Best Practices for Managing Compliance in China

October 2013

Executive Summary

- Because of a highly competitive and culturally different operating environment, ensuring adherence to corporate ethics and compliance policies remains a concern for many US companies doing business in China. A recent US-China Business Council (USCBC) member survey on compliance best practices found that 60 percent of interviewed companies were concerned about competing with companies not following the Foreign Corrupt Practices Act (FCPA).
- Underdeveloped rule of law and lack of transparency greatly increase the risk that Chinese government agencies may solicit companies for benefits or kickbacks.
- Compliance training and monitoring techniques such as audits and whistle-blower programs are critical components of a successful compliance program. Over 90 percent of interviewed companies incorporate such techniques into their compliance programs.
- An increasing number of companies is seeking to incorporate into their existing compliance programs measures that will minimize liability risks from joint venture (JV) and third-party service providers.
- Companies tend to run compliance programs and set up local compliance teams in accordance with regional characteristics, by incorporating tailored training or allowing regional teams to approve entertainment expenses programs.
- US companies vary in the thresholds they set for entertainment expenditures for Chinese government stakeholders, as well as the methods by which they approve expenditure requests.
- The majority of companies interviewed was not optimistic that new Chinese government compliance efforts would lead to significant improvement in the enforcement of China's anti-bribery laws.

Table of Contents

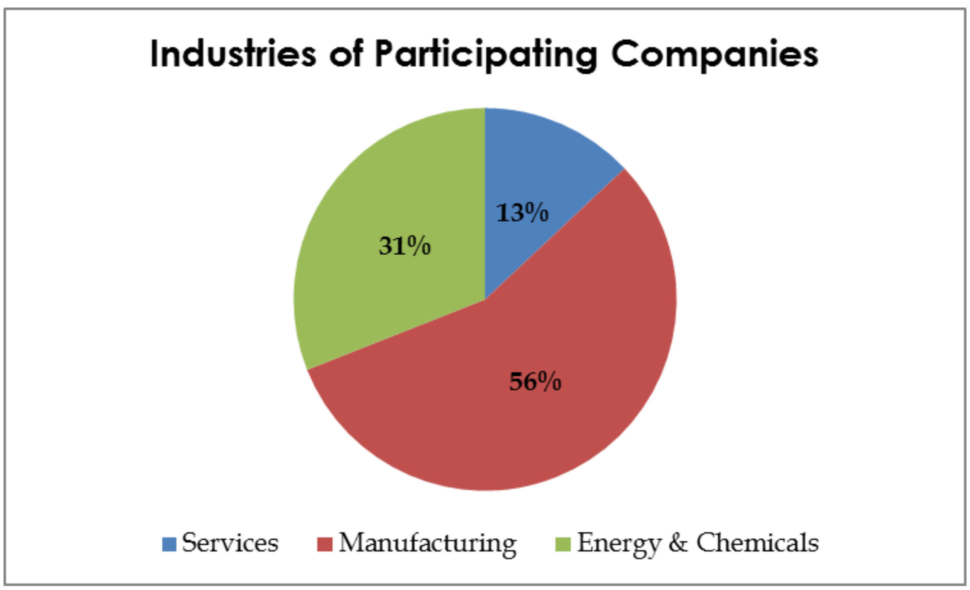
Introduction

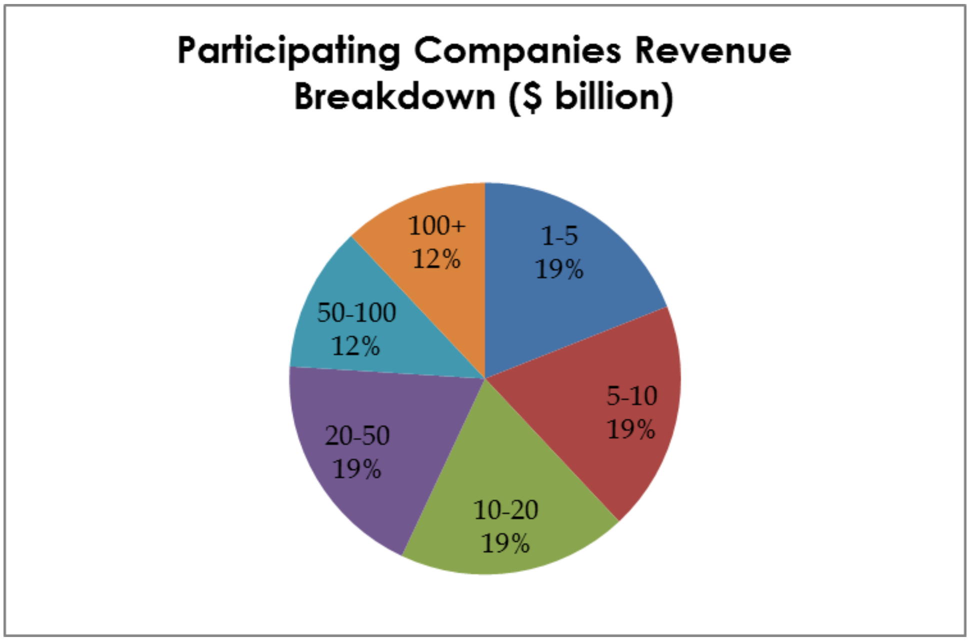
Foreign companies doing business in China encounter local perspectives and assumptions that make adherence to corporate compliance programs an ever evolving and challenging effort. Practices normally considered unacceptable in the US may not only be allowed in China, but may even be strongly encouraged by local cultural conventions. Developing internal practices that take these norms into consideration—while protecting a company's legal obligations and international reputation—is a difficult process that requires balancing strongly competing interests.

In the summer of 2013, US-China Business Council (USCBC) interviewed more than 30 member companies from a broad range of industries to learn more about which practices foster employee compliance in the China market. The interviews covered different aspects of company compliance programs, including the expense approval process, training programs, and solicitation of benefits. This report, based on those interviews, examines compliance practices, how compliance practices affect companies' abilities to compete in China, and future trends in compliance enforcement. It provides benchmarking for US companies seeking appropriate ways to remain competitive *and* compliant.

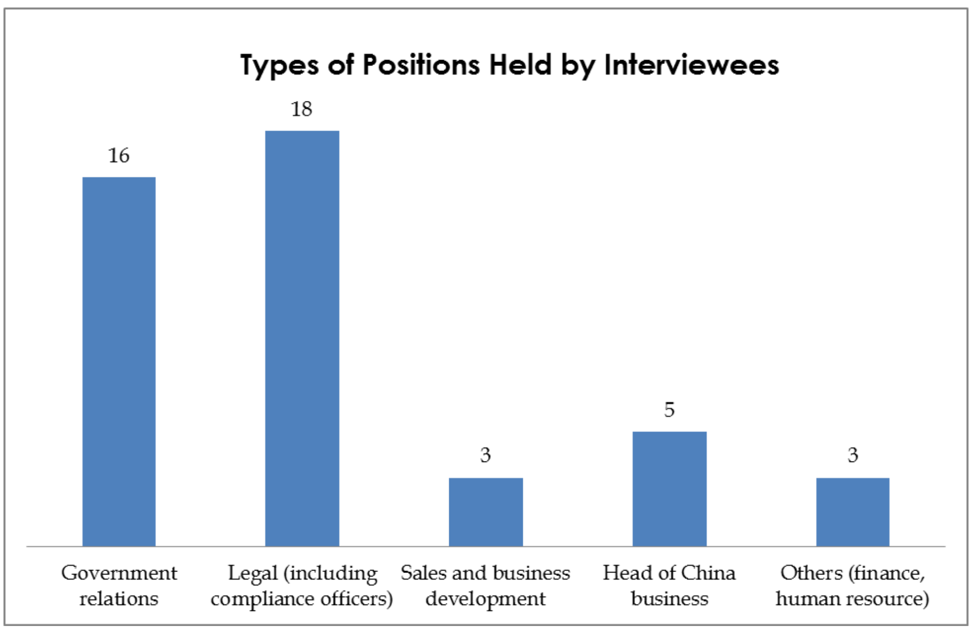
All interviewed companies agree that the Foreign Corrupt Practices Act (FCPA) is the guiding document for establishing clear company guidelines when conducting international business. In a country like China, where culture dictates practices beyond what might be deemed appropriate in the US, the FCPA provides a clear framework for conducting business. Respondents hope that over time, the observance of these requirements will spread appropriate business practices to companies currently not following FCPA requirements, creating a more level playing field and increasing transparency for all groups participating in the market.

