

The first in a six-part series on Corporate Risk Mitigation looks at the importance of conducting effective due diligence in Asia



Safeguarding net returns

Managing a sustainable business in Asia presents testing challenges and constant risks, which the economic downturn and volatile financial markets have only served to exacerbate. Yet multinationals and overseas investors know very well that Asia, and particularly the mainland, offers many of the best opportunities for long-term growth, which they cannot afford to pass up or postpone simply because of valid concerns about unfamiliar business practices, unknown markets or undeclared financial dealings.

What they need is a comprehensive set of risk mitigation policies, and the methods and imagination to conduct effective due diligence for every proposed contract or potential partnership.

Many businesses start by assuming that any investment outside their home countries automatically entails more risk. There is no inherent reason why that should be so. It is the case, though, that any move into new territory is bound to bring up unpredictable variables and uncertainty.

Some ventures will have to identify and mitigate the full extent of risks that can result from non-transparent business environments, still evolving legal systems, unreliable market information and different cultural or ethical norms.

Corporate risk manifests itself in many forms. But, in our experience, certain critical issues commonly recur. One area that often leads to difficulties is the selection of unsuitable joint venture partners or distributors. Many organisations do little or no investigative due diligence into the background and reputation of prospective partners. Sometimes, they allow themselves to be too dependent on third parties, who are motivated by fees or commissions, but have little interest in the longer-term success of the business.

The result is that the interests of the two organisations are made to seem aligned at the outset. However, once money has changed hands and ties are formed, it soon turns out there will be serious problems in sustaining a solid and mutually beneficial working relationship.

Another key issue is the failure to appreciate the significance of differences in business culture. One sees this when the more legalistic, contract-driven Western model meets the

EXECUTIVE INSIGHTS

Edited by John Cremer

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Chinese or Asian approach, perceived as more reliant on relationships and undocumented agreements to get things done. The major element of risk here is in the potential for basic misunderstanding about procedures, responsibilities, financial commitments and legal interpretation.

We find Western firms spending an inordinate amount of time concocting documents and drafting warranties. Many of these may not be enforceable in Asian countries and, therefore, do not effectively address the real risks. The same firms spend too little time understanding how their prospective partners actually operate or separating what they must insist on from what they can leave for local consideration.

How partners could operate includes tight financial compliance and intolerance of anything that even hints at corruption. Only so much can be conceded to "local custom and practice", and companies that fail to take a stand on these issues expose themselves to untold risk but generally fare worse than those which adopt "zero-tolerance" policies against corruption and put a high premium on corporate ethics.

Dealing with local consideration instances—where there could be some flexibility—might include specific internal controls, reporting requirements, levels of authorisation and approved access to sensitive data. Provided systems are in place to effect comprehensive audits and impose necessary controls, other risks can then be gauged according to context.

For example, few Western businesses take much account of the "company chop". In Asia, though, it is still viewed as essential for opening

accounts, moving money or committing to contracts and obligations. Consequently, control of the chop is a genuine area of risk. The use of a counterfeit in the mainland or Japan is a very serious offence, so there should be local systems to register chops, keep them secure and authorise use.

As a consultant, our company sees that the structure and organisation of some multinationals can be a significant factor in making them more vulnerable to risk in emerging markets. They bring problems on themselves through lack of clarity and management direction and absence of a visible, well-enforced deterrence policy.

After recently examining several cases we had helped clients resolve, we identified certain common denominators. Significantly, we also noticed that the same key factors kept appearing in these cases, though in different combinations. We believe that any large company with three or more of these factors runs a higher risk of a significant corporate crisis. This could be anything from the exposure of corruption to creating conditions that allow for potentially massive fraud. Organisations would be wise to act immediately and focus resources—internal and external—to minimise the possibilities and mitigate such risk. The main factors are:

- Matrix management systems; and a recent exercise to re-engineer business processes or effect significant restructuring
- Expatriate management who are rotated every two years or so, coupled with a high turnover of local staff
- Internal controls which are insufficient or not appropriate to the local environment, such as not recognising the importance of company chops in countries in Asia
- Over-reliance on "technical solutions" or apparently sophisticated electronic controls; these do not necessarily reduce the risk of collusion between internal staff, which can result in the compromise of security passwords
- Insufficient pre-employment screening of staff and allowing recently hired executives to recruit teams from their previous workplace
- Loyalty will lie with the "tribe" or between individuals, not with the new company; anti-money laundering programmes which are perfunctory are not relevant to the local circumstances, or do not properly address the actual threat

- Weak external accounting procedures, or the use of auditors who have little or no experience in the industry in which the company operates
- Internal audit staff reluctant to confront local management or not given the support and authority to take any concerns directly to a higher level
- Previous instances of early warnings going ignored or minor frauds being covered up for internal corporate or political reasons. This can easily lead to a culture that is tolerant of corruption or, at least, is prepared to turn a blind eye
- Low overall staff morale, which will probably be due to a combination of the above factors and can result in an unhappy workforce not paying full attention to all of their responsibilities

In addition to these factors, companies are always hostage to events outside their control. Whether it is Sars, swine flu, subprime fallout or the fluctuating price of oil, only so much can be done to anticipate or guard against risks that come out of nowhere, yet may have a lasting material impact on the business.

Insurance can provide some measure of protection, but the real key is for companies to dedicate sufficient time and intelligence to understanding where potential risks might emerge.

They should also formulate contingency plans for a few of the more likely worst-case scenarios. Then, if terrorist activity, say, leads to a crucial sea lane being affected or the rates for air freight dramatically increase, a workable alternative could be rolled out with minimal disruption.

Risk mitigation is not a quick fix. It is a continuous process which necessarily evolves in step with the development of an organisation. It requires foresight, realism, accountability and honesty, without which any system of risk controls counts for little.

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