

## Forensic Sourcing in China

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An effective approach to managing purchasing compliance

“A great way to catch fraud and save some money at the same time”

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May 6, 2009

# Executive Summary

- Local purchases in China by US corporations and their Chinese subsidiaries will reach an estimated annual \$500BN in 2008. The size and rapid growth of buying in China for production and import purposes, poses a massive risk of corruption that has not been adequately addressed by US public corporations and their boards.
- While some these questionable business practices may have been silently tolerated in the past by US management in order to accommodate rapid growth, today they represent very serious legal and ethical challenges that need to be addressed. We believe that US corporations can neither afford to wait for evidence of corruption to emerge nor to undermine local management through intrusive and frequently ineffective audits.
- Instead we advocate a systematic process, we call Forensic Sourcing, supported by a neutral outside party, that reviews all significant purchases and subjects them to market based competition and lets the resulting data reveal both economic inefficiencies and legal irregularities.
- The expertise and independence brought to the process by a neutral third party consultant working with a law firm, helps protect US management from legal challenges under current law (Sarbanes Oxley and FCPA) and provides superior economic benefits in the form of better terms and pricing compared to internally driven reviews.
- A typical project will start with a six week diagnostic phase in order to size the economic sourcing opportunity and assess the organization's vulnerability to corruption at a high level. If the diagnostic phase indicates that there is an economic opportunity or that corruption is likely, a Forensic Sourcing project prioritized based on opportunity and corruption risk should be launched. Typically such a project takes about six to nine months, depending on scope and complexity of the categories addressed and yields approximately 8-15% in annual savings.

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- II. **Legal Perspective:** Compliance challenges and risks for U.S. public companies operating in China
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- IV. **Mitchell Madison Group and USA China Law Group:** Our backgrounds and qualifications

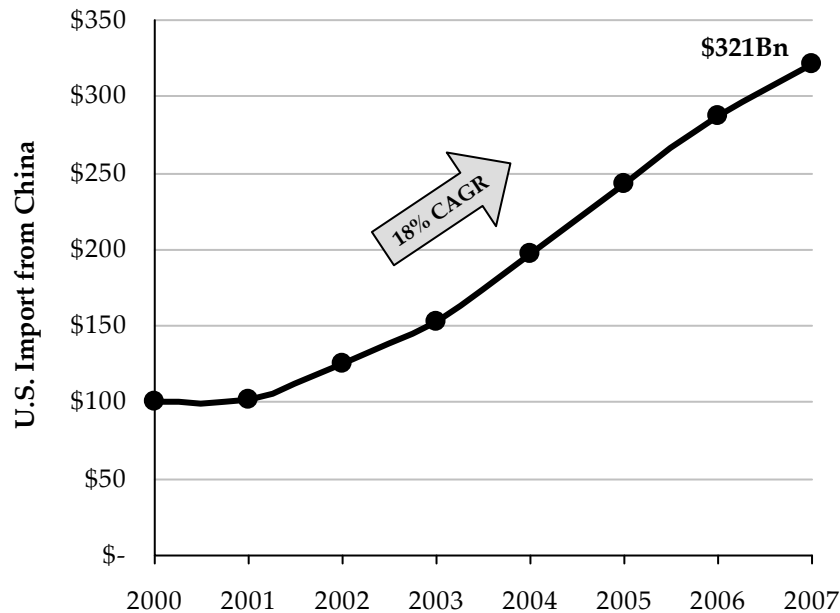
# I. Background

US imports from China have reached \$320BN in 2007 after growing at an average rate of 18% this decade. Using high level estimates, we believe that companies subject to US law purchase at least \$500BN of goods and services from Chinese suppliers, either locally in China in the form of intermediate production inputs or in the US as imports of finished goods.

## US Corporate China Purchases

2007 Est., \$ Billions

Estimate

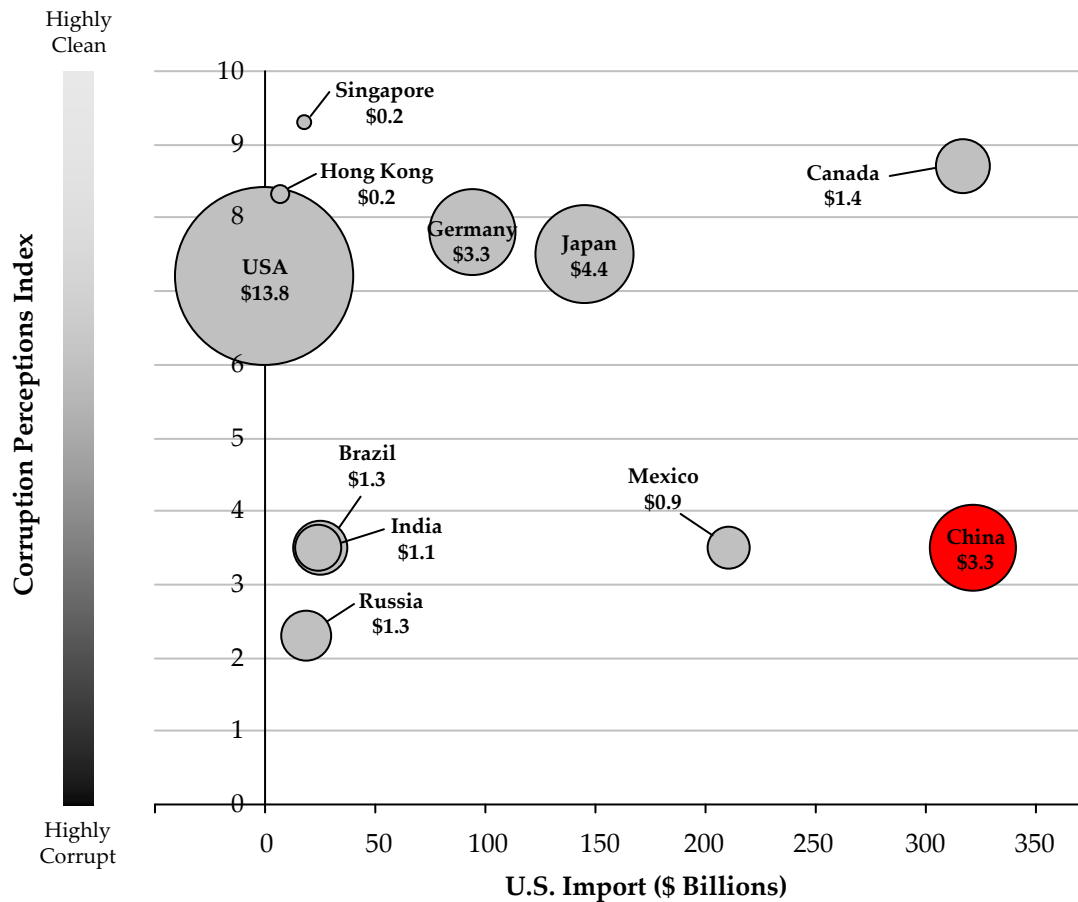


\$ 321	U.S. Imports from China
+ 100	U.S.-owned China Corporations Exporting to third Countires
<hr/>	
= 421	Subtotal
X 60%	Material Cost Ratio (est.)
X 2	Intermediate Consumption Multiplier
<hr/>	
<u><u>~ 500</u></u>	<b>U.S. Corporate China Purchases</b>

In the 2007 Transparency International “Corruption Perceptions Index (2008 results will be published on September 23rd), China scores a low 3.5, which it interestingly shares with Brazil, Mexico and India, the world’s other major offshoring destinations.

