# Fraud risks and trends in the China real estate industry

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# Preface

As a result of macroeconomic changes and a slowdown in economic growth, the real estate industry in China is facing pressure from multiple sources including market forces, regulations, capital and costs. KPMG has noticed that as some real estate companies struggle to handle these external pressures, and long-standing inadequacies in their internal controls flare up, causing tremendous losses. Companies that fail to identify and investigate fraud risks at an early stage, especially in relation to embezzlement and improper procurement, may be subject to serious operational disruptions. Such disruptions may lead to reputational, operational and financial losses to their stakeholders. In this report, we analyse fraud risks and trends seen in the real estate industry based on our up-to-date industrial and professional experience. This report covers three recent case studies with combined financial losses over RMB1.53 billion (USD 219 million) and includes analyses of the background, root causes of the frauds and the services KPMG provided. The report concludes with practical advice on how to prevent, detect and respond to similar fraud risks.

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1 USD ≈ 7 RMB

# Our observations

The real estate industry has certain unique characteristics. Companies are project-oriented, staff turnover rates are high, and management is project-based. These characteristics result in an environment that is conducive to fraudulent activities, such as embezzlement and improper procurement.

Fraudulent activities are usually undertaken by individual employees or groups of employees for their own self-interest. They often take advantage of their positions and internal control deficiencies to conceal fraudulent and illegal conduct. However, as overall current business growth is slumping in the real estate industry, such employees are facing overwhelming internal and external pressures, which will likely result in their misconduct being exposed.

Although fraudulent activities often have different forms, they can be detected through certain common indicators that are often neglected in daily business operations. We recommend companies stay alert in respect to the following indicators, and closely monitor and further investigate immediately when they emerge:

- Abnormal sales trends
- Long-term receivables
- Abnormal ageing of customer advances
- Capital liquidity deterioration
- Unusually frequent transactions with suppliers / related parties
- Management overriding controls
- Abnormal employee behaviour
- Surging numbers of complaints or whistleblowing reports in a short period of time

# Case studies

## 1 Revenue interception by internal employee

### Overview

KPMG assisted a multinational real estate group in an internal investigation at its project company in China. Following customer complaints, the group management suspected that a sales manager in the Chinese project company was involved in a range of fraudulent activities, such as selling the same property to multiple customers and extending the property sales/purchase process without a justifiable reason. We found that the project company had only been established recently, not all internal control procedures had been implemented, the sales department had too much power, and personnel duties were not properly segregated. The sales department took advantage of these loopholes to directly participate in almost all key processes, including signing sales contracts, registering sales contracts on the local government agency's online database, collecting payments from customers, managing POS machines and "supporting" the finance department in collection reconciliations. The weak control environment lasted for an extended period of time and allowed the sales manager to collect payments from customers using his personal POS machine, purportedly in the name of the company, and then conceal the embezzlement by tampering with the company's property sales registers, property transaction records and reconciliation statements.

### Support from KPMG

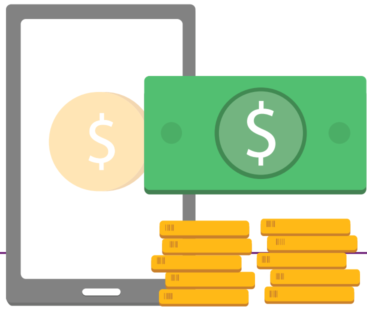
KPMG worked closely with the group's legal counsel to perform a series of internal investigation procedures, including forensic technology analysis to identify electronic evidence based on the customer complaints. KPMG's procedures included:

- Analysing financial data regarding revenue, cash and bank advances, accounts receivable ageing and related supporting documents.
- Reviewing the company's e-mails and other electronic data to identify potential evidence.
- Visiting property buyers to verify the existence and accuracy of the property transaction records.
- Reconciling records from the official property sales register against the company's internal records.
- Interviewing the management and staff of the Chinese project company and analysing the root causes of the fraud.
- Quantifying the financial impact of the fraud.
- Identifying internal control deficiencies based on the above-mentioned work and assisting the company in designing and developing its internal control procedures.
- Assisting the company and legal counsel in responding to inquiries from regulators and external auditors.