A profile of company respondents:





Among the 45 individual respondents, the majority of interviewees hold a legal or government relations function, accounting for 40 percent and 36 percent of respondents, respectively. Specific job functions are outlined below:



Legal Background

Since the implementation of FCPA in 1977, all US companies operating internationally are required to implement internal policies to ensure the ethical conduct of their employees and limit the risk of corruption. Under FCPA, any company registered in or trading securities in the US is prohibited from bribing foreign government officials. In the decades following FCPA implementation, other US laws and regulations governing compliance have come into effect. Provisions of key laws include:

- **FCPA** FCPA contains both anti-bribery and accounting provisions to ensure business is conducted ethically around the world. These provisions apply to US persons and businesses; US and foreign public companies that are listed on US stock exchanges or that are required to file periodic reports with the US Securities and Exchange Commission; and certain foreign persons and businesses acting in US territory. The anti-bribery provisions make payments to foreign officials—whether to obtain or retain business—illegal. The accounting regulations require that companies maintain accurate records and internal auditing controls. Companies are prohibited from knowingly falsifying records to circumvent the maintenance of a system of internal controls.[1]

- **US Sarbanes-Oxley Act (SOX)** Enacted in 2002, SOX sets personal accountability standards for senior company executives and requires that they certify the accuracy of accounting and financial records published by the company. The law also requires greater independence for external auditing companies and increases the oversight role for boards of directors.

- **Dodd-Frank Wall Street Reform and Consumer Protection Act** Signed into law in 2010 in response to the global financial crisis, Dodd-Frank brought about significant changes in the regulation of the US financial industry. Certain articles of the act are applicable to all US companies across industries. One of Dodd-Frank's more controversial provisions is its whistle-blower bounty program, which allows persons who provide information leading to successful SEC enforcement to receive 10 to 30 percent of monetary sanctions over $1 million.

In addition to FCPA, local Chinese laws are also an essential component of most companies' China compliance programs. While the Chinese government has a number of regulations aimed at preventing bribery, there is currently no overarching law comparable to FCPA. On paper, current Chinese regulations are extremely strict. These rules have only recently begun to be enforced. Provisions of relevant Chinese regulations include:

- **PRC Criminal Law** Released in 1997 and revised in 2011, the Chinese Criminal Law in Articles 389 to 391 and Article 393 states that any bribe given to state officials, state agencies, state-owned enterprises or civil organizations in order to receive improper benefits is prohibited. If violated, PRC Criminal Law subjects the legal entity or individual to criminal fines or imprisonment.

- **Interpretation of the Supreme People's Court and the Supreme People's Procuratorate on Several Issues Concerning the Specific Application of the Law in the Handling of Criminal Bribe-Giving Cases** Released in 2013, the interpretation clarifies details on corruption-related court judgments and expands sentencing thresholds (for example, bribe amounts between RMB 200,000 and RMB 1 million are classified as "serious cases," which could result in fines or imprisonment from five to ten years). The interpretation also establishes incentives for voluntary disclosure, such as leniency in sentencing.

- **Anti-Unfair Competition Law** Article 15 of the PRC Anti-Unfair Competition Law prohibits various forms of bribery in business transactions, including reimbursements of expenses that are not properly recorded in company financial accounts. SAIC is tasked with enforcing the law. Penalties for committing bribery are similar to the penalties codified in the criminal law, with fines ranging from RMB 10,000 ($1,465) to RMB 200,000 ($29,298).

- **SAIC Interim Provisions on Prohibition of Commercial Bribery Activities** These serve as the implementing regulations for the anti-unfair competition law. The interim provisions outline proper accounting procedures in business transactions and specify examples of bribes and bribery activity.

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[1] http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf

Depending on the case, violators can face a combination of administrative fines, confiscation of illegal gains, and criminal prosecution.

- **Company Law** First issued in 1994, the company law marked a significant step in building a modern corporate legal system in China. The law prohibits persons convicted of bribery and other economic crimes from holding senior management positions. Though separate laws govern specific investment vehicles (like joint ventures and wholly foreign-owned enterprises), the company law applies to all corruption-related areas not specifically addressed in those regulations.

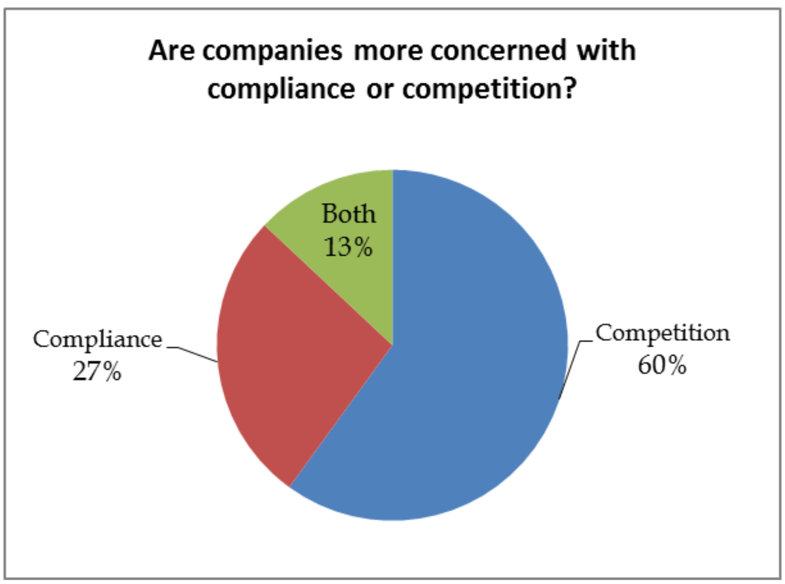
Similar to the role of the US Securities and Exchange Commission (SEC) and Department of Justice (DOJ), the Ministry of Public Security (MPS), along with its provincial and local counterparts, acts as the authority to enforce anti-bribery provisions. China's Supreme Court, along with its provincial and local courts, acts as the prosecutor of criminal violations.

As a result of these provisions, US companies are obligated to carry out careful oversight of their activities in China, including government relations, sales, and marketing activities. In USCBC's 2012 annual membership survey, members ranked competition with companies not following FCPA as a top ten issue. These companies reported that their competitors in China—domestic and foreign—may be subject to less rigorous compliance laws in their home countries, or may be skirting Chinese laws on corruption to gain market advantage.

Compliance Programs: Competitive Challenges and Consequent Benefits

Competitive Challenges

Competition with companies not following FCPA was a top operating challenge for US companies in 2012. USCBC interviews in 2013 reveal that around 60 percent of companies surveyed are more concerned with competition from firms not following FCPA strictures than with managing compliance program enforcement in China. Only 27 percent say they are more concerned with local enforcement of compliance programs.



USCBC's 2013 annual membership survey—conducted at the same time as these compliance interviews were being conducted—further confirms this sentiment. Of responding companies, 35 percent indicated that their compliance with FCPA resulted in a loss of business—such as not being selected in a government procurement tender—to a competing company not bound by the same restrictions. Most of these companies agree that it is extremely difficult to prove that competitors received some benefit from engaging in non-compliant behaviour.

Respondents say that these perceptions about the competitive disadvantage of US companies are extremely important because they have a direct bearing on how local employees respond to internal compliance programs, training, and requirements. Companies identify a number of challenges in enforcing compliance in China:

- **Compliance benefits underappreciated in the China operating environment** Companies state that being a good corporate citizen in China simply because it is "the right thing to do" is seldom understood or appreciated in the local market. And because of the lack of a level playing field for market access and daily operations, internal company restrictions on government interaction (in terms of both quantity and quality) often result in self-imposed limits that make doing business harder. For example, company compliance practices may prohibit an employee from engaging in informal entertainment activities with government officials when their company or industry is being selectively investigated by a government agency. This can have a negative impact when a company undergoes a Chinese government investigation in which strong government relations can result in increased process transparency.

