



Forensic Focus

Financial Reporting
Fraud in China
- Outlook and Trends

KPMG China





With China's economic growth slowing and increasing financial pressures from global headquarters and/or capital markets, KPMG has seen a growing trend in pervasive and sophisticated financial reporting fraud in China. We see this trend in both domestic private Chinese entities, and even in China subsidiaries of multinational companies and listed companies, historically considered to be at lower risk for such fraud. The consequences of financial reporting fraud are expensive and operationally disruptive if not detected early and addressed professionally. Having regulators, lawyers and accountants poring through data and disrupting business operations hurts share values; brand and market perception; and retention of good personnel, clients and suppliers. This paper highlights trends we have observed and offer case studies of recent experiences and insights for your consideration.



What we are seeing

Despite the rapidly changing forms of financial reporting fraudulent behaviour and misconduct, we see that the majority of cases share classic early warning signs, which still go unnoticed.

Financial reporting fraud schemes often start as smaller issues (e.g. bill & hold, cut-off manipulation) to achieve short-term financial goals, with the hope and intent that they can be reversed in subsequent financial periods as business performance improves. However, with China's slowing economic growth resulting in businesses struggling to meet management set targets, such schemes are becoming increasingly difficult to maintain and have adapted to become more sophisticated to avoid detection.

Below are some common "red flags" that organizations should be aware of, and may warrant further monitoring and investigation:

- Unusual sales trends
- Irregular stock levels at distributors
- Large advance payments from customers
- Abnormal payments to suppliers
- Increase of overdue accounts receivables
- Sudden increase of new customers
- Uncharacteristic acquisitions/divestitures

Based on our experience, no particular industry or sector is immune from financial reporting risks, but we see that these risks are amplified for organizations that are undergoing:

- **Mergers & acquisitions:** Opportunities for fraud increase with the incentive to maximise the success of potential deal conditions.
- **Regulation changes:** Faced with an uncertain regulatory environment, financial statements are vulnerable to manipulation as organisations seek to meet conflicting stakeholder agendas and expectations.
- **Management rotations:** Personnel issues can often trigger financial reporting fraud, as incoming and outgoing management manipulate financials for their own agendas.
- **Unreasonable KPI pressure:** Negative behaviours often appear in a culture of metrics over compliance.



Financial reporting fraud schemes

What happens when the early warning signs are ignored?

When an organization is in a volatile environment and without an adequate fraud risk management framework to prevent, detect and respond to fraud, opportunities for financial reporting fraud increase exponentially. We list below examples of common ways to manipulate financial records:

- Bill & hold arrangements
- Over/under valuation of assets and liabilities in acquisitions
- Manipulation of accruals
- Off-book bank accounts and transactions
- "Hidden" liabilities
- Round-tripping transactions
- Related party transactions at non arm's length values

Instead of being committed by a single person or team, our experience is that most financial reporting fraud cases involves cross department collusion, involving finance staff as well as other departments (e.g. sales, logistics), adding to the complexity and difficulty in detecting these schemes.



Case Study

Case Study #1 – Global consumer products manufacturer

Background

KPMG assisted a global leading consumer products manufacturer on an internal investigation at its China subsidiary. It was alleged that various employees, including the China CEO, were involved in a sophisticated financial reporting fraud scheme involving overstatement of revenue and under-recording of sales rebates.

The China subsidiary's business previously had reported steady growth, but was increasingly unable to meet its KPIs set by HQ. This resulted in a high pressure environment, with a high turnover of key management staff. Early warning signs of bill & hold issues were ignored, until an incoming China CFO alerted HQ.

Investigation approach

We worked closely with the company's legal counsel to conduct forensic accounting investigation procedures and to provide forensic technology support. Our procedures included:

- Executing an unannounced simultaneous inventory stock-take at all warehouses
- Collecting structured and non-structured data from various sources
- Performing forensic data analysis on revenue, sales returns, cost, AR aging and inventory data
- Reviewing supporting documents to ascertain the fundamental issues
- Circulating independent confirmations to customers to reconcile the receivable variances
- Completing site visits to confirm the existence of certain customers
- Interviewing relevant management and employees to perform a root cause analysis
- Assisting the company to respond to inquiries from regulators and financial auditors
- Quantifying the financial impact of the financial reporting fraud scheme

Financial and non-financial implications

Beyond the immediate financial impact of the financial reporting fraud, the most significant consequence was that the internal investigation triggered inquiries from regulators in multiple jurisdictions for the company and its Chinese subsidiary.

