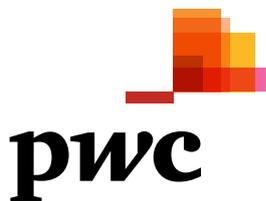




Doing business and investing in China



A compilation of insider knowledge and advice, whether you're entering the China market for the first time or growing your existing business.



普华永道

www.pwccn.com/investchina

本书内容详尽丰富, 独立成章, 实用性强, 同时充分展示了普华永道的专业水准和对中国市场的深刻认知, 是外资进入中国并在中国市场发展的很好的参考材料。

项怀诚
前财政部部长

The content in this book is rich, well organised and detailed. It offers a uniquely independent and practical perspective, showcasing PwC's professional standards and extensive on-the-ground experience in the China market. It serves as a solid reference for foreign investors looking to grow their operations in China.

Mr. Huaicheng Xiang
Former Minister of Finance

中国市场有着巨大的增长潜力, 我们期望和世界各国的投资者分享我们的经验和专业知识, 精诚合作, 把握机遇, 共同发展。

杨绍信
普华永道亚太区及中国主席

The China market has tremendous growth potential. By sharing our experience and perspectives, we look forward to collaborating with investors from all over the world to grow and develop this market.

Mr. Silas Yang
*PwC Asia Pacific Chairman
China and Hong Kong Executive Chairman*

Welcome

In my discussions with global CEOs around the region, I find our conversations inevitably returning to one prevailing theme: every year is more challenging than the last. With the continuing global economic recession and rapidly changing market, businesses are operating in uncertain economic times. Closer to home, China's economic growth has begun to slow, and the regulatory landscape remains challenging for foreign investors.

The good news is that we operate in one of the most dynamic economies in the world. With new leadership and promising recovery signals, I'm confident that over the longer term, China will continue to deliver tremendous opportunities for global investors. China, however, is a market like no other. Its size and regional diversity call for a sensitive and sophisticated market approach, and its re-emergence as one of the world's foremost economies has set off an unprecedented pull for companies to invest and do business here.

For business owners and executives across all industries looking to enter or grow their China operations, we've developed this book by listening to you tell us what concerns you most. Organised into a series of separate, stand-alone chapters, this book presents perspectives from PwC industry professionals and specialists in China, shaped by their real, on-the-ground experience in China. For a good understanding and workable foundation to build on your China strategy, focus on a topic that resonates with you most and your current business cycle.

We hope you'll find context for some of your immediate concerns here, from a PwC perspective, about doing business in China. Should you have more specific questions about your particular industry or situation, please feel free to turn to our professional advisers at any one of our 22 offices across China.

We look forward to helping you succeed in one of the fastest-growing and most promising parts of the world.

Regards,



Frank Lyn

Managing Partner, PwC China and Hong Kong

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Executive summary

One transformational change seen this past decade is that of China as a sourcing destination evolving into China as a market. While locating key parts of your supply and value chain in China still offers many benefits as a part of a regional and global strategy, the focus for businesses has clearly shifted from an “emerging labour pool” to an “emerging middle class.” It is no longer about benefiting from low cost anymore, but about tapping the world’s strongest sustainable growth market.

Rapid changes in demographics and market forces are opening up exciting new sectors and opportunities that would never have been thought possible a few years ago, much less open to foreign investment. And foreign businesses need China, a need reinforced by concerns over the recent global economic slowdown. We asked over 366 CEOs in the Asia Pacific Economic Cooperation region to what extent a drop in China’s GDP below 7.5%

would affect their organisation: 56% said it would affect their organisation to some extent, while 32% said it would affect them to a great extent.¹ A majority of foreign businesses are now clearly tied to the Chinese economy, with 43% of CEOs ranking China as the most important growth market for their companies.

China’s simultaneous catalysts – an ageing population, growing wealth, changing consumer attitudes, rising environmental awareness, greater mobility, urbanisation, and decreasing household sizes – are pushing the country through a process of great change. To keep up, market reform is moving a growing number of sectors and markets towards liberalisation. And China’s new leadership is committed to deepening reform and opening up its markets.²

The message from early entrants is clear: make sure you are fully prepared and committed before investing. The reality of the China environment is oftentimes several degrees more nuanced and complex than what new market entrants or investors initially expect, so they should pay careful attention to on-the-ground risks. The key to success is to have fully assessed your markets and risks, and be invested-really invested-in knowing your customers and partners, your government touch points and stakeholders.

1. PwC. “APEC CEO Survey: Addressing challenges, expanding possibilities.” 2012

2. A broader discussion on China’s new leadership agenda can be found in “New government leadership, new agenda for growth” in this book

A market beyond your comfort zone

While the reasons for entry are compelling, finding the right path into the China market has its challenges. Businesses expanding into China are pulled by demands that are tethered to this country, unique from the culturally related regions of the West. Many have discovered that success in their markets does not necessarily equate to the same outcome in China. This book takes you through some critical hurdles and success factors.

Several themes weave throughout these articles. One is that careful planning is crucial to any China strategy. The message from early entrants is clear: make sure you are fully prepared and committed before investing. The reality of the China environment is oftentimes several degrees more nuanced and complex than what new market entrants or investors initially expect, so they should pay careful attention to on-the-ground risks. The key to success is to have fully assessed your markets and risks, and be invested – really invested – in knowing your customers and partners, your government touch points and stakeholders.

The best way to mitigate your risks is by knowing your customers and partners, your government touch points and your stakeholders. Tailored due diligence, with independent sources whom you can trust, should be your strongest safeguard. Look at the same issue from various lenses, experimenting with different techniques while soliciting an array of viewpoints.

China has changed and is still changing. While some markets are opening up to foreign investment, Chinese companies are demonstrating abilities to innovate, develop new proprietary technologies, and expand beyond their borders. Foreign companies may not be as attractive as they were a couple of decades ago, and recent economic woes have cast doubt over the business models that have prevailed in the West. Chinese authorities and executives alike have gained a new assertiveness, as well as a greater appreciation of their own strengths.

As a result, potential Chinese partners, customers, and industry workforces are more critically evaluating the actual value propositions of foreign companies investing or selling into China. The valuations of Chinese companies in M&A deals have gone up; good deals are harder to find. Foreign companies need to carefully assess whether their products and services are adequately adapted to the local market. When partnering with local players, they need to think ahead to issues of post-deal integration, local talent recruitment, management and retention, and building flexibility and adaptability into their business models.

When incorporating risks into strategic planning, you should examine every level of risk, throughout all business functions. You will find that they are often intertwined, and such an analysis affords a bird's eye view of the local business environment and practices. An integrated China strategy must therefore address risks that stem from both creating value and protecting it.

Find business partners that are open to fresh thinking and new ideas. These partners must have enough experience in the local industry and familiarity with differences in local consumer and industry segments to see how to carry through with these ideas. Above all, these partners must possess the resources and relationships that complement yours. But alliances come with their risks. Trust and regular communication throughout the relationship cycle cannot be over-emphasised.

Flexibility and persistence

There is no single business model that is key to unlocking the China market. In fact, there is no single China market. The different markets, geographies and industries within China can be as diverse as each company.³ Local regulations and local enforcement of central regulations can also differ greatly, so cultivating a wide network of local contacts in government, while gaining an understanding of local practices, will help lower your compliance risks. Maintaining positive and sustainable relations with government departments and the people you're comfortable with can help you stay on top of new regulatory changes as they happen.

And while regulatory reforms strain to keep up with market growth, consumer attitudes in China continue to shift on a regular basis. Your approach towards China therefore requires that you regularly update your business strategies to match competitor, customer, economic and regulatory changes.

As mentioned, adaptability is crucial in China. Align your business to match your treasury, tax, regulatory, and market growth strategies, so you can capture market opportunities and mitigate risks as new channels and policies emerge. For instance, a dynamic and flexible treasury strategy needs to account for an environment of constantly changing regulation, so that low cash flow scenarios may be avoided in the face of sudden opportunities or threats. When forecasting cash flow, over-engineering the planning process may be counter-productive in a complex system. Too many changes have unknown consequences in this market. Try instead to gain a better insight into the drivers of cash flow and various scenarios in order to find the right capital structure to absorb external changes.

Investors should also be guided by flexibility when finding potential joint venture partners or M&A targets. The China deals environment can be a challenge, as good deals are harder to find, and the process can be complex and protracted. Investors must make sure M&A is the right entry and growth path for them. Make sure you look at all options before proceeding down an acquisition path.

In an environment of higher valuations, long deal processes, and an expanded role for government, you'll need a fair amount of patience and persistence. Conduct due diligence as early as possible, and test how ready your target is for integration. A proactive assessment of your target's internal controls and corporate governance can help prevent implementing new procedures and processes without due consideration for Chinese cultural differences, practicality and the regulatory environment.

Other types of due diligence potentially relevant in this environment include environmental, information technology, and human resources. But again, while investors should be careful to identify all potential risks, getting a broader view is critical. Investors must remember to put all risks in the right context, and take calculated risks based on informed decisions. Finally, there may be more stakeholders than you may think. Mapping them out can give you an understanding of which organisations have a say in your business interests.

3. A regional and city tier analysis can be found in the Appendices

Solving the critical talent question

Whether you are planning to grow organically or through acquisitions and partnerships, your business will be best served by having your interests well represented with a strong team in the field. Finding local talent, however, is a long-term exercise in sustainable capacity building. Demographic growth is slowing while costs are rising, leading to higher wages and staggering yearly turnover figures. But the demand for talent in China is not slowing down. Almost half of China CEOs are looking to expand head count by more than 5% in 2012. This is in contrast to just 28% of CEOs globally who have the same plans for head count growth.⁴

Talent challenges can be solved by focusing on bolstering talent development and engagement, in addition to hiring the right people. Competencies and skills are required for a range of different functions – including finance, reporting, logistics, corporate governance and research. But across the spectrum, the talents most in demand are not skilled technical staff – they're middle managers.

Finding and keeping competent localised middle managers integrated into your leadership succession plans are keys to solving challenges in long-term capacity building. Businesses will discover that talent is a key factor in unlocking China's market potential, which may lie in its latent capacity to innovate. Beyond the fundamental market opportunities, there is an ecosystem of innovation gathering pace. In 2011, China had 49 of the 86 global tech IPOs, or 57%.⁵ Dominance in technology IPOs, says PwC's Global Technology Leader Raman Chitkara, maps closely with Japan and Korea during their tech booms.⁶ More importantly, young and talented minds are fostering an incubator of new ideas, from biotechnology to clean energy.

An understanding of China's history, culture and language can allow investors to better relate to their partners, build relations in government and tap the local market. While local advisers can help you bridge these cultural gaps, you should ensure that your local teams are properly staffed with long-term senior management, as building your talent can take patience and persistence. Careful planning, accompanied by an open mind, flexible strategy and realistic approach can allow investors to achieve success over the long term.

4. PwC. "15th Annual Global CEO Survey." 2012

5. PwC. "Global Technology: Q4 and full-year IPO review." 2012

6. Deagon, Brian. "China is seen evolving into innovative tech powerhouse." *Investor's Business Daily*, 24 August 2012.

New leadership, new agenda for growth

Foreign investment in China's new political and economic landscape

China has made remarkable progress over the past decade. Its share of global GDP has risen from 4.4% in 2002 to around 10% in 2011. Currently, China is the world's largest exporter and its second-largest importer, and holder of the biggest foreign currency reserves. And despite China's slowdown in growth, it is expected to overtake the US as the world's largest economy (measured by GDP at purchasing power parity) as early as 2018, according to PwC estimates.¹

As the nation stands on the cusp of an economic transformation, the newly-elected "fifth generation" of leaders will not only need to ensure its existing path of reform and liberalisation continues but also bring about a more balanced growth. In November 2012, the 18th National Congress of the Communist Party of China (CPC) sent the international community a clear and

consistent message that the new leadership remains committed to "deepening reform and opening up."²

Led by Party Secretary General Xi Jinping, China's new leaders are veterans with long service records in local and central governments. Each brings a wealth of experience in handling tough situations. They've been deeply involved in China's economic transformation over the past three decades as direct policymakers, caretakers and participants. Their experience will allow for policies that follow a continuation of current reform and liberalisation. The diverse backgrounds of the new leadership – Xi holds a doctorate of law, while Li Keqiang has a doctorate of economics – contrasts with the engineering-focused backgrounds of the previous leadership. These credentials will add new dimensions to future policy making.

1. PwC. "The World in 2050." 2011

2. All quotations in this commentary have been sourced from Xinhua News Agency's English media reports

China: By the numbers

\$7.5
trillion

China's GDP value
in 2011

\$4.9
trillion

Fixed asset
investment in 2011

9.9%

Average GDP growth rate over the past
three decades

\$3.2
trillion

Size of foreign
reserves by June
2012

38%

Domestic consumption as a % of GDP

\$116
billion

Value of foreign
investment into
China in 2011

51%

Rate of urbanisation in 2011

\$60
billion

Value of China's
outbound
investment in 2011

18.4
million

Units of car production in 2011

Themes for a new China

The keynote report delivered by President Hu Jintao at the 18th Party Congress largely reflects the new leadership's consensus. The "crystallisation of the wisdom of the whole Party," it provides general guidelines of the new leadership for the next 10 years.

Three key themes stand out:

- **Restructuring the economy**
- **Boosting domestic demand**
- **Spurring green growth**

These themes must be put into perspective if we are to understand their implications for foreign companies operating in China. It's believed the themes will be translated into more detailed action plans when the new government forms at the National People's Congress in March 2013.

As China moves towards the "new normal" of single-digit growth, investors should focus on China's growing domestic market and rising incomes, as well as green projects and the movement of labour-intensive industries towards the central and western parts of the country.

Single-digit growth: The new normal

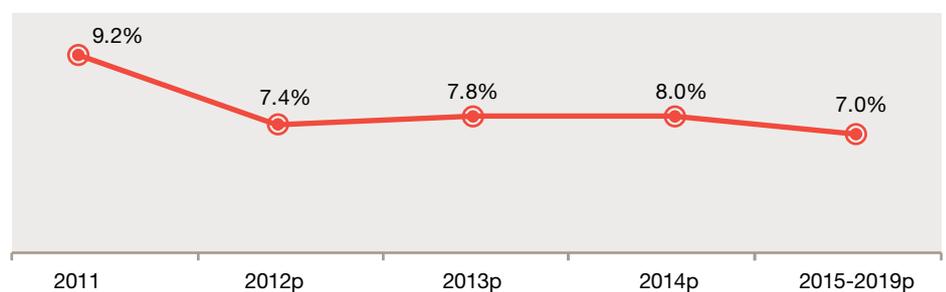
As President Hu pointed out in the report, China also faces many challenges that include an unbalanced industrial structure, resource and environmental constraints, large development gaps between urban and rural areas and between regions and income, social problems in various areas that affect people's immediate interest, bureaucratism and corruption, and systemic barriers that stand in the way of promoting development in a scientific way.

Challenges also include severe environmental damage, of which the economic losses have been estimated at RMB 1.39 trillion (US\$22 billion) in 2009.³ In the words of Premier Wen Jiabao, the pattern of economic growth is "imbalanced, uncoordinated and unsustainable." China's new leadership will need to tackle these issues.

In China's 12th Five-Year Plan, the target growth rate has been set at 7% between 2011 and 2015. While this stands in stark contrast to the double-digit growth rates of previous years, the government can still achieve its new goal of "doubling China's 2010 GDP by 2020" by maintaining this rate of

growth over the next eight years. While the economy will pick up in 2013, slower growth is expected over the longer term if the country is to successfully shift its growth patterns towards consumption. PwC forecasts that China's GDP will grow 7.8% in 2013 and 8.0% in 2014.

China GDP growth rate



p = projected

Source: PwC macroeconomics unit. Please note that these are PwC's main scenario projections and are therefore subject to considerable uncertainties. We recommend readers to look at a range of alternative scenarios.

3. Ministry of Environmental Protection of the People's Republic of China. "China's growth in environmental losses have overtaken that of GDP." China Business News, 2 February 2012

Shift towards domestic consumption

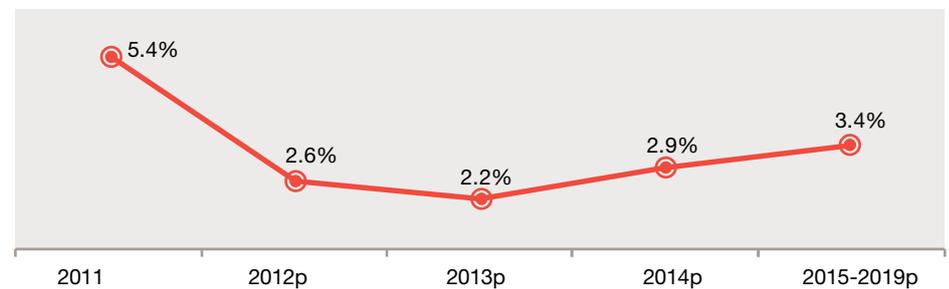
Over the past three decades, China's economic expansion has largely been driven by three growth pillars: investment, exports and domestic consumption. But massive government investment has yielded low returns, especially for infrastructure-related projects. Furthermore, over-capacity in energy and resource intensive industries has increased the country's reliance on foreign oil and minerals imports. The costs of labour, land, water and resources are also on the rise. Sluggish external demand has severely affected China's exports, forcing many factories along the coast to shut down.

Of China's three growth pillars, domestic consumption has been the weakest, with growth in worker salaries lagging consistently behind that of GDP. Most of the wealth generated has been controlled by the state, and reinvested into industries and infrastructure projects. The rising cost of education, housing, healthcare and pension have forced the population to prioritise saving over spending.

In his November report to the Party Congress, President Hu called for "doubling per capita income for both urban and rural residents by 2020." This is the first time the government has linked economic growth with per capita income increase for its residents. The report also vowed to "establish a long-term mechanism for increasing consumer demand" and "unleash the potential of individual consumption." In an effort to dispel concerns over spending, the government has promised progress on ensuring rights to education, employment, medical and old-age care and housing are extended to as much of the population as possible.

"Doubling per capita income" will mean two things for investors: Firstly, labour costs will continue to rise, which may also drive inflation. However, the central bank's efforts to bring inflation back under its target of 4% to prevent a repeat of the asset bubble and non-performing loans associated with the 2008-2009 economic stimulus programme may yield results. PwC forecasts China's inflation to continue to be slow, staying at below 4% over the next few years.

China inflation rate

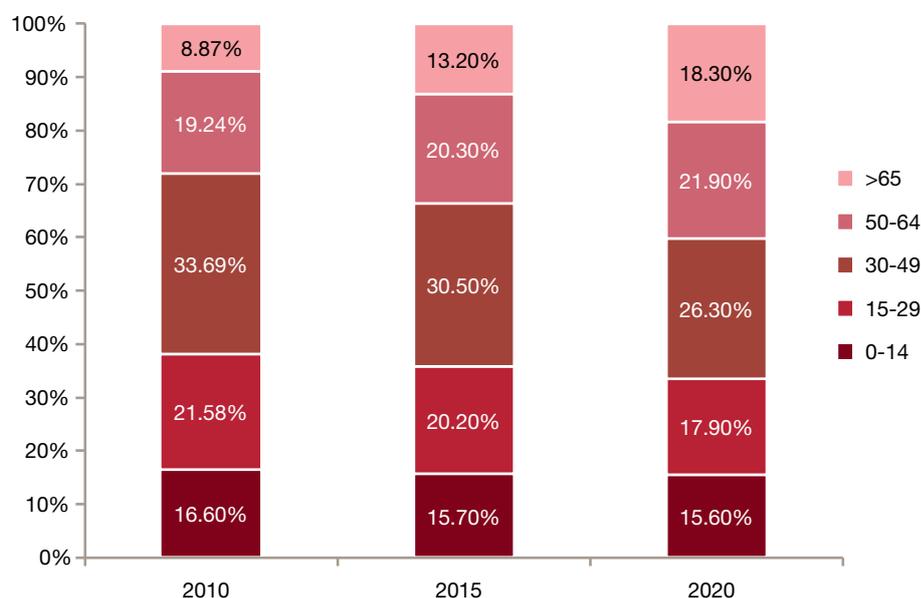


p = projected
Source: PwC macroeconomics unit

Secondly, it implies that China's domestic market will expand markedly in the coming years. According to the National Bureau of Statistics of China, China's retail sales grew 14% year-on-year in the first three quarters of 2012 to RMB 14.9 trillion, contributing to about 55% of GDP. Better established foreign brands in particular will benefit from this increased purchasing power.

China's rapidly ageing society will be another chief driver of change (the number of Chinese over the age of 50 is expected to grow to over 40% by 2020, from 28.11% in 2010). Demographic changes will therefore turn China from a 'population surplus' to a 'population deficit' by 2015, a scenario that would pose challenges and opportunities in a number of sectors, including the debt, equity and insurance markets, while directly impacting industries such as healthcare, pharmaceuticals and senior care, and influencing numerous other sectors.

Age group distribution*



*All PwC estimates

Urbanisation and movement inland

Meanwhile, regional demographics are also shifting. While China's urbanisation rate reached 51.27% in 2011, the first time in its history that city dwellers outnumbered the rural population, significant changes to the resident permit registration (*hukou*) system have yet to be proposed. The government's position is for an "orderly" transition of migrant workers – 250 million of them in 2011 – into urban residents. Bolstering the support mechanisms for these migrant workers should be an objective for encouraging economic growth.

As analysts expect at least another 200 million migrant workers to move to urban areas,⁴ China's growing middle class will spur an additional RMB 40 trillion in investment demand over the next 10 years, while residential consumption should rise from RMB 16

trillion in 2011 to RMB 30 trillion in 2016. Sectors from building design and construction material to real estate management will provide opportunities for foreign investors. Perhaps less intuitive areas for residential-related investment are household appliances, and culture and recreational activities.

As the government strives to implement a strategy of "regional development," China will "give high priority to rural areas in developing infrastructure." It will also invest more in "old revolutionary base areas," ethnic minorities, border areas and underdeveloped areas through initiatives such as "pairing assistance projects." Foreign investors need to consider moving their labour-intensive industries to the western and central parts of China to reap benefits from preferential treatments, while partnering with more developed cities to cultivate the inland market.⁵

4. Chi, Fulin. "Urbanisation will support China's sustainable growth." 2012

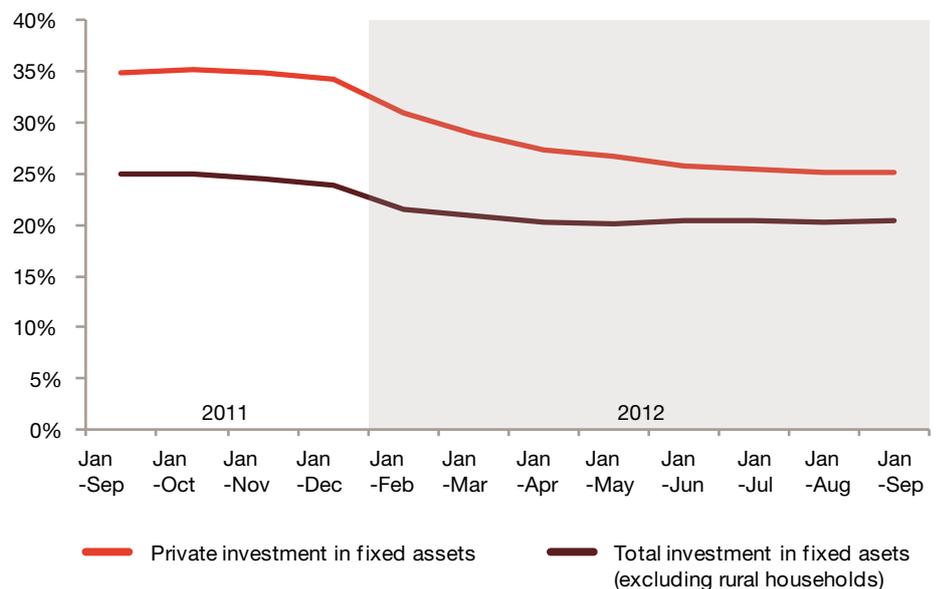
5. See Appendices for a city tier and regional overview

Promoting the private sector

China's private sector, which includes foreign-invested enterprises (FIEs) in China, comprises 60% of GDP⁶ and employs the majority of the country's workforce. But the new leaders will need political resolve to make good on the government's public agenda of breaking up state monopoly in key economic sectors to encourage more private competition. These leaders will need to implement reforms to open up state-owned enterprises to greater private and foreign participation. The new 36 Articles of the State Council promising more market access to the private sector was met with limited response. While calling for support for small and micro businesses, particularly in science and technology, President Hu stressed "increased investment in industries crucial to national and economic security, as well as further development and reform of the state sector." These statements seem to backtrack on previous government commitments to break up monopolies and stimulate economic vitality.

However, data released over 2012 have offered an optimistic outlook for private investment. For the first nine months ended September 2012, private investment in fixed assets reached RMB 15.94 trillion, a year-on-year increase of 25.1%, and accounting for 62% of total investment in fixed assets.⁷ Private investment continues to dominate growth, consistently outpacing state investment over the past few years, a healthy indicator of private enterprise's role in building a stronger economy.

Growth rate of private investment in fixed assets and total investment in fixed assets (excluding rural households)



Source: National Bureau of Statistics

And China's commitment towards freer regulation and strengthening competition from private and foreign investors is becoming evident to global observers. According to the IFC and the World Bank,⁸ China is ranked among the top 10 economies for business-friendly regulation. The country has, over the past eight years, made the greatest progress towards easing business regulations for its entrepreneurs among all territories in Asia Pacific. Regulatory efficiencies have improved the most since 2005. That year, the government adopted a new company law. The government also established a new credit registry in 2006, enacted its first bankruptcy law in 2007, and a corporate income tax law in 2008. The country has also made starting a business less expensive, waiving a series of administrative fees for small businesses from January 2012 to December 2014.

Yet private businesses continue to face multiple challenges, from access to finance, bank loans and government incentives, to high taxes and employee turnover. FIEs face additional difficulties with restricted market access, joint venture and licensing requirements, forced transfer of technology and inability to qualify for subsidies. FIEs also encounter challenges in securing R&D funds and public procurement contracts, and not being able to take part in standards-drafting processes.⁹

6. Xu, Xiaofeng. "China Private Sector Report Released." Yangtze Evening Post, 12 March 2012

7. National Bureau of Statistics of China. "Private Investments in Fixed Assets for January to September." 2012

8. IFC and World Bank. "Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises." 2012

9. European Union Chamber of Commerce in China. "Business Confidence Survey 2012"

China growth trends

	2005	2010	2015	Trend
Real GDP growth	10%	11%	7-8%	Growth significantly moderates
Five-year average export growth	~26%	~17%	~10%	Slowing exports as “upgrading” occurs
Consumption – GDP share	38%	37%	40%	Consumption outgrows GDP
Services – GDP share	41%	43%	45%	Expansion of services sector
Inland – GDP share	44%	47%	52%	Inland growth accounts for half of GDP
Middle class & affluent	15%	23%	38%	Significant increase
Hourly labour wage	US\$1.1	US\$2.2	US\$4.6	Higher labour costs
USD:RMB exchange rate	8.2	6.8	5.7	Appreciation ~3% per annum

Source: US-China Business Council – 12th FYP report

Future investment priorities

With the new leadership transition, China is at a political and economic crossroad. Without further political reform, economic gains from the existing system will be limited as China moves further into a “deep water zone.” Leaders have been advocating for change to reduce government intervention and allow for more market-driven resource allocation. Managing corruption also requires clearly set boundaries by the government. The task for China’s new leadership is to push forward on reform measures that have stalled since the 1990s. In recognition of rising corruption, President Hu’s report concludes that if not handled well, it could “prove fatal to the Party and even cause the collapse of the Party and the fall of the state.”

Finally, the government has an interest in providing greater direction and clarity on its investment priorities, which will provide foreign investors more incentive to invest in key industries. In the revised *Catalogue for the Guidance of Foreign Invested Industries*, investors are encouraged to invest in advanced manufacturing, high-and new-technology industries, energy-saving and environmental protection, modern services and inland provinces. Foreign investors should look to those industries as good entry and growth points into the China market. Most importantly, they should always stand ready to respond to further policy changes as they occur in China.

10. See also Market entry and growth chapter for a discussion on the revised catalogue

12th Five-Year Plan

China's 12th Five-Year Plan is a good starting point from which to align your business goals with that of the government's plans. As one of the government's most transparent points of reference, the Five-Year Plan indicates how China's economic, social, environmental, geographic and legal landscape is likely to evolve over the coming five years. Neither a law nor regulation, the Plan serves as a road map of government priorities and interests. It can also act as a basis for your strategies and tactics.

Currently, the Plan provides greater clarity on the government's investment priorities, giving foreign investors more incentives to invest in key industries such as advanced manufacturing, energy saving, environmental protection and modern services. It also suggests tightened regulation on energy conservation and environmental protection, a development for which companies doing business in China will need to prepare. In addition, the Government Work Report delivered at the 2012 National People's Congress emphasised its position on "allowing the private sector to invest in railway, municipal construction, finance, energy, education and health care sectors."¹¹

11. For information on the 12th Five-Year Plan (2011-2015), see also PwC's 10Minutes: Commentary on Premier Wen Jiabao's 2012 Government Work Report

Major cities: Population and economic data

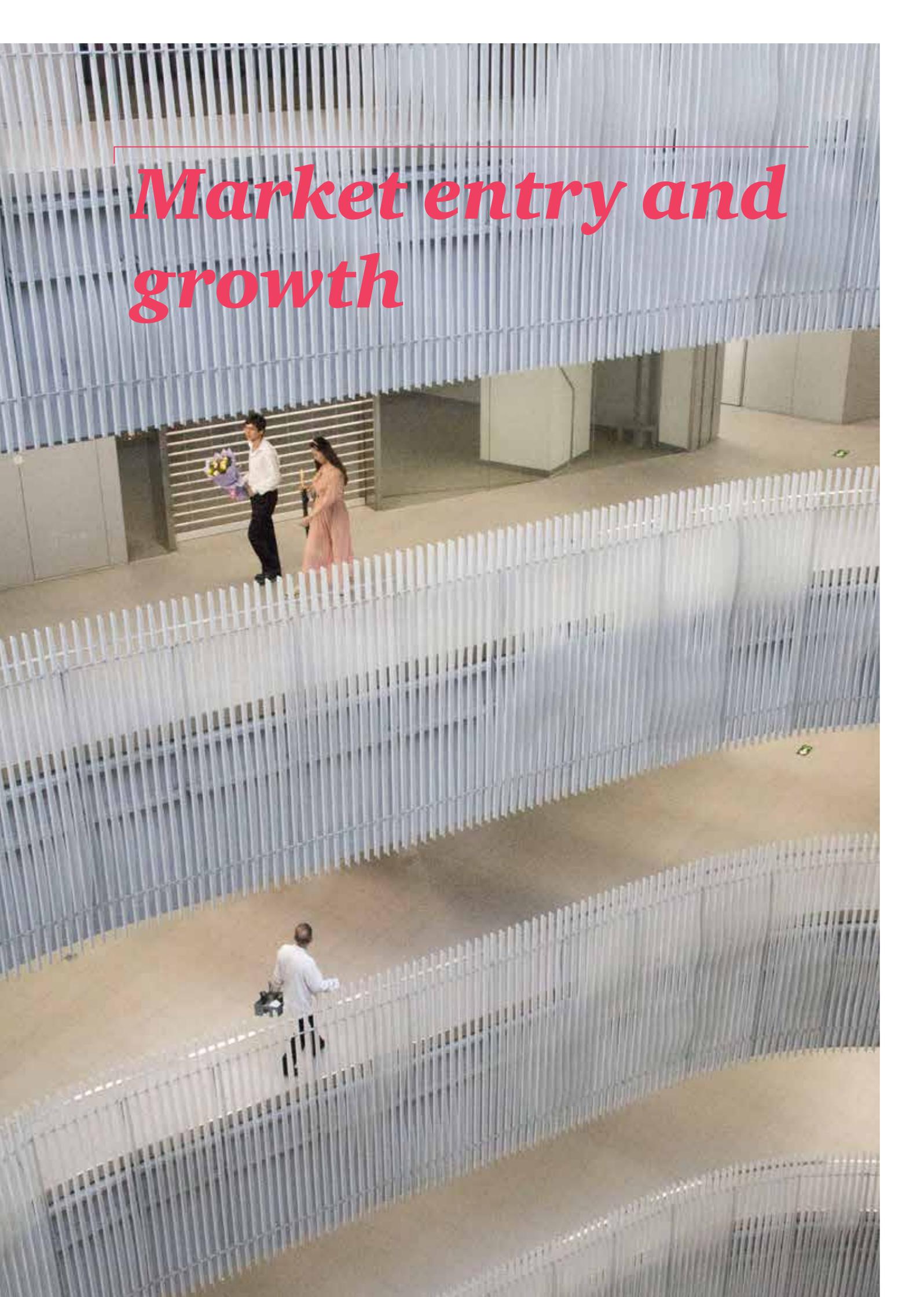
Anqing Population: 6.16 (FY 2009) GRP: RMB 79,613 (FY 2009) PCI: RMB 13,454.14	Shenyang Population: 7.20 GRP: RMB 501,754.27	Dalian Population: 5.86 GRP: RMB 515,816.21 PCI: RMB 19,014.37	Harbin Population: 9.92 GRP: RMB 366,485.38
Jiujiang Population: 4.91 (FY 2009) GRP: RMB 83,136 (FY 2009) PCI: RMB 14,203.00	Tianjin Population: 12.99 GRP: RMB 922,446 PCI: RMB 24,292.60	Qingdao Population: 7.64 GRP: RMB 566,619 PCI: RMB 22,367.88	Beijing Population: 19.62 GRP: RMB 1,411,358 PCI: RMB 29,072.93
Guilin Population: 5.12 (FY 2009) GRP: RMB 94,823 (FY 2009) PCI: RMB 16,620.00	Nanjing Population: 6.32 GRP: RMB 513,065 PCI: RMB 24,678.00	Suzhou Population: 6.38 GRP: RMB 774,020 PCI: RMB 27,188.00	Shanghai Population: 23.03 GRP: RMB 1,716,598 PCI: RMB 31,838.08
Wenzhou Population: 7.79 (FY 2009) GRP: RMB 252,734 (FY 2009)	Wuhan Population: 8.38 GRP: RMB 556,593 PCI: RMB 18,385.00	Xiamen Population: 1.08 GRP: RMB 206,007.37 PCI: RMB 26,131.00	Xi'an Population: 7.83 GRP: RMB 324,149 PCI: RMB 18,963.00
Shantou Population: 5.11 (FY 2009) GRP: RMB 103,587 (FY 2009)	Chongqing Population: 28.85 GRP: RMB 792,558 PCI: RMB 17,532.43	Shenzhen Population: 2.06 GRP: RMB 958,151 PCI: RMB 29,244.50	Chengdu Population: 11.49 GRP: RMB 555,133.36 PCI: RMB 17,589.00
Kunming Population: 6.36 GRP: RMB 212,037 PCI: RMB 14,482.00 (FY 2008)	Guangzhou Population: 8.06 GRP: RMB 1,074,828.28 PCI: RMB 27,609.60		

Population: Population (in millions)
 GRP: Growth regional product (RMB in millions)
 PCI: Per capita income (FY 2009 figures)

Source: WindInfo and China Statistical Yearbook. 2011 figures, unless otherwise stated



Market entry and growth



Observations

1. China is not a single market. Profound differences can exist from region to region, from Tier 1 to Tier 4 cities, from industry to industry, and among different income levels.
2. Data availability and reliability are important considerations for any market study into China.
3. There are many trade-offs to consider before deciding whether to work with a partner (inorganic growth) or to pursue a go-it-alone strategy (organic growth).
4. China partners are increasingly calling on foreign counterparts to offer more attractive value propositions, including technology transfer and know-how, in return for local presence and assistance.
5. There is no defined formula for China entry; successful companies are flexible, and adapt quickly to the realities of their particular industry and market.

Recommendations

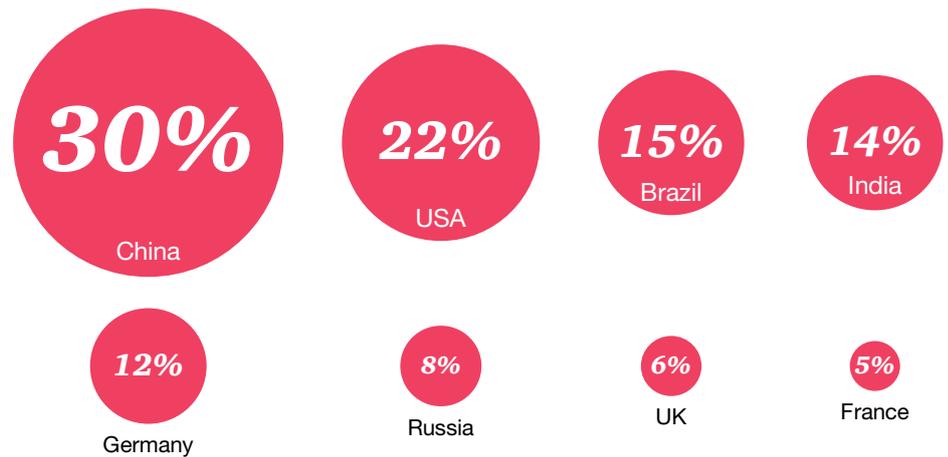
1. Relationships in China are helpful in aiding your due diligence and market research, particularly if your own investigative resources are insufficient.
2. When analysing market research, find an adviser who is sufficiently familiar with the local market and contextual subtleties to interpret the data correctly.
3. Properly localising your products and services for the China market takes a considerable amount of resources and research. Make sure you're ready to commit.
4. Clear communication and trust will guide the success of any business partnership in China.
5. Ensure that your business strategy and industry focus are in line with government policies on foreign investment.

Coming up with the best-fit strategy

The sheer speed and scope of China's growth are what make the country so unique and the investment opportunities so attractive. Of the over 1,200 CEOs surveyed in PwC's 2012 Global CEO Survey, 30% have said that they are looking to China as one of their "top three important regions for their overall growth prospects over the next 12 months."¹ In a 2012 American Chamber of Commerce in China (AmCham-China) business climate survey, "82% of respondents surveyed plan to increase investment in their China operations in 2012, with 66% saying their goal is to produce goods and services for China, an 8% increase from two years ago."² That's why China is and will be a compelling place to do business.

Businesses setting strategies for entering or growing in the China market should seek out proper market analysis, capability building and investment structuring. This chapter will discuss these and other considerations for market entry and growth.

The top regions for overall growth prospects over the next 12 months, according to 1,258 CEOs.



Source: PwC 15th Global CEO Survey 2012

An increasing number of foreign companies are trying to venture into China on their own, later discovering that, to accelerate growth, they'll have to work with local partners to leverage resources such as sales channels, customer bases and low production costs. Identifying the right local partner, aligning their interests and fulfilling their strategic intention, with assistance from external advisers, is often critical for market entry.

Angeline Cheng, PwC China Consulting Associate Director

1. PwC. "15th Annual Global CEO Survey." 2012
2. American Chamber of Commerce in China. "AmCham China Business Climate Survey Report." 2012

Consumer markets in China are heterogeneous, regionally divided and diverse in terms of income levels, taste and sophistication. The culture, customs and traditions of the Chinese people make up an integral part of business decisions and government policy. Understanding these differences, and adopting a flexible market entry strategy that can accommodate these differences, will go a long way in China.

