

# Fraud Risk Prevention and Controls:

## Establishing an Effective Internal Reporting Mechanism for China Based Businesses

As China's economy continues to grow, an increasing number of domestic companies are set to expand operations internationally and are faced with heightened, stringent financial reporting requirements and internal control expectations from global investors. Accordingly, enforcement authorities in China have refined the applicable internal control guidelines and regulations, under which domestic companies are encouraged to maintain an effective internal control framework that is akin to global best practices, so as to strengthen corporate governance and risk management.

Whilst a well-designed internal control system could effectively reduce the risk of fraud occurring, it does not eliminate such risk completely. In reality, no matter how comprehensive an organisation's internal control measures are, it is hard to ensure that they are impenetrable, as there remains potential loopholes for unscrupulous insiders (such as employees) to engage in misconduct.

Where compliance and internal audit checks may fail to capture such behaviours, they can be potentially discovered by colleagues within the same organisation. Provided that a whistle-blower may provide timely reports internally, it can contribute significantly to fraud prevention and overall corporate governance.

In 2008, the Ministry of Finance, the China Securities Regulatory Commission, the National Audit Office, the China Banking Regulatory Commission, and the China Insurance Regulatory Commission jointly issued the Basic Standard for Enterprise Internal Control, which provides that domestic listed companies should establish internal

reporting and whistle-blower protection mechanisms to serve as potential methods of fraud detection. Similar recommendations have also been made by the Hong Kong Stock Exchange in accordance with Appendix 14 of the Hong Kong Listing Rules. Nevertheless, in practice, whilst most companies have set up an internal reporting mechanism, they often have not focused their attention on the corresponding internal communications and allegation handling procedures. Absent of the above, an internal reporting mechanism may risk becoming ineffective or even obsolete.

*“According to the 2020 Report to the Nations - Asia-Pacific Edition published by the Association of Certified Fraud Examiners, 44 percent of fraud cases were reported by tips, whilst half of those reports were made by internal employees, making internal tip-offs by far the most effective method of fraud detection.”*



## CASE STUDY

When a private company based in Mainland China was preparing to list on the Hong Kong Stock Exchange, a former employee was accused of involvement in organised fraud and subjected to criminal investigations by the Public Security Bureau. The official investigation revealed that the employee had misused its position to directly participate in, and organise the fraud. As other employees were not aware of the existence of the internal reporting mechanism and were afraid of the repercussions of speaking up, the fraudster was able to conceal the misconduct from executive management for a prolonged period of four years. FTI Consulting was engaged by the company to conduct an independent investigation and reform its internal control system. Immediate outcomes, resulting directly from FTI Consulting's work included the establishment of a comprehensive internal reporting mechanism as a matter of priority.

### Potential value that an internal reporting mechanism can bring

**Strengthening risk detection:** According to the 2020 Report to the Nations - Asia-Pacific Edition published by the Association of Certified Fraud Examiners, 44 percent of fraud cases were reported by tips, whilst half of those reports were made by internal employees, making internal tip-offs by far the most effective method of fraud detection.

**Mitigating potential losses:** The same report further pointed out that companies that have set up an internal reporting mechanism can detect fraud more quickly, thereby greatly reducing the resultant economic losses. Similarly, based on our experience, it is common for companies to detect serious violations of law and regulation in a more timely manner through internal reports. In China, common types of fraudulent schemes that are identified by whistle-blowers include suspected bribery payments, asset misappropriation, undisclosed 'related party' transactions, employee collusion and financial statement misstatement.

**Maintaining corporate reputation:** In cases of internal fraud, some employees may turn to external reporting due to fear of retaliation, prompting enquiries from law enforcement bodies, regulators, media and the public, often before the company's management are able to obtain sufficient information to establish the facts in response to external scrutiny. An effective reporting management mechanism can, on the other hand, encourage employees to prioritise internal reporting to protect corporate reputation.