### Impact of the fraud

The sales manager's embezzlement of funds severely undermined the company's business operations. The fraud activity not only resulted in significant financial losses, but also led to adjustments to the company's financial statements and severely damaged its reputation and brand. Additionally, the group and its Chinese project company received multiple regulatory inquiries as a result of customer complaints.

The internal investigation discovered that a financial loss of RMB130 million (USD19 million) had resulted from the embezzlement, forcing the company to adjust its financial statements, report to the local judicial authorities and make corresponding disclosures to the capital market. The company also had to take measures to stabilise its business and compensate the affected customers as part of its remedial procedures.



## 2 Profit diversion by JV partner

### Overview

KPMG helped an overseas-listed real estate group perform an internal investigation into the financial situation of its Sino-foreign joint venture (JV). According to an internal report, there was a material risk that the joint venture's customer deposits, time deposits, and loans had been embezzled. We noticed that although our client was the controlling JV party, the joint-venture's daily operations and financial management were in practice under the minority JV partner personnel's control. Certain key control procedures such as those in relation to bank account openings, e-banking applications, cash collection, cash disbursement, issuance of cheques and company stamp usage were mostly ineffective. The JV's general manager (also the owner of the minority JV partner) colluded with the JV's finance manager and cashier to transfer out an enormous amount of funds through over 50 bank accounts from 2014 to 2019 to companies controlled by the general manager. These individuals concealed the off-the-books transactions by forging bank statements, bank slips, time deposit receipts and other supporting documents and deceived the foreign JV partner, which only realized the issues as the JV's business went down after five years of strong performance.

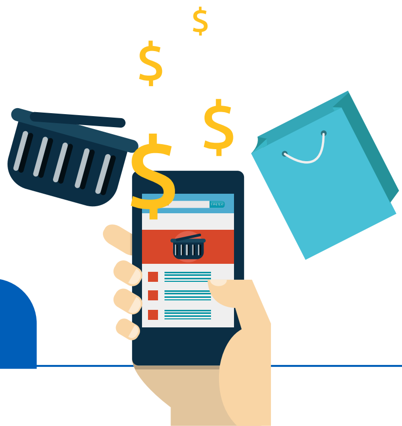
### Support from KPMG

KPMG worked closely with the group's headquarters and external lawyers to carry out internal investigation procedures. KPMG's procedures included:

- Verifying the JV bank accounts' completeness, opening dates, status and balances through independent procedures.
- Analysing cash pool movements using big data analysis as well as visualization tools.
- Leveraging professional forensic institution to help analyse the consistency of information such as handwriting and company stamp usage.
- Performing independent bank confirmation procedures and checking financial discrepancies.
- Analysing the company's internal supporting documents to identify the channels and methods used to embezzle funds.
- Reviewing the company's e-mails and other internal electronic files to identify electronic evidence.
- Interviewing relevant management and staff to identify internal control deficiencies and analyse the root causes of the fraud.
- Assisting the client and legal counsel in responding to inquiries from the special investigation committee under the Board of Directors and external auditors.
- Reporting internal control weaknesses discovered in the investigation to the client for future remedial procedures.

### Impact of the fraud

The internal investigation into the above-mentioned embezzlement conducted by the JV partner resulted in a significant financial loss of more than RMB1.4 billion (USD200 million), which resulted in adjustments to the company's financial statements. The group and its Chinese joint venture received numerous inquiries from multiple regulators and this fraud also caused a negative impression of the local investment environment. Certain people involved in this fraud had to face criminal investigations from Chinese law enforcement agencies.



## 3 Procurement fraud

### Overview

KPMG helped an HKEX-listed real estate group perform internal reviews of procurement and payment processes at three subsidiaries in its property and hotel management segments. Our review identified internal control gaps across different segments of the group. We also identified a number of red flags, such as rapid growth in procurement expenses, unreasonable land costs, frequent related-party transactions, and transactions with dubious business purposes.

