



How to Deal with Operating Risks in China

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E&OE

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Germany and China strengthening economic relations?



German companies benefit from the positive economic development

▶ **Infrastructure**

- By 2012 the world's fastest train (German manufactured), from Guangzhou to Wuhan, will extend to Beijing, allowing passengers to zip from one end of China to the other in under 8 hours.
- The recently launched Beijing-Shanghai railway is the world's longest high-speed line ever constructed in a single phase.
- Other new rail lines: Shanghai to Hangzhou (27mins)
Hong Kong to Shenzhen (10mins)

▶ **Automotive**

- BMW and JV partner Brilliance will invest EUR 1 billion to expand production capacity at their Shenyang plant to 200,000 units over the medium term. China is BMW's 3rd largest market.
- VW will launch new electric cars in China under its new "Kaili" brand in conjunction with FAW Group. VW sold 714,200 cars in China from January to May 2011, compared to 248,000 in Germany and 194,600 in the US.

▶ **Green China**

- China will invest USD 62 billion in the construction of four hydroelectric dams.
- Siemens received a EUR 250 million order for components used for transmitting hydro power from the North to the coastal industrial region of Guangdong.

▶ **Chemicals, Machinery, Healthcare, Finance, Real Estate, Consumer Goods...**



What are the profit drivers?

Actions that lead to business success in China

- ▶ **Staying flexible, being able to react to changes**
- ▶ **Optimised sourcing**
- ▶ **Creative cooperation arrangements**
- ▶ **Reducing IPR infringements by applying the black box approach**
- ▶ **Regional coverage by a healthy mixture of own office, home office, engagement of distributors or traders etc.**
- ▶ **Sales: customer training, technical service hotline, strong after-sales service**



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A rapidly changing environment

The Constantly Changing Market Environment

- ▶ Sales: In the past Western companies succeeded in selling to China what they wanted to sell. Now Western companies increasingly are only be able to **sell what the Chinese customer wants to buy**.
- ▶ Purchase: Cost increases, e.g. **wages**, prompt suppliers to postpone or even cancel existing orders.
- ▶ Chinese companies have caught up with the world: Government encourages more high-value industries through tax incentives (HNTE/ATSE status). As a result, China today accounts for 90% of the worldwide increase in trademark registrations.
- ▶ Chinese manufacturers advantages over foreign counterparts: Have more cost advantage, are closer to the market, and receive local government support.
- ▶ Trend: The China headquarters becomes more independent from the head office in its decision making. Naturally this development produces friction between the head office and the China operations headquarters
→ **Power/policy struggle**.
- ▶ Constant regulatory changes by Government:
 - New Social Insurance Law – from July 2011, foreign workers in China are obligated to **contribute to the national social security system**, which means an additional monthly cost of up to RMB 1,177 for the employee and RMB 3,958 for the employer. Implementation measures still have yet to be confirmed.
 - New Representative Office (RO) Regulations – offices have to deal with **increased administrative burden and harsher penalties** as Beijing ends the misuse of ROs to conduct operational activities.
 - Security Scheme: suppliers of products linked to “critical infrastructure” would have to **disclose confidential product information**. Foreign companies feel this infringes IP rights, and is the Government’s attempt at developing homegrown brands → “indigenous innovation”.



The ease of doing business in China

The World Bank Report “Doing Business 2011” compares regulations in 183 economies and ranks the countries after their “Ease of Doing Business”

▶ **China is globally ranked 79 out of 183 economies.**

Measured aspects are e.g.:

- Dealing with licenses
- Employing staff
- Enforcing contracts
- Paying taxes

▶ **The situation in China:**

Dealing with licenses

37 procedures and 336 days for setting up a new warehouse (used example)

China ranked 181/183 worldwide

Paying taxes

7 different payments p.a. and 398 hours p.a. for the preparing, filing and paying of taxes for a medium-size business China ranked 114/183 worldwide

Global Rank of selected economies:

<u>Rank</u>	<u>Country</u>
1	Singapore
2	Hong Kong
4	United Kingdom
5	USA
18	Japan
22	Germany
79	China
134	India



Major risk areas in China operations

Key areas to watch out for

General

- ▶ Theft of Plant and Equipment
- ▶ Kickback Commission / Bribery
- ▶ Credit controls and Collection
- ▶ False Signature
- ▶ Intellectual Property

Financial



Corruption Perception Index 2010

Index 10 = low or no corruption, Index 1 = high corruption level

Rank	Country	Index
1	Denmark	9.3
1	New Zealand	9.3
13	Hong Kong *	8.4
15	Germany	7.9
....
78	China	3.5
87	India	3.3

* Corruption in Hong Kong is low due to strict anti-corruption legislation and an independent enforcement agency named ICAC (Independent Commission Against Corruption) which was set up in established in 1974 by then Governor Murray MacLehose when Hong Kong was under British rule.