**Protecting the rights and interests of investors:** The negative impact of fraudulent behaviours will be directly reflected in the company's valuation or stock price, causing significant losses for investors. Trading in the company's shares may also be suspended pending an investigation. Even if trading eventually resumes, the history of allegations of fraud on a company's public record may leave investors sceptical of management integrity and their ability to ensure compliance.

### Key considerations for establishing an internal reporting mechanism

As mentioned above, domestic regulations in Mainland China expressly stipulate that listed companies are required to establish an internal reporting mechanism, whilst non-public large and medium-sized companies are encouraged to do the same. However, in reality, many employees are not aware of the internal reporting procedures, or even the very existence of a whistle-blower mechanism.

The following paragraphs describe what we view as best practices for setting up an internal reporting mechanism, including the corresponding communication strategies and allegation handling procedures, so that the true value of such a mechanism can play out.

*"Companies should establish multiple reporting channels that allow employees or external parties to report misconduct anonymously or with real names and provide relevant information that is useful for management to take prompt corrective actions."*

## Unimpeded and confidential reporting channels

Companies should establish multiple reporting channels that allow employees or external parties to report misconduct anonymously or with real names and provide relevant information that is useful for management to take prompt corrective actions. Some common and easy-to-implement practices include setting up dedicated mailboxes in notable locations of business premises, or through websites, and publicising reporting hotlines and email addresses. If the company's business is located at multiple locations or even extends overseas, the linguistic background of employees (including various dialects in Mainland China) needs to be factored in to ensure that existing reporting channels can handle relevant native languages.

A company should publicise its internal reporting mechanism through comprehensive staff training as part of an employee's initial induction and continuing education programme. In addition, relevant policies and accompanying guidance materials should be reflected in employee handbooks, so that internal reporting processes are well understood by employees.

Even if employees are aware of the reporting mechanism and are willing to report, they may still hold back for fear of retaliation or turn to external reporting, thereby exposing management to unforeseen external scrutiny. In practice, whether employees give priority to internal reporting depends, to a large extent, on the existence of effective whistle-blower protection. Management should therefore endeavour to raise awareness of whistle-blower protection and prevent actual or perceived repercussions against them, including workplace discrimination, disciplinary punishment and even wrongful dismissal.

Although China has not yet formulated a set of unified laws designed to confer formal protection of whistle-blowers, its citizens' general reporting rights and the protection that they should receive are reflected in existing laws and regulations, such as the Several Provisions of the Supreme People's Procuratorate, the Ministry of Public Security and the Ministry of Finance on Protecting and Rewarding Whistleblowers of Occupational Crimes issued in 2016. The legislation explicitly stipulates that dismissal of whistle-blowers is a wrongful act of retaliation which is forbidden by law.



## CASE STUDY

A global pharmaceutical company was accused in 2014 of allowing its Mainland China-based employees to conduct commercial bribery and issue false invoices. A whistle-blower had repeatedly reported the allegations to the executives at head office and even the company's external auditor via email. According to media reports, the company failed to conduct a meaningful internal investigation and wrongfully dismissed the suspected whistle-blower. As a consequence, the company missed an opportunity to deal with the suspected misconduct in a timely manner, and was later subject to criminal investigations by judicial authorities, resulting in a record fine of RMB 3 billion.

## Transparent investigation procedures

If the whistle-blower's report is not handled in a timely manner or, worse still, is routinely ignored by management, an organisation's internal reporting mechanism may lose credibility and be potentially rendered in vein. Therefore, companies should implement a set of investigation protocols that address the whistle-blower complaints swiftly and effectively, in a transparent manner.

**Independent dedicated personnel:** To ensure fairness of the investigation processes, companies should appoint experienced or independent senior management as the dedicated personnel to handle whistle-blower complaints and follow-up monitoring, and to ensure that such dedicated personnel will report to relevant stakeholders directly. This dedicated personnel should review the facts available and consider whether the reported complaint has sufficient justification that requires further inquiry. If the conditions for an investigation are not met or the case is not accepted, the responsible personnel should, where appropriate, provide relevant feedback to the whistle-blower before closing the case.