There is, of course, no defined formula for unlocking the China market. Companies who have been successful in meeting their goals are usually those with an adaptive strategy. They are nimble enough to respond to changes in the fluctuating environment and innovative enough to approach China differently. They do not expect to use the same business strategy that had worked in their home markets, or from any other emerging market, even should that strategy be tried and proven.

“On business development, we would traditionally start with a standard product set and adapt it to the local needs,” says Lázaro Compos, CEO of SWIFT, an international network for the financial services community. “But in India and China, you need to forget the products that you’ve got and start from scratch. Start from what it is they need and build from there.”³



3. PwC. “15th Annual Global CEO Survey.” 2012

Market research

Leading companies engage in a meticulous exploratory process when planning their China market entry strategy. Research as much as you can about how the Chinese business environment might affect your operations in your strategies, scrutinise your plans carefully and look at similar strategies that have played out in this market. Important issues to address at this early stage include competitor profiles, addressable market size, how products fit in or are differentiated from what exists, what their target market is buying, and why they're buying it. Figure 1 outlines the various issues you'll need to address from market analysis to entry into China.

As mentioned, China isn't a single market. Take into account the different geographies and markets within China – there are vast differences, for example, between relatively cosmopolitan Tier 1 cities, and smaller towns that are the Tier 3 and Tier 4 cities. Even urban markets in the same province have drastic dissimilarities. Compare Guangdong's Shenzhen, with its young migrant population of predominantly Mandarin speakers, with Guangdong's Guangzhou, and its older, more family-centred composition of Cantonese speakers. Each region must therefore be researched before entry, as customer preferences as well as regulatory and value chain considerations vary.⁴ There exists a broad spectrum in income level as well, and new types of Chinese consumers are emerging, exhibiting unique spending behaviours. Plans are subject to change though, and some flexibility will be needed to account for the change in dynamics of these disparate markets.

Says Robert Koch, CEO of Koch Enterprises, on his company's entrance into China, "Probably the longest part was our preliminary investigations, learning more about the country, the culture, the geography, where our customers would be, where the competition might be, the quality of competition."⁵ Relationships can prove particularly useful in helping you find out more about the market, particularly if you lack the appropriate investigative resources.

Product/service localisation

KFC, owned by American Yum! Brands Inc., owes much of its success to its flexible business strategy, designed specifically for the Chinese market, for Chinese customers. From the time its first stores first appeared in 1987, KFC's menu has grown to include not just their traditional fried chicken, but beef, seafood and rice dishes, fresh vegetables, soups, and breakfasts – choices that appeal more to local palates. Today, KFC has nearly 3,800 restaurants in more than 800 cities throughout China, and continues to open an average of one new location per day.⁶

Localisation can be one of the most important ingredients for rapid market growth in China. According to PwC research,⁷ China and India are the two markets in which multinational CEOs are most likely to modify or develop their own products specifically for local needs, due to their size. Nestlé's R&D centre in Beijing, for instance, is collaborating with Xi'an Jiaotong University to research the nutritional benefits of traditional Chinese herbal ingredients. General Electric has set up innovation centres in Shenyang and Xi'an, with a third Chengdu centre targeted at the local health care market, aimed to help the government reduce local medical costs.⁸ Only 25% of CEOs say their products and services in China are the same as that of their headquarter's market.

But unless a company has made sufficient commitment to China and is prepared to invest the necessary funds to research and develop localised products and services, its China unit will operate at a disadvantage to their local competitors. Often, China-based executives struggle to build a case with headquarters to secure the funds needed for proper localisation. Many businesses find it difficult to justify committing scarce resources to "question mark" China units that yield limited profitability. And with a number of China subsidiaries of foreign multinationals currently accounting for a small percentage of global revenue, businesses must make a decision on whether to settle with limited growth or fully commit to this market.⁹

4. See also Appendices for a quick overview of China's regions and city tiers

5. PwC. "Building a presence in today's growth markets: The experience of privately held companies." 2011

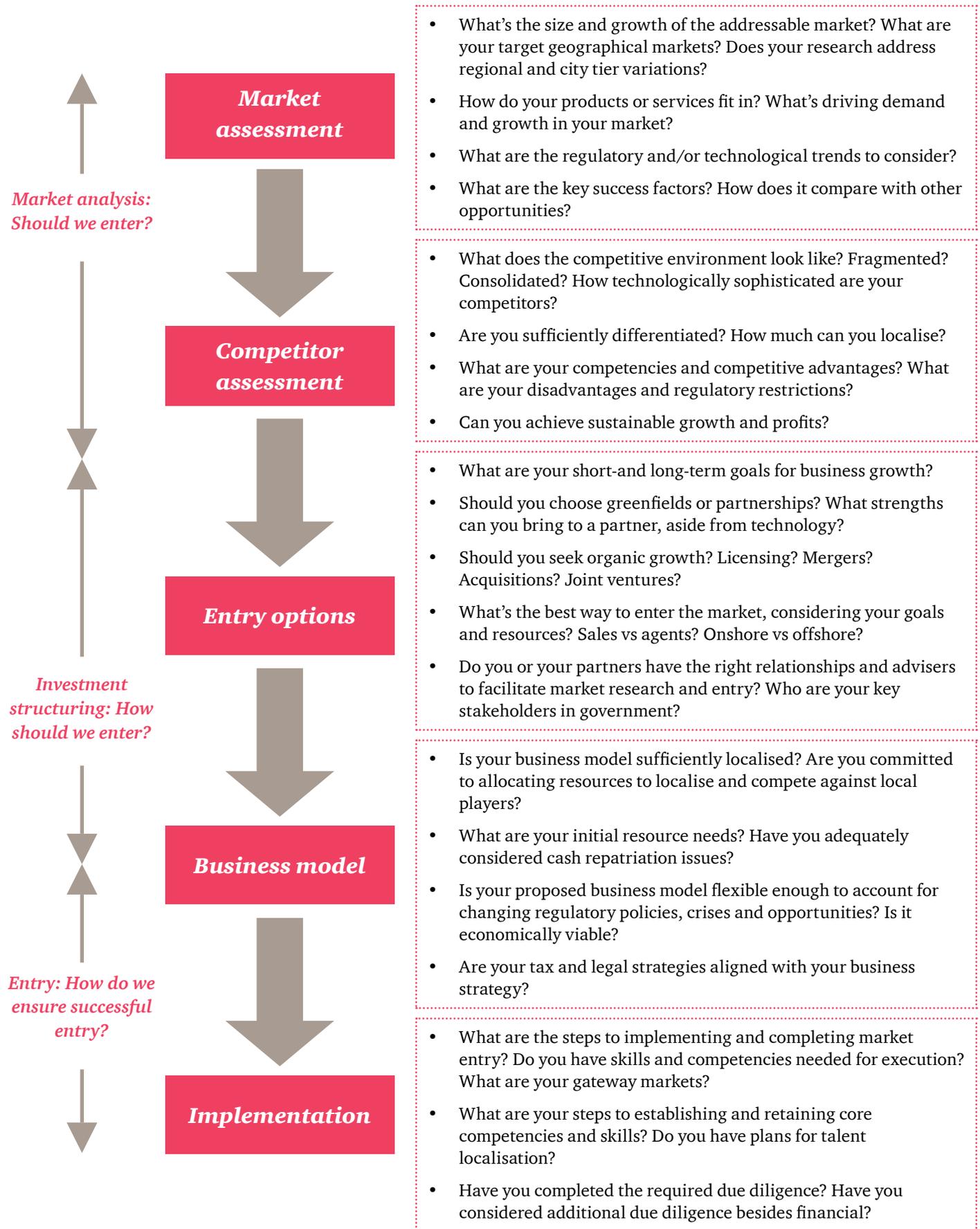
6. Yum! Brands. *Yum! China*. 2012. <http://www.yum.com/brands/china.asp>

7. PwC. "15th Annual Global CEO Survey." 2012

8. *Xinhua*. "GE to build innovation center in Chengdu." 18 January 2011

9. See also Supply chain strategies chapter for a discussion on the benefits of R&D centres

Figure 1. Approach to China market entry strategy



Open and closed industries for foreign investors

Normally, a foreign-invested enterprise (FIE) is set up for a specialised purpose with a specific business scope. An FIE refers to equity joint ventures, cooperative joint ventures with limited liability, wholly foreign-owned enterprises and foreign investment companies limited by shares. Foreign investors have traditionally set up FIEs for trade or production, but have expanded quickly into service, wholesale, retail or other types of business in China.¹⁰

There are opportunities and restrictions for foreign investors in different industries in China. These sectors are designated by the government as encouraged, permitted, restricted or prohibited. The 2011 Catalogue for the Guidance for Foreign-Invested Industries reflects which industries are open to foreign investment (see also the *Catalogue for the Guidance of Foreign-Invested Industries* found in this chapter).

Encouraged

Priority industries that are encouraged include high tech, environmental protection and new energy. The Chinese government offers preferential tax treatment and other incentives to foreign investors in these growth industries. This policy is designed to attract new advanced technologies, equipment and management know-how to the sectors.

Permitted

Industries not listed in the three basic categories of “encouraged,” “restricted” and “prohibited” are considered permitted, which acts as a default category. These industries are open to foreign investment, unless other PRC regulations state otherwise.

Restricted

Restricted industries include financial services, mining and media, where the government controls foreign investment. Foreign investors in the banking industry, for instance, are barred from owning more than 20% of a local bank, while commercial banks cannot be more than 25% foreign owned. Further, foreign investors can only invest in up to two commercial banks in China. These policies are designed to restrict foreign investment that will impair China’s sustainable development. Foreign investment in low-technology, resource-intensive and heavily polluting sectors are no longer encouraged.

Tighter restrictions are placed on foreign investors on the approvals process and on the amount and nature of a company’s capital contributions. In order to access these restricted industries, multinationals may be required to enter into a joint venture with a Chinese enterprise or other partnership with local shareholders. Setting up an investment project in restricted industries in China requires careful planning – particularly in areas such as raw material sourcing and distribution – and an assessment of the tax implications.

Prohibited

The sectors that are prohibited from foreign investment are quite specific. They include cultural, sports and entertainment industries, certain types of scientific research, and education.

10. See also Tax management: planning and compliance chapter for tax implications

Making sense of the numbers

Chinese consumer markets may be comparatively easy to observe and research, but these also evolve quickly. A continuing challenge lies in accounting for changing and shifting needs and tastes. Relevant research in industrial trade, manufacturing or other markets may be more difficult to find, if you don't have the right people with appropriate and localised industry experience. All these factors make it difficult to set strategy.

Data availability and reliability are also important considerations for any market study. The urban migrant population can be difficult to track, while some Chinese consumers are becoming more reluctant to disclose personal details. Market statistics might either be region-or industry-specific or too broad or out of date to be useful. Researchers should also note that much of the useful market information may be in Chinese.

A commonly used public data source of market information is the National Bureau of Statistics, but specific industry sources vary. A quick starting point can be to refer to the government ministry overseeing that industry as well as the reports and research of respective official industry associations.

Participating in industry conferences can also give you a sense of who is particularly active in a particular industry. Researchers looking for Internet-related information, for example, might start with the Ministry of Industry and Information Technology, as well as the China Internet Network Information Centre. Entrants looking at greentech markets may reference the China Greentech Report and associated white papers released by the China Greentech Initiative, which details opportunity assessments in the various cleantech markets in China.

Companies will need to develop an understanding of how research data are gathered. This can help them to correctly interpret the data, an exercise which can approach another level of art. Commonly, the locally based analyst should have an in-depth familiarity with China, as well as an understanding of the background of that particular industry in order to penetrate the inherent subtleties of the information and the background government policies. This analyst can then help you correctly distill the data into useful conclusions that can be integrated into your entry strategy.

After going through this research process, you may decide, for instance, that it's too difficult to enter the market yourself and that you may need to partner with an existing local company. Or you may decide that due to the competitive environment, you cannot afford the risk of losing intellectual property by working with a partner. Only after thorough consideration of your business objectives and market strategy should you begin considering options for your mode of entry into China.

Modes of entry

There are multiple channels of entry open to foreign investors, but they must fundamentally be backed by your company’s business objectives. Knowing what you’d like to achieve in China will help to determine the entry vehicles that can help take you there.

There are a number of options open for business operation after you have decided to enter China. The subsequent section discusses more common options for foreign investors. Additionally, based on your decisions as to which operation model to choose, one or more of investment vehicles should be set up. We will also detail the most commonly employed of these vehicles. Figure 2 illustrates some of the most common business operation options and investment vehicles.

Figure 2. Modes of entry

Typical options for business operation	Representative office (RO)	Wholly foreign owned enterprise (WFOE)	Foreign invested commercial enterprise (FICE)	Joint venture (JV)
Greenfield (alone or with a partner)				
Acquire an existing business (minority, majority or 100% interest)				
Licensing to distributors / franchise				

Catalogue for the Guidance of Foreign-Invested Industries

As one of the key tools used by the Chinese government to direct foreign investment into the country, the Catalogue for the Guidance of Foreign-Invested Industries¹¹ outlines sectors where foreign investment is encouraged, restricted or prohibited. Major changes from the latest revision, effective 30 January 2012, are shown below.

The encouraged category describes sectors in which China will push for dominance. It shows where the Chinese government wants foreign investment to go. In the same way, the catalogue shows which sectors the Chinese government has decided to limit or reduce. The restricted and prohibited categories show the sectors that are limited to foreign investment. Even for those who are not considering investment in China, the catalogue gives insight into the government's strategies.

For the developed regions of China, the goal of the catalogue is to steer foreign investment towards: 1) investment in high-value-added, non-labour-intensive businesses, 2) investment in technically advanced manufacturing, and 3) investment in low pollution and energy saving technologies.

The intention of the Chinese government towards foreign investment is clear. Foreign investment is intended to support China's manufacturing sector by providing access to modern advanced technology. There is no longer a focus on job creation and less interest in foreign investment in the sectors outside the areas that will help China develop. Foreign investors should take this into account as investing against the trend in China seldom succeeds.

Figure 3. Major revisions to the Catalogue for the Guidance of Foreign-Invested Industries

Newly encouraged	Newly permitted (previously restricted or prohibited)	Downgraded to permitted (previously encouraged)	Newly prohibited
<ul style="list-style-type: none"> Vocational training Venture capital enterprises Construction and operation of vehicle charging stations, new energy vehicles and battery changing stations Construction and operation of water treatment plants New types of high-technology materials including glass, nanomaterials, special textiles and new materials (for aerospace and aviation) 	<ul style="list-style-type: none"> Production of carbonated soft drinks Construction and operation of oil refineries Commercial companies engaged in franchise business, commission business and business management Automobile wholesale, retail and logistics Medical institutions Financial leasing companies Import and distribution of books, newspapers, journals, audiovisual products, e-journals and Internet music services 	<ul style="list-style-type: none"> Automobile manufacturing Coal and polysilicon chemicals 	<ul style="list-style-type: none"> Domestic express parcel services Construction and operation of villas

11. National Development and Reform Commission (NDRC) and the Ministry of Commerce of China. "The Revised Catalog of Industries for Guiding Foreign Investment." 24 December 2011. http://www.gov.cn/fifg/2011-12/29/content_2033089.htm (accessed November 2012)

Typical options for business operation



Investors are often faced with an essential question when deciding on their business operation model in China. That is:

Do you plan to work with partners (inorganic) or without them (organic)?

Typical trade-offs between organic and inorganic growth include speed to market, upfront investment, control and management, competition, leveraging of existing customer base, and valuation and integration requirements. Some cases involve companies having to pursue greenfield investments due to either a lack of existing acquirable businesses that have similar business models or the need to build a new production site using specific technology. No one-size-fits-all guide exists to help companies decide on the proper route to take.

That said, an increasing number of companies coming to China have chosen to look beyond a purely organic method of growth. They are starting to consider the possibilities of working with (or even buying into) local companies, in their attempts to pursue faster growth or eliminate competition.

On the other hand, local private companies that had once been small enough to acquire have now grown too large for outright acquisition and management. These companies now seek attractive value propositions from foreign partners before entering partnership discussions. We'll discuss this in further detail in the Doing deals chapter.

Greenfield (going it alone, or with a partner)

Once you're certain that the opportunity is in China, your team on the ground will need to engage in a market and competitor assessment, and build relationships. You might want to first set up an entity, whether in the form of a representative office or a wholly foreign-owned enterprise (WFOE).

After an assessment of the competition and resources available, companies may decide to pursue greenfield investments out of a lack of available resources or capabilities on the ground. At this stage, they can opt for either one of two choices:

1. Going it alone in the greenfield investment, or
2. Finding a local partner to work with you on that greenfield.



- Finding and building the right relationships within the government¹³
- Establishing your sales and distribution networks, customer base and relationships
- Setting up robust logistics, transportation, facilities and other supply chain infrastructure¹⁴
- Localising your products and services to tailor to local market needs, and accepting a slower speed to market as a result
- Planning for a longer-term time horizon: building capacity in China is likely to be a long and drawn-out process, while short-term returns might be difficult to realise

Having local partners working on your greenfield projects would help address these business issues. Leveraging their existing local teams, networks and other tangible/intangible resources can help accelerate the start-up process. Those who intend to build a new production site with advanced technology, for example, can rely on their local partner to help facilitate land acquisitions, apply for construction permits, obtain banking facilities and possibly even secure downstream customers. Note that the local partners may seek technology transfer or financial considerations in return.

Choosing to work with a local partner will mean that the joint venture (JV) will be your entry vehicle. You and your partners can then pool capital and relevant assets into this JV.

In choosing the first option, businesses often cite the loss of control or technology transfer risks as important considerations. There are challenges to this choice, however, some of which may include:

- Complicated setup processes and high costs, particularly for government-related licences or registration processes and procedures
- The need to commit the necessary skills and expertise from headquarters to initially manage your operations and programme succession plans¹²
- Building a local team with the right competencies and skills, as well as local knowledge and connections

12. See also Human resources and talent management chapter

13. See also Government relations, regulatory compliance and stakeholder alignment chapter

14. See also Supply chain strategies chapter

Acquiring an existing business

There has been a recent resurgence in interest towards acquisitions and buy-outs over the past few years, as foreign investors recalibrate their entry strategies. There are many reasons why a foreign investor might pursue this route, as equity-based partnerships hold the promise of tapping a local partner's infrastructure, resources and networks, boosting their speed-to-market and localisation potential. Partnering with a Chinese company also allows improved access to domestic sales channels – and you can grow your market faster.

Essentially, there are four common acquisition scenarios:

1. Minority ownership (less than 50%)
2. Majority ownership (more than 50%)
3. Equal share (exactly 50%)
4. Buy-out (100%)

The following are some common issues to consider when deciding which scenario to plan for:

- **Regulatory constraints:** In some restricted industries, including commercial banking, foreign companies are only allowed a minority stake. Certain business licences are also available only to local companies or entities that are minority foreign owned.
- **Control of the business:** Majority owners would typically assume control over the business, and hold decision-making ability on key matters.
- **Control of the operation:** The ability to appoint key management roles (such as general managers, finance controllers, production and supply chain managers) is subject to negotiation and agreement among the foreign and local parties.
- **Revenue consolidation:** Majority ownership enables revenue consolidation into the parent company or the foreign group.
- **Injection of intangible assets:** Majority ownership can more readily allow a transfer of intangible assets (including know-how and technology licensing) from the majority owner to the business.
- **Willingness of the local companies to cede ownership:** The local partners might be unwilling to relinquish control (at least not immediately), which means the foreign company may have to settle for minority ownership.

Common acquisition scenarios:

- 1. Minority ownership (less than 50%)**
- 2. Majority ownership (more than 50%)**
- 3. Equal share (exactly 50%)**
- 4. Buy-out (100%)**



Many foreign companies would prefer majority ownership, mainly due to reasons of control and revenue consolidation. Some may opt for a 100% buy-out.

It's worth noting, however, that a 100% acquisition, or even a majority interest, can carry significant risk if your company lacks the sizeable operations and competencies on the ground to run that acquisition. Owners of most local companies are often also their managers, who typically hold the keys to driving the company forward. If these owners subsequently sell all their shares to the investor, that would mean that they've essentially cashed out of the business, and you will need a team to quickly fill the gaps and replace them during the transition period. Otherwise, you may risk losing complete control of the company or key personnel to the departing management team. Managing a successful majority/buy-out acquisition will therefore require the right base of capable managers and infrastructure on the ground to absorb the additional operation.

There are also cases in which foreign companies might choose to take a staged approach to acquisition, starting from a minority stake, then gradually transitioning to majority ownership and finally to a buyout over a three-to-five-year time frame. During this period, foreign companies can gradually develop and establish their capabilities to run and manage this business, while offering sufficient incentives (properly structuring earn-out provisions, for instance) to retain the local core management team. One incentive is to offer an international career and role in the group to the former target manager, who can then transition from being a general manager of a promising privately owned enterprise to an executive of a worldwide enterprise.

An "equal share" joint venture (50:50) is sometimes a compromise solution between both foreign and local partners. Aside from the limitations in revenue consolidation, this type of arrangement may result in neither party wielding the necessary power to make decisions at the board level. Equal share

joint ventures may occasionally even hinder the growth potential of the business in the event the relationship turns sour, and thus should be entered into with a high degree of caution. Note that a joint venture can be formed through:

1. A completely new legal entity to which both parties can assign relevant assets, or
2. A transformation of an existing local company entity into a foreign joint venture (either through the buyout of an existing share from the local shareholders, an increase in its capital, or a mixture of both).

For more on joint ventures, please see the description of joint ventures in the subsequent section on *Typical investment vehicles*.

Licensing to distributors/ franchising

Another way in which a foreign investor can enter the Chinese market and establish instant brand recognition is by finding a local distributor to manage their products for them. This can be a relatively quick and simple way to manoeuvre your products into the market, and to start generating revenue with minimal resource commitment. If the local distributor already has a network set up, then they can sell any type of good. The downside is the resulting reduction in your managerial control and input into the way in which your goods are marketed and/or handled.

However, as a foreign investor, your responsibility lies in setting up and monitoring a system to ensure that your partners handle these goods appropriately and comply with your standards. There is much greater risk inherent in this option: You would be relinquishing some control to your distributors, as you would receive payments upfront (subject to actual negotiations with the distributors).

To manage your distribution risk, manufacturers may also wish to work with more than one distributor in China. You may need to consider whether or not to grant exclusivity to the distributor or dealer. Typically, signing two distributors to the same market is not practical, so businesses might consider limiting the territory of distribution to one or several provinces. Other options include one-year term limits, or annual sales target requirements, as prerequisites for licensing contract renewal.

Master franchising

While many international franchisers in China set up joint ventures or wholly foreign-owned enterprises (see *Typical investment vehicles*) for their franchising model, some may choose to sell master franchising rights to a local company.¹⁵ This model involves giving up a large amount of control, and placing a lot of trust in the local master franchisee. Local connections and knowledge will be valuable in finding the right partner, and determining the right fit will take time.

15. International Franchise Association. "Franchising industry in China." 2010

Typical investment vehicles

Representative offices

While businesses can't conduct any real business with representative offices, they're easy and relatively inexpensive to establish. As a result, they're effective for testing the waters and gauging a true market need.

A representative office is comparatively simple and faster to establish as there are fewer regulations and no capital requirements. It's also a lower-risk option for foreign investors and a common way to enter sectors that have recently been opened to foreign investors. Some regulated industries, including the finance industry, require the setup of a representative office first before undertaking other forms of investment in China.

However, representative offices are somewhat limited by the fact that they are not legal business entities. They're only permitted to engage in "non-direct business operations" in China such as conducting market research or acting as a business liaison for the parent company. They cannot be used for any actual sales, generate any revenue or enter into any contracts.¹⁶

Wholly foreign-owned enterprises (WFOEs)

Wholly foreign-owned enterprises (WFOEs) are the preferred vehicle for businesses with an established product or service that can be easily imported and sold in China. Establishing a WFOE is becoming a leading option as a mode of entry for investors. In the 2012 AmCham-China survey of MNCs,¹⁷ 66% of respondents said their parent companies had established a WFOE in China.

WFOEs are attractive options as they give investors 100% equity and control. Without having to share with a partner company, a WFOE has complete jurisdiction over its internal decisions, operations, human resources and corporate culture. This independence also allows you to align your strategies closer to your parent and sister companies. WFOEs also lower the exposure of risks of working with a partner.

In contrast to representative offices, WFOEs have the ability to do business legally in China. They can conduct sales, issue invoices and receive revenues. They are also capable of converting renminbi (RMB) into other currencies, which is a necessary function for remitting money to your parent companies outside of China, upon fulfilling certain documentation and procedure requirements.¹⁸

However, establishing a WFOE can be a time-consuming process. Greenfield operations will require talented local staff and expert advice if it is to be set up properly.

The Chinese government does restrict WFOEs from certain industries. In the securities industry, for example, a foreign entity cannot own more than 49% of a Chinese securities trading and underwriting company. This, however, is an improvement on the 33% ownership limit set previously.¹⁹ In such industries, you'll need to work with a local partner and share ownership.

Foreign-invested commercial enterprises (FICE)

The foreign-invested commercial enterprise (FICE) is a popular variant on the WFOE. The China FICE can distribute either imported or locally manufactured products throughout their wholesale, retail and franchise systems. They can also provide related services such as storage and warehousing, training, and inventory management. Branch offices can also be opened and operated anywhere in the country. They cannot, however, change the nature of the product they've purchased for sale – a FICE registered to sell shoe products cannot sell food, nor can it alter its products. There are two main types of China FICE: the wholesale FICE and the retail FICE.

16. See also Tax management: planning and compliance chapter for more on representative offices

17. American Chamber of Commerce in China. "AmCham China Business Climate Survey Report." 2012

18. See also Finance and treasury chapter for more on cash repatriation

19. McMahon, Dinny, and Bob Davis. "Beijing loosens some foreign ownership limits." *Wall Street Journal*, 4 May 2012

Intellectual property in joint ventures

The protection of intellectual property is often a headline issue for joint ventures and mergers. In the due diligence process, you may need to assess the uniqueness of the technology you're bringing to the joint venture. In general, the less unique or cutting edge your technology, the lower the risk.

Without patent protection, common solutions to protect your IP include implementing security controls that can help reduce the risk for replication or theft. These include ensuring that the partner is not present when calibrating machinery, or integrating technology in a way that's either difficult to reverse engineer or incorporates easily identifiable "call signs" in the event of litigation. You might also opt to hold your intellectual property offshore, licensing in the technology through a royalty/licence fee arrangement.

Joint ventures (JV)

In the 2012 AmCham survey, 25% of respondents said their parent companies had established a joint venture in China.²⁰ There are generally two forms of joint ventures in China – equity joint ventures and cooperative joint ventures. In an equity joint venture, the profits, risks and losses are shared in proportion to each partners' equity stakes. In general, businesses should expect a six-to-12-month process to negotiate a joint venture.

Timing is driven by two factors, the time it takes to prepare the regulatory and legal documents, and the time it takes for approval. This timeline can be extended beyond 12 months, depending on factors such as the industry in which the JV will operate and whether the partner is a state-owned enterprise.

Ownership is normally determined by capital contributions. Foreign investors must invest at least 25% into the JV for it to be treated as a foreign-invested enterprise.

A cooperative joint venture is different. It has more flexibility; e.g., the sharing of profits is governed by the JV contract.

Note, however, that under the regulations of the People's Republic of China (PRC), any joint venture partner has the right to sell their ownership interest to a third party, without the partner's consent. Your only recourse would then be to purchase that ownership interest.²¹ This may potentially place you in a difficult situation, so make sure to deal with this issue directly in your joint venture agreement.

Some licences are even available only to Sino-foreign equity/cooperative joint ventures. For example, as the government heavily regulates the Internet sector, basic Internet service providers must be at least 51% owned by a state-owned enterprise. Therefore, a foreign investor must choose a state-owned enterprise as a JV partner. In addition, if a foreign investor has over a certain number of retail stores that distribute certain products such as books, newspapers and medicines, then their ownership in the enterprise is limited to 49%.

Because of a lack of one unified source in China to assess the reputation of a company or management team, finding a partner in those with whom you have an existing working relationship can lead to a higher chance for your joint venture to succeed. The challenges of a joint venture often start at the negotiation stage. Establishing a joint venture is time consuming, and plans may go off track at any point in the talks. There's also a risk of confusion on the legal framework of a deal, which may give rise to distrust. Clear communication and a trusting partnership are critical in executing management decisions. Make sure the other party understands who will exercise control over the JV.

Partnerships in China are also about balance. At the negotiation stage, investors need to navigate the fine line between incentivising your local partner and ensuring they have enough control of the operations. Make sure you have enough incentives for your partner to continue putting in their fair share in the joint venture, but don't give up too much control.

20. American Chamber of Commerce in China. "AmCham China Business Climate Survey Report." 2012

21. *Provisions of the Supreme Court on several issues concerning the trial of disputes involving foreign funded enterprises*. Article 11 (Supreme People's Court of the People's Republic of China, 5 August 2010)

Multinationals should also consider what they want out of the partnership, which could lead to an eventual exit strategy. Successful joint ventures in the past have been established and amicably wound up by companies that eventually bought out their partners. Starbucks, for instance, announced in 2006 that it would buy out its local partner, Beijing Mei Da Coffee (owned by H&Q Asia Pacific), in a then-joint venture that operated 60 coffee shops in Beijing and Tianjin.²² In the early 1990s, Coca-Cola bought out the shares of all its bottling plants. Negotiations with the Chinese government were lengthy and challenging, however, and often involved assisting its state-owned partners in developing their own branded beverages.²³ Winding down a joint venture while maintaining good will with the Chinese partner is thus often as important as starting one in good faith.

Control over the board of directors may not be particularly helpful, as the board usually has little say in the running of typical Chinese corporations that may lack Western corporate governance structures. And while it's not advisable to rely on the JV contract or legal stipulations to exercise overall authority, companies should still ensure there are legal provisions for an exit strategy in the case of a deadlock, or provide for non-competition clauses in case the partner or its affiliates start a competing business. Businesses should also have a localised and experienced general manager on the ground that can facilitate communication, supervise the joint venture and represent their interests.

There are other considerations and risks aside from selecting the right partner and aligning expectations. Since due diligence is a less common practice in China, the process may have to be explained to a potential JV partner. Consider how the organisational structure will be set up, how you'll handle human resources and staff issues (including potential pay inequity between expatriate and local staff), and how you will manage accounting, financial and other operational reporting. The liquidity of your partner is paramount in your review. If your partner has liquidity issues, the risk for fund misallocation rises. The compliance profile (particularly in the area of tax compliance) of their business can also be a good barometer for how they'll conduct their business.

A more detailed listing of your entry methods, of course, is dependent on the nature of your business, home territory and industry. Deciding on an investment mode of entry into China is not a simple task and needs to be formulated in conjunction with numerous other considerations.

In the other chapters of *Doing Business and Investing in China*, we'll take a deeper dive into the other factors that you need to be aware of when planning your business strategy in China.



22. *The Economic Times*. "Starbucks acquires control of China JV." 25 October 2006

23. Mok, Vincent, Xiudian Dai, and Godfrey Yeung. "An internalization approach to joint ventures: The case of Coca-Cola in China." *Asia Pacific Business Review*, 2002

Doing deals



Observations

1. Compared with many developed Western markets, good deals are harder to find in China, and deal size is generally smaller.
2. Domestic strategic objectives of the government can play a more influential role in shaping deals conducted.
3. Deal valuations can be higher than typical international levels, driven by the competitive environment, strong economy and robust long-term outlook.
4. The deal process can be more complex and protracted.
5. Finding significant issues and risks during due diligence is typical.
6. For joint ventures, parties may have significantly different views on how to operate the business post-deal.

Recommendations

1. Investors must make sure that a merger or acquisition is the best growth strategy for them and make sure they evaluate all options before proceeding with any acquisition plan.
2. Investors must be sure to perform adequate due diligence as early as possible in the deal process to uncover deal/target risks.
3. Although investors should be careful to identify all potential risks, putting them into the right context can allow a buyer to make informed decisions and take calculated risks.
4. Buyer deal teams should work with experienced locally based advisers to leverage their experience and manage key deal execution challenges, perform due diligence, assist with negotiations and resolve issues identified.
5. Foreign investors need to be flexible, patient and persistent throughout the negotiation process to be successful at doing deals.
6. Post-merger integration needs to be considered early on and carefully planned with full management buy-in from both sides. If integration is not properly planned or executed, it can have a significant impact on the value of the entire deal.



Buying a company in China can be tough. But for many investors, it's critical to their future growth, and could be a challenge worth considering, as buying existing companies, or growing through mergers and acquisitions, and entry into other cooperative-type partnerships can be more effective than starting from scratch. Doing deals in China means access to China's high-growth economy, large population, rising affluence and innovation potential.

Foreign investors will encounter a number of significant challenges when making an acquisition in China. To make the process smoother and improve chances for success, they'll need to:

- Do their research, understand the environment and perform due diligence as early as possible during the deal process
- Understand the nature of the bureaucracy and approvals required
- Be aware that negotiations can be long and drawn-out, especially when dealing with key deal terms and pricing
- Develop a strategy for dealing with management and integration issues early on so that when the deal is successfully completed, new problems do not surface later on down the line

Despite these challenges, having an informed approach can lead to a successful closing and pay off in the long term.



China deal volume is flattening out but still robust

The climate for inbound M&A deals in China has slowed in the post-financial crisis environment, largely due to North American and European economic uncertainties in their home regions. Despite that, foreign direct investment coming into China remains strong, with US\$37.88 billion of foreign direct investment (FDI) in the first quarter of 2012.¹ The number of deals by foreign investors in China in 2011 totalled 482, holding steady from that of the previous year.² While total deal volume will likely drop in 2012, with just 156 deals in the first half of 2012,³ there are still many foreign companies looking to do deals in China as part of their overall growth strategy.

Acquiring an existing business is an option that many investors choose because it allows them to tap into the resources of their local partner. Buying a local, existing entity offers a foreign owner access to local infrastructure, resources, networks, distribution chains, relationships and business licences. This option can be a more efficient and quicker alternative than trying to grow organically or operating without a local partner.

As discussed in the Market entry and growth chapter, there are four common acquisition scenarios for foreign companies in China – minority share, majority share, equal share and buyout.⁴ The decision on which option an investor should go with is tied into their corporate strategy and growth plans. In addition, it is important to consider the structure of the acquisition, as each

option offers varying degrees of control and various other trade-offs. For instance, an equal-share operation would mean that both partners share control of the business, operations, decision-making and revenue. While most companies may prefer a majority share, or even a 100% buy-out, foreign companies may need to be more persistent and patient in negotiating this type of agreement with their local partners and may face more regulatory challenges for such deals.

1. Ministry of Commerce

2. PwC. "2011 M&A Review and 2012 Outlook"

3. PwC. "2012 M&A Review and Outlook"

4. See also Market entry and growth chapter for further considerations about these acquisition options, advantages and disadvantages



Deal considerations

The deal structure isn't completely up to just the foreign buyer and the local partner. There are regulatory constraints in some restricted industries in China that will limit foreign companies to minority stakes. Additional obstacles or variables in the deal landscape can influence how the deal comes together. Investors need to consider and prepare for differences (in the China deals market compared with other developed markets), especially in the following areas:

- The size of the deals themselves
- The number of quality deals available
- The role of government
- Valuation
- Length of time required for the deal process

Deal sizes tend to be relatively modest

Compared with that of other developed countries, deal sizes in the China market are generally smaller, below US\$50 million on average. This is largely because Chinese companies willing to take on foreign investment or with the greatest potential for growth are often in earlier stages of development. Depending on the sector, the market can be fragmented in China, with many players spread out over a large geography, and regionally divided. In order to meet growth objectives and reach adequate scale, foreign investors may need to consider some form of “roll-up” strategy, buying a number of smaller companies in a series of acquisitions to combine into one larger firm.

How to find the right target

The ratio between deals considered and deals executed is referred to as the “deal funnel.”⁵ In some emerging market countries, the deal funnel ratio is about 50:1. That is, of the 50 deals that a company considers, one will go through to completion. In China, the deal funnel ratio is much larger, at over 100:1, meaning that companies looking to make deals may need to try that much harder to find the right one.

5. PwC. “Getting on the right side of the delta: A deal-maker’s guide to growth economies.” 2012



A shortage of deals exists, in part, because there have been so many completed in the recent past that a lot of the best opportunities have already been taken. Many of the remaining companies in China that are suitable may not be as interested in mergers and acquisitions as they once were. Chinese entrepreneurs are more confident and business savvy than ever. They are growing successfully on their own and don't necessarily need a foreign partner, particularly when it comes to serving the rapidly expanding domestic market. Those that fared well during the last financial crisis are especially demanding in negotiations now. For foreign buyers, these changes can mean that Chinese companies in general are more reluctant

to sell or are demanding higher valuations. Locals are also reluctant to give up majority control or a large share of future profits when they feel that their own product offerings or business models are as good, if not better, than that of their foreign investors.

To find a willing partner, foreign companies need to offer more than just deep pockets. These days, Chinese companies have numerous alternative sources of domestic financing available to them, including domestic private equity. Foreign investors that offer technology or know-how may fare better in finding local partners, particularly in a number of fields currently being promoted by China as "encouraged

industries." These priority industries include high tech, greentech and new energy, as well as certain segments of the auto industry.

Aside from offering new technology, foreign investors may also attract Chinese partners by bringing in access to a strong brand or foreign markets to help their partners gain a competitive advantage in the Chinese market or expand overseas, with a growing focus on emerging markets such as Central and Southeast Asia, as well as Africa.⁶

6. According to PwC's 2012 Global CEO Survey, 63% of Chinese CEOs believe emerging markets are more important to their future than developed markets

The government plays an important role in the deals market

As the government must consider its domestic interests, it maintains a very influential role in managing all aspects of national development, including the management of investment into China by foreign investors. Its long-term strategic outlook will influence policies regarding which areas of investments are permitted and to what extent foreigners can invest in companies of various industries. Most transactions involving a foreign investor will require approvals from various central government or regional/local bodies.

Some government and regulatory bodies that play the most important roles are the National Development and Reform Commission (NDRC), the State-owned Assets Supervision and Administration Commission (SASAC) and the Ministry of Commerce (MOFCOM). These central government bodies are heavy influencers on the nature and direction of foreign investment into China.

MOFCOM is responsible for foreign trade policy, export and import regulations, foreign direct investments, market competition, and negotiating bilateral and multilateral trade agreements. SASAC has responsibility over managing China's state-owned enterprises, and drafting related laws and regulations governing them. The NDRC is responsible for overall macroeconomic planning and policy.⁷

The NDRC, as the state's economic planner, must approve all deals of a

particular size, and must also approve any major new investments in China. SASAC approves any deal involving a state-owned enterprise (SOE). In addition to the aforementioned, there may also be some regional industry-related or situation-specific approvals that will play a role.

Certain sectors are covered by additional industry-specific regulations. For example, for banking-related investments, investors need approval from the China Banking Regulatory Commission (CBRC). In addition, transactions that may end up with the resulting entity controlling over 50% of the market share of that industry will require approval of MOFCOM as the antitrust regulatory body, while the China Securities Regulatory Commission (CSRC) needs to review any deal involving listed companies. The complete set of approvals required will depend largely on the deal structure, the



7. See also Government relations, regulatory compliance and stakeholder alignment chapter for a detailed list of key regulators

type of target and the value of the deal, and must be fully understood prior to proceeding too far down any deal path. Engaging experienced legal and deal advisers to assist with this process is critical.