Business Sector Risk Areas – Examples of Corruption

Purchase: Pre-qualification, Tender and Negotiations

- ▶ Price fixing
- ▶ Loser's fee
- ▶ Manipulation of pre-qualification
- ▶ Corruptly negotiated contract
- ▶ Specification of overly sophisticated design
- ▶ Inflation of resources and time requirements
- ▶ Companies spend a lot of time on negotiation but fail to check on approval, implementation and compliance

Sales and Project Execution

- ▶ False invoicing: pricing, discount, supply of inferior materials or less equipment
- ▶ Excessive repair work, overstating man-days use
- ▶ False extension of time requirements
- ▶ Delaying issue of payment certificates, withholding payment
- ▶ Refusal to issue inspection certificate



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Alarm signals

General Issues

- ▶ Non-compliance of corporate governance rules
- ▶ Sudden change of company standard processes and approval procedures
- ▶ Sudden change of key performance indicators; e.g. sales, sales discount, accounts receivables, accounts payables, customer claims, goods return
- ▶ Delay in company-wide accounting software implementation
- ▶ Lack of follow-up actions on Internal Audit Review

HR Issues

- ▶ Lack of employee screening during recruitment
- ▶ Family relationships of staff within the company / supplier / customer
- ▶ Sudden lifestyle changes

Segregation of Duty and Policy Issues

- ▶ Lack of “4-Eye Principle” for payments;
e.g. General Manager versus CFO, Cashier versus Accountant
- ▶ Lack of control in usage of “Chops”
- ▶ Non-compliance of Gift and Entertainment Policy



Proven Tools

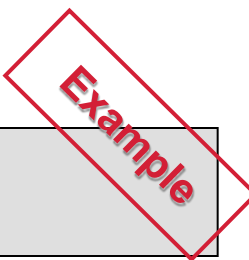
- ▶ **Authority & Responsibility Delegation:**
establish fixed processes and approval procedures for purchase, sales and payments – and name position/person
- ▶ **Divide and conquer**
→ Split activities between China and Hong Kong. A major US retail chain moved key functions of their QC activities back to Hong Kong
- ▶ Rotate staff especially in sales, purchase, QC
- ▶ “Meet the people” i.e. other than the GM – very often somebody in the company knows about fraud, non-compliance etc. and is willing to tell
- ▶ Carrefour maintains an “Ethics Hotline”
- ▶ Benchmark pricing structure with third parties



Proven Tools

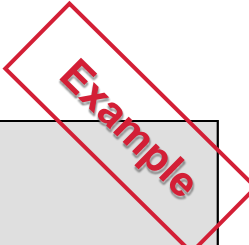
- ▶ Management's Philosophy & Operating style, clear organisational structure
- ▶ Corporate Governance Policy and System – typically most serious frauds are committed by GMs who are not subject to internal reviews or regular counterchecks
- ▶ Staff coaching and development → integrity, ethical values, competence
- ▶ Include clauses in employment handbook, employment contracts
- ▶ Transparency: monitoring, communication policy
- ▶ Controlling
- ▶ Control systems e.g. Internal Audit, External Audit
- ▶ Outsource non-core activities
- ▶ Risk Assessment (see examples)





Conducting compliance and risk management analysis

Description of risk	Cause/ Loss potential	Likelihood (1=low; 3=high)	Counter measure	Person in charge
GENERAL				
Compliance with government laws (validity of certificates & licenses)				
Compliance with corporate policies				
Contract risks (suppliers, customers, commercial agents, tenancy agreement)				
Damage to premises or buildings, Break-in and larceny				
Use and safe keeping of company chops				
FINANCE & ACCOUNTING				
Compliance with accounting & reporting rules				
Taxation: corporate, VAT, personnel tax & Social Security				