### Country Economics vs. Corruption Level

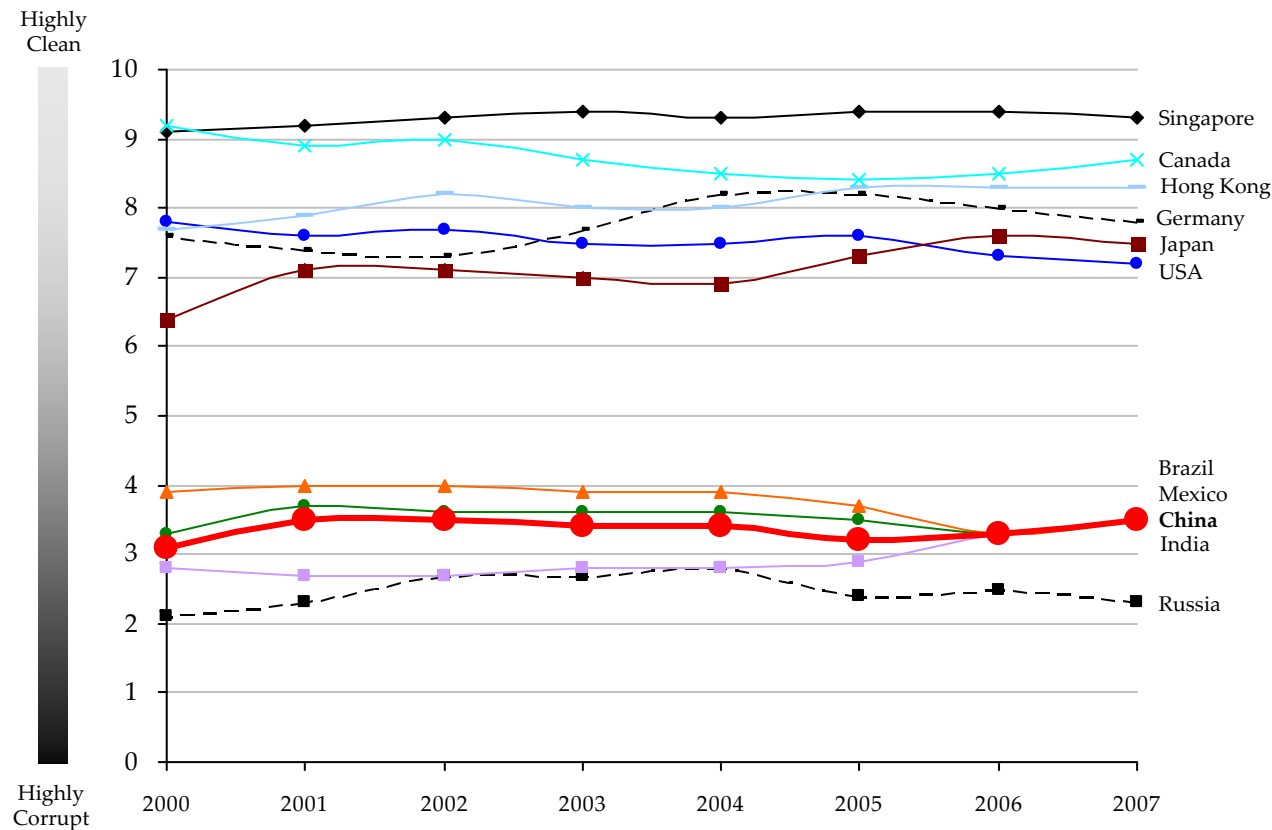
2007, Bubble Size is GDP \$ Trillions



Source: U.S. Census Bureau; Transparency International; International Monetary Fund; MMG Analysis

Despite efforts on the part of the Chinese government to address corruption, these numbers have not really improved during this decade. We anticipate that corruption will continue to be a problem in China for the foreseeable future, because existing laws are not strong enough, are not being vigorously enforced and have mostly been focused on government graft, not private sector corruption. In addition, rapid GDP and FDI growth continues to create corruption opportunities, making it difficult to apply lessons from more mature economies to China.

### Corruption Perceptions Index History 2000–2007

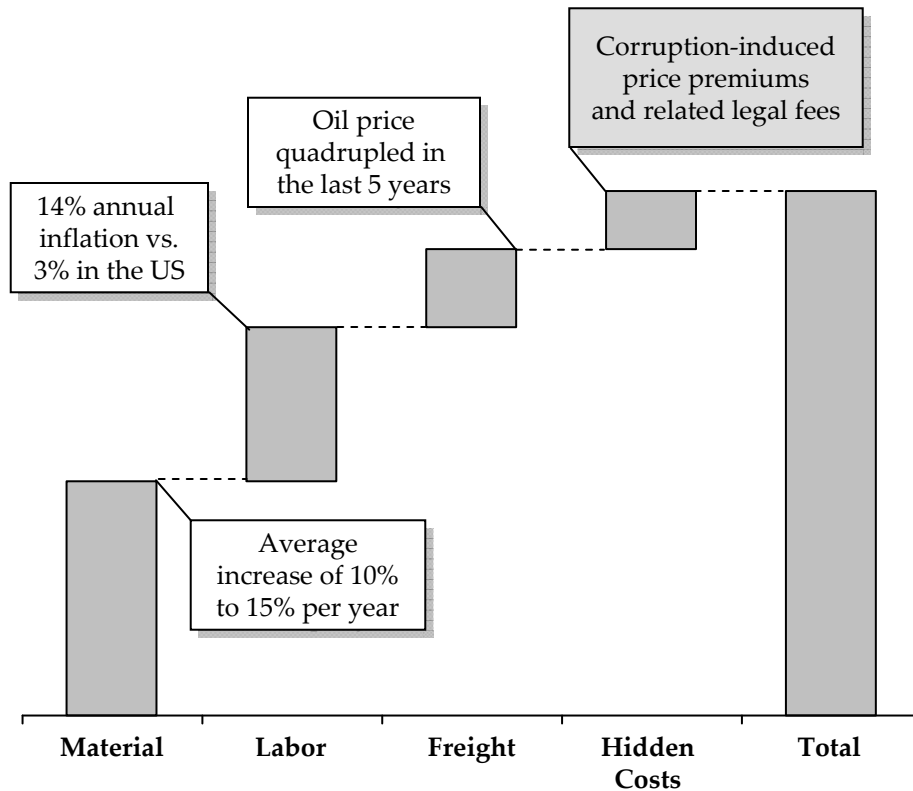


Source: Transparency International; MMG Analysis

We believe that optimizing and professionalizing purchasing in China represents a very significant margin enhancing opportunity that should be a top agenda item for any US public company operating in China.

