

## Case study

If corruption and bribery faced by enterprises are not properly handled, they can result in loss of reputation, loss of money, operational difficulties, and eventually lead to the complete collapse of a business. Most incidents of corruption and bribery do not suddenly emerge overnight, but rather are preceded by a number of tell-tale signs. Management, therefore, should stay alert at all times for even the smallest hint of malpractice.

The following case<sup>\*</sup> has been included as it illustrates the major areas of concern in integrity management and the techniques which managers should acquire in practice. Moreover, it details the common causes of corruption and bribery to help managers put integrity management into practice by introducing appropriate

preventive measures. All characters appearing in the following case study are fictitious and any resemblance to real persons, living or dead, is purely coincidental.



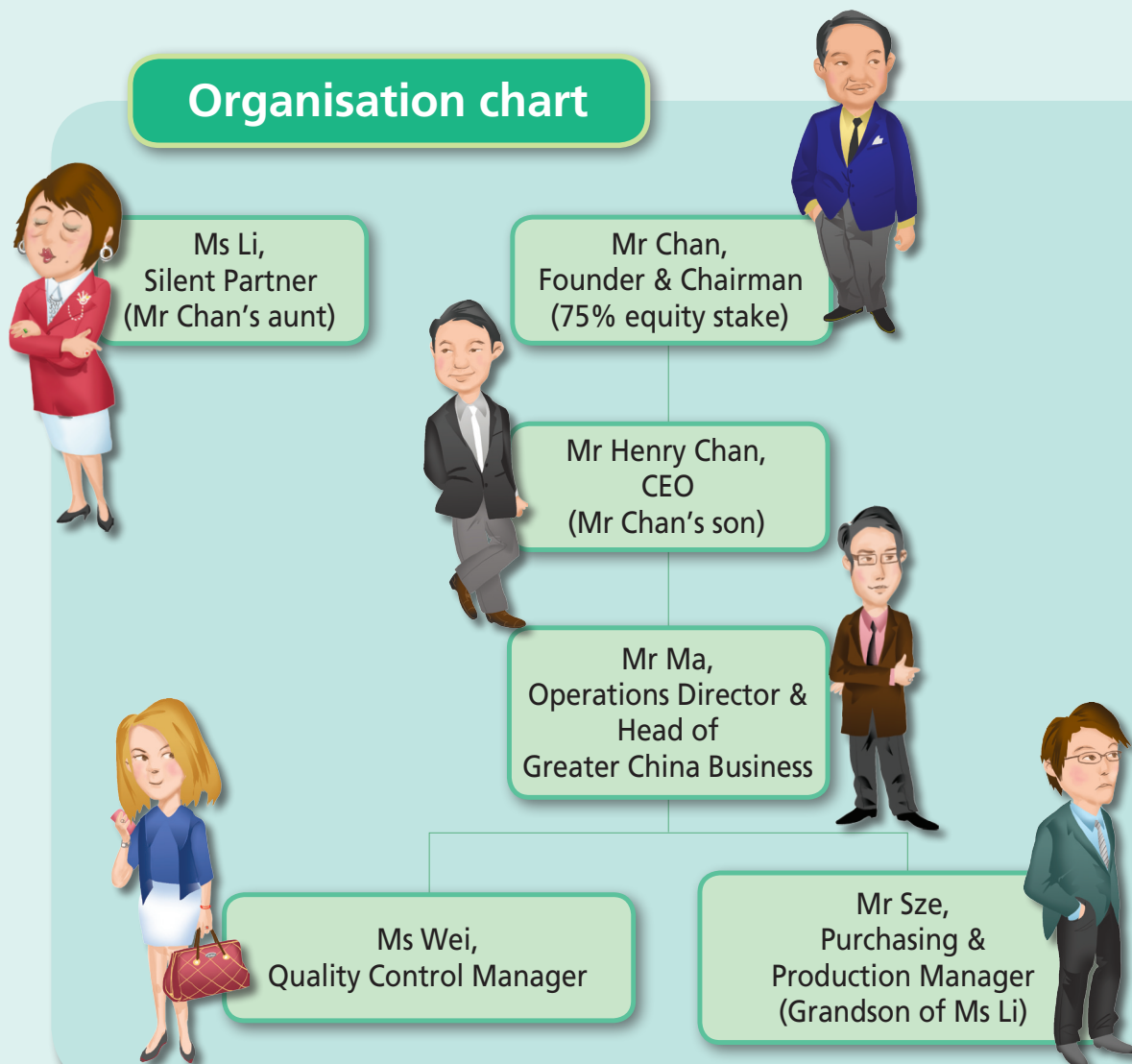
<sup>\*</sup> Case adapted from: *Kitchen Best: Ethics when Doing Cross-Boundary Business in Southern China*, Grace Loo, 2011 — prepared for the ICAC, Hong Kong by the Asia Case Research Centre, the University of Hong Kong.