The internal investigation revealed that, as a result of the financial reporting fraud, the company's top line during the review period was overstated by approximately CNY 250 million (roughly USD 38.5 million), and that its net profit during the review period was overstated by approximately CNY 190 million (roughly USD 29.2 million).

Disciplinary actions were issued to specific individuals identified during the course of the investigation, and measures were simultaneously taken to keep operations stable and functional.

Case Study #2 – Hong Kong listed retailer

Background

KPMG assisted a Hong Kong listed retailer with an internal investigation into concerns of financial statement fraud, including undisclosed related party transactions and advance payments being made to suppliers without reasonable business rationale.

The concerns were initially raised by the external auditors and subsequently reported to the regulators. It was suspected that the scheme had been ongoing for many years, and neither the governance body (e.g. the Board of Directors) nor the external auditor could identify specific evidence of the suspected financial statement fraud.

Investigation approach

We worked closely with the company's independent investigation committee to investigate the suspected financial statement fraud. Our procedures included:

- Collecting structured and non-structured data from various sources.
- Reviewing supporting documents for identified high-risk transactions.
- Performing unannounced site visits to multiple locations of identified suppliers to verify details of their business operations.
- Interviewing relevant directors, management members, employees and suppliers to analyse their potential relationships.
- Assisting the independent investigation committee to respond to inquiries from the regulators and external auditors promptly with facts.
- Assisting the company and its independent investigation committee to evaluate the policies, procedures and controls in relation to the advance payment process and provided recommendations for improvement.

Financial and non financial implications

As a result of the irregularities and control weaknesses in the company's advance payment and financial reporting processes identified through the investigation, the company could not meet its filing deadlines and was suspended from trading for more than one year, with the CEO stepping down.

The company received inquiries from the regulators, and it is likely that its shares will be suspended further, significantly increasing its risk of being de-listed from the Hong Kong stock exchange. The regulator also requested the company and its board to assess its controls with respect to advance payments. KPMG assisted the company with this request, to provide an assessment and remediation plan for the company's consideration.

Further, the Company has a new externally recruited CEO, who we will be working to continue to implement and evaluate the effectiveness of the remediation measures to enhance the company's internal control environment.





The path forward - prevention, detection and response

The above case studies illustrate the severe consequences of financial reporting fraud. Therefore, we recommend your organization designs and implements an appropriate framework with protocols that prevent, detect and respond to such risks and issues. We outline below questions to consider to assess your organisation's vulnerability to financial reporting fraud, and to respond to potential financial reporting investigations.

Prevention - questions to consider

- Is your finance team "too helpful" to the business?
- Are your company's business results too good to be true?
- Are your existing controls effective enough to prevent financial fraud?
- Is your organisation facing unreasonable KPI pressures?
- Is your company going through a "vulnerable" period?
- Have you adopted and implemented an appropriate data analytics regime to detect financial fraud?
- Is there an existing investigation protocol in response to indicators or allegations of financial fraud?

Detection and response - stakeholders to consider

A financial fraud investigation involves many stakeholders, no matter the size or industry of the organization. We set out below key stakeholders to be considered, and the specific concerns each stakeholder may have.

- Governance body – how will the Board of Directors justify that they met their required duty of care in monitoring the organization's activities to prevent the occurrence of financial fraud?
- Corporate executives – how will they respond to regulators, address board inquiries and prepare remediation plans?
- Line management – how will they cooperate with the investigation while maintaining staff morale and public image?
- Forensic investigators – do they have the right skills and local and international coverage, and how will they complete their investigation procedures and quantifications under tight schedules?
- Legal counsel – how will they ensure legal privilege and guide the company in responding to regulators' inquiries?
- Financial auditor – how will they assess the situation, justify their past audit opinions and verify the investigation findings?
- Public relations advisors – how to ensure professional messaging to all relevant parties that is timely on point, consistent and appropriate to the particular circumstances of the situation?



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