## Key China Costs

Illustrative



Purchasing related corruption affects a US corporation's cost of operating in China in two ways:

- It imposes a potentially very significant, but generally unknown and ignored cost in the form of legal challenges under US law.
- Eliminating it may represent the single largest opportunity to improve gross margins in China. Depending on the industry, local purchases may represent 50%-75% of total cost and reducing purchasing costs by 10% would provide an instant 5% gross margin boost.

## II. Legal Perspective

### Key Legal Issues for U.S. Executives and Boards

U.S. corporations can neither afford to wait for evidence of corruption to emerge nor to undermine local management through intrusive and frequently ineffective audits

- The size and rapid growth of buying in China for production and import purposes, poses a massive risk of corruption that has not been adequately addressed by US public corporations and their boards.
- While some of these questionable business practices may have been silently tolerated in the past by US management in order to accommodate rapid growth, today they represent very serious legal and ethical challenges that need to be addressed.
- Many executives we spoke to about this, are very concerned about compliance issues in their Chinese purchasing operations, but are hesitant to take a heavy handed audit approach for fear of undermining their management teams in China, where talent is in extremely short supply.
- Ignoring the problem is unacceptable given the severe legal repercussions, and publicly known cases certainly only represent the tip of the iceberg.
- The expertise and independence brought to the process by a neutral third party consultant working with a law firm, helps protect US management from legal challenges under current law (Sarbanes Oxley and FCPA).

## U.S. Anti-Corruption Laws

Both the Federal Corrupt Practices Act as well as the Sarbanes-Oxley Act provide for significant criminal and civil penalties for corruption violations.

U.S. Law	Overview
Foreign Corrupt Practices Act (FCPA)	<ul style="list-style-type: none"> <li>○ The Foreign Corrupt Practices Act is a U.S. federal law that prohibits the bribery of foreign government officials by U.S. companies and prescribes accounting and record-keeping practices. The definition of “foreign official” includes an official of a state-owned business enterprise.</li> <li>○ The anti-bribery provisions of the FCPA apply to any company with securities registered pursuant to SEC regulations or subject to SEC reporting requirements or to a person acting on behalf of such company or person</li> <li>○ U.S. persons who are unable to defend their actions under the FCPA’s anti-bribery provisions face severe penalties. U.S. companies can be fined up to \$2 million while U.S. individuals (including officers and directors of companies that have willfully violated the FCPA) can be fined up to \$100,000 and imprisoned for up to five years, or both. In addition, civil penalties may be imposed.</li> </ul>
Sarbanes-Oxley Act	<ul style="list-style-type: none"> <li>○ The Sarbanes-Oxley Act (“SOX”) imposes requirements on publicly traded companies</li> <li>○ Section 302 of SOX requires senior management to not only accurately report material financial information but also to establish and maintain internal controls so that management has the accurate financial information.</li> <li>○ The disclosure requirements of Section 302 require the CEO and CFO to advise the external auditors of any situation, regardless of materiality, that indicates dishonesty on the part of any employee that participates in or plays a significant role in any of the controls that support any of the information that flow into the preparation of a financial statement Consolidation &amp; Adjustments, financial statement Notes preparation, or preparation of Supplemental SEC 10K/10Q, etc. disclosures.</li> <li>○ SOX provides for both criminal and civil penalties. With respect to criminal penalties, Section 807 of SOX provides for fines and imprisonment of not more than 25 years or both.</li> </ul>

# China Anti-Corruption Laws

Statistics published by the Chinese government establish foreign companies were involved in approximately 60% of the 100,000 corruption investigations in the past decade.

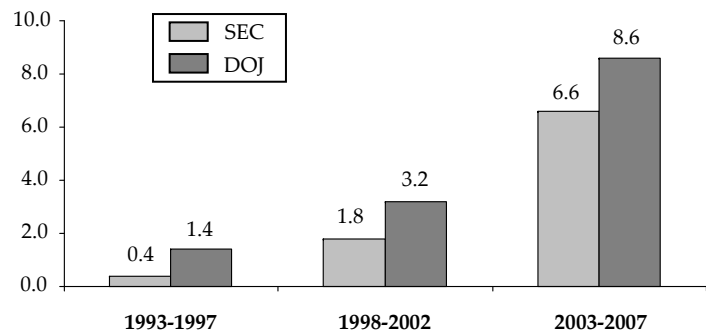
China Law	Overview
<b>Chinese Criminal Code</b>	The Criminal Code prohibits bribery including bribery of state functionaries or state related business enterprises. The definitions of these persons and entities is extremely broad in scope and includes people who perform public services in the legislative, administrative or judicial branches, the military, employees of state owned enterprises from cashiers to officers and directors.
<b>Chinese Company Law</b>	Governs business organizations. It specifies that “a foreign company shall assume civil liability for the operational activities of its branches within Chinese territory.” Therefore, when a branch of a U.S. company, its directors or officers commit a violation of the anti-bribery provision in the Company Law, the foreign company will be held liable.
<b>Anti-Unfair Competition Law</b>	Prohibits businesses to “bribe through cash, property, or any other means in order to sell or purchase merchandise. Anyone who gives the other party any kickbacks shall be deemed to have committed bribery and punished accordingly.” Kickbacks is broadly defined and includes payments for research and consultant services as well as benefits such as subsidized travel and entertainment. These provisions overlap with criminal bribery.

## Recent Trends in FCPA Enforcement

Foreign Corrupt Practices Act (“FCPA”) cases have increased both in number as well as in financial impact.