## Company background

Kitchen Best Appliance Company Limited (Kitchen Best) was a home electrical appliances company based in Hong Kong. The company, founded by Hong Kong businessman Mr Chan in the mid 1980s, specialised in the manufacturing and marketing of kitchen appliances such as rice cookers, pressure cookers and electric water dispensers. While the company had an office and showroom in Hong Kong, its factory was located in Foshan in Guangdong Province, China.

Kitchen Best grew rapidly and, apart from serving the Asian market, also started to serve other markets including Europe and the US through various trading companies and sourcing agents in Hong Kong. The headcount at the company expanded from 80 to 1,500, with approximately 30 staff working in management, logistics and administration in Hong Kong, and the rest based in the Foshan factory.

### Organisation chart



## Management team

In the early days after Kitchen Best was established, Mr Chan personally oversaw all aspects of the business, and important decisions could not be made without his involvement and approval. He had close relationships with most of his senior staff and ran the business with a paternalistic style that was well-liked and respected by his workers. In recent years, except for managing relationships with certain key customers and suppliers, Mr Chan began to leave the day-to-day management of the company to his son Henry Chan.

Henry graduated with a Master's Degree in Business Administration from an American university. After taking up the role of Chief Executive, he brought a more western and less paternalistic management style to the company. To expand the company's reach in the European and American markets, he frequently travelled overseas to attend exhibitions and trade fairs and spent most of his time in Hong Kong liaising with customers. Henry would only visit the Foshan factory on Fridays and at weekends to meet with his senior management and suppliers. He relied heavily on the expertise of his senior management and their close connections with the clients and suppliers to manage daily operations of the mainland factory.

Mr Ma was from mainland China and had been with Kitchen Best more or less from the very beginning, and had worked his way up from a production line labourer to his current role — overseeing the entire factory operations. Mr Ma was Mr Chan's right-hand man and responsible for managing Kitchen Best's China and Macao accounts.

## Kitchen appliances distributor — Shago

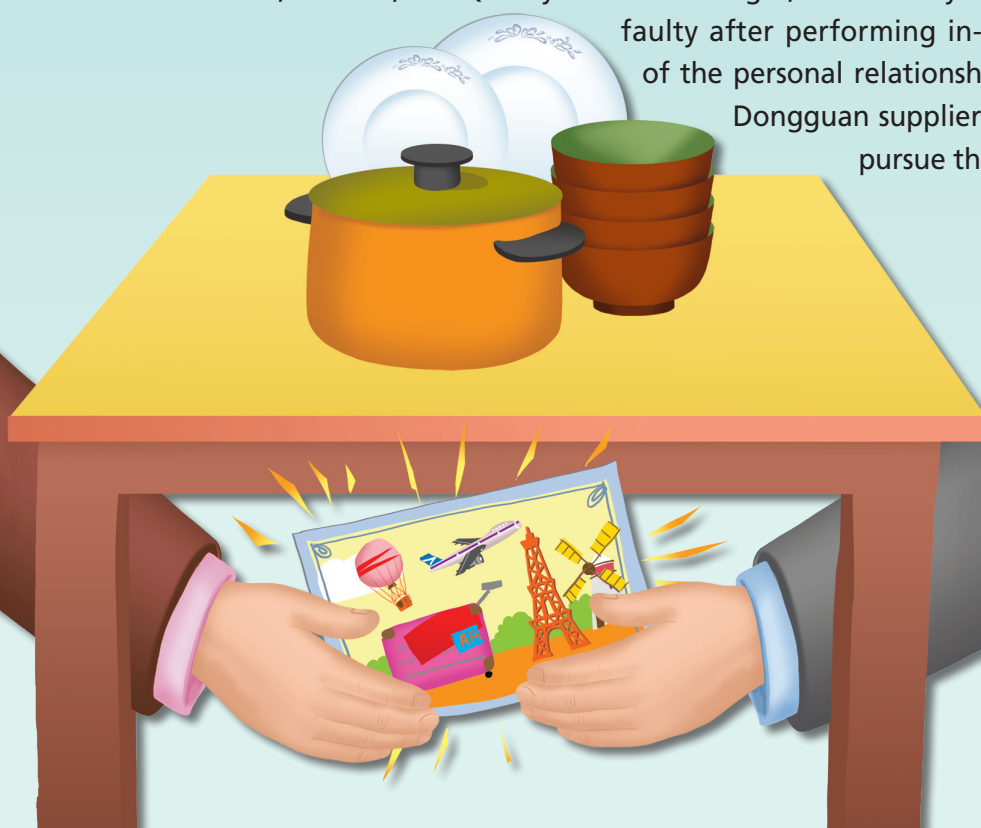
Shago, a major distributor of kitchen appliances in Singapore, Malaysia, Thailand and Indonesia had been working with Kitchen Best for over eight years. Last year, Shago placed production orders for a range of appliances for its 40th Anniversary collection with Kitchen Best. Some of these appliances came with a special gift set of microwavable tableware. Shago asked Kitchen Best to help source these gifts on its behalf.

