



*The Risk Consulting Company*

## **Doing Business in China: Corruption and Internal Fraud**

**March 16<sup>th</sup> 2005**



**Samuel Porteous**  
**Kroll Greater China Regional Managing Director**  
**[sporteou@krollworldwide.com](mailto:sporteou@krollworldwide.com)**



*The Risk Consulting Company*



# Economic Progress/Stability/Corruption

- The thread of weakness running through all the Chinese governments plans and the economy's progress is the cancer of corruption
- Corruption is the Achille's Heel of the Communist Party – Tiananmen/Princelings/Transparency
- Central – Regional – Local Governments –very different views



# **The Architect Understood the Interplay**

**“We need two hands – one to persist with the open-door policy and domestic economic reform, the other to resolutely fight against economic crimes”  
[Deng Xiao Ping, 1982]**



# How widespread is the problem?

- The problems are acknowledged in:
  - Government pronouncements: “life and death struggle” for the party
  - Official statistics
  - Unofficial surveys amongst FIEs
  - Media Coverage



## Some Statistics: “Unaccounted for Cadres”

- 15,000 Communist Party members and cadres disappeared in the first half of 2003
- Gov reports -- 6,528 party members and cadres became “unaccounted for”, 8,731 fled abroad 1,252 committed suicide
- Guangdong, Henan and Fujian provinces had the highest number of disappearing cadres (China Economic Review March 2004 p.6.)



# Corruption

- Abuse of Bankruptcy status by state firms with excellent results to avoid debts  
Qinghai – 500/900 state firms
- Bribes for loans US150K for US113 Million
- Why the BVI is 3<sup>rd</sup> largest source of FDI
- Why luxury watches sell in an obscure Northern City

- 
- 
- 
- 
- 
- 
- 
- 
- 
- 

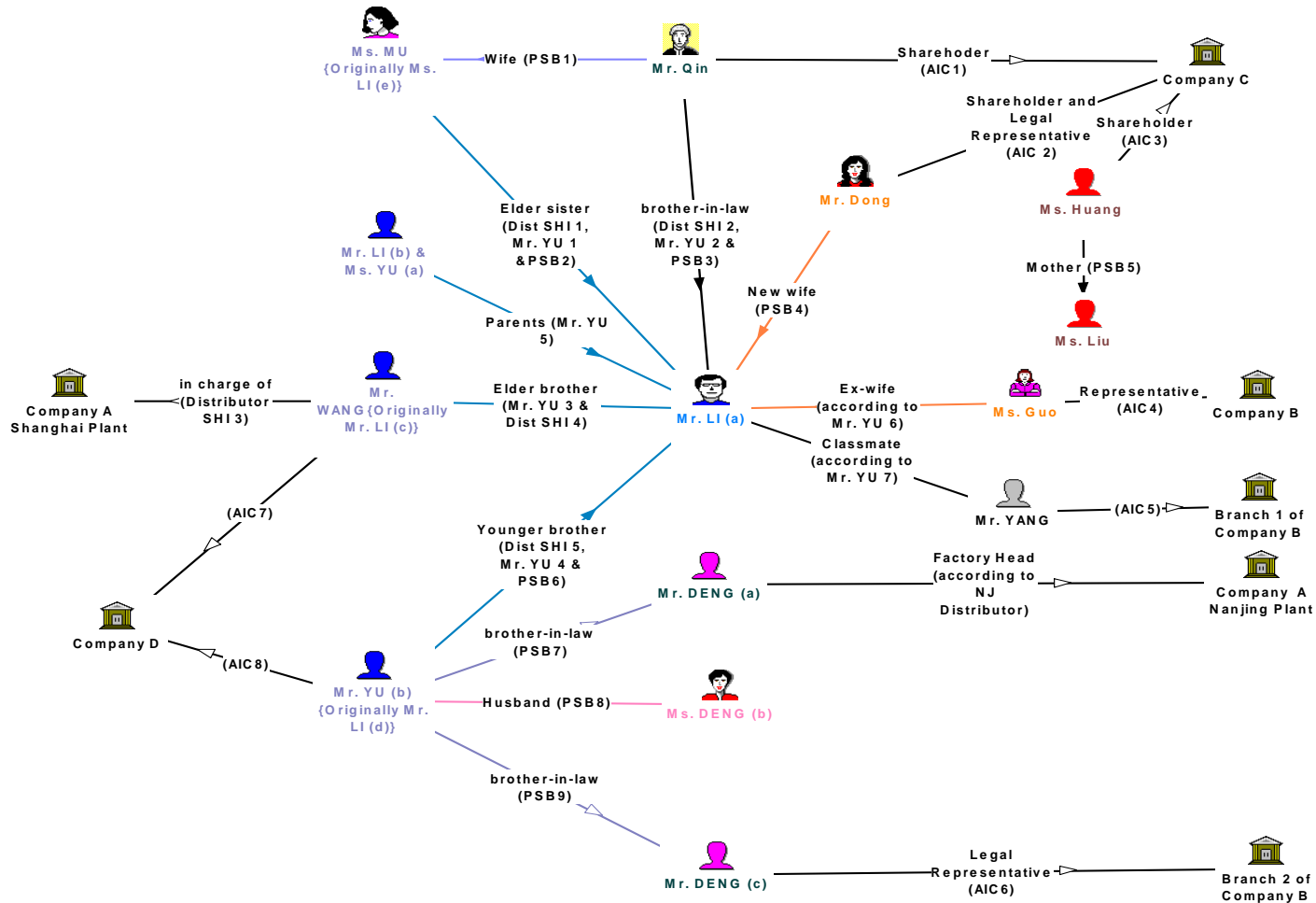
## Part II: Corruption and Fraud Impacts on Foreign Firms