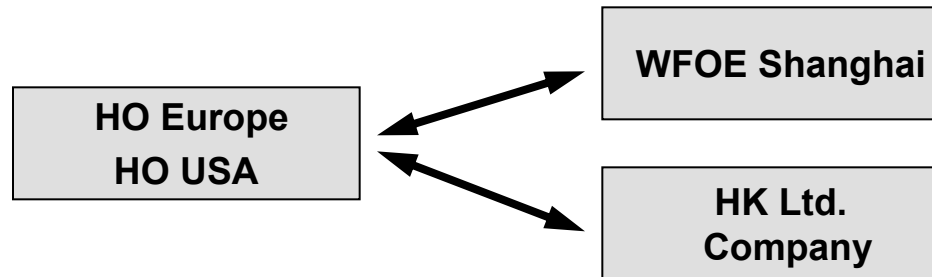
Conducting compliance and risk management analysis

Description of risk	Cause/ Loss potential	Likelihood (1=low; 3=high)	Counter measure	Person in charge
PERSONNEL				
Employee screening, family relationship with supplier & customer, lifestyle changes				
SALES				
Know your customer				
Price policy				
Discounts				
PURCHASE				
Know your supplier				
Pricing				
Discounts				
Returns				

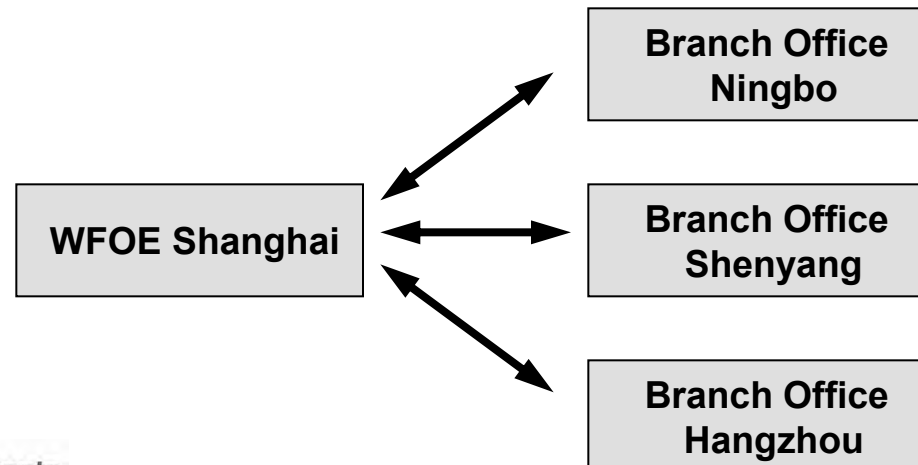
How an ERP System can bridge distances...

...and language barriers: The system needs to be bilingual (English & Chinese)

- ▶ Between Head Office in Europe / USA and China / Hong Kong subsidiary



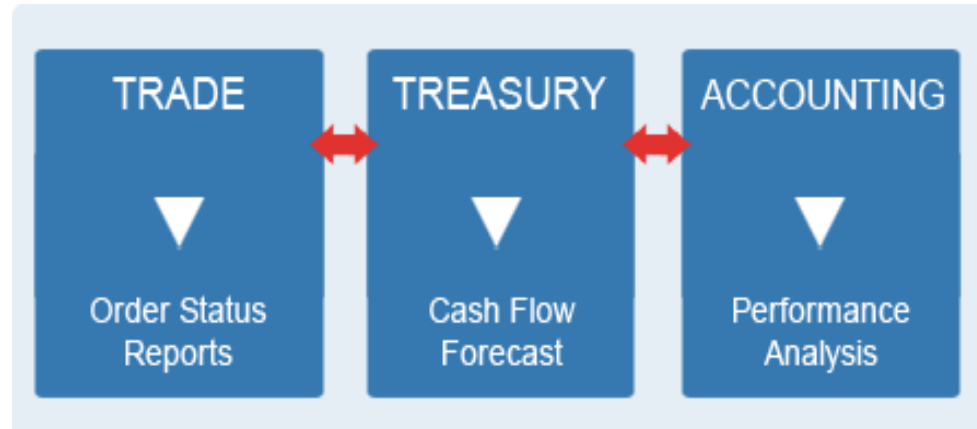
- ▶ Between Head Office in China and branch offices in China