After these appliances — with gift sets — had been distributed in the market, Shago soon received customer complaints that the bowls and plates in the gift sets were not microwavable. Shago immediately lodged a complaint and demanded both a refund and compensation from Kitchen Best.

Henry received the complaint and subsequent investigation revealed that Mr Sze, Kitchen Best's Purchasing and Production Manager, had been responsible for purchasing the gift sets. Mr Sze was the grandson of Ms Li, another shareholder in Kitchen Best, and had joined Kitchen Best upon her recommendation.

Henry had noticed that Mr Sze had been engaging in frequent wining and dining with company suppliers and, moreover, that — although Mr Sze was not a skillful gambler — he always purported to win when he gambled with them. Henry believed these were just casual private entertainment activities after work, and as such he saw no need to interfere.

It was found that Mr Sze had awarded the contract for supply of the gift sets to a factory in Dongguan owned by his brother-in-law and was offered a free package tour to Europe in return. In fact, Ms Wei, the Quality Control Manager, had already discovered the gift sets were faulty after performing in-house testing, but mindful of the personal relationship between Mr Sze and the Dongguan supplier, decided not to report it or pursue the matter any further.



## Haus de Metro retail chain

Recently, Kitchen Best received an anonymous letter stating that a shipment for the German retail chain, Haus de Metro (HdM), did not meet the company's safety requirements, contrary to the satisfactory testing report received by Kitchen Best.

Kitchen Best had subcontracted HdM's order for electric water dispensers to Qinghua Electrical Appliance Limited (Qinghua) — another Foshan-based home appliances manufacturer — as its own production lines were fully occupied. At the end of production, Kitchen Best arranged for Keemark Testing Services (Keemark), an independent testing agency based in Hong Kong, to conduct product testing and inspection as required by HdM.

Keemark sent its inspection team, comprising a Hong Kong team leader and several members from the Guangdong sub-office, to conduct a site inspection at Qinghua's factory and collect random samples for laboratory testing. Qinghua had ordered paint of inferior quality for the production of the outer casing of the electric water dispenser in order to minimise production costs. Hence, Qinghua's proprietor was nervous that the samples might fail to meet the EU's Restriction on Hazardous Substances standards which limit the use of harmful substances in the manufacturing of electrical and electronic products. To pass the test, Qinghua's proprietor made a deal with the team leader of Keemark, who allowed Qinghua to interfere with the sample drawing and substitute the random samples with some selected ones for laboratory testing. In return, the proprietor deposited a financial bribe into the team leader's wife's bank account in Hong Kong.

Although Henry was fully aware of this matter, he remained silent to avoid rocking the boat.



## Honghua Appliances

Honghua Appliances (Honghua) is a Macao-based group that owned a home appliances retail chain in southern China. Sales generated from Honghua comprised around 5% of Kitchen Best's revenues and they were considered a key customer because they had plans to expand their retail business to other parts of China and hence great future potential.

Through wining and dining, Mr Ma had, over time, built a close relationship with Mr Lau, a Macao citizen who served as Honghua's General Manager for Greater China. Through kickbacks paid into Mr Lau's personal account in Macao, Mr Ma had enticed Mr Lau to direct Honghua's Purchasing Manager to place orders of kitchen appliances with Kitchen Best.

