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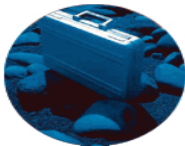
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律華會計師事務所

International Accountants

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## "PEELING THE ONION - Part 3"



### ***Fraud is fraud ... in anyone's philosophy!***

Whether it is a result of, as Xunzi argued, "All men being inherently evil", or the more contemporary social pressures associated with the "to get rich is glorious" mentality, however **fraud has become a widespread problem for many foreign firms** doing business in China.

Many western economies adhere to business operations and corporate governance built upon stringent audit/accounting requirements and certain legal disclosures. However, Chinese business has, for centuries, been built upon connections (Guanxi) and verbal confirmations. It is due to these differences and lack of **corporate transparency** that "Business Fraud" is one layer of the "Doing Business in China" onion that is not so easy for foreign firms to peel, but often the most costly!

Whilst 'fraud' inherently involves illegal activities, professional crimes can involve a multitude of activities and deceitful behaviour that is not necessarily captured through a strict legal definition of 'fraud'.

"Business fraud" can basically be split into two categories - **direct and indirect**. It is this latter group that foreign companies find most difficult to detect and resolve. Where as direct forms of professional crime may include embezzlement of assets, ghosting of work hours, falsification of financial statements or over payment of salary, indirect forms are not so easy to detect. These may include, for example, various forms of **nepotism**, local joint venture (JV) partners establishing competing companies to the JV itself, or even supplier contracts where the supplier is in fact the JV partner's own private company or an employee's relative.

A hypothetical example would be for an employee who orders all the firm's printing requirements from a single supplier, which is in fact owned by the employee's

Uncle. However, this supplier actually does no printing at all, but merely marks up the goods from another affiliate printing company.

In the West many companies, and indeed regulatory bodies, have **control mechanisms** to limit the extent of such behaviour. These include internal controls such as authorisation levels, segregation of duties, job rotations, tendering processes for contracts and internal audits, and more importantly regulatory requirements such as "disclosure of conflicts of interest" or external audits. The end result is a much **tighter corporate governance** environment and greater operational transparency.

In China, however, many foreign investors seem to treat their mainland Foreign Invested Enterprises (FIEs) as "outposts", essentially ignoring all the management training and processes that have proven integral in the more developed economies of the world. Whether it be due to a lack of "**hands-on**" **management, language and cultural differences, or simply a misunderstanding of the business environment**, there have been too many failed Joint Ventures to simply blame on 'the difficult Chinese market'. All too often, the real cause of an FIE's failure in China actually involves unscrupulous behaviour and misinformation.



### How to limit your exposure

#### Due Diligence:

With stringent statutory audits and other overseas reporting requirements (such as to Stock Exchanges and other regulatory bodies) forming strong financial corporate governance in many Western countries, financial statements are generally considered to be "**fair and true**". However in China, with newly-developing accounting regulations, coupled with possible collusion between JV partners and external auditors/financial advisors, company financial reports may not be necessarily so reliable.

Many potential JV partners simply present **fraudulent accounting books and financial statements, false bank statements and even illegal contracts**. With this in mind, it is suggested that foreign investors conduct thorough business due diligence (both legal and financial) before entering into any business negotiation or contracts, so as to first identify "**who**" **you are in fact really dealing with**. Part of this process should include a background and credit check on the partners, their business and, depending on the industry, licenses and solidity of standing with relevant local and state Government departments.

#### Internal/External Audits:

Many companies spend large budgets on backup data centres, software virus protection and fireproof server rooms, yet are **not properly protected from Employee A**, the company Accounts Receivable clerk, who has access to all the

firm's billing and collection information.

This is particularly important in China where many FIEs maintain only small finance teams. In such cases, there may not be the personnel nor the resources to adequately **ensure segregation of duties or audit trail procedures**. As a result, there are many occasions where money has easily been siphoned off to individual employee's and Chinese partners' bank accounts. This lack of control actually ends up causing more damage to the company's financial position, let alone reputation, than any worm virus could ever cause.

To limit such exposure foreign investors should insist on having accounts **audited by a reputable accounting firm with international standards** who can also provide constructive advice on the internal controls. They should also insist on having the right of access to the accounts at any time for monitoring purposes.

Whilst external audits are statutory requirements and may uncover 'accounting irregularities', internal audits are also an essential tool to uncovering potential fraudulent activities and are just as important. **Internal audits and system audits** can uncover lack of internal controls and weaknesses, areas for potential fraud and audit-trail compliance. This may help to discover potential Employee A's before they bring down the whole operation. After all, Mr. Nick Leeson brought down one of the oldest established Merchant Banks in the world through a lack on internal controls - **what's to stop Employee A in your China operation?**

#### Management:

The management team in many FIEs are often decided by JV partners or through hiring of local staff who have the appropriate experience and education to deal with both the Chinese business environment and Western management principles.