- **Potentially bureaucratic processes** Interviewees have also commented that companies' compliance processes can easily become highly bureaucratic, with larger companies often creating complex or un-navigable compliance procedures. Therefore, such policies can be difficult for local employees to understand and comply with, and even more difficult for companies to enforce.

- **High costs** It is very expensive for companies to formulate and maintain a large internal team to manage compliance, as well as absorb the expenses for training, monitoring, compliance audits, and compliance reporting system maintenance. Additionally, companies report many hidden costs in compliance policy enforcement. These are largely the result of employee termination and include severance packages, recruiting, and the time lost to training new staff so they can meaningfully contribute to company operations.

Consequent Compliance Benefits

Even with the above challenges, none of the companies interviewed question the necessity of running these compliance programs, largely because tangible and intangible benefits outweigh the negatives:

- **Protection** Compliance programs lower operating risk by drawing clear behavioural lines for staff. Interviewees report that clearly defined norms are particularly important in China. Employees there have high expectations of receiving clear directions on behavior, even when it comes to mundane and routine situations that have no relation to government interaction.

- **Company branding** Many companies state that compliance programs help raise credibility for a company's brand and products, especially in light of regular product safety scandals.

- **Lower costs** Companies report reduced expenses due to limiting entertainment budgets for government officials. They also report lower costs from cutting the use of distributors to limit the risk of FCPA violations. In addition, companies that follow FCPA rules reduce their risk of high-cost litigation, government-imposed fines, unfavourable market reactions (due to weakened brand reputation), and requiring senior management to spend excessive time and attention on official government investigations.

- **Better ability to manage government expectations** The threat of FCPA-related investigations and penalties allows US companies to establish clear internal "lines in the sand," and helps the company explain to third parties the activities in which they are permitted to engage. Many companies interviewed say that the FCPA makes it easier to define and defend their government relations practices. For example, it may be difficult at first to decline a government employee's request for special treatment, but repetition of this FCPA-related message over time ensures that the government official will expect this response and no longer ask for special treatment. This does not mean there will not be some business lost. However, generally speaking, officials eventually do stop asking for favors. Companies report that "sticking to your guns" allows the relationship to be more professional and business-focused. One company executive says, "FCPA equips our company with a shield in China. As these policies become more prevalent in Chinese business culture, distributors, suppliers, and government officials increasingly understand these are rules that foreign companies are forced to live by and are inflexible in breaking them. This effectively pre-empts inappropriate discussions and generally helps avoid these situations."

- **Human resources** Compliance policies can be an incentive for recruiting new talent. Two companies note that potential talent was very interested in companies that forbade them from engaging in non-compliant activity – something they may have been encouraged to do in their previous positions.

Company Example

One US company saw tangible benefits as a result of its compliance programs. In 2007, the company's China business unit was tasked with evaluating local distributors' compliance with FCPA. At the time, the company employed 300 distributors operating on their behalf in China. Following its analysis of all distributors, in 2008 the company eliminated fully two-thirds of them, lowering the total to 70. Consequently, the company's profit margins increased 17 percent.

Managing Requests from Government Stakeholders

FCPA sets guidelines for, but does not forbid, interaction between companies and foreign government officials. However, to avoid any potential risk of FCPA violation, some US companies prohibit their employees from entertainment and gift exchanges with government or quasi-government entities. Prohibiting interaction with government officials could result in two possible negative outcomes:

- Employees are unable to maintain working relationships with government or quasi-government entities with whom they need to interact for business.
- Employees find other ways to maintain relationships that are forbidden by company rules.

In the first scenario, the company's business is impacted, while in the other, an employee may be prompted to act unethically. As one legal counsel says, "a perfect policy intends to bring risk to zero; however, enforcement in practice is nearly impossible."

The goal of FCPA is to prohibit US companies from bribing foreign government entities to secure immediate or future preferential business outcomes. However, in China's often opaque and highly discretionary business licensing and approval environment, the breadth of what could constitute an FCPA violation places additional burdens on companies, according to respondents, even in the simple day-to-day management of routine operations. Based on USCBC interviews, the non-transparent implementation of rules and regulations by PRC government agencies can result in some officials taking advantage of their own authority. In situations in which an official has the authority to conduct inspections or decide procedures for product approval, companies are faced with a difficult situation. There are significant concerns about retaliation among companies that turned down requests from approval authorities or inspectors. While retaliation is difficult to prove, examples include longer licensing and approval processes, unfounded requests for unnecessary documents, and much higher inspection frequencies.

Companies cite numerous examples of the types of benefit requests they receive and some of their common strategies for handling these requests:

- **Requests to visit global headquarters or manufacturing facilities in other countries** Companies take different approaches to these requests. Some strictly prohibit company-sponsored international travel for government officials. Others cover trip expenses in narrow sets of circumstances. These companies describe the general practice of company-sponsored economy flights directly to and from company sites with additional limits on in-country travel expenses as a proportion of time engaged in official business. Approvals for these requests tend to be time consuming and generally require the approval of global compliance personnel. Other documentation often required to approve a travel request include detailed agendas and business rationale for the trip; itinerary and cost quotes issued by an approved travel agency; and detailed name list with titles, birthdays, and participant affiliations. Trips to popular American destinations such as Las Vegas—a favourite of Chinese tourists—are broadly prohibited.

- **Requests for job or internship opportunities for associates** Twenty percent of companies have been approached with such requests, with around two-thirds of these reporting they refused. The remaining one-third of companies report taking the request into consideration rather than immediately turning it down. For many companies, the best mitigation strategy is to provide information on public application channels while saying the company is happy to consider a particular application. In these cases, it is also important to note that company policy precludes special consideration for certain candidates.

- **Requests for company sponsorship or advertising** This particular request tends to come from government officials working in high-tech or investment zones. These officials often request sponsorship for sports tournaments or advertising in local magazines. Some companies say that they are able to refuse these requests by explaining the challenging internal approval process—especially lead time—that must be undertaken in order to receive approval for sponsoring events.

- **Requests for services from a specified third-party service provider** Companies report that one of the most common requests from local officials is to use a specific company for third-party services, such as auditing tax records; customs clearance; or office furnishing. Respondents note that these requests are more difficult to deal with as they may be legitimate, and—in fact—government licensing practices are such that companies may legally and legitimately need to use a government-designated service provider. But multinational companies tend to adopt international practices for using services providers, in which global corporate headquarters choose the service provider for its China branches. Because of this, many companies turn down this type of service request. Some companies overcome these requests by reporting them to higher government authorities with which the companies have long-standing relationships.

- **Request for gift cards** Companies report receiving requests for gift cards from agencies during inspections. Respondents note that they generally refuse such requests by citing company rules forbidding giving gift cards and—more recently—by citing evolving Chinese rules that place greater restrictions on the giving of gift cards.

- **General expectations for gifts** Respondents point out that the expectations of specific government offices vary by geography and government function. Nevertheless, in many instances, whenever a local official visits a company site, there is an expectation of being presented with a gift. Companies report that for local government officers in first tier cities, a company-branded gift is usually fine; in second and third-tier cities, officials may ask for cash reimbursement or entertainment. Respondents note that although they turn down requests for cash reimbursement and entertainment, they tend to experience negative impacts on their licensing or business development work whenever they do so.

Compliance Programs: Structures and Reporting Lines

Companies employ a wide range of reporting structures to manage links between compliance personnel in China and the rest of the company. Many firms stress the importance of a semi-autonomous local compliance team for adapting global company practices to China's unique cultural expectations. Respondents note that compliance practices implemented and enforced by an international team without China experience risks creating internal bureaucratic structures that are not suitable for China's fast-paced market. Such enforcement may also alienate local staff, discouraging rather than encouraging full acceptance of compliance practices.