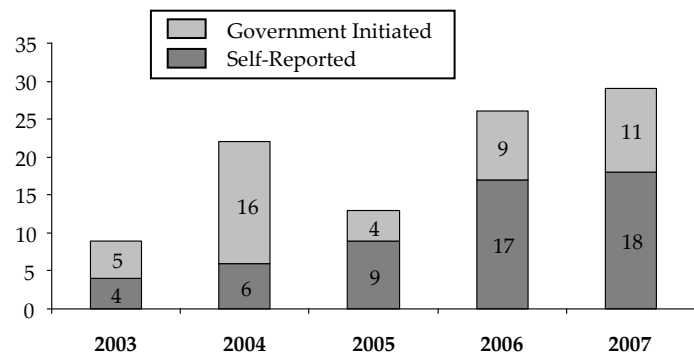
### Average SEC & DOJ Proceedings

1990 – 2007



### Reported Investigations

2003 – 2007



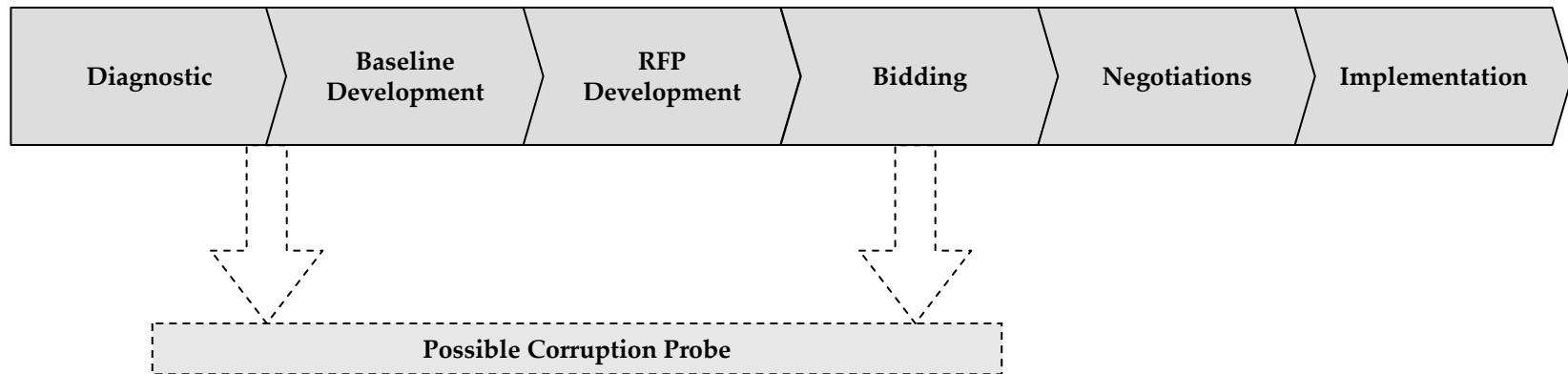
### Recent Cases

- **Baker Hughes** – agreed in 2007 to pay the largest FCPA penalty in history of **\$44 million**, which includes \$11 million criminal fine and a civil penalty and disgorgement of approximately \$33 million, in connection with its improper business practices in a number of countries
- **Vetco International** – three subsidiaries agreed in 2007 to pay **\$26 million**
- **Chevron** – agreed in 2007 to pay **\$30 million** to various enforcement bodies and for civil penalty
- **York International** – agreed in 2007 to pay **\$22 million** in fines and disgorgement.
- **El Paso Corporation** – agreed in 2007 to pay **\$7.75 million** in fine and disgorgement
- **Statoil ASA** – agreed in 2006 to pay **\$21 million** in fines and disgorgement
- **Schnitzer Steel Industries** – agreed in 2006 to pay **\$15.2 million** for fine, disgorgement and prejudgment interest

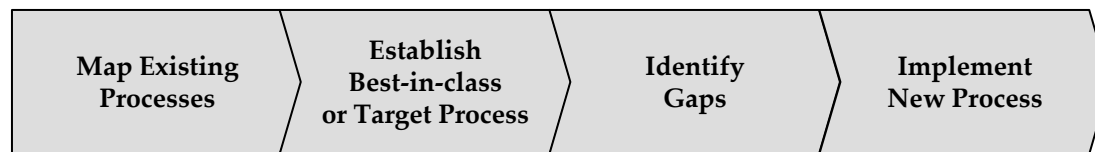
### III. Forensic Sourcing

Forensic sourcing is a systematic process supported by a neutral outside party that reviews all significant purchases and subjects them to market based competition and lets the resulting data reveal both economic inefficiencies and legal irregularities.

#### Forensic Sourcing Process



#### Typical Process Audit



#### Issues with the audit process:

- Slow, cumbersome, expensive
- Focused on finding wrong doing, not optimizing behavior
- Possible to follow the prescribed process and still have poor commercial terms
- Long time to benefits

## Forensic Sourcing vs. Traditional Sourcing

Forensic sourcing requires the same process, category, country and analytical expertise required for traditional sourcing, but is different in a several key aspects.

### Key Aspects of Forensic Sourcing

- Must have the mandate of the CEO and board and be free of any conflicts of interest (including compensation)
- Must be managed by an outside sourcing consultant working with an independent team and in conjunction with a US based but China experienced law firm
- Must examine a wide swath of purchasing categories as 80/20 approaches often miss major instances of corruption
- Must be ready to take decisive action should there be evidence of wrong doing

## **Red Flags in China Purchasing**

There are several indicators, some easily available, that indicate potential problems and may require a full blown investigation. The main purpose of the Forensic Sourcing exercise is obtain better commercial terms and to identify any warnings signs of corruption that may require further actions.

### **Common Red Flags**

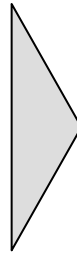
1. Long-tenured, insular local procurement staff and entrenched supplier relationships
2. Fragmented, largely local supplier base
3. Purchasing data not immediately available or considered “unclean”
4. Poorly documented parts specifications and lack of formal testing procedures
5. Extensive use of low-valued added intermediaries or distributors
6. Large incumbent vs. non-incumbent first round bid differences

## **Red Flag 1 – Long-tenured, insular local procurement staff and entrenched supplier relationships**

Having experienced, long-tenured procurement staff is a double edged sword. Some companies deliberately churn their purchasing staff and suppliers, but risk losing valuable expertise in the process, which is impractical especially in fast growing environments. We usually work with our local Chinese law firm partner to conduct some basic investigation on suspect staff and suppliers, which is relatively inexpensive and quick.

