

# Where did the marketing budget go?

China markets briefing for risk, legal and compliance professionals

In our [March issue](#), we discussed challenges faced by the internal audit and compliance teams (“IA & compliance professionals”) of multinational companies (“MNCs”) during the COVID-19 pandemic, particularly in relation to their Chinese subsidiaries, joint ventures and business partners, and we explored ways to overcome these challenges and avoid losing visibility into the China business.

Another area of concern that has come to our attention recently relates to marketing expenses incurred in China. Questions raised by the regional office or HQ typically include the effectiveness of the marketing

expenditure – hence a business issue – or concerns of potentially inflated or fictitious expenses – in other words, a compliance issue. The latter is nothing new, but because of the COVID-19 related obstacles covered in our previous article, there are increased challenges for the regional office and HQ in monitoring marketing activities and assessing expenditures.

This article seeks to highlight the underlying issues with respect to marketing expenses and the common red flags that IA & compliance professionals should pay attention to. We also provide advice for monitoring and detection of those issues.

## Marketing expenses – a recurring issue

Marketing expenses come in many forms: payments to marketing companies and advertising agencies; sponsorships of educational events; subsidies and rebates to distributors; employee expense claims; and so on.

Sizeable marketing budgets and inadequate controls often allow room for abuse. Hence they are increasingly under the spotlight, not only of IA & compliance professionals, but also of local tax authorities seeking out tax avoidance.

Common fraud schemes include:

- employee collusion with vendors to pad or inflate costs, or to pay for fictitious services, often for personal gain;
- using vendors to make improper payments, bypassing company controls and violating compliance requirements;
- submitting *fapiao*s (i.e. official tax invoices in China) from shell companies or for services that were never rendered, for expense claim or payment;
- issuing POs in order to use up marketing budget and park funds at vendors for later use; and
- a combination of the above.

### What are potential red flags

IA & compliance professionals are advised to be alert to the following red flags:



When increase in marketing expenses is disproportionate to increase in sales;



When local management is reluctant or unable to share details of expenditures (especially during remote reviews);



Vendors selected by local management (vs vendors screened and approved by HQ);



Data analysis shows an unreasonably short time interval between PO issuance and completion of services



Pass-through expenses are incurred by third parties (e.g. agencies and distributors) and limited information is retained by the business; and



When the industry in general is under enhanced regulatory scrutiny.

## Early detection is key

### Refreshing the audit programme

IA & compliance professionals are advised to revisit whether their internal audit and compliance review programmes covering marketing expenses are appropriately tailored for local markets. Would the above-mentioned red flags or other issues be noted? When potential issues are identified, further investigations or other follow-up actions should be undertaken on a timely manner.

### Monitoring through analytics

Putting in place an effective and robust analytics programme is another key means of monitoring and early detection. While the concept of “big data” is often referred to, any analytics tool needs to be suitably customised and fit-for-purpose. Data readiness, especially in the local market, often needs to be addressed up front.

Also, it is not just about the analytics tool and methodology you deploy, but how you analyse and interrogate the information, and then execute follow-up actions, is critical.

### Managing third parties

With regard to expenses incurred by third parties, it is important to exercise audit rights to review books and records of vendors and distributors on a periodic basis. Third parties should also be evaluated both for service performance and also for compliance behaviour.

Lastly, as stated in our March issue, there has also been increased interest in technology-based third party management solutions that allow HQ and the regional office to better understand the profile of local business partners, and help compliance teams mitigate potential fraud, collusion and other compliance risks.



## Conclusion

Sales and marketing activities are required to promote the business and educate the market about products and services. For an enormous market like China, third parties often play a critical part in those activities. However, time and time again, abuse of marketing expenses often cause issues for companies. To better manage those risks, it is important for IA & compliance professionals to tailor their audit plans, design a fit-for-purpose analytics programme and enhance their third party risk management solutions.

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