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# MADE UP IN CHINA

Cases of fraud in China are threatening the already unstable financial gates, writes *Liana Cafolla*

Slowing economies are not standing in the way of investors and entrepreneurs who want a foothold in the vast China market, but fraud is. Experts in fact predict as the financial crisis digs in, fraud will become more pervasive, or at least more obvious.

“If employees feel that their jobs may be threatened and their freedom becomes more restricted as firms cut costs, this could increase the rationalization of committing a white-collar crime,” says Jean Roux, Central China forensic services lead partner of PricewaterhouseCoopers.

He says employees think they are less likely to get caught when more companies are bypassing common controls to keep business cycles buoyant.

Forensic experts say it’s dangerous for employees to harbour such thoughts because companies look harder for potential areas of losses, misappropriation or other wrongdoing when sales go down and cash flow is stretched.

“History tells us that recessionary forces result in more frauds coming to

light as scams become less sustainable than when times are good because expenditure tends to be scrutinized more carefully,” says Neill Poole, managing director of Alvarez & Marsal Asia in Hong Kong, a specialist in dispute, analysis and forensics.

“This may give the illusion of more fraud when in fact it is just existing fraud coming to light,” he says. “However, we have also seen increases in certain types of fraud, historically, which have clearly been a direct consequence of recessionary factors.”

## Scamming from the top

Financial fraud is not restricted to China. Even the most respected investors in the world’s largest economy are not immune. December saw the revelation of a massive fraud perpetrated in the U.S. by Bernard Madoff, once considered an investment supremo. Madoff has reportedly admitted to F.B.I. investigators that his prestigious US\$50 billion investment business is nothing more than a Ponzi, or illegal pyramid,

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scheme. The list of victims included the world's top banks such as HSBC, Banco Santander, The Royal Bank of Scotland, Natixis and Nomura, investment funds and insurance companies.

In Germany, Siemens AG, one of the country's biggest and most respected firms, was fined a record US\$1.6 billion last month after it admitted to paying bribes of more than US\$1 billion around the world to win public works contracts.

As the Chinese economy becomes more market-driven, one area where forensic experts expect to see a proliferation of cases is in fraudulent misstatement of financial statements perpetrated at senior levels.

A high-profile fraud case exposed recently involves Wong Kwong-yu, founder and chairman of China's biggest

appliance chain, Gome Electrical Appliances Holdings, who has estimated assets worth 43 billion yuan. Beijing police confirmed in November that they have detained and are investigating Wong for alleged economic crimes, including illicit asset transfers, share price manipulation, money laundering, tax evasion and bribing officials to win approval for Gome's initial public offering in Hong Kong in 2006, according to a report posted on the website of the China Internet Information Centre, which is published by the State Council.

Violet Ho, managing director of risk consultancy Kroll's Beijing office, says it is not uncommon for companies to inflate sales and manipulate or fabricate financial information before they go

for an IPO. In the most serious cases, companies can be delisted for such fraudulent activities when the frauds are exposed, she says.

A case in point is the now-defunct Shanghai Land Holdings, which was delisted from the Hong Kong stock exchange in October 2005, more than a year after its former chairman, Zhou Zhengyi, was jailed for stock market fraud. Zhou, who once ranked 11th on Forbes' list of China's richest, was rearrested by Shanghai authorities in 2007 on charges of bribery, tax receipt forgery and embezzlement, and was given a 16-year jail term in the mainland last year.

Fraud translates into hard numbers that show damage to both the country and companies. Figures from the School of Public Policy at Tsinghua University

## How to spot a fraud

The first line of defence against fraud is audit. Daniel Lin, an assurance partner at Grant Thornton, says auditors should maintain a questioning frame of mind, asking themselves questions like, "If I wanted to increase my revenue fictitiously, what would I do?"

The two most frequent answers are misappropriation of assets and fraudulent financial reporting. Most high-level fraud involves the latter, including creating fictitious sales, non-existent bad debts or faking write-offs by, for example, claiming somebody bought the wrong technology and so it was written off, he says.

Related party transactions between companies often go unreported in China. Derek Broadley, a partner in Deloitte's audit technical department, said: "When fraud is uncovered at a company, it is not uncommon that there have been

cash transfers to or from entities whose relationship with the company was previously undisclosed.

"A common method of fraudulently moving cash out of a company would be to instruct the company to buy or sell assets at prices that are outside of market norms, thereby stripping the company of value at the expense of outside shareholders," he explains. "This is an area that is particularly difficult to audit if it is not disclosed that the other party is related, as it may be difficult to establish a market-related price for unique assets such as trademarks, patents or mining rights."