### **Problem Indicators**

- Little supplier turnover
- Insular purchasing staff, possibly relatives
- Local head of procurement (i.e. not an expat)
- Lack of background checks on staff



### **Critical Actions**

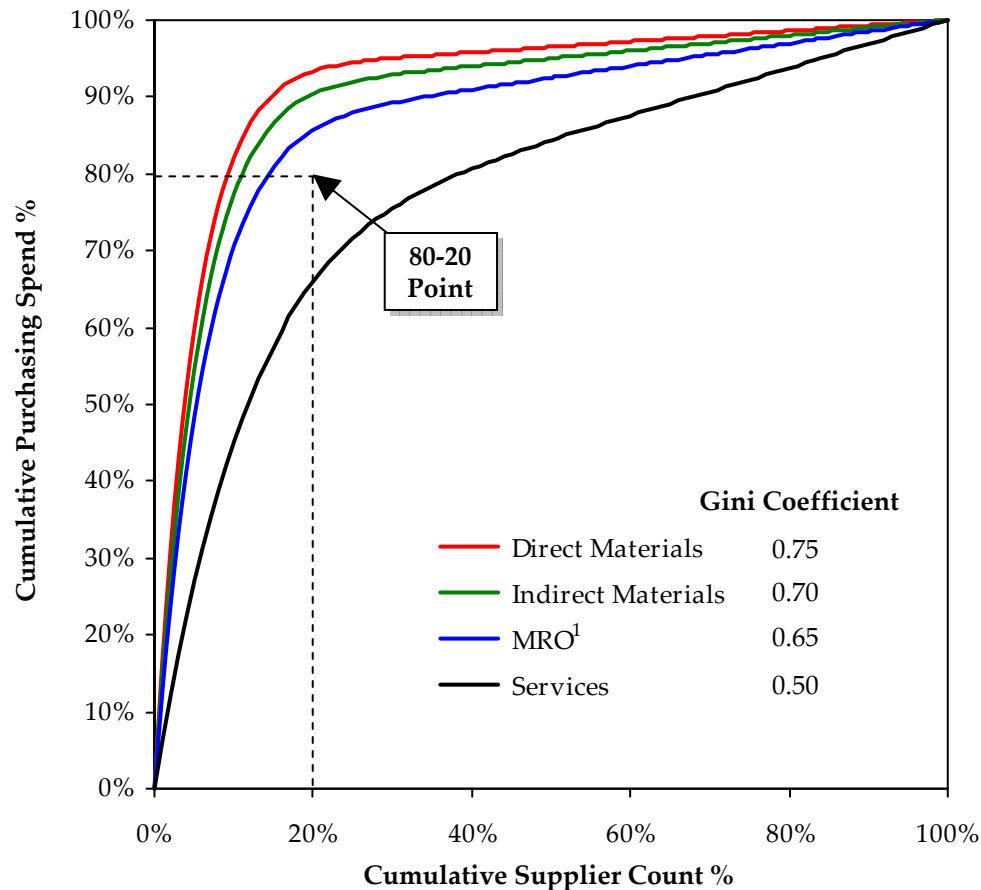
- Grave offenders must be terminated
- Zero tolerance policy going forward with amnesty for lower level staff
- Total transparency vis-à-vis board, shareholders, and regulatory agencies

## Red Flag 2 – Fragmented, largely local supplier base

The combination of a highly fragmented and largely local supplier base is almost always a red flag. In almost every case we examined, consolidating vendors and purchasing from larger national or international suppliers resulted in 20% + savings, even after allowing for incremental logistics costs and supply chain risks.

Disguised, aggregated client data

### Supplier Concentration for Typical Client



Area	Red Flag Metrics	
	Gini Coefficient	% Local Vendors
Direct Materials	< 0.60	> 20%
Indirect Materials	< 0.55	> 30%
MRO	< 0.50	> 60%
Services	< 0.40	> 60%

<sup>1</sup> MRO is for machine/equipment, maintenance, repair and other non-inventory items

# Red Flag 3 – Purchasing data not immediately available or considered “unclean”

A relatively easy litmus test is to request a full data dump of the PO and AP systems directly from the IT department. If the request is not filled within 24 hours, or IT needs to “check” with procurement first, there is something to hide.

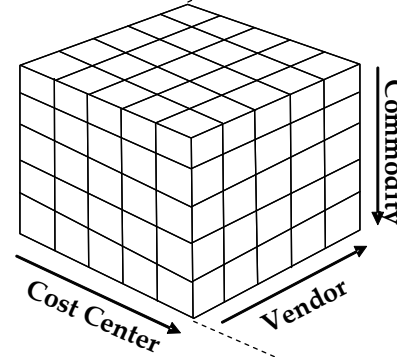
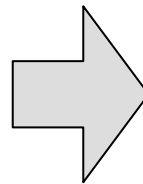
## Comprehensive AP Data Request

Field Name	Additional Information
<input type="checkbox"/> A/P System	Name of the A/P system from which the transaction existed
<input type="checkbox"/> Cost Center ID	ID for the department that purchased the goods/services.
<input type="checkbox"/> Cost Center Name	Name for the cost center in the transaction
<input type="checkbox"/> GL Account	GL account for which the invoice was applied against.
<input type="checkbox"/> GL Account Description	Description for the GL account in the transaction
<input type="checkbox"/> Vendor ID	Links to the vendor ID in the vendor details file
<input type="checkbox"/> Invoice Date	This is the vendor’s invoice date.
<input type="checkbox"/> Invoice Amount	Full invoiced amount before any discount
<input type="checkbox"/> Invoice Currency	Original invoice currency
<input type="checkbox"/> Payment Terms	Invoice payment terms
	...



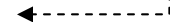
Potential Corruption if Data Delayed or Tampered

## Sourcing Cube Development



### Sourcing Cube Benefits

Ability to define purchasing-relevant categories and examine spend across vendor, GL account, time period etc.



## Red Flag 4 – Poorly documented part specs and lack of formal testing procedures

Poorly articulated specifications, lack of ongoing testing programs, un-specified parts properties with supposedly large production yield impacts, etc. are powerful barriers to switching from potentially corrupt suppliers to competitive ones.

### Common Specifications Issues

- Product datasheets not on-hand, incomplete, or outdated
- Critical specs or acceptable tolerances not established
- Claim of “mystical” specs critical for production yield
- Specifications only owned by individual engineers

### Common Testing Issues

- Qualification standards not established or documented
- Poor details in feedback for failed products
- Little testing capability and/or capacity
- Purchasing veto on engineering recommendations



### Impact

- Entry barriers for alternative suppliers
- Difficult to benchmark or RFP
- Lengthens switching implementation time

### Approach

- 80/20 approach with deep-dive into a few key parts
- Resistance collapses, if decisive battle around one or two key commodities is won
- Must have Mandarin speaking engineering talent on your side

## Red Flag 5 – Extensive use of low-valued added intermediaries or distributors

Local distributors are a common method for setting up kick-back schemes, but are fortunately relatively easy to identify. Often such schemes are more prevalent in smaller or MRO type purchases.

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**Disguised Actual  
Experience**

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### Case Example

- U.S. public company with extensive manufacturing operations in China.
- Small Chinese local distributors used extensively in Indirect Materials and MRO.
- A significant local supplier (distributor) sells parts to client that are made by large international conglomerates. Client represents vast majority of distributor's revenues.
- Background investigation shows that supplier was established only days before supplying large volumes of product to client and that it is headed by an unqualified front person (a local farmer).
- During RFP process, supplier refuses to disclose the original manufacturer names. However, even where original manufacturers are known, the client local head of purchasing refuses to buy directly. Additionally distributor attempted to discourage original manufacturer from bidding.
- In RFP, original manufacturers underbid supplier by over 20% in first round.
- Subsequent investigation indicated extensive kick-back schemes covering multiple suppliers and involving government officials.