Interviews suggest that companies use a variety of structures in managing compliance. Some companies elect to have a dedicated compliance officer, or they include a compliance component in the responsibilities of specific staff members. Nearly 40 percent of interviewed companies report employing full-time compliance officers at the local level (either covering China or Asia-Pacific). Of those, only 20 percent employ dedicated compliance officer at the regional level. Respondents claim that setting up a dedicated compliance officer position ensures there is just one specific point of contact for all compliance-related matters, allowing other staff to focus on their specific responsibilities.

Companies that do not employ dedicated compliance personnel instead delegate compliance responsibilities to other company functions. The people in these positions—such as legal, human resources, and finance—typically interact with government officials in the course of their daily work as well.

Some common reporting structures:

- **Direct report to Asia-Pacific leadership with dotted line reporting to China and US compliance heads** In this structure—the most common among companies interviewed—the senior compliance staff in China reports directly to the Asia-Pacific chief legal counsel or managing director, with a dotted line to the compliance leader in the US. This structure gives greater authority to local compliance staff in formulating local compliance policy. Companies also report that this structure can result in better engagement with local staff, as compliance approvals are often gained more quickly within the market instead of waiting for global team deliberation and response.

- **Direct report to the US compliance head with dotted line reporting to China leadership** In this structure, the senior compliance staff in China report directly to the compliance leader in the US, with a dotted line to the China president. This structure tends to restrict the scope of allowable activities in which employees can engage, and can greatly lengthen the time from request to approval. Companies with this structure seldom tailor compliance programs to China. However, respondents note that this structure is perhaps the most secure, since it ensures that headquarters is apprised of all market activities. Based on USCBC interviews, only those companies with small China footprints—and thus less need to manage a large number of internal requests—utilize this compliance structure.

- **China compliance committee direct report to China leadership with dotted line reporting to the US compliance head** About 25 percent of interviewed companies report using a China compliance committee staffed by the head of country operations and other local company leadership, including dedicated compliance staff and the heads of sales, government affairs, and human resources. Such committees are generally headed by (and report to) the China head, with a dotted line to the compliance leader in the US.

  Under this approach, the committee meets regularly to discuss compliance issues, such as specific approval requests, compliance investigations, and changes to compliance practices across business groups and functions. Depending on the size of the company and the amount of direct engagement with government or quasi-government groups, a committee may meet as often as every two weeks but no less than once per month. In instances when large approvals are sought or when internal ethics practices are egregiously violated, the committee may seek guidance from corporate functions in the US.

Less commonly-used structures include:

- **Multileveled compliance committees** For some companies, compliance committees are active at all levels: global, regional, country and specific business units. These groups conduct risk appraisals according to their levels and coordinate as the need arises. However, most companies with this structure cite infrequent communication between committees, which can lead to problems for consistent implementation of compliance practices.

- **Senior executive as compliance manager** In this structure, the senior country executive is responsible for all compliance matters. Only companies with a small presence in China can realistically utilize this structure, as the time commitment for managing compliance is large.

Compliance Programs: Adapting Global Policies to China

In more than 30 interviews with US companies operating in China, USCBC found that compliance programs have changed significantly in the past five years, in terms of both rule making and enforcement. Companies report that the cultural norms in China dictating the management of relationships with government and non-government stakeholders through meals, entertainment, and gift giving create significant challenges to imposing global compliance practices on China operations. For example, nearly all companies interviewed say they send moon cakes—a traditional baked good given during the Mid-Autumn festival holiday—to government and commercial contacts. At the same time, most respondents report challenges in convincing the global team of the importance of giving gifts in accordance with this local tradition.

More than 90 percent of interviewed companies report that compliance policies are developed by their global teams and then implemented in specific regions. Nearly 60 percent of interviewed companies have China-specific rules, built on compliance principles set by global management. Policies that diverge from global practices tend to take into account local cultural conditions and are primarily focused on entertainment rules and compliance reporting structures.

Factors that drive companies to set China-specific rules include:

- FCPA enforcement has strengthened in the past five years. From 2005 to July 2013, there were 18 US SEC FCPA cases related to US companies' behaviour in China.[2] A China-tailored practice can help mitigate risks specific to that market.

- US companies' business in China has expanded quickly in the past five years, offering strong growth as the rest of the world contracted during the financial crisis. This has resulted in the increased importance of China for many companies. As data from USCBC's 2013 membership survey shows, 96 percent of respondents view China as their top priority market or as one of the company's top five priorities for global investment. As a result of China's prominence in investment planning, companies perceive that there is an increased need to employ a tailored compliance practice to better fit the local culture and needs.

Below are two different cases of US companies managing their specific China compliance practices under their global policy umbrellas. In each scenario, the situation changed due to local business and operational needs.

- **Case 1** One company in the chemical industry prohibited all gift-giving and entertainment with government officials or SOE executives because the global organization had no specific policy on gift-giving. Consequently, employees complained regularly of being perceived as disrespectful and

[2] SEC: FCPA Enforcement Action: http://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml

insensitive. To address employee complaints, the regional unit stressed to the global team the importance of maintaining government relationships with appropriate entertainment and gifts, as neglecting them could negatively impact the business. Consequently the global team granted permission to regional staff to develop China-specific guidelines. As of this writing, the regional legal counsel is working to draft China-specific gift and entertainment rules, which would clarify allowed activities, thresholds, and approval authority.

- **Case 2** Before the end of 2012, another company in the chemical industry reported that all entertainment-related expenses required approval from the global team, a time consuming effort. This damaged the enthusiasm of local employees, leading many to avoid engagement with government entities. This negatively affected business, so the global team modified the rules to authorize the China team to approve meals of less than RMB 300 ($48) per person and gifts of less than RMB 200 ($32) per person.

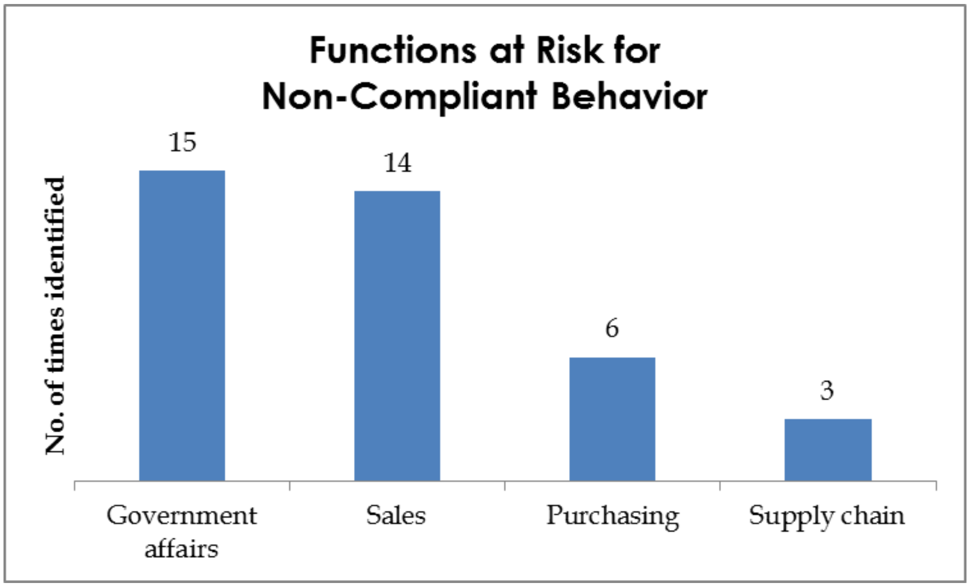
Whether regions are allowed to develop specific compliance rules depends largely on the local team's efforts to communicate local conditions to their global policymakers. Companies that have experience working with global teams to loosen domestic compliance rules report that local teams are more persuasive when they present detailed plans with specific thresholds, approval limits, and reporting authority.

Compliance Programs: Assessing Risks

Risk assessment is one of the essential starting points for many companies' compliance programs. Such evaluations help companies identify the highest compliance threats in their operations, determine which job functions and practices are involved, and develop strategies to manage them. Internal compliance personnel generally take the responsibility for conducting these evaluations, which vary from company to company. Companies report a number of methods for assessing risk, including direct conversations with local business units, regional offices, and frontline employees. Other companies go a step further and conduct internal surveys to collect risk factors from targeted functions and employees.

