INTERNATIONAL ANTI-FRAUD EFFORTS: THE ISSUES OF BORDERLESS FRAUD
FINANCIAL STATEMENT FRAUD: CHINESE STYLE

China is generally viewed as a country that does not adhere to international accounting policies and guidelines. Many companies are alleged to manipulate their records to establish a successful operating environment or reduce the burden from corporate income or business tax. Learn through case study analysis the innovative ways corruption is hidden from investigators and the methods that can be used to uncover it.

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FINANCIAL STATEMENT FRAUD: CHINESE STYLE

In Asia, corporate misconduct is flourishing. We see it in the press, in reports from short sellers, and in disclosures by audit firms. We also see that the methods of financial statement fraud used by companies in Asia, many of which are listed, have not changed over the past decade. What has come to be known as a “Chinese reverse takeover” (RTO) is a case in point. The fraudulent activities being uncovered are not particularly new or especially sophisticated; in fact, they are somewhat predictable. In this paper, we share some of the tactics used by Asian companies in misleading auditors and bankers when engaging in financial statement fraud. We will also review some techniques and cases taken by Asian companies, in particular Chinese companies, to manipulate accounting records, and some of the warning signs and characteristics of companies engaging in financial statement fraud will be defined. We will analyze through these case studies how some companies in Asia use “creative” means to falsify their financial records—whether to cover up corruption, fraud, money laundering, or tax evasion.

Accounting Standards and Company Filings in the PRC

The Ministry of Finance (MOF) in the People’s Republic of China (PRC) has been working for over a decade to develop a set of Chinese Accounting Standards that are largely in line with International Financial Reporting Standards (IFRS). The MOF issued the first Accounting Standards in 1997, and in 2006 published a revised set of Accounting Standards for Business Enterprises (ASBE). To date, 38 standards have been adopted and the MOF and the International Accounting Standards Board (IASB) regard the ASBE as substantially reflective of IFRS. The ASBE is meant to make PRC companies more comparable to other international companies.

NOTES

1 www.asianlii.org/cn/legis/cen/laws/toc-A.html
PRC accounting records and financial reports must be prepared and maintained in Chinese. Foreign Invested Enterprises (FIEs) and other foreign organizations may, at the same time, use one foreign language (such as English) together with Chinese.

China’s State Administration of Industry and Commerce (SAIC) is responsible for business registration and business licenses, and acts as the government supervisor of corporations. The agency is primarily concerned with legal compliance issues, and not with financial statements or taxes. Most companies see the sole purpose of an SAIC filing as getting their business license issued and renewed. So filings with the SAIC do not include a great deal of financial information, audited or not.

**PRC VAT Obligations**

Chinese companies pay a variety of taxes, such as the Value Added Tax (VAT), Enterprise Income Tax (EIT), business tax, and payroll taxes administered by the State Administration of Taxation (SAT). VAT is essentially a sales tax on every transaction conducted in the PRC, and approximately 80 percent of all corporate taxes are collected through VAT.

PRC regulations categorize taxpayers as *general VAT taxpayers* and *small-scale VAT taxpayers*, depending on sales volume and the adequacy of their accounting system. General VAT taxpayers with an adequate accounting system are allowed to reduce their VAT burden by crediting input VAT against output VAT.

Small-scale VAT taxpayers are generally entities that have insignificant VAT transactions or are unable to properly account for their input and output VAT due to an inadequate accounting system. These taxpayers are subject
to a simplified VAT calculation method, with a VAT rate of 4 percent for trading enterprises, and 6 percent for production-oriented and other enterprises. No credits or deductions are allowed for input VAT.

To obtain a credit against the tax payable, a company needs Special VAT invoices (SVIs) that include matching transaction numbers that prove the vendor was paid the VAT and the vendor has reported it to the State Administration of Tax (SAT). Trade in fake SVIs is a major source of revenue loss for the PRC government.

Therefore, by having a larger amount of input VAT, the taxpayer can get a smaller amount of VAT tax liability. The input VAT is determined on a periodic basis, rather than on the matching basis followed under the accounting rules. Hence, there is a mismatch in the cash flows for output VAT and input VAT.