Companies can also consider appointing qualified professionals to conduct independent investigations and implement follow-up corrective actions to remediate root causes of fraudulent behaviour. In the event of serious allegations of misconduct, it is common for a listed company to set up an independent investigation committee to investigate such allegations, and the committee may also appoint forensic accountants and legal experts to assist in establishing the facts.

**Transparent follow up procedures:** Upon commencement of formal investigations, the investigative team should give the parties with alleged involvement of misconduct an opportunity to explain themselves, and where necessary, seek formal legal advice from Counsel on a possible course of action. In order to maintain fairness of the investigation, the company should make it clear that all employees must not obstruct the investigation, nor retaliate against the whistle-blowers or the investigative team. The investigative team should also keep all case-related information strictly confidential.

### **Credible response and rectification mechanism**

After completion of the investigation, the dedicated personnel should duly report relevant findings to management or a function of management such as the Audit Committee. All relevant internal records and documents generated throughout the process of compliant acceptance, investigation and reporting should be properly retained, subject to legal advice.

When a complaint has been substantiated, management may consider commencing disciplinary action against the wrongdoers and assess what additional remedial actions would be appropriate to deter this type of behaviour in the future. Where practicable, the company should seek legal advice and take the initiative to report the matter to relevant authorities, in accordance with applicable laws and regulations in Mainland China. In addition, Mainland China-based listed companies must truthfully disclose their Internal Control Self-Assessment Report in accordance with the provisions of the Basic Standard for Enterprise Internal Control.

Last but not least, if any errors or omissions are found in the business or internal control system, the investigative team should also report such observations to the management and internal audit department for review and rectification.

### **Cultivation of an ethical corporate culture**

In order to create a compliant operating environment, the support and engagement of management is essential. Management should take the lead in establishing a good corporate culture and encourage employees to report suspected misconduct. In particular, management should adopt a clear and strong tone when advocating compliance, and foster an ethical corporate culture as part of the corporate accountability system.

Specifically, to encourage employees to report concerns of misconduct or fraud, companies should maintain regular communication and develop corresponding training programmes. On a regular basis, companies should carry out a comprehensive assessment of their operations to identify high-risk functions and strengthen employees' fraud awareness. Training topics could be designed in the following way:

- Collecting feedback from executives, employees and the internal audit department;
- Analysing common risks in the industry;
- Reviewing the advice of auditors; and
- Obtaining professional advice from an outside corporate governance and internal control adviser.

### **Conclusion**

In short, failure to detect internal misconduct in a timely manner and addressing internal control weaknesses reactively in the face of external inquiries may result in significant risks. Empirical evidence has consistently shown that if employees can take the initiative to make internal reports on known misconduct, they can not only prevent fraudulent behaviours from deteriorating, but also protect companies and investors from significant reputational and financial damage.



## CHECK LIST

### Establishment of multi-faceted internal reporting channels

- ☒ Multiple communication channels (e.g. telephone hotlines, dedicated emails and mailboxes)
- ☒ Detailed reporting procedures in employee handbooks and availability of training to employees
- ☒ Publicised whistle-blower protection policy

### Transparent investigation procedures

- ☒ Experienced and independent senior executive as dedicated personnel to handle whistle-blower complaints
- ☒ Investigation procedures that address the whistle-blower complaints swiftly and effectively
- ☒ Independent assistance from professional forensic accountants and legal experts

### Stakeholder reporting and possible disciplinary and remedial actions

- ☒ Regular reporting of investigation progress and findings to those charged with governance
- ☒ Evidence preservation and documentation detention
- ☒ Assessment of self-reporting obligations

### Cultivation of an ethical corporate culture

- ☒ Full support and engagement from senior management
- ☒ Employee training programmes to enhance overall fraud awareness
- ☒ Regular and comprehensive assessment of fraud risks

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