

Mitigating Corporate Risk in Asia – An Overview

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Managing and growing a sustainable business in Asia can present unique challenges to foreign multinational corporations and to overseas investors. The current global economic downturn and continued volatility on the world's financial markets has, exacerbated these risks. Yet Asia, and particularly China, still offer the greatest opportunity for growth. Many companies will fail to seize the moment or will become entangled in difficulties simply because they lack comprehensive and relevant risk mitigation policies or because they have failed to conduct effective due diligence.

The informed investor will already be aware that risks to foreign companies seeking to operate in Asia are more considerable than in their home countries; this is due principally to a number of unpredictable variables including non-transparent business environments, poorly developed and still evolving legal systems, insufficient and unreliable market and business information, and rapid and confusing change. Despite all the above, multinational corporations

have little or no option but to be involved. So what then are the principal risks, operational risks and other issues which can be identified and mitigated?

Corporate risk manifests itself in a variety of forms, not all of which are unique to Asia. Some of the more common operational issues include the selection of unsuitable joint venture partners. In our experience, this is a critical issue. The selection and assessment of joint venture partners or distributors is a matter of the first import. Sadly, many organisations do little or no investigative due diligence into the background and reputation of prospective partners, sometimes being too dependent on third parties who are commission or introduction fee-oriented, and who have little interest in the longer-term success of the business. A key consideration must also be whether or not the interests of the two organisations will remain aligned on a sustainable basis – after the multinational corporation has parted with its cash, and what long-term and sustainable incentives exist

Top Corporate Risk Factors in Asia

Organisational and structural factors which increase multinational corporations' risk profile in Asia:

- Matrix management systems
- A recent business process re-engineering exercise or significant restructuring
- Expatriate management who are rotated every two years or so
- High local staff turnover
- Internal controls which are insufficient or not appropriate to the Asian environment
- Overdependence or over-reliance on "technical solutions"
- Insufficient pre-employment screening of employees or hiring of complete "tribes" from previous workplaces
- 'Wooden' Anti-Money Laundering programmes
- Weak External accounting procedures
- Internal audit staff reluctant to confront local management for cultural reasons
- Previous early warnings or minor frauds which had been covered up resulting in a corrupt culture
- Overall low staff morale

for a Chinese partner to sustain the working relationship? If this is not clear from the outset, serious problems can often occur.

Another key issue is the significantly differing business cultures between the legalistic / contract-driven Western business model, and the Chinese or Asian relationship-driven approach. Many Western firms spend an inordinate amount of time concocting U.S.-style legal documentation and drafting detailed representations and warranties in these contracts; in reality, many of these can never be enforceable in Asian countries. Sadly, the same firms spend little or no time on understanding, in any great detail, what makes their prospective new partners tick.

Most recently, a number of ugly disputes have occurred during the downsizing of operations, particularly in Southern China. Downsizing exercises need to be carefully executed in order to protect the long-term reputation of multinational corporations, and, setting aside the unfortunate public image issues, to avoid incurring the ire of the local government; this is especially important if the company wishes to return following the economic downturn.

Whilst corruption is certainly endemic in many Asian countries, it is not necessary that it be tolerated in a foreign corporate environment. In fact, companies that have failed to take a stand and who have tolerated unchecked corruption have fared worse than other companies with better developed corporate ethics and “zero-tolerance” policies. Key areas include kick-backs from public relations companies, marketing spend and all forms of vendor commissions and payments. Hong Kong and Singapore have exemplary anti-corruption mechanisms, and free advice and guidance can be provided by the ICAC in Hong Kong via their corruption prevention department.

Whilst many companies bring with them tried and tested internal controls and systems, not all may be appropriate to the Asian environment. For example, internal audit teams from the West seldom understand the critical import of company and individual chops as business instruments in the Chinese and Japanese cultures. Although some companies may have brought in state-of-the-art electronic compliance systems to

segregate job functions, authorisation levels and access to sensitive data, these systems cannot protect a multinational corporation from abuses. These typically include unauthorised use of a company chop to open accounts, move money or commit the company to onerous obligations. Consequently, audit and risk assessments are way off mark and fail to identify key vulnerabilities.

No Western-style system that we have seen to date, effectively manages to curtail risks arising from such apparently unimportant but actually crucial instruments. The use of a counterfeit company chop in China or Japan is a very serious offence and various local control systems exist to register chops. Many multinational corporations and their internal audit departments are blissfully unaware of these risks and of the processes which exist in-country, to mitigate them.

The potential for collusion between employees and outside parties should be high on management’s priority list. This risk is intensified where employees actually control or have beneficial interests in companies who are suppliers to the multinational corporation. Apart from the almost inevitable quality control and price implications, such arrangements can lead to counterfeit goods being injected into the genuine supply chain, causing considerable damage to brand equity as well as significant loss of revenue.

Most recently, we have become aware of highly sophisticated counterfeiting syndicates who have effectively taken over the management of brands, and who have even licensed others to produce goods without genuine authority. This “brand-jacking” can be an enterprise-threatening problem, and must be dealt with on a strategic basis corporate wide. Previously issued genuine legal documents such as licenses to produce, etc. - have been amended by culprits who, using the company’s own legal documentation and language, have authorised other companies to produce “unlimited amounts” of their product in return for large sums of money disguised as royalty payments. This is not a simple intellectual property problem it is, in effect, an organised crime and needs to be dealt with as such.

Poor quality control is often a downstream

consequence of unchecked corruption elsewhere in the organisation. Where companies outsource this vital function, special attention should always be paid to any suspicion of corrupt payments to product inspectors and the like. Failing to address this problem can lead to catastrophic liabilities and consequences, especially in the pharmaceutical and food sectors.