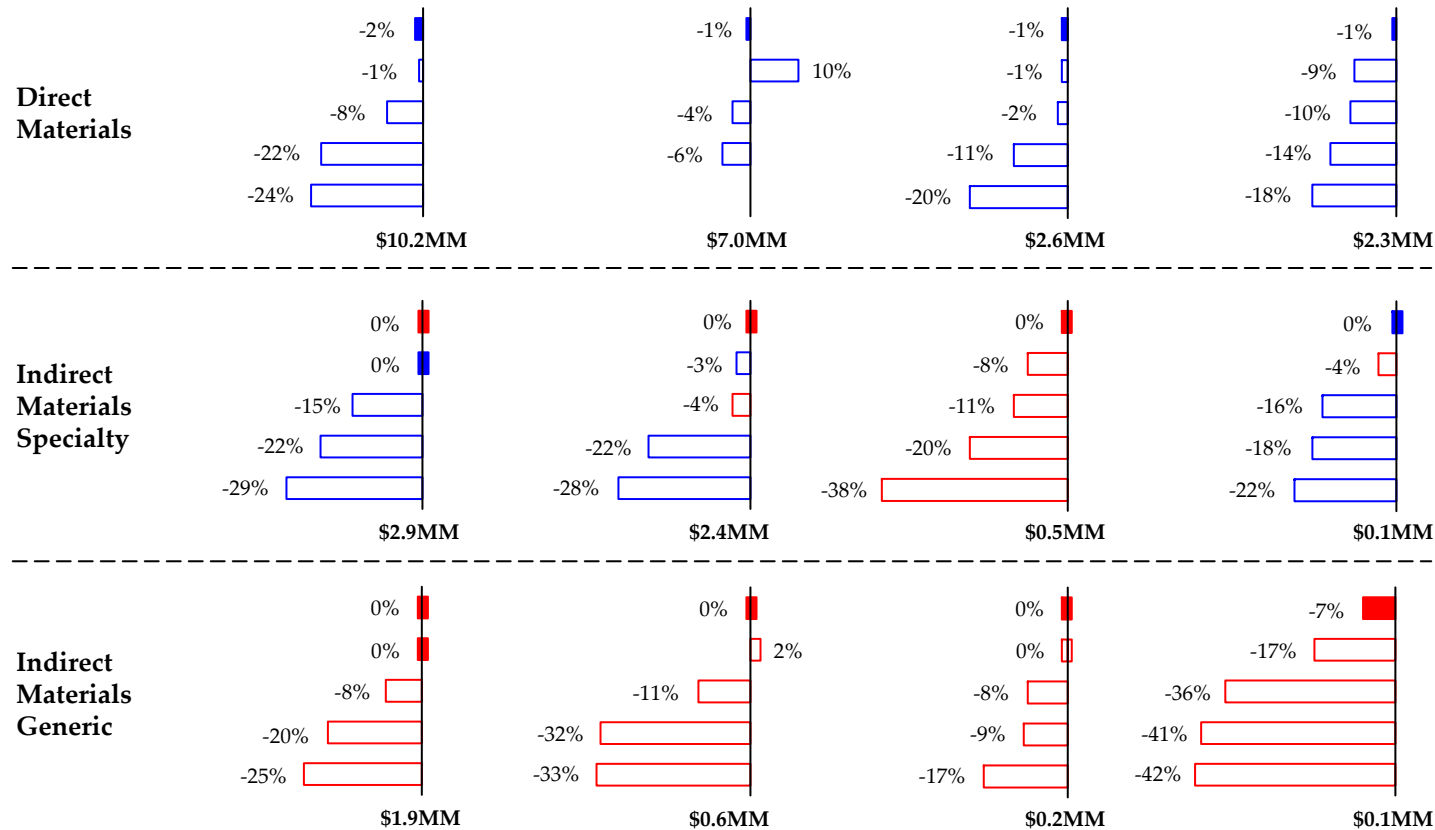
# Red Flag 6 – Large incumbent vs. non-incumbent first round bid differences

While it is common for incumbent suppliers to bid higher than new suppliers in an initial RFP response, zero price concessions or differences in excess of 15% compared to credible non-incumbents may indicate an unnatural level of entrenchment. If such relationships are based on corruption, it is imperative that suppliers understand that a neutral third party is running a totally dispassionate, data driven process with the full support from the company’s management and board of directors.

**Disguised Client Experience**

## Vendor Bids Comparison

% Savings, \$MM Baseline Spend



**For A Specific Part XYZ**

- Incumbent Global
- Incumbent Local
- Non-incumbent Global
- Non-incumbent Local

**\$ Spend**

## Launching A Forensic Sourcing Project

A typical project will start with a six week diagnostic phase in order to size the economic sourcing opportunity and assess the organization's vulnerability to corruption at a high level. If the diagnostic phase indicates that there is an economic opportunity or that corruption is likely, a Forensic Sourcing project prioritized based on savings opportunity and corruption risk should be launched. Typically such projects take about six to nine months depending on scope and complexity of the categories.

### Project Prioritization

		Economic Opportunity	
		High	Low
Corruption Risk	High	Immediate Focus	Secondary Focus
	Low	Secondary Focus	Ignore



