AMBA 660 Case Study

GSK China Scandal: A Risky Business?

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A Chinese court found GSK guilty of bribing doctors and hospitals in order to boost its sales in the country. The company was also charged with using pharmaceutical industry groups and travel agencies to channel the bribes to the recipients. China started its investigation of GSK executives in June 2013 and convicted them after 15 months. GSK was fined $489 million, which was the largest corporate penalty ever imposed in the country. For comparison, "the three largest settlements under the U.S. Foreign Corrupt Practices Act (FCPA) are Siemens AG ($800 million), KBR Inc./Halliburton Co. ($579 million), and BAE Systems ($400 million)" (Legal Monitor International, 2014, para. 2)

Mark Reilly, GSK's former China Head, and four other executives were also convicted. Each received suspended prison sentences of between two to three years. These reduced sentences were due to their confession and cooperation in the investigation (Legal Monitor International, 2014).

The GSK case reflects an increased Chinese emphasis on enforcing its anti-corruption laws against foreign companies and individuals who pay or offer bribes. Historically, China's anti-corruption efforts were focused on Chinese government officials who received or solicited bribes. The GSK convictions reflect the Chinese determination to move beyond that historical focus. Foreign companies and employees doing business in the country should be aware that they operate under China's anti-corruption laws, in addition to their home countries' laws, such as FCPA (United States), and the Anti-Bribery Act (UK) (Legal Monitor International, 2014)

GSK: History & Background (Hoovers, 2016)

In 1873, Englishman Joseph Nathan established an import-export business in New Zealand. He bought the rights to a process for making powered milk, and started selling it under the Glaxo brand. Nathan's son Alec was sent to London to run their business there. The Glaxo brand became a household name after the publication of a guide to child care; the Glaxo Baby Book. After World War I, Glaxo began distribution in South America and India.

In 1927, Glaxo introduced its first pharmaceutical product, *Ostelin* (a liquid vitamin D), and continued to expand globally in the 1930s. During this period, the company introduced *Ostermilk*, a vitamin-fortified milk. Glaxo began making penicillin and anesthetics during WWII; and went public in 1947. A sharp drop in antibiotic prices in the mid-1950s forced the company to diversify, and buy medical instruments businesses, veterinary companies, and drug distribution companies. Glaxo began its US operations in 1978.

In 1980, Glaxo abandoned its non-pharmaceutical operations. In 1981, its antiulcer drug, Zantac became a market leader in this sector. In 1995, Glaxo bought its British rival Wellcome. In 1997, Glaxo created a new genetics division, buying Spectra Biomedical and its gene variation technology. In 1998, the company Glaxo ended its joint venture with Warner-Lambert that had begun in 1993. In addition, Glaxo sold the Canadian and US marketing rights to Zantac.

GSK Overview

GSK is a global healthcare company that operates in more than 150 countries, and has 89 manufacturing sites worldwide. The company has R&D centers in Belgium, China, UK, and USA. The company's product portfolio includes (GSK, 2016):

A. Pharmaceuticals: Leader in respiratory diseases and HIV medication (£ 14.2 billion turnover, 60% of group turnover).

B. Vaccines: The company produces 39 different vaccines; 690 million doses were sold in 2015 (£ 3.7 billion turnover, 15% of group turnover).

C. Consumer Healthcare: Includes oral health, wellness, skin care, and nutrition. The company's portfolio of global brands includes Panadol (Tylenol equivalent), Sensodyne, Horlicks, and Voltaren (£ 6.0 billion turnover, 25% of group turnover).

In 2015, GSK bought Novartis' vaccine business for $ 7.1 billion, and sold its oncology line to Novartis for $ 16 billion. The two companies also merged their consumer healthcare operations creating the world's top provider of OTC (over-the-counter) products (Hoovers, 2016).

