Pre-empting Fraud: Understanding the mindset of the Chinese entrepreneur

By Violet Ho, Kroll

Although China remains an attractive destination for private equity investors, it has gained a reputation as a market where contracts are often treated more like vague notions than bona fide agreements. Kroll commissioned the Economist Intelligence Unit to carry out the Annual Global Fraud Survey, which found that fraud continues to be pervasive in China, with 67% of senior executives based in China reporting they were affected by fraud in 2012 – 2013. The study also found the average percentage of revenue lost to fraud across industries in China rose 50% from 0.8% in 2011-2012 to 1.2% in 2012-2013.

While all investors face fraud risk in China, regardless of their geographic origin or investing strategy, private equity investors often have limited legal recourse because private equity investments in China tend to be minority positions. It is therefore critical that private equity investors understand the Chinese culture of doing business and the mindset of the Chinese entrepreneur.

Familism and *Guanxi*

Chinese entrepreneurship has for centuries been built upon two attributes of Chinese society: (1) familism and (2) *guanxi*. These cultural practices in turn shape the nature of fraud and inform the precautions foreign investors should employ.

Familism is the social convention that prioritizes the entire family above the needs of individual members. Familism has great influence on business decisions in Chinese society, particularly since many of China's companies are family-based. Foreign management may find it hard to penetrate this circle of trust and loyalty, making it challenging to enforce corporate governance standards or select business decisions.

Guanxi refers to personalized networks of influence and reciprocity that individuals and businesses possess. *Guanxi* is a central foundation in Chinese society; such informal relationships, including those with the Chinese government, govern almost every aspect of social and business interactions. Entrepreneurs call upon *guanxi* to execute or enhance a range of business transactions. For example, an entrepreneur with well-developed *guanxi* may receive licenses or a loan approval more rapidly than a less connected competitor. It is essential for investors to investigate the precise favors or exchanges the entrepreneur calls upon and issues via his informal network. The relationship between *guanxi* and fraud is complex; a firm that exhibits these advantageous connections may or may not be engaging in fraudulent practices. Investors should also pay close attention to how the entrepreneur developed his *guanxi*, particularly relationships with government counterparts. Is it an institutional alliance based on operational strength and contributions to the local economy, or one based on bribery?

Understanding the mindset of a Chinese entrepreneur

First-generation Chinese entrepreneurs, partly because they often come from humble beginnings, are highly ambitious and willing to take risks if they sense a maximum pay-out on their investments. This propensity towards risk taking may not change when the private company transitions to a listed and/or international company, which could create corporate governance challenges. Indeed, 21% of companies based in China feel highly vulnerable to management conflict of interest, according to the 2013/14 Kroll Global Fraud Report.

Recognizing the tell-tale signs of fraud

When investing in the "China story," investors should not be consumed by an entrepreneur's ambitious pitch until they can corroborate the story. When something sounds too good to be true, investors need to dig deeper.

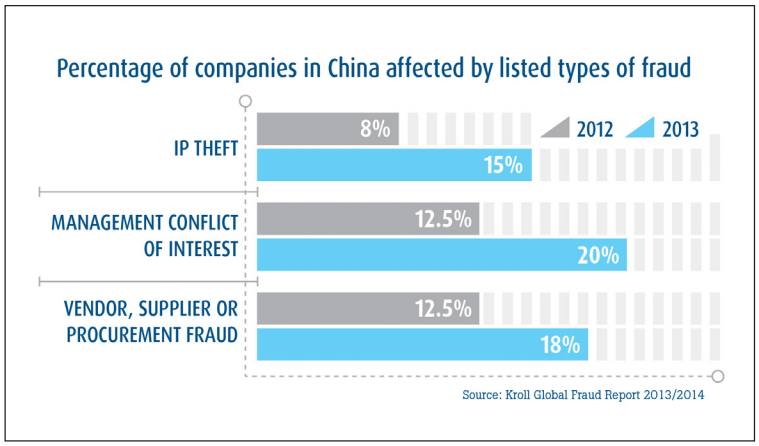
Fraud channeled through third parties is very common in China, with 18% of firms based in China reporting that they are highly vulnerable to vendor, supplier or procurement fraud[1]. A foreign investor, for example, may believe a particular acquisition is legitimate and revenue-generating, when it is actually an over-priced purchase of a business owned by an entrepreneur's family. Such schemes are a simply a conduit to channel funds back to the entrepreneur's pocket. They take multiple forms and complexity, so it is important for an investor to confirm the veracity of intermediary contracts and acquisitions a Chinese entrepreneur pursues.