Like some Western companies, PRC enterprises have their own methods to manipulate their company’s financial position for minimizing the amount of tax paid, including a set of books for tax purposes. PRC companies are no different than the companies in the West when it comes to manipulating the books. Revenue is one of the easiest figures in accounting records for a company to manipulate, as revenue can be manipulated by inflating sales by the early recognition of sales transactions or deferring invoicing to reduce VAT exposure.

**The Opportunity Within Delivered Goods**

PRC companies are obliged to account for VAT payable in the accounting records at the time of delivery of goods to the customer. The company also incurs a liability to pay output VAT to the SAT once the sales invoice has been issued.
To avoid paying the VAT liability before being paid, companies in the PRC deliver the goods at one date but issue the sales invoice with the VAT at a later date. It is not uncommon to find that a VAT sales invoice has not been delivered with the goods to a customer. In other cases, some customers get vendors to accept a goods delivery without recording the receipt of the goods as purchases. These customers then accept the deferral of receipt of the VAT sales invoice, since it increases inventory for operating activities and defers the cash settlement of the sales transaction and VAT.

In these later cases, the goods are still recorded as an asset (i.e., inventory), instead of an expense (i.e., the goods sold). This way, the vendor can manipulate their sales records and their VAT liabilities, thereby affecting cash flow while customers defer their payment obligations.

**Manipulating Goods Delivery: An Example**

Another accounting technique used in the PRC is the early recognition of sales transactions. PRC subsidiaries or representative offices of non-PRC companies often use this technique, since they are less focused on managing their exposure to VAT and more focused on financial performance and achieving their financial targets.

For example, let’s suppose that Company A is delivering goods from a warehouse to Company B. Documents like the VAT sales invoices, packing lists and delivery notes are presented at the time of delivery and are sent with the goods delivered. Company B receives and accepts the goods, and the sales transaction is recorded as a sale by Company A. This seems normal. In fact, Company B did not place a proper purchase order to Company A. What happened was that Company A delivered the goods with the sales records to boost sales performance, and in some
cases, the destination itself is actually under Company A’s control.

This has also been seen in cases of consignment stock. Company A organizes an agreement with Company B by claiming that Company B’s onsite inventory should be recognized on a consumption basis and not under the delivery terms. Using this technique, Company B avoids being charged at the time of accepting the goods. In these instances, the inventory volume that Company B consumes is something the two parties have agreed upon on a monthly basis. In this example, Company A recognizes the sales transaction to Company B according to a predetermined schedule. This practice is particularly good when Company A has to control the monthly sales performance to achieve their sales targets.

This approach for revenue manipulation distorts cash management. If the sales and accounts receivable keep growing, but this isn’t reflected in the cash flow statement, it becomes a warning sign. Moreover, another warning sign is that there may not be a consignment-sales contract between the parties. In these cases, checking on who bears the insurance costs if there is inventory loss can help determine who owns the delivered goods.

**Invoicing Arrangements**

Companies in the PRC using deferred revenue techniques can record a high volume of expenses and decline in revenue. This can affect the bottom line if the expenses get recorded on time. In these instances, companies defer receiving expense or purchase invoices. In contrast, some companies may need to record extra expenses to equalize an overstatement of revenue. This overstatement may have been necessary if they wanted to meet revenue targets. Going back to the example, Company A (with excessive...
purchase invoices) and Company B (with insufficient purchase invoices) fall into the act of “trading invoices.” This is typical in companies that have undisclosed relationships. Since the purchase invoices do not get recorded, Company A tells the vendor to issue a purchase invoice to Company B, instead of Company A itself. Company B then arranges payment to settle with the vendor on behalf of Company A, which carried the original purchase invoice obligation. In such an arrangement, an equalization of tax obligations follows, which can then cover the skewed accounting transactions.

Fictitious Invoices
The SAT expects that companies record VAT invoices in a timely manner. Where a company generates high income levels with unexpectedly low costs, that company is exposed to a higher tax obligation. In addition to the invoicing arrangement discussed above, companies may be tempted to purchase fake VAT invoices at a very low cost, thereby inflating operating costs. Such fake VAT receipts show fabricated company addresses. In such cases, we have found that addresses refer to wastelands, landfills, or even remote housing properties. The SAT has online resources for companies to check the validity of VAT invoices. However, invoices must be entered individually and this is too time consuming when the volume of transactions is large.