### Typical China Forensic Savings Experience

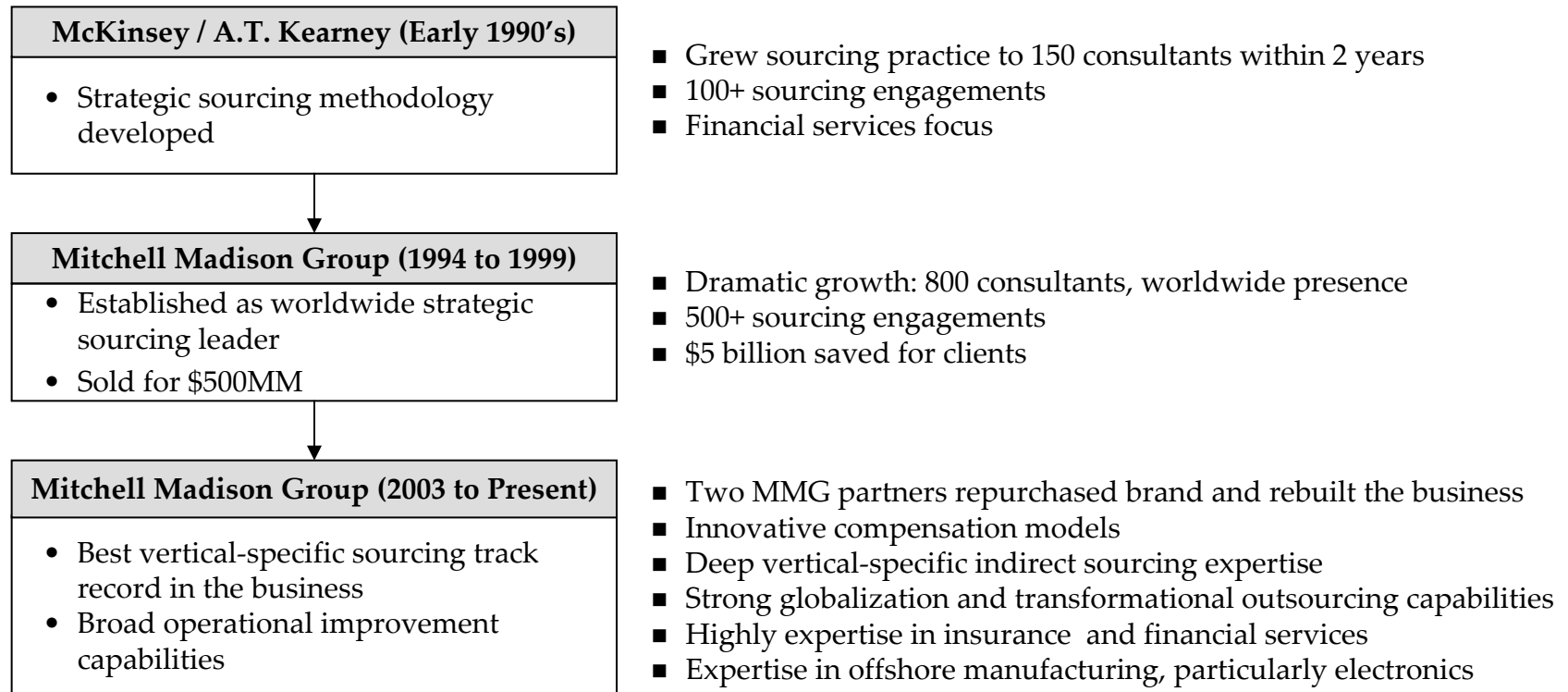
Annual % savings of addressed categories

Area	No Corruption	Corruption
Direct Materials	8-12%	20-25%
Indirect Materials	10-15%	20-30%
MRO	10-15%	25-50%
Services	12-18%	25-50%

## IV. Mitchell Madison Group and USA China Law Group

The Mitchell Madison Group is a global performance improvement specialist with a strong track record.

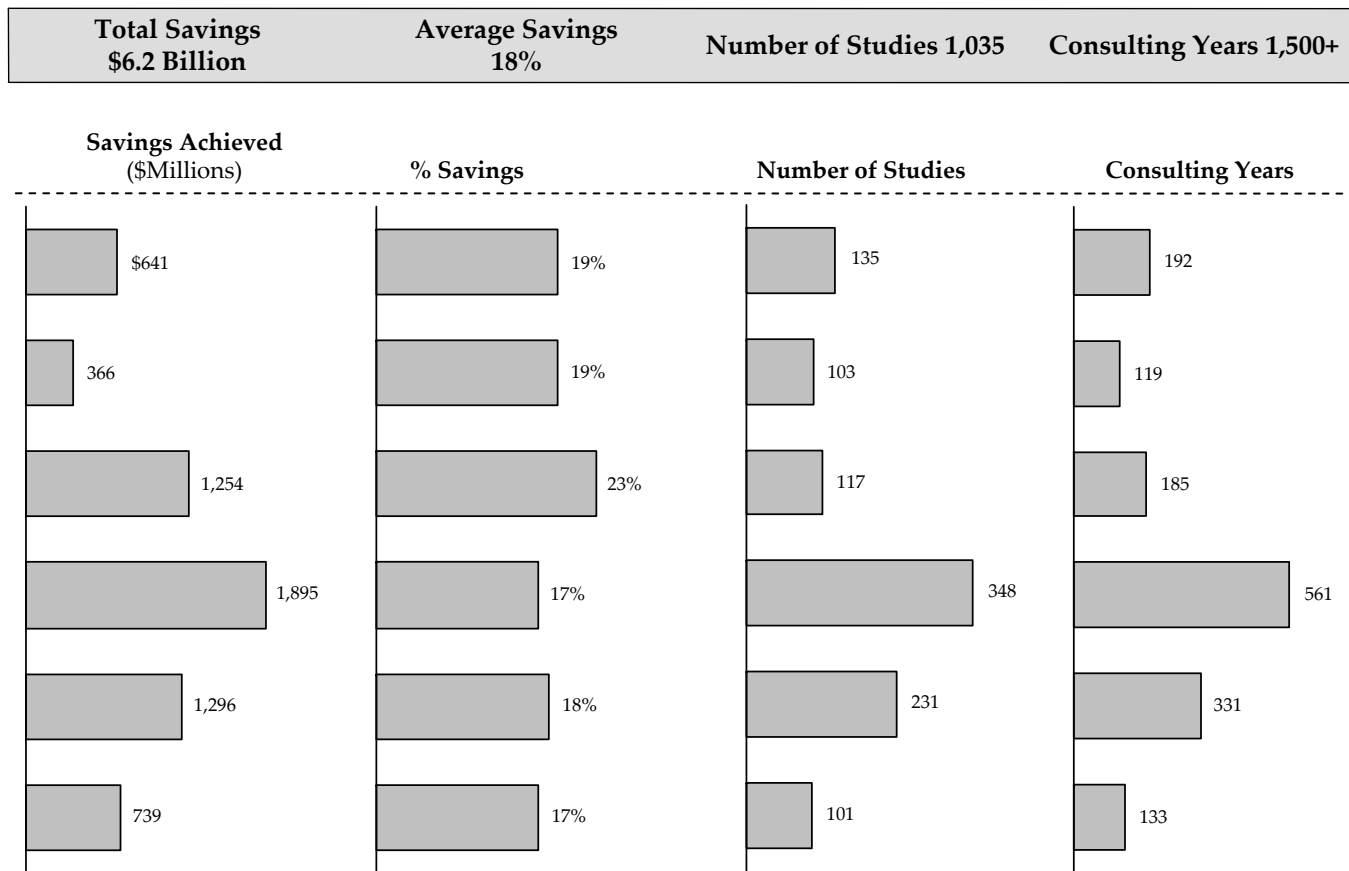
### Mitchell Madison Group History



# MMG Category Experience

MMG’s approach has been applied to 175+ markets consistently achieving savings in the range of 15-25% for our clients.

