Five Fraud Prevention Strategies to Protect Your Business in China

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Foreign companies entering a high-risk market like China must pay attention to their compliance programs at the local level. Passive supervision from the top simply won't suffice.

As a starting point, the below internal control measures should be carefully considered and strengthened where appropriate.

1. Embed internal controls in the corporate governance structure

When starting a new business venture in China, it is vital to embed internal control mechanisms within the company's governance structure.

The corporate governance structure of a wholly foreign-owned enterprise (WFOE) in China is made up of an executive director or alternately several directors constituting a board, one or several supervisor(s), and an authorized representative of the shareholder(s).

In addition, one individual shall occupy the position of the company's legal representative, a role that can be assigned either to the executive director (alternately to the chairman of the board of directors) or to an optional general manager position.

A clear segregation of duties sets the foundation for an effective reporting line, allowing shareholders to have better supervision and control over their China operation in the long term.

Lured by the prospect of a leaner and more efficient decision-making structure, foreign businesses in China too often entrust considerable authority to a sole employee, usually the legal representative, paving the way to a loss of transparency and control.

When an employee is able to perform important duties without supervision or prior authorization from a manager higher up in the reporting line, there is always a risk that this individual ends up acting in his or her self-interest. An opportunistic legal representative could do considerable harm to the company if proper checks and balances are not in place.

2. Monitor custody of company chops

On an ongoing basis, the shareholders should monitor whether each person is fulfilling their duty in accordance with the company's Articles of Association and PRC Company Law. Likewise, in China, careful consideration should be awarded to the assignment of the custody of the company chops.

Sometimes also referred to as seals or stamps, chops in China are engraved with a given company' details, such as its registered legal name and are used to legally authorize documents – much like the signature of a senior executive in other countries.

In effect, whoever holds the company chops is de facto granted authority to act in the company's name. In the day-to-day operations, this could mean signing contracts on behalf of the company, or authorizing payments at the bank, for example.

"A failure to monitor the custody of company chops could provide an opportunity for local employees to perform fraud," said Ivy Gu, who is a Manager on Dezan Shira & Associates' Business Risks, Internal Controls & Investigations (BRICI) team.

Gu told *China Briefing*: "We recently encountered a case where the General Manager of a WFOE in Ningbo had used the company chop and the Legal Representative's signature chop to transfer RMB 12 million to his personal company right after capital was injected by the shareholders into the WFOE."

Thus, all companies in China are advised to develop thorough internal control mechanisms to ensure its employees use chops legitimately. The solution may lie in dividing the chop usage and guardianship responsibility between different persons, or better yet, appoint a third-party custodian to safeguard the company chops.

In addition, it is recommended to establish who at the senior-management level permits to use a given chop if the regular holder is absent, and to clarify when the chop's guardian is required to secure additional approval prior to usage.

In certain cases, it could be requested that the signature of a senior manager be applied prior to chop usage, to further strengthen the segregation of duties.

Finally, creating a log documenting the time, date, and reason each time a chop is used or accessed from the company's safe, is also advisable.

3. Automate inventory management, segregate purchasing functions

For trading or manufacturing companies, implementing internal controls related to inventory management is essential.

Having an automated warehouse management system could significantly limit the incidence of inventory misappropriation, while physical stock takes should also be performed periodically to verify the accuracy of electronic data and reduce the risk of employees tampering with the system.

"Earlier this year, an investigation we conducted revealed that the local warehouse manager of an international company was able to steal inventory undetected by intentionally making an incomplete count of the raw materials during the quarterly stocktaking process," said Gu. "Such incidence of asset misappropriation could have been prevented if a third-party had been entrusted with the physical stock count," Gu added.

It is also essential to appropriately segregate the duties of the purchasing manager and warehouse manager to limit the risk of collusion of a sole decision-maker with suppliers.

There should be a clear reporting line defined whereby the warehouse manager instructs the purchasing manager to place new orders with suppliers, upon authorization from a senior manager.

Obviously, the decision regarding the choice of suppliers to begin with and pricing should be carefully controlled.

More generally, different steps in any purchasing process should be assigned to different staffs, and variances in the price paid for goods and supplies should be investigated, to limit the incidence of cash theft or collusion between staffs and suppliers.

4. Control sales prices and monitor shipping

Similarly, on the sales-side of things, price ranges for different products should be firmly set.

For some businesses, each product might have a set price, while for others, there is room for negotiation with each individual client.

In the latter case, businesses should establish firm ranges for which employees can sell a given product, whether it is in a certain range for all sales or different ranges based on the quantity sold.

Prior to proceeding with a sale outside the set range, the sales team should be requested to secure additional approval from a senior manager. This dampens the potential for cash theft or collusion with customers.

Additionally, businesses should record any item shipped out with the relevant invoice, to avoid back-channel sales profiting individuals as opposed to the company.

The consistency between inventory data, shipping records, invoicing, and the sales figures in the books should be carefully monitored, and the relevant duties appropriately segregated.

5. Separation of roles in cash management

Last but not least, a segregation of duties regarding cash management is absolutely essential to limit the incidence of cash theft. The responsibility to initiate and approve e-banking requests, for instance, should be separated.

One practical solution could be for the finance manager at HQ level to hold the e-banking token required to approve payments.

Likewise, the cashier holding the corporate check book should not have free access to the company chops; otherwise, that employee would have the opportunity to initiate payments at the bank undetected.

The cashier and bookkeeping functions should also be segregated, to ensure that all banking transactions and cash movements are properly recorded.

Referring to another recent fraud investigation performed by her team, Gu recounted: "The General Manager of a WFOE in Suzhou had instructed the local cashier to open three bank accounts under her name, and the General Manager would transfer money from the company bank account into the personal bank accounts of the cashier from time to time. The cashier also was responsible for the bookkeeping and was instructed to record the payments as payables to suppliers in the company books."

"Such cash embezzlement and asset misappropriation could have been prevented if the cashier and bookkeeping functions had been properly segregated," said Gu.

Once such internal control processes have been implemented, compliance to these internal policies should be closely monitored and further encouraged by evaluating key staffs and business partners.

This is Part 2 of a three-part series about fraud prevention in China. In Part 1, we examined what fraud looks like in China, and how to assess fraud risks. In Part 3, we will discuss due diligence and monitoring strategies to combat fraud in China.

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