Although there is a fair amount of regulation surrounding any deal, investors may have reason to be optimistic, as recently issued M&A regulations have added some clarity to the deal-making process and business environment. Other positive developments are that Chinese authorities are clarifying tax regulations and evolving accounting standards to global systems like the International Financial Reporting Standards (IFRS). Regulations will continue to develop as the Chinese government understands the importance of deal making to the country's growth.



Higher valuations can be a challenge

There are a number of reasons why valuations are inflated in China, but supply and demand is one of the primary influencers. There are currently too many buyers, particularly with the emergence of numerous local Chinese financial buyers who are now also competing for deals. In 2011, domestic M&A activity grew by 11% over the previous year, with 3,262 deals.⁸

The real estate market can also influence a company's valuations. Some entrepreneurs, especially those located in heated real estate economies in urban or developed areas along the east coast, will count higher real estate values as part of their company valuations.

Foreign buyers may also find that there are differences in valuation methodologies. Many companies in China, for instance, use an asset-based valuation method, focusing on net book value, and may not be familiar with methods that are based on a company's potential and future earnings. The difference in reporting may lead to very different figures, which can be difficult to reconcile during negotiations.

A longer deal process is typical

Investors will need to be patient during the acquisitions process. Although the foreign investor and the Chinese target may both state they want to complete a transaction as effectively as possible within three to six months, both come from very different perspectives and are motivated by varying incentives. In fact, it is not unheard of for the process to drag on for 24 or even 36 months. The rhythm of the process can be irregular, starting and stopping at times depending on the type of deal, the players involved and the regulatory approvals that need to be dealt with.

Negotiating and renegotiating will also require great patience. Investors should understand and appreciate that cultural differences will also come into play when dealing with Chinese negotiators, who are very patient and often may not have the same sense of urgency. They also may not appreciate the foreign investor's desire to speed up the deal timeline. The Chinese party will take their time in making a decision, and can usually afford to wait until they judge that the environment and opportunity are ideal for them. To complete a deal, therefore, an investor will need to be flexible, patient and persistent.

Local expectations have changed. Today's China investors now negotiate with local partners that expect higher valuations, as pressure from bidding rivals and more available sources of capital push up prices. Yet great success is still within reach, through the right mix of patience, flexibility and proper planning.

Ken Su, PwC China Transaction Services Partner

8. PwC. "2011 M&A review and 2012 outlook"

Successfully doing a deal in China

While there is no simple solution to ensuring success, it is critical to be mindful of key aspects of doing deals in China.

Strategic focus and target selection

It is critical for investors to think through its corporate strategy to make sure that doing a deal is the most appropriate course of action and that it will contribute to long-term goals. Finding a suitable target is critical and this can be a difficult challenge in China because of the nature of the current deal market where opportunities may be limited. Even navigating the sheer size of the country can be a challenge, and understanding the many regional or geographic differences will require local insight. Foreign investors trying to find the right target in this environment may need a full team designated to corporate development, including on-the-ground professional advisers and agents to seek out appropriate targets. The investment team and advisers' primary function will include conducting a market analysis of players, understanding the basics of target uptakes, meeting stakeholders and officials, and building the relationships necessary to begin discussions for any deal.

There are a number of factors to consider when shortlisting targets for due diligence. It will be important to have visibility of the target's key operational status and financial performance, locations, corporate affiliations and major stakeholders, and finding out whether or not an acquisition is possible with the potential target. Some of this information may be publicly available, but some may require the buyer to approach the target company for further information. This process will require local experience with the market, along with an understanding of local rules and regulations.

Due diligence is critical to any deal

The information obtained during due diligence is critical in determining the deal structure, validating the valuation and supporting any negotiation discussions. In China, conducting due diligence as early as possible is necessary to identify any potential challenges that investors may face during the M&A process, as well as identify issues for post-deal integration. While there are many issues that could be uncovered during the course of conducting due diligence, it is particularly common to find issues or risks in the following areas:

- Significant deficiencies in corporate record-keeping, spanning financial transaction records, legal agreements, tax documentation and employee records
- Insufficient detailed operational and financial performance measurement data potentially impairing a buyer's ability to conduct various types of detailed business analyses
- Failure to have complete ownership of all necessary tangible and intangible assets for the business operations, including title to building and equipment, as well as land-use rights and intellectual property rights
- Issues with tax filing compliance as well as outstanding tax liabilities
- Failure to properly calculate and/or fully pay up employee social benefits and other related obligations
- Business practices such as facilitation payments that are inconsistent with US or EU regulations

- Multiple sets of records/data for operating results and financial position, some of which will deviate significantly from actual results and financial position
- Unrecorded transactions and liabilities, as well as undisclosed financial commitments
- A significant volume of related-party transactions, many of which may be at non-market terms

Due diligence may also uncover something more fundamental, such as operational problems, and highlight key areas where additional effort and work are required to make the target companies ready for imminent takeover and allow for integration work to begin. Compared with Western companies, Chinese companies may have less experience in using financial metrics to measure their performance and lack the necessary analysis and business information. There may even be issues with the quality of audits, financial records, taxes, governance, and proper documentation of policies and practices. These types of risks are more common in privately owned businesses, but they also occur in state-owned enterprises.

Although investors should seek to identify and be aware of all the risks, understanding their context can allow a buyer to take risks that are informed or calculated. Having a strong adviser experienced in doing deals in China will help with this assessment. Professionals who are familiar with the China market can advise on what practices may or may not be typical for a particular industry and provide context on the levels of risk and recommend solutions to issues identified.



While effective due diligence in a fast-moving deals environment must focus on a number of key areas, typically financial, tax and legal due diligence, there are other types of due diligence that are potentially equally important to consider for foreign investors when looking at a target. While an adviser can help guide an investor through determining what additional types of due diligence are needed, these topics are also covered in other chapters of this book, and the more important types of additional due diligence include:

- Environmental (see accompanying insert)
- Information technology⁹
- Human resources
- Internal controls¹⁰

Getting a cleaner picture of your deal risk: Environmental due diligence

Chinese laws cover all significant aspects of environment, health and safety (EHS), and its requirements are stringent. If your target has inadequate performance in this area, you may be liable for material risks and liabilities. These can be managed with appropriate indemnities and warranties in the structure of a deal.

There are several key environment, health and safety issues that a multinational corporate must consider in due diligence:

- Liability for historic land and groundwater contamination
- Inadequate waste and hazardous materials handling and disposal
- Non-compliance with wastewater discharge and air emission standards
- Poor ventilation and dust and noise treatment facilities
- Lack of proper safety schemes
- Liability for occupational disease and injury compensation claims
- Uncertainty over unofficial arrangements with local governments
- Inadequate documentation

9. See also Internal control chapter

10. See also Internal control chapter on "Re-assessing internal controls for due diligence"

Negotiating

At the negotiations stage, both the buyer and the seller must try to come to an agreement on how the deal will be structured and what the price will be. In terms of structure, a key part of the discussion will centre on the degree of ownership between the partners, and as a result, what roles they will play after the acquisition is complete. Additional considerations involve the levels of actual effective control, day-to-day decision-making, revenue consolidation, contribution of assets, intellectual property and company culture. Foreign buyers should decide if they want to set up a new joint venture or wholly foreign-owned enterprise to take over the seller's business (i.e., as an asset deal) or to purchase the equity interest of the target (i.e., as an equity deal).¹¹ Other considerations may involve the items to be included in the actual purchase, such as real estate or other fixed assets of the target company.

The deal structure is also particularly important from a tax perspective. Depending on how the transaction is set up, the tax costs for the buyer and the seller will vary significantly. This variation can have a big impact on the final cost of the deal.

The treatment of risks identified in due diligence should also be incorporated into negotiations. This can be factored in through proper protection terms in the final agreement (see *Closing* in the next section) and necessary post-deal service agreements between the relevant parties. This is particularly important if the target is to be carved out of a larger organisation (also relevant for joint ventures), and/or integrated into a new operational group upon closing.

A good advisory team can be a strong asset during the negotiating process, to manage the financial, legal, tax and valuation issues that will be considered in determining the right price and structure. The advisers will also be valuable when assessing any issues that may have come up during due diligence and recommending whether they impact the pricing strategy or if there are key agreement terms to be inserted into the contract during negotiations. As mentioned earlier, the chief reason that deals do not go to completion in China is the inability to bridge the price expectations between the foreign buyer and Chinese seller. An adviser will be helpful in managing valuation and contract term negotiations.

Closing

In preparation for the deal's closing, buyers will need to ensure that all the required approvals have been issued, and all relevant supporting documents are correct and agreed upon by both parties. Deal parties will need legal advisers to draft and finalise the sales and purchase agreement (SPA). This document is typically a detailed contract that addresses the transaction parameters and should also address all the issues identified during the due diligence process. For instance, it would contain rights or indemnifications to protect the buyer from any unexpected post-deal results. In addition, many deals also require both parties to agree to a post-deal transition services agreement or other associated agreements to make the deal work post-completion.

Role of the PMO

To lead project management

Structure set-up

- Define project team structure
- Establish a communication mechanism
- Develop integration principles

Integration execution

- Evaluate and prioritise resource needs
- Drive and implement integration management
- Assist functional teams in developing project management tools

Monitoring

- Ensure the realisation of project objectives and milestones
- Monitor and track integration progress
- Manage integration risks

Reporting

- Report progress to senior management
- Provide decision-making support

11. See also Market entry and growth chapter

Integration

The closing of a deal is usually the start of a large amount of work. Investors will need to have prepared an integration strategy to manage changes in all potential aspects of the operation, including the “front line” of the business and support functions such as human resources, information technology systems, finances and office administration. An overall strategy should already be in place well before the signing of the deal, with detailed action plans covering all possible work streams developed during the due diligence and negotiation process and finalised soon after signing. A proper transition can then begin during the period between signing and closing.

Integration can be the longest and most challenging step in the M&A cycle. If poorly executed, it can seriously impair the value of the deal or impair the effectiveness of post-deal business operations. In order to properly capture deal value, the establishment of a project management office (PMO) is strongly recommended to ensure that all work streams are moving towards the same goals in delivering overall deal value.

At the moment, the focus of integration in Chinese deals tends to be weighted towards core business functions such as sales channels and production efficiencies. As the market matures, an increasing number of companies are beginning to put more of a focus on risk management and broader operational effectiveness issues. The transition and integration of supporting functions, such as human resources, IT systems and finance, are also beginning to receive more attention.

The process of integration is a challenging exercise in change management, and the local management team is a critical ally in managing these changes. Key leaders must come together and collaboratively agree on an integration plan. They should all participate in the project steering committee and be charged with the overall success (or failure) of the integration. The project management office must also be empowered with the authority to push things forward.

Among all potential changes, work culture transition is often considered the most challenging issue faced by foreign investors. The rapid decade-long growth in the economy has boosted China’s level of confidence, changing their attitudes towards foreign investment in a subtle, yet very significant way. When dealing with the changes required in delivering deal value, foreign investors are increasingly asked to respect and abide by Chinese work culture, instead of a more direct adoption of “proven” work cultures from a Western business context. Finding a way to balance these views is often key.

The Internal control chapter will also include a discussion on combining systems and processes.

Planning for deal success

While anecdotal and empirical evidence tends to show there are generally higher risks associated with acquisitions in a developing market like China, due to difficulty in justifying valuations, issues with the business assets itself, incompatibilities between buyer and seller, and government regulations, there is still a great opportunity for many companies in China.

With the right planning and strategy, foreign companies can reduce their risks and improve on their chances for success. Investors should take extra care, be thorough in the deal process and exercise more patience when looking at deals in the China environment. Working with an experienced local adviser will be important, especially when dealing with regulatory approvals, performing due diligence or negotiating with the local seller. Having an understanding of China’s history, culture and language will also help foreign companies relate to the local market and their potential partners. And with an open-minded attitude, flexible strategy and realistic approach, an investor will be able to achieve success in China, not just in completing the deal, but in business over a much longer term.

Managing risks



Observations

1. Businesses may superimpose global strategies onto China without first considering local consumer needs or market dynamics.
2. Companies without insight into local business practices and culture sometimes find themselves wholly unprepared for the underlying risks.
3. Businesses may struggle to integrate *guanxi* into their business, and recognise its importance in Chinese business culture.
4. Global compliance policies, training and procedures have proven largely inadequate in identifying red flags and assessing risk in China.
5. With an increasing number of companies implementing lean operations, the resulting reduced controls and streamlined processes are posing an increasing risk.

Recommendations

1. Adopt a holistic and China-specific risk management framework.
2. Address both strategic drivers (i.e., growth and cost rationalisation) and sustainability drivers (i.e., business infrastructure and compliance) in risk management.
3. Set an appropriate tone from the top and reassure local country managers that compliance is a priority – even if it could have a significant impact on the bottom line.
4. Tailor your global approach to compliance and invest in more localised procedures and specialist teams.
5. Appoint China-based senior management to lead compliance programmes to ensure they are proactive and effective.



Guy McLeod, the President of Airbus China, once said this about China: “Nowhere in the world is there a market like this – nowhere. To me, the 21st century will be the Chinese century. China will change the economic balance of the world.”¹ With the onset of the global financial crisis and its subsequent slow recovery, China has emerged as a key growth market for multinationals. Having a presence in China is now a competitive imperative – multinationals that had tried to set up operations in China and left in failure are now coming back, and those that have been aggressively expanding in the country for years are being forced to adapt, as their traditional competitive advantages have begun to erode.²

If multinationals are to be successful, they should have an integrated China strategy in place to address the significant and unique risks and challenges that come with operating in this high-growth, dynamic environment. This strategy should include a robust, China-specific risk management framework that addresses strategic drivers (such as **growth** and **cost rationalisation**) as well as sustainability drivers (such as their own **business infrastructure** and **compliance**) (See Figure 1).

Multinationals with a properly integrated China strategy – one that addresses growth, compliance and business infrastructure risks – have established sustainable competitive advantages, while minimising the time and resources spent reacting to issues.

In the following sections, we will discuss some of the key China-specific risks facing multinationals. We’ll first address risks associated with strategic drivers in the section “value creation,” and then delve into sustainability risks in the section “value protection and sustainability.” For a more comprehensive overview of risk in China, please see Figure 2 of this chapter. Other chapters in the book also cover risks in China in more detail.

1. Fernandez, Juan Antonio, and Laurie Underwood. *China CEO-Voices of Experience*. 2006
2. Economist Intelligence Unit. “Multinational companies and China: What future?” 2011



Figure 1. Dimensions of an integrated China strategy



Value creation: Entering China – a cost rationalisation or growth story?

The growth story

Since the early 1980s, China has primarily been viewed as a low-cost manufacturing hub, and has effectively served as an inexpensive producer for global brands. However, this perception is starting to change. Increasing labour costs, an aging workforce and a persistent labour shortage have caused manufacturers' profit margins to decline steadily.³ As a result, while cost rationalisation (i.e., increasing cost efficiencies by optimising available business options) is still an attractive feature of the China market for multinationals, global and local businesses alike are now starting to change strategies to tap China as an engine for growth. Currently, approximately one-third of global business leaders rank China among their top three regions for generating growth over the next year.⁴

But despite this opportunity, entering China without a thorough understanding of the market and the Chinese consumer is fraught with risk. All too often, when looking for growth in China, executives tend to focus on risks they will face in the short-term (e.g., market entry) without planning for risks that accompany a long-term presence in the market.

Myth of the Chinese market and consumers

CEOs the world over are now banking on market growth and the increasing buying power of the Chinese consumer, in particular that of China's emerging middle class (the "emerging middle"). When compared with developed and other emerging economies, the projected increase in domestic purchasing power in China is substantial, with Chinese consumers' buying power expected to trail only that of the US and the EU by 2020.

In their rush to capitalise on the potential rewards the market has to offer, executives in MNCs will sometimes try to superimpose their global strategies onto China without first considering local consumer needs or market dynamics. As mentioned in the Market entry and growth chapter, value propositions designed for consumers in developed markets rarely work for the needs of China's emerging middle, particularly given the enormous geographic and demographic diversity in the market. As a result, one of the greatest challenges facing multinationals is establishing a viable business model on the China level: not only must products be adapted, but also production, distribution and marketing capabilities must be redesigned based on local customer segmentation and the dynamics driving the market.⁵



3. Barboza, David. "China shifts away from low-cost factories." *The New York Times*, 15 September 2010

4. PwC. "15th Annual Global CEO Survey: The view from China." 2012

5. PwC. "15th Annual Global CEO Survey: The view from China." 2012



Many of the multinationals that had left China in failure blame the Chinese consumer for having high, unrealistic expectations, coupled with an unwillingness to pay a premium for their products. But several China success stories demonstrate that this is not necessarily the case. One such success story is that of Apple. According to Apple, sales in China, Hong Kong and Taiwan rose to 12% of the company's total in the 2010 fiscal year, compared with 2% in 2009, making it the company's fastest-growing region by revenue. As Apple CEO Tim Cook stated, "I've never seen a country with as many people rising into the middle class that aspire to buy products that Apple makes. China, the sky's the limit there."⁶

Despite the fact that the iPhone is 30% more expensive in China than in the US, Apple China reported that its Shanghai store sells more iPhones per square foot than any other store in the world.⁷ Apple's success in China can perhaps be attributed to its understanding of this emerging middle. In China, Apple marketed the iPhone as a luxury good, meaning that higher-income Chinese consumers developed a preference for the brand due to the prestige or "face" (status or social standing) associated with owning an iPhone. Even though the mobile phone market is highly competitive in China and its position is currently being challenged, Apple has the most favourable future brand consideration rating among high-end Chinese handset users – a factor that enables Apple to continue to increase its consumer base, even with premium-priced products.⁸

6. Krishnamoorthy, Anand. "China becomes Apple's second-largest market as sky's the limit, CEO says." *Bloomberg News*, 19 October 2011

7. Rein, Shaun. "How Apple turned around in China." *CNBC*, 8 March 2011

8. Morgan Stanley Research Global. "The China Files: US Corporates and China's Megatransition." 2010

Growing pains

Apple's growth has not come without its hiccups. It has come under scrutiny because its primary supplier, Hon Hai Precision Industry (trading as Foxconn), was in violation of Chinese labour laws. Foxconn, a Taiwanese manufacturer of electronic components with factories in several locations across China, made headlines after a number of labour-related incidents. The news drew international attention to Foxconn and its labour practices. Its poor working conditions included excessive overtime, unpaid wages and salaries that weren't enough to cover basic living expenses.⁹ Although Foxconn has many multinational clients, the resulting backlash against Apple, as one of its largest customers, was severe.

To try and repair some of the resulting reputational damage, Apple engaged the not-for-profit Fair Labour Association (FLA) to audit major Foxconn factories. According to the FLA report, Foxconn was in violation of a slew of Chinese labour laws: over half of Foxconn's employees worked more than the legal limit, most of the audited facilities did not pay proper overtime wages required by law, and more than 43% of workers said they either experienced or witnessed some kind of work-related accident.¹⁰

This is a prime example of the vital importance of anticipating and mitigating risks associated with expanding to a new market. In this case, Apple did not adequately monitor its key supplier's compliance practices. Foxconn's labour malpractices therefore caused Apple reputational and financial loss. For Apple to mitigate the risk of future reputational damage, they had to look beyond growth and cost rationalisation, and place equal emphasis on compliance and business infrastructure.

Cost rationalisation (optimising cost efficiencies)

Despite the rapidly rising cost of labour and aging workforce, China is still viewed as one of the most attractive low-cost sourcing destination countries, drawing in new market entrants from all over the world hoping to capitalise on the low cost of labour and natural resources, and the massive, flexible work force. China has become an important player in global supply chains, and as a result, is a primary driver for many multinationals' global cost rationalisation strategies. While the benefits of such a strategy are well understood, companies lacking insights into the local business practices and culture sometimes find themselves wholly unprepared for the underlying risks.

Due to China's sheer size and geographical diversity, it is not uncommon for multinationals to rely heavily on local suppliers, dealers, distributors, agents and other middlemen to manage their China-side operations. This reliance on local partners poses a challenge for multinationals, as it is difficult for them to maintain full control over the sourcing, production and distribution process in such an arrangement. This challenge, coupled with a lack of reliable infrastructure, weak quality controls and inadequate intellectual property protection, may in fact counteract the cost rationalisation benefits that accompany setting up operations in China.¹¹

Are mergers and acquisitions a good channel?

In China, multinationals often seek to acquire or form alliances with Chinese companies to gain access to their sourcing arrangements as well as access to a myriad of relationships (see *Guanxi: A double-edged sword*, later in this chapter). This approach can be extremely beneficial to multinationals, if successful. However, finding the right partner and managing that alliance can be a considerable challenge in China. Due diligence processes, financial reporting systems and levels of transparency can vary widely. "Information accuracy and quality of management are the most important criteria," says Lily Hsieh, chief financial officer of Yum! Brands China, on her organisation's approach to finding local partners. "We find that companies already listed or on the path to be listed have better disclosure standards. We also spend a lot of time with senior management in order to understand their mind set, sense of integrity, ground rules and behaviour styles."¹²

In general, acquisitions in emerging markets are risky, with a fairly high chance of not meeting all deal objectives, even for proven deal-makers. As mentioned in the *Doing Deals* chapter, between 50% to 60% of deals that go into due diligence in emerging markets fail to complete.¹³ In China specifically, a target company's business models, supply chain advantages and relationship networks are neither readily transferable nor easily integrated into the multinational's global operations. This is the case despite the fact that deal valuation often factors into most of these elements as key value drivers in the due diligence and deal negotiation process. Multinationals should therefore assess the risks and impact of rationalising costs via mergers and acquisitions, and pay attention to "soft aspects" such as *guanxi*, which can be embedded into all Chinese business to a certain degree.

9. Reuters. "Foxconn worker plunges to death at China plant." 5 November 2010

10. Pepitone, Julianne. "Apple supplier audit finds major wage and overtime violations." *CNN Money*, 29 March 2012

11. See also Supply chain strategies chapter for more on supply chain risks

12. PwC. "Doing business in a changing China." *The View*, 2010

13. PwC. *Levelling the playing field: avoiding the pitfalls of the past when doing deals in emerging markets*. 2012

Behind the numbers

While analysing financial and operational data is key to any cost rationalisation strategy, it is especially vital in China to consider the risks that lie beyond mere numbers. When performing due diligence or reviewing any other financials, it's important to consider the business infrastructure of the target Chinese company, including the corporate culture and internal controls environment, business processes, information management systems, management style and relationship network with both internal and external stakeholders.¹⁴

With the increasing reliance on technology to operate the China business as part of the global platform, multinationals need to carefully assess the internal controls environment, including the controls over the IT systems surrounding the operational and financial reporting process (where all the key management reports are generated).¹⁵ While Chinese enterprises have recently started to invest in better and stronger information security measures, many still fail to take into consideration the importance of aligning people, process and technology safeguards when creating these security measures. This oversight can leave plenty of opportunity for employees to circumvent whatever has been put in place.¹⁶

In a recent case in which a multinational acquired a Chinese company, PwC discovered that the general manager of the acquired company was exerting his influence over members of the IT department. He had encouraged staff to collaborate in overriding the controls in place in order to alter figures in the system from the back-end, despite the perceived segregation of duties within the department. This type of control override is not uncommon in China, since it is customary in Chinese business culture to respect seniority, regardless of written company policies. But if multinationals accept that this sort of override can occur, and implement a robust system to help identify red flags, they can quickly take appropriate action to minimise any negative effects.



14. See also Doing deals chapter on conducting due diligence

15. See also Internal control chapter

16. PwC. 2012 Global state of information security survey: China highlights. 2011

Value protection and sustainability

Business infrastructure

As multinationals become increasingly global, their operations and underlying business processes rise in complexity. For executives to execute their strategies across multiple regions, they must ensure that their business model is suitable on a global, regional and local level. Multinationals cannot assume that they can simply transplant their home business model to a new market.

In the case of China, the volatility of the market means that business agility is especially important. Multinationals need to emphasise business infrastructure at the China level, taking into consideration both the local culture and the increasing competitiveness of the market. A company that gets off to a good start in China may be caught off guard if it assumes the situation can remain constant – it should reassess its business model on a periodic basis by collecting data, monitoring the business environment and weighing the evolving risks against the benefits of maintaining or expanding their presence. This is crucial to ensuring that the integration of China into global operations does not threaten the ultimate quality of the product at a regional or global level.

Why systems and controls matter

In the past, due to their comparatively less sophisticated business and operational environment, many Chinese enterprises would simply rely on manual processes instead of deploying enterprise resource planning (ERP) systems to handle management and operational issues. With the increasing complexity in running businesses, ERP systems, which integrate multiple business processes to facilitate process optimisation by automating procedures and control points, are becoming more widely adopted. By the end of 2010, approximately 90% of large-and mid-scale enterprises in China had some kind of management software (pan-ERP) in place.¹⁷

And although ERP systems in China are lower on the agenda than in developed countries, companies in China are increasing their level of investment to enhance business infrastructure and operational efficiency. Nevertheless, the implementation of internal controls over end-to-end business processes (as a part of an ERP implementation) is sometimes either overlooked or not well monitored. This can have far-reaching implications for multinationals in China, especially considering China's growing importance in the global value chain.

In one recent case, a US multinational ran into recurring problems with components sourced from China. Vendor management at this company was centrally controlled and monitored at the US headquarters. In accordance with global standards, all potential new vendors had to first undergo a robust technical and engineering vendor qualification and testing process before approval. However, a breakdown occurred somewhere during the process, and substandard components made their way into the supply chain.

Eventually, the source of the substandard components was discovered – the China-based general manager had bypassed the vendor qualification process completely by splitting the purchase orders and allocating a significant portion to vendors with which he had personal ties. Despite the significant amount of management time and resources invested in the vendor selection process, the ERP system was not effectively configured to ensure that purchase orders could only be issued to vendors certified by US headquarters. As a result, the quality of the final product dropped sharply, and the multinational's reputation was negatively impacted, resulting in financial losses.

This case illustrates how important it is to have a strong foundation and business infrastructure in the form of the right systems and controls. Although the business invested time and money at the front-end, they gave an insufficient amount of attention to infrastructure controls, resulting in negative consequences for the business.

17. Credit Suisse. "China ERP Software Market." 2011

The other side of localisation

In an effort to cope with the increasing cost of labour and inflation in China, some multinationals have undertaken initiatives to streamline their businesses, namely consolidating roles and delayering organisational structures. With an increasing number of companies implementing lean operations, a certain degree of operational and controls knowledge is lost. As the economy continues to improve, signs are now emerging that these reduced controls and streamlined processes may be posing a bigger risk than many executives and board members had initially realised.

In one case, a US multinational had made cutbacks on expatriate employee costs by implementing a management localisation plan to try to reduce expenses. Normally, when executed successfully, resource localisation can be a key success factor in running effective operations in China. This strategy has proven to be a key leadership imperative – senior management must have a deep understanding of the local marketplace and business practices for companies to truly be successful.¹⁸

However, an inadvertent side effect in this case had been the consolidation of too much power into the role of the China general manager. Management reporting to the US was structured in such a way that the Chinese line managers would then report to the general manager. The general manager would, in turn, report to management in the US on all aspects of the operation. As the only employee in China who could speak English fluently, the China general manager, was the sole communications touch point that US management would interface with.

Soon after assuming this role, the general manager changed key suppliers to companies with which he had a close personal relationship; these suppliers asked for an inflated price, while producing a product that did not meet customer requirements. The general manager told US management that these new suppliers had been vetted and endorsed by all of the local managers, when in fact they were not. As a result, there was a sharp decrease in product quality. After a slew of customer complaints, the company ultimately had to issue a product recall in the US.

Here, in an attempt to streamline the business and cut costs, the multinational had inadvertently concentrated too much power into one individual and cut off all other lines of communication (due to the language barrier). By trying to rationalise costs, the company failed to adequately weigh the risks of making such a considerable business infrastructure change.

Compliance, the China way

Multinationals with a presence in China have an ongoing responsibility to comply with both anti-corruption laws in China and in their home country, including the US Foreign Corrupt Practices Act (FCPA), UK Bribery Act and similar laws. But implementing global compliance policies and procedures without understanding the legal and cultural aspects of business practices in China leaves multinationals exposed to a certain level of risk. In some cases, Chinese business culture and practices can conflict with overseas laws, and failure to identify these areas of conflict could result in control overrides, fines and potential reputational damage.

Many of the challenges faced by multinationals operating in China are typical of those facing any firm

operating in a fast-growing emerging economy; others have a uniquely Chinese flavour. Some factors to consider include the prevalence of large cash transactions; widespread use of third parties, agents and intermediaries; the culturally accepted norm of giving and receiving gifts; a culture of “guanxi” or personal relationships, and employees’ reluctance to challenge superiors, even over matters which they suspect could be very serious. Accounting practices also typically do not meet international standards for record-keeping in reasonable detail.

Another idiosyncrasy of doing business in China is the easy availability of fake third-party documents. Fake bank confirmations, “fapiao” (tax receipts), credit card receipts and other supporting documents are all relatively easy to acquire. Use of fake *fapiao* and supporting documentation is the most common mechanism to extract cash from firms, either as fraud to enrich employees or as a means to fund bribes which may constitute a violation of the FCPA and/or the UK Bribery Act.

Though the risks apply to all industries and businesses subject to the FCPA or UK Bribery Act, certain industries – where the target market is constituted largely of individuals who meet the Department of Justice’s definition of “government officials” – are particularly vulnerable. These industries include the pharmaceutical, medical device, real estate, automotive, entertainment, oil, mining and manufacturing industries.

The changing legal environment, the increasing disparity in wealth, the growing social divide and the scarcity of qualified professional resources have compounded the complexity and increased the urgency of compliance management. In light of this, multinationals must implement a China-oriented risk management framework.

18. See also Human resources and talent management chapter

Figure 2. Integrated China risks strategy

Managing growth risks

- Safeguard against uncertainties with a commercially viable business model
- Adapt your value propositions to China's fragmented consumer market profile
- Ensure your global promotion/marketing campaigns are tailored for Chinese markets
- Account for the impact of the latest Five-Year Plan (2011 to 2015) and its "green" focus
- Align your business with the increasing number of environmental and social regulations
- Appreciate the impact of local regulations on your preferred operational policies
- Understand the impact of a possible tightening of liquidity, especially for infrastructure projects
- Assess the liquidity of your potential partners as they impact your funding needs
- Recognise that a local partner may want to appropriate your brand name and technical intellectual property for their own use
- Verify that your cash repatriation models are effective, to avoid trapping money in China
- Maintain a cost optimal and legal business model (despite expansion and strategic changes) to ensure competitiveness
- Harness excess sales-oriented operations to relieve pressure on controls circumvention
- Identify potential credit issues stemming from lack of effective local credit rating agencies
- Reinforce control with robust shared service centres to accommodate remote business sites

Managing business infrastructure risks

- Verify effective management and protection of your intellectual property
- Guard against systemic controls slippage due to cost cutting
- Identify communication breakdowns (particularly from language issues) between overseas MNC HQ and local management on a timely basis
- Prevent management power from residing among a few key executives, making them indispensable
- Identify possible control overrides resulting from possible staff deference to management in Chinese organisations
- Check against weakening segregation of duties arising from opaque organisational structures and reporting lines
- Streamline employment and remuneration structures to avoid internal tension
- Invest in a reliable management reporting system to strengthen decision-making capabilities
- Set up effective reporting to maintain market competitiveness
- Recruit and retain qualified personnel with knowledge of both local and international GAAP
- Raise IT security awareness to decrease risk of information breaches and data privacy issues which can damage reputation (cyber attacks)
- Rein in excess spending on IT beyond actual needs
- Simplify complex company structures to avoid reporting errors
- Install robust governance over vendor selection process to ensure quality of sourced products
- Optimise strategic sourcing strategies in China to ensure competitiveness
- Ensure documentation and transparency of vendor selection and bidding processes to deter bribery and avoid conflicts of interest, which can cause reputational issues
- Implement adequate safety processes into your supply chain
- Verify the compatibility of global, regional and local supply chain models to eliminate poor margins

Managing cost rationalisation risks

- Safeguard against inappropriate use of local outsourced manufacturers and suppliers impacting cost and quality
- Understand the potential for local partners to make decisions to help their business partners
- Appreciate increasing nationalistic sentiment over foreign acquisitions of Chinese companies (i.e., government approvals and regulatory risks)
- Identify informal arrangements between suppliers, customers and other business partners that could discontinue after acquisition
- Verify the accuracy of valuations by local appraisers, as quality or techniques may differ
- Properly transition staff of a legacy state-owned enterprise culture to adapt to a multinational environment
- Address inefficient and unpredictable distribution channels in less-developed areas
- Plan selection of local distributors carefully; poor choices can impact sales prices/revenues and reputation
- Ensure a low-cost sourcing strategy does not risk product safety, which can impact long-term reputation
- Increase awareness of suppliers' social responsibility practices to reduce reputational and financial risk
- Implement effective operating model to accommodate costs of expatriate employees in critical areas
- Resolve conflicting loyalties between local and multinational management in a timely fashion

Managing compliance risks

- Address inappropriate (and potentially illegal) operating licence structures
- Commit “on the ground” resources who understand and can address day-to-day regional/national regulation and legal issues to ensure compliance
- Increase awareness of the impact of Chinese business culture/practices conflicting with overseas laws (e.g., FCPA and UK Bribery Act) to prevent fines and reputational damage
- Properly differentiate between “appreciation” and “kickbacks” in the context of Chinese hospitality and gift giving Implement and monitor a China-oriented fraud risk prevention framework to protect reputation
- Appreciate the importance of maintaining open “bureaucratic relationships” to exercise local legal rights and support efficient operations
- Recognise that local courts may rule in favour of local partners in the event of disputes
- Forbid the use of pirated software, which can lead to IP infringements and legal issues
- Keep on top of changing tax regulations
- Avoid improper transfer pricing arrangements
- Ensure accurate and up-to-date in-house tax policies, robust VAT administration and accurate and complete custom duty information to safeguard against penalties and charges
- Understand local labour laws that protect employees and erode planned benefits of M&A
- Properly grasp the implications of labour laws, practices and business ethics
- Align your MNC's HR strategy with the contemporary Chinese local environment
- Appreciate the challenges of recruiting/retaining local talent due to limited resources
- Account for health and safety requirements to avoid fines and reputation issues
- Safeguard against poor management that can lead to underfunding of pension liabilities/contributions to state funds

Building an effective compliance programme

The experience of many multinationals clearly demonstrates that global compliance policies, training and procedures have proven largely inadequate to the task of identifying red flags and assessing risk in China. Instead, multinationals are adapting their global or generalist approach to compliance and investing in more localised procedures and specialist teams. China-based Mandarin-speaking compliance staff, more country-specific training and straightforward codes of conduct translated into Chinese are now the norm for most multinationals.

These localised compliance programmes must deal with a series of cultural practises within China's opaque business environment which can pose potentially serious compliance challenges to multinationals. Distribution channels, for instance, are a simple, convenient and often the preferred entry point into China for many multinationals. However, these channels also present significant challenges to multinationals

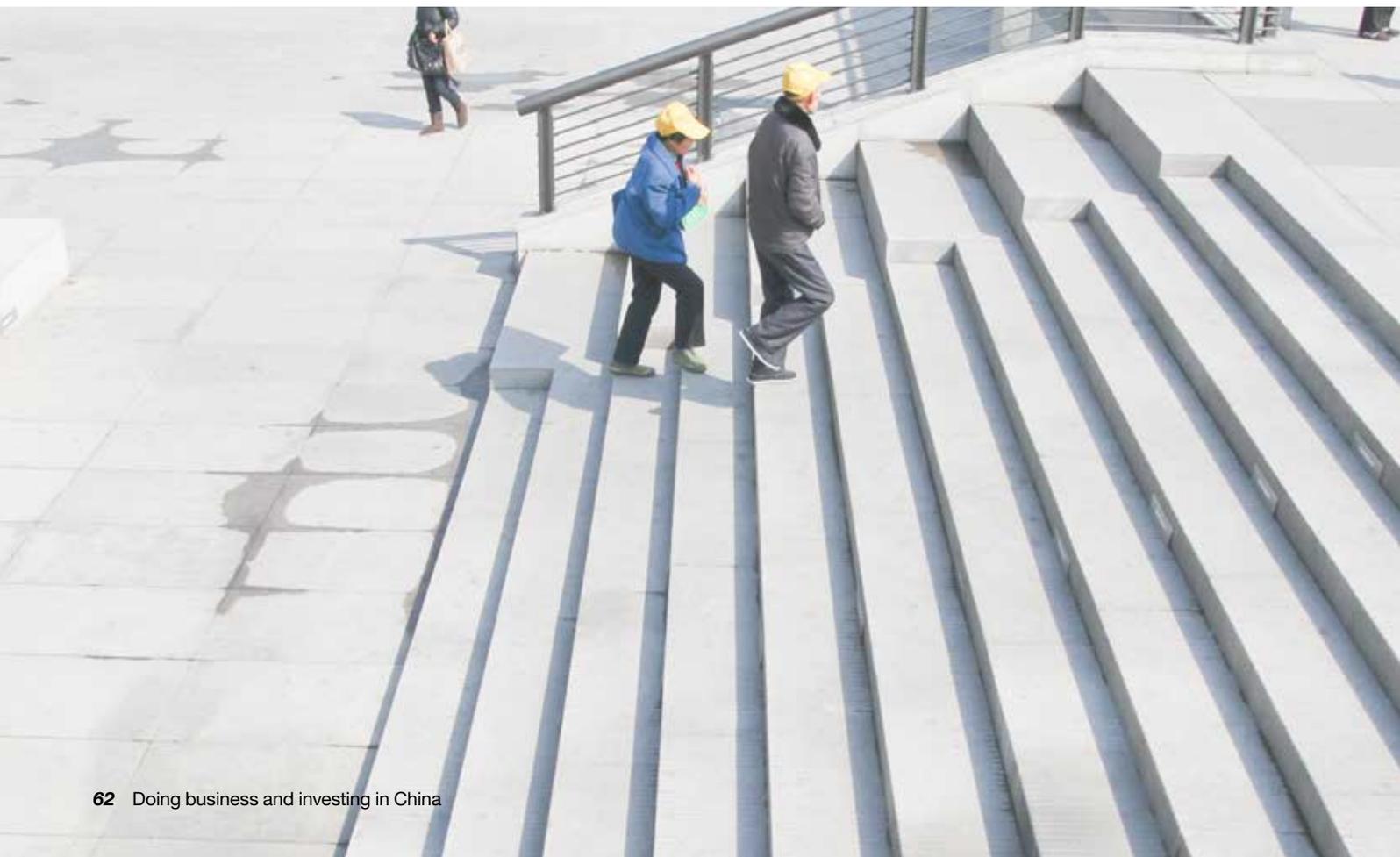
which cannot be certain who the end-user is and how much they are paying. Other challenges are mentioned in the compliance section.

Multinationals' response to these challenges – investment in localised compliance procedures to ensure they keep pace with rapidly increasing sales volume – comes from the realisation that compliance is no longer a luxury to which a firm can just pay lip service. The most proactive and effective compliance programmes are led by China-based

senior management who report to management in the multinational's home country, as the local senior management will be better equipped to navigate the Chinese business culture while at the same time are accountable to headquarters. Thus, setting an appropriate tone from the top and reassuring local country managers that compliance is the priority – even if it could have a significant impact on the bottom line – is necessary.

The current China environment necessitates adopting a risk management approach whereby risks can be managed across a range of different areas of expertise. A comprehensive risk assessment goes beyond silos, geographic distances and cultural differences.