PRC Chops
Chops, or official stamps, are how PRC companies validate operational and management decisions in company documents. A company can have several chops, and these are more important than signatures. All companies have a particular chop for use to mark the execution for all

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2 Shanghai Tax Bureau’s website, www.csj.sh.gov.cn/wsbs/ptfp/login.jsp
documents. For example, a financial chop is used for banking activities or check processing.

A company’s legal representative has a chop, usually of the person’s name, one often used in combination with the company chop. It really is the case that whoever controls the company and legal representative chops can thereby legally bind the company.

Too often, the control of chops is surrendered to local employees, only to discover that a breach of use has happened. As with most other business activities in the PRC, the chops themselves get falsified.

Now that we have covered a few of the typical problem areas and pitfalls seen at firms working in the PRC, a closer look can be made to outline the warning signs often found in business transgressions.

**Warning Signs of Corporate Fraud**

Many companies that engage in financial statement fraud ultimately collapse or face substantial financial distress. Comparisons of many of these failed companies provide a number of clues of what to look for. The clues themselves are not necessarily damning, but signal red flags that call for more investigation. There may be a sensible and reasonable answer as to why the warning bells rang. However, if these criteria have been identified and the explanations don’t make sense, then the company may be headed for trouble.

**The Importance of Good Corporate Governance**

In Asia, many companies have opaque structures and tightly held shareholder and management control. This is a consequence of the greater proportion of family-run companies, but often the company outgrows its...
management or its management forgets that they must consider the interests of other stakeholders. Good corporate governance provides a solid foundation for any company and healthy governance is a key part of a successful business.

Management and Shareholder Control
In Asia, many family-owned companies have major shareholders filling senior management positions, and it is not uncommon for the largest such shareholder to be both CEO and Chairman of the company. Independent directors are often not independent, but are “friends of the family.” Sometimes, members of the family management team will even be on the audit committee.

In these situations where there is insufficient segregation of duties, there is often limited control by the Board on the CEO and senior management. In addition, it is also common to find that suppliers and customers have close relations, providing substantial opportunity for improper conduct. Most disturbing is that, sometimes, the attitude of the Chairman is that this is his company and he can do what he wants with it—usually to the detriment of other lenders, creditors, or shareholders.

It is especially important to watch out for any assets shown in the financial statements as held on trust by the company, particularly in the PRC. Who is the beneficial owner? Often, these transactions are in reality related-party transactions.

Complicated Business Structures
In Western businesses, a complicated structure is often considered a red flag for fraud, since it is said to make it more difficult to properly assess the group’s operations. In Asia, however, a complicated structure is commonplace, as
owners tend to have a legal entity for each asset. For example, they buy a property or build a factory and have a company incorporated to hold that asset.

That said, having many interwoven and complex shareholder structures not only makes it more difficult to properly assess the group’s operations, but it makes it more difficult for management to control. Peace Mark Holdings Limited (Peace Mark), for example, was a Hong Kong listed company that had more than 200 subsidiaries in its corporate structure. Moulin Global Eyecare Holdings Limited (Moulin), another failed Hong Kong listed company, had more than 300 bank accounts for just over 30 subsidiaries.

Information Technology Requirements
As the world has become more sophisticated and the demand for real-time information has grown, accounting systems regularly fail to keep up. Often, companies expand but do not upgrade their accounting systems. This means they usually have insufficient information to react to changes affecting the company. Too often, Asian companies do not invest in sophisticated IT and accounting systems.

Often, many manufacturers are not even aware of the cost of manufacturing a particular product. In other cases, companies cobble together combinations of different accounting systems using manual adjustments. This means financial information cannot be produced in a timely or reliable manner. Companies that operate in such a way are rarely efficient and rely more on luck than proper management skills to produce profits.
Resignation of Directors and Auditors
Across Asia, resignations of directors are regularly accompanied by explanations that the resignation is due to “personal reasons.” In Hong Kong, “personal reasons disease” is a common occurrence. Ocean Grand Holdings Limited (Ocean Grand) is a case in point, where five directors resigned in the week immediately prior to the appointment of the Provisional Liquidators. Similarly, four directors and senior management of Orient Power Holdings Limited (Orient Power) resigned in the months before its collapse, and four directors of Moulin resigned less than two months before its collapse.

