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JUST ANTI-CORRUPTION

In China, a perfect storm brews over US multinationals

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Brent Carlson and Colum Bancroft at AlixPartners explain why employees in China are becoming increasingly tempted to break the law.

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Against the backdrop of China's slowing economy, rising tensions due to trade tariffs and economic rivalry, and increased allegations of hacking and corporate malfeasance, multinationals are facing a brewing storm over their operations in China. This increasingly pressurised environment is ripe for more fraud and corruption. At the root of the problem lies an unprecedented high level of risk, as corruption, declining revenues, channel stuffing, supply chain fraud, and employee wrongdoing converge.

Foreign companies in China have put considerable effort and investment into building compliance and fraud prevention programmes, but as the external pressures increase, more will need to be done to stay ahead of a rapidly evolving situation. Companies need to reassess the effectiveness of their programmes to weather the coming storm.

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Trade and economic tensions raising FCPA risks

As trade tensions between the US and China continue to mount, much of the media coverage has focused on global supply chains and multinationals seeking to relocate operations outside China. One area of risk – which may not manifest itself immediately but whose effects might be felt deeper and longer – is the Foreign Corrupt Practices Act.

China's response to US tariffs and the trade tensions has varied, from hints of retaliation to suggestions of accommodation. Nevertheless, since the US first levied tariffs against Chinese goods last June, American companies have reported an overwhelmingly negative impact of the tariffs on their business in China. Furthermore, and perhaps more importantly, American companies have reported an increase in non-tariff barriers in China. Local environmental and tax regulators have increased inspections of companies. Companies also report longer times to clear customs and secure necessary licences.

FCPA risks stem from two primary sources within a company's operations – revenue generation and regulatory issues. Non-tariff barriers have been classic issues for FCPA cases. With the reported increase in these barriers, employees within a company's China operations face considerably increased pressure to commit acts that could violate the FCPA.

Pressure from these types of barriers has been an issue in China operations for some time. A May 2018 survey of American companies in China (just prior to the first round of tariffs), showed the top three challenges were: inconsistent regulatory interpretation and unclear laws and enforcement; regulatory compliance risks; and increasing Chinese protectionism.

The uptick in non-tariff barriers is only the latest chapter in the saga of increasing Chinese protectionism. This underscores the likelihood that the rising pressures for FCPA risks in China will not abate anytime soon, unless US–China trade tensions are quickly resolved, which seems unlikely.

Increasing fraud stems from China's slowing economy

Another problem harming foreign companies' prospects in China is an acceleration of types of fraud other than corruption. Conflicts of interest, embezzlement, theft of intellectual property and bogus financial reporting were not uncommon during China's peak boom period or "Wild West" days over the last two decades. Now China faces a slowing economy, and, as pressures increase on a business in a slowdown, the pressures to commit fraud also increase.

China's economy has reached a turning point. Although it remains an important market – indeed a global priority – for many multinational companies, firms in China are facing diminishing growth prospects and even greater risks of fraud and corruption.

After several warning signs, China's economic slowdown is now becoming widely recognised. China's latest annual GDP growth rate (as of December 2018) stands around 6.5%, about half of what it was at the start of the decade, with targets for 2019 trending even lower. Some economists say actual growth is much lower still. Apple's earnings announcement in early January pointed to an economic slowdown in China, and this has been termed a "canary in the coal mine" warning that points to more troubles ahead for companies.

Although market commentators broadly agree that China's economy is slowing, it is not yet widely recognised that the slowdown is structural. In turn, the magnitude of the impact on foreign companies operating in China has yet to reach its peak. China has a historically high level of debt, particularly in terms of its debt-to-GDP ratio (now over 300%). For context, China's debt levels are comparable to those seen in Japan's economy before it entered its two "Lost Decades" and the US economy before it entered the financial crisis of 2008 and subsequent recession. In fact, China's debt continues to expand at least twice as fast as the underlying economy. This situation is unsustainable. Over the long term, China will need to reduce its debt load to avoid a crisis. However, deleveraging also comes with the price of slower economic growth.

This has profound implications for American companies operating in China.

Experienced anti-fraud professionals recognise that rising pressures on revenue growth give rise to more fraud. One issue that seems to be occurring more frequently in China, and which may prove more insidious than corruption, is the re-emergence of revenue-recognition issues, particularly in the form of "channel stuffing". This is a business practice used to inflate sales and earnings figures by deliberately sending products into distribution channels that exceed customer demand. Channel stuffing occurs when employees inappropriately move revenues into earlier periods. In the context of a slowing economy, however, the problems are not simply those of timing of revenue recognition. Rather, when an economy slows, this means overall demand is decreasing. In this context channel stuffing provides a means to generate revenues that never actually appear. Furthermore, channel stuffing in a slowdown raises the risk of a company's sudden and unexpected collapse.

Increased whistleblowing and the convergence of fraud and corruption

In addition to the evolving pressures facing multinationals in China, whistleblowing activity has increased considerably over the past several years. According to a report issued by the US Securities and Exchange Commission, from 2012 through 2018, the number of whistleblower tips received from China by the SEC grew by approximately 67%. In 2018 the SEC received more tip-offs from China than any other developing country.

The nature of the allegations increasingly involves both fraud and corruption issues. Previously it was more common to see whistleblower tip-offs addressing single issues or a cluster of related issues. Now we are seeing an increase in tip-offs for both the FCPA and channel stuffing in operations in China.

Outlook on the trade tensions and China's slowing economy

China is, and will remain, an important global market, but the situation for US multinationals will get worse before it gets better. The underlying issues behind the trade tensions run deep, extending back over 20 years, and revolve around access to China's markets for foreign multinationals as well as technology transfers (including alleged theft of intellectual property). These are thorny issues that will not likely get resolved soon.

Expect a rocky road ahead, with progress followed by setbacks, and conciliation and retaliation almost simultaneously. A good example of this occurred in early December when the US and China were coming to an apparent truce in further tariff increases. Amid these negotiations, Huawei's CFO was arrested while transiting in Canada to face extradition to the US for alleged trade sanction violations. Also, the conviction in New York of a former Hong Kong official for FCPA violations while promoting China's Belt and Road Program in Africa has complicated matters.

During the initial periods of China's economic development, starting with the boom time of foreign in-bound investment beginning in the mid 1990s, foreign citizens were largely given a wide berth by Chinese law enforcement. The situation has changed in recent years. For example, the former head of China operations at pharmaceutical giant GSK (a UK subject) was convicted of corruption charges. The company was fined the equivalent of nearly $500 million). China is likely to enforce its laws and regulations more aggressively against US citizens. In fact, on 3 January, the US Department of State issued a travel advisory for these very reasons.

Finally, the DOJ's China initiative, announced late last year with a stated goal of identifying "FCPA cases involving Chinese companies that compete with American businesses," also increases the stakes in the ongoing tensions between the two countries.

Companies need to reassess their prevention and detection programmes

While companies have rightly put a lot of effort into building ethics and compliance programmes in their global operations, the convergence of fraud and corruption adds further complexity to maintaining the effectiveness of the existing programmes. As the pressures for US multinationals increase, corruption will increasingly be effected via classic fraud schemes involving circumvention and override of policies, procedures and internal controls. US companies will need to re-evaluate the overall effectiveness of their programmes considering the changing conditions in China.

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