Jasper Xu, PwC China Risk and Controls Solutions Partner



Guanxi, a double-edged sword

The Chinese word *guanxi* refers to “the concept of drawing on connections in order to secure favours in personal relations... broadly, it means interpersonal linkages with the implication of continued exchange of favours.”¹⁹ This central idea of Chinese society can influence decisions in a corporate environment and affect strategic choices. *Guanxi* networks can have a direct impact on market expansion and sales growth of Chinese firms by affecting resource sharing and social, economic and political contexts in inter-firm transactions. *Guanxi* networks can offer a distinct advantage when doing business in China (e.g., maintaining open

“bureaucratic relationships” can help companies support efficient operations), but also come with their own challenges (e.g., some legitimate *guanxi* building may lead to corruption, such as the awarding of a contract to someone in *guanxi* networks instead of the bidder with the best qualifications). *Guanxi*, and its importance in Chinese business culture, is something that multinationals might struggle to integrate into their business.

There have been numerous instances where the failure of a multinational to understand *guanxi* has adversely impacted their business. The *guanxi* underpinning business transactions could override other legitimate performance and financial indicators. The reciprocal

nature of *guanxi* also dictates informal obligations to “return the favour.” In mature markets, projects requiring the allocation of a large sum of money would typically go to tender in order to achieve cost efficiencies and ensure quality. Normally, strict guidelines and assessment schemes based on price, value for money, ability to fulfil contractual obligations and independence would be considered before making a decision. In China, some fraud cases have revealed that the majority of the suppliers bidding for the capital project were a part of the *guanxi* network of those charged with making the final decision. This poses a challenge for multinationals’ traditional control procedures, as *guanxi* networks are often hidden rather than open and transparent.



Collaboration between business functions, operating regions and across disparate stakeholders allows executives to increase their visibility, affording an integrated view of the local business environment and practices so that they are better able to identify the root causes of their business risks. Addressing these root causes allows businesses to develop a risk management approach that suits their China business strategy, and ensures sustainable growth.

Jasper Xu, PwC China Risk and Controls Solutions Partner

19. Luo, Yadong. *Guanxi and Business*. World Scientific, 2007

The war for talent

As we'll discuss in the Human resources and talent management chapter, the China labour market is one of high employee turnover and labour shortages. This can pose a substantial risk for multinationals in any country. While in previous years, foreign multinationals in China had access to a massive labour pool and were thought of as the preferred employers for local Chinese workers, this perception is now beginning to change. For example, in 2007, only 13% of Chinese people indicated they would prefer working for domestic companies (versus multinationals). But this figure rose to 55% in 2009, as many Chinese believe that domestic firms now offer broader career paths.²⁰ This shift in perception makes competition for talent even fiercer – as career and salary expectations of local Chinese steadily increase, Chinese employees may exhibit comparatively lower loyalty to their companies than their counterparts in developed countries, resulting in frequent employee turnover.

Finding and retaining key talent, particularly at the mid-to-senior-management level, is ranked as the top business challenge facing multinationals in China, and this shortage in requisite talent makes it particularly difficult for multinationals to execute their business strategies locally.²¹ This poses a significant risk to multinationals in China, who oftentimes make considerable investments in training its people, only to have them leave shortly thereafter, which may therefore impact their business' overall profitability locally.²² Additionally, as mentioned in the compliance section, rising career and salary expectations, *guanxi*, and other “soft aspects” in Chinese business culture may ultimately serve as a justification for fraudulent activities.

Taking an integrated approach to the China risks environment

With the evolving competitive landscape in China, multinationals have to use an integrated approach to critically review how well they are managing their risks. The key to successfully managing risks lies in taking a holistic approach, wherein executives first identify the root causes for their business risks in China, and then develop a risk management approach that is tailored to their China business strategy. As multinationals may not be able to address every potential risk they face, they must be clear which risks they are willing to take and avoid, and their overall risk management approach must be consistent and clearly communicated throughout the organisation.

Multinationals in China may take the following approach when designing their China risk management strategy (note that this process may vary depending on the needs of each individual organisation):

1. The C-suite needs to review and approve their universe of risks in China, including the overall risk appetite of the organisation (extent of risk that an organisation pursues/is willing to take on) and the risk tolerance for each strategic business unit (i.e., the degree of risk in association with specific business objectives that an organisation is willing to accept).
2. Develop the China risk management strategy and ensure it falls within the organisation's agreed-upon risk appetite.
3. Each year, risk areas facing the business need to be identified and prioritised, and each risk area must have an assigned “owner.”

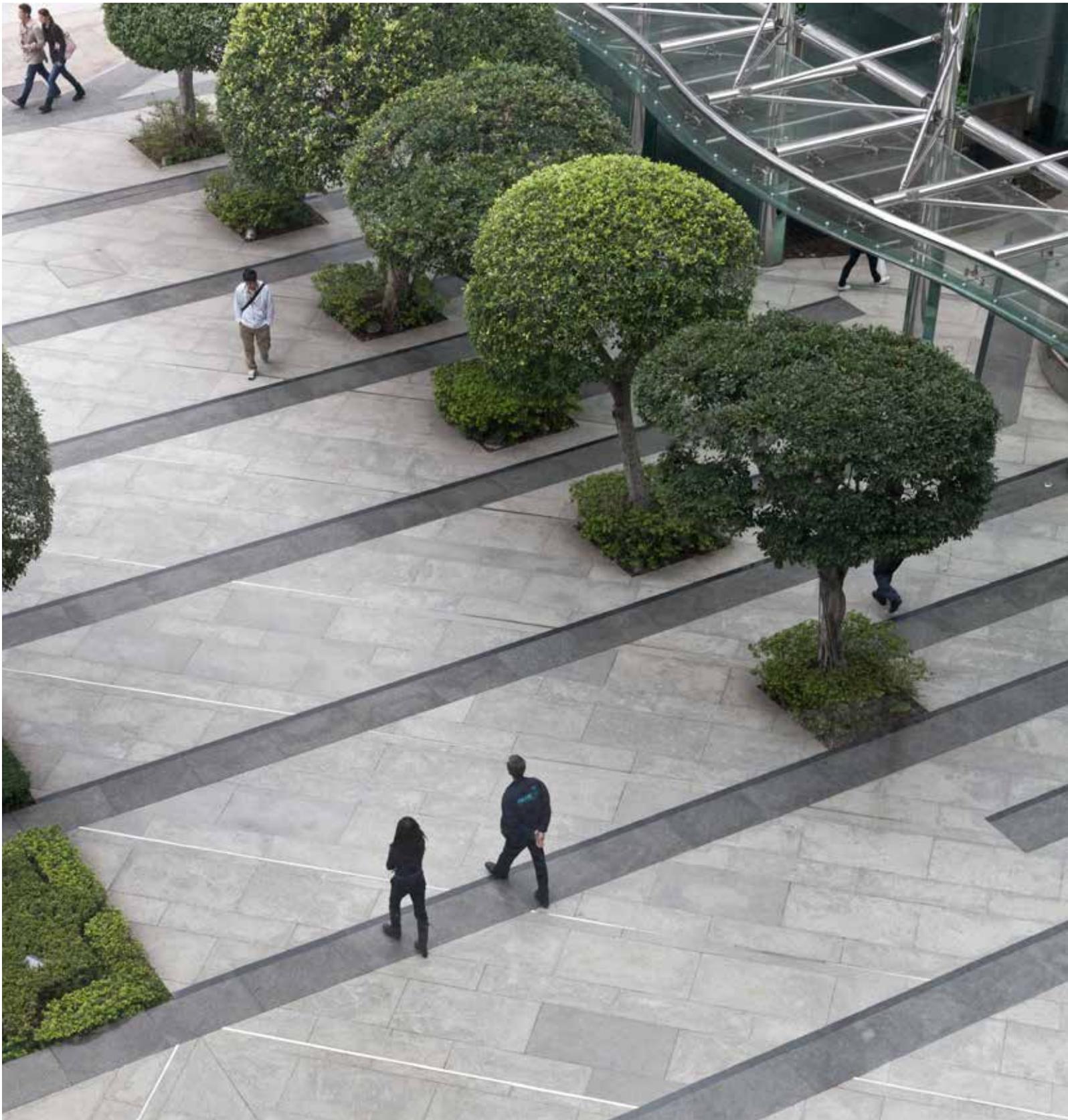
4. Reassess your control framework annually; review existing controls to ensure they are still relevant and effective for the business, and develop new controls to address any newly identified risk areas. As control effectiveness tends to degrade over time, an annual assessment of the internal control framework is critical to effectively managing risk in China.
5. Create risk registers at the business unit level that outline strategies for mitigating risks.
6. Implement monitoring systems/early warning systems to help identify red flags. Ensure that any issues identified are investigated on a timely basis and have a clear escalation process.
7. Business unit leaders should prepare a statement of governance for the China CEO or general manager annually.
8. The China CEO (assisted by a local risk management team) should summarise the governance statements and present to global headquarters. Having a local risk management team enables the organisation to have localised procedures and specialist teams that are better equipped to assess risks locally and can support the China CEO to modify the China business strategy as needed.

Once the right integrated strategy is in place, multinationals will be able to establish sustainable competitive advantages, and minimise time and resources spent reacting to issues. As China transitions from a destination for cost rationalisation to a growth engine, it is vital for multinationals to plan and execute the integration of their developing business infrastructure and compliance efforts with their business strategies to grow in this massive market. China's 1.3 billion consumers and its massive labour pool will continue to be an attractive incentive for multinationals, despite the rising costs.

20. PwC. “15th Annual Global CEO Survey: The view from China.” 2012

21. American Chamber of Commerce in China. “AmCham China Business Climate Survey Report.” 2012

22. See also Human resources and talent management chapter for more on this issue, as well as relevant retention strategies



Internal control



Observations

1. Internal controls and corporate governance evaluations are often not part of due diligence in China.
2. Systems and processes between Chinese and Western companies can often be dissimilar.
3. The business volume of Chinese operations can sometimes be too much for global systems to handle.
4. Business technological innovation in China is advancing quickly.
5. Variations in Chinese tax and accounting laws can affect the migration of reporting systems.
6. Businesses need to account for long-and medium-term risks such as carbon taxes and carbon trading mechanisms.

Recommendations

1. Internal audit functions should play an advisory role in both pre-deal due diligence and post-deal integration teams.
2. Global systems must be tailored for local application.
3. Secure the commitment of the local workforce through regular visits; demonstrate your commitment by taking part in local training programme delivery.
4. Locally based advisers can serve bridging roles between foreign IT directors and China IT staff during the systems integration process.
5. Building up China integrated reporting capacity will result in improved corporate governance and cost efficiencies for tax and resource consumption.

Re-assessing internal controls for due diligence

Many years ago, a European multinational acquired a Chinese company, for which they went through the motions of completing the mandatory financial due diligence. Once the books seemed to be in order, the deal closed, and a solitary manager was sent from the head office to oversee the country's operations. A few years down the road, things began to go wrong. The China chief, who operated without much communication with the head office, had completely lost the trust of the local staff, and operations were in disarray. As the subsidiary began to unravel, the European head office contracted an external adviser, PwC, to conduct an independent review of all of the company's systems and processes. This review included an investigation on everything about its operations, from its internal controls on sales and key business cycles, to its tax and environmental compliance.

The report, produced some months later, offered some intriguing insights into the nature of the China business and its controls environment. A number of these issues were quite pressing: Some internal procedures and best practices were not followed, and systems were improperly implemented in some places. Even more problematic was the fact that the entity was not in compliance with many local tax and environmental rules, and the non-compliance risks were great enough that the company could have faced substantial regulatory challenges. On the strength of the report's findings and recommendations, the company was able to focus its resources in China, and turn around the operation.

"This is not an uncommon story in China," says John Barnes, a PwC Risk and Controls Solutions Partner. "But it's one which could be easily avoided with due diligence that's focused on the right internal and environmental controls and corporate governance structures." To remedy this, foreign investors could simply opt to conduct an evaluation of a target company's internal and environmental controls and corporate governance procedures in their due diligence, a practice which is still quite rare in this market. Processes in which to delegate authority, allocate responsibility, as well as standards and procedures, are often very different in China. For example, if a Chinese

company lacks effective internal controls, all exceptions to the rule may simply be passed to senior management for approval. Your primary areas of focus can include order to cash, treasury, procurement, capital expenditure and regulatory compliance for environmental and social considerations.

For mergers and acquisitions, internal audit functions should be involved in the merger and acquisition process from pre-acquisition due diligence to post-deal integration. Businesses should look at the governance; risk and control environments; primary business processes controls; information technology (IT) systems; compliance programmes; environmental and health and safety processes; and the risk and control culture of the target company.¹ By understanding the differences in culture and audit and risk management strategies in China, the company can then develop a plan to integrate internal audit, systems, risk management, Sarbanes-Oxley compliance and other compliance functions, or even use best practices from the target, should they be more practical. Generally speaking, internal controls evaluations tend to be reactionary, as in the case of PN21 Hong Kong listing rules on internal controls reporting.²

However, a proactive assessment of a

1. See also Doing deals chapter for a discussion on due diligence considerations
2. The Stock Exchange of Hong Kong Ltd. "Practice Note 21: "Due diligence by sponsors in respect of initial listing applications"

target's internal controls and corporate governance can help to prevent the implementation of new procedures and processes without due consideration for Chinese cultural differences, practicality and the regulatory environment, which could potentially create disruptions and engender local distrust and confusion on the intent of the new management. Some of these considerations are mentioned later in this chapter.

For particularly large acquisitions, internal audit should become part of the integration team in China to ensure that control standards are met from day one and prior control weaknesses are remediated.³ Training on compliance and internal controls for local staff is also essential to ensure this day one readiness. A phased approach (i.e., assess, implement and embed) can ensure a smooth implementation, considering the complex and diverse group structures of some Chinese companies, along with a general lack of experience in these areas.⁴ Global leadership should also be involved in monitoring risks, interacting with the leadership of the company on a regular basis, conducting regular visits and participating in the delivery of training programmes. Without involvement from leadership, internal controls may be treated as an additional compliance burden.

Internal audit functions should also play

an advisory role in post-deal integration teams for process and control design; IT systems integration; data migration, quality and security; validation and tracking of benefits and cost savings; and product management assurance. Management and the audit committee must have a common understanding of the appropriate timeline in the China setting for a company to achieve standards that are consistent with the head office, as compliance may be a drawn-out process, due to potential regulatory complications.

Many of these principles also apply to newly established China operations, as businesses need to establish a strong system of internal controls from the very start. Policies and procedures at the local level must balance the objectives of the following:

1. Corporate standards and values
2. Regional and national laws
3. Regulations
4. China accounting standards
5. Sustainability in the Chinese work culture (to ensure employee engagement and well being)

3. PwC. "State of the internal audit profession study." 2011

4. PwC. "China's evolving financial reporting and internal controls." 2012

Considerations in systems and process integration

Integrating systems requires more than just a change in process and procedure: it involves wide-scale culture change for the target. With cultural change, buy-in and engagement from staff is critical, as the acquiring company is asking that they work in different ways and follow a set of different rules. Businesses must ensure leadership and staff support, to ensure the success of any cultural change in a target company.⁵

The Chinese work environment could potentially influence systems implementation in a number of ways. While most Western firms use internal checks and automated systems, for instance, they are not universally relied on in China. Manual systems that incorporate chops, stamps and signatures are preferred, and some companies might appear to be slightly over-staffed, as manual systems run

parallel with computer systems. Therefore, many of the efficiencies and synergies that foreign investors may expect to achieve in combining systems may not be realised, as the Chinese preference has been to maintain the status quo. Global headquarters should take into account the time needed for staff to adjust to a migration from a system of physical documentation and signature to a paperless system, as a degree of organisational change is inevitable.

In addition, language may precipitate the need for a Chinese front-end interface. More importantly, systems for domestics may at times be drastically dissimilar from global products, with processes and work flows that are also quite different. Work flow arrangements would have to be reorganised within the company and a suitable strategy

proposed to match the work flows of the system. Chinese domestic companies also tend to have fewer systems overall, but these systems are relatively new and advanced – another potential point of departure.

“Global policies and standards must be tailored for local application,” says John Barnes. “Otherwise, they will lose their relevance and be ignored.” While global standards can be quite extensive, Chinese businesses often operate under different regulatory and work environments, and custom tailoring will be required.

You may need to look at your target’s occupational health and safety policies, for example, as China has very specific rules and guidelines on health and safety, including overtime, engagement controls, leave and social security

5. See also Doing deals chapter for a discussion on deal integration considerations



contributions. The government also has its own set of environmental regulations, for which policies will need to be amended to reflect. Other regulatory considerations may also apply, particularly in the financial services industry, where systems are highly regulated in the way business is done in China, and the different approvals processes required

Variations in Chinese tax and accounting laws also have significance on the migration of reporting systems.⁶ These differences often result in a local company operating a blanket system that can process and report on financial data for purposes of both tax and accounting requirements. As a result, reasons of practicality may require that tax reporting systems be maintained alongside global systems, as incorporating China-specific

considerations to a global system to accommodate one country unit is often not cost-effective. China operations may therefore be faced with the prospect of running two systems, one to report to global headquarters, and another for China tax filing purposes.

Of course, you will still need timely, reliable and consistent financial and operational information to support your decision making. Identify the gaps between your business requirements and current system capabilities. If management reporting needs can't be met at your China target, make sure there are short-and long-term solutions in place to meet these needs before undertaking full integration.

Due to the size of the China market, companies should also consider the effect that their target's business volume may have on global systems. In pursuing mergers or acquisitions, a component of due diligence on internal controls should factor in a close examination of the IT environment and existing IT infrastructure. One should consider whether the systems used in the head office can scale up to accommodate for the amount of business in China.

The company may even opt to commission a report on the target's technological infrastructure, turnover and amount of data that may have to be uploaded onto the group system. This is particularly pertinent when the turnover of the China business is based on thousands of relatively minor orders, which means that the acquiring company's systems have to be able to cope with that level of data demand.

Global multinationals may also have to be prepared to account for resistance from their joint venture or merger partners, should these partners be expected to absorb costs of systems change. Joint venture partners, for instance, may opt to simply combine the books on the financial side. There have been cases in which Chinese partners have been reticent to take on capital costs associated with operational software, especially if they perceive the benefit as chiefly for the foreign partner or global headquarters.

With all these considerations to account for, our position is that such challenges are not insurmountable, and the advantages of combining systems with the head office, which allow for quick and easy access of key management information, still outweigh the perceived disadvantages.

6. See also Accounting and reporting chapter for a discussion on differences between accounting and tax laws



The state of systems and IT in China

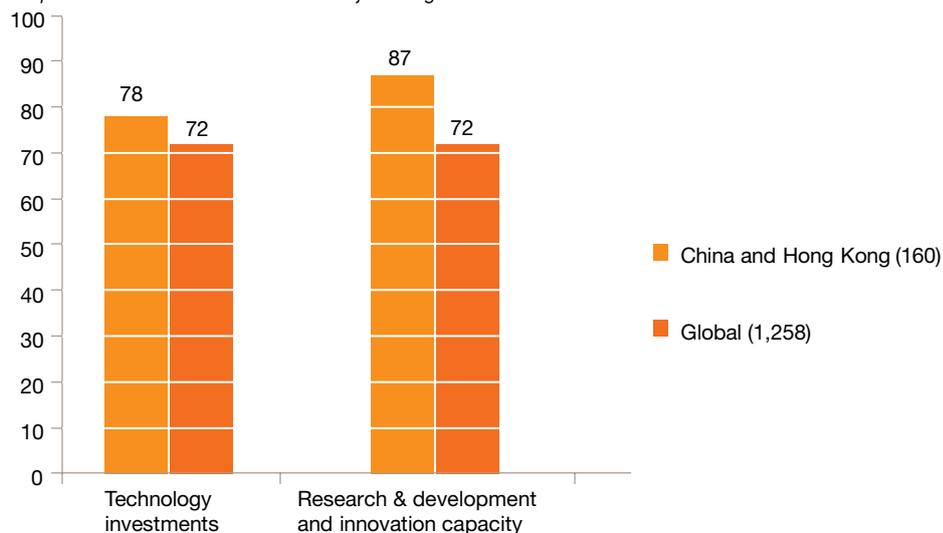
Compared with the IT environment about 10 years ago, data and information systems in China such as enterprise resource management (ERP) are no longer outdated, with many systems in China even surpassing the technology of legacy systems found in many Western multinational companies. The new Chinese systems are now streamlined and efficient, and many domestic companies are technologically very flexible, using international systems and standards to meet the demands of constantly shifting market conditions and a high growth rate. Innovation in the field of information technology is now commonplace.

At the moment, chief information officers are working hard to keep up with the current wave of business technological innovation in China. Information and communications technology, and in particular, cloud computing and mobility, have enormous potential to improve the productivity of the small and medium enterprises segment in how they create, commercialise and collaborate on innovations.⁷

The new wave of systems implemented over the last five years has taken on increased sophistication. Chinese and Hong Kong domestic firms have made technology improvements a priority, with 78% of CEOs stating that they would be making technology investments in their company in the next 12 months.

China and Hong Kong CEOs have made technology and innovation a priority

Respondents who stated 'some' or 'a major change'



Source: PwC 15th Global CEO Survey 2012

There have also been significant advancements in channel systems, customer management systems, marketing, background data, management accounting and SIPs. Another wave is also emerging from the e-commerce industry, with traditional channels expanding to mobile and e-channels.

In China, cloud computing, as a replacement for traditional data centre infrastructure technologies and management processes, are no longer just theoretical, and are starting to be used in the real business world. Hong Kong in particular is becoming a popular cloud computing hub for China and the rest of the Asia Pacific.⁸ The US telco giant, Verizon, also opened a new 3,000-square-metre Hong Kong-based data centre as a hub to roll out IT cloud services to multinationals and local companies in China and India.⁹

7. PwC. "2011 APEC CEO Survey: The future redefined." 2011

8. PwC. "10Minutes on expanding business in the Asia Pacific." 2012

9. Ko, Carol. "Verizon paves path to cloud with new Hong Kong data centre." Computer World, 10 October 2011

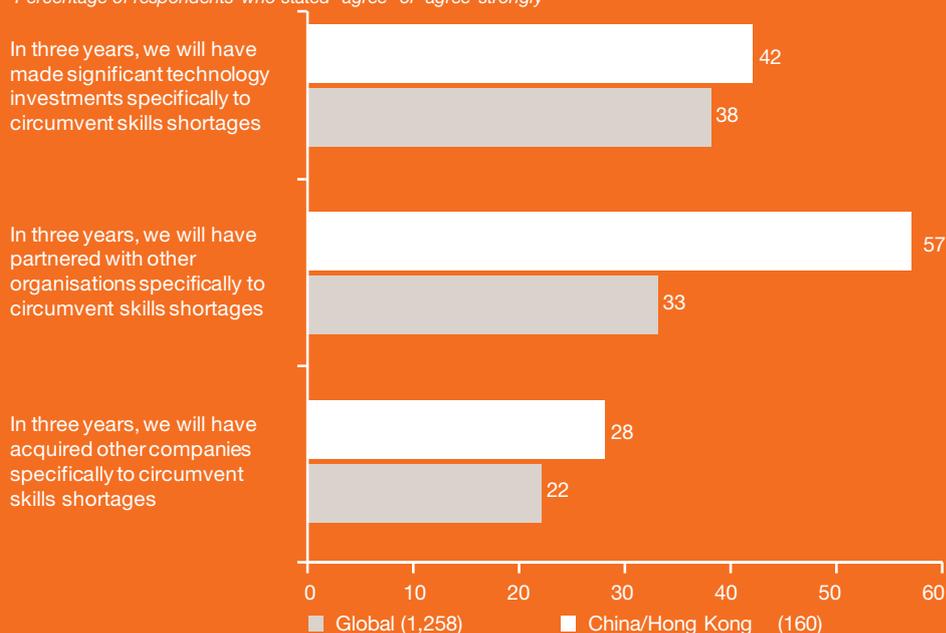
Technology replacing people

There may be resistance in Chinese corporate culture against replacing people with machines, the sentiment might be taking a new direction in the future, according to PwC's 2012 Global CEO Survey responses (see table to the right).

Dealing with skills shortages: CEOs looking to technology, partnerships and acquisitions

To what extent do you agree or disagree with the following statements about the future of your global workforce?

Percentage of respondents who stated 'agree' or 'agree strongly'



Source: PwC 15th Global CEO Survey 2012

A total of 42% of China's CEOs in 2012, higher than the global average, expressed willingness to make technology investments to circumvent skills shortages. This may be a signal that CEOs in China are prepared to accept a move towards more automation and systems, though partnerships with other organisations remain a top priority, which may also suggest a rise in the use of service providers.¹⁰ While labour of this nature may still be relatively cheap, these numbers suggest that domestic companies may be beginning to consider relying more on technology and automation, instead of manual checks, due to growing wages.

10. Also see a discussion on service providers and shared service centres in China in this chapter



Bridging the skills gap

Too often, head office people pay only cursory visits to their local operations in China, focusing only on head office strategies and head office plans. If you are serious about your operations in China, then you need to roll up your sleeves, get in there and look at things from the other side. Delivering key and strategic messages about the importance of local operations to the head office and giving them recognition for the contribution they make to head office profitability and to local environmental and social communities will engender a more committed local management and workforce.

Businesses operating in China will need to consider attracting IT talent to support its systems integration and management, as key infrastructure, such as data centres and support infrastructure, may have to be put in place to support the business. Fortunately, information technology is not an area in which China is lacking in talent, as this technical skill is arguably easier to develop in this market than capabilities in management and strategy.

But while the market is rich in young and technologically savvy professionals and systems engineers, it lacks in staff with sufficient years of experience in managing information technology. A global survey of chief audit executives¹¹ listed soft skills, in addition to technology expertise, as invaluable in today's environment: critical thinking skills, understanding the strategy and business model, communications and leadership. Businesses might therefore wish to contract local advisers to fill in the gap, or send IT managers to the country to work with the local IT team on implementation.

Locally based advisers can also be invaluable in acting as bridges between foreign IT directors and China staff in the project management of systems and process integration. A neutral party sensitive to the personal and professional cultural gaps from both sides in a merger, acquisition or joint venture can go a long way in ensuring that personal and professional culture differences are smoothed out, and properly mediated.

11. PwC. "State of the internal audit profession study." 2011



Service providers and shared service centres in China

As CEOs with operations in China look to circumvent skills shortages by partnering with other organisations, service providers in China are stepping up to diversify their offerings, as the country emerges as a new magnet for outsourcing firms. With the growth and maturation of the China workforce, routine transactional processes, as well as some value-added processes, are becoming possible in the country.¹² They are providing a cost-reduction opportunity that would not have been possible a decade ago, and are even beginning to threaten the current dominance of Indian and US centres.¹³ In addition, shared service centres are gaining in popularity in China. Domestic and multinational players in China have expressed the intention or have already implemented shared service centres locally. Indeed, approximately 28% of businesses intend to acquire other companies in three years to deal with their talent shortages.

Given the relative importance of treasury operations in China,¹⁴ some multinationals have set up finance processing shared service centres in China to serve the greater region around the country.

In one instance, a global multi-industry manufacturer on the *Financial Times* 500 established a shared service centre in Shanghai, initially to serve its China operations. However, it later expanded this centre to serve the entire Asia Pacific area, covering 14 countries. The firm overcame an initial challenge of integrating the multiple enterprise resource planning platforms to increase control and optimise efficiency for financial processing work. The company was thereby able to set up a talent pool in the Shanghai shared service centre, boasting extensive knowledge and experience in finance.

In another example, one global manufacturer of engineered electronics components merged its dispersed finance shared service functions into one single centralised organisation. With the improved operational efficiency and internal control, the company is now considering expanding the financial shared services centre to cover all of the Asia Pacific.

It's also worthwhile to look at the growing range of service provider offerings here. As new entrants in China aggressively plan to enter high-value-added markets for application development and maintenance (ADM), R&D and design services, they are beginning to grab market share from incumbent providers. The challenge here is in choosing good providers, which may also depend on your IT strategy.

In China, the growth in the number of providers offering and targeting ADM services is continuing to expand, followed by IT infrastructure and engineering services. Chinese service providers are also targeting new offerings in high value-added services such as R&D and product design. Meanwhile, 35% of Chinese service providers intend to introduce human resources services, compared with the 10% average in the Asia Pacific. Management training has become a greater focus for these providers, along with language skills enhancement.

12. PwC. "Why global sourcing? Why now?" 2010

13. Duke University and PwC. "The ever-changing global service provider industry: ORN service provider survey report." 2011

14. See also Finance and treasury chapter for a discussion on treasury strategies

Sustainability reporting

Obtaining sustainability data and information that's reliable, measured and balanced requires robust internal controls and monitoring systems and processes. Effective and audited measurement and reporting systems and processes for energy consumption, paper use, water efficiency, waste-water and carbon emissions should be developed as early as possible in the lifecycle of your China operations. They should also be considered when undertaking due diligence for joint ventures, mergers and acquisitions.

What you'll need to consider

Getting this information, however, is often not straightforward, due to less developed local market conditions and the current state of the talent pool for monitoring and reporting. Companies should therefore consider the following issues and challenges:

- **Access to the relevant data.** Working with local partners and suppliers to access relevant data or establish the required monitoring systems and processes can be challenging, given their relative lack of awareness in this field. While there's little complexity in China pricing models for electricity or water, internal monitoring IT systems and processes for energy and water use may also be poor to non-existent, particularly in older plants, buildings and factories.

Make this a consideration when purchasing or renting capital infrastructure, and when entering into relationships with your suppliers and partners.

- **Transparency over your value chains.** Due to practical considerations and reputational issues, substantiating claims of reliability for China-sourced non-financial information can sometimes prove difficult. The challenge lies in obtaining reliable information across your whole supply chain that account for an accurate overview of your reputational risks.
- **Balanced information from Chinese partners.** Due to the still-emergent conditions for non-financial reporting and the low cost-related incentives for increasing energy and water efficiency in China, foreign investors will need to work proactively with partners to encourage balanced data reporting, should they miss sustainability key performance indicators such as energy efficiency targets.

Traditionally, sustainability reporting has framed the creation of the report for stakeholders as a primary objective. However, the process of developing the report could also yield a more holistic view of your operations in China, lead to greater insights and help map new avenues for improvement. Such improvements can range from bolstering your governance procedures and strengthening risk management, to driving new cost efficiencies.

John Barnes, PwC China Head of Sustainability and Climate Change

Steps to improving your China reporting

Companies wanting to bolster their capacity for sustainability reporting in China should first acknowledge that quick and clear solutions can be elusive. The China environment currently is more suited for gradual evolution and capacity building. Below are three steps for gradually putting the right reporting infrastructure in place.

One notable development is the potential for a domestic carbon market in China. The central government has a stated goal of launching a unified national carbon trading platform by 2015, while carbon tax and cap-and-trade systems are becoming a major point of policy discussions. Implementation is still years away, and questions such as tax neutrality, revenue management and incentives for greentech solutions are still unresolved. But should such systems be introduced in the near future, businesses may be left exposed to heightened disclosure requirements for energy use and emissions. Many China operations have not shown the capacity to deal with the consequences of carbon taxes or the eventuality of emissions caps.

- 1. Set up a baseline year for measurement.** Arriving at this preliminary baseline can yield several benefits. It can jump-start the process of implementing adequate internal controls, while allowing you to discover various ways to improve your operations. Another potential advantage is the increase in visibility for your tax positions, which, depending on your industry and geography, may encompass a wide range of China-specific environmental, social and governance-related taxes and levies. As businesses increase their transparency with a range of stakeholders on these tax positions, they can also demonstrate their wider social and economic impact and better monitor and manage their tax risks.
- 2. Identify your skills and infrastructure gaps, and build a team with the right experience.** With a comprehensive reporting infrastructure in place, you can now look more closely at your specific systems and processes. Companies can consider how to tighten up reporting, verification and monitoring processes. Management can then determine what they need to do to take their reporting to the next level (whether through third party assurance or the layering or streamlining of checks and balances). One particular concern, however, is that the skills necessary to implement and maintain the reporting and monitoring of these systems may lag behind that of other economies, so time and patience are necessary to finding the right expertise.
- 3. Address reporting deficiencies.** Take the time to invest in training, while raising awareness with business partners and suppliers. Once you've understood your deficiencies and assembled an experienced team with the right skills, you can begin to address these gaps. Invest the time to train your partners and suppliers in monitoring and reporting their inputs, outputs and performance. This becomes particularly crucial should your China presence take the form of a joint venture or acquired subsidiary. If your partner does the bulk of the heavy lifting in your China operations, you'll need to assign additional resources and people on the ground to assist in training and awareness raising on the importance of sustainability reporting.



Human resources and talent management

Observations

1. The talent market has become increasingly competitive.
2. Local employees are increasingly choosing to work for state-owned enterprises over foreign multinationals.
3. Mid-to-senior-level managers in China are relatively young, compared with their Western counterparts, while turnover is high.
4. Market realities may require that expatriates and Chinese returnees fill talent gaps in the short term.
5. Chinese workers value career advancement opportunities over salary considerations.

Recommendations

1. Family-focused benefits and perks can help retain workers with aging parents or children.
2. Begin succession planning early. Identify promising staff and devote sufficient resources to their development, while integrating them into global mobility programmes.
3. When selecting managers to send to second and third tier cities within China, consider staff with local roots in those regions.
4. Training programmes must be culturally sensitive for locals and expatriates, as well as returnees.
5. Make sure there's a clear path for career development and advancement, as well as sufficient opportunities.

The challenges of finding talent

Designated as one of China's Special Economic Zones, an area with a free market-oriented economy, Shenzhen attracts a large amount of foreign investments, as well as economic migrants, hailing from every region in the country. Today, the average age of the population in Shenzhen is less than 30, mostly comprising migrant workers whose families do not live there.

A telecommunications equipment company based in Shenzhen maintains a fleet of Mercedes Benzes in their stock of company cars as a form of transport for their clients, dignitaries and other VIPs, including parents of staff workers.

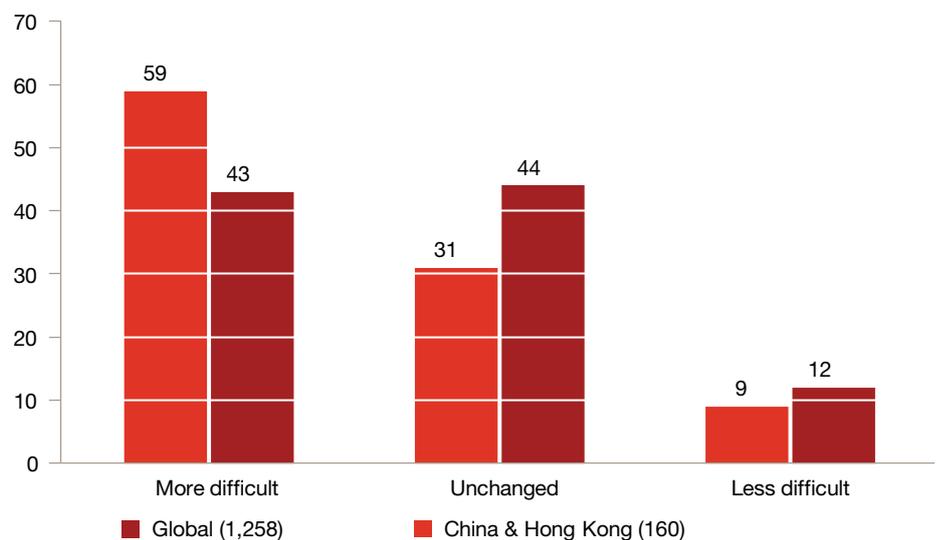
When a parent of one of their staff members comes to Shenzhen to visit, administration sends a car from their Mercedes-Benz fleet to pick them up and take them to company headquarters. This gives the workers a sense of pride. Greeting their parents in an expensive car is a sign of how well their company treats them. Their parents, in turn, feel assured that their children are in good hands with a family-focused firm. This policy has become one of the defining planks of the firm's strategy in engaging its employees. The measure, sensitive to and reflective of the socioeconomic and geographical realities of China, has become very effective.

An innovative strategy like this can make a key difference in competing for talent. In China, where there's a significant talent shortage, you'll need to be creative to attract talented workers and to keep them.

Foreign firms dealing in China should realise that culturally sensitive human resource policies are fundamental to the success of their talent strategies. Besides considering prevailing labour conditions, wage increase policies and social security, investors need to look at the shortage of skilled workers, who tend to value social benefits and job security over money.

Figure 1. Chinese CEOs are finding it more difficult to hire workers

In general, has it become more difficult or less difficult to hire workers in your industry, or is it unchanged?



Source: PwC 15th Global CEO Survey 2012

The difficulty in finding talent is not due to a shortage in numbers. In fact, there are more and more Chinese university graduates. Yet many Chinese graduates are finding it challenging to find work.

In one survey, 83 human resources professionals who hire local graduates commented on the suitability of Chinese candidates. According to HR professionals, less than 10% of Chinese candidates are suited to work in a foreign company in nine selected occupations: engineers, finance workers, accountants, quantitative analysts, generalists, life science researchers, doctors, nurses and support staff.¹ One reason cited is that

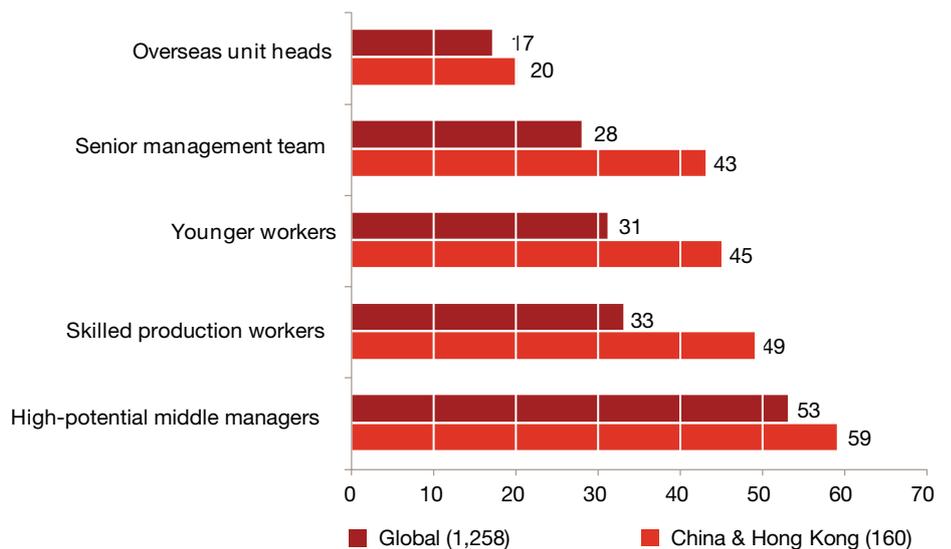
Chinese education focuses more on theory than practical experience, and graduates have little experience working on projects or teams. Another hurdle is poor English skills, considered a must for foreign multinationals.

Some foreign firms believe that candidates are unsuitable for the job market because they don't have the critical thinking or soft skills to complement their technical capabilities. While it's relatively easy to develop a supply of talent in certain fields such as information technology, cultivating commercial and management talent is decidedly more difficult. CEOs based in

China and Hong Kong have identified high-potential middle managers as their greatest challenge for recruitment and retention, according to PwC's 15th Annual Global CEO Survey.² (See Figure 2.)

Figure 2. Finding middle managers poses the biggest challenge

With which of the following groups do you currently face the greatest challenges with regard to recruitment and retention?



