

Keeping your China Business on a leash

MANAGING DIRECTOR JUERGEN KRACHT ADDRESSES THE RECENT PROBLEMS THAT CHINESE COMPANIES HAVE ENCOUNTERED OVERSEAS DUE TO A LACK OF CORPORATE TRANSPARENCY AND CORRECT ACCOUNTING. DOES THIS MEAN HEAD OFFICES NEED TO BE MORE VIGILANT OF THEIR CHINA OPERATIONS?



Those with experience in doing business in China know that a lack of accountability and transparency exists in companies, which are often run like private kingdoms.

This problem of weak corporate governance locally negatively impacts Chinese companies' reputation overseas. Some that publicly listed on overseas stock markets, such as Sino Forest, have hit the headlines due to alleged inconsistencies or even fraud in these companies' reporting, resulting in investors losing confidence in Chinese companies. For instance, accusations of illegally inflated assets and earnings by equity research firm Muddy Waters Research caused the share price of Sino Forest to fall by more than 80%, and the Ontario Securities commission has currently suspended trading of its shares pending investigation. In a new twist to the situation, two investors have filed a detailed claim against the company, seeking over USD 6.6 billion in damages.

The reaction to these allegations is remarkable: Some companies confirmed falsified contracts or "mathematical errors", some restated their earnings as far back as 2008, one said that their financial records were destroyed by fire, another claimed that the truck transporting their accounting records was stolen, some were delisted, and in some cases the auditors resigned. In one case, an international audit firm had to restate the bank balance at 10% of the original amount! But there are also companies who vehemently denied the allegations, although their share price fell nevertheless.

Another worry over Chinese companies' credibility is that many, including Sino Forest, have accessed overseas stock markets through "reverse takeovers". In essence, this is a back-door method of publicly listing where a private company purchases a listed company. Such a process can take as little as a month to complete and is substantially cheaper than following the full initial public offering (IPO). As many as 500 Chinese companies are accused of taking over failing U.S. companies in this way, with the purpose of bypassing the strict regulatory scrutiny for traditional IPOs.

As a result, recently regulators in U.S., Canada, Hong Kong and Singapore have stepped up probes. Currently more than 20 China-based companies have been delisted or

suspended by the SEC. A Singapore court even went as far as sentencing a former independent director to four months in prison for his role in making a misleading regulatory filing. The challenge is that foreign regulators have little power over the matter. The SEC is pushing for a deal that would allow U.S. regulators to conduct "joint inspections" of China-based audit firms. Negotiations on this topic have been going on since 2007 and may take longer as China has traditionally denied overseas authorities access to the domestic market.

Since the renewed scrutiny only covers companies listed overseas, we may be seeing only the tip of the iceberg of what the real situation is like in China's corporate world.

Why is corporate governance important to our operations in China?

The above developments highlight the inherent risks we may face as companies doing business in China. If we have dealings with such firms our own business may be at risk. The key issue is the reliability of the Chinese customer or supplier, and the foremost tool to avoid damage or loss is simply the "know your business partner" principle. To be effective, this process should be conducted by in-house staff not involved in the daily operations and who report directly to the Controller at head office (HO) level. Alternatively, an external party may be engaged.

Gone are the days where arguments like "China is different" or "everybody does it" were valid. Foreign companies should simply apply the same corporate governance rules that apply in their home country. The major risk areas in China are:

- ▶ Company Chop Abuse
- ▶ Incorrect Accounts Payable
- ▶ Kickbacks and Illegal Commissions
- ▶ Mis-stated Cash Transactions
- ▶ Stolen Inventory, Fixed Assets
- ▶ Theft of Plant and Equipment, Intellectual Property
- ▶ Wrong sales terms, Credit Control and Collection

Kickbacks are a key challenge: The Corruption Perceptions Index 2010 (www.transparency.org) ranks China at 78th place (India 87th), where corruption encompasses all dealings with government and businesses – including possibly auditors. Kickbacks in China are an established practice, and we can confirm that this was the case even in Hong Kong until the Independent Commission Against Corruption was established in 1974.

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Corporate governance of subsidiaries in China only works when the HO establishes clear rules and oversees the implementation of a comprehensive checks-and-balances system. Conducting regular compliance and risk management analyses (either in-house or outsourced) is crucial to ensure compliance.

The long leash

The obstacles to succeed in China are known and this requires flexibility. Companies have reacted to the fast changing market environment and to new market opportunities by giving their subsidiary more freedom, including the development of products specifically for the China market or product adaptation to local market requirements – taking into account the differences between Eastern and Western China. This requires flexibility and a high level of decision making power at the China subsidiary.