**Kroll**

*The Risk Consulting Company*

# The Ideal General Manager





# China Risks ....

## *From Kroll's China Files*

- ❖ Kroll's investigations commonly uncover suppliers, corrupt employees (and ex-employees) involved in:
  - Purchasing and sales corruption, kick-backs (Everybody Out Case Top Employee and All Under)
  - Theft of confidential information (Compete/threats upon dismissal/Hostile Takeover)
  - Owning companies they are doing business with (9 Companies Liaison Case -- Torsten)



# **China Risks ....**

## ***From Kroll's China Files***

- Theft of company assets, raw materials, products
- Corruption, bribery and blackmail
- Physical threats (When the partnership goes bad Dalian and Xiamen)
- Sexual Harassment or other damaging allegations (increasing – Car Case, Why They Don't Want You at Work Case )
- Counterfeit, 'gray market', distribution fraud (Why you cannot recall your product)





# China Risks

- ❖ Internal fraud, diversion of assets
  - What has your partner done tax-wise (Shipments to Africa, tax evasion, smuggling, silent partners)
  - Abuse of replacement parts and inventory systems
- ❖ Nuisance or Fraudulent Litigation (Rumple)
- ❖ Asset searching
  - If you are successful you need to find their assets



# What are the key enablers for fraud?

- FIE representatives' unfamiliarity with local language, culture and business mores;
- Over-reliance on one trusted local management figure – CEO/CFO;
- Inadequate or inappropriate business controls environment – ignores potential degree of COLLUSION which can be experienced;
- Generally poor standards of local auditing /accounting support;
- Low expectations for performance on part of FIE;
- FIEs lack of independent local connections and influence;



# How is fraud typically detected?

- Internal whistleblower [Anonymous Letters and Emails]
- Business Partner Tip-off (often suppliers or others who earn money from you)
- Regulatory Authority Action – Tax Evasion, Smuggling
- Sudden departure of key management staff or accountants for unexplained reasons
- Sudden unexplained downturn in business performance



# New Pressure on MNEs to Investigate

- FCPA
- SARBANES OXLEY
- Moral, Legal, Commercial motives



# What role do external consultants play?

- Engaged by FIE under the following circumstances:
  - Inquire as third parties into allegations/rumors;
  - With prima facie case, conduct internal inquiries to establish facts and quantum;
  - Remedial consulting.
- Focus is on response not prevention



# Mitigate these Risks through Best Practices Risk Management

- ❖ **Due Diligence: Identify problematic individuals and companies before you lock in your relationship**
  - Investment partner, acquisition, supplier, distributor,
- ❖ **Employee, Supplier / Distributor Integrity Programs**
- ❖ **Discreet Internal fraud investigations when problems arise**





# THANK YOU