

Avoiding FCPA Risk While Doing Business in China

Cultural, social, political, and economic issues may create a “perfect storm” for FCPA violations. Are you prepared?

By Kevin Corbett and Ed Rial



Violations of the FCPA can be costly

Violations of the FCPA's antibribery provisions may result in the following penalties:

- **Criminal penalties** of up to \$2 million for corporations and other businesses and up to \$100,000 for officers, directors, stockholders, employees, and agents. Actual fines may be much higher under the Alternative Fines Act — up to twice the benefit the corrupt payment was intended to elicit. Criminal penalties also include imprisonment for up to five years.
- **Civil penalties**, brought by the U.S. Attorney General or the SEC, of up to \$10,000 against any firm as well as any officer, director, employee, or agent of a firm, or stockholder acting on behalf of the firm. Additional penalties, including disgorgement of profits obtained through corrupt behavior, may also be levied in an SEC enforcement action. The U.S. Attorney General or the SEC may also bring a civil action to enjoin any act or practice of a firm that appears to violate the antibribery provisions.
- **Other governmental action**, such as being barred from doing business with the Federal government, ineligibility to receive export licenses, and suspension or debarment from the securities business or from certain federal agency programs.
- **Private causes of action** under the Racketeer Influenced and Corrupt Organizations Act (RICO), or actions under other federal or state laws, which could treble damages. For example, a competitor might bring action under RICO, alleging damages resulting from the loss of a contract due to a competitor's bribery of the awarding officials.

Doing business in China or planning to? Clearly, you are not alone. According to a 2007 report by the Economist Intelligence Unit, China is and will continue to be the top emerging market for foreign direct investment (FDI) through 2011. The U.S.-China Business Council's Forecast 2008: Investment in China reports FDI in China grew by 13.8 percent in 2007 over 2006, with the U.S. contributing \$2.6 billion, China's sixth largest source of FDI.

While China may offer your business considerable opportunities, including a market for selling products and a site for outsourcing, it also presents significant risks. One such risk, off the radar of most companies for more than two decades, is the risk of violating the U.S. Foreign Corrupt Practices Act of 1977 (FCPA). The FCPA is a product of the Watergate years, when the U.S. grew increasingly uncomfortable with some U.S. companies' practice of bribing foreign officials to "grease the wheels" of commerce. Along with accounting ("books and records") and internal control requirements, the FCPA makes it illegal to bribe foreign officials in return for a business advantage — or to do so indirectly through third-party intermediaries. The act carries very serious criminal and civil penalties enforced jointly by the U.S. Department of Justice (DOJ) and the U.S. Securities and Exchange Commission (SEC).

The FCPA has seen vigorous enforcement action by the DOJ and SEC since 2001, resulting in substantial fines and costs to numerous U.S. multinationals. More recently, U.S. authorities have also instituted criminal and civil FCPA proceedings against foreign-based companies listed on U.S. exchanges.

Why the surge? Among several factors, Nick Robinson, a partner in the Forensic

& Dispute Services practice of Deloitte China points to growing intolerance of fraud and corruption issues overall:

“Generally, some of the big scandals that have occurred over the last few years have sparked an increasing interest amongst U.S. regulators and an increasing reluctance for organizations’ stakeholders to accept fraud and corrupt activities,” says Robinson.

Adoption of the Sarbanes-Oxley Act of 2002 has likely been another trigger for FCPA enforcement, notes Patrick Norton, partner at the law firm of Steptoe and Johnson in Washington, DC:

“As company auditors and senior management have been required to certify the accuracy of their books, many have uncovered and reported problems with foreign payments that otherwise might have been missed one way or another,” says Norton.

Finally, growing corporate expansion into new, remote markets whose business cultures historically may have condoned, and in some instances, encouraged paying bribes has likely contributed to the renewed attention to FCPA enforcement.

Challenges in China — A perfect storm?