Source: PwC 15th Global CEO Survey 2012

1. McKinsey Global Institute. "The emerging global labour market." 2005

2. PwC. "15th Annual Global CEO Survey." 2012



Ambitious growth plans have resulted in talent constraints in China, and every company has limited resources. It's therefore important for companies to link business strategy to talent development needs. In this way, companies are able to focus its resources on developing the competencies that will enable effective execution of its key strategic objectives.

Yongling Sun, PwC China People & Change Partner

As the China market continues to gain speed, it is increasingly difficult for local talent to keep up. The Chinese education system needs to prepare new graduates to compete in such an aggressive and mature market. Uneven funding is the other problem – Beijing has a lopsided edge over Tier 2 cities, and even over Shanghai. In short, the supply of talent is not adequately matching demand at present.

Hiring has become more challenging for multinationals, who need to regain their previous sheen of attractiveness to new graduates. Locals are gravitating towards state-owned organisations and domestic companies that can provide either more security, benefits, or beat Western compensation packages. In 2007, 41% of highly skilled Chinese professionals preferred working for a Western multinational, compared with 9% who would rather have a job at a domestic firm, according to the Corporate Executive Board.³ Preference for multinational employments rose to 44% by the second quarter of 2010, but preference for Chinese employers also jumped to 28%.

3. Schmidt, Conrad. *The battle for China's talent*. Harvard Business Review, 2011



What does the talent gap mean for you?

The issue of talent in China can be a significant stumbling block in the growth of your business in China. As we'll discuss in the Finance and treasury chapter, without good treasury managers, you may encounter cash flow challenges. Without managers to handle joint ventures and M&As, your interests may not be adequately represented. Without administrative and technical proficiency in implementing systems and optimising processes, you may face gaps in integration.

In reality, Chinese CEOs have found that talent constraints have restricted their growth far more than their counterparts abroad (see Figure 3).

Importing talent

Companies who can't find the talent they need within China often import it from other places. For many multinationals, expatriates offer the key skill sets that they need to fill gaps in their business and management strategies. The number of expatriates coming to China from places such as Hong Kong, Taiwan and Singapore is increasing every year. Global exchange programmes and secondments are also common ways for multinationals to bring in talent from their networks.

Although expat wages can be much higher than local packages, the investment can be worthwhile. Note that the traditional in-and-out approach of sending mid-level expatriates to China on short-period rotations may not help in building long-term sustainability though. Leading companies send their best people, and keep them there for the long term.

With cultural and language differences, foreigners tend to have distinct disadvantages to their local counterparts, who have an innate understanding of the local business practices and work culture. This also means that the Chinese employees in the firm will have to spend an inordinate amount of time translating the language and explaining the market situation to their foreign colleagues.

Incorporating local talent should be the focal point of your corporate succession plans. At Newegg, American employees focus on imparting skills and knowledge to the local Chinese, who in turn have the opportunity to work at the US headquarters on specific projects. Newegg's Executive Vice-President S.C. Lee, feels strongly about developing their local managers: "We employ several Americans who speak Chinese, and we send them to China both as expats and for short-term projects," he says. "But we are very clear that we are sending expertise to China because we believe that general management responsibility resides locally."

Another growing segment of workers are Chinese returnees and sojourners who have studied and worked abroad but have later returned to their own country. Known as "sea turtles," Chinese returnees offer a unique skills set and an understanding of both Chinese and Western working cultures. Multinationals looking for this combination of skills find value in "sea turtles" and employ them to fill managerial posts. Returnees already speak and read Chinese and are also more likely to accept a local salary package.

Although they might not have to adjust to cultural differences, they are faced with their own readjustment concerns. "Reverse culture shock" can be common, as returnees try to familiarise themselves with the Chinese workplace, after spending their formative years abroad. Companies that understand the needs of their staff offer specialised training or orientation programmes for returnees to help them reintegrate into the Chinese work setting.

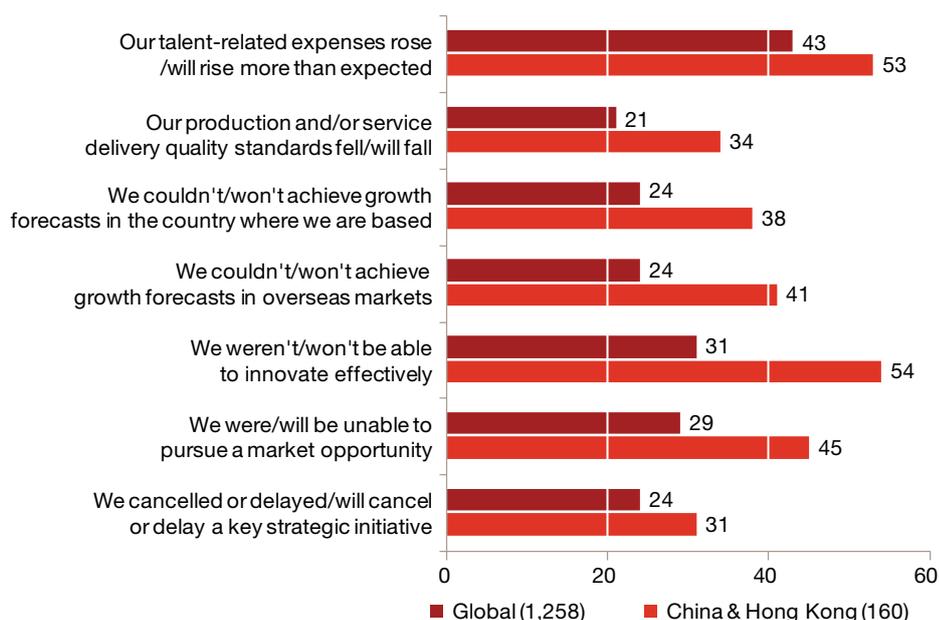
Training

Multinationals need to design training programmes appropriate for a Chinese work setting. Strategies that may work abroad might not be appropriate in a Chinese cultural environment. Chinese managers, for example, tend to be more comfortable in a hierarchical company with clearly delineated chains of command. Managers may be less comfortable dealing with subordinates who challenge authority or boldly express opinions.

To mitigate this problem, an increasingly popular option is to source external training support from third party training consulting firms that provide coaching programmes for executives. Such programmes have been well received by young and relatively inexperienced managers. There is a catch though: these consultants charge hefty fees, and many of them are of questionable quality. Make sure proper due diligence is conducted in choosing the right training firm.

Figure 3. China and Hong Kong CEOs are more adversely impacted by talent constraints

Have talent constraints impacted your company's growth and profitability over the past 12 months in the following ways?



Source: PwC 15th Global CEO Survey 2012

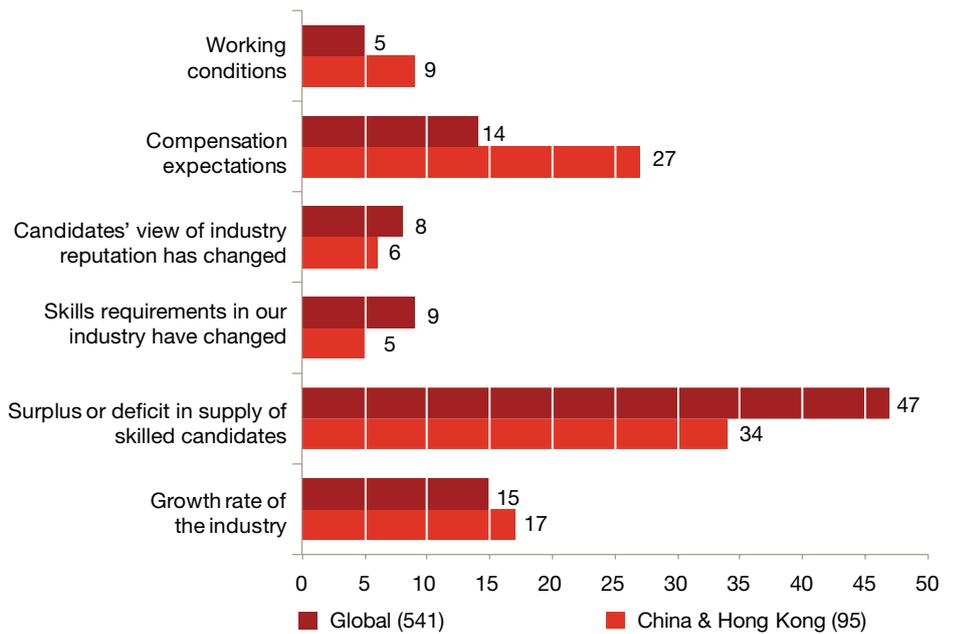
Beyond boot camps

Once you have the talents you need, the next and arguably most important challenge, is keeping them. Some multinationals, especially those with strong international brands well recognised in China, have a clear edge over local companies when attracting new graduates. They often can't retain them though – many locals leave for careers with state-owned enterprises and local firms offering better compensation packages. As a result, larger foreign firms end up as little more than “training camps” for talented young Chinese, who work for a couple of years, pick up valuable experience and training, and move on.

Multinationals competing to retain staff should think of innovative strategies. Offering a higher salary helps, but it isn't the only, or even the best way, to motivate and retain talent. In a climate where the talent supply does not match market demands, those who are truly in demand can receive offers that can double their current salaries. Hence, multinationals trying to compete merely on salary will lose out to those who can simply outbid them.

Figure 4. Compensation expectations an issue in China

Which of the following statements are the primary reasons why it is more difficult to hire workers in your industry?



Source: PwC 15th Global CEO Survey 2012

I'm always asked why young employees are no longer loyal. I have the urge to respond by saying: 'They're still loyal, just not to any particular job or organisation. They're loyal to their own career goals and objectives.' If employers can align company objectives with individual employee goals, the young employees of this generation will work as hard, if not harder, than that of previous generations.

Johnny Yu, PwC China People & Change Partner

Succession planning

Multinationals need to be aware that succession planning in China has to start early: recognising promising local staff and devote resources to developing their potential before others can get to them. Keep in mind that domestic companies in China often promote faster than most companies outside the country. Even senior managers lack the experience compared with their peers in other parts of the world. The average age of a Chinese CEO is just over 47 years, almost ten years younger than CEOs in Europe and the US.⁴

This also means that newly promoted managers lack the guidance of experienced senior management, so they're often faced with a lot of pressure. Many of them end up leaving, as higher salaries and job titles are easy to find elsewhere. But this becomes a cycle, as the problem is not solved. A 2010 survey of over 2,200 mid-to senior-level managers in mainland China found that two-thirds had received at least one competing job offer in the last 18 months, and that nearly half (46%) had moved to a new role with a more than 30% rise in compensation.⁵ Wages are going up over all, and salaries in China are predicted to rise to US\$16,300 by 2021, from US\$3,828 in 2011.⁶

Career paths in China also tend to be linear, which means that people who are good at what they do are promoted quickly. But this means technically proficient workers, who may be recognised for their practical skills, may be thrust into managerial roles, even when they are not ready or able to manage people. This is also an inefficient use of talent within the company. China managers can consider introducing multiple career paths to corporate HR strategies.

“As recently as 10 years ago, we were intent on recruiting the best talent from around the entire country. But we experienced some setbacks. We hired experienced, talented people and gave them large salaries. But did we retain them? No. Even if some stayed, they never reached their full potential. We spent a lot of time trying to figure out what went wrong... And, I think, becoming a leading national brewer is not primarily measured by the number of your plants, or your market penetration, or the amount of beer you sell. Rather, the standard by which a national company should be measured is whether or not its corporate culture can welcome and accommodate talent from anywhere in the country and all the diversity of experience and background that implies.”

Ming Bo Sun,
President and Executive Director, Tsingtao Brewery Co. Ltd.

4. Chief Executive Officer. “Enter the dragons.” September 22, 2007. CEO/Cass Business School survey

5. PwC. “Millennials at work: Shaping the workplace.” 2011

6. PwC. “APEC CEO Survey: Addressing challenges, expanding possibilities.” 2012

Retention strategies

In many surveys, Chinese employees often list career development opportunities as the single most important factor in choosing a career (after job security, compensation and benefits). Some leading companies have developed employment value propositions to help employees understand what it means for the new recruit to work for their company. These propositions list the expectations of the employer, and what the employee should expect from working with the hiring company. This includes monetary and non-monetary rewards, details of work environment and benefits.

Such talent retention principles might be similar to that of other markets, but should be tailored for China and its local talent environment. Dave Whan, John Deer's Director of Talent Management Strategy and Policy design, says, "In developing the employee value proposition in China – whether it's compensation, recognition, or the intrinsic value of the work itself – where we place emphasis can vary region by region. To become an employer of choice in every region, our approach will be similar, but we'll have to customise it based on feedback we receive from both current employees and the markets."

Appointing a human resources manager who has an understanding of local culture and conditions can go a long way in offering the right combination of non-monetary rewards to encourage higher retention.

Such managers should listen carefully to employee feedback – it's the small things that matter. Many employees want more personal engagement from their company. For example, one China-based employee at a multinational investment bank complained that their annual bonus was delivered as mail to their internal mailbox. "We get this letter, informing us about our raise for the coming year," said the respondent. "But there's no human or personal touch to it. It would have been much better if the manager could call us to their office and tell us what our raise would be for that year."

A new strategy is to shift the focus of compensation and benefits from the individual to the entire family. In China, many employees lack proper social safety nets and families have to take care of more than one generation of dependents. Showing cultural sensitivity to the socioeconomic situation of employees in China is crucial to employee engagement.

Let's go back to the example of the Shenzhen firm at the start of this chapter. Putting a focus on the family helps to build a community around your employers and their families, while encouraging a more nurturing work environment. Another company in the chemical industry offers regular community classes such as yoga and cooking for employees' kids and parents. This is an intangible benefit for family-oriented employees and this also works as an effective retention strategy. By building a deep sense of community with employees' family members and building ties that go outside the workplace, employees have much more incentive to stay.

Other companies follow similar family-friendly policies that are of negligible cost to the company, but are of great symbolic and emotional value to staff. In China, all employees are required to undergo health checks before entering employment. Some companies have chosen to offer the same health checks to their children, spouse and parents. During the Mid-Autumn Festival, mooncakes and thank-you letters may be sent to parents of staff, as a show of appreciation for the hard work that their children have contributed.

In major cities, one benefit that can raise your competitiveness is a private health package (comparable with that of expats') for senior management. Compared with local hospitals, the added privacy, better sanitation and higher service standards of private international hospitals can make a distinct difference to local employees.

Is your talent strategy fit for growth?

Only half of recruitment activity in the Asia Pacific is growth driven. The other half is to replace leavers in existing roles. The costs of new-hire leavers are significant, and our analysis shows they can be up to 100% of annual salary for managerial and professional staff and up to 150% for senior management.⁷

Cost-focused measurements around talent strategy need to give way to measurements around returns on investment, as leaders in China look for new approaches to solve the talent problem. For example, we've found that returns on investment for human capital in the Asia Pacific is higher than that of the West, due to a combination of impressive top-line growth and lower employee costs.

But increased competition and high levels of turnover in China have organisations wrestling with rising costs and declining productivity. PwC has therefore highlighted five priorities for businesses to help you break out of this cycle.

Attracting talent

1. Upgrade hiring and on-boarding processes. Ensure new hires become productive members quickly, to safeguard your investment in recruiting. Best practice organisations assign a mentor/buddy to new hires and engage them beyond their first day of work.

Retaining and rewarding employees

2. Pay attention to internal talent. Building talent within the company improves engagement and retention. Create internal job markets and lateral career paths, and focus efforts and investment on top talent.
3. Look beyond financial incentives. One study found that, for tasks that required even basic cognitive skills, higher bonuses actually led to poor performance.⁸

People, processes and systems

4. Take a systematic and analytical approach to talent management. Improve your understanding of how talent affects your bottom line, and adopt a systematic approach to measuring the effectiveness of your talent strategies.
5. Make targeted investments in strategic HR processes: Up-skill your HR functions to the role of strategic business partner; a purely functional and reactive HR cannot drive growth.

7. PwC Saratoga Asia-Pacific. "Breaking out of the talent spiral: Key human capital trends in Asia-Pacific." 2012

8. Ariely, D. *The upside of irrationality-The unexpected benefits of defying logic at work and at home*. New York: HarperCollins 2010

Talent mobility

Another issue that might pose an even larger challenge is the supply of experienced talents in second and third tier cities and the interior regions of China, where many companies may wish to expand their operations. In such cities, the home-grown talent pool does not match industry needs for a market growing at such a rapid pace.

Relocation programmes will require a robust raft of incentives and benefits to attract managers to locations that are far from family and where standards of living might be comparatively low. Such incentives could be in the form of a hefty salary increase or promotion.

However, those incentives may not be enough, given family obligations and *hukou* (household registration) restrictions. It's estimated that only a third of all Chinese graduates move to other provinces for work.

What firms have found effective is the provision of relocation packages to managers who are from the target cities or regions. These employees would have increased motivation to return to their hometown, given the package is attractive enough, as it allows them the opportunity to be closer to family.

Finally, reverse transfers, or moving top performers from China to developed markets for a short period of time to become “credentialised” have become a very popular retention and development measure. However, it's important too that these transfers are done with cultural sensitivity. Some Chinese employees might develop homesickness or a fear that they are missing out on developing the right relationships in China. A programme to send local staff to work in the headquarters and other regions must be systematic, with proper support structures in place to ensure there is room to grow within the company.

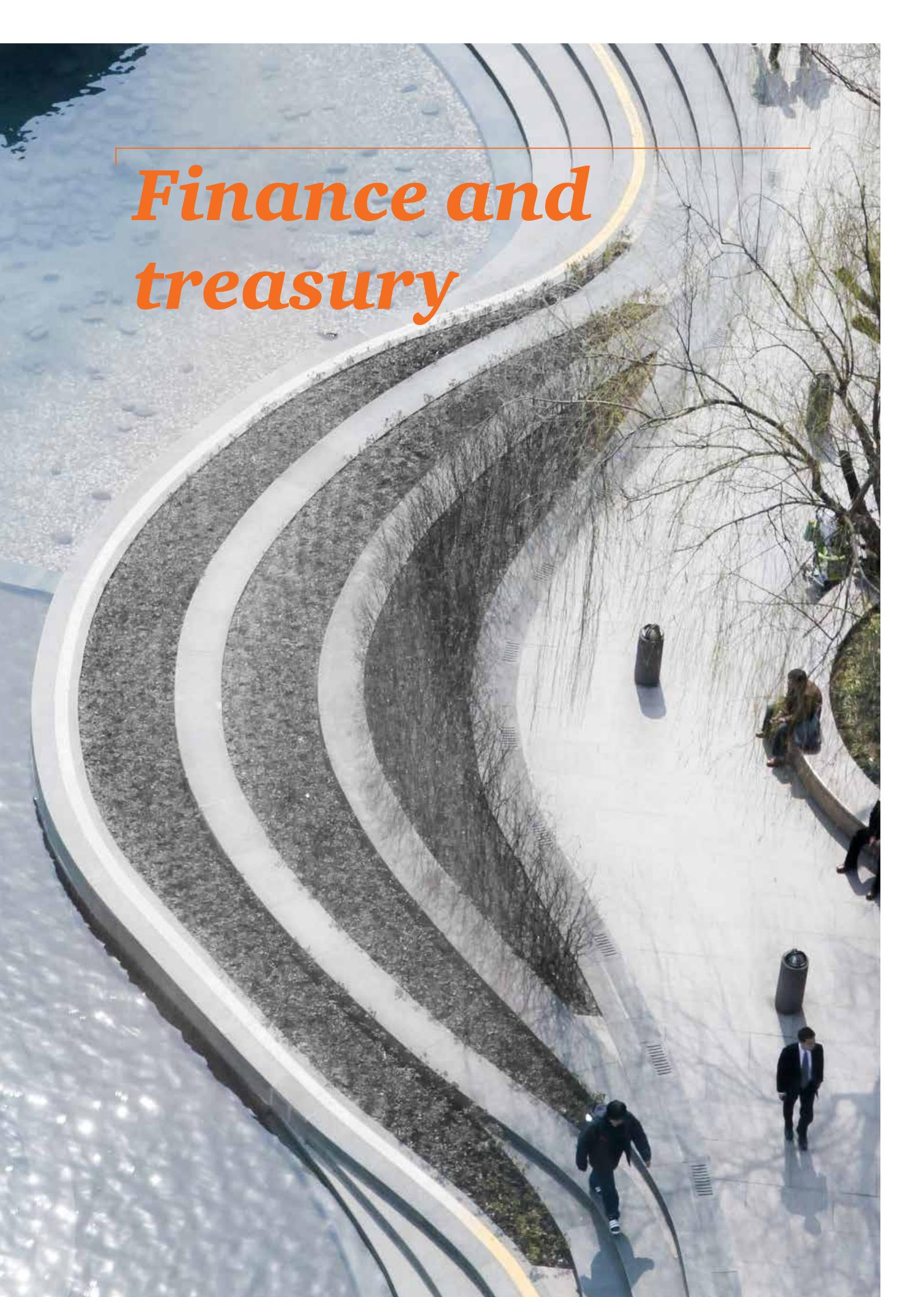
Growing talent locally

Although many multinationals still pay premiums to bring expatriate talent to China, such a move can cause local staff to lose confidence in their abilities and prospects for promotion. In China, 44% of CEOs said they would prefer that their regional management teams are native to the markets they are managing.⁹ And because Chinese workers tend to value opportunities to advance in their current position over higher salaries, firms should make sure that there's a clear and defined path of career advancement, a challenging environment, as well as opportunities to develop their skills and abilities.

“We like to cultivate our own human resources, with the belief that talent can only be discovered when given the opportunity,” says Cheung Yan, Chairlady of Nine Dragons Paper (Holding) Ltd. “If not, you cannot retain good people. Such a human resources management philosophy must be supported by an ever-innovating management system....As [middle managers] become decision makers in their own operations, they make their best efforts to learn and improve continually, think proactively and innovatively, and maintain a high level of energy in their work.”

Developing talent in China and addressing the talent shortage must be factored in a company's long-term growth plans. In the long run, ensuring that local hires take over management from expatriates must be part of a long-term strategy. This is because winning the local talent war in China remains the key to success in this market.

9. PwC. “15th Annual Global CEO Survey.” 2012

An aerial photograph of a modern park or waterfront area. The scene features several curved, light-colored concrete paths that wind through a landscape of dark, leafless trees and patches of grass. To the left, a body of water is visible, with sunlight reflecting off its surface. In the lower right portion of the image, several people are walking along the paths. The overall atmosphere is bright and clear, suggesting a sunny day.

Finance and treasury

Observations

1. The expanding role of the yuan or renminbi (RMB) in the global economy creates opportunities for many companies.
2. While the government is adopting a strategy of relaxing long-term financial-related controls, policies remain quite fluid and open to interpretation.
3. Businesses are often underinvested in their China treasury. The role of treasury in driving cash flow improvements, capital efficiency and the business platform is underutilised.
4. Too many myths about operating treasury in China are accepted as fact.

Recommendations

1. Adopt a dynamic and flexible treasury strategy to account for constantly changing business agendas and regulatory policies.
2. Evaluate how the RMB's growing internationalisation can affect the company from a competitive, revenue, cost, cash flow and risk perspective.
3. Ensure that your treasury is properly resourced (in terms of staffing, IT etc.) so it can take on a more strategic-minded approach.
4. Optimise cash and banking management practices to minimise your funding needs.
5. Align treasury with the broader China and regulatory agenda to support your business agenda.

Treasury strategy

China is becoming an increasingly fundamental part of corporate strategies globally. As a result, companies will need to have the right treasury and cash management foundations in place to allow them to effectively execute their strategies. Developing a dynamic and flexible treasury strategy and planning ahead are key measures in an environment of ever-changing market conditions and constantly shifting regulations. It's therefore particularly important for foreign firms in China to transform their treasury function. Businesses will need to move up the treasury development curve, from a model that's focused on processing transactions and reacting to new regulations to one that's strategic: flexible, automated, standardised and well planned (see Figure 1).

Figure 1. The treasury development model



Global and regional alignment

Aside from strategic treasury development, multinationals should also look to China's treasury role in the overall region. As more and more Asia regional headquarters migrate to China, some treasury functions are starting to follow. Their rationale is centred on being closer to the business, not on serving as a traditional, tax-efficient treasury transaction processing centre, found in places such as Singapore. This will change over time, as the foreign exchange and RMB regulatory landscape evolve and the rule of law and other dynamics solidify.

While treasury activities such as cash pools, treasury-related profits and transaction processing can continue to be run through Hong Kong, Singapore (and more recently, Malaysia), it may also make strategic sense to funnel talent and focus treasury functions into a China-based regional treasury centre with the majority of the decision-making power. For years, Shanghai has also been extending financial incentives to companies willing to relocate. In

February 2012, the National Development and Reform Committee (NDRC) also outlined its goal of establishing Shanghai as a global RMB innovation, trading, pricing and clearing centre by 2015.¹ Likewise, Beijing announced in 2009 that it will provide a raft of subsidies to foreign businesses moving their regional headquarters to the city.

Moving the treasury function to China also demonstrates added commitment to the country, and can allow for closer ties to a market that many businesses perceive as central to their growth plans. Some leading multinationals, including Honeywell International Ltd. and General Motors, have set up their regional treasury centres in China.²

To overcome the inherent limitations, Honeywell has opted to open treasury centres in Shanghai to service the Greater China region of mainland China, Hong Kong and Taiwan, with another regional office in Singapore to manage the rest of the Asia Pacific region.

Other locations such as Hong Kong and Singapore, because of their open economies, still have significant cross-border, talent and infrastructure advantages over Shanghai. The fact that certain activities, including regional cash pooling and cross-border netting, are limited in China, is just one example.

Many foreign businesses have also established, or are thinking of establishing, finance shared service centres ("SSC") in China that support operations in China or the Asia region. A number of treasury-related activities can also be included in these SSCs. At a minimum, treasury should streamline and automate their disbursement and collection techniques and bank account structure and partners to assist the SSC in achieving its objectives.

1. National Development and Reform Committee and Shanghai Municipal Government. "Detailed plan to develop Shanghai as an IFC during China's twelfth five-year period." 2012. The Stock Exchange of Hong Kong Ltd. "Practice Note 21: "Due diligence by sponsors in respect of initial listing applications"

2. Treasury & Risk Magazine. "How to map your moves in China." 1 November 2004

Working with the RMB

Due to foreign exchange restrictions, treasury strategies are somewhat held back by limitations on how they can use the RMB and foreign currencies within and outside of China, and in cross-border transactions. However, as China continues to experiment with loosening restrictions, companies will be able to do more with the RMB to support business growth, manage costs, and drive efficiencies and effectiveness. And with the number of cross-border trade-related transactions being settled in RMB (instead of US dollars) on the rise, companies have the opportunity to re-evaluate the role that RMB plays in its business, not just within China, but also globally.

The regulatory easing over the RMB is driving an increased appetite from businesses to use the RMB for cross-border and offshore transactions. Using the renminbi can realise a range of potential benefits, including:

- 1) Improving top-line revenue with customers that prefer the RMB;
- 2) Improving the cost structure of deals with suppliers that prefer the RMB (but have historically priced in USD with a “cushion” to compensate for expected depreciation);
- 3) Altering the foreign currency risk profile to better manage risk through global treasury centres;
- 4) Supporting and aligning with the agenda of the State Administration of Foreign Exchange (SAFE);
- 5) Reducing complexity in foreign exchange processes, which are burdened by much manual documentation, while varying province to province; and
- 6) Cutting down the number of currencies to better manage in-country liquidity.

As with any other currency, there's little a company can do to truly manage its long-term RMB currency risk, other than changing one's competitive position in terms of cost structure and pricing practices (financial hedging merely buys the company some time). Nevertheless, this risk should not be ignored. According to PwC research, 62% of chief executive officers based in China and Hong Kong consider exchange rate volatility as a potential economic threat to their growth prospects.³ With the RMB becoming less regulated and thus increasingly relevant, treasuries must also take into consideration how this affects the way they operate and manage their businesses.

As mentioned in the above list, China suppliers have historically factored in between a 5% to 25% cushion into non-RMB-denominated transactions and contracts to compensate for assumed losses in value from a depreciation in foreign currency. The liberalisation of the RMB allows companies to take on more control and gives them added negotiation room when dealing with these suppliers.

Companies need to pay further attention to the rise of the RMB market, as it's still limited in scope. However, as government policy leans increasingly towards encouraging trade settlements in the RMB, businesses can improve their alignment with the government agenda by using more of the currency. Companies should also keep in mind the mid-to long-term currency environment as they update their operating models to reflect growth plans, the competitive landscape and other strategic issues.

65%

of 160 China and Hong Kong CEOs believe the world will be more open to cross-border capital flows

Source: PwC 15th Global CEO Survey 2012

3. PwC. "15th Annual Global CEO Survey." 2012

Investing in capabilities

Building a team of solid and experienced treasury professionals is a crucial aspect of operating in China's dynamic growth market and complex regulatory and operating environment. As businesses need longer lead times to react to changes in the environment, treasury departments must have the foresight and experience to strategise and plan ahead, and should do so as far in advance as possible. Yet many operations in China, foreign and domestic, are underinvested in treasury from a people and technology perspective. As corporate treasuries focus solely on keeping up with the business, processing transactions and reacting to regulations, more proactive activities such as optimising liquidity and working capital, funding and capital management, can fall by the wayside.

Domestic companies themselves have only recently begun to formalise the treasury function and its role in supporting growth, managing risk and preserving capital. So there's generally a lack of experienced talent in the market from which to draw. Building and keeping a good team therefore requires a more creative approach to achieve desired short-and long-term outcomes.⁴

The increasing importance of China and the Asia region in a multinational company's strategic agenda requires companies to improve their global connectivity and alignment. Likewise, Global Treasury needs to determine how to best support the business as it changes, by optimising the role and alignment of treasury activities at the global, Asia region and China level. The myth that, 'it's China (or it's Asia) so it's different or cannot be done', needs to be challenged, as significant advancements have occurred over the last three to five years.

Robert Vettoretti , PwC China Consulting Director



4. See also Human resources and talent management chapter for more on hiring and retaining talent

Banking and regulatory landscape

China's complex treasury landscape is driven, of course, primarily by the combination of the banking and regulatory environment. While there has been much progress, the banking and regulatory system in China is still in its development stage.

Comparison of foreign and domestic banks

China is set to overtake the US as the world's largest banking market by 2023, based on projected growth of domestic banking credit assets, according to a PwC report.⁵ As international banks have a less-than-5% share of the China market,⁶ companies will typically need to work with local banks. Local banks, fortunately, are eager to grow internationally (in our recent survey, 66.5% of domestic banking respondents are committed to expanding overseas, while 9% want to speed up overseas development).⁷ As a result, they are keen to lend to multinationals, and have more resources than foreign banks within China with which to give credit.

Foreign banks have an advantage over their domestic peers, however, in the areas of technological sophistication, relationship management, transparency and global expertise. For instance, foreign banks' cross-border services

tend to be more comprehensive and seamless. That gap is closing though. Because of their branch networks, relationships with the State Administration of Foreign Exchange (SAFE) and overall way of doing business, local banks will often have better capabilities within China to process transactions such as foreign exchange and local collections. Domestic banks also have a much larger deposit base – a tremendous source of capital. They are therefore not as constrained as foreign banks in their lending caps.

One major challenge in effectively leveraging the domestic banks more broadly arises when dealing with their individual branches, which are often operated quite separately from the head offices. The experience of working with different branches might therefore seem like working with completely separate banks. Finally, the domestic banks are also still developing their services, technology, customer support and relationship management models, which can be a challenge for companies that are used to working with international banks.

Key regulators

In developing an effective treasury, it's crucial for businesses to cultivate a good relationship with SAFE, the state agency that sets foreign exchange policies (along with other responsibilities). Companies in good standing with SAFE may have better insight into managing the approval process and may be able to contribute to new policies as they are developed and introduced. In addition, as the government is inclined to experiment with new liberalisation policies, working closely with SAFE may provide some perspective, in assisting SAFE in its reform efforts, while also improving treasury's effectiveness.

Depending on what they're trying to accomplish, treasuries must also pay attention to a number of other regulators. For instance, establishing a finance company will require involvement from the China Banking Regulatory Commission (CBRC).⁸

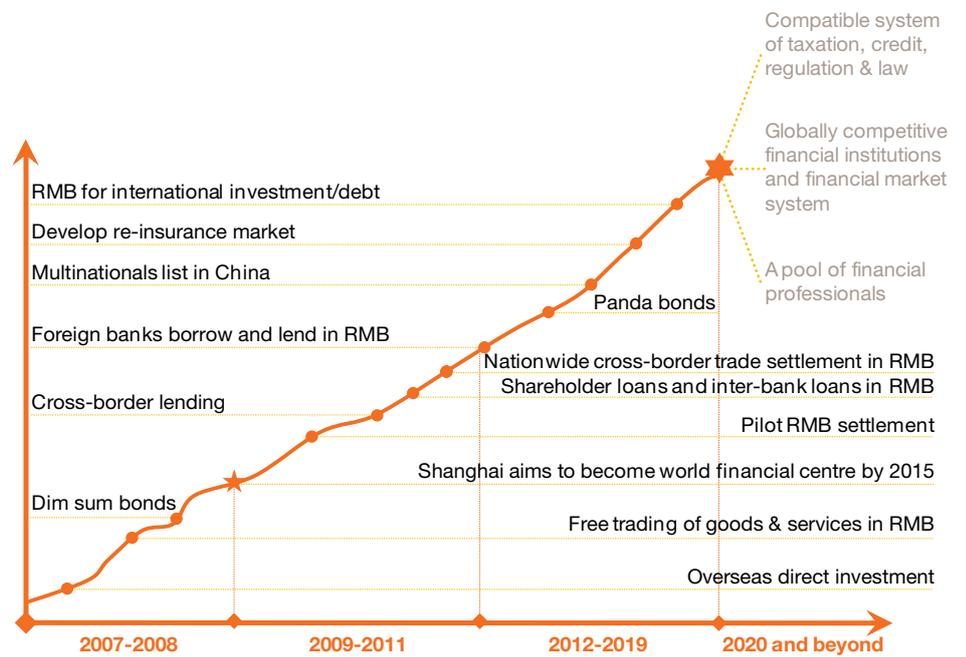
5. PwC. *Banking in 2050*, May 2011

6. According to PwC's 2012 *Foreign Banks in China* survey, the Big Six foreign retail banks, including the Bank of East Asia, Citibank, DBS Bank, Hang Seng Bank, HSBC and Standard Chartered Bank, collectively operate 413 branches in June 2012

7. PwC. "Chinese Bankers Survey." 2011

8. See also *Government relations, regulatory compliance and stakeholder alignment* chapter for a detailed list and description of the regulators

Figure 2. China financial regulatory trends



Regulatory trends

China's improvements over the past decade, including the introduction of entrusted loans (making indirect inter-company loans possible through banks, and upgrades a company's ability to execute cross-border payments in RMB), have all been steps in the right direction in facilitating the management of cash. More and more cross-border transactions are now becoming possible. Trade-related accounts payable and receivables, foreign direct investment, shareholder loans, inter-bank bond investments, overseas direct investments and cross-border lending are just a few of them.

While nationwide regulations are introduced centrally, interpretation of rules such as tax, customs and foreign exchange regulations by the various provinces and cities can vary. This makes executing a completely standardised treasury structure and process a bit more challenging, although this is changing quickly. The ability to manage cash and treasury well within each province, while aligning with the business strategy, are just two of the reasons why American company Yum! Brands, owners of KFC and Pizza Hut, have adopted a treasury approach that's province focused.

And despite the liberalisation and economic reforms, government policies remain stringent in its control of foreign exchange and other transactions. This leaves treasuries engaging in much documentation and bureaucratic finessing. And while Beijing is gradually adopting the long-term policy of relaxing these controls, due to the government's trial-and-error approach to implementation, policies are often subject to interpretation. Therefore, the fluidity of such policies is a significant factor in successful long-term cash flow planning.

Cash, liquidity and funding

Managing cash, liquidity and funding is very much an art in China. But when done properly, it can be efficient and effective.

Looking into the future: cash flow forecasting

Significant company growth plans, new acquisitions and joint ventures, new plants, a broader country footprint, and evolving business, regulatory, political and social environment all make for a near-insurmountable task for treasuries trying to forecast future cash flow. However, because of the limited tools available to financing the business, as well as an uncertain regulatory landscape, it is nonetheless necessary to make the attempt.

The point is not to predict cash flow with a high degree of accuracy, although that would be ideal. The desired outcome should rather be an understanding of a range of potential scenarios, so that management can make decisions and develop financing and investment plans “A” and “B” (and perhaps even plans “C” and “D”).

Any heavily regulated environment typically means that the ability to react will require time. For China, the combination of regulation, growth and cultural norms that affect business practices creates an interesting dynamic: On one hand, advance planning is unavoidable. But too much planning may be irrelevant in such a complex system, as a number of changes will have unknown consequences.

Treasury therefore has to strike the right balance. Their forecasts must be sufficient to support key decisions, but without over-engineering the process. If businesses can gain better insight into the drivers of cash flow and various scenarios, they can better prepare with the right capital structure to absorb changes in the business and China environment. Cash flow forecasting is a lens into the future and is crucial to minimising your trapped cash issues. They can also ward against the risks of not being able to finance your business growth.

Optimising cash and liquidity

Significant growth and investment and the sheer scale of businesses in China are driving a need to optimise cash and liquidity management. This is also driving a move towards centralisation, standardisation and automation for treasury, in order to free up cash that's either idle or tied up in working capital, particularly in accounts receivable and inventory. The number and type of bank accounts, bank partners, collection and disbursement techniques, and liquidity structures are all tools used by leading companies.

Bank accounts and relationships

Cash optimisation starts with a streamlined and effective bank account structure. This structure is often unnecessarily complicated at many multinational corporations, which are constrained by previous regulations and business practices. Various account types are necessary in China in order to comply with regulations that are intended to control the currency and speculation, accounting for the complexity and the need for many account types (see Figure 3).⁹

9. PwC and HSBC. “Doing business in China.” 2011

Figure 3. Overview of Chinese yuan (CNY) and foreign currency (FCY) accounts

CNY accounts		FCY accounts	
Account type	Purpose	Account	Purpose
Basic account	Cash withdrawals and salary payments	Current account	Trade and non-trade transactions settlement account
Regular account	Onshore payments and collections	Capital account	Capital contribution
Special purpose accounts	Loan, tax, customs duty, RMB reinvestment capital verification etc.	Loan accounts	FCY intercompany (including parent's) and bank loans

Fundamentally, the objective should be to minimise the number of your accounts and banking relationships to drive efficiency and effectiveness across your cash conversion cycle, while improving the services your business units receive. Having more accounts and relationships raises complexity and cost, and reduces your level of visibility, transparency and control. But there are pitfalls to oversimplifying an account structure in China. A customer, for instance, may require that a company have an account with a bank at a particular branch. Or a local tax authority may prefer that an account be opened at a certain location, even if such an account would not be strictly required under regulation.

In addition to the differences between foreign and domestic banks discussed previously, one must consider the policies and sophistication of the domestic bank's core capabilities. For example, while many domestic banks have the ability to automatically sweep funds from corporate accounts at the

end of the day, individual policies may differ. Some may require businesses to move their money by 3 pm each day, while others have a later cut-off time. Banks with earlier cut-off times present an opportunity cost for your business. Some banks are more automated, while others are cheaper. Others still have better technology solutions.