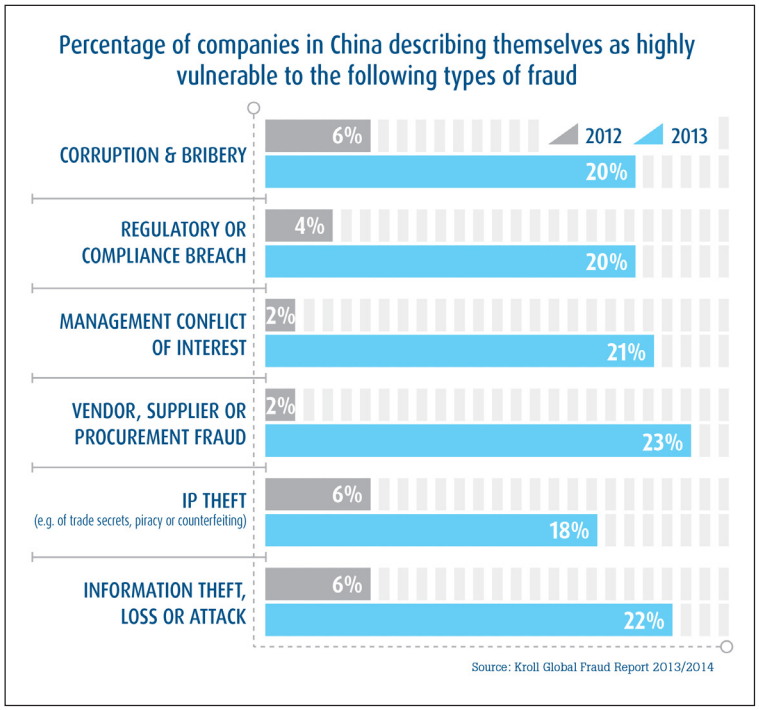
Potential investors should also question sales and revenue figures, as well as relationships with distributors. For example, a multinational client in the retail sector – who was once impressed by the double-digit sales growth of its China branch – appointed Kroll to investigate the large accounts receivable that were building up with distributors.

1. *Kroll Global Fraud Report 2013/14 (http://www.kroll.com/resources/reports/global-fraud-reports/).*

Kroll found that the China branch was simply moving goods back and forth from its family-owned distributors. The contracts permitted the distributor to return all unsold goods with no penalty. The illusion of profitability initially boosted the company's share price; however, share price dropped significantly once the story came to light.

In the West, many companies possess control mechanisms to limit such behavior. These include job rotations, authorization levels, segregation of duties, tendering processes for contracts and internal audits, and more importantly, regulatory requirements such as disclosure of conflicts of interest or external audits. To the extent these measures are in place in China, they may not be sufficient to remedy fraud. Junior employees rarely disagree with senior management, and internal authorization can be easily obtained when the entrepreneur's family members are the other department heads.





Pre & Post-transaction checks

For foreign investors, conducting extensive and thorough reputation-focused due diligence before entering into a transaction is a priority. This must include a thorough background search on the partners, their business, and track record working with foreign investors.

The mistake many investors make is to rest on their laurels after the deal is done. Post-transaction, an investor should conduct an in-depth risk assessment of how the company mitigates or handles instances of fraud, bribery and corruption, money laundering, related-party transactions, and conflicts of interest. Based on the findings, appropriate anti-fraud, anti-corruption measures can be put in place. A local team put in place by the head office should manage these measures, given the challenges mentioned above. Where satisfactory due diligence cannot be conducted before an acquisition, regulators now expect effective post-acquisition due diligence to identify the risks in a relatively short time after the deal. The primary objective of the forensic due diligence is to evaluate the potential future loss in value resulting from inappropriate or unethical business practices of the target. This analysis generally concentrates on specific areas, such as inventory and supply chain management, consultancy and agency fees, travel and entertainment expenses, political and charitable donations, and cash transactions.

China should not be a place that investors shirk in trepidation; rather, it is a vibrant place where intrepid investors and entrepreneurs can do business for potentially a great reward, but only when done right.

About the Author

Violet Ho is a Senior Managing Director for Kroll's Greater China Investigation & Disputes practice.