Online access to the ERP Platform

Information tools and management tools at your fingertips

With an online ERP System, dedicated staff can access, manage and control the China or Hong Kong subsidiary – **Anytime, anywhere.**



Head Office in Europe/USA

- ▶ Management
- ▶ Import Manager
- ▶ CFO / Controller

Monitor, Control
→ & Approval (optional)

Subsidiaries' data

← Manage, Control
& Access Data

Key staff at China & Hong Kong subsidiary

- Management / CFO ◀
- Sales Manager ◀
- Accountant / Controller ◀

Example: Flow chart online approval

WFOE in Shanghai with offices in Shenyang and Beijing

Trade Department

Staff – apply

Shenyang



STEP 1

Trade Department

Manager – approve

Beijing

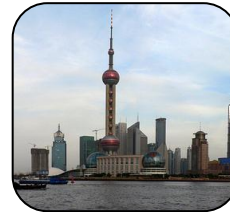


STEP 2

Accounting Department *

Pay

Shanghai

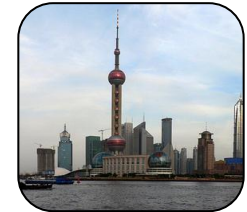


STEP 3

Accounting Department *

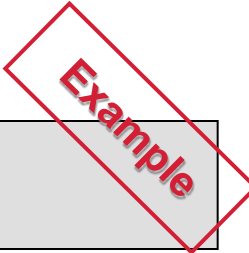
Bookkeeping

Shanghai



STEP 4

* in-house or outsource to service provider



China Corporate Card: Corporate Data Management and Transparency

Authorization Person	Position	Approval Rights	Tel
Alan Hu		all seals	1234 5678
Bryan Wong		all certificates, documents & seals	3333 3333
Charles Rose		all seals	4321 7896
▶ David Chan		Business License, Financial Seal	
John Smith		all documents	
Rachel Dees		Customs Certificate	

- ▶ All important **company data** on licenses, key persons and officially registered data **stored in one place**
- ▶ Management of corporate governance processes with document handling procedures and varying access rights

- ▶ Tracking of official documents – certificates and licenses; who is in possession of what.
- ▶ Documents' records of commencement date and expiry date. Notification of when an official document is about to expire.

Name	Kept By	From Date	Expiry Date
Company Seal	Mark	01/01/10	01/07/10
Legal Rep Seal	Mark	01/01/10	01/07/10
Financial Seal	Robin	01/01/10	03/25/10
Customs Seal	Robin	01/06/10	01/01/11
Contract Seal	Robin	01/06/10	01/01/11



Recommendations for risk management

Checklist

- ▶ Careful strategic planning of the right investment form
- ▶ Define the different roles of GM, directors, LR etc. as precise as possible
- ▶ Set guidelines: Which actions are to be taken by whom? What needs whose approval?
- ▶ Check whether the AoA, internal guidelines, employment contracts are harmonised
- ▶ Sign termination related documents
- ▶ Define contract signing limits
- ▶ Store chops in a safe place
- ▶ Keep records of chop use & keep them separate
- ▶ Keep all certificates and licenses valid
- ▶ Check with the authorities what is actually registered

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We have a 29-year track record of serving international clients in China

- ▶ **Established in 1982 in Hong Kong**
- ▶ **Professional service provider focused on China and Hong Kong**
- ▶ **More than 80 Chinese and foreign specialists**
- ▶ **Three China offices strategically located in Hong Kong, Shanghai and Shenzhen**
- ▶ **High level of local expertise and multicultural experience**
- ▶ **Proven ability to apply international business understanding to local structures and situations in order to advise clients**
- ▶ **29-year history of close coordination with the client leading to long-term relationships**
- ▶ **Strong support from a large network of partners**



Integrated Services – Total Solutions in China and Hong Kong – Our 6 Core Services



FIDUCIA'S PARTNERS

We are a member of the following associations:

- **CDI Global**: Specialists in international company search
- **AGN International**: A worldwide association of separate and independent accounting and consulting firms