GSK: Competition

2015 Key Figures	**GSK**	**Pfizer**	**MSD**	**Novartis**
Annual Sales	$35.46B	$ 48.85B	$ 39.50B	$ 50.39B
Employees	101,255	97,900	68,000	118,700
Market Cap	$196.56B	$ 199.33B	$ 146.90B	$ 204.25B

Source: Hoover (2016)

GSK: Basic Financial Information (GSK, 2016)

Sales (2015)	$ 35.46 billion
Sales Growth (vs. 2014)	(0.75) %
Net Income (2015)	$ 12.48 billion
Net Income Growth (vs. 2014)	191.7 %

GSK: Code of Business Conduct (GSK, 2014, 2015)

GSK trains its employees at all levels on its compliance program to ensure that its code of business conduct is understood and abided by. This includes new intakes, as well as recertification for existing employees.

GSK mentions that it has zero tolerance for corrupt practices and bribery: "*Our Code of Conduct is not negotiable. It is absolutely essential to how we achieve success.*"

GSK provides a hotline for reporting violations and non-compliance with its code of business conduct. Included in the Code of Business Conduct is whistleblower protection: "*GSK encourages everyone to report concerns without fear of reprisal.*"

"We operate under many legal and regulatory requirements which protect patients and consumers around the world. As a global company, this means the laws and regulations in one country can impact business activities in another. For example, our Corporate Integrity Agreement (CIA) with the US government has stringent obligations that reinforce US healthcare laws and programme requirements associated with engaging US healthcare professionals and activities anywhere across the globe. These US requirements are explained in detail on our GSK Code of Conduct and company policies resource centre. We are expected to seek guidance from a Compliance Officer or Legal Counsel if questions arise on the impact and relevance of different countries' laws on our local activities."

"*Failure to comply with the Code of Conduct, GSK policies, or applicable legal and regulatory requirements will result in disciplinary action up to and including termination of employment. This also applies to managers who ignore violations or fail to detect and/or correct them."*

"*No matter where we operate in the world, we must live by our values, be aware of, and abide by, the legal standards and regulatory requirements applicable to our business."*

If the code is so solid, then what happened at GSK China?

Laws governing GSK's Chinese operations:

1. Chinese criminal and antimonopoly laws.

2. UK Bribery Act (GSK is headquartered in UK).

3. FCPA of 1977 - as amended in 1988 (GSK is listed on NYSE).

The Chinese Healthcare System

In the 1990s, China experimented with free-market health care. The government's reforms left most Chinese people uninsured. In 1999, only 7% of rural Chinese (900 million) had coverage compared to 49% of the urban population. Also, healthcare workers never really had the opportunity to develop as independent healthcare professionals. Since then, new economic rules and incentives have encouraged physicians to operate like entrepreneurs, as if in a capitalist economy (Blumenthal & Hsiao, 2015).

Chinese physicians are chronically underpaid and overworked. They have often supplemented their low incomes through bribes from pharmaceutical companies, as well as payments that families make directly to them to ensure timely and proper medical care (Shobert, 2013).

The Chinese government maintained control of pricing in the healthcare sector, limiting the prices charged for certain services e.g. physicians' and nurses time. Yet, the government allowed much more flexible pricing for pharmaceuticals, thus encouraging the hospitals and physicians to increase the use of medications. This led to an increase in the cost of healthcare, while negatively impacting quality, and limiting access to the uninsured Chinese population. By the late 1990s, this resulted in distrust and public anger towards physicians and healthcare institutions, as well in increased threat of social instability (Blumenthal & Hsiao, 2015).

In 2003, the Chinese government responded by introducing a modest health insurance program that partially covered some of the hospital expenses for rural Chinese, because those expenses were deemed to be too high. This response reflected the limited understanding of the Chinese authorities of the real issues in healthcare management, and accordingly, the reforms did not rectify the problem (Blumenthal & Hsiao, 2015).

By 2008, the Chinese authorities realized that the healthcare system needed major reforms in both insurance and the delivery system. The officials started a plan to provide affordable basic healthcare for all Chinese by 2020. By 2012, a government-subsidized health insurance system provided 95% of the Chinese population with a modest, albeit comprehensive, coverage (Blumenthal & Hsiao, 2015).