The short leash

On the other hand, the main challenges in the day-to-day operations in China remain:

- ▶ Establishing dual control – ‘4-eye principle’
- ▶ Ensuring reliability of financial data – data quality (accounting and financial reporting); staff quality; data polishing (to please/impress the chief/supervisor)
- ▶ Avoiding financial risks in areas of; cash transactions, management of A/R and A/P, inventory and fixed assets
- ▶ Combating possible fraud and graft

The issue is to find a sound balance between market opportunities and the inherent risks of operating in China. In order to cope with this dilemma, I advise a dual strategy that:

- 1) commits the China subsidiary to maintain up-to-date records of their business dealings and performance, all on one platform;
- 2) allows the head office to approve, monitor and control any process.

Can this be easily achieved? By applying modern-day technology, an online ERP system can support businesses to split functions into separate and distinct areas, whilst keeping all activities on one single platform. For example:

A C T I V I T Y	<ul style="list-style-type: none"> • Customer management • Product development • Product adaptation to local requirements • Localisation of production 	<ul style="list-style-type: none"> • Price policy, rebate system, credit policy • Finance: -Reporting -Controlling • HR policy • Corporate governance
E R P F E A T U R E S	<ul style="list-style-type: none"> ▶ Immediate reaction to market changes ▶ Power to make decisions on a local level 	<ul style="list-style-type: none"> ▶ ‘4-eye principle’ – approvals required by two or more parties ▶ Remote online access by HO to subsidiary’s corporate data
1) CHINA INDEPENDENCE = MAXIMISE SUCCESS		2) DEPENDENCE ON HO = MINIMISE RISK

To find out more about how an ERP system can support, secure and optimise your operations, email contact@fiducia-china.com.

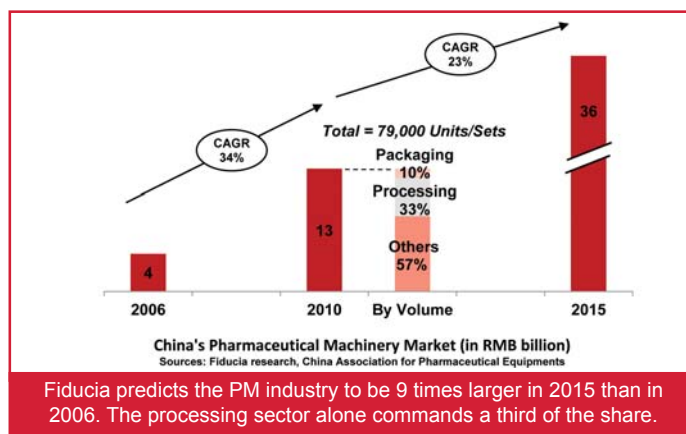
Rise of the Machines: An Investor’s Dream

CHINA FOCUS HIGHLIGHTS THE PHARMACEUTICAL MACHINERY (‘PM’ FOR SHORT) INDUSTRY, WHERE THERE ARE VERY PROMISING SIGNS OF GROWTH. BASED ON MORE THAN 80 QUALITATIVE INTERVIEWS, FIDUCIA’S CHINA CONSULTING TEAM EVALUATE TWO HIGH-POTENTIAL AREAS AND OFFER RECOMMENDATIONS ON HOW TO ACHIEVE HIGH GROWTH.

In attempts to improve the health of its population, China has set up a complete pharmaceutical industry value chain. In terms of the market value, China is expected to become third in the world in 2011 and will overtake Japan as No. 2 by 2015, as its production value reached RMB 985 billion in 2010 and grew by 22% annually since 2006. To further support market growth and stimulate industry consolidation, the government introduced the Good Manufacturing Practice for (GMP) – a set of guidelines which regulate the production and quality of pharmaceutical products.

Better machinery for better drugs

GMP not only has impact on pharmaceutical companies but also on PM manufacturers. With stricter requirements for full automation, inspection and isolators, the regulation will further boost demand as companies will have to replace sub-standard machinery with new ones. Within PM, Fiducia’s China Consulting team identified two sectors that have high potential for high growth: Freeze-Drying and Blister Packaging.



▶ Freeze-Drying

Freeze-drying involves dehydration process technology, and is the largest sector within PM. This technique is more advanced and sophisticated than other processing methods, yet freeze-drying’s penetration rate into China’s pharmaceutical production lines is only 20%, still lower than that of developed countries (>30%). Given China’s overall goal of becoming an international player, this sector will be expected to raise itself to similar levels seen in developed economies.