Fiducia Management Consultants

A multinational team with deep relevant China experience



Christina Fung

- ▶ Certified CPA (US) with MBA in international business
- ▶ More than a decade of experience providing clients with personal and corporate tax services
- ▶ Head of Fiducia's Finance & Accounting department



Pinky Kwan

- ▶ Over 30 years of experience in international trading and export commodities business
- ▶ Head of Fiducia's Trade Service department with team members in Hong Kong, Shenzhen & Shanghai



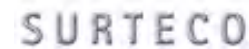
Stefan Kracht

- ▶ EMBA Degree from Kellogg-HKUST
- ▶ Worked as a consultant with Bain & Co. in London and managed a trading company in Shanghai
- ▶ Head of Fiducia's Corporate Consulting department



Client References

Over the years, Fiducia has worked with multinational clients from various industries



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CHINA

Newsletter on business trends

Happy Chinese New Year and prosperity

People born under the balanced in outlook and to be informed of all the. Despite being fond of lose their temper. They in the years of the She

The Impact of Chemicals and its Development

FACT SHEET

- CHINA'S CHEMICALS CONTRIBUTE TO GLOBAL INDUSTRY TURNOVER
- CHINA'S CHEMICALS PRODUCTION 2
- CHEMICALS INDUSTRY ACCOUNTS FOR GDP (ITS 3RD LARGEST SECTOR)

When we upgrade to the latest mobile for is a better screen and faster process are choosing better chemicals; the built common applications. Chemicals play lives, from garments to food to iPhones aware of it.

The same holds for China's economy. factory, but behind this the local supply materials for manufacturing is key to fu production. Below are some examples chemicals in everyday goods.

- **High-Tech Products – Rare Earths**
Rare Earths are essential raw material latest technology, including mobile pho missiles, radar systems and also green turbines and hybrid vehicles. China cut supply of Rare Earths in the world.
- **Paint & Coating – Fine/Specialty Ch**
Paints and water-proof coating require ingredients. China now produces more kinds of fine chemicals, however in mo technology and equipment used in Chi those developed countries were using
- **Textiles – Synthetic Fibres**

CHINA

Newsletter on business trends

Transforming China Plans – Part II: T

IN THE SECOND PART OF CHINA'S FIVE-YEAR PLANNING EVALUATION OF GOVERNMENT SHARE BUSINESS IN CHINA. Really check. China is the second largest economic came with compromise social inequality. The reform across the country public ease tensions was addressed Plan, meanwhile the 12th issue with the underlying domestic growth' and a rather than economic d

7 + 7 = Prosperity
The 12th Plan has set growth from 2011 to 2020 of 7.5% in the 11th Plan expectations during the high as 14% (in 1992). performance is too aggressive long run. Therefore a high society is deemed more conservative target. CH USD 8.1 trillion, 60% of

With a new outlook, Beijing from export-led to a domestic China wants domestic developed countries, so Chinese people spend its highly criticised trade more self dependence

The 12th Plan includes receive significant attention

- Environmental Tech
- Biotechnology & Bio
- High-end Manufactu
- Next-generation Info

CHINA

Newsletter on business trends

Holding up Half of t

"WOMEN HOLD UP HALF OF T FAMOUSLY ATTRIBUTED TO M ASKS WHAT ROLES AND POS CORPORATE CHINA TODAY

Mao's message seems to cat corporate strata in Germany f companies there recently cor proportion of woman within th reducing the gender gap. But top female executives, the ca role of women in the business increasingly under the spotli

In the case of China, "half of interpreted in a much more d were required to contribute a Mao's socialist society in the opening up and reform period factory jobs that required dax mere muscle power categori proverbial 'factory girls'.