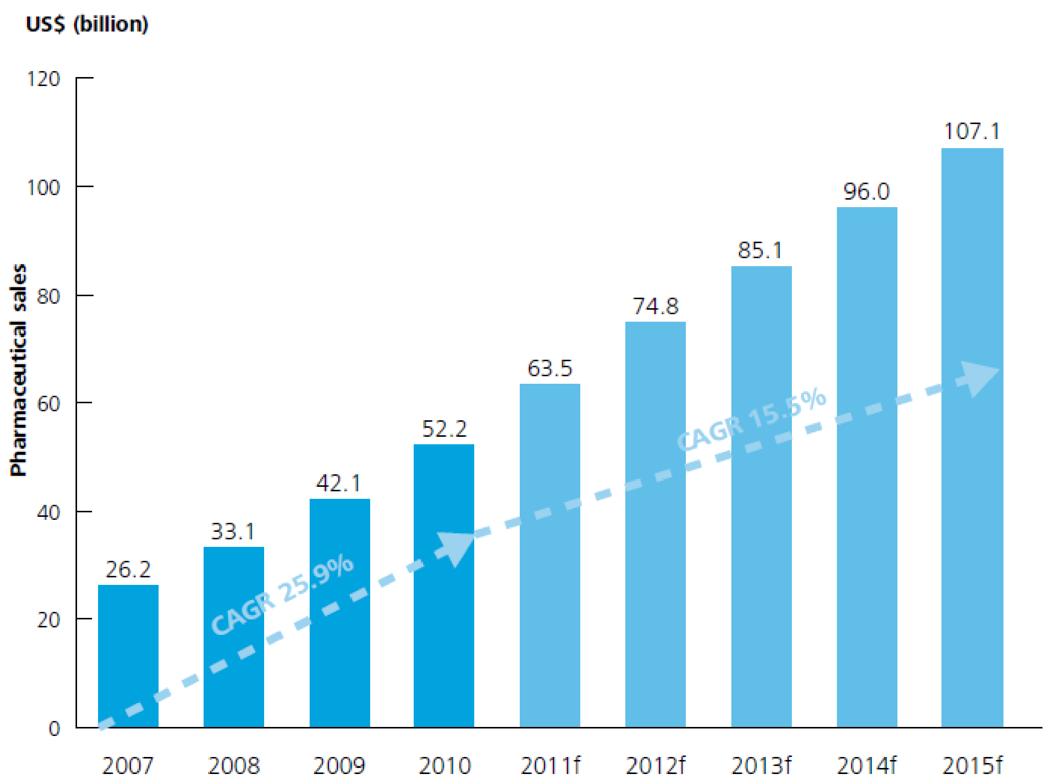
While these extensive 2008 reforms are still in progress, they have faced many challenges. Several of the publicly owned, but profit-driven, hospitals have resisted these reforms. In 2012, the authorities responded by inviting private investors to own up to 20% of the hospitals. Also, major inequities still exist between the quality of the healthcare services in the urban and the rural areas. In addition, the country is continuing to struggle with creating a trusted, professional and high-quality physician workforce (Blumenthal & Hsiao, 2015).

Chinese Pharmaceuticals Market

The Chinese pharmaceutical market is the second largest globally, after the U.S. (Globe News Wire, 2015); mainly due to the country's large population, rather than due to market sophistication (Deloitte, 2011).

Chinese hospitals have long been criticized for their over-prescribing of pricey pharmaceuticals and their high drug prices. And while the authorities have "tried to address these issues, they have not yet found an effective balance between government regulation and market forces" (Wu, Zu, Liu, & Wu, 2014, p. 293). The National Development and Reform Commission sets price caps for retail drugs on the Urban Employee Basic Medical Insurance reimbursement drug list. However, market forces determine the prices for drugs that are not on the list. Chinese hospitals are the main channel for pharmaceuticals distribution (80%), while the remaining 20% are distributed through stand-alone pharmacies (Wu et al., 2014).