Broadley says companies need substantive controls in authorizing related-party and unusual transactions.

The costs of fraud to a company are not always immediately apparent but can run high, says Lin. For example, employee theft may not

amount to much on an individual scale, but can balloon when multiplied by dozens or hundreds of employees. If a salesman is receiving gifts – a common mainland euphemism for bribes – from a particular dealer, nothing may show up on the books but the company may be paying dearly by not getting the best available deals on the market.

The tone at the top is crucial. "If employees believe that the company does not take fraud seriously, they may begin to rationalize that it is not really wrong," says Broadley.

But what if the fraud is being perpetrated at the top level? Lin acknowledges that even the most intensive and skilled questioning cannot always uncover scams. "If a crooked board sets out to deceive you, it's very difficult to find anything. People don't realize there's a limit on audit – we don't look at everything."

show that public sector fraud has cost between 13 percent and 16 percent of China's gross domestic product over the past decade. During the same time, in the private sector, fraud and kickbacks have cost the Chinese economy 15 percent to 20 percent of its GDP, according to Ho.

Ho says these figures are starting to overlap and that in the last five years, she is seeing more private-public collusion among multiple parties and entities. "This includes manipulation of accounts, goods being diverted and monies being paid to fictitious accounts or companies," she says.

According to a PricewaterhouseCoopers report on global fraud in 2007, asset misappropriation topped the list of fraud cases reported in China at 25 percent.

Other common frauds were intellectual property infringement (14 percent), accounting fraud (8 percent), corruption and bribery (7 percent) and money laundering (4 percent).

Ho says China's accession to the World Trade Organization in 2005 opened up the Chinese market for foreign investments, but "there is too much money looking for a home in China." Official statistics showed foreign investment in the mainland reached US\$95 billion last year, up 15 percent from US\$82.7 billion in 2007.

To get through the bureaucratic maze involved in investing in China, such as obtaining approvals or endorsements from different officials, foreign investors often resort to under-the-counter payments, Ho says.

The impact on organizations, however, is far more lethal than in-house fraud because the entire documentation structure under which a company exists and operates may be fraudulent. Foreign companies without an adequate understanding of the mainland or reliable contacts are particularly vulnerable and may end up paying bribes to secure documentation that is bogus. "This may mean your entire operation is built on a house of cards," she says.

Ho says even the best preventive measures will not keep a company safe from all threats and risks, but due diligence will help avert some.

Kroll was hired three years ago by an overseas investor who was planning a US\$80 million investment into a mainland food and beverage company and ended up uncovering a web of frauds. The mainland company made bogus claims about its products winning several international prizes. It lied about having a production base in northeastern China, which turned out to be an empty plot of land not even owned by the company. A background check on the company's front man showed a history of aborted transactions. Kroll found his seed money came from a previous fraudulent deal with a Japanese investor. In the end, the would-be investor backed out.

### **Playing without rules**

Apart from excess incoming cash, the mainland is also hampered by under-developed legal and tax systems and arbitrary enforcement.

Indeed, China tied with India and Brazil in third place in a list of countries that appeared most frequently on the actions in breach of the omnipotent Foreign Corrupt Practices Act between 2000 and 2006, according to a ranking by The Corruption Perceptions Index produced by Transparency International, a global anti-corruption organization.



One company that has an abundance of direct knowledge about the extent – and frustrations – of fraud in China is Standard Chartered Bank, which has been doubling its presence on the mainland for each of the last three years, says Nelson Yeung, head of fraud risk management at Standard Chartered Bank (China) Ltd.

Yeung, a former senior police inspector, set up the department about a year ago and relies on local internal information gathered from the bank's branches to fight a seemingly interminable battle against fraud.

The most common problems the bank confronts are falsification of documents on a vast scale, lack of staff integrity and syndicated fraud.

False documents are often submitted by small and medium sized enterprises applying for loans or individuals seeking mortgages. The fakes could be bank statements, proofs of income, tax bills, identity cards or information in the application itself.

"More likely than not you're getting a false story about how they're going to use the loan," says Yeung, who is often shocked by the copious amount and high quality of false documents accumulated by people.

Looking for official help is useless, he says, because even mainland police cannot tell the bogus documents from the real ones, and tax officials often refuse to reply to questions of any kind.

Another ruse used by fraudsters is claiming to be a member of the military, which is impossible to verify, thus leaving the bank's hands tied. "Soldiers claim to come from a secret unit that can't be identified," says Yeung.