### Support from KPMG

KPMG reviewed relevant procedures and investigated high-risk transactions with the help of the group's finance department. Our procedures included:

- Performing big data analysis on historical procurement records.
- Reviewing contracts with over 30 suppliers to understand their services and quotation models.
- Performing benchmarking analysis on tender prices and comparing them against the contract prices.
- Comparing the contract prices against local market prices.
- Reviewing procurement records for repair parts and performing inventory stock-takes.
- Reviewing compensation agreements with original landowners (e.g. local residences) and reconciling corresponding compensation mechanisms with payment records.
- Visiting local authorities for third-party relocation records to quantify the land costs.
- Checking bank transaction receipts against the company's internal records to confirm the business purpose and substance of the transactions.

### Impact of the fraud

Our review revealed abnormalities and control deficiencies in the procurement and payment processes at all three subsidiaries, which included tendering collusion, dual contracts, order splitting, fictitious procurement, non-arm's length transactions with non-controlling shareholders, and excessively high costs in relation to land acquisition and relocation. Based on the review findings, the group stopped transactions with certain problematic suppliers and the group's management committee requested each segment's procurement department to carry out rigorous self-inspections and remediations. KPMG also assisted the group in evaluating its procurement and payment procedures and provided an improvement plan.

# The path forward

# - Prevention, detection and response

The cases studies reflect the serious consequences of fraudulent activities in the real estate industry. They also show various degrees of information asymmetry between real estate investors and management, and how this asymmetry provides opportunities for fraud to occur. In light of such cases, we recommend companies design and exercise appropriate governance framework and internal control programs to prevent, detect and respond to relevant fraud risks, so as to better protect relevant stakeholders' financial interests, reputations and/or other rights.

## Prevention

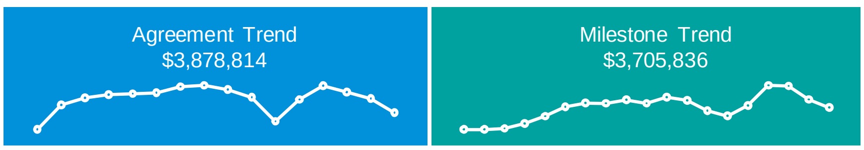
When the real estate industry is experiencing market changes, management should place more emphasis on fraud risks prevention and develop corresponding policies. Companies may consider the following aspects while developing and maintaining a fraud prevention mechanism:

- Examine the organisational structure to address structural design weaknesses
- Implement internal monitoring to rectify identified control deficiencies
- Improve internal control to prevent risk events in daily operations
- Formulate disciplinary policies to hold staff accountable for violating laws or regulations
- Provide dedicated training to raise awareness of fraud risks among all levels of employees
- Set up reporting hotlines to encourage internal and external speaking up by affected parties.