The multi-generational mod
With the one-child policy still in place, childbearing is very a central event not only in the young women and their part but also of both sides' parent extended family. While State Enterprises often retain child-services as a reminder of the former work-unit system with its all-encompassing social provisions, there is little flexibi arrangements in China, so in cases the grandparents will ta care of small children. Howev this multi-generational model is also a trend among young more time with their children control their upbringing" state General Manager at IFM Ele

Ms. Renate Tietjen, Chief Representative of Melchers in Guangzhou

CHINA FOCUS

Newsletter on business trends and corporate strategies

JUNE 2011
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Averting China's Water Crisis

AS THIS ARTICLE GOES TO PRINT, CHINA IS FACING ITS WORST DROUGHT IN 50 YEARS DUE TO IRREGULAR WEATHER PATTERNS, BUT MORE ALARMINGLY BECAUSE OF WATER SHORTAGES FROM WORSENING WATER CONTAMINATION. ACCORDING TO THE MINISTRY OF ENVIRONMENTAL PROTECTION, ONLY 70% OF URBAN WASTEWATER LAST YEAR WAS TREATED 'SUFFICIENTLY'.

River	Pollution Level
1. Pearl River	High
2. Yangtze River	High
3. Huai River	High
4. Yellow River	High
5. Hai River	High
6. Liao River	High
7. Songhua River	High

Concern: Over half of China's major rivers are severely polluted.

Inner China neglected
First tier cities and coastal areas achieved high sewage treatment rates exceeding 70%, but for inner China and underdeveloped urban areas, average rates barely reached 50%. Since focus is foremost on municipal sewage and industrial wastewater treatment, progress in small towns and rural areas is very slow. At the end of 2010, less than half of national counties had established sewage treatment plants, and treatment rates were below 35% in these areas.

Organisations helping the cause
Currently, over 95% of water plants do not meet the recently revised water quality standards. "In many cases the lower level authorities have difficulties in fulfilling their targets with the technology they have at hand, so they need to expand their horizons and look for solutions further afield. In Hunan province alone, there are 190 water treatment plants which require an upgrade to reach their specific targets in the Five-Year Plan, and we can present a platform for solutions to meet their requirements," attests Marco Rhyner of Cleantech Switzerland, which supports Swiss environmental and sustainable energy industries in foreign markets.

Magali Menant of German green-tech platform Econet has a similar approach: "Our goal is to promote German know-how on the Chinese market. In the water sector we work closely together with associations such as the German Water Partnership. Together we plan a roadshow through several Chinese cities later this year to present innovative solutions made in Germany, focusing on energy efficiency in the water sector. We build up essential contacts and find opportunities in the market, which is often hard for SMEs to achieve on their own."

Possibilities are also abound in the treatment of sewage sludge, which still has a poor safe disposal rate of less than 10%. "This is currently a hot topic, nobody seems to really know how to handle the sludge," confirms Martin Woller,

who as Austrian Consul of Commercial Affairs in Guangzhou promotes environmental technology in China through the foreign trade platform Advantage Austria.

Marketing water issues
Some projects do not have a direct commercial relation, but rather a more general mission to raise awareness. For example Econet China, in cooperation with the renowned Fraunhofer Institute, will start an exchange with Chinese authorities in the city of Taicang. "Of course we hope that we can also promote German technology by this, but the main purpose is to create a greater sensibility for environmental issues and innovative solutions," Ms. Menant explains. The German Energy Center and College (GECC) also aims to create greater awareness for green-tech solutions. Florian Göbel, who at GECC regularly organises events in Chinese, comments: "We cooperate both with German companies and educational institutions, as well as with our partner companies in China who are also active in water conservation or wastewater management, for example by offering vocational training courses to develop a better market understanding."

Market-entry strategy
Green-tech companies who want to enter China should not be blinded by the sheer size of the market. Mr. Rhyner warns: "Great potential alone will not directly lead to orders, while we can help to establish contacts, companies should have a reference project at hand and constantly refer to the advantages of their applications." Ms. Menant concurs: "Reference projects are essential to get a foothold in the market." Such projects require sometimes the combination of various competences that small companies alone cannot provide. Therefore a pool or consortium of companies that provide a total-solution expertise is a good strategy.

Local technical design institutes which help during the project planning phase are often important door openers and can help with their own network of contacts. Foreign companies already in the market can also provide helpful support. "We have all variations of set-ups within our platform, from entirely offshore-based companies to Representative Offices to full-fledged sales or production organisations". Mr. Rhyner states.

Companies from the green-tech sector may want to find their own specific inroads, but they can rely on support from organisations and consultancies with industry expertise and experience in China.

For further information on market-entry support for foreign companies from the green technology and renewable energy sectors, please refer to the full article on www.fiducia-china.com

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What is your next move?



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