Resignations of auditors can also be a clear warning sign. In the case of Moulin, two audit firms resigned within just six months of its collapse. Similarly, Ocean Grand’s auditors resigned just six months before its collapse.

The Importance of the Capital Structure
A company’s capital structure is critical to its success. Depending on the mix of debt and equity adopted, a company’s fortunes will vary substantially. While a company with a greater proportion of debt funding over equity has the capacity to increase returns to equity holders, it also increases risk for all stakeholders.

The Working Capital Blowout
Company earnings that have been artificially inflated—whether through aggressive accounting practices or financial statement fraud—will not provide operating cash flow for the company. Instead, other assets on the balance sheet (such as accounts receivable; inventory; prepaid expenses; loans receivable; or property, plant, and equipment) will increase. Sometimes, liabilities may be reduced.
Companies that engage in financial statement fraud have earnings growth that is not accompanied by a corresponding growth in cash flow. Over extended periods, the rate of growth in earnings should be in proportion to the rate of growth in operating cash flow. A lasting discrepancy in their rates of growth is a red flag that should be investigated.

Particularly in Asia, inventories and receivables are the types of asset most commonly misstated by companies seeking to deceive stakeholders. There are many stories of neighboring companies in China that come together to pool inventory at audit time, or finance the same purchase multiple times. With the extent of global trade performed by many companies, receivables, too, can be easily manipulated. There have been a number of cases in Hong Kong of artificial sales being made to related parties or parties that simply do not exist.

Therefore, it is crucial to monitor a company’s working capital to sales ratio. A working capital to sales ratio of more than 20 percent can be considered high. By way of example, the failed Moulin had a net working capital ratio of 109 percent. This means that for every HK$1 of product sold by the company, it needed to borrow HK$9. An industry peer had a ratio of 6 percent.

**Borrowing When You Have Cash**

Why do companies with high cash balances require additional funding? Usually, firms with high levels of cash are accumulating it for a specific purpose, such as funding expansion or acquisitions. Alternatively, they may be trying to reward shareholders. Therefore, it is concerning to see companies with reportedly large levels of cash, but also high and increasing debt levels on their balance sheet.
SK Global Co Limited, a large Korean company that collapsed in 2003, reportedly used a practice of shifting cash into a subsidiary company just prior to financial year-end and shifting it out straight after, using companies in six different jurisdictions, all with different financial year-ends, to inflate its reported consolidated cash balances.

Similarly, Ocean Grand and Moulin are examples of creative accounting practices when it comes to dealing with cash. A look at their reported cash-to-market-capitalization ratio highlights the problem. Ocean Grand with cash-to-market capitalization of 146 percent substantially exceeded Moulin at (compared to other companies) an abnormally high 36 percent.

**Regular Capital Raisings**
Companies that engage in regular capital-raising exercises should also be closely reviewed. Management may seek to raise capital or need to raise capital to hide inherent weaknesses in their operations. This will either dilute shareholder interests or impose further debt on a capital structure that may already be under pressure. With relatively easy access to capital in today’s markets, companies facing a liquidity crisis can seek to “raise” their way out of problems. Therefore, it is critical to examine how previous capital raisings have been conducted. If on-going capital raisings are merely being used to fund losses or perhaps a working capital blowout as discussed earlier, then further review is required.

For example, when Moulin’s financial statements were adjusted to eliminate the false accounting, it was found to have been insolvent since the late 1990s. It was notable that during the period of 1999 to its collapse, the company issued convertible notes, made two private placements, and renegotiated its borrowing facilities three times.
Balance Sheet Massaging
For small, medium, and even some large companies, more than one acquisition every two or three years may be too much. It is important to analyze earlier acquisitions and assess their success. Many companies are able to mask underlying financial problems by growing the size of their business. The volume and size of transactions conducted can help companies hide problems given the churn of funds throughout the company.

Conclusion
Financial statement fraud accounts for more than 50 percent by dollar value of all occupational fraud in Asia. Ultimately, given the higher cost associated with financial statement fraud and the impact on a wider range of stakeholders, it is surprising that it has had less focus than the highly publicized anti-corruption and bribery activities seen in the popular press.

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