Two months ago, an injection of foreign capital led to a change in Honghua's management. The new management found the practice of under-the-table money unacceptable and fired two managers for receiving kickbacks from suppliers. The company also decided to re-evaluate all its suppliers to ensure that they were competitive. Kitchen Best's co-operation with Honghua was at risk of becoming insecure, as it was not as competitive in delivery time or product development capacity as other suppliers.

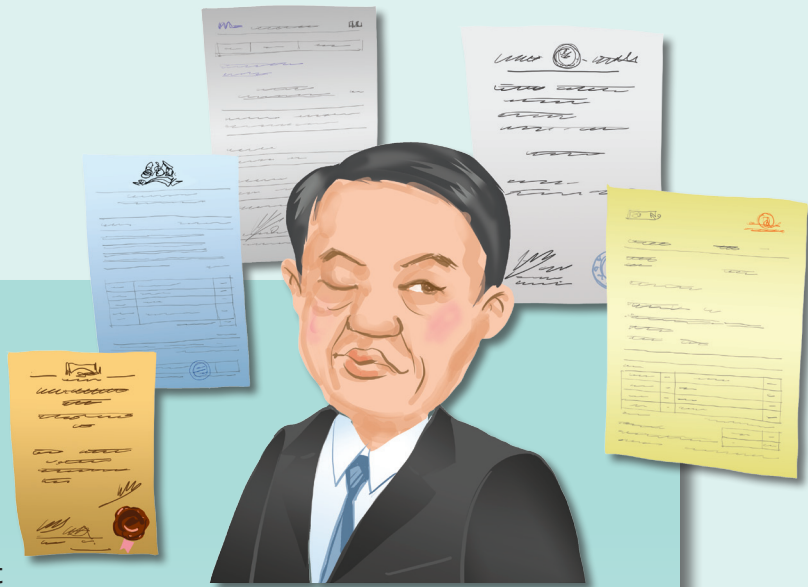




## Trouble brewing

All along, Kitchen Best had no clear guidelines or vetting procedures for expenses incurred from wining and dining or entertainment provided to suppliers and customers. In fact, Mr Ma regularly used kickbacks, entertainment and gift-giving to help facilitate opening and maintaining accounts. Expenses for such activities were reimbursed to Mr Ma through fake invoices booked as 'entertainment expenses'. Up to that stage, Mr Chan had turned a blind eye to such practices as long as Mr Ma was able to generate new business relationships and maintain them.

Although Henry had reservations about such practices and had never openly endorsed them, he did not actively try to stop them because he found it difficult to deal with mainland customers due to his own cultural barriers, and he viewed such practices as an inevitable part of conducting business in China. To make matters worse, while Henry was trying to salvage the Honghua account, he discovered that Mr Ma had not only been reimbursing such expenses but had also been inflating the amount for his own personal gain.



This year is a turning point for Henry and Kitchen Best, which will enable him to closely examine the company's operations and future development. What exactly should he do to put things back on track? How can he better monitor the business operations across the border? How can he better monitor the conduct of staff with vastly different backgrounds and cultural values?

## Case analysis

### Supervisory ineptitude — a breeding ground for unscrupulous corporate cultures

*Many SME proprietors like to try and do everything hands on at start up. As their business grows, however, they find themselves unable to oversee all the different job functions and end up delegating a lot of work to their subordinates. This is an inevitable phase in the growth of a company — with management delegating power to trusted subordinates. This trust should, however, never be allowed to become 'unconditional' simply by virtue of current or previous 'good working/personal relationships'. If bribery or corrupt practices creep in as a result of lax supervision, it can rapidly eat into your company's hard-earned profits and severely damage its reputation.*

*In this case, Mr Chan had close relationships with most of his senior staff. After the factory operation stabilised, he left operations management to his son and his trusted mainland employees, only occasionally visiting when problems arose. This was a key mistake: Henry Chan relied too heavily on his senior management and would only visit the Foshan factory on Fridays and weekends to meet them. Since the company lacked effective controls and had no clear guidelines on the acceptance and offering of advantages, its employees could easily have had the false impression that the company took no stance on such matters and that they could handle them as best they saw fit. As a result, Mr Ma and Mr Sze saw many opportunities for corruption under this regime.*

### Recommendations

Every company or enterprise has its own specific internal operating procedures. When a company is set up, initially certain procedures may simply be based on personal preference or convenience. As the company keeps growing, these work procedures should be periodically reviewed and system controls should be introduced company-wide to each work process to help limit corruption and malpractice.