During the past decade, disbursement and collection types have shifted gradually from the traditional cash, commercial paper and cheque payments to electronic payments. A recent report from the State Administration for Industry & Commerce (SAIC) indicates that the ratio of cheque business, once a dominate payment tool, is declining significantly year over year, while electronic payments are experiencing steady growth. As of 2010, more than 90% of payment value is conducted via electronic means. This trend is expected to continue as technology security infrastructure develops further. In addition, the inefficiencies experienced

across the country when using commercial notes and cheques have contributed to the development of electronic payment tools.

Bank acceptance drafts (essentially post-dated checks) are also common practice in certain industries, and their use increases or decreases with the state of the economy and the availability of bank funding. Managing them effectively, given the associated working capital, finance and risk dimensions, is important for many companies. Finally, while cash is still prevalent in some segments, the high growth of credit and debit cards is changing the payment landscape rather quickly.

Foreign currency processing remains overly manual and micro-managed across China. But significant efforts are under way to improve efficiency, consistency and automation. A number of pilots are currently under way to refine new processes, which should be welcome news to most multinational treasury functions.¹⁰

10. PwC and HSBC. "Doing business in China." 2011

Liquidity management

Similar to the situation in other countries, a cash pool-type structure is a key tool available in China. Generally, pooling is allowed only when operating within the same legal entity. Since the People's Bank of China (PBOC)'s "General rules for lending" prohibits intercompany lending between non-financial institutions, entrustment loans can be used to work within such rules.¹¹ Effectively, RMB or foreign currency pools can be set up through an entrustment loan framework, which allows funds to move from one company to the other, with a bank acting as an agent (for which they charge a fee) to facilitate this movement. Setting up entrustment loans, however, do require a moderate-to-long lead time, and businesses should begin planning with the appropriate bank months in advance. As in any country, such

structures need to be tax efficient, or the benefits of the "pool" would be negated. Work to prevent unnecessary taxes from being incurred in the flow of various intercompany funds, whether they be in the form of principal, interest income or expenses.

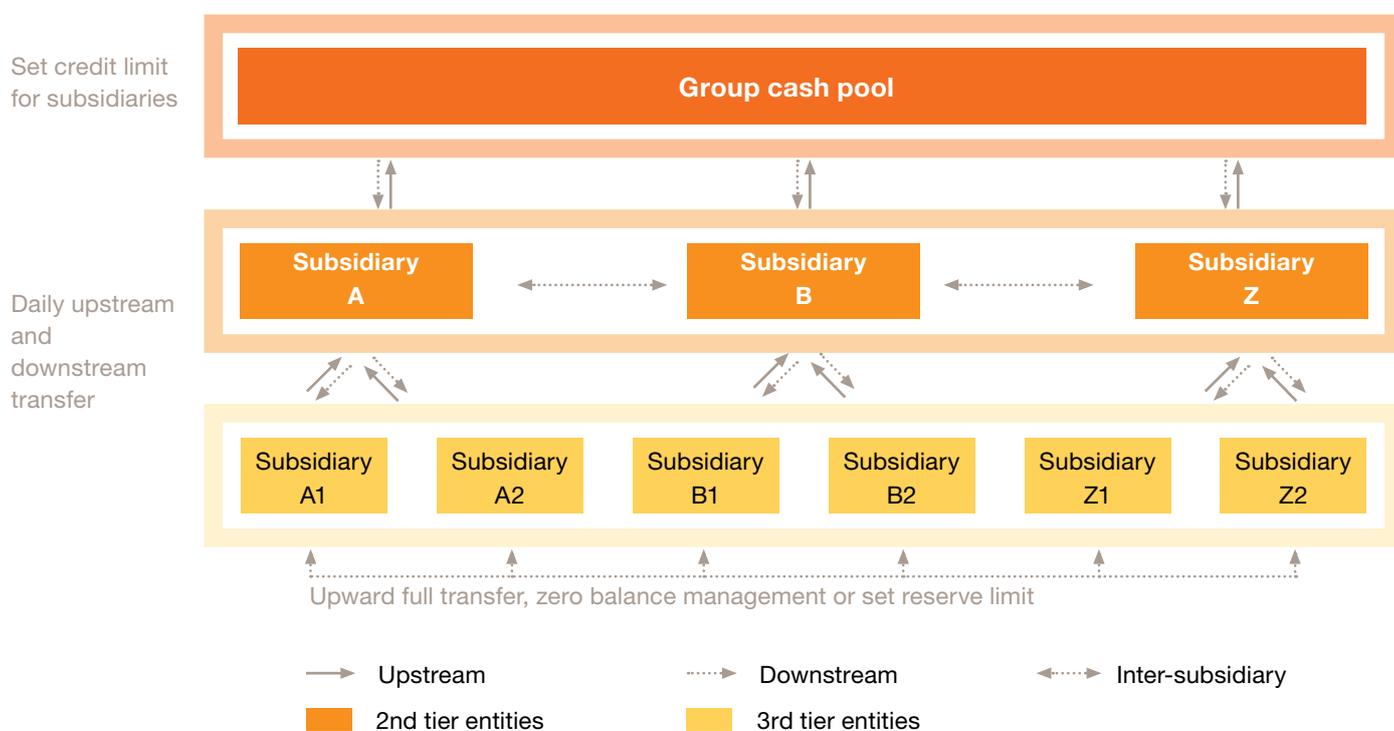
Pool-participating companies may be legal entities such as joint ventures, wholly foreign-owned enterprises or branches. Considerations such as ownership structures come into play when selecting which entities will participate and which won't. A pool header, an entity that will receive all the pooled cash and funnel it back down to the subsidiaries, must also be chosen.

In China, cross-currency pools and notional pooling are generally not allowed; however, SAFE and the PBOC do make policy changes to further enable new solutions. The banks,

meanwhile, continue to develop products to better utilise cash, such as structures that provide incremental returns (off-shore) to capture trapped cash, back-to-back loans, and tax-efficient solutions that minimise business and other taxes.

These entrustment loans can also be used, at times, on a cross-border basis to funnel your excess liquidity to other parts of the world. While these cross-border loans will eventually need to be repaid (within a term of two years), they can help to meet temporary cash needs. However, businesses should note that there have historically been onerous regulatory barriers to these loans, and additional paperwork will have to be submitted for SAFE approval. In addition, generally no new loan can be approved until the prior loan is extinguished.

Figure 4. A typical cash pool under an entrustment loan framework



11. Under CSRC 2003 Reg 56, listed companies are prohibited from lending to controlling shareholders or related entities under entrustment loan arrangements. As a result, the group company should be very careful in designing pooling structure when listed entities are concerned

Funding growth

Off-shore financing

In general, companies tend to be more willing to inject cash raised outside China as equity or debt as it is generally cheaper than raising funds onshore. Due to restrictions on transferring funds into China, businesses are required to produce evidence and documentation for what the money is for and how it would be used.

As Beijing pursues the gradual process of internationalising its currency, eventually championing the RMB as a global currency for trade and investment, Hong Kong has become a key platform for issuing RMB and RMB-denominated products. This has led to a need for new policies that can recognise investing in China using the RMB rather than a foreign currency. In particular, RMB-denominated bonds in Hong Kong, or “dim sum” bonds, are popular. The RMB’s value in Hong Kong (referred to as CNH) is a different market than the onshore Chinese yuan (CNY) market, although convergence seems to be narrowing the gap.

One example of a business using the offshore market came in 2011, when Caterpillar Finance issued a RMB 1 billion two-year bond in Hong Kong, marketed to institutional investors with an indicative coupon of around 2.25%. The company had secured approval from Chinese regulators such as the PBOC and SAFE to transfer proceeds from this bond financing directly into mainland China. A few months before that, McDonald’s also succeeded in the same tactic, raising RMB 200 million in RMB bonds sold in Hong Kong to finance their expansion in China.

Note, however, that firms will still need regulatory permission to transfer the funds raised from these bonds into the mainland. Businesses who wish to “onshore” their RMB funds raised in offshore markets must ensure that Chinese authorities are informed and brought on board as early as possible in the planning process. The lack of clarity is a hurdle that companies must overcome to properly take advantage of this new avenue of funding. It’s important to consider that, due to the limited RMB products and their use offshore, the RMB market is still relatively small. It may also remain so until there are significant policy changes.

Another way to raise RMB in offshore markets is through initial public offerings denominated in RMB. In April 2011, for example, Hui Xian, the Chinese property investment trust, raised RMB 10.48 billion in Hong Kong, marking the first RMB-denominated initial public offering outside of mainland China. One of the many reasons foreign companies might also list in Hong Kong is to build their image and reputation in the region and to support China’s long-term agenda. This may further support China’s efforts in a mutually beneficial way and is another example of treasury aligning with and supporting the business strategy.

On-shore financing

Within China, external financing vehicles for foreign multinationals are still limited and very much dominated by traditional bank loans set at PBOC (or slightly discounted) rates. The simple procedures and policies for executing such loans is a major driver for their popularity.

Various segments of the capital markets, including the sale of commercial paper and long-term bonds, are continuing to grow, but foreign companies are currently restricted from using them as financing vehicles. These markets are slowly opening up, however, and might see some changes within the next few years. “Panda bonds,” or bonds issued by foreign companies within China, and on-shore equity listings, for example, are currently under discussion for multinationals. There is also a growing trend among multinationals in announcing their intention to raise equity in China via listing on one of the stock exchanges, particularly Shanghai. This may become possible for larger companies in the future with the proposed international board of the Shanghai Stock Exchange. Other vehicles like project financing and leasing are not popular, mainly because of strict limitations and the lack of clarity on the range of legal and regulatory complexities.

Finance companies

Finance companies are a type of business licence that can further enable more effective treasury management in China. These companies enable treasury to be more efficient and effective across a range of activities. Finance companies, as defined by the CBRC, are relatively new. They are non-bank financial institutions that provide financial management services to the group member's entities in order to strengthen centralised cash management and improve efficiency in the use of cash.

Finance companies are essentially regarded as a virtual in-house bank, and represent an alternative financing vehicle within the group. They act as an in-house financial institution in executing treasury functions such as foreign exchange transactions, entrustment loans, and accepting/discounting bills and deposits.

But basic liquidity management should not be your sole business need when

weighing the feasibility of a finance company. Finance companies have the ability to perform many other financial services common to a centralised treasury, on behalf of your group's entities. These include settlements, collections, payments, providing guarantees, and dealing with loans and lease financings. This structure also allows for better corporate governance, funding capacity and lending authority.

However, a finance company is strictly regulated by the CBRC and faces stringent compliance and reporting requirements. One downside is that a finance company also exposes a business to a larger number of regulatory compliance activities, and the potential for additional taxes. As finance companies are relatively new and developing in China, this is usually primarily an option for larger companies. Only companies with a sufficient amount of scale and financing consider them worth the extra time and effort.

Alternatively, companies can also establish in mainland China a regional headquarters ("RHQ"), another vehicle available to treasury. An RHQ can play an active role in centralising the regional treasury by taking advantage of local favourable policies. Lastly, a Chinese holding company ("CHC") can help enhance group cash management, as it can achieve cash concentration via the entrustment loan arrangement. Unlike the finance company and RHQ, the CHC is regulated by MOFCOM, not CBRC, and the regulation is less stringent in its compliance and reporting requirements. Multinationals would commonly set up a CHC to hold various investments in China, which can enhance tax efficiency where dividends are distributed by subsidiaries in China to the holding company.

Usage of finance companies may not be as common as that of other countries with better tax incentives and less regulated currencies. But the financial system continues to evolve in the right direction in making finance companies more attractive in China.

Getting your cash out: repatriation

Depending on the economic and investment climate, as well as the prevailing value of the RMB, it may make sense for multinationals to take their cash out of China. Depending on the method of repatriation, however, certain regulatory restrictions can crop up.

For example, if a company wishes to repatriate funds through dividends, the company may be constrained by the China unit's retained earnings. Wholly foreign-owned enterprises have to keep 10% of their retained earnings from distribution until the accumulated reserve reaches 50% of its registered capital. A China business with US\$50 million in net income would not be able to dividend more than that amount. In addition, the wait time for approvals from MOFCOM and SAFE also tends to be long, bringing with it the accompanying opportunity costs.

On paper, the process for getting your cash out of the country is relatively straightforward. Companies can repatriate cash on the current account by way of trade payments, service fee payments and payments for the import of intangibles such as trademark royalties and licence fees. Under the capital account, companies can repatriate loan principal and interest, overseas guarantees, offshore lending and even capital reductions, as long as they meet the various range of documentation requirements.

In practice, however, companies may still have “trapped” cash in China, cash which could otherwise be used in other international operations or to pay down debt at the global level.

To repatriate cash, multinationals tend to face three common external issues:

- 1) For outbound payments on non-trade services alone, there are currently almost 50 different regulations and circulars governing outbound payments of non-trade items at the moment, which makes them hard to keep track of
- 2) Local practices at banks (the gatekeepers of SAFE) vary on occasion
- 3) The various local branches of SAFE might have varying interpretations of the regulations, which makes it hard for a company to standardise their own practices

However, some of these challenges are internal to the companies themselves:

- The company may fail to properly justify their overseas payments, or do not clearly state the nature of their payment
- Lack of supporting documentation. Sometimes, the company may have misplaced a key document, such as a customs declaration form
- Prerequisite applications (such as an import licensing or foreign registration) were not made
- The lack of a sound transfer policy, or documentation to justify the rationale for the payment
- The corporate structure may not be suited for cash repatriation

Cash repatriation, however, is not a stand-alone issue, and depending on the situation, you may find yourself dealing with the customs authority for trade-related items and the tax authorities for non-trade payments. Generally speaking, corporations require two things for approval from the authorities: documentation and a valid commercial purpose.

To repatriate a royalty fee out of China, for example, you need a valid commercial purpose for why you need to charge the royalty fee and the rate that should be charged. Meanwhile, the related royalty agreement will need to be registered with the local Ministry of Commerce.

Even with a valid purpose and the right documentation, the local application of tax regulation might complicate matters. Companies who might, for example, want to apply a beneficial withholding tax rate with the Chinese tax authority under the Hong Kong-China treaty, may face challenges from the local tax bureau.¹²

A profit repatriation strategy is therefore important to ensure that all requirements are met and cash can be remitted as needed. Planning ahead is key.

Understanding the concerns of the officials will make things easier. The foreign exchange authorities follow three major principles when reviewing remittance applications:

- 1) Reasonable grounds: That is, whether the payment is reasonable and has commercial justification
- 2) Authenticity: Whether the payment is truly genuine
- 3) Documentation: Payment must be supported by relevant documentation required by the foreign exchange authority

SAFE has essentially delegated most of its authority to processing foreign exchange remittances for current account items to the banks, and companies can simply process their remittance at the bank by providing the necessary supporting documentation.

If, for whatever reason, you don't have the necessary documentation ready, or if the type of remittance does not seem to be covered by existing regulation, you may consider bringing up your case with the foreign exchange authority for special consideration. Robust discussions and negotiations with the foreign exchange and other relevant authorities may also be needed if the "trapped cash" has accumulated over a long period of time, as it will require a certain amount of retroactive foreign loan registration.

Preventative measures are definitely more effective and less costly than remedial actions. Planning ahead, understanding the regulations and requirements, and getting the documents prepared and ready will always pay off. A cash repatriation strategy needs advance planning and active process management to be effective and efficient. The company's business model needs to accommodate the different repatriation methods, with solid documentation in place, while ensuring that the relevant registrations and tax clearances are made.



12. See also Tax management: planning and compliance chapter for more on withholding taxes

The following questions should be considered when planning for cash repatriation:

1. What is the commercial purpose for making this China remittance?
2. Do I have all the necessary agreements and contracts in place?
3. Is there any documentation to support my story if I am challenged by the tax or customs authorities?
4. Did I complete the necessary registration with all the relevant government bodies?
5. Can I secure a tax deduction after repatriation of service and royalty charges?



Supply chain strategies



Observations

1. Rising productivity and moves inland are offsetting declining cost advantages.
2. Due to the country's size, proper location selection for your supply chain is critical for corporate strategies that position China as a key market.
3. China still boasts unsurpassed flexibility and robust infrastructure.
4. Product quality risks can stem from China's pricing pressures and low profit margins.
5. Lower costs, talent, incentives and proximity to market are compelling reasons to move research & development functions to China.

Recommendations

1. Make sure you balance your China cost considerations against other supply chain attributes such as asset performance, flexibility and responsiveness.
2. Align tax considerations with supply chain models such as SCOR to drive operational sustainability and cost savings.
3. Consider multiple manufacturing hubs as a potential solution, factoring in global logistics, transfer pricing and local incentives.
4. Work with your suppliers, and provide them with the tools to monitor the quality standards of their operations and that of their contractors.
5. Be prepared to make commitments to train new research staff on practical analysis, standard methods and processes.

There are many opportunities for multinationals in China to reduce product cost and supply chain costs, as well as developing a strong base from which to compete with local companies in the Chinese market. Close cooperation amongst companies and supply chain partners can lead to savings and mutually beneficial outcomes.

Craig Kerr, PwC's Greater China Operations Leader

In late 2011, PepsiCo sold its Chinese bottling operations to Tianjin-based Taiwanese beverage company, Tingyi Holding.¹ To some, the deal didn't look great on paper. PepsiCo gave up its bottling operation, valued at US\$600 million, and in return received a 5% indirect stake, worth US\$55 million, in Tingyi's affiliate bottling company – a US\$545-million loss on a single deal.

But this was a strategic sale for PepsiCo – which, after a couple of years of straight losses in its bottling business, had not been faring well in the Chinese market. By having a local Chinese partner take over its bottling services, PepsiCo gained Tingyi's well-established and extensive distribution channel. And with a new channel to sell more volume, PepsiCo gave itself a chance to get its China business back in order.

Prior to this joint venture announcement, PepsiCo had limited access to national distribution networks, a fairly rudimentary requirement for China's food-and-beverage market. But with the right distribution channels, PepsiCo could now restore its China growth strategy by improving on the strength and reach of its supply chain, and increasing the speed with which it brings its product innovations to market.

Supply chain performance in China is important to those who perceive China primarily as a low-cost sourcing or manufacturing region. But for those targeting the China market, getting your supply chain right can give you a competitive advantage. Not getting it right can be the difference between success and failure.

The following are top supply chain considerations for multinationals in China. We'll address each in turn.

1. Cost
2. Location
3. Flexibility
4. Quality and supply assurance
5. Sustainability
6. Research and development

1. Zacks Investment Research. "Pepsi Partners Tingyi in China." *Zacks Equity Research Analyst Blog*, 7 November 2011

Rationalising costs

For multinationals in China, cost is often a top consideration – and increasingly a top concern. Rising prices and shifting exchange rates are further eroding China's cost advantages. In a 2012 American Chamber of Commerce survey, 39% of foreign-invested enterprises ranked labour costs as the greatest risk for their China organisation.²

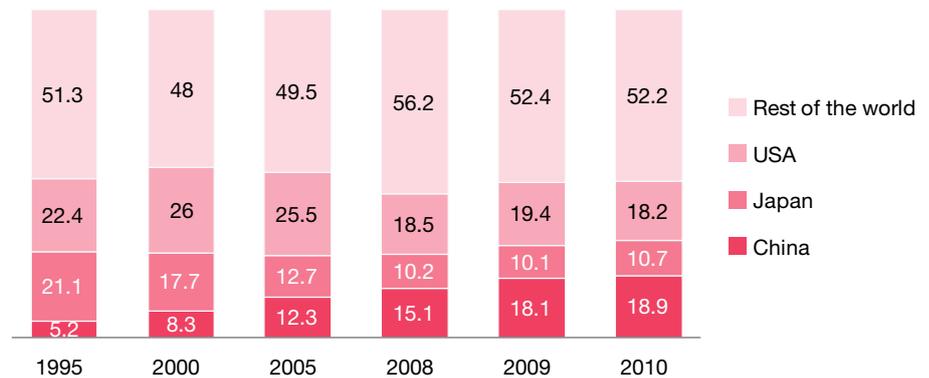
But in setting supply chain strategy, you'll need to look at three layers of cost:

1. Labour and material costs
2. Total supply chain costs
3. Taxation

Labour and material costs have been, for many multinationals, the initial driver of supply chain considerations in China. Yet these low-cost benefits are eroding through a combination of cost increases in China, particularly in the coastal areas (which are frequented more often by multinationals), as well as exchange rate migration.

But despite these rising costs, China remains competitive, illustrated by its ever-increasing share of global manufacturing. Costs are increasingly offset by moves inland, where labour costs are lower. Meanwhile, rapid growth in productivity has outpaced that of many emerging economies. As a result, labour costs should continue to remain a source of competitive advantage for China-based supply chains, and will help frame China's position in the value chain.

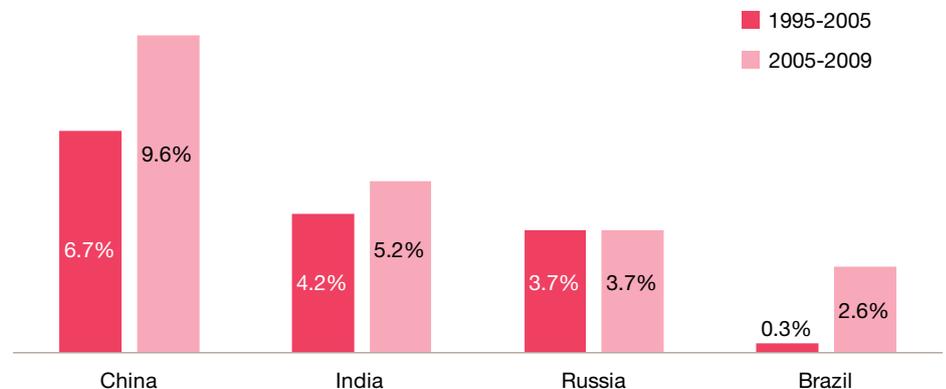
Manufacturing output by country (%)



Source: UN National Accounts Database

Labour productivity growth-emerging economies

GDP per persons employed, annual average



Source: The Conference Board Total Economy Database: Summary Statistics, Jan 2010

2. AmCham China. "2012 China Business Climate Survey Report." 2012



Multinationals are increasingly taking a more sophisticated approach. While the pursuit of lower-cost labour remains a priority (something we'll discuss in the next section), relative impact on profit can vary from industry to industry. Studies have shown that labour costs in China currently comprise 3% of cost of goods sold in the footwear industry and 4% in the heavy machinery industry, while accounting for 20% in the personal computers industry.³ Equally important cost considerations include transportation, order management and sourcing costs. And as labour costs in China inch closer to parity with that of other economies, multinationals are starting to look more closely at other cost factors to arrive at an optimal supply chain footprint.

The impact of taxation on supply chains, for instance, is increasingly under the microscope. Such taxation considerations can range from localised or regional incentives for locating in Zone X, City Y or Region Z, to key cost efficiencies that arise from the strategic placement of different parts of the supply chain, from a global or regional perspective. Understanding your value chain, and how China fits into it, can lead to tremendous tax savings.

Finally, cost is not the only element of a supply chain's performance, as we'll discuss later. Other dimensions must be considered and balanced when designing the supply chain, including:

- Asset performance, especially in uncertain market conditions (important to CFOs)
- Delivery performance
- Flexibility (important to customers)

An optimised supply chain balances cost against these other attributes to support your overall business strategy, as illustrated in the earlier PepsiCo example.

3. Accenture. "Wage increases in China: Should multinationals rethink their manufacturing and sourcing strategies?" 2011

Value chain transformation

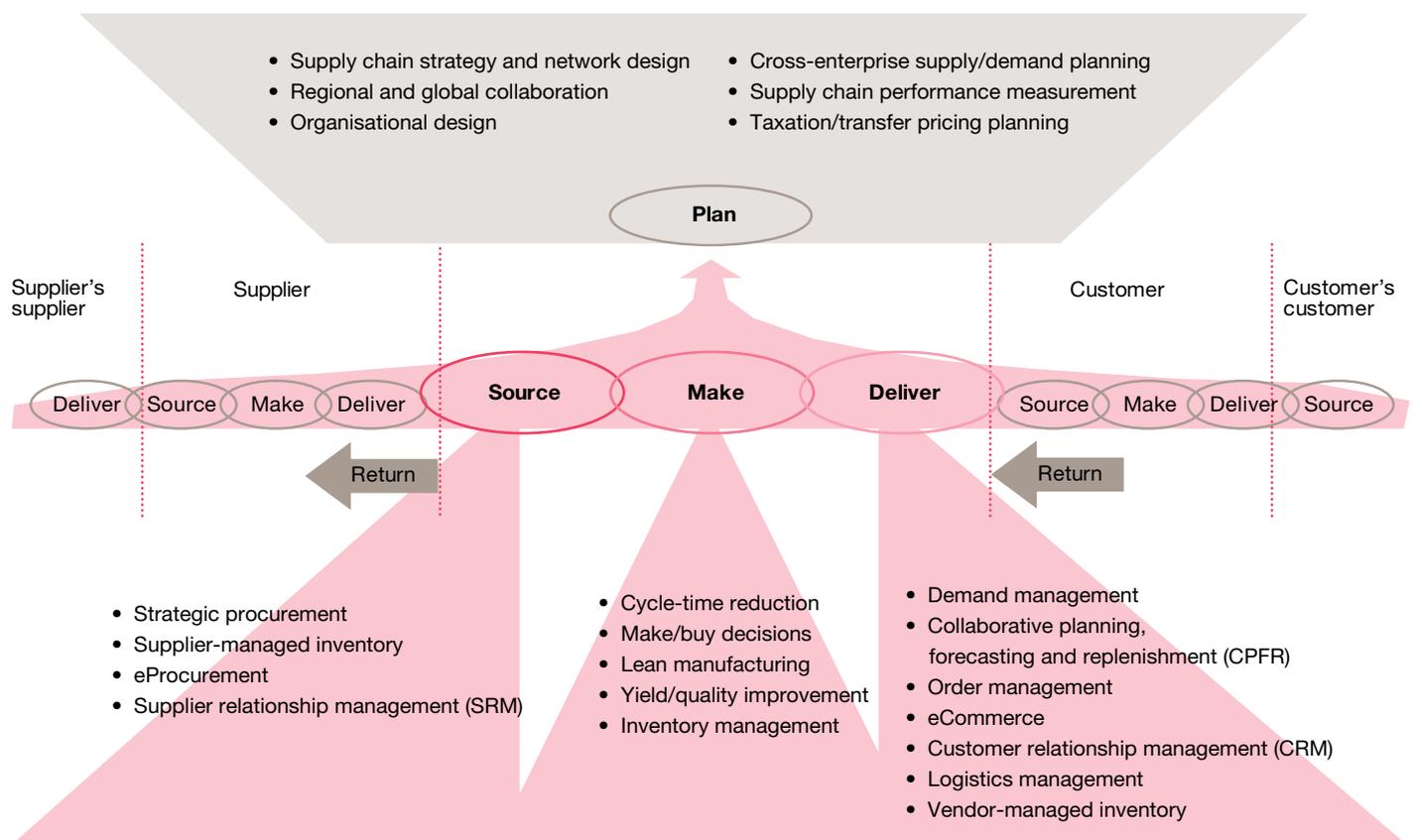
Taking advantage of cross-border tax implications can help optimise the way you set up your multinational operations, and transform your entire value chain. Key considerations include transfer pricing, a tax incurred when goods or services are moved across borders, based on the value added to the product. Value chain transformation (VCT) can help determine where key parts of your operations need to be located in China and globally to best serve the needs of both your management and your customers in the most efficient manner. This can be combined with tools such as the Supply Chain Management Council's SCOR model (based on the five management processes of plan, source, make, deliver and return), in helping to analyse and articulate an optimal solution.

Combining these models will help you understand how to consolidate products for different markets into a more efficient workflow. And by looking equally at both tax and operations, you'll find astute ways to save on tax payments.

Many supply chain management changes have historically placed emphasis on tax savings. VCT, however, aligns tax considerations with your operational and business goals, overall profitability and performance, to arrive at a more sustainable result. VCT will be of particular benefit to businesses that have or can anticipate the following:

- Recent acquisitions or mergers
- New lines of business or geographical expansion
- Significant investment in product research and development or IP
- New or updated technology systems
- Challenges in managing tax positions and an effective tax rate

Supply chain planning encompasses a comprehensive perspective of business operations



Source: PwC's PRTM Management Consultants

The right location

China's geographical size requires that location take a front seat in your supply chain planning. As focus shifts towards the China market, multinationals tend to progress through familiar trajectories – starting from procurement offices or sourcing operations, then migrating into manufacturing and full-spectrum supply chains. Whether you're using China as a low-cost location for sourcing or manufacturing, or focused on serving the China market, choosing the right location(s) for your supply chain can mean major consequences for your strategy. Businesses should expect to spend a few years investing in setting up their supply chain in China.

China as a low-cost location

According to PwC research, larger companies are more likely to employ their own in-house procurement staff, while smaller companies engage independent commercial agents for their sourcing activities in China.⁴

A number of factors come into play when choosing a manufacturing location. While the eastern seaboard generally has the strongest infrastructure, this advantage is qualified by high regional labour costs. Up until recently, the simple solution had been to move business further inland, where resources and the general cost of doing business

4. PwC. "Sourcing and logistics in China." 2008



are lower than that of the coast. And while this differential remains, wage inflation and new social security requirements have also consistently entered the labour cost equation throughout the mainland. Further challenges can accompany moves to inland locations, including shortages in supply chain and management talent; inconsistent infrastructure and regulatory limitations across geographies; fragmented distribution systems; and underuse of technology in certain regions.

Companies are also focusing on enhancing productivity through improved process and automation so that the eastern seaboard remains a cost-effective location for higher value-add activities. So whereas a number of multinationals are moving inland, many are also looking to alternate locations within Asia. Some are even pulling final assembly and customisation processes closer to the regions in which their customers are located.

China as a market

Should China be a key market for your business, proper location selection must play a decisive role in corporate strategies. In one case, a European car manufacturer had been looking for a new location for its distribution warehouse. Their preference would be for a single central distribution hub from which spare parts could be shipped to dealers throughout mainland China. However, with customers requiring a one-day turnaround in a country so large, and with infrastructure that varies widely across different locations, the solution had to factor in several layers of complexity.

While coastal logistics hubs have robust import and export capabilities, inland logistics infrastructure primarily serves growth in the domestic economy. Localised regulations also prevent regionally comprehensive logistics systems, and there are many small players. Currently, more than 700,000 logistics companies are registered in China, according to the State Administration for Industry of Commerce (SAIC).



Maintaining flexibility

Because of the mutual interdependency of supply chains globally, China's distance from major Western markets can pose a flexibility challenge. As a rule, shorter supply chains tend to be more responsive and carry less risk. Products manufactured in China take longer to deliver to overseas markets. With ocean freighters taking over a month to bring goods from China to North America, supply chain managers need to exercise care in inventory planning in order to get their timing right.

Moving quickly in response to market needs may be an even more important consideration than costs when fitting Chinese manufacturing into your global needs. With the unpredictability of the global climate, it has become much harder to forecast market trends. One may want the freedom to quickly scale up when market demand rises, and scale down when demand declines. Last-minute product changes to match customer needs may also call for speedy turnarounds. Having tight communication and reliable transfer of data are therefore key to maintaining flexibility and responsiveness in your supply chain.

We publish in English and also in Mandarin and we find that the kind of products we need to build are completely different for the customer base which works in a bilingual environment, versus the customer base that's very local. So we're building many more local products now in China than, say, 10 years ago when it was pretty much focused on multinational companies trying to do business here.

Nancy McKinstry, CEO and Chair of the Executive Board, Wolters Kluwer



5. PwC. "15th Annual Global CEO Survey." 2012

But while distances are great and labour and fuel costs continue to climb relentlessly, the Chinese manufacturing system is still reputed for its unparalleled flexibility. As Apple executives have pointed out, Chinese factories can scale up and down at a “China speed.” Chinese manufacturers are often still their best option when release dates are looming and last-minute changes are needed. When pressed to redesign iPhone screens at the last minute, Apple called on a Chinese factory to overhaul their assembly line. The plant was mobilised to pump out 10,000 new iPhones daily within 96 hours.⁶

And countries in Central and South America “don’t have the fabric-mill infrastructure in volume like China,” says John Singleton, senior vice president of supply chain for American retailer Abercrombie & Fitch (A&F).⁷ A&F wanted to continue using China as part of their manufacturing hub and cut back costs in other ways. They now reduce costs on air delivery in favour of ocean freight. An entire supply chain can now be found in China.

Another consideration for multinationals doing business within China, of course, is proximity to the China market. And with China’s focus on domestic consumption, many multinationals have integrated their China supply chains as both a global sourcing centre and a supplier of local markets. For example, Walmart sources its local produce in China through a “direct farm programme,” developed with the Chinese government and farmers’ cooperatives. The company contracts farmers to grow the produce, and uses its logistics and transportation system to ensure fresh produce reaches its local supermarkets, while effectively eliminating one link in the supply chain.



6. Duhigg, Charles, and Keith Bradsher. “How the U.S. lost out on iPhone work.” *The New York Times*, 21 January 2012
7. Murphy, Maxwell. “Pitting costs against control.” *The Wall Street Journal*, February 28, 2012

Optimising quality and supply assurance

Making sure data from your suppliers are reliable can have an impact on product quality. Companies are now looking for more quality reassurance from their suppliers for reliable work flows, quality of work, environmental and health standards, labour practices, and trust from their business partner.

A high degree of vigilance is needed both within China and foreign markets, and regular audits are recommended. As mentioned, the accuracy of the information provided by your suppliers cannot be compromised, and collaboration with suppliers is important to ensuring integrity. Levi Strauss, for instance, has “a zero-tolerance policy” for suppliers who provide inconsistent or false reporting. After two or three warnings, the apparel company would end their contract with the supplier. They do, however, offer its full support and cooperation to suppliers who flag their problems.⁸

Factory audits and inspections should also be thorough. High-profile cases in the past have involved public discoveries of numerous violations of ISO9001 standards, despite frequent audits by multinationals. However, primary suppliers often contract many sub-suppliers or parts suppliers, and periodic and snap inspections can only pick up on a certain amount of quality issues. And these issues may multiply in relation to the technological complexity of your product. Again, working with your supplier benefits both parties, and they should be encouraged and given tools with which to monitor the quality standards of their own contractors. Making quality demands and imposing sanctions may foster an environment of bad faith, and encourage suppliers to conceal and fudge data wherever possible.

Overall, it's now much easier to find a partner that can deliver quality than it had been 10 or 20 years ago, as markets gain greater transparency and efficiency. But concerns over the quality or standards of goods produced in China still loom large, as procurement departments demand faster turnaround times, lower prices and increasing volume. Cutting corners can be the result of the pressure of meeting demands in scaling up, accelerating production or cutting costs. More risks can also crop up over time, even for those with supplier relationships maintained over long periods. Ensuring there are plenty of backup suppliers can be critical in case quality problems need to be remedied on tight deadlines.



With food and drug safety concerns also trending high in China, consumers are increasingly looking to foreign multinationals for their perceived higher safety standards. Preserving consumer trust and confidence should take priority over price concerns in an environment in which safety and quality considerations are rising in tandem. But multinationals should be aware that many product quality risks are also linked to China's high-inflation environment.

8. MIT Sloan Management Review. “Improving environmental performance in your Chinese supply chain.” December 21, 2011



Consider the recent high-profile case of nine large domestic pharmaceuticals companies selling gel capsules made with industrial gelatin containing hazardous levels of chromium (instead of edible gelatin). The average profit margin of China's medical capsule sector before the scandal had been very low: between 3% and 5%.⁹ And in the wake of the 2008 Chinese milk scandal, Stratfor Forecasting had determined that the act of adulterating milk and baby food also stemmed from pricing pressures: Rising milk costs (grain required to feed cows was getting more expensive) and price controls (government policies directed at the dairy sector to counteract inflation) acted together to clamp down on disappearing profits.¹⁰

Even large-scale suppliers are not immune when cost pressures bump up against high inflation. But particular care is needed in evaluating the merits and standards of small-scale suppliers in fragmented industries locked in aggressive competition and price wars. Keep in mind too that smaller suppliers may lack the finance and technology to meet proper quality management and supervision requirements themselves.

With this issue in mind, the government has made food safety a priority in its 12th Five-Year Plan. The plan includes ramping up China's cold chain infrastructure, for example, in order to lower the circulation decay and loss rates of fruits and vegetables by 15%, meat products by 8.5% and aquatic products by 10%, all by the end of 2015.¹¹ At the moment, there is still a lack of controlled temperature warehouses and talent in cold chain management. Companies with cold chains should ratchet up their management accordingly, as supply chains are still fragmented, and proper communication can suffer as a result. In one instance, a UK retailer lost thousands of dollars value of yogurt when their goods were shipped across China in trucks. The drivers did not see the point of the trucks' refrigeration capabilities, and therefore opted not to use them.

9. Liu, Je. "Capsule safety scandal to put prices up." *China Daily*, May 14, 2012

10. Stratfor. "China: The economic roots of the milk scandal." 2008

11. Research in China. "China Cold Chain Logistics Industry Report, 2011-2012." 2011

Aligning suppliers with your sustainability agenda

As China becomes a major component of many global supply chains, ensuring that your China suppliers are aligned with your sustainability agenda can make a difference to your energy efficiency strategies and green reputation. According to Hewlett-Packard's supply chain policy, the company is prepared to terminate contracts with suppliers who do not comply with its corporate policies and code of conduct on energy efficiency and corporate footprint management.¹² It pioneered a China-specific energy efficiency initiative in 2010 to engage its major suppliers in developing their energy improvement plans and sharing best practices. Currently, 76% of its suppliers have greenhouse gas reduction goals, while close to 50% are looking at their own supply chains, an impressive achievement in this market.¹³

Fortunately, lowering greenhouse gas emissions and bolstering environmental records is still a comparatively easy win in China. A BSR Insight report estimates that Chinese factories use approximately 11 times more energy than their Japanese counterparts.¹⁴ Moving operations to Leadership in Energy and Environmental Design (LEED)-certified premises could position you at the forefront of sustainable practices. The Ministry of Housing and Urban-Rural Development (MOHURD) is also promoting their own 3-Star system, which is quickly gaining momentum because of increased enforcement and 3-Star specific subsidies. However, according to the 2012 China Greentech Report, green building materials are often not available in China, and many products are prohibitively expensive.¹⁵ Nevertheless, a focused energy and sustainable procurement programme could reduce costs and overall energy demand by a large margin, boosting the environmental sustainability of your supply chain practices, your bottom line and your relationship with the government.

Li & Fung, for example, installed upgrades to their lighting technology, ventilation, heating and air conditioning at factories where it does business, while implementing other energy efficient and water management measures. Carrefour China is also conscious of its sustainability practices, introducing recycled shopping bags, and adopting a new purchasing model for buying commodities directly from farmers.

China is central to Walmart's sustainability strategy, which it relies on to boost its reputation globally. Approximately 20,000 Chinese suppliers account for 70% of American-owned Walmart goods sold globally every year, and in 2002, the company moved its global sourcing headquarters from Hong Kong to Shenzhen in mainland China.¹⁶ In 2008, Walmart announced that it would improve the energy efficiency of its top 200 Chinese suppliers by 20% by the year 2012. They would eventually require these suppliers to be subject to third party audits. In April 2011, it announced 119 factories had surpassed that target.¹⁷

12. "Supply chain SER conformance." *HP.com*. <http://h41111.www4.hp.com/globalcitizenship/pl/pl/environment/supplychain/compliance.html> (accessed August 27, 2012)

13. Hewlett-Packard. "HP Global Citizenship Report 2010." 2010

14. Schuchard, Ryan. *Getting started on supply chain efficiency in China*. BSR Insight Article, 2010

15. China Greentech Initiative. "The China Greentech Report." 2012

16. Schell, Orville. "How Walmart is changing China." *The Atlantic*, December 1, 2011

17. Walmart. "2011 Global Responsibility Report." 2011



Despite this, Walmart and many other companies still struggle to ensure factories of China suppliers meet its sustainability requirements. Companies are collaborating with other buyers to leverage their influence on suppliers to improve their environmental standards. In 2007, Nike began working with Levi Strauss and Adidas on environmental health and safety (EHS) audit report sharing, monitoring and removal of pollutants and contaminants at their common suppliers.

