being sidelined by the overarching Superdealer Ltd; they were angry, and possibly the source of the tip-off.

In examining the dealers that were part of Arthur's shadow business, we noticed a chronological pattern of incorporation of various companies, involving identical amounts of capital for each company. It became clear that after the required period for keeping the registered capital in the bank, one firm's registered capital was then taken out and used to incorporate the next entity.

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

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

It was calculated that through his various schemes he had extracted several million dollars for himself from the XYZ business over several years.

He was still on pre-departure leave when the proof

of his wrongdoings was obtained and he had not yet formally left the company. Based on legal advice on the investigative findings, Arthur was summoned to meet a head office auditor and the company's lawyer "to discuss departure terms" and was then confronted with the proof. The interviewers gave Arthur opportunities to lie by not presenting evidence at first, and then presented documents that proved he was lying, whereupon Arthur caved in and admitted his guilt. Arthur's resignation was, therefore, rejected. Finally, he was dismissed with cause and all his severance payments were withheld.

## Conclusion

In most such cases, the victim companies had neglected basic business controls and measures to reduce the risk of such a disaster happening. Furthermore, they reacted too slowly to first signs showing that the problem had existed.

To prevent fraud, companies should have a robust and comprehensive program of fraud risk management measures. Here we present a number of key measures:

- 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 vigilant against alternative loyalties centering on cliques
- Cultural differences must be well managed, avoid the “them and us” syndrome

## Autor

**Peter Humphrey**



ChinaWhys

Tel.: +86 139 1179 6504  
peter.humphrey@chinawhys.com  
[www.chinawhys.com](http://www.chinawhys.com)

Peter Humphrey is the founder and Managing Director of China-Whys, an advisory firm promoting business ethics and transparency. He is Founding President of the China Chapter of the Association of Certified Fraud Examiners (ACFE). He is fluent in Chinese and has dealt with China and other communist countries for 37 years.