Since Mr Chan and Henry did not stay very long each week in the Foshan factory, it was important that checks and balances be incorporated into the daily operations for detection and prevention of improper and corrupt practices — especially in the areas of procurement, sales and marketing, and accounting.



### **Procurement**

To prevent staff such as Mr Sze from selecting a supplier that was owned by a relative, or accepting advantages from suppliers for purchasing substandard goods, Henry should consider controlling the use of suppliers by drawing up a list of approved suppliers and contractors. Kitchen Best should also formulate a policy prohibiting employees from accepting any advantages from suppliers to avoid unfairness. Duties for negotiating a purchase, deciding on a purchase, and inspecting goods delivered should be segregated to help guard against malpractice.

### **Sales and marketing**

Pressure from sales competition can easily lead to employees cutting corners to acquire new business and it may be tempting to build relationships and secure new orders through wining and dining and offering kickbacks as Mr Ma did. Kitchen Best should formulate clear guidelines on offering and accepting advantages and entertainment. Henry should regularly meet and receive feedback from key customers and establish a complaint channel in order to detect any irregularities at an early stage.

### **Accounting**

Mr Ma was able to claim reimbursement of entertainment expenses from the company via inflated invoices, which was a reflection on the lax accounting control system at Kitchen Best. Instead, Kitchen Best should provide clear guidelines on employee expense reimbursement. These could include: setting a maximum limit for each reimbursement of staff at different levels, requesting prior approval for reimbursement of entertainment expenses, verification of receipts by the claimant's supervisor and settling of payments using a corporate credit card.

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## Tolerating bribery leads to eventual disaster

*SME operators naturally wish their businesses to succeed and generate profit. If they, however, concentrate exclusively on performance and overlook the possibility that some employees may use illegal means to achieve their business objectives, or even turn a blind eye to observed corruption and bribery offences, they are courting with a business disaster.*

*All illegitimate acts in this case are listed below:*

- 1. Mr Sze, the Purchasing and Production Manager, was offered a free package tour to Europe in return for his placing orders with his brother-in-law for the microwavable tableware gift sets ordered by the Malaysian distributor Shago. Mr Sze committed the offence of 'acceptance of bribes by non-State functionaries' under the Criminal Law of the People's Republic of China.*
- 2. Kitchen Best's contractor Qinghua bribed the team leader of a testing agency in Hong Kong via financial bribes deposited into the team leader's wife's Hong Kong bank account to ensure that their electric water dispensers with substandard paint could 'pass' safety tests. Both parties committed offences of 'offering a bribe' and 'accepting a bribe', respectively, under the Prevention of Bribery Ordinance of Hong Kong.*
- 3. Operations Director, Mr Ma, used falsified invoices for reimbursement of expenses for gift-giving and entertainment to customers, contrary to Section 9(3) of the Prevention of Bribery Ordinance.*
- 4. Mr Ma gave monetary advantages to Mr Lau, Honghua's General Manager for Greater China, by depositing bribes into Mr Lau's personal account in Macao to persuade Mr Lau to direct Honghua's Purchasing Manager to place orders for home appliances with Kitchen Best. Mr Ma's act contravened the law, Prevention and Suppression of Bribery in the Private Sector in Macao.*

*Though Henry knew Mr Sze was the mastermind behind the microwavable tableware incident, he remained indifferent and chose not to act. In the Qinghua incident, Henry simply buried his head in the sand to steer clear of trouble. Mr Chan and Henry both turned a blind eye to Mr Ma's acts and took no action to try and prevent Mr Ma from doing so. Their silence finally meant that Kitchen Best ended up in very deep water.*

## Recommendations

If a company tolerates dishonest staff and allows them to continue with malpractices, this encourages a culture of favouritism and flattery. This spreads easily to other employees, who will also begin to flout laws and disregard regulations. Ultimately, staff morale dwindles and many loyal and truthful staff will leave the company in despair, eventually draining the company of its best talent.

In this case, Henry did not take decisive action against Qinghua's staff bribing the testing agency to get around testing requirements. This action not only misled his employees into thinking that the company tolerated such acts, but also arose suspicion that Kitchen Best had also been involved in such illegal dealings.

Henry should have immediately reported the acts of bribery to the appropriate law enforcement agency. He should also impose some types of penalty on Qinghua such as refraining from subcontracting to Qinghua for an appropriate time period.