## Sourcing Legacy across 175+ Markets



Source: MMG Benchmarks; Include Legacy MMG 1994–1999

In the past few years, the Mitchell Madison Group has assisted some of the world's largest and most sophisticated institutions in a broad range of consulting engagements.

**Recent MMG Clients (partial list)**



## USA China Law Group Qualifications & Practice Areas

Mitchell Madison has partnered with the USA China Law Group to bring the critical legal and local China expertise to the Forensic Sourcing process.

The USA China Law Group is the exclusive representative of an international alliance of top-tier legal, financial, and management firms. We focus on providing comprehensive legal and related advisory and financial services to clients interested in pursuing investments in China or seeking to establish or expand their presence in the United States and/or China. The Group brings together more than 100 attorneys and business professionals located in Los Angeles, Guangzhou, Beijing, Shanghai, Nanjing, and Hong Kong.

Our clients benefit from the collective expertise, experience and connections of the members of the USA China Law Group, both in the United States and in China. We help our clients become familiar with the local business environment and formulate strategies to effectively and efficiently achieve their goals.

Our multi-disciplinary team is able to provide local counsel and expertise in every major city in China. We understand municipal, provincial, and national political realities, state economic policies, and the macro and micro markets in China.

We provide strategic business advice to those looking to invest or do business in China. We also have extensive experience advising international companies on how to achieve successful market entry and expansion into the United States.

The USA China Law Group has established strategic relationships with major investment banks, asset management companies, multinational corporations, and governmental and non-governmental organizations. These relationships and our team's experience and expertise maximize our ability to identify and validate business opportunities and to provide practical business advice to our domestic and international clients.

### Practice Areas

**Foreign Direct Investment**  
**Joint Ventures & Strategic Alliance**  
**Mergers & Acquisitions**  
**Corporate Reorganization**  
**International Trade**  
**Anti-Dumping**  
**Intellectual Property**

**Securities Law**  
**Non-Performing Loans & Distressed Assets**  
**Real Estate Law**  
**Risk and Asset Management**  
**Corporate Counsel**  
**Labor Law**  
**Litigation, Arbitration and Mediation**

# USA China Law Group Members

## **Alpha Leader Group**

The Alpha Leader Group Limited is a Hong Kong company with subsidiaries based in the People's Republic of China. These subsidiaries include Alpha and Leader Associates Limited, a Hong Kong company which provides financial services and investment advice; Alpha & Leader Law Firm, a Chinese law firm based in Guangzhou, and Ader Asset Management Limited, a Cayman Islands company based in Guangzhou, which provides management services related to non-performing loans in China.

Alpha & Leader Group has extensive relationships with major investment banks, asset management companies, multi-national corporations and governmental and non-governmental organizations both in China and internationally. These associations, combined with their in depth understanding of China's local, provincial and national economic policies and market realities maximizes Alpha & Leader's ability to assess business opportunities and advise their domestic and international clients on effective paths to success.

## **Allan Law Group**

Allan Law Group P.C., based in Southern California, has extensive experience representing the legal interests of domestic and international companies operating in the global marketplace. The attorneys at the Allan Law Group have handled international trade and investments, market entry strategies, and intellectual property rights for clients around the world for over 30 years.

The Allan Law Group represents numerous clients with business interests in China. The attorneys' active involvement in the legal and business communities both in the United States and abroad gives them unique insight into effective management of a broad range of U.S. business law and international business law matters, such as business formation, contract law, intellectual property rights, corporate law, and litigation.

## **Ma Jian Law Firm**

Ma Jian Law Firm, based in Nanjing, represents clients in the areas of corporate law, real estate transactions, finance and banking, international business, litigation, arbitration and alternative dispute resolution. The attorneys at Ma Jian Law Firm have been nationally distinguished with permanent governmental appointments and internationally recognized in the United States, Canada, Hong Kong, and Taiwan.

The Ma Jian Law Firm represents a wide range of clients in different industries. Included among their clients are Nanjing City Water Conservancy Bureau, Jiangsu Province Concrete Association, Nanjing Zhonghai Real Estate Development Ltd., Fujian Mindong Electric Power Inc. Co., Nanjing Film Studio, Nantong City Jianshan Pesticide Chemical Industry Inc. Co., and Nanjing City Grain Bureau.

## Key Partner Bios

### Hans Dau, Mitchell Madison Group



**Hans Dau**

Hans Dau is a partner and co-founder of The Mitchell Madison Group LLC, a global management consulting firm. The company was originally founded in 1992 and has currently offices in New York, Los Angeles, London and Manila. Mr. Dau works primarily with senior executives of global financial services and manufacturing companies on corporate strategy and cost management issues. He is a recognized thought leader in the areas of sourcing of complex services, outsourcing and globalization of corporate cost structures.

His consulting work has been instrumental in the turnaround of many of his clients and he has pioneered innovative compensation models that are linked to a client's financial success. Recently he has focused on assisting US public companies address economic and compliance risks inherent in managing Chinese supply chains.

Prior to starting the Mitchell Madison Group, he was a senior vice president and co-founder of Zeborg Inc., an enterprise software company. He was responsible for product management, leading the development of six major applications within two years, before selling the company to Emptoris, Inc.

Mr. Dau has worked extensively in North America, Europe and Asia and is a dual citizen of the US and Germany. Mr. Dau received a MBA from the Amos Tuck School at Dartmouth College and a degree in business and economics from the University of Mannheim, Germany. He resides with his wife and two children in the Los Angeles, CA area.

[hans.dau@mitchellmadison.com](mailto:hans.dau@mitchellmadison.com)

+1 310 909 7600

### Robert J. Allan, USA China Law Group



**Robert J. Allan**

Robert J. Allan is a barrister and solicitor and an AV rated attorney with over 30 years of international legal experience. Mr. Allan has earned a global reputation for excellence in both the legal and business community, and has been honored with an AV Rating; Martindale-Hubbell's highest rating for legal ability and ethical standards. He has extensive experience representing the interests of existing and emerging domestic and international businesses and provides insightful legal counsel on matters such as corporate compliance, corporate governance, global finance and transactional representation.

Mr. Allan has considerable expertise in corporate compliance and global corporate structures. His ability to understand the nuances of establishing and growing an international business provides him with an exceptional ability to forecast the challenges many businesses face while expanding their international operations.

Mr. Allan founded the USA China Law Group, an organization dedicated to providing high quality legal and strategic business advice to individuals, businesses and corporations looking to establish and grow a business presence in China.

Mr. Allan earned his Law Degree from The University of British Columbia, Faculty of Law, Vancouver in British Columbia, Canada and his bachelor's degree from the University of Calgary. He currently resides in Malibu, California with his wife and two children.

[rallan@usachinalaw.com](mailto:rallan@usachinalaw.com)

+1 310 317 9212