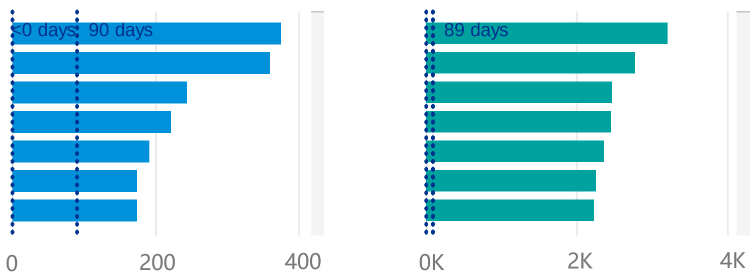
## Detection

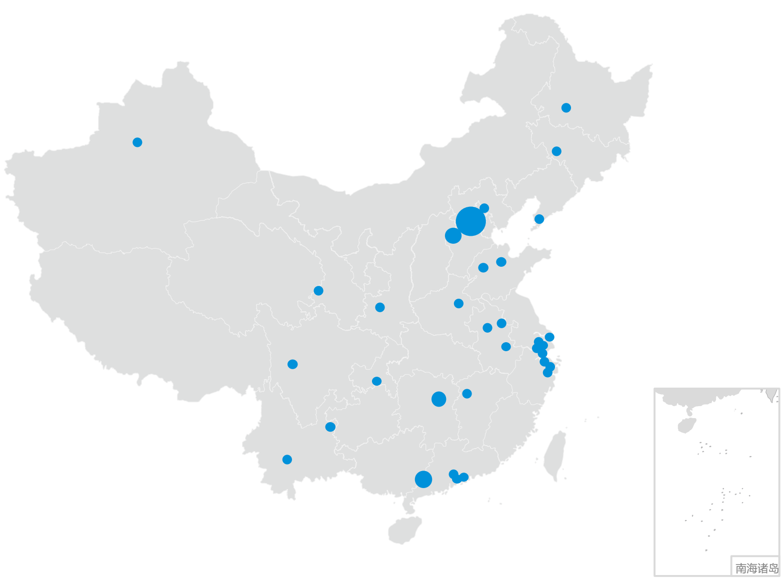
Fraud risk events are harmful to all enterprises and can cause enormous losses. Therefore, we recommend that companies put together internal and external resources to better identify fraud risk indicators in each business segment so as to prevent these risk events from occurring. Real estate companies should also leverage big data available to support the design of big data analysis systems based on the characteristics of their business operations and regulator focus in order to detect potential fraud risks in a timely manner. Currently available data analysis methods allow companies to do the following:

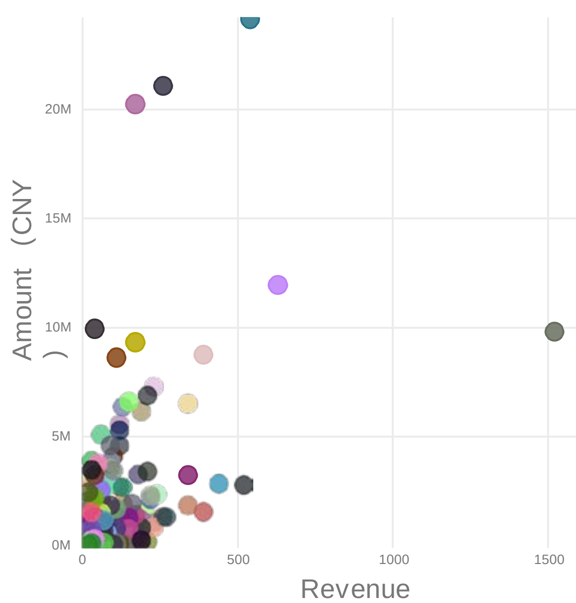
- Perform gap analysis between the current state and the expected results.
- Continuously monitor and analyse each business segment’s operational and financial data (e.g. payments and cash collections).
- Perform real estate project performance analysis for different departments, regions and targeted customer groups on a regular basis.
- Perform in-depth analysis of suppliers’ tendering data, service performance, quotation pattern, actual cost and fair market prices.
- Carry out timely analysis of the company’s business status based on its internal management statements, regional sales trends, and industry data.
- Perform compliance analysis on specific sales registration data against regulatory requirements.




2. Abnormal Lead Time



## Response

A company should develop a top-down and inside-out response mechanism based on fraud risks that have been identified or issues that have been escalated for internal investigation.

At the outset of internal investigations, management should conduct prompt preliminary evaluations of the fraud risk exposure in order to stabilize staff morale and minimize the spread of confidential (especially unsubstantiated) information. In the interim, management should consider bringing in third-party professionals (e.g. legal counsel and forensic investigation personnel), where appropriate, who can help develop consistent investigation strategies, formulate specific plans, quantify financial impacts, reply to internal and external inquiries. In addition, third-party professionals can provide effective remedial action plans to reduce further disruption to the company's operations.

After the internal investigation is completed, management should carefully consider how to make truthful disclosures to external auditors, regulators and the capital market in order to minimise negative impact on the company's reputation and market trust. Companies should also seek help from judicial authorities where necessary in order to recover losses through appropriate legal methods.

Proactively preventing, detecting and responding to fraud risks is a necessary part of a company's long-term strategy. For this reason, a company's management and governance should constantly learn and stay up-to-date on how to leverage different resources to strengthen controls, reduce risks and eventually grow businesses.

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