For existing freeze-drying production lines, the new GMP requires an upgrade of auto loading and unloading systems together with the isolator systems. This will require technology and know-how from foreign companies, therefore domestic players are looking to form alliances. Yet, despite their lack of advanced technology, Chinese producers enjoy economies of scale, which bring significant cost advantage and leads to them holding a larger market share.

To read the rest of this article, the full version is available on www.fiducia-china.com.

The China Trader – Part II of III: 3 Decades of Canton Fairs

PINKY KWAN HEADS FIDUCIA'S TRADE SERVICE DEPARTMENT WITH TEAM MEMBERS IN HONG KONG, SHENZHEN AND SHANGHAI. PINKY'S FIELDS OF EXPERTISE COVER ALL TRADE RELATED BUSINESS PROCESSES. WITH OVER 35 YEARS OF EXPERIENCE IN INTERNATIONAL TRADING AND EXPORT COMMODITY BUSINESS, SHE HAS VISITED THE CHINA IMPORT AND EXPORT FAIR, BROADLY KNOWN AS THE CANTON FAIR, NEARLY EVERY YEAR.

Her first visit was back in 1988. At that time, China was not as open towards doing business with foreigners. An interpreter/negotiator was essential as suppliers could only speak Chinese and were reluctant towards dealing with foreigners. Real negotiations were difficult, as suppliers had fixed prices for their products and were extremely unwilling to even consider giving reductions. Most of the time, the quantities were also fixed, as they would only offer and contract what was available. And that was not very much.



Pinky, on the far right, working hard to ensure a smooth talks between clients and supplier, back in 1989.

Pinky had to strike a balance between suppliers' offers and clients' requirements. For several days she would go to and from the airport, bringing one delegation and then waiting until the next one arrived. Along with her market knowledge and product expertise, Pinky's determination and tough skin have helped many client companies to successfully source from China. Here, she offers some tips and tricks on how to approach the 21st-century Canton Fair:

"From its humble beginnings in 1957, the Canton Fair has certainly developed into a must-attend affair on the global trade fair circuit. In order to get the best result out of the Canton Fair visit, I distinguish between the first time buyer and the experienced one.

As a first time buyer:

- ▶ You will be overwhelmed with the varieties of products and the wide range of suppliers. Find a map and do online research beforehand. Trade fair websites are very information-friendly and most provide a list of exhibitors.
- ▶ The trade fair covers over 800,000sqm of space and has everything you need for your final product range.
- ▶ Bring business cards as suppliers will normally ask you for one before they give you a catalogue.
- ▶ Take along a small trolley, as the catalogues from exhibitors seem to get thicker and heavier year by year. You can ask instead if they have a CD version. This will be easier to carry and more eco-friendly.
- ▶ Suppliers normally don't give samples on the fair.
- ▶ Normally the Minimum Order Quantity is a 20 feet container. You will have to consider filling up a whole

container with different items from one supplier in order for your inquiry to be considered.

As an experienced buyer:

- ▶ You will probably have your standard supplier and you want to visit them to see what new products they have. Search online first to know exactly where their booth is.
- ▶ The trade fair is a great opportunity to keep up with the current environment. Learn about the market development, which companies are still competing, which are growing, which ones are the most aggressive in the market and which have left.
- ▶ If you are looking for a new potential supplier, you need to find out first if this is a manufacturer or a trader. Naturally traders will have a mark-up on their prices as opposed to direct manufacturers.
- ▶ After choosing the product, a negotiation with a supplier normally includes four elements: packing, pricing, shipment and payment term.

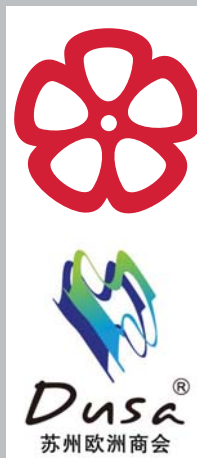
"As long as your knowledge of the product price range and negotiation tactics are in place, you will not be cheated."

Pinky Kwan, General Manager and Head of Trade Services at Fiducia Management Consultants

- ▶ Talk about the packing and conclude on a packing method accordingly, as it will influence the price.
- ▶ Price negotiations are always a hassle. The Chinese will never miss the opportunity to start with a very high price. As long as your knowledge of the product price range and negotiation tactics are in place, you will not be cheated.
- ▶ Note down the price, and make sure your supplier does too, as the emailed quotation afterwards will otherwise show a different price.
- ▶ Payment terms of course vary in accordance to the product. Some products and suppliers need to buy the material in advance and this has to be paid for before it goes into production. But the normal payment term is: 30% down payment and 70% after shipment for fast moving consumer goods. Try to have these points covered with your supplier before placing an order to avoid surprises.