Many companies report that employees directly interacting with government agencies or quasi-government entities tend to be at higher risk for non-compliant behavior. In the USCBC survey, interviewees identify the following positions as falling into some of the highest risk categories (companies were permitted to identify multiple positions in their response):

- 59 percent of companies list government affairs;
- 51 percent of companies list sales and business development;
- 22 percent of companies list procurement; and
- 11 percent of companies list supply chain.



Location is another risk factor. Many multinational companies with operations across the Asia–Pacific region say that they do not view China as the worst market for compliance. Instead, Indonesia, Malaysia, and India are considered higher risk markets.

Companies that conduct risk assessments typically submit the results to management, which then designs engagement plans to address areas of concern. These plans often include increased training for high-risk employees and thorough monitoring of high-risk positions and regions, based on assessment results.

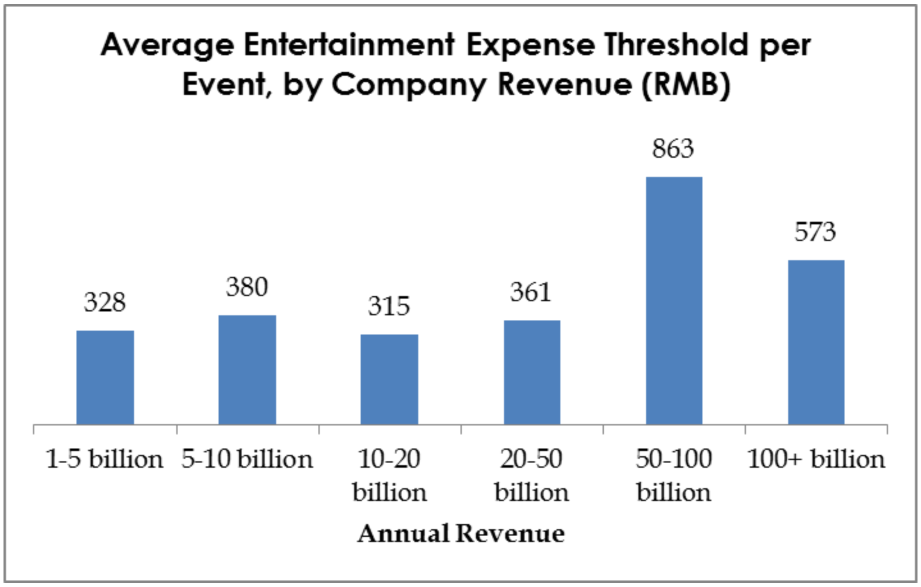
Compliance Programs: Expenses and Gift-giving Thresholds

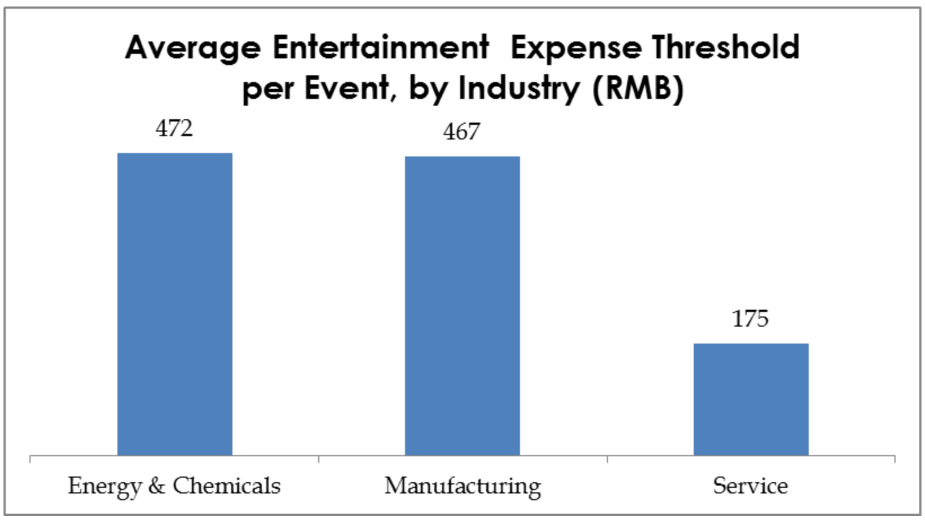
One of the top compliance questions received by USCBC relates to monetary thresholds associated with commercial and government entertainment. As such, a large portion of this report is dedicated to reviewing these practices in detail.

Entertainment

Companies across industries employ a wide variety of methods to oversee entertainment expenses for government and quasi-government officials. Fully 94 percent of companies report using mandatory monetary thresholds—limits on the amount that can be spent on entertainment and gift giving—for expenses with state actors. According to interview results, **the average threshold for entertainment expenses in China is RMB 443 ($72) per event. The range of variance is RMB 150 to RMB 1220 ($24-197).** Of companies that report using monetary thresholds, 44 percent use global company-wide limits in US dollars, while 56 percent keep thresholds in local currency to better address local market conditions.

Approval thresholds are generally set by global corporate organizations. In some cases, these thresholds may exceed what is deemed necessary for local operations and may be lowered. In China, for example, one respondent cites a global pre-approved threshold of RMB 300 ($48) per person for meals with government officials. The local compliance counsel decided this threshold was too high and instituted a local RMB 200 pre-approved limit.





Some companies take pre-approved limits a step further and use varying thresholds depending on the cost of living in various cities across China. For these companies, thresholds in cities such as Shanghai and Beijing are comparatively higher than those for less expensive cities like Changsha and Xi'an. These thresholds are usually set in consultation with local business leaders and after comparing local purchasing power to that in cities such as Beijing and Shanghai.

Companies that rely on dollar-based valuations report that they face yearly purchasing power erosion as the RMB gains in value on international currency exchanges. In order to ensure that spending limits remain consistent with global exchange rates, local purchasing power, and corporate global policies, annual reviews of these thresholds are typically required.

Gift Giving

In the Chinese cultural context, gift giving has long been a component of business collaboration. However, recent Chinese government anti-corruption campaigns and increases in FCPA prosecutions have led many companies to re-evaluate their gift giving processes to ensure compliance with both domestic and international laws. Additionally, as a result of evolving Chinese government business practices, many companies report that local government officials in developed Chinese cities no longer expect gifts to be exchanged during meetings or events.

The majority of companies interviewed discourage gift giving. When it is unavoidable, however, companies favor giving gifts of minimal monetary value with corporate logos. Flash drives, calendars, notebooks, and small toys that directly relate to the company's business are generally considered appropriate. These gifts are very low in value, often costing no more than RMB 50. They are also often pre-approved for giving. In exceptional circumstances – such as when a global CEO visits China and engages with government officials—more expensive gifts are usually exchanged. Some companies prohibit the gifting of items such as cigarettes, alcohol, and cash. Companies are divided over the appropriateness of gift cards, with some saying they are acceptable if tied to non-transferable expenditures (such as movie vouchers), and others saying gift cards are inappropriate under any circumstances.

While most companies prefer inexpensive corporate-branded gifts, most still maintain certain thresholds for gift-giving beyond this level. **The average threshold for gifts across all companies interviewed is RMB 354 ($57).** Twelve percent of companies do not allow gift giving outside of branded gifts, while 12 percent of companies allow no gift giving whatsoever.

Company Example

In an effort to pre-emptively discourage suppliers, customers, and partners from sending gifts during the Chinese holiday season, one manufacturer proactively sent letters informing the stakeholders of their policy of not accepting gifts. The first year this practice was instated, local staff reported negative feedback from stakeholders. Over time, however, this practice was accepted and has significantly cut down on gifts received by company employees.