Doing business in China poses significant FCPA risks, according to Transparency International, a noted watchdog of corruption worldwide. The organization considers China to carry a relatively high corruption risk, ranking it 72nd out of 180 countries (180 being the most corrupt) on its [2007 Corruption Perceptions Index \(CPI\)](#).¹

China’s risk ranking results in part from the complexity of its mixed economy. The FCPA specifically prohibits companies,

their employees, and their agents from offering or authorizing anything of value, directly or through third parties, to foreign officials for the purpose of obtaining or retaining business or gaining a business advantage. For FCPA purposes, “foreign official” has come to mean not only high-ranking government officials, but also employees of state-owned enterprises (SOEs), for example. So a doctor working for a state-owned hospital or the plant manager of a state-owned manufacturing facility, for example, may be considered a foreign official under the FCPA. This expansive foreign official “pool” means companies are more likely to come into contact with Chinese “foreign officials” in negotiating contracts than they would in countries where such negotiations would typically take place with non-governmental enterprises. As Patrick Norton notes, interaction with Chinese government officials also occurs on many levels:

“The other side of the problem in China is that the interaction with actual government officials tends to be more common than in many countries. Despite a lot of streamlining of the various approval processes, you still need to be interacting with the government on a whole range of matters that are important to your business, such as licensing, and you need officials’ assistance on many matters. ”

The issue also goes beyond frequency of interaction, says Clarence Kwan, National Managing Partner of the U.S. Chinese Services Group of Deloitte LLP.

“If you look at the top 10 operating issues identified by U.S. companies in a recent American Chamber of Commerce in China white paper, the No. 2 operating

¹ www.transparency.org/policy_research/surveys_indices/cpi/2007

issue is business licensing and the regulatory approval processes in China,” Kwan notes. “It is not just a matter of frequency of contact. There are also significant barriers to doing business in China. If a company has to get something done, the company may have to look to find a way to expedite these processes.”

“The mountains are high ...”

Other factors can also contribute to corruption risk in China. In contrast to the U.S., where laws cover many activities and tend to contain specific proscriptive language, Chinese laws are generally simple and vague, leaving considerable discretionary power in the hands of bureaucrats. With that power may come the temptation to benefit personally, creating an environment that might be more conducive to corrupt behavior.

Furthermore, China’s sheer size and its decentralized government create many administrative challenges. Central and provincial governments are not always operating in connection with the edicts from Beijing condemning corruption, and these edicts may not be interpreted the same way or be as strictly enforced in the outlying regions. As an old Chinese saying notes, “The mountains are high and the emperor is far away.”

China is also undergoing a remarkable socioeconomic transformation, one that presents tremendous opportunities, but can be unsettling to social and governmental institutions as well as to individuals. In the midst of such wealth creation, there is temptation — and pressure — to proceed up the economic ladder. Seeing others profiting from common, albeit illegal, practices can foster a “Why not me?” attitude.

“In many cases I have dealt with,” says Nick Robinson, “when people are put in a situation where integrity is tested through, for example, the offering of a bribe, individuals will ask themselves two basic questions. The first one is, ‘Will I get caught?’ and the second is, ‘Is the bribe worth more than my job?’ Because of the massive disparity in salaries and economic benefits between organizations, certainly this is something multinationals need to be aware of when operating in China.”

Another ethical dilemma emerges in situations where employees may believe that improper payments are necessary to “make their numbers” or achieve organizational goals. While China’s economy may be booming, the U.S. economy has been sluggish, possibly intensifying such pressure on local subsidiaries or affiliates to meet high performance goals.

Weathering the storm

The combination of these cultural, historical, economic, and social factors may create a perfect storm for FCPA violations, underscoring the need for companies doing business in China to proactively assess their risks and institute compliance measures designed to mitigate those risks. It is important to remember that, under the FCPA, a bribe does not have to be successful in producing the desired outcome; merely authorizing such a payment may violate the FCPA. Also important to remember is that a company is responsible for the actions of its officers, directors, employees, and shareholders, as well as the actions of third parties working on its behalf. A “third party” could include agents, subagents, distributors, vendors,

consultants, and other service providers. Accordingly, it is essential to perform due diligence on business partners and other third parties — the failure to do so may lead to significant criminal and civil exposures under the FCPA and local anti-corruption laws. (See [What to Watch Out For](#) on page 5.)