And because companies need to consider their actions in the context of China, initiatives must account for local conditions, leading to locally tailored sustainability programmes, particularly for worker health and safety issues. IKEA notes that full compliance with its standards will take longer in China, due to challenges related to the gap between legislated work hours and reality in China.¹⁸ They've taken the pragmatic approach of first securing a maximum work week of 60 hours, plus a maximum of 36 overtime hours per month, by the end of fiscal 2012.

Regional variations and a dynamically changing economy have led to many challenges at the national level in monitoring and enforcing environmental compliance. The independence and quality of your third party EHS auditors is therefore vitally important in making sure your suppliers are in compliance with these environmental standards, to reduce the risk of plant shutdown and financial penalties.

Potential benefits to compliance can include better relations with monitoring bodies, regulatory enforcers and other government bodies. For instance, YiXing-Union Cogeneration Co. Ltd., a coal-fired cogeneration power plant in Jiangsu, became an early adopter of advanced emission-reduction technologies. This allowed the plant to meet China's mandates ahead of schedule, resulting in a positive relationship with local and provincial governments, with regulators now promoting the company's results as a showcase for other local power generators.¹⁹

With the Chinese government trying to ensure their food producers and factories keep from breaking environmental regulations, ensuring your suppliers keep in line with and surpass regulations can help align your interests with those of the government. Walmart, for instance, works closely with the Institute of Public and Environmental Affairs to identify factories violating China's environmental emissions regulations.

18. IKEA. "IKEA Sustainability Report." 2010

19. China Greentech Initiative. "The China Greentech Report." 2012

Research and development (R&D)

In certain industries, China is an increasingly ideal place for R&D. One particular global pharmaceuticals company has invested heavily in increasing product development in coastal China, and has chosen to move their product development operations, including records and material storage, to an inland location. Expanding their R&D capability, the company decided, was much more cost-effective in China than in any other international location.

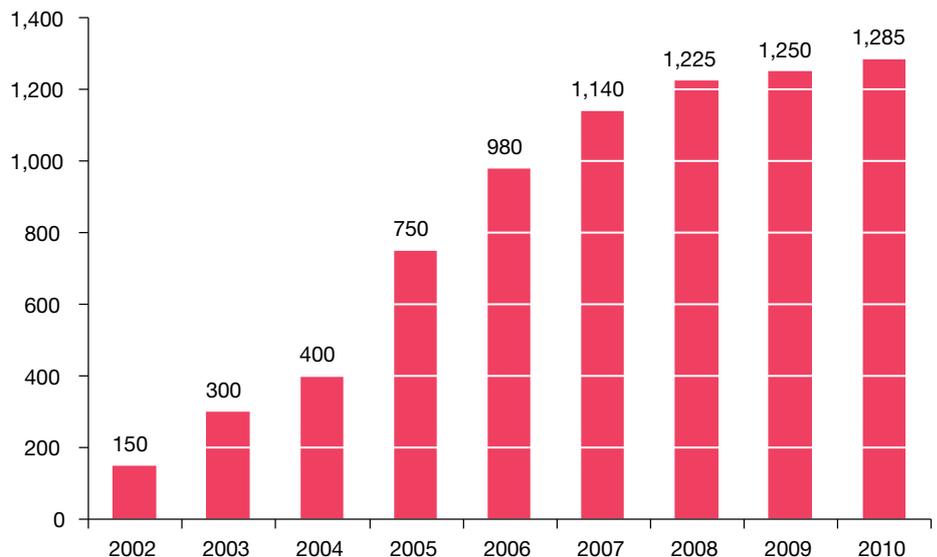
And there's a potent combination of reasons why a company would want to move research and development to China, including:

1. Proximity to manufacturing and supply chain
2. Lower costs
3. Tax incentives
4. R&D talent
5. Proximity to the Chinese market

There are clear benefits to close co-location of R&D with manufacturing and supply chain operations, which are now so commonly centred on China, leading to increased operational clockspeed. Getting products faster to market and to volume manufacturing can be a competitive differentiator.

While cost advantages diminish for manufacturing, cost efficiencies have become more pronounced in R&D, due to China's low setup costs. In addition, China's contract research organisations (CROs), which conduct studies and research for multiple clients, are experiencing a marked increase in standards and competitiveness over the last few years.

Number of registered foreign R&D centres in China



Source: Ministry of Commerce

But developing technology within the borders of mainland China is actively encouraged by the government, and there are numerous tax incentives available. The government is making a concerted push to encourage businesses with technology to bring to the table to come. Its priority on research is very clear: China's R&D expenditures are scheduled to reach 2.5% of GDP by 2020, and its share of the world's R&D expenditures has grown to 12.3% in 2010, from 5% in 2002.²¹ One example of such of an incentive is the extra 50% expense reduction allowed to companies for eligible R&D costs, including:

- Expenses incurred through the development of new technology and products

- Salary expenses for R&D personnel
- The depreciation of instruments and equipment used for R&D purposes

Other technology incentives are available for government-assessed high/new technology enterprises (HNTEs), technology advanced service enterprises in one of 21 service outsourcing model cities in China, and companies in software and integrated circuit industries.²²

21. UNESCO. "UNESCO Science Report 2010: The current status of science around the world." 2010

22. PwC. "Global R&D Tax News: Issue 5." 2011

Inexpensive technical and research talent is also becoming more abundant and increasingly sophisticated. China has the largest number of scientific research staff in the world,²³ though such professionals are more accustomed to theoretical research than practice. Businesses must be prepared to make training commitments to new hires on practical analysis, standard methods and processes, as well as management. Many multinationals have accordingly set up R&D “competence centres” in China to take advantage of this newly risen talent pool. Once such centres are set up, however, China heads are advised to spend time on internal marketing to ensure that global teams are aware of its competencies, to ensure a steady stream of work.

But arguably one of the most important advantages of setting up in China – the proximity to the local market, can be fully realised through the establishment of end-to-end “product centres.” Lifecycle research and development ranging from market feasibility to design, testing implementation and maintenance are all conducted in such centres, where localised staff research and develop products specifically for the China market.

And the trend now is for products developed for the China market to be introduced globally. US-based beauty company Estée Lauder has consistently

demonstrated its commitment to China, setting up an Asia Innovation Centre in Shanghai in June 2011 to develop products for Asian skin. It subsequently launched its Osiao skin care brand for Asian women in September 2012. Its Nutritious cosmetics brand, which it developed specifically for mainland Chinese women, is also being sold globally.²⁴

China's future place in global supply chains

Despite rising fuel, labour and logistics costs, basing significant supply chain operations in China – even potentially at higher labour costs than emerging “low cost countries” – can help open doors to this large market. High productivity and the attractions of research and development are also distinct advantages. Many companies have therefore made a conscious strategic decision to maintain a supply chain

presence in China, guaranteeing the country a place in the global sourcing networks of many global multinationals for years to come. Make a critical review of your sourcing activities in China and other sourcing markets, and look for ways in which your sourcing partnerships can help realise additional cost-reduction potential.

23. *China Daily*. “China plans to enlarge talent pool to 180 million by 2010.” 15 May 2012

24. PwC. “2012 outlook for the retail and consumer products sector in Asia.” 2012



***Government
relations,
regulatory
compliance and
stakeholder
alignment***

Observations

1. Foreign businesses cite a lack of access to Chinese government officials as one significant risk.
2. In mature industries, building relationships in government is not as important as that of developing or transforming industries.
3. Securing the right connections in China necessitates a considerable commitment of time and resources.
4. Foreign investors offering services, goods or strategies that are new or unfamiliar to the Chinese market may need to put even more effort in their communications to ensure all stakeholders are properly appraised.

Recommendations

1. Foreign investors need a strategy that works collaboratively with government regulations. They should continually look for common ground with government officials.
2. Investors should work with officials they are comfortable with, and strive to maintain these relationships. Be persistent and consistent.
3. Local managers cultivating a wide network of local contacts can lower a company's compliance risks.
4. Trusted partners or advisers on the ground with the right knowledge and local connections can also ensure your interests are heard by the appropriate government officials when they need to be.
5. Investors may need to map out their stakeholders when conducting due diligence, and properly gauge their issues and concerns.

Despite the many regulatory issues, regulatory compliance is actually considered a relatively minor risk in the China corporate world, as Chinese businesses have learned to work within the system. Of the 160 China and Hong Kong CEOs surveyed in PwC's 15th Annual Global CEO Survey, only 44% consider over-regulation a threat to their growth, compared with the global average of 56%.¹ Domestic companies also tend to have more flexibility in the China market than their foreign counterparts, having factored the shifting regulatory environment quite early into their business plans. Only 36% of China CEOs believe that changes in regulation have influenced their anticipated need to change strategy.

For foreign companies in China, however, regulations can be a major concern. In seeking a successful strategy for dealing with government, foreign businesses should seek out constructive avenues of action. Investors should adopt a careful and measured approach in working with the government. They should lobby the government to take a collaborative and progressive outlook towards regulatory reform. And they should be active in engaging relationships with government officials in order to stay informed.

The common ground between both businesses and the government is growing, while the needs of the private and public sectors have become increasingly intertwined. Roughly a third of CEOs in China believe that workforce skills are a top priority for government, and 93% say their business has a role in development of the workforce, other than their own employees. The risks of talent constraints are also well recognised by the government. China's 12th Five-Year Plan, introduced in 2011, outlines a strategy for finding and nurturing talent, with the idea of bringing home 2,000 skilled Chinese expats.

Foreign companies operating in China should stress their contribution to the development of local "homegrown" talent, and look for ways in which to collaborate better with the Chinese government in the areas of professional development of human capital, as well as improving indigenous innovation and technological capacity. Other issues that are ripe for increased collaboration between China's public and private sectors include infrastructure development, education, intellectual property protection, health care and regulatory convergence standards. In pushing their efforts on sustainability, Walmart, for instance, is aligning their strategy with the government on issues of people's health and social stability, as the 12th Five-Year Plan emphasises food safety and domestic consumption.²

However, lack of access to government officials is among the risks widely cited by foreign businesses in emerging markets, and overcoming that may require a concerted effort in China.³ But with the right connections, resources and subject matter expertise, the extra effort to involve themselves in government discussions can often pay off in the end. Effective partnership models with the China government will also result in better communication and opportunities.

1. PwC. "15th Annual Global CEO Survey." 2012

2. See also Supply chain strategies chapter for more on food safety concerns in China

3. PwC. "Building a presence in today's growth markets: The experience of privately held companies." 2011

Working at the local level

As we've seen in other chapters, policy implementation can be subject to local variations in interpretation and enforcement.⁴ While regulations are introduced centrally in China, enforcement of these regulations is applied at the provincial and city level, and interpretations often vary.

Therefore, businesses need to focus on cultivating local government relationships. "Different officials have different mindsets when they manage their relationships with investors," says Cheri Fu, co-founder of Galleria, a US-based home decor importer and wholesaler.⁵ "They [local officials] can manage relationships with local employees and with other government departments – environmental, fire etc. – and help communicate with other officials," says Fu. Putting a consistent effort in working with local government officials whom you are most comfortable with is a strong way of maintaining good relations.

While building connections with an official that goes beyond pleasantries can be helpful for future dealings with the government, companies should also be aware that not all relationships are immediately relevant for their needs. Businesses should not underestimate the value of any one relationship. Different civil servants have different areas of responsibility, and they may come into play at any given time.

Cultivating a large regional network of government contacts in as many provinces and cities as possible can help lower compliance risks associated with entering new markets, cities or provinces. Ideally, locally based Chinese managers should engage in regular communication in a local cultural context with their counterparts in the local government.

Maintaining such a broad regional portfolio of quality relationships also underscores the importance of incorporating local Chinese managers into your team to help bridge cultural gaps. A relationship network cultivated by local Chinese management with sufficient breadth and quality can produce contacts that can help point you in the right direction at key moments in your business cycle. For example, global hydraulics company Husco International employs local staff familiar with Chinese regulations and can help build strong relationships with key civil servants.⁶ Local partners can also help your team in developing these relationships when starting out, and act as a liaison for you at the entry stage.

China simply can't be treated as a single market, and local regulations make this case particularly convincing. Businesses must often factor in local government, bureaus and a raft of related stakeholders into their business dealings and market entry strategies.

Anthea Wong, PwC China Tax Partner

4. See also Tax management: planning and compliance chapter and Finance and treasury chapter for further examples of regulations that differ between central and local governments
5. PwC. "Establishing a business presence in China." 2011
6. PwC. "Building a presence in today's growth markets: The experience of privately held companies." 2011



Getting a perspective on relationships

In highly restricted markets, relationships can be essential to driving your business. But while government relationships can support the success of businesses operating in highly controlled industries, they are by no means a guarantee to success. For more mature industries in China, with clearly defined rules and expectations, government relationships may be no more beneficial than they are in other economies, particularly in emerging markets.

In such instances, relationships act more as lubricants, easing procedures from day-to-day registration and filings to the inner clockwork of complex approvals processes. But what businesses most often overlook in the China operational environment is the importance of managing a consistent and systematic “group-to-government strategy,” establishing consistent communication channels with all relevant stakeholders, particularly in approaching unfamiliar territory and new markets.

Establishing new relationships

Newcomers may find themselves on unfamiliar ground more often than expected, balancing a legal, tax and regulatory system that’s still developing relative to that of other markets. Even established multinationals such as Yum! Brands need clarity in navigating legal grey areas and sensitive issues. With thousands of outlets across the nation, one of Yum!’s challenges is to triage their responses to the volume of government inquiries and audits they face on an ongoing basis. The company also has a need, for accounting purposes, to value the liabilities of more informal agreements. As certain laws and regulations in many areas have yet to achieve full clarity, consistent and regular dialogue is often needed to resolve ambiguities.

Due to this requirement, multinationals such as Yum! have put ample resources towards well-staffed departments in China focused solely on government and stakeholder relations. But those without the necessary resources and experience will nevertheless need to ensure that their issues are aligned with that of the government and local stakeholders. Time-strapped businesses can opt to work with trusted partners or advisers on the ground with the knowledge and local connections to help ensure that their voice is heard at the right time, and that all stakeholder expectations are met.

Companies who attempt to make these connections without local assistance will also need to map out a systematic process of engagement before taking the plunge. Acquiring the right connections in a complex bureaucracy can be difficult, and a generous amount of time and energy is needed to manage and maintain key relationships. Even businesses with dedicated departments often lack consistency in trying to maintain regular dialogue.

The main challenge here for foreign businesses is that of time and resource commitment. Frequent conversations are needed to smooth out wrinkles and correct mis-steps in the process. Even seemingly clear-cut transactions such as capital injection into China, which does not require heavy discussion, still require an inordinate amount of time for regulatory compliance and filings. For example, representatives will need to present their case, prepare the necessary documents for cash injection, and finally exchange that money into the local currency. Many find the process of following through on such rules and procedures tedious and time consuming. As a result, it is often worthwhile to outsource this type of government networking and relationship management to experts and advisers, in order to concentrate on the actual work of running your business.



The presentation of special cases

Note, however, that extra effort in reaching out can be instrumental when attempting something unfamiliar in the China market, be it a new business model, concept or technology. In such cases, regular communication with all stakeholders will help to smooth out the process, while making sure everyone is aware of what you're trying to do. Make sure you manage government and stakeholder expectations and keep them informed early and often, so that there are no surprises.

At such times, businesses may have to take a careful and deliberate approach when interfacing with authorities, in relation to the scope and nature of the issue in question. Careful consideration should be taken as to the current stage of discussion or negotiation with a government department before each engagement. Should the query be exploratory in nature, an informal conversation by a local staff member with a civil servant will often suffice in obtaining the necessary advice or information. When businesses wish to convey to authorities a more serious intent, an official and formal meeting should be arranged. For example, foreign companies with a special investment or cash injection requirement may ask for a meeting with the Ministry of Commerce.

Knowing your stakeholders as part of due diligence

Entrants who do not align their interests with that of governments and local stakeholders may find themselves at a disadvantage during crucial moments in their business. If you're new to China and don't have the relationships you need, make sure your local advisers or partners do, as they can be instrumental in helping you take your case to the authorities. Advisers may have the inside track on the workings of a deal, allowing them to help in your due diligence by analysing whom your key stakeholders are, and interfacing with them so that your position is understood and interpreted correctly. In addition, they can also accurately interpret the positions of the government and local stakeholders, so that your business can shift strategies accordingly.

In taking a more holistic approach to due diligence, it may also be helpful to map out all key stakeholders with some level of detail to give yourself an understanding of which organisations have a say in your business interests, while giving you an awareness of their issues and concerns. And there are often more stakeholders on the map than newcomers may have sketched out at the drawing table. For example, businesses trying to repatriate their cash may assume they would only need to deal with the State Administration of Foreign Exchange (SAFE), when in reality tax and customs authorities also come into play.⁷

Other stakeholders may include banks, professional firms and industry associations. At other times, it may be a government organisation such as the local environmental protection bureau. Government authorities may sometimes consult with them when formulating government policies. Try to speak with several investors or local companies who may have experienced similar processes for their feedback on whom the relevant government authorities and stakeholders might be in any particular deal, as well as the potential issues and challenges. This can also help you keep informed of operating realities before plunging into uncertain terrain and markets.

7. See also Finance and treasury chapter for further details on cash repatriation

Key regulators

Government regulators in China have a sector-specific focus. The following is an alphabetically ordered list of some regulators that may be relevant to your business, depending on your sector and the focus of your activity:

General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) is the in-charge authority supervising quality inspections on imports and exports. AQSIQ promulgates a Catalogue of Goods that are subject to statutory inspection annually. Imports/exports that are not listed in this catalogue may still be subject to random inspection by the local AQSIQ offices.

China Banking Regulatory Commission (CBRC) regulates Chinese state-owned commercial banks, joint-stock commercial banks, city commercial banks, urban credit cooperatives, rural credit cooperatives, rural commercial banks, locally incorporated foreign banks, policy banks, postal savings banks, asset management companies, finance companies, trust companies and financial leasing companies.

China Insurance Regulatory Commission (CIRC) regulates life insurance, property and casualty insurance companies.

China Securities Regulatory Commission (CSRC) regulates securities companies, funds, futures companies, and equity and corporate bond insurance companies.

Ministry of Commerce (MOFCOM) and its local subsidiaries are the major government authorities that deal with matters relating to foreign investment in China. They have authority over the approval of enterprises with foreign participation and import of technology. MOFCOM and its local subsidiaries are likely to have the most contact with foreign investors.

Ministry of Finance (MoF) is responsible for formulating the accounting practices for foreign-invested enterprises operating in China.

National Development & Reform Commission (NDRC) has responsibility for overall macroeconomic planning and policy. It studies and formulates policy for economic development.

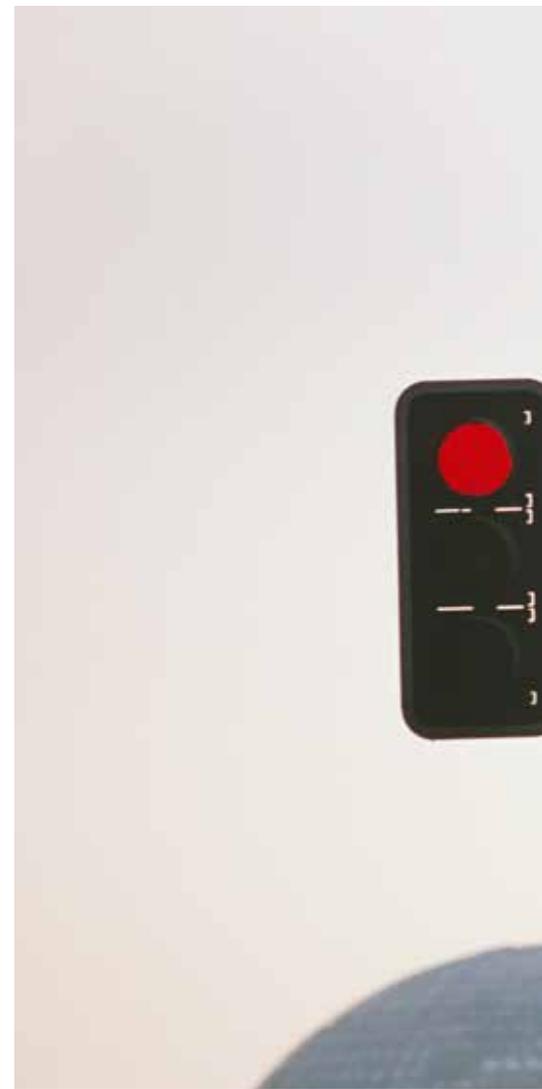
People's Bank of China (PBOC) has ministry-level status and reports directly to the State Council. Its main responsibilities include drafting and enforcing relevant laws, controlling the money supply, forming monetary policy, and regulating financial markets, including the renminbi exchange, the state foreign exchange and gold reserves.

Securities Association of China (SAC), established on 28 August 1991, is a non-profit self-regulatory organisation with “legal person” status subject to the guidance, supervision and administration of the CSRC and the Ministry of Civil Affairs. The members of SAC include securities companies, securities investment fund management companies, financial asset management companies and securities investment consulting agencies.

Shanghai Stock Exchange is a non-profit membership institution directly governed by the CSRC. After several years of operation, the exchange has become the dominant stock market in mainland China in terms of the number of listed companies, the number of shares listed, total market value, tradable market value, securities turnover in value, stock turnover in value and the T-bond turnover in value.

Shenzhen Stock Exchange has more than 150 members and two trading halls.

State Administration of Foreign Exchange (SAFE) functions as part of the PBOC, responsible for setting foreign exchange policies, making recommendations, establishing/regulating current and capital account funds transfer activities, and overseeing the implementation of rules and penalising rules breakers. In practice, SAFE performs a supervisory function for foreign exchange transactions conducted by foreign-invested enterprises.





State Administration of Industry and Commerce (SAIC) is responsible for regulating domestic day-to-day commercial activities. Representative offices are required to register with SAIC. All commercial entities in China must register with SAIC and submit annual or tri-annual re-registration documents to local SAIC offices as required by law.

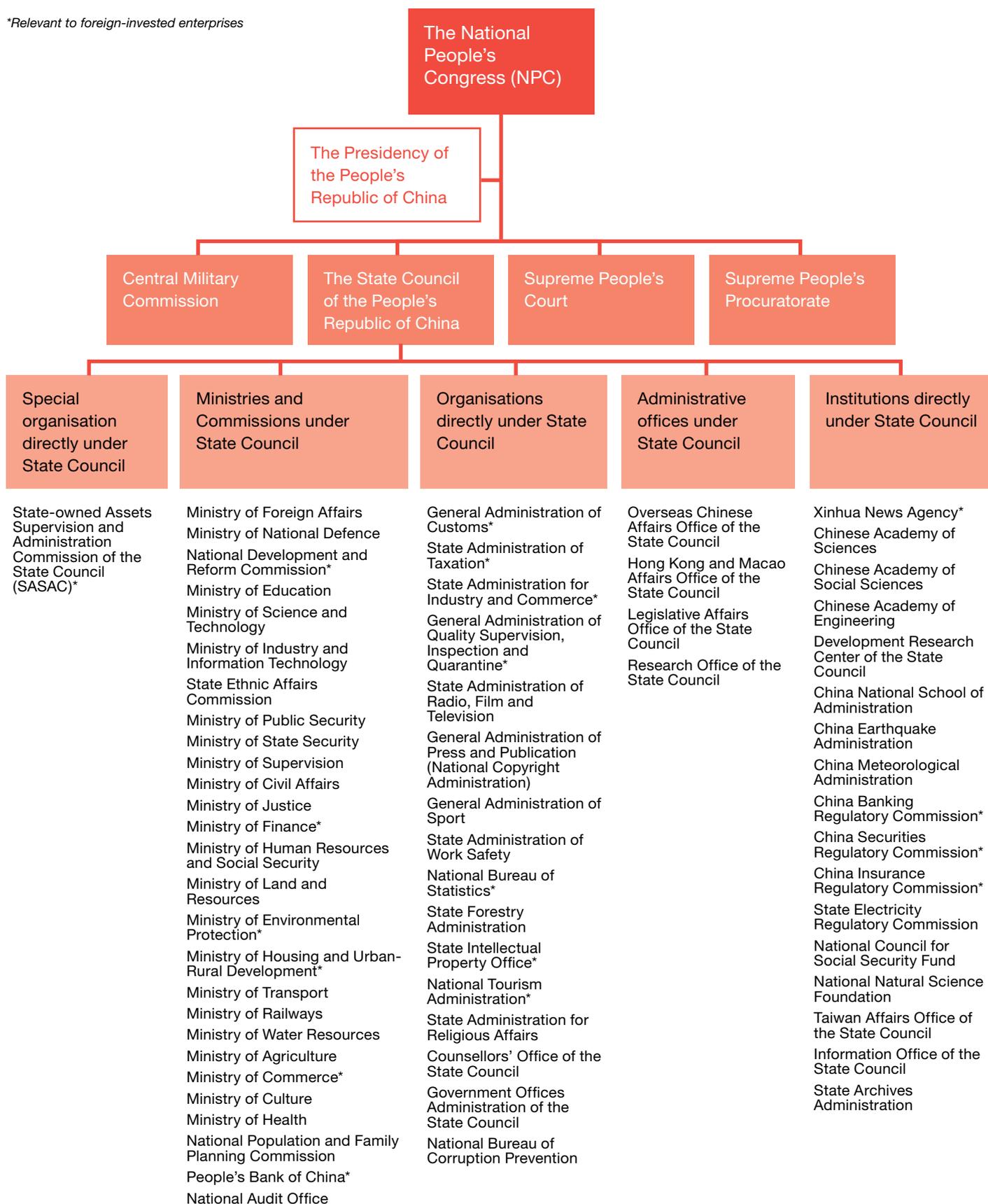
State Administration of Taxation (SAT) is responsible for the collection of taxes and enforcing tax laws. These laws are enforced and administered on a day-to-day basis by one tax bureau (local tax bureau) under the local government, and another tax bureau (state tax bureau) under the SAT in Beijing. These tax bureaus are responsible for ensuring that the policies laid down by SAT are implemented in accordance with local conditions as well as for tax assessments, collecting tax payments, performing tax audits and conducting tax negotiations with taxpayers. SAT is responsible for making tax policies for the whole country (including drafting new or revising tax laws and regulations) and for acting as the tax appeal body with respect to disputes between the tax bureaus and taxpayers.

Trademark Office of the SAIC is responsible for trademark registration and administration nationally. The local Administrations for Industry and Commerce (AICs) supervise the use of trademarks and deal with trademark infringements. In most cases, the party to file first will secure rights to that mark in China, so file as early as possible. For instance, a Shanghai snack maker owns the name and logo of the computer game, *Angry Birds*, while the trademark for Facebook is registered for a variety of products.⁸ The office maintains a free, searchable database online. Companies are encouraged to use this resource on a regular basis.

8. Pierson, David. "Trademark squatting in China doesn't sit well with U.S. retailers." *Los Angeles Times*, 28 March 2012

People's Republic of China government structure

*Relevant to foreign-invested enterprises





The Central Government

The National People's Congress (NPC) of the People's Republic of China is the highest organ of state power. **The Standing Committee of the NPC** is the permanent organ of the NPC. The term of office of the NPC and its Standing Committee is five years. The NPC and its Standing Committee are empowered with the rights of legislation, decision, supervision, election and removal.

The President of the People's Republic of China is the head of state, as well as the supreme representative of China both internally and externally. The state presidency is an independent state apparatus and a component part of China's state organisation. China's system of the head of state is a system of collective leadership. The President is subordinate to the NPC and directly receives instructions from the supreme organ of state power.

The Central Military Commission of the People's Republic of China is the highest state military organ with the responsibility of commanding the entire armed forces in the country. Led by a chairman and consisting of vice chairmen and members, the Commission is elected for a term of five years and can stand for re-election.

The State Council of the People's Republic of China, namely the Central People's Government, is the highest executive organ of state power, as well as the highest organ of state administration. The State Council is made up of a Premier, vice-premiers, state councilors, ministers in charge of ministries and commissions, the auditor-general and the secretary-general. The Premier of the State Council is nominated by the President, reviewed by the NPC, and appointed and removed by the President. Other members of the State Council are nominated by the Premier, reviewed by the NPC or its Standing Committee, and appointed and removed by the President. In the State Council, a single term of office is five years, and incumbents cannot be reappointed after two successive terms.

The Supreme People's Court is the highest trial organ in the country and exercises its right of trial independently. It is also the highest supervising organ over the trial practices of the local people's courts and special people's courts at various levels. It reports its work to the National People's Congress and its Standing Committee. The right of appointment and removal of the president and vice presidents as well as members of the trial committee of the Supreme People's Court lies with the National People's Congress.

The Supreme People's Procuratorate, local people's procuratorates and special people's procuratorates such as the military procuratorate make up the prosecution system. The people's procuratorates are the legal supervision organs of the state.

Legislation

The *National People's Congress* and its *Standing Committee* are empowered to exercise legislative power. The *State Council* is also authorised to adopt administrative regulations and measures in accordance with the constitutions and laws. At the local level, the *People's Congress* of the provinces, autonomous regions and municipalities directly under the central government may also adopt local regulations, provided they do not contravene the Constitution or the state laws.

China's tax laws applicable to enterprises are drafted by the *State Administration of Taxation* and the *Ministry of Finance* before being submitted to the *State Council* for discussion and review. Once passed by the State Council, they are then submitted to the *National People's Congress* for final approval and promulgation. Implementing rules and regulations are also drafted by the State Administration of Taxation and submitted to the State Council for approval.



The landscape

Businesses should understand that China's government, while a one-party system, is not a monolithic entity on a linear course of economic development. There are differences in agreement on process, timing and degree of change needed to realise reform.⁹ Some views are inclined towards more comprehensive reform, while others gravitate towards a firmer ground of promoting "tried and tested" policies. These differences, some of which can be subtle, can have a significant impact on businesses operating in China. CEOs should therefore try to understand the differences and commonalities in the points of view of Chinese leadership and develop strategies that can adapt to this environment in times of political change.

The political landscape in China today cannot be defined by any ideology or the policies of a strong leader like Chairman Mao or Deng Xiaoping. The leadership is becoming increasingly diversified, and the leaders' views are also becoming more transparent. There is some public debate going on.

Cheng Li, Director of Research,
John L. Thornton China Center of the Brookings Institution and
author of *China's Leaders*

9. PwC. "Doing business in a changing China." 2010



***Tax management:
planning and
compliance***

Observations

1. The Chinese tax system is complex, and tax policies are changing rapidly to keep pace with economic development. At the same time, local implementation rules on tax policies warrant particular attention.
2. In addition to technical concerns and practical issues, commercial (non-tax) justifications will also be increasingly attached to tax planning and compliance.
3. Aggressive planning schemes without commercial bases tend to face more challenges. Anti-tax avoidance, including transfer pricing, is an increasing concern for tax authorities.
4. On the tax administrative side, authorities have started focusing on taxpayer services, but there is still room for improvement.

Recommendations

1. Ensure tax strategy is aligned with the overall business strategy and that tax implications are taken into account when choosing an optimal business model and transaction flows.
2. Stay on top of new tax developments and insights on tax regulations. Know the administrative practices of the local level tax bureaus.
3. Plan ahead for potential tax risks and consequences with tax risk management.

Aligning tax strategy with overall business strategy

The China tax environment may be in constant flux, but one thing is clear: tax management, both planning and compliance, are rising on the corporate agenda. Investors need to take tax laws and regulations into serious consideration and ensure that their tax strategies are aligned with overall business strategy. They need to make sure that the two complement each other. Doing this can help investors minimise tax exposure, control costs and avoid reputational risks. Software firms, for example, can be set up in China under one of several potential

business models, each of which can be subject to different sets of tax policies and benefits. Investors need to understand which model is best for the business, in light of the overall business strategy, and the tax implications.

Tax and business strategies should also be aligned when a business is looking for locations in China. While some regions offer financial subsidy and/or refund in respect of taxes, other business factors should be taken into consideration, including the availability of a skilled labour force, proximity to major markets and infrastructure.

Tax reform trends and what they mean for business

Since 2008, tax reforms in China have moved forward at a steady pace, especially in the realm of corporate taxation. Foreign-invested enterprises (FIEs) and domestic-invested enterprises now apply to the same corporate tax laws and regulations in China, including the Corporate Income Tax (CIT) and other applicable taxes. Further to CIT reform, the Chinese government is rolling out a turnover tax reform, which

will help reduce the multiple taxation issue associated with goods and services. On the tax administrative side, with the improvement in resources, technology and organisation systems, the Chinese tax authorities have strengthened tax administration on large and key taxpayers, non-China resident enterprises and anti-avoidance issues.

An overview of the tax administration system

Unlike common-law countries, the taxation system in China is based on law, not precedent. China's major tax laws are passed by the People's Congress, and regulations for implementation are formulated by the State Council. The Ministry of Finance (MoF) and the State Administration of Taxation (SAT) are then responsible for interpreting and implementing these tax laws and regulations. Finally, the branches of the local-level tax bureaus collect the tax revenue from the taxpayers, and then report back to the higher-level authorities.

Since the local level tax bureaus effectively act as “windows” for the tax authorities to interface with taxpayers and to implement the tax laws and regulations, businesses need to stay up to speed, not only on the ongoing development of laws and regulations, but also on how they are practised by their local level-tax bureaus.

Handling tax audits and disputes

Taxpayers will inevitably have to face a tax audit or investigation as part of the lifecycle of their business. These audits/investigations are carried out by independent tax audit/investigation teams at the local level or provincial tax bureaus, or even in rare cases, by state level authorities. The tax audit/investigation may be driven by issues such as the types of taxes, geography, types of taxpayers or different specific tax administration purposes. Selection criteria for these audits/investigations can touch on the taxpayer's financial and tax position, level of sales, industry and the nationality of the parent company. Even an informant can trigger an audit.

Taxpayers may want to plan ahead for such events, by conducting a tax risk assessment on a periodical basis. That way, a business will be able to identify the areas of tax risk and have them remedied before the actual tax audit/investigation.

When handling a tax audit/investigation, the taxpayer should try to find out what the tax authorities are actually after. In order to submit the right information and documents to the authorities, the taxpayer needs to know exactly what the tax authorities' motives are, as well as their underlying agenda, if any.

In case of a tax dispute, there is a set of appeal procedures to the higher-level tax authorities. In China, tax disputes are normally settled in this way rather than through court proceedings. Cross-border double taxation issues resulting from, say transfer pricing adjustments, however, may be resolved through Mutual Agreement Procedures between the State Administration of Taxation and the competent authority of the treaty country.

An overview of taxes for consideration

China levies a range of taxes, as follows:

Income taxes:

- Corporate Income Tax (CIT), including withholding income tax (WHT)
- Individual Income Tax (IIT)

Turnover taxes and customs duty:

- Value-added Tax (VAT)
- Business Tax (BT)
- Consumption Tax (CT)
- Customs Duty (CD)

Property and behaviour taxes:

- Real Estate Tax (RET)
- Urban and Township Land-use Tax (UTLT)
- Land Appreciation Tax (LAT)
- Vehicle and Vessel Tax (VVT)
- Motor Vehicle Acquisition Tax (MVAT)
- Stamp Duty (SD)
- Deed Tax (DT)
- Vessel Tonnage Tax (VTT)
- Tobacco Tax (TT)
- Arable Land Occupation Tax (ALOT)

Miscellaneous surtaxes and local surcharges:

- Resource Tax (RT)
- Urban Construction and Maintenance Tax (UCMT)
- Education Surcharges (ES)
- Other local surcharges

Turnover taxes and income taxes are the biggest contributors to China's tax revenue, of which Value-added Tax represents the top source.

Taxes for consideration: income taxes, turnover taxes

The following two main forms of investment in China will have both income and turnover tax implications:

1. FIEs registered in China, and
2. Non-China resident enterprises.

Taxes for FIEs

Under normal conditions, foreign investors who want to set up businesses in China will opt for FIEs as their operational vehicles. FIEs, from a CIT standpoint, are “tax-resident enterprises of China.” This means they will need to use worldwide income as their CIT base for reporting purposes.

The key tax management issues of an FIE during its lifecycle can be classified into planning and compliance. Below, we’ll discuss the lifecycle for entry and operation, and then talk about corporate restructuring and their tax implications. We’ll also highlight the process of withholding individual income tax for employees, of which foreign businesses should take particular note.

Entry

If a foreign investor wants to inject fresh cash into China to set up a new FIE or increase the capital of an existing FIE, the cash injection is generally not subject to Chinese tax, besides stamp duties. However, should the foreign investor choose to invest in the FIE through non-cash assets, then it needs to review the CIT (and other tax) implications, taking into account the various facts and circumstances.

Operation

After setting up in China, an FIE will need to pay turnover tax once it comes into operation. This, of course, depends on the nature of their business and the type of products or services involved. Types of turnover taxes include:

- Value-added tax (VAT), which applies to importation, production, distribution and retailing activities in respect of tangible goods and a few prescribed services. The general VAT rate is 13% or 17%. If an FIE qualifies as a general VAT payer, the input VAT that it incurs (that is, the VAT paid on goods and certain prescribed services to the suppliers) can be credited against its output VAT (that is, the VAT collected from the customers) in calculating the VAT payable. Enterprises regarded as “small businesses” are subject to a more simplified VAT calculation, which is 3% of the gross sales amount, without the input VAT credit. The export of goods from China may be entitled to a VAT exemption on the sales amount and a refund of a certain portion of the input VAT depending on the goods exported.
- Consumption Tax (CT) is levied on manufacturers and importers of specified categories of consumer goods that are largely luxury and non-necessity or scarce resources products. The tax liability is calculated based on the sales amount and/or the sales volume depending on the goods concerned. CT is imposed on top of the applicable VAT and CD, if applicable.
- Business Tax (BT) is imposed on most services provided, as long as either the provider or recipient of the services is within China. BT is also imposed on the sale of immovable property and the transfer of intangible assets in China. The rate of BT ranges from 3% to 20%, depending on the nature of the business, while the most common rate is either 3% or 5%. Limited exemptions may apply to some prescribed services. At the moment, the Chinese government is pushing forward a reform of the existing turnover tax system to gradually replace BT with VAT for industries that are currently subject to BT. From 1 January 2012, a pilot programme for turnover tax reform was formally introduced to selected industries in Shanghai and other selected cities. Depending on the effectiveness of this pilot programme, the reform may be rolled out across the country in the near future.