Preparation is key (don't forget to bring lots of business cards!) and although today most suppliers speak a second or even third language, having product and logistics support safeguards against the cutthroat Chinese trade industry."

ANNOUNCEMENT



Fiducia recently conducted a survey on 'Recruiting and Retention Systems' among members of DUSA European Association Suzhou. Client Relationship Manager Christian Groeger will give a first presentation of key results to the DUSA board and to Fiducia Clients in early September. Watch out for the forthcoming **China Focus October issue** as the results and announcements of further presentations will be published.

Fiducia recognised as content partner to the HKTDC Economic Forum

As part of our ongoing collaboration with The Hong Kong Trade Development Council (HKTDC) to promote the Pearl of the Orient, articles written by Fiducia are now available on HKTDC's 'Economic Forum' – a content section of the HKTDC website offering economic analyses and reports on Hong Kong and global economies. The Forum can be found on www.hktcd.org and also includes works written by other business economists and think-tank members.

UPCOMING EVENTS

2nd – 6th September Berlin/Cologne, Germany IFA 2011 / Spoga+Gafa 2011

Managing Director Juergen Kracht and Supply Chain Executive Anne Kuschert will visit IFA on 2nd – 3rd, and at Spoga+Gafa on 4th – 6th. IFA is one of the biggest trade shows for electronics and appliances. Spoga+Gafa is the joint trade fair that collectively showcases products for sport, camping and garden lifestyle. If you would like to set up an appointment, please email contact@fiducia-china.com.

8th September Shanghai, China Fiducia and FMT Dinner Party

In a relaxed environment accompanied by food and drinks, Fiducia and our executive search partner FMT International AG will raise issues related to China's development away from being a country for cheap labour and how this impacts foreign enterprises. The main purpose of the evening is to stimulate discussion on what industry leaders think and their different approaches to tackling this worrying issue.

18th – 20th September Istanbul, Turkey AGN World Congress 2011

As members of AGN International, over 200 accounting and consulting firms are invited to come together in Turkey for an exciting few days of technical presentations, combined with a chance to soak up the rich culture and history of Istanbul. Fiducia's Head of Finance & Accounting Christina Fung will participate, together with Business Development Manager Thaddaeus Mueller who represents AGN's Asia Pacific region as Chairman of its board.

Hong Kong: No.1 Place for Offshore RMB Investments

FOLLOWING A DRAFT NOTICE BY THE MINISTRY OF COMMERCE (MOFCOM) ON AUGUST 22ND AND ANNOUNCEMENTS BY INCOMING PREMIER LI KEQIANG DURING HIS VISIT TO HONG KONG IN THE SAME MONTH, A REGULATED PROCESS FOR USING FUNDS FROM OFFSHORE RMB ACCOUNTS FOR FOREIGN DIRECT INVESTMENTS (FDI) INTO MAINLAND CHINA IS EXPECTED TO BE IN PLACE BY THE END OF 2011 FOR HK COMPANIES. THIS MOVE FOLLOWS SIMILAR REGULATIONS ISSUED BY THE PEOPLE'S BANK OF CHINA (PBOC) ON JUNE 3RD.

Currently, RMB inflow is regulated on a case-by-case basis, with approval required by MOFCOM and the PBOC at the ministerial level. According to the new draft plans, RMB funds can now be used for pay-in and increase of registered capital, as well as shareholder loans to subsidiary WFOEs in China, in addition to the purchase of shares and assets of Chinese companies. RMB funds for investment have to be obtained "legitimately", i.e. through transactions such as cross-border trade settlements, offshore RMB-denominated bond issuances or stock sales. They cannot be used, however, to issue entrusted loans or to repay bank loans.

Chinese regulations on mergers and acquisitions, anti-monopoly provisions and restrictions as specified in the Foreign Investment Guidance Catalogue still apply. To prevent the inflow of speculative "hot money", offshore RMB investment in certain sectors such as real estate, domestic securities and financial derivatives are not permitted.

For the RMB-offshore FDI scheme to become effective, MOFCOM still has to release the final regulations, which is expected as early as September 2011. In addition, implementation rules on the local level defining the interaction between MOFCOM and PBOC, as well as offshore banks and financial regulators, will need to be formulated. As the Hong Kong Monetary Authority disclosed recently, the negotiations on these issues are expected to be finished before the end of this year.

This development marks a further step in the internationalisation of the RMB. It will also increase the attractiveness of Hong Kong as the financial centre for foreign companies; they can use RMB for both the settlement of transactions and for their investments into China.

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