Over the past 5 years in particular there has been a trend for companies to cutback on Expatriate packages and a push towards **localisation of staff**. However, whilst saving money and satisfying more appropriate resourcing decisions, this trend often leaves many FIE head offices without hands-on management exposure, and can effectively lead to a **loss of day-to-day operational and financial control**.

This loss of control may manifest itself in a multitude of problems, such as a rogue JV project (as witnessed by one soft-drink company's manufacturing plant being turned into a tanning factory by an unscrupulous JV partner), misuse of company funds (such as the purchase of assets by the management team to satisfy their own private company's fixed asset requirements, or pledging assets to banks for loan approvals without the foreign partner's consent), and even the potential for the company to become involved in illegal activities (such as trading in activities without appropriate business licenses).

Though there are advantages to localisation of staff and management teams, a good measure to limit exposure to these problems is for the foreign partner/firm to insist on the right to **name the Chief Financial Officer (CFO) to the FIE**. This ensures day-to-day control over both financial and operational policies. It also allows the foreign party the ability to prepare separate financial reports (for Head Office) under International Accounting Standards or overseas accounting standards, and to appoint

an independent accountant for compliance purposes.

Whilst there is obviously a cost-benefit payoff to be made in this decision, acting in the **interests of shareholders is of the utmost importance**. This decision is illustrated in one well-known example where a multinational decided to send a CFO to its FIE in China, only after three years of operations. This three year period allowed the JV partner to effectively run the company for their own personal benefit and to extract all the technology and knowledge they needed to first run the company into the ground and then establish their own private company. In fact when the CFO finally did arrive, all he was required to do was a few simple book entries ... to **write off the entire multi-million dollar operation!**

#### Company Structure:

Aside from the management team, the structure of the company and **articles of association**, and internal control procedures play an integral role in ensuring control of the company and in limiting exposure to management fraud.

Faith in partners is essential to any successful Joint Venture, however the company's articles of association can protect parties when things don't go to plan. Whether this be more control over the Board of Directors, clauses requiring countersignature of major investment contracts, competitive tendering obligations or remedies in case of fraudulent activities, foreign investors need to ensure that they are **fully protected** when it comes to management control. Such measures also serve to dissuade local management from fraudulent activities and set clear guidelines and rules.

The Company should also ensure that the articles provide a **clean route of exit** should the firm wish to pull out before the end of the JV's contracted life. Typically this will be a lot longer than the length of time that the instigating management will work for the company. Corporate strategies change, company financial circumstances change and China's policies and legal structure is changing daily. Thus, the FIE needs to be able to change their business model to suit the Chinese market, regulatory requirements and overall business strategy of all interested parties.



#### What can you do if you are the victim of business fraud in China?

Whilst the Chinese legal system does provide both criminal and civil remedies for business fraud, there are many areas which still require **further legislation and consolidation**. These loopholes, for example, cover the indirect examples of fraud discussed above, such as diversion of funds for the benefit of relatives/friends, sale of corporate assets at unjustifiably low prices, culpable neglect of directors and establishing companies in competition with the existing entity.

Where as such activities are covered in many Western countries through corporate legislation, fiduciary duties, conflict of interest disclosures and employment contract laws, the lack of legislation in China leaves FIEs open to **large risks and potential difficulties in prosecution.**

The **criminal law** essentially covers such crimes as bribery, misappropriation of funds and conversion of funds and property for personal use. If successfully prosecuted, criminal restitution includes imprisonment, fines and/or confiscation and conversion of stolen property for restitution.

**Civil legislation**, on the other hand, primarily covers misappropriation of corporate funds or assets and remedies associated with bribery, embezzlement and income derived from competing businesses. However, it must be noted that whilst these remedies are available to corporation itself, there are **no such remedies or derivative suits available to shareholders.** This ruling may cause difficulties for foreign investors who control minor interests and/or are unable to exert Board of Director control when pursuing fraudulent management or venture partners. After all, what is to force a rogue JV chairman to file a civil action against himself for embezzlement if he has majority control?



### The End Game

The Chinese legal system is certainly rapidly changing to protect FIEs from business fraud. At present though, the inconsistency in its application, along with the time delays and costs associated with trials means that **prevention is certainly the safest option.**

Through conducting thorough business due diligence, undertaking annual internal and external audits, instituting appropriate management controls and implementing safe corporate structures, **foreign firms may be able to limit their exposure to business fraud in China.**

With so much at stake, it would appear that many foreign firms subscribe to the Mencian teaching that "All men are inherently good". Whilst this may certainly be implied in a safe corporate environment, **it only takes one bad onion to turn everything sour ... in anyone's philosophy.**

*Cameron Hume , LehmanBrown - Beijing.*

***"Peeling the Onion" is a series of newsletters designed to assist in the financial and accounting control of your China operations. We would love to hear what issues you would like to know about in coming articles, so please contact us with any questions."***

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