- If an FIE engages in import or export activities, it may also be subject to customs duties. In general, customs duties are charged in either specific or ad valorem terms. For specific duty, a lump sum amount is charged based on a quantitative amount of the goods. For ad valorem duty, the customs value of the goods is multiplied by an ad valorem duty rate to arrive at the amount of duty payable. Import VAT and/or customs duties may be exempted for certain goods, machinery and equipment if certain conditions are met. Import duties are imposed on a wide range of tangible goods and some intangibles, whereas export customs duties are imposed on a few scarce resources produced in China.
- The CIT liability of an FIE is calculated based on its taxable profit, multiplied by the applicable tax rate. Here are some key CIT treatments:
 - The standard CIT rate is 25%. However, a lower tax rate is available for qualified small and thin-profit enterprises (20%) and for qualified new/high-technology enterprises (15%).
 - There are also other tax incentives that are “predominantly industry-oriented, limited geography-based.” This is a marked shift from incentive regimes before 2008, which had tried to attract foreign direct investment over many different industries for numerous favoured geographic areas.
 - Under normal conditions, an FIE should be able to deduct costs and expenditures from its taxable revenues. However, for certain prescribed expenditures, CIT deductions are not allowed, or only deductible on a certain portion of these expenses.
 - If an FIE, being a tax-resident enterprise, has already paid income tax overseas (for income derived from sources outside of China – if any), then it may credit the foreign income taxes against China CIT payable. This is called the “foreign tax credit.” It is limited, however, by the amount of income tax otherwise payable in China for that non-China-sourced income.
 - The branch offices of an FIE can consolidate their CIT filings with headquarters. However, there is no group relief scheme (in which group companies are considered a single company for tax purpose) for subsidiaries to make consolidated CIT filings in China.
 - Tax losses can be carried forward for five years to offset future taxable income. However, tax losses cannot be carried backward.
 - China’s anti-avoidance rules currently include transfer pricing rules, controlled foreign corporation rules, thin-capitalisation rules and general anti-avoidance rules. Of the above, transfer pricing has drawn the particular attention of tax authorities for the previous decade. In recent years, the Chinese tax authorities have also started paying more and more attention to other tax avoidance issues.

Investors need to take tax laws and regulations into serious consideration and ensure that their tax strategies are aligned with overall business strategy.

Matthew Mui, PwC National Tax Policy Services Partner

Corporate restructuring

FIEs may want to conduct corporate restructuring transactions within China or as part of a global or regional restructuring. For CIT purposes, the general rule of thumb is that businesses going through a corporate restructuring should recognise the gain or loss from the transfer of relevant assets and equity at a fair value, when that transaction takes place. However, if certain prescribed conditions are satisfied, the parties could opt for special tax treatment (basically, a tax deferral). But for cross-border transactions, such special tax treatments are available only for a handful of specific transactions.

In addition, VAT and/or BT may also be applicable if the transaction involves the sale of goods or assets, or the transfer of intangible assets or immovable properties. Of course, VAT and/or BT may be exempted if certain conditions are satisfied.

Withholding Individual Income Tax for employee's employment income¹

As an employer, FIEs have an obligation to withhold their employees' Individual Income Tax (IIT) on salary and wages (including bonuses and other employment-related gratuities) every month. Progressive IIT rates range from 3% to 45%, and are applicable to both local and expatriate employees, including those under secondment (or temporary transfer). IIT regulations do, however, allow for more favourable treatment for expatriate employees on deductions than for local staff. Expatriates, for example, can enjoy a deduction in their prescribed types of cost-of-living allowance. In addition, expatriate employees on short-term assignments (less than one year) have their IIT liabilities calculated based on the actual number of days residing in China, if they meet certain criteria.



1. Chinese IIT imposed not only to the employment income but also to other personal income.

Transfer pricing

China is rapidly developing its transfer pricing legislation and implementation. China requires the annual reporting of transactions between “associated enterprises”. Transfer pricing audits have also been gradually broadened in recent years to intangibles and services.

Businesses will need to deal with such audits seriously, with a designated team of tax and operational staff members assigned and a clear plan and strategy to see the audit process through. In addition, advance pricing agreements (APAs) and cost-sharing agreements (CSAs), legislated by CIT Law, could now be effective tools for reducing transfer pricing risks, as they help assure that future profit levels of Chinese subsidiaries are accepted by the Chinese tax authorities.



Taxes for non-China resident enterprises

Businesses that choose to do operations in China without registering an FIE are considered non-China-resident enterprises (non-TREs) for tax purpose. In general, non-TREs are also subject to tax implications in China for both passive income and active income.

Passive income

Examples of passive income include dividends, interests and royalties, as well as gains for equity transfers.

- Dividends, interests and royalties: A foreign investor's China subsidiary (in the form of an FIE) may distribute dividends to foreign investors (shareholders), or the foreign investors may provide shareholders' loans, technologies or other intangibles etc. to the FIE, and then require the FIE to repatriate the cash through a distribution of interests and royalty fees. In such cases, the subsidiary (FIE) will need to withhold a withholding income tax at 10% of the passive income, according to Chinese CIT regulations, before remittance.

If the foreign investor (recipient) is a tax resident from a country or region that has signed a tax treaty with China,² that recipient may apply to enjoy a tax treaty benefit. These benefits may include reduced withholding tax rates. But the recipients and/or the FIEs will still need to go through certain procedures and prove that the recipients are the "beneficial owners" of the dividends/interests/royalties.

On top of withholding income taxes, interests and royalties may also be subject to BT.

- Gains on equity transfer: At some point, a foreign investor may want to buy or set up a company in China, and then sell it sometime later to either Chinese or overseas buyers.

Withholding income tax may be imposed if the investor derives a disposal gain based on fair value on the sale. There are no different tax treatments for the disposal gains in capital (investment) nature or revenue nature in China. The gains are generally subject to 10% withholding income tax. If the transferor is a tax resident of a country or region that has signed a tax treaty with China, the transferor may apply for treaty benefits in respect of disposal gains (e.g., tax exemption in China) if certain conditions indicated in the tax treaty are met. Even if the equity transfer of the Chinese enterprise is indirectly conducted by foreign enterprises, the Chinese tax authorities can still invoke general anti-tax avoidance rules to impose withholding income tax on the resulting gain, if the holding structure under certain circumstances are regarded as lacking commercial purposes.

On the other hand, the buyer of that company should also check the deal against all relevant Chinese tax regulations since it may affect the tax basis of the acquiring enterprise and its China tax implications.

- Exiting: One way in which foreign investors may exit from an FIE is to reduce its capital. Capital reduction itself (excluding the recipient of dividend and/or disposal gains) is generally not subject to Chinese taxes, although getting approval for this is not exactly straightforward.³

Liquidating an FIE is another option. In calculating the taxable income recognised from liquidating the FIE (for CIT purposes), the entire liquidation period will be seen as one independent tax year. The remaining assets obtained by the foreign investor will be recognised as dividend income and disposal gains, respectively. They are, again, subject to a withholding income tax of 10% (or lower, where tax treaty benefits apply).

Withholding income tax rates under China's tax treaties with other jurisdictions (as of 31 December 2011) are summarised in the Appendices of this book.

2. Up until the end of 2011, China has signed 97 double taxation treaties with other countries (regions).

3. See also Finance and treasury chapter on cash repatriation strategies

Active income

Foreign investors may be earning or deemed to earn China-sourced income via representative offices and other project-based visits. Such income is seen as active income subject to China tax, instead of passive income.

- **Representative offices:** Representative offices are set up by foreign companies in China without a separate legal entity status in China. Most representative offices in China are mainly required to pay two types of taxes, CIT and BT. There are also two ways to tax a representative office:
 - Based on the actual income/profit, and
 - Based on the deemed income/profit.

On appearance, representative offices are required to report China-sourced income/profit on an actual basis, at an amount that's equivalent to their function and risk. That is, the higher the risk and greater the function of the office, then the higher the reported profit and income should be. When the tax bureau in charge examines and determines that a representative office has failed to keep complete and accurate books or is unable to calculate and file its tax liabilities on an actual basis, the representative office may be required to file the tax on a deemed basis, which would normally be a percentage of the representative office's income or expenses.

In practice, however, since representative offices are not legal entities and their accounting is consolidated with overseas headquarters, it is difficult for most foreign companies to allocate the income in a way that Chinese tax authorities can verify its fairness. As a result, many representative offices in China are still required to file their CIT and BT under the deemed method. Most importantly, the deemed profit rate has increased drastically in recent years, which raises the tax cost and overall cost of doing business in China.

- **Project-based visits:** In addition to physically registering a representative office in China, foreign companies may also be able to conduct business in China by sending people to work there on a project-by-project basis. If the foreign companies provide taxable labour services in China, such services are generally subject to BT on gross service fees (subject to the upcoming tax reform). They may also be subject to CIT, depending on whether an "establishment or place" (or "permanent establishment" if the relevant tax treaty is available) is triggered. CIT may be imposed at 25% of actual profit or deemed profit. In addition, the foreign company may also have to withhold IIT for the people working in China.



Other applicable taxes for consideration



Where a foreign company or an FIE chooses to hold property in China, the holding of property, including real estate, is subject to the following taxes:

- Deed Tax, which is applicable when receiving real property.
- Real Estate Tax and Urban and Township Land Use Tax, which are applicable when holding real estate.
- Land Appreciation Tax, which is applicable when disposing real property.
- Vehicle and Vessel Tax, which is levied on all vehicles and vessels registered within China according to a fixed amount per year, deadweight tonnage or weight

Concluding dutiable documents in China is subject to Stamp Duty and acquiring motor vehicles is subject to Motor Vehicle Acquisition Tax.

Urban Construction and Maintenance Tax and Education Surcharges are applicable for entities paying VAT, BT or CT in China, and calculated at various percentages. In addition, local-level tax authorities may impose certain local surcharges, depending on the location of the entities in China.

There are also some special taxes and fees, such as Resource Tax, levied for taxpayers engaged in specialised industries.

Accounting and reporting



Observations

1. There are currently two accounting regulation systems in China, ASBE¹ and CAS 2006.² CAS 2006 is substantively converged with IFRS,³ and ultimately, will be adopted by all companies (except for small enterprises that elect to adopt ASBE).
2. Even if the functional currency is not renminbi, your company in China will still need to present one set of financial statements in renminbi for statutory purposes.
3. Tax regulations require that companies make necessary adjustments to their accounting profits to arrive at their taxable profits. With the issuance of CAS 2006, there would be even more differences between accounting books and tax returns.

Recommendations

1. Make sure you have at least a general understanding of the differences among ASBE, CAS 2006 and IFRS, and their different impacts on the financial positions and results. Ensure your companies in China select an appropriate accounting regulation system to adopt.
2. Pay attention to the accounting year in China which must be from 1 January to 31 December and may not be the same as your group's reporting packages.
3. Ensure your local accounting profit is appropriately adjusted to the taxable profit in the tax return in accordance with the tax regulations.

1. The Accounting System for Business Enterprises, 16 specific accounting standards and other related accounting regulations

2. The Accounting Standards for Business Enterprises (2006) and other related accounting regulations (referred to informally as the China accounting standards 2006, or CAS 2006)

3. The International Financial Reporting Standards

Introduction to books and records

The Accounting Law defines the roles of the governmental departments on accounting matters and specifies the fundamental requirements of accounting practice, accounting procedures and accounting supervision. The Accounting Law empowers the department of finance under the State Council, i.e., the Ministry of Finance (MoF), to administer nationwide accounting matters, including the promulgation of uniform accounting regulations/accounting standards that must be complied with throughout the country by all the applicable companies.

In China, your companies are required to maintain accounting records and prepare annual financial statements in accordance with the accounting regulations/accounting standards issued by MoF. The Accounting Law stipulates that companies must keep three kinds of primary accounting records: journals, a general ledger and sub-ledgers, as well as appropriate supplementary memorandum records. Computerised accounting systems, if used, can be regarded as the company's accounting records.

All accounting documents, books and financial statements prepared by a company must be written in Chinese. They can also be written concurrently in a foreign language. Companies are required to keep accounting records, financial statements and supplementary memoranda for at least 15 years.

Two accounting regulation systems

At the moment, there are two parallel accounting regulation systems, both issued by MoF:

1. The Accounting System for Business Enterprises, 16 specific accounting standards and other related accounting regulations (ASBE), and
2. The Accounting Standards for Business Enterprises (2006) and other related accounting regulations (CAS 2006).

ASBE

ASBE is effective from 1 January 2001 and is applicable to all types of companies, until certain types of companies are required to, or those companies have volunteered to adopt CAS 2006 from 1 January 2007 or thereafter, e.g., all listed companies are required to adopt CAS 2006 from 1 January 2007. ASBE comprises the Accounting System for Business Enterprises, 16 specific accounting standards and other related accounting regulations. The Accounting System for Business Enterprises sets out the accounting treatments for major line items in financial statements, in the order of assets, liabilities, equity, income, expenses etc.

The 16 specific accounting standards include:

1. Inventories
2. Fixed assets
3. Intangible assets
4. Investments
5. Borrowing costs
6. Debt restructurings
7. Revenue
8. Construction contracts
9. Leases
10. Exchange of non-monetary assets
11. Contingencies
12. Accounting policies, changes of accounting estimates and correction of errors
13. Cash flow statements
14. Events after the balance sheet date
15. Interim financial reporting
16. Related-party disclosures

However, these 16 specific accounting standards themselves do not form a comprehensive basis of accounting. They serve only as additional/supplementary accounting requirements/guidance to the Accounting System for Business Enterprises. Some of them are only applicable to the joint-stock companies.

Although the recognition and measurement principles under ASBE are largely in line with those under International Financial Reporting Standards (IFRS), there are major differences in a number of areas. Here are some examples:

- Fair value measurement is not allowed
- Recognition of deferred tax is not mandatory
- The concepts of financial instruments and share-based payments are not introduced
- Preparation of consolidated financial statements is not mandatory for non-listed companies

CAS 2006

CAS 2006 was issued by MoF on 15 February 2006. It forms a comprehensive basis of accounting and is seen as substantively converged with the IFRS. CAS 2006 is effective from 1 January 2007 for all listed companies and becomes effective for companies such as financial institutions and large and medium-size state-owned enterprises in the following years as required by the various authorities.

In many provinces and cities, certain other types of companies may also have already been required by the local finance authorities to adopt CAS 2006. Eventually, CAS 2006 will be the only basis of financial reporting for all types of business enterprises, except those small enterprises that are qualified to adopt the “Accounting Standards for Small Enterprises” (see also Accounting Standards for Small Enterprises later in this chapter). For those companies that have not yet adopted CAS 2006 (mainly non-listed foreign investment enterprises and privately owned enterprises), the mandatory adoption date is yet to be determined by MoF, though early adoption is allowed.

As of April 2012, CAS 2006 comprises one basic standard, 38 specific standards, application guidance for 32 specific standards, four interpretations and four yearly issued annual report guidance; that is, from 2008 to 2011.

In addition, the officials of the Accounting Regulatory Department of the MoF, who are responsible for drafting CAS 2006, have formed a team to compile a guidebook to CAS 2006, which is equivalent to the “implementation guidance” for IFRS. This guidebook is one of the major sources for further guidance and interpretation on the implementation of CAS 2006. The most updated book is the “*Implementation Guidance 2010*,” published at the end of 2010.

CAS 2006 is more converged with IFRS than ASBE, particularly in the areas of:

- Deferred taxation
- Business combinations under non-common control
- Share-based payments
- Financial instruments
- Assessment for asset impairment

While CAS 2006 doesn’t reflect a literal translation of IFRS, it essentially matches all of the accounting principles under IFRS. In addition, it interprets accounting treatments for certain types of transactions that often take place within the China environment (e.g., combinations of companies under common control), and certain specific industry accounting issues, such as the extraction of oil and natural gas.

There are still a small number of differences between CAS 2006 and IFRS. For example, the reversal of impairment loss already provided for on non-current non-financial assets is not allowed.

For a comparison of the index of CAS 2006 and IFRS, please see the Appendices.

A summary of accounting requirements

The following discussion on the accounting regulation systems in China are based on the requirements under both ASBE and CAS 2006 (unless specified otherwise).

Financial statements

A complete set of financial statements include:

- A balance sheet
- An income statement (profit and loss account)
- A cash flow statement
- A statement of changes in owners' equity
- Notes to financial statements

Under ASBE, the statement of changes in owners' equity is not required. For sample financial statements under CAS 2006, please see the Appendices.

Notes to the financial statements

Notes to the financial statements must include at least the following information:

- Basis of preparation of the financial statements
- Statement of compliance with CAS 2006 (this isn't required under ASBE)
- Description of significant accounting policies, including the measurement bases for items recognised in the financial statements and the bases for selecting those accounting policies
- Description of the key accounting estimates, including the bases for determining any accounting estimates that may have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next accounting period (not required under ASBE)
- Descriptions of any changes in accounting policies and accounting estimates, and corrections of errors
- Additional descriptions of significant items presented on the face of the balance sheet, income statement, cash flow statement and statement of changes in owners' equity
- Disclosure of contingencies and commitments, non-adjusting events after the balance sheet date, related-party relationships and transactions

Although CAS 2006 has substantially converged with IFRS, there are additional considerations to be taken during the implementation due to the special circumstances in China. A number of transactions or events under the specific environments in China may result in accounting treatments different from those derived from the principles and description in IFRS. Some of the differences are not explicitly described in the accounting standards.

Baolang Chen, PwC China Assurance Partner

Accounting year and tax year

The accounting year for a company starts on 1 January and ends on 31 December. That is to say, only the calendar year is allowed as the accounting year. And for the purpose of calculating income tax, the calendar year is also the tax year. Companies are required to file their annual income tax returns and statutory audited financial statements to local tax authorities within five months after the end of a tax year.

Companies are also subject to an annual examination by the local industrial and commercial bureau (the authority responsible for administering the registration of companies). During the annual examination process, companies are required to file their statutory audited financial statements together with other annual examination materials before 30 June of the year subsequent to the accounting year.

Recording currency/functional currency

Under Chinese Accounting Law, renminbi (RMB) has to be the recording currency (functional currency) for purposes of bookkeeping and presenting financial statements. Foreign currencies are also permitted as the recording currency if they meet the criteria for determining the recording currency set out in accounting regulations/accounting standards.

Under ASBE, companies in which income and expenses are mainly in currencies other than RMB can choose one of those currencies as their recording currency.

Under CAS 2006, companies can choose the currency of the primary economic environment in which they operate as their recording currency.

However, under both ASBE and CAS 2006, a set of financial statements for statutory purposes must be presented in RMB by translating the financial statements in the recording currency.

To resolve CAS 2006 implementation issues, you need to know the thought process of the standard setters. This requires an accumulation of experience. For those accounting treatments that are not explicitly stated or would not be able to be derived directly from the principles and description in the standards, verbal interpretations from the standards setters might be needed.

Baolang Chen, PwC China Assurance Partner

Foreign currency translation

Under ASBE, foreign currency transactions are translated into the recording currency using the spot exchange rate at the date of the transactions or the spot exchange rate at the beginning of the period.

ASBE doesn't address the distinction between monetary items and non-monetary items. Instead, it has a specific requirement that the period-end balance of each foreign currency account (including foreign currency prepayments and advances from customers – non-monetary items) be translated using the spot rate at period-end.

Under CAS 2006, foreign currency transactions are translated into the recording currency using the spot exchange rate at the date of the transactions or an exchange rate that approximates the actual spot exchange rate on the date of transactions, by applying a systematic and rational method.

CAS 2006 addresses the distinction between monetary items and non-monetary items as follows:

- Foreign currency monetary items are translated using the spot exchange rate at the balance sheet date.
- Foreign currency non-monetary items measured in terms of historical cost are translated using the spot exchange rate on the date of the transaction.
- Foreign currency non-monetary items that are measured at fair value are translated using the spot exchange rate on the date when the fair value was determined.

Note that most foreign-invested enterprises choose to record their books in RMB because China is the economic environment in which they primarily generate and expend cash.

Financial instruments

Under ASBE, concepts such as “financial instruments,” “financial assets,” “financial liabilities” and “derivatives” are not introduced.

The following items are stated at cost (for assets, cost less impairment) and fair value measurement is not permitted:

- Receivables (accounts receivable, notes receivable and other receivables etc.)
- Payables (accounts payable, notes payable and other payables etc.)
- Investments (short-term investments and long-term investments etc.)
- Borrowings (short-term borrowings and long-term borrowings etc.)

You also don't need to account for derivatives until the gains and losses are realised.

CAS 2006 is different. Concepts such as “financial instruments,” “financial assets,” “financial liabilities” and “derivatives” are explicitly and specifically defined.

Financial assets are initially classified as financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables and available-for-sale financial assets. Financial liabilities are initially classified as financial liabilities at fair value through profit or loss and other financial liabilities.

Under CAS 2006, financial instruments are initially measured at fair value. Except for held-to-maturity investments, loans and receivables and other financial liabilities, which are subsequently measured at amortised cost using the effective-interest-rate method, all other financial instruments are subsequently measured at fair value.

Accounts receivables

Under ASBE, accounts receivables are presented at actual amounts net of provision for doubtful debts.

Under CAS 2006, however, accounts receivables (one type of financial asset) are recognised initially at fair value and subsequently measured at amortised cost using the effective-interest method, less provision for impairment. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the initial effective interest rate.

Subsequent recoveries of the amounts previously written down are reversed into profit or loss.

Inventories

Inventories are initially measured at cost.

Under ASBE, a company can choose the first-in/first-out method, the last-in/first-out method, the weighted average cost method or the specific identification method to assign the actual cost of inventories.

But under CAS 2006, the last-in/first-out method is not allowed.

At the balance sheet date, inventories are measured at the lower of cost and net realisable value.

Fixed assets

Fixed assets are measured initially at cost. The cost of a self-constructed fixed asset is a sum of the expenditures your company needs to incur to bring the asset to working conditions for its intended use.

A company should choose the depreciation method that reflects the pattern that the future economic benefits of that asset are expected to be consumed. The depreciation can be determined using the straight-line method, the units of production method, the double-diminishing balance method or the sum-of-the-digits method.

If there's indication that the fixed assets are impaired, then impairment tests will be carried out. If these tests show the recoverable amount as less than the carrying value, then an impairment loss is recognised and recorded in profit or loss.

Under ASBE, when there's indication that the need for an impairment provision recorded in a prior year no longer exists or has decreased, then the provision for impairment loss is reversed. Under CAS 2006, once an impairment loss is recognised, it should not be reversed in the subsequent periods.

Intangible assets

Intangible assets are measured initially at cost and are amortised over a period in which the economic benefits of those assets are expected to be consumed.

Under ASBE, intangible assets with an indefinite useful life are amortised over a period of not more than 10 years. Under CAS 2006, however, an intangible asset with an indefinite useful life is not amortised. CAS 2006 nonetheless requires companies to run annual impairment tests on such assets.

Under ASBE, expenditures on an internal research and development project are recognised in profit or loss for the period in which they are incurred. Under CAS 2006, these expenditures are classified into expenditures in the research phase and expenditures in the development phase. Expenditures in the research phase are recognised in profit or loss for the period in which they are incurred. Expenditures in the development phase are recognised as intangible assets only upon satisfying certain conditions.

Regulations under ASBE and CAS 2006 for impairment tests of intangible assets are similar to fixed assets, except for intangible assets with indefinite useful lives (which under CAS 2006 has to be tested for impairment at least once a year).

Since all lands are owned by the state in China, companies should normally make a lump sum payment to obtain a land-use right for a certain period of time. The land-use right is recognised as an intangible asset and is amortised over its approved land-use period.

Borrowing costs

Under ASBE, qualifying assets only include fixed assets and properties under development by real estate development companies. Only borrowing costs incurred on specific borrowings are eligible for capitalisation; borrowing costs on general borrowings are recognised as expenses during the period in which they are incurred.

Under CAS 2006, qualifying assets include fixed assets, investment properties, inventories, costs of construction contract and development expenditures recognised as intangible assets etc. Borrowing costs incurred on both specific borrowings and general borrowings are eligible for capitalisation.

Share-based payments

Under ASBE, share-based payments are not accounted for until the date of settlement. If the equity instruments granted are those of the company's parent or another company within the group, the accounting treatment is not pushed down to the company.

Under CAS 2006, regardless of whose equity instruments are granted (the company, the parent or another company within the group), the company is required to recognise the service received as expenses during the vesting period. You'll have to measure the equity-settled share-based payments at the fair value of the equity instruments granted at the grant date. They cannot be remeasured. Cash-settled share-based payments, however, are measured at the fair value of the liabilities and are remeasured at each balance sheet date and the settlement date, with the changes in fair value recognised in profit or loss.

Revenue recognition

You can only recognise revenue from the sale of goods when:

- The significant risks and rewards of ownership of the goods are transferred to the buyer;
- The company does not keep continuing managerial involvement to the degree usually associated with ownership or effective control over the goods sold; and
- It's probable the economic benefit associated with the transaction will flow to the company and the amount of revenue and associated costs can be measured reliably.

Revenue arising from the rendering of services is recognised using the “percentage-of-completion method” when:

- The amount of revenue and associated costs arising from the rendering of services can be reliably estimated; and
- It's probable that the economic benefits associated with the transaction will flow in and the stage of completion of transaction can be reliably measured.

Government grants

Under ASBE, government grants are recognised in profit or loss when they are received, unless a related government document calls for specific accounting treatment (e.g., it may require grants to be recognised directly into equity).

Under CAS 2006, government grants are recognised when they're received and the company can comply with the conditions attached to the grants. Government grants related to assets are recognised as deferred income, and evenly amortised over the useful lives of the related assets in profit or loss.

Government grants related to income are accounted for as follows:

- Where the grants are to be compensation for related expenses or losses to be incurred in the future, they're recognised as deferred income, and included in profit or loss over the periods in which the related costs are recognised
- Where the grants are compensation for related expenses or losses already incurred, the grants are recognised immediately in profit or loss for the current period
- Under CAS 2006, government grants are presented as a gross amount as deferred income or non-operating income and are not offset against the carry amount of the relevant assets or the expenses to be compensated.

Deferred income taxes

Under ASBE, either the tax payable method or the income statement-based tax-effect accounting method may be used in accounting for income taxes.

Under CAS 2006, only the balance sheet-based tax-effect accounting method is used in accounting for income taxes.

Owners' equity

Owners' equity shown on the balance sheet includes paid-in capital, capital reserves, surplus reserve and undistributed profits.

Paid-in capital is the actual amount of registered capital contributed by the investors in a company in accordance with the company's articles of association, investment contracts or agreements. The amount of capital contributed by an investor in excess of its share of the registered capital is shown as capital reserves.

For foreign-invested enterprises, surplus reserves include the following:

- **Reserve fund:** This is a fund appropriated from net profit in accordance with laws and administrative regulations. When approved, the fund can be used to offset accumulated losses or increase registered capital. Wholly owned foreign enterprises need to appropriate a minimum reserve fund that's 10% of the current year net profit (after offsetting any accumulated loss, if any), unless the cumulated reserve fund appropriated reaches 50% of the registered capital. For other foreign-invested enterprises, the appropriation rate is determined by the board of directors.
- **Enterprise expansion fund:** This is a fund appropriated from net profit in accordance with laws and administrative regulations for the purpose of the enterprise's production and development. When approved, the fund can be used to increase registered capital. This fund is not required for wholly owned foreign enterprises. For other foreign-invested enterprises, the appropriation rate is determined by the board of directors.

Business combination

Under ASBE, business combination is not specifically addressed.

Under CAS 2006, the purchase method is used for business combination of entities not under common control. While goodwill is not amortised, it is reviewed for impairment at least once a year.

For a business combination of entities under common control, the pooling-of-interests method is used.

Consolidation (for investments in subsidiaries)

Under ASBE, the following investee entities are defined as subsidiaries and are consolidated:

- Investee entities over which the parent holds more than 50% (not including 50%) of the registered capital of the investee; or
- Investee entities over which the parent holds 50% or less of the registered capital of the investee, but in substance, has control.

Control is the parent's ability to govern the financial and operating policies of a subsidiary in order to gain benefits from the latter's activities.

Under CAS 2006, the focus is on the power of control in determining whether a parent/subsidiary relationship exists. A parent includes all subsidiaries within the scope of consolidation, as long as control exists.

Under ASBE, non-listed companies are not required to prepare consolidated financial statements, while there is no such exemption under CAS 2006.

Consolidation (for investments in joint ventures)

Joint ventures are companies in which the investor has joint control with the other investor, generally accompanying a shareholding of 50% of the voting rights.

Under ASBE, joint ventures are consolidated using the "proportionate consolidation method."

Under CAS 2006, investments in joint ventures are accounted for using the "equity method."

Consolidation (for investments in associates)

Associates are companies in which the investor has significant influence but no control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Under both ASBE and CAS 2006, investments in associates are accounted for using the equity method.

Stand-alone financial statements

All companies, with or without subsidiaries, are required to prepare stand-alone financial statements (as opposed to consolidated financial statements).

Under ASBE, investments in subsidiaries, joint ventures and associates are all accounted for using the equity method in stand-alone financial statements. Under CAS 2006, investments in subsidiaries are accounted for using the "cost method." Investments in joint ventures and associates are accounted for using the equity method.

Cash flow statements

Your company is required, under ASBE, to prepare cash flow statements using both the direct and indirect method.

Under CAS 2006, cash flow statements are prepared using the direct method. A reconciliation of net profit to the amount of cash flows from operating activities using the indirect method is disclosed in the notes to the financial statements.

Related-party relationships

Specific disclosures are required for related-party relationships and transactions.

Under ASBE, if a party has the power to directly or indirectly exercise control, joint control or significant influence over another party, then these parties are in a related-party relationship. If two or more parties are controlled by the same party, then there's also a related-party relationship between the controlled parties.

Under CAS 2006, besides the above-mentioned related-party relationships, if a party is controlled or jointly controlled by its investor, and another party is at least significantly influenced by the same investor, these two parties are also regarded as related parties.

State-owned enterprises are common in China. However, these enterprises are not regarded as related parties merely on the basis that they're all controlled by the state (unless another related-party relationship exists between them).

Accounting Standards for Small Enterprises

The Accounting Standards for Small Enterprises (ASSE), issued by MoF in November 2011, is only applicable to small enterprises that have not yet adopted CAS 2006. It will be effective from 1 January 2013, and early adoption is encouraged. The ASSE's main objectives are to simplify the bookkeeping of small enterprises and to eliminate the differences between the books and taxes as much as possible.

The criteria for qualifying as a small enterprise, mainly in terms of the size and nature of the enterprises, are set out in a regulation issued jointly by five ministries under the State Council (including MoF and the Ministry of Industry and Information Technology, etc). Moreover, small enterprises that fall into one of the following three categories are not allowed to adopt ASSE:

- Small enterprises that are the parents or subsidiaries within a consolidation group (For this purpose, the parents or subsidiaries only refer to those companies incorporated within China)

Under ASSE, accounting treatments are more in line with tax laws and regulations. For example, assets are stated at cost and provision for impairment is not allowed.

- Small enterprises that issue publicly-traded shares or bonds
- Small enterprises that are financial institutions or have the nature of financial institutions

Differences between accounting profit and taxable profit

You would normally have to make necessary adjustments to your company's accounting profit in accordance with tax regulations in order to arrive at its taxable profit. This is inevitable, and with the issuance of CAS 2006, differences between the accounting books and tax returns have increased. For the purpose of calculating enterprise income tax, accounting regulations/accounting standards are significantly different from tax regulations.

For example:

- If companies make provisions for impairment of assets without first obtaining approval from the tax authorities, the amounts of the provisions must be added back to the accounting profit when determining taxable profit.
- The non-straight-line depreciation method is not allowed, except under certain specific circumstances (such as fixed assets suffering from severe corrosion over the years). In addition, the tax authorities have set minimum depreciation periods for certain assets.
- Unrealised gains and losses arising from changes in fair value (such as fair value changes of derivatives) are not tax payable/deductible.

Audit requirements and practices

Audited financial statements

Foreign-invested enterprises are required to engage a Chinese-registered certified public accounting (CPA) firm (which includes approved Sino-foreign joint venture CPA firms) to audit their statutory annual financial statements. It is generally the duty of the board of directors of a foreign-invested enterprise to appoint the auditor.

Audits are required under the company laws, financial reporting regulations and income tax laws in China, and audited financial statements should be filed with the tax authorities, together with the annual income tax returns. Foreign-invested enterprises are required to provide auditors with all the enterprise's documents, books and reports. The financial statements to be submitted for an annual audit include the balance sheet, income statement, statement of changes in owners' equity, statement of cash flows and relevant supporting notes.

Audited financial statements must be submitted to a number of government authorities, mainly:

- The local offices of the State Administration of Industry and Commerce
- The State Administration of Taxation
- The local Finance Bureau
- The State Administration of Foreign Exchange

Audited financial statements must be submitted to the relevant authorities within four to six months of year-end, depending on local government requirements.

Accounting profession

The national regulatory authority for China's CPA profession is the Ministry of Finance. The Chinese Institute of Certified Public Accountants (CICPA), which was established in late 1988, is the organisation that regulates the profession. In addition to licensing certified public accountants, the CICPA's main functions are:

- To ensure that all CPAs perform their duties in accordance with the relevant laws and regulations
- To promote the development of the profession
- To enhance the professionalism of its members and maintain their legitimate professional rights
- To promote the exchange of work experiences and business information
- To improve the association between Chinese CPAs and their foreign counterparts

The registration of CPAs in China was discontinued in 1952 and resumed again in 1980, resulting in a shortage of experienced and qualified professionals and a general unfamiliarity with international practices. However, in recent years, with an increasing emphasis on accounting education and the encouragement of more people to enter the profession, this situation is improving rapidly.

Only Chinese-registered CPA firms may audit the statutory financial statements of foreign-invested enterprises, certify capital contributions, certify the financial statements upon the liquidation and dissolution of a venture and perform other attesting services on financial statements in accordance with Chinese standards. Many of the larger, international accounting firms have established a presence in China through Sino-foreign joint ventures and local member firms. These firms generally combine qualified PRC accountants with staff support from the firms' overseas offices, particularly offices in Hong Kong, Taiwan and the United States. The joint ventures and member firms can, with this support, provide most of the usual auditing, accounting and taxation services offered by international accounting firms elsewhere in the world.

Although approved joint ventures and member CPA firms are the only foreign-owned firms able to perform statutory audits in China, other foreign CPA firms may be engaged to perform certain audit and accounting work for accounting and management control purposes. This includes developing accounting and internal control systems, training local accounting personnel, reviewing specific financial information for accuracy and reliability, and performing full or limited-scope audits to meet the audit requirements of the foreign partner's parent company. If requested by the foreign partner and with the consent of the Chinese partner, in certain cases, they may also perform joint audits with the local CPA firms to ensure that the audits will satisfy both the Chinese and the foreign partner's home country auditing standards and requirements.

Auditing standards

The audit requirements for enterprises are contained in the Accounting Law, Company Law, and in the Regulations on Accounting and Financial Reporting.

The requirement for annual audits is also contained in the Enterprise Income Tax Law, which came into effect in January 2008.

Rules on the audits of financial statements by certified public accountants were formulated by the CICPA and first published in December 1988. They were subsequently updated in December 1995 before the CICPA issued new auditing standards (in 2006) that were substantially converged with International Standards on Auditing; these standards came into effect from 1 January 2007. In November 2010, CICPA issued the revised China Standards on Auditing (CSA 2010, also Clarity CSAs) to keep continuous convergence with Clarity International Standards on Auditing; the Clarity CSAs came into effect on 1 January 2012.

A typical unqualified audit report would read as follows:

“We have audited the accompanying financial statements of XYZ Company, which comprise the balance sheet as at [date], and the income statement, statement of changes in owners’ equity and cash flow statement for the year then ended, and the notes to these financial statements.

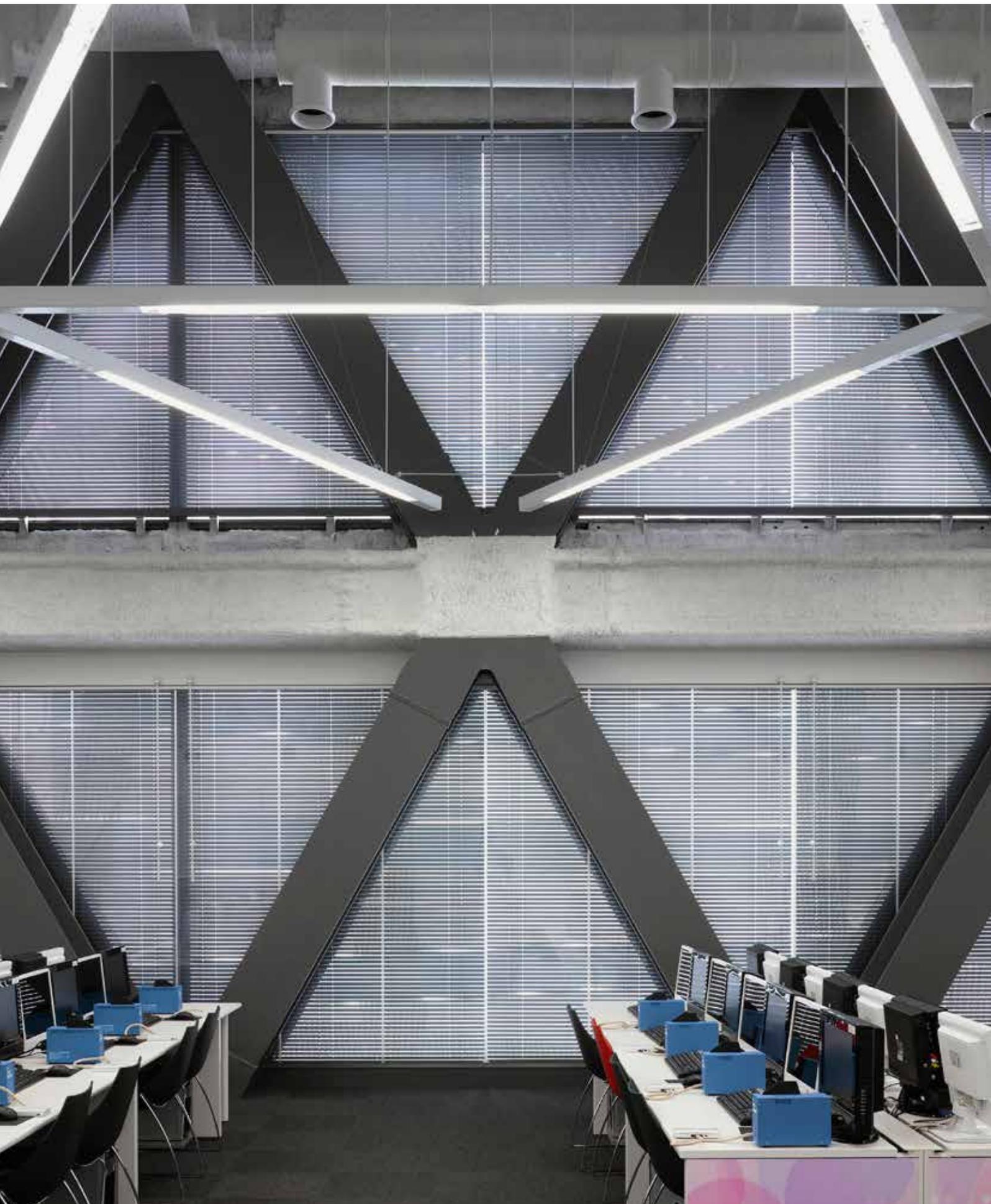
Management’s responsibility for the financial statements

“Management of XYZ Company is responsible for the preparation and fair presentation of these financial statements in accordance with the requirements of Accounting Standards for Business Enterprises, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.”

An unqualified opinion would typically be as follows:

“In our opinion, the financial statements present fairly, in all material respects, the financial position of ABC Company as at [date], and its financial performance and its cash flows for the year then ended in accordance with the requirements of Accounting Standards for Business Enterprises.”