Compliance Programs: Expense Approvals

Expense Pre-approval Processes

Generally, companies split expense approvals into pre- and post-approval processes. Pre-approval processes require employees to gain approval before money is spent on entertainment or gift giving. Post-approval processes, conversely, allow employees to pay for entertainment or gifts and then submit relevant receipts for reimbursement. Discussions with member companies reveal three different pre-approval processes for entertainment and gift giving expenses:[3]

- **Pre-approval for any government related expenses** In a typical pre-approval process, an employee submits an application to the regional leadership team for review. Depending on the level of expense, applications may need to be submitted to the global compliance counsel. Twenty five percent of companies interviewed require pre-approval for any government-related expense. Companies that operate in highly sensitive industries—such as medical devices or pharmaceuticals—or whose operations include a high number of employees in high-risk functions tend to require pre-approval for all government-related expenses. While these processes can help a company control potential risk, they can also result in employee dissatisfaction: because such approvals can take as long as two months, they often delay commercial operations to a significant degree.

  Many companies with repeated government interaction set frequency restrictions on the number of times an employee is allowed to entertain a specific government official. Most companies allow three meals with one government official per year. If this limit is exceeded, an employee must seek approval from higher authorities. However, other companies view frequency limits differently. One manufacturing company considered instituting frequency restrictions, but after a considerable effort to make the process practical for employees, it decided not to do so.

- **Pre-approval for any expenses that exceed a pre-approved monetary threshold** The majority of companies—51 percent of those interviewed—set pre-approval expense thresholds that are tailored to various employee functions and levels. These levels are guided by global limits and may generally be adapted to fit the local market. Only those expenses that exceed these pre-approved amounts required additional approval. Many companies implement rigorous approval processes for expenses that exceed thresholds. Such expenses often require approval from the most senior regional staff and additional approval from the global compliance counsel. Companies reported that these approvals can be significantly more time-consuming than the normal process. Acceptable reasons for exceeding approval thresholds included meetings during senior government official visits, visits from company senior global leadership, and large corporate events.

- **No pre-approval required** Only 16 percent of companies surveyed report having no pre-approval or pre-approved threshold expense requirements. These companies tend to have a small presence in China. Under this approach, employees who may need to engage in entertainment and gift-giving often work closely with the company's local approval authority (often the country head of operations) on expense-related issues, keeping that person apprised of any anticipated expenses.

[3] Respondents were allowed to select between a number of targeted processes. Multiple responses were allowed.

Company Example

One manufacturer noted that a recent change to mandatory pre-approval for all government interaction negatively impacted the company's working relationship with the government. Because government engagement in China was frequently unscheduled, with officials popping by unannounced or with very short advance notice, and because pre-approval was managed by the US legal counsel, employees who engaged with government officials found themselves refusing these meetings, to the detriment of the overall relationship. This company recommended including language in the compliance policy that permits meetings or minor expenses if engagement with a government official is needed and occurs spontaneously.

Companies interviewed require similar information in approval requests:

- Names, titles, and affiliations (government official, agent, company, etc.) of attendees
- Projects associated with the expense
- Location
- Goal of the expense
- Requested approval amount
- Other information tailored to the nature of the expense

Companies report three ways of requesting approvals: through email, a physical application form, or an online pre-approval system. In China, the majority of companies interviewed require both a physical application form and an email.

Fifty-seven percent of companies utilize email as the primary application method. These allow for immediate digital transmission and can include all required information. Email also allows employees to receive formal approval from managers who are out of the office on business. However, managers report that while emails are relatively simple to send, tracking approvals over the long term is less efficient. For those managing multiple staff members, identifying specific email requests among hundreds of daily email messages can be difficult.

Thirty-two percent of companies interviewed utilize physical application forms for all pre-approvals, with a majority of companies requiring physical applications for any expenses exceeding a set threshold. This system provides a physical paper trail that can be filed and referenced as needed. However, physical documents also have downsides. Complex approvals often require multiple signatures from senior management, and assembling the required signatures can be time-consuming.

One employee notes that the pre-approval process can take as long as two weeks, while physical applications are exchanged among travelling senior staff. In addition, physical documents can easily be misplaced. Lastly, for large organizations, where hundreds of such approvals are concurrently under consideration, managing employee expenses requires personnel dedicated to inputting data into the company's electronic expense tracking system. This process is also time-consuming and raises costs by requiring dedicated staff.

Of the companies interviewed, fewer than 10 percent used pre-approval online systems. There were many reasons for this. One executive notes that in the US, the majority of business expenses are paid using corporate credit cards, which are tracked through online systems like Concur. In these systems, a pre-approval application lays out the details of a proposed expense, which is then sent to the necessary approval personnel. However, in China, where most expenses are paid with cash, expenditures are more difficult to track and online systems are less universally applicable.

The major benefit of online approval systems is the flexibility they allow in tracking a wide variety of expenses. One company, for example, universally applies a specific accounting code to all expenses for government officials. This allows for the immediate review of all expenses in that category. Online systems also have the benefit of automatically escalating applications to higher approval personnel if certain thresholds are exceeded. Once a manager approves an employee's expense, the system automatically notifies the next approval person. This saves time and ensures that senior authorities are notified only after lower authorities have signed off. Lastly, some companies require that certain staff, such as compliance officers, are notified about certain expenses. These may include entertainment expenses with all government officials or those that exceeded a certain threshold. Respondents note that online monitoring systems help ensure that appropriate parties are notified when these expenses arise.

Post-expense approvals and verification

After employees post work-related expenses, nearly all companies require a post-expense approval process handled by the finance department, regardless of whether approval has been obtained in advance. Employees must include all relevant documents: transaction receipts, pre-approval emails and signed physical applications, along with the names and titles of attendees. These companies generally require an employee to print their approval email and submit it with receipts when applying for reimbursement from the finance team.

The review of transactions is a critical last step to ensure employee compliance. Companies that do not require pre-approval stress that a rigorous post-expense approval process ensures employees make reasonable expenses. Furthermore, at the end of each year, managers in these companies typically receive a full list of employee expenses. This allows them to review the previous years' expenses and amended spending habits when necessary. This is a popular method for continued improvement in companies that are focused on cutting costs.

Company Example

One company discovered that some employees were expensing costs for personal taxi use. In response, the company required employees to handwrite where the taxi was flagged, where it was going, and the business reason for taking the taxi. This cut down significantly on non-business taxi expenditures.

Compliance Programs: Corporate Social Responsibility Activities

Companies report a variety of strategies to address compliance concerns that arise during the course of pursuing corporate social responsibility (CSR) initiatives. The majority of interviewees say that they do not participate in CSR activities with local Chinese companies or non-profits because of the perceived risk of giving to entities tied to government officials and the lack of transparency in the allocation of donated funds. Companies that do engage in these activities, however, prefer to work with organizations that have an international track record and a positive reputation or those that have a global agreement with the company.

The handful of interviewed companies that work with Chinese non-profit organizations have complex due diligence processes. Companies that have significant previous experience with local non-profits report that these processes can take up to two months to complete when approving new local entities. Companies with less experience interacting with local entities on CSR initiatives report that approval lead times can take as long as a year. Before such a partnership is considered, companies report requiring some or all of the following information:

- Disclosures on ownership
- Names and resumes of sitting board members

- Accounting records
- Media reports
- External auditor reports

If a partnership is approved, these companies use signed compliance contracts that obligate the Chinese partner to abide by FCPA requirements and allow the company to pursue monetary damages through civil litigation in Chinese courts should non-compliant behavior be discovered.

These companies also report that securing approval for a variety of non-profit organizations can be beneficial, depending on the company's long-term goals in the market. This allows companies to respond immediately to disaster situations and other situations in which they decide to donate on short notice.

Company Example

One manufacturer shared its experience trying to donate in response to the 2008 Sichuan earthquake. Due to its rigorous expense approval process, it was unable to donate immediately. In response, the manufacturer approved a number of non-profits covering a variety of different areas to ensure it was in a position to quickly make future donations. Consequently, when an earthquake struck Sichuan in 2013, the company was able to gain immediate internal approval for a specific donation to the charity that was pre-approved for natural disaster donations.

Compliance Programs: Training

Compliance training is a key component in ensuring that employees abide by company policies, particularly in markets unfamiliar with FCPA requirements. For example, one company notes that its Chinese staff members were surprised that company interpretations of FCPA meant restrictions on meeting with government officials. Staffers commented that the idea was completely foreign to them.