Nick Robinson sums it up this way: “Organizations operating in China need to have in place a proactive, top-down, bottom-up anticorruption and fraud control policy involving training, how employees are rewarded, and their general behavior to address those two questions when they are offered a bribe: Will I get caught? And is it worth more than my job is worth? It has to have a preventive element that looks at all those things and also an investigative element so that if something does go wrong you know how to respond — how to deal with it, how to collect the evidence, and how to act appropriately.”

In addition, Clarence Kwan believes that companies’ U.S. headquarters must make allowances for the constraints placed on their associates in China.

“U.S. headquarters should have the tolerance to be able to say, ‘We know you are not playing on a level playing field, so we understand that you may lose some business opportunities to remain compliant.’ Otherwise, U.S. companies will be putting their China-based executives between a rock and a hard place — on the one hand expecting them to be competitive against their global and domestic peers and on the other hand not letting them do certain things.” Kwan notes.

Clearly, if the perfect storm is brewing, an umbrella alone is not enough. Understanding the risks and constraints, proper internal controls, employee training, regular audits, investigations into suspect activities, and due diligence are all necessary to mitigate FCPA risk and help prevent violations.

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What to Watch Out For

The following schemes, common in China, may violate the FCPA:

1. Cash payments; abuses of petty cash

“Greasing the wheels” with cash to expedite business transactions has been standard practice for centuries in China. Though the Chinese government has attempted to reverse this custom by enacting anti-corruption laws over the past several years and aggressively prosecuting violators, the problem remains endemic, posing a high risk for companies doing business there.

2. Payments to shell companies

Bribes can be disguised in payments to shell companies — entities with limited or no operations, or limited or no assets that generally lack a bona fide business purpose. Invoices for fictitious services are typically generated and payments are made to the shell entities in order to pass money to the government official.

3. Commission payments to third parties on behalf of foreign officials

Bribery payments can also be disguised as payments to agents, distributors, vendors, and other third-party intermediaries, who then channel the funds to the government official. Common schemes include payments that exceed the “stated” or “normal” commission rate for similar goods and services, upfront commissions, and “success fees.”

4. Donations to “charities”

Bribery schemes can also be masked as charitable contributions. Payments are typically “contributed” to a charity that lacks a bona fide charitable purpose, with the funds later passed to the government official, or made to a legitimate charity, with some benefit later given to the government official.

5. Erroneous charges

Bribery can also be masked through

fraudulent accounting entries in which payments appear legitimate in a company’s books and records (for example, as invoices for consulting projects, environmental studies, etc.), though no product or service is actually provided.

6. Excessive gifts and entertainment

Though giving gifts or providing entertainment to customers is common throughout much of China, such activities may violate the FCPA. All too often, lavish and excessive entertainment is provided to government officials and key decision makers. Even the centuries-old Chinese tradition of giving “moon cakes” during the mid-autumn festival has come under fire as a subtle form of bribery, as the cakes have become more elaborate. Modest gifts not designed to corruptly influence government officials will not likely be considered FCPA violations; more elaborate, expensive gifts will raise concerns regarding the purpose and the intention of the gift and potentially violate the FCPA.

7. Delegation trips, site visits, and unrelated travel

While site visits, delegation trips, and training trips to international locations are highly valued by business partners throughout China and allowed by the FCPA under certain conditions, excessive expenses, especially when not tied to a specific business purpose, may violate the FCPA. For example, per diem payments, side trips, entertainment, extravagant accommodations, lavish gifts, inclusion of family members, and built-in vacations may result in FCPA liability.

8. Benefits to associates of foreign officials

Payments or other perks offered to relatives, friends, and acquaintances of the foreign official in an effort to gain special benefit or obtain new business may also violate the FCPA.

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Front cover illustration: Chinese finger puzzle

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