Despite strong government intervention; especially in the form of hospital bidding, and price controls, market competition still has a downward impact drug prices in hospital. Also, there is an inverse relationship between the number of competitors and drug prices (Wu et al., 2014).



Pharmaceutical sales in China (Deloitte, 2011, p. 6)

In China, generics are the mainstay of the pharmaceutical industry, and are expected to remain so in the future. And while the Chinese government supports innovation to meet industry targets, it will continue to rely on prescribing generics in the public insurance plan in order to control costs. On the other hand, improving IP protection is encouraging global pharmaceutical companies to tap the unmet demand in the Chinese patented drug market. Chinese consumers have more confidence in foreign brands, and accordingly, patented drugs are expected to grow at a CAGR of about 25% annually (Deloitte, 2011).

GSK China: What Happened?

July 2013

Chinese police raided GSK's Shanghai headquarters, seized documents, and then announced that certain GSK employees were under investigation for *economic crimes*. The Chinese Ministry of Public Security announced that four GSK executives have confessed to economic crimes. A few days later, the Chinese authorities charged GSK with paying three billion Renminbi in bribes since 2007 using a network of 700 conference organizers (Campbell, 2014).

Ten GSK employees were detained in relation to the scandal, including Peter Humphrey, a British consultant who specializes in fraud investigations in China, and who was previously a GSK contractor. Mark Reilly, the head of GSK's Chinese operation was out of the country at that time (Campbell, 2014).

Abbas Hussain, GSK's emerging markets head, announced that some GSK China employees appeared to have acted outside the company's regulations and policies, and breached Chinese laws. He also added that GSK would support the Chinese government in reforming the medical sector and pledged that the company would revise its drug prices to make them more affordable (Campbell, 2014).

GSK's CEO, Sir Andrew Witty, admitted that four executives seemed to have operated out of the company's control processes, and committed bribery. However, he refused to take personal responsibility, and insisted that he remained confident in GSK's worldwide compliance program. He also mentioned that the company would seek an independent review of what happened in China (Campbell, 2014).

September 2013

The Chinese authorities challenged GSK's defense that the bribery had occurred outside the company's compliance system and control. As per a Xinhua news report, a Chinese government's spokesperson has alleged that the bribery was organized by GSK China, rather than its sales reps. He also added that the company's internal auditing was geared towards covering up of those violations (Campbell, 2014). GSK had around 5,000 sales reps at that time (Jourdan & Hirschler, 2015).

October 2013

GSK Sales in China plunged 61% following the bribery scandal; however, CEO Sir Andrew Witty denied that GSK was considering withdrawing from the Chinese market. He also stressed that GSK was totally committed to China, and that the country was crucial for the company's future. He added that GSK was totally committed to helping the Chinese authorities with their investigation to uncover what had really happened, and to take the necessary corrective actions. Mark Reilly, the British former head of GSK China, returned back to the country to assist the Chinese authorities with their investigation; however, he was subsequently barred from leaving China (Campbell, 2014).

December 2013

Glaxo stopped payments to Chinese physicians for promoting its drugs (Campbell, 2014), and stopped the sales reps incentive scheme that was based on the number of prescriptions the physicians wrote (Campbell, 2014; Jourdan & Hirschler, 2015).

April 2014

GSK announced that it was investigating bribery allegations in Lebanon, Jordan, and Iraq. An investigation by the BBC's Panorama program claimed that a Polish GSK regional manager and 11 Polish doctors had been charged with bribery. However, despite these numerous investigations, GSK maintained that it did not have a companywide issue of non-compliance with its code of business conduct (Campbell, 2014).

May 2014

The Chinese authorities accused Mark Reilly, GSK China's former head, of pressing the sales reps into bribing as they wrapped-up their ten-month long investigation into the scandal. The authorities alleged that Reilly had ordered his sales reps to bribe health institutions, hospitals, and physicians in order to boost sales, and to gain billions of dollars in illegal revenue. In addition, Reilly was also accused, along with two other Chinese GSK executives of bribing government officials in Beijing and Shanghai. The case was then handed over to prosecutors (Campbell, 2014).

