The Fraud Examiner

HOW FRAUD INVESTIGATION JUST GOT HARDER IN CHINA

Exploring the impact of China's clampdown on public records

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Over the past 15 years, I have witnessed the gradual emergence of an investigation industry in China. It began from crude anti-counterfeit outfits and family investigation agencies and gradually extended to the more sophisticated areas of due diligence, fraud investigation and forensics, as well as compliance and FCPA investigations. In the same period, we saw increasing availability of what in most countries we call "public records," including company registration files, annual returns and some limited, but useful, personal data.

The availability of such records combined with a CFE's skill set of forensic accountants enabled anti-fraud professionals to do their job in a country where foreign investors feel at risk due to a high white-collar crime rate, a lack of transparency and strong cultural barriers in business operations.

The promising environment that evolved for the fight against fraud and bribery in company operations in China has suffered a major setback due to a sudden government action to suppress certain data contained in such records. Why has this U-turn happened, and what is its impact on anti-fraud work?

In January 2013, forensic and investigation firms -- and local law firms -- found that they or their search agents could no longer freely access records filed with the Administration of Industry and Commerce (AIC) bureaus around the country. The AIC registers, incorporates, inspects and regulates all companies in China, and collects their annual returns. These records, until recently accessible in full, contain useful data and documents relating to the birth, evolution and status of a company, names and personal details of shareholders, annual financial data and annual audit reports.

It is by examining these records in conjunction with a forensic accounting review that a CFE here can close the circle on a fraud -- for example, by proving that Mr. X, an employee of Company Z, has set up his own firm (and, by the way, with no physical existence) and inserted this phantom into the sales chain as part of a large-scale distribution fraud against his employer.

Or, it can enable a would-be investor considering buying shares in a Chinese company listed on Nasdaq to determine that the company has inflated its sales data and that its principals have actually been involved in a string of stock-listing frauds.

During 2011 and 2012, short-seller Muddy Waters not only shorted Chinese stocks (such as Sino Forest)

that it had identified (possibly correctly) as fraudulent, it also published its findings on each firm in a manner viewed by authorities in Beijing as rabidly anti-Chinese, thus putting the Chinese Foreign Ministry on the back foot and unnecessarily provoking a government reaction. Soon after that, *Bloomberg* ran exposés on the business web and assets of a (now disgraced) Chinese Politburo member Mr. Bo Xi Lai and his wife, and then gave the family of China's new President-to-be Mr. Xi Jinping similar treatment. In a third such article, the *New York Times* threw oil on the fire in October with a detailed piece on the wealth of Premier Wen Jiabao's family.

For a moment it appeared that these publishing adventures — using some of the investigative techniques of the forensic investigators, such as analysing AIC records — were making China's ruling elite wobble. In retaliatory crackdowns, one in May 2012 and one in January 2013, more than 1,000 local investigators and their alleged sources each time were detained, according to Chinese media. Then in February this year, the government issued strict new rules to restrict access to what it called "personal information."

Critics describe this clampdown as an attempt to protect corrupt government officials from exposure. But as an anti-fraud worker in China serving purely corporate clients on corporate matters or in litigation support I find this a very dark day for due diligence and forensics work. I find this a step backwards that will make due diligence and catching fraudsters harder. We will have to be even more creative from now on.

As the recent disaster of a $580 million fraud at a Chinese company acquired by Caterpillar shows, due diligence in China is a vital part of M&A for any sensible acquirer. If Caterpillar had done the kind of due diligence combining accounting with background investigation, retrieval of AIC records and discreet supporting inquiries, it might have spotted the fraud before doing the deal last year. But today, even if it wanted to take that approach, it would find it much harder to do as a result of the clampdown on public records.

Harbin Electric, a Chinese firm publicly-listed in the U.S. via reverse merger, i.e. a "backdoor listing," claimed in SEC filings that one of its largest clients in 2009 was a car seat maker to whom it sold motors, earning 10 percent of its revenue for the year, and that the A/R due from this client was $10 million by that year's end. A discreet interview with a sales engineer working for the customer, however, revealed that the customer had bought just $58,300 of goods between 2006 and 2007 and bought nothing else from Harbin Electric after that. This publicized case was an example of a widespread method of deception whereby Chinese firms exploited regulatory gaps and differences between Chinese company names and their English translations to file records and numbers in the U.S. that hugely differ from those they filed in China. For the U.S. audience such firms were faking revenue data in order to ramp up their share price in the U.S. market. Middlemen who took these companies abroad fabricated financial statements and got accounting firms to window-dress them, and supplied fake bank statements, fund transfer notes, bank drafts, delivery notes, etc. The brokers eager for these deals to be completed deliberately limited the due diligence scope as they would benefit from these listings going through regardless of any future losses to investors. In another example of this, we saw a rigged financial due diligence report done by "qualified accountants" engaged by a PE broker on a Chinese juice maker that was being groomed for listing in the U.S. It showed revenue packaged to come (ostensibly) from seven large customers, each contributing an uncannily similar 13 to 15 percent of the total, and A/R from three of them in identical figures. They had concocted the totals that they wanted to report, and simply divided it by seven.

At the same time that this skullduggery was going on in these cases, a financial institution which was trying to decide whether to invest in these firms engaged us to perform independent behind-the-scenes due diligence which included retrieval of records and returns filed by these companies locally in China, a review by forensic investigators, and a comparison with SEC filings. This way, they spotted the rat and avoided making potentially loss-making share investments. Following this year's clampdown on the release of financial data from AIC files, this is no longer possible.

With financial returns and personal identification data less available to help connect the dots, fraud investigation and due diligence in China must rely more on human source inquiries, both with related parties and with insiders (such as managers, sales agents, production staff, suppliers and so on) to ascertain that real business exists; and a forensic internal review, if circumstances allow it, in order to identify not only signs of irregularities but to drill down into their origins. The costs of this work will be well justified if they can prevent or detect large losses.

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