For this and similar reasons, respondents seem to stress that frequent and continuous training—along with top-level management support—is critical for instilling a culture of compliance in China. Additionally, companies say that training materials should not only be translated from English to Chinese, but that they should also be tailored to the China market and China-based employees. All companies interviewed report some compliance-related training for China employees.

For China operations, corporate compliance training tends to focus on internal policies and external laws. Training often includes specific modules on gift giving, entertainment, and engaging with government officials, as well as more general overviews of relevant international anti-bribery regulations, such as FCPA, SOX, Dodd-Frank, and related international regulations. Companies report the most success when training provides clear, consistent messaging that compliance is not negotiable and that certain types of behavior are strictly prohibited. Respondents note the importance of communicating this information to employees early and often, in order to continually reinforce messaging.

Respondents stress that adapting training to local market conditions is critical for helping local employees understand and internalize the message. For example, one company says explaining that the US government may bring charges under FCPA is much less persuasive than providing case studies of employees convicted of corruption in China. Additionally, stressing and providing real examples of how an employee can still engage in appropriate relationship building while staying within the proscribed compliance policies helps to lessen employee concerns.

Company Example

A company found itself overwhelmed with in-person training and discovered that training messages were not accepted by local staff. After interviewing a number of employees, the company realized its legal team was viewed as an enforcement group and was not trusted by employees. In response, the company created a "train-the-trainer" program, in which direct managers were trained by the legal team to conduct trainings themselves. This increased engagement because staff members were more likely to respect the opinions of someone who they work closely with rather than the legal team. Additionally, in an effort to keep compliance topics fresh in employees' minds, the company selected one basic compliance topic a week to be covered by all managers in country. These topics included declining bribes or best practices for sharing information with third parties. The legal team prepared two slides on the topic to ensure aligned messaging, thus limiting the workload of the commercial staff, but still getting the message out broadly.

Training primarily occurs in two ways: online and in-person. Most companies use a combination of the two forms, offering training in both English and Chinese. The frequency of training increases in direct proportion to the risk level associated with certain types of employees.

- **Online** Seventy-two percent of employers report requiring online training for employees. The average frequency of online training is twice annually. Online training allows employers to track the training status of all employees in a region and automatically notifies employees when training becomes available. Additionally, in companies with employees who frequently travel, online training allows participation no matter where an employee is located. However, because online training is less engaging than in-person training, many companies are concerned that employees participating in online training may not fully assimilate the ideas covered.
- **In-person** Sixty percent of respondents report having an in-person training component in their programs. These training sessions are generally conducted by human resources staff in conjunction with in-house legal teams. Companies who report successful training programs emphasize the usefulness of real-world examples to illustrate the importance of business ethics. Upon completion of training, most employees are required to sign an affirmation that they understand the content and agree to abide by company policy. This document is filed with the HR or legal team. Many companies report training staff in person only during large-scale meetings when teams are already together. Other companies conduct in-person training as needed.

Some companies also tie compliance training to employees' yearly reviews. For example, one company requires their employees to be trained three times per year, with employees allowed to choose from among several dates. If employees have not completed the requisite number of training sessions by the time of their yearly reviews, they are ineligible for bonuses.

Tracking who has undergone in-person training can be very challenging, as this information needs to be manually uploaded into electronic systems. Human resources, legal, and business unit staff may all be involved in tracking the frequency of employee trainings. One company includes this tracking responsibility in the job description of legal team administrative assistants—when they are not working on other projects, they are required to upload in-person training data into the system that tracks online training. The company notes that this is time consuming but much easier than using physical documents.

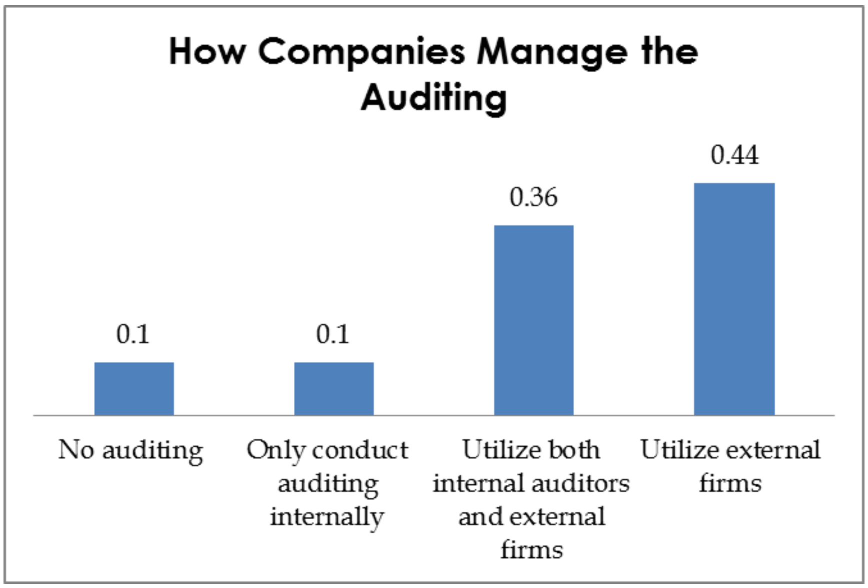
Regardless of what form compliance training takes, respondents stress the importance of clearly documenting training activities to ensure legal protection for the company, if an employee later engages in non-compliant activities. In addition, a company can move more rapidly to internally discipline non-compliant employees when it has documents that attest to compliance training.

Compliance Programs: Monitoring

The most common methods for monitoring compliance are auditing company expense reports and establishing whistle-blower mechanisms.

Auditing

Auditing can be conducted internally (by compliance officers, financial managers, auditing team members, etc.) or externally (by an outside firm). Auditors evaluate whether report expenses match invoices and they ensure that compliance guidelines are observed. Forty-four percent of interviewed companies use external, internationally recognized auditing firms to assess employees and third-party service providers. Additionally, 36 percent of the interviewed companies augment existing internal auditing with external auditing, either at regular intervals or randomly. Companies primarily utilize random audits to ensure a thorough, independent internal review.



A small number of interviewed companies—around 10 percent—employ only an internal auditing team to conduct random audits of their local operations. The size of the company appears to dictate how audits are conducted. Companies with a large China presence, for example, are more likely to employ a locally-based audit team, while smaller companies maintain a global audit team that they dispatch to respective markets when reviews are needed. To maintain compliance without in-depth audits and to save costs, some companies' local legal counsels or internal auditors conduct random compliance audits during regular business trips.

As mentioned above, risk assessment is usually the starting point for companies' compliance programs. The majority of companies interviewed report that auditing is based on risk profiles generated from this risk assessment. In these cases, audit frequency may depend on the risk associated with a particular department's function. For example, one company reports that it audits low-risk departments only once every three years, while it audits high-risk departments twice annually.

Auditing results are often reported to the global team and may be used as a basis for updating company compliance rules, revaluating risk, and identifying new challenges, as well as determining whether more training and monitoring activities need to be undertaken.

Whistle-blowers

All companies interviewed encouraged proactive employee reporting—i.e. "whistle-blowing"—when employees witness non-compliant activities. Companies describe a variety of reporting channels including compliance hotlines, web portals, and "open-door" policies. Several companies stress that non-reprisal—that is, forbidding negative action against an employee for bringing forward concerns—and anonymity are critical in making staff feel comfortable in disclosing information.

- **Compliance hotlines** Nearly all interviewed companies offer hotlines for staff to anonymously report compliance concerns. The most successful hotlines are those with multi-lingual support and local call-in numbers. These are frequently managed by independent third-party agencies. A number of companies noted that employees do not use hotlines if they are tied to a US number. Once a complaint is received, the third party translates it into English and provides it to the chief compliance officer—normally based in the US—who then decides whether an investigation is necessary. Because hotlines are often heavily advertised internally, employees frequently use it to communicate a wide variety of non-compliance related issues, such as complaints about salary and tips for management.

- **Web portals** Online databases allow employees to report compliance concerns anonymously. System reports are typically transmitted to global or local compliance officers, depending on the company.

- **Open-door policies** Employees are encouraged to speak freely with their managers and also the legal department. Companies report that in environments with open-door policies, legal teams need to put in effort to get to know employees and to be seen as allies rather than enforcers.