The second problem, staff integrity, is often due to ignorance or cultural differences, he says. Clients regularly turn up at the bank bearing blank documents from their employer to show

proof of income. The bank's staff will often offer to help fill out the documents, thinking they are being helpful, without realizing that they are in fact helping to create false documents.

"Some staff are so innocent that if customers ask for blank-headed papers and envelopes, they'll give them," says Yeung. He found nine out of 11 mortgage applications containing fraudulent documents over a three-month period, and they were thought to have been provided by the bank's own relationship manager.

The third issue is syndicated fraud. White-collar crimes are still not recognized as very serious in China, says Yeung, and the purpose of

“Some staff are so innocent that if customers ask for blank-headed papers and envelopes, they’ll give them.”

documents is often perceived differently on the mainland. A tax certificate, for example, is considered only a receipt, so producing a counterfeit tax certificate is not a crime because it's not faking a government document.

In the past, police would close cases and rule that no crimes had been committed as long as the fraudulent documents had been uncovered and the bank suffered no loss. If money was lent based on false documents, the police would ask how the bank could be sure that the client didn't intend to repay the money. So they would say there's no case. Still today, the problem is a lack of

resources to conduct investigations, he says. "So many police or other authorities will say, well, this is a part of your cost of business, can't you just accept it?"

Another problem is that no laws exist on which to base a prosecution. Even where they do exist, "it's very difficult to prosecute – 99 percent of cases are disappointing," Yeung says.

"You have to convince the police there's definitely a crime. You have to collect all the evidence. So the only workable strategy is we have to learn the business. All you can do is try and build an internal prevention strategy. That's the only way," he says.

### Looking for clues

The good news for companies looking to avoid getting sucked in by fraud is the mind-boggling array of expertise on hand to help. For example, forensic investigators have teams with a cross-section of talent that zoom in on companies troubled by fraud, leaving no stones unturned.

The Big Four accounting firms all offer anti-fraud services. Around three quarters of Deloitte's 80-person forensics team works on the mainland and the department has been growing at 50 to 60 percent in size annually. Most of their business is with multinational companies that have moved into the mainland in the last five to 10 years – coinciding with the rise in prominence of the Foreign Corrupt Practices Act after the passage of Sarbanes-Oxley, which raises the stakes for violating the act because top management have to sign off on company financials.

FCPA was originally passed in 1977 when the Watergate scandal brought corruption to the top of the U.S. political agenda. Its jurisdiction encompasses U.S. companies and individuals, as well as foreign companies that are listed or offer securities in the U.S. It also covers all



transactions that pass through the U.S. banking system.

While most multinational firms doing business on the mainland employ internal compliance and audit teams, they usually rely on external firms to provide specific industry-wide analysis, which is particularly important for assessing fraud risk, according to Guy Norman, a forensic and dispute services partner at Deloitte.

“In China, a large part of what we’re doing is called ‘business intelligence’ – understanding who you are dealing with and what sort of business partners you have who ultimately own companies and potentially what links they have to government, other businesses or competitors.”

Fraud most often occurs in two types of businesses – technology, media and telecom companies where revenue recognition is the area most frauds are committed, and consumer businesses including retail and luxury brands, where employee theft constitutes the biggest problem.

Grant Jamieson, a principal in financial advisory services at KPMG, says their 30-person forensics team, which includes accountants, auditors, private investigators, former regulators, ex-journalists, lawyers and psychologists, helps clients identify and investigate fraud and implement counter measures.

The tasks confronted by his team read like a synopsis of hit U.S. television crime series *CSI*. A company may ask them to discreetly find out what has happened to an employee who has been arrested by mainland police, or they may be called to investigate the true identity of a business contact – often it’s not clear who is or is not a government employee, says Jamieson. They may be asked to investigate claims that mainland customs are demanding kickbacks and not releasing products until they have been paid, causing disruption to business.

“The U.S. treats this very seriously and requires an independent (person) to come in and have a look at it,” he says.

Technology is at the centre of the forensic team’s work. They start by data gathering, which may involve, with the client’s consent, entering the premises being investigated at night and removing hard disks from computers, and data mining using keyword searches. The savings to firms is difficult to estimate, but in intellectual property infringement cases such as royalties and fake luxury products, the values involved can be as much as US\$100 million, he says.

Although the number of fraud cases will likely increase during the financial crisis, fewer companies are expected to be wound up because Beijing has become more committed to maintaining social stability, according to Deloitte’s Norman.

“Ten years ago, if a company failed, it would be put into liquidation, but often behind corporate failure there’s some element of fraud. Now there’s an increasing shift towards saving companies, I think we’ll be more and more active in the next year or two,” he says. **A+**