Many companies have anti-money laundering policies which can only be described as wooden or inappropriate to the actual threat. In the current environment, governments are paying increasing attention to money laundering and U.S. companies have been under increasing scrutiny in relation to the Foreign Corrupt Practices Act (“FCPA”), which prohibits payment to foreign officials to obtain business. The current regulatory framework in many Western countries is being actively reviewed and any perception of corporate wrongdoings will, in this climate, attract severe penalties from regulators.

The Psychology and structure of MNC’s – does this make them more vulnerable to risk in emerging markets?

Above are just some of the potential dangers for Western businesses operating in Asia. However, the structure and organisation of some multinational corporations can be a significant factor in making them much more vulnerable to risk in emerging markets, such as Asia. That many multinational corporations bring problems onto themselves by virtue of their structure, lack of clarity and direction in management, and the lack of a visible and well-enforced deterrence policy.

We recently examined a number of major cases and crises which FTI-International Risk has helped clients to resolve. We then sought to identify whether or not there were any common factors in these situations which arose. Significantly, in each of the cases studied the same key factors - which appear in the table above - were present in one combination or another and had a major bearing on the problem. We believe that any multinational corporation with three or more of these factors runs a higher risk of a significant corporate crisis, corruption exposure or the potential for massive fraud. Such organisations would be wise to act immediately to focus their resources, both

internal and external, to contain and mitigate such risk.

Organisational and structural factors which increase multinational corporations’ risk profile in Asia:

1. Matrix management systems;
2. A recent business process re-engineering exercise or significant restructuring;
3. Expatriate management who are rotated every two years or so;
4. High local staff turnover;
5. Internal controls which are insufficient or not appropriate to the Asian environment – such as not allowing for company chops and local / national practices;
6. Overdependence or over-reliance on “technical solutions” or on apparently sophisticated electronic controls; this whilst failing to allow for the real risk of collusion between internal staff, resulting in the compromise of such systems and passwords;
7. Insufficient pre-employment screening of employees and permitting recently hired executives to recruit personnel in complete “tribes” from their previous workplace – their loyalty will not lie with the new company;
8. Anti-money laundering programmes which are “wooden” or which are not relevant to the local circumstances or the actual threat;
9. External accounting procedures which were weak, or the use of external auditors who have little or no experience in the industry being audited;
10. Internal audit staff being reluctant to confront local management for cultural reasons – especially so in Japan;
11. Previous early warnings or minor frauds which had been covered up for internal corporate or political reasons, resulting in a corrupt culture; and
12. Overall staff morale being low – probably due to a combination of all the above factors, resulting in an unhappy workplace.

Unforeseen and Political Risk

In addition to the factors outlined above,

companies operating in Asia are to a certain extent, hostage to events outside of their control, which are not immediately apparent but yet which may have a material impact on their businesses.

Specific to Asia at this time, are issues surrounding North Korea's increasing belligerence and the likelihood of increased sanctions, their enforcement and the potential for low-intensity attacks on South Korean or foreign shipping, or the closure of air space and sea lanes in the East China sea as a direct consequence. This, for example, could significantly increase freight and air rates as well as related insurance.

In South Asia, Pakistan's growing fragility is of deep concern as is the spread of terrorist activity to India and to the international business community operating there. In Southeast Asia, despite the recent bombing in Jakarta, the outlook is more cautiously optimistic and, setting aside the recent bombing outrage, is unlikely to significantly undermine foreign investment and trade in Indonesia.

Another political risk stemming from regulatory reform in the U.S. and elsewhere is now apparent. The U.S. is the epicentre of regulatory reform with a rising tsunami of changes; these calculated to rein in hedge funds, investment banks, brokerages, insurers and others. Efforts to beef up regulatory oversight will certainly require overhauling of risk management models, which will be expensive, time-consuming and may materially impact on the manner in which firms can do business. These reforms may well impact Asia by affecting investment flows, slowing down transactions and increasing risk adversity. Nationalistic and protectionist trends abound, and the U.S. is currently launching aggressive action aimed at "off-shore banking centres", having somewhat irrationally labelled some of these as money laundering centres. Hong Kong was previously thus targeted, but following discussions with the Chinese premier, the U.S. apparently recanted somewhat.

Managing "Off-Balance Sheet" Risk in Asia

It's clear that for foreign companies to succeed in Asia and other emerging markets, it is critical that they understand clearly where the actual risks lie and take robust measures to mitigate

these. Risk mitigation is not a quick fix but a continuous process which necessarily evolves apace with the development of an organisation.

Companies should not rely solely on their auditors, whether internal or external, to prevent catastrophic fraud or related issues. Auditors are "watch-dogs", not "bloodhounds", and their function, training and structure is not sufficient to protect companies from such risk. Companies must police themselves.

Multinational corporations should be aware of the significant risks associated with internal changes in technology; especially so if the IT function, compliance and security functions are not properly integrated or if they fail to work together co-operatively. This risk is again exacerbated when companies operate a matrix management system across countries.

Finally – and at the risk of stating the obvious - for companies to effectively mitigate risk and to thrive in the Asian environment, it is crucial to have honest employees, strong and relevant internal controls, robust and visible deterrents and clear management responsibility to prevent fraud and corruption. Senior staff must expressly be accountable for this as part of their job descriptions, and as far as is possible, clear and distinct reporting lines to mitigate confusion between the operating units and the corporate headquarters thousands of miles away.

This article was the first of a six-part series on Corporate Risk Mitigation, in co-operation with and published in the South China Morning Post.



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