Companies express concern over one of the more controversial provisions of Dodd-Frank—the whistle-blower bounty program—which allows persons who provide information leading to a successful SEC enforcement to receive 10 to 30 percent of monetary sanctions. Companies feel that this provision makes it more difficult to manage and enforce employee compliance because employees know there is only a positive benefit (the possibility for significant financial gain) and no consequences (such as penalties for spurious claims) for reporting on their employers. One company in the chemical industry notes, "the DOJ is encouraging our employees to report compliance issues to them instead of raising issues internally."

Compliance Programs: Responding to non-compliance

Investigation

Upon discovering non-compliant behavior, most companies immediately initiate an internal investigation managed by either its regional or global team. For less serious violations, such as expense irregularity, regional teams conduct investigations and report their findings to the global teams. For more serious violations, particularly in cases involving an egregious compliance violation or an employee at or above the director level, a global team is usually brought in to manage the investigation. Companies use a variety of methods for investigating non-compliant behavior, such as:

- Assembling an internal investigative team comprised of HR, legal, local and global compliance representatives.
- Employing a third-party investigative company to evaluate the issue. Third parties can also be useful in interviewing alleged infringers. Such outside evaluations can add clout to a decision to terminate an employee.
- Utilizing internal auditors and external firms in the investigation process.

A small number of companies place specific limits on investigation timelines. One company, for example, requires initial investigations to take place within nine working days, while another caps investigations at fifteen working days. Such an approach ensures quick discipline for employees who engage in non-compliant activities. Additionally, in cases when a whistle-blower comes forward, short investigations can prove to employees that the company values the quick resolution of compliance issues.

Addressing Non-Compliance

- **Employee non-compliance** The majority of companies interviewed maintain a zero-tolerance policy for any compliance violations. However, because FCPA is not a Chinese law and because Chinese labor law makes it extremely difficult to fire an employee, companies note that relying on the general concept of "zero-tolerance" may make it difficult for companies to take quick and decisive action. One company recommends eliminating zero-tolerance policy wording from internal training materials and instead defining and clearly linking specific infractions to explicit punishments. This results in more practical and precise enforcement methods, especially when it comes to terminating employee contracts.

- **Service provider non-compliance** A number of interviewed companies note that if a third-party service provider is discovered to have engaged in non-compliant behavior, they terminate that contract. However, limited use of audits in the case of service providers may hamper the ability of companies to discover non-compliant behavior, effectively limiting the usefulness of compliance clauses within the contract.

Managing Compliance with Joint Ventures

Joint ventures (JVs)—either majority or minority owned—add a layer of complexity to company efforts to ensure FCPA compliance. Working with a Chinese partner to instil compliance culture and monitor compliance practices within a JV can be difficult. Regardless of difficulty, companies may be liable under FCPA for anything that their JV does, even if it is a minority partner.

Nearly all companies interviewed stress the importance of continually discussing compliance to ensure that it is considered a priority in the partnership. A foreign partner may often not have direct input on the JV's day-to-day operations. Therefore, respondents note it is vital to ensure that senior leaders at the JV company continually reinforce the compliance message. Companies generally agree that influencing a JV partner is challenging and has limited efficacy in the short term. Respondents note that the most effective changes come from continual reinforcement over the long term. Respondents also stress the necessity of discussing all compliance-related policies before a JV partnership is finalized and enshrining such policies in the final contract.

- **Reinforce compliance continually** As with internal compliance policies, companies say that compliance should be raised continually, both formally and informally. Formally, a company can include compliance topics on the official agenda of JV board of director meetings. Some companies also report sending compliance training teams to work with the JV during employee training sessions. However, this can open the company—whether a majority or minority stakeholder—to the risk of legal liability if the JV is found to engage in non-compliant activities.

- **Raise issues through all available channels** Formal channels should be pursued whenever possible to reinforce the importance of compliance in the partnership. However, because of the cultural nuances of conducting business in China, respondents say it may be more effective to work behind the scenes with key company leaders to win their support for more stringent compliance observance. One company reports securing greater buy-in on their compliance programs by seeking support from leadership privately before pushing publically.

Twenty-three percent of companies who reported having a JV with a Chinese company reserve the right to audit the JV, with the right codified within the JV contract. These companies report that auditing is a way to evaluate their partner's compliance program. Once an audit has been completed, a company is better equipped to persuasively discuss and compare the two companies' compliance practices and recommend modifications to the Chinese company if necessary.

Company Example

One company shared its experiences with a long running JV, in which it had recently acquired a majority share. Having repeatedly encountered compliance problems over the years, the company understood that compliance decisions were often resented by the JV's employees and ineffectively implemented. In response, the company created a neutral committee to oversee JV compliance policy changes, interface with the JV legal teams, and handle compliance infringement within the JV. The committee was made up of one manager from the foreign company, one manager from the partner company, one manager from the JV, and one legal representative from each company. The company has found that this independent body's decisions are more effectively implemented and better respected by the JV employees.

Managing Compliance with Third parties and Associations

Third parties

All US companies in China utilize third-party service providers, such as professional services firms (consulting, law, tax, etc.), distributors, suppliers, and agents. Companies have a wide variety of practices to ensure the third party is compliant with international regulations. Risk assessments, background checks, and audits are all methods a company can use to evaluate the risk posed by partnership with a third party. Each company interviewed evaluates risk differently, but generally, sales agents, public relations agencies, and customs brokers are classified as the most high-risk groups.

- **Due diligence** Seventy-seven percent of companies require third parties to go through a due diligence process before signing a contract. These companies often utilize external firms to conduct background checks. Of those companies that require a due diligence process, only 8 percent do so internally. One company notes that depending on the scope of an investigation, an internal check can be extremely time consuming. Some companies focus these efforts only on certain third parties with high compliance risk, such as sales agents.

- **Training** Besides due diligence, many companies provide compliance training to third parties. Due to the logistical challenges of assembling these groups as well as the perception that the company is meddling in the internal operations of third parties, only 26 percent of companies report providing training to their service providers. Training is typically highly targeted—for example, training for sales representatives in specific territories—and it includes information about acceptable practices and policy breaches. Some companies do not train their third-party partners, due to liability concerns. If a third party is discovered to have engaged in non-compliant behavior, a company may be legally culpable if it was actively involved in training the third party regarding compliance practices. Under FCPA in particular, this is an area that is not well defined.

- **Auditing** Among the many precautions companies take to limit risk from third parties, respondents say that auditing is one of the most difficult. Auditing requires significant manpower commitments and depends on the creditability of information provided by contractors. Only a very small number of companies report initiating internal or external audits of service providers, though most include an

FCPA clause in third-party contracts to preserve auditing rights. Overall, respondents say that auditing third parties can be very difficult and time consuming.

- **Third-party service provider** Some companies report that they set very strict approval processes to discourage the use of third parties and thus decrease compliance risk. For example, one company requires any new sales agents to be approved by the global vice president. Such an approval takes a lot of time and communication, which consequently lowers the frequency of contacting new sales agents. By limiting the use of third-party contractors, companies may limit their risks for non-compliance.

  Other companies use third parties as a way of limiting direct liability and shifting risk. For example, a company may contract third-party service providers to deal directly with government agencies in an effort to reduce the company's direct risk of FCPA violations. Companies note that it is often more difficult to manage third-party compliance, but that outsourcing may shift some compliance culpability away from the company. Nevertheless, respondents stress that a company may put itself at risk if it utilizes a third-party service provider, because it would still be liable under FCPA.

Trade Associations

The majority of Chinese trade associations are sponsored by the government in some form, so some companies incorporate tailored policies to govern interactions with these groups. They usually categorize association executives as government officials in internal compliance rules, and they limit entertainment activities and require special approval process. Some companies also require FCPA clauses to be included in association agreements, which are drafted by the association and signed by companies. Due to the rareness of these relationships, fewer than 10 percent of companies have made specific compliance rules for interacting with Chinese trade associations. Generally, companies report being less concerned with FCPA than anti-trust considerations when dealing with trade associations.