GSK Annual Data (Yahoo! Finance, 2016) All numbers in thousands

Period Ending	**Dec 31, 2015**	**Dec 31, 2014**	**Dec 31, 2013**
Total Revenue	**35,260,000**	**35,872,000**	**43,899,000**
Cost of Revenue	13,048,000	11,418,000	14,219,000
Gross Profit	**22,212,000**	**24,454,000**	**29,680,000**
Operating Expenses			
Research Development	5,247,000	5,379,000	6,498,000
Selling General and Administrative	1,751,000	13,466,000	11,542,000
Non Recurring	-	-	-
Others	-	-	-
Total Operating Expenses	-	-	-
Operating Income or Loss	**15,214,000**	**5,609,000**	**11,640,000**
Income from Continuing Operations			
Total Other Income/Expenses Net	1,396,000	106,000	568,000
Earnings Before Interest And Taxes	16,630,000	5,762,000	12,279,000

Interest Expense	1,116,000	1,134,000	1,270,000
Income Before Tax	15,514,000	4,628,000	11,009,000
Income Tax Expense	3,175,000	214,000	1,688,000
Minority Interest	74,000	(117,000)	(318,000)
Net Income From Continuing Ops	12,434,000	4,344,000	9,075,000
Non-recurring Events			
Discontinued Operations	-	-	-
Extraordinary Items	-	-	-
Effect Of Accounting Changes	-	-	-
Other Items	-	-	-
Net Income	**12,413,000**	**4,297,000**	**9,003,000**
Preferred Stock And Other Adjustments	-	-	-
Net Income Applicable To Common Shares	**12,413,000**	**4,297,000**	**9,003,000**

Assignment

A. General Instructions

1. Use UMUC's library as much as possible for research in this assignment. Look for worldwide data, and not North American data; remember; this is a global business course!
2. Only cite scholarly publications and reliable non-scholarly sources such as The Economist, Financial Times, WSJ, NYT, Bloomberg, Reuters, Money, Forbes, and Fortune. Reliable non-scholarly sources may yield articles which are more useful for practitioners. Websites like Wikipedia, answers.com, QuickMBA and NetMBA are unacceptable for graduate level work.
3. Your analysis should be supported by a minimum of three scholarly (peer-reviewed) articles, and a minimum of three reliable non-scholarly sources. You can also use the required readings from this week to support your analysis where appropriate.
4. Your analysis should be written in an academic paper format; not a question and answer format.
5. Please include the following: A half page **Introduction,** and a half page **Lessons Learned & Conclusion** at the end of your report. Use section headings to organize your paper. An Executive Summary is **not** required.
6. All questions are to be attempted. Do not restate the information from the case study; go beyond the included information; analyze and draw your own conclusions!
7. Your report should be approximately 8 pages long, with one inch margins, 12-point font, double-spacing, and should be posted as a Word document. The cover page, references, and appendices, if any, are not part of the page count. All graphics and tables, if any, should be placed in an appendix.
8. Use the APA format for in-text citations and the reference list.

B. Case Study Questions

All questions are to be attempted. Support your answers using scholarly and reliable non-scholarly sources!

1. Did GSK help create this corrupt environment? Is the company to blame for this scandal?
2. Are local companies similarly targeted in China, or was GSK targeted because it was a foreign company?
3. How did GSK respond to the allegations? Was its response professional from your point of view?

4. How is GSK currently performing in China? What is the company's future outlook in the country from your perspective?
5. Is China becoming a less hospitable place for multinationals? Why or why not?
6. What is your advice to the CEO of a multinational company that has recently decided to move to China? Your advice should be based on GSK's experience and that of similar companies that have ventured into China.
7. What laws should a multinational company refer to when operating internationally?

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