Henry should be impartial and prompt in dealing with any corrupt practices, in order to convey a clear message of 'zero tolerance' of corruption to his employees and create a culture where staff like Ms Wei are encouraged to speak up about corrupt activities, or simply when things go wrong, such as the issue of the faulty tableware.

As long as employees at all levels abide by the law and value integrity, illegitimate acts and unethical behaviour will not emerge.

## Turning a blind eye to conflicts of interest

*Allowing an employee to award contracts to suppliers owned by himself/herself or owned by his/her relative, without declaring any conflict of interest, can lead to suspicion of favouritism and is unfair to other suppliers. Lack of competition, favouritism and allowing illegal dealings to occur also affects the quality of goods or services provided, and may jeopardise the interests of the company.*

*In this case, Mr Sze, the Purchasing and Production Manager, had awarded the order for microwavable tableware gift sets to a factory in Dongguan, owned by his brother-in-law, an apparent conflict of interest. Despite their quality issues, the gift sets were still sent out to customers. As a result, Kitchen Best was not only required to make a full refund, but also compensation.*

## Recommendations

Kitchen Best should provide adequate guidance to its employees on how to deal with conflicts of interest. The best solution is to prevent employees from getting involved in any situations where conflict of interest could arise, and protect them from potential temptations of corruption and bribery. Where a conflict of interest is unavoidable, if circumstances permit, the employee concerned should not take part in the decision-making process, instead, his/her duties should be delegated to another employee and/or the process should be closely supervised by an independent person.

Kitchen Best should issue clear guidelines to employees on how to handle conflicts of interest, and should also consider asking the suppliers who take part in tendering exercises to declare any relationships with any of the company's employees. This will serve as a cross-check on internal declarations, enable managers to gather more information, and help staff handle potential conflict of interest.



## Management are accountable when they smell trouble

*The moral standard of employees is often revealed in their attitudes towards work and their behaviours. Supervisors can spot the tell-tale signs easily by observing people carefully. Even when these behaviours do not actually contravene the law, supervisors may be courting with disaster if they fail to take preventive measures, do not warn employees with integrity problems, or appear interested in petty gains.*

*In this case, Henry allowed Mr Ma to use gifts, kickbacks and wining and dining to help consolidate client relationships. Mr Sze, the Purchasing and Production Manager, accepted frequent entertainment from suppliers and even enjoyed gambling with them, but Henry saw nothing wrong with this either. Although the lifestyle of a subordinate is his/her personal choice and entertainment is an acceptable form of business and social behaviour — excessively 'close' relationships, especially those involving money, are likely to result in an employee placing himself/herself in a position of obligation which may affect his/her objectivity in dealing with suppliers.*

### Recommendations

Managers cannot realistically be held accountable for every single mistake committed by their subordinates as a result of minor negligence or insufficient experience, but if they are unaware of, or tolerate, serious, frequent and/or common acts of misconduct, they are shirking their responsibilities.

Moreover, if they turn a blind eye to obvious signs of wrongdoing, their supervising abilities as managers will soon be brought into question. Managers should pay due attention to the everyday work of their subordinates. They should be alert for any warning signs of corruption and bribery by subordinates including:

- a) how they handle small favours offered by suppliers or customers;
- b) whether they are involved in unnecessary or excessively frequent social activities; and
- c) whether they have any monetary dealings with individual suppliers or customers.

The edge that SMEs possess lies in the flexibility of their operations. The conduct of a manager can exert a subtle influence on other employees — and management style, governance philosophies and ways of running the business all easily coalesce into a corporate culture.

As a leader of the company, Henry should serve as a role model and demonstrate his determination to cultivate an ethical corporate culture — adopting a 'zero tolerance' attitude towards malpractice.

In conclusion, Henry should take decisive measures to immediately stop malpractice by employees and report them to the appropriate law enforcement agencies.

Then, he must adopt a new integrity-based management style with well established systems and procedures, as well as strengthening corporate governance. He should also formulate an effective code of conduct for staff as building a corporate culture of integrity is essential to the future success of any company.

The above case highlights the risks of corruption and bribery caused by mismanagement from different perspectives. The owners of SMEs must adopt integrity management measures by taking immediate and resolute action against corrupt practices. In this way, SMEs can protect the company's interests and reputation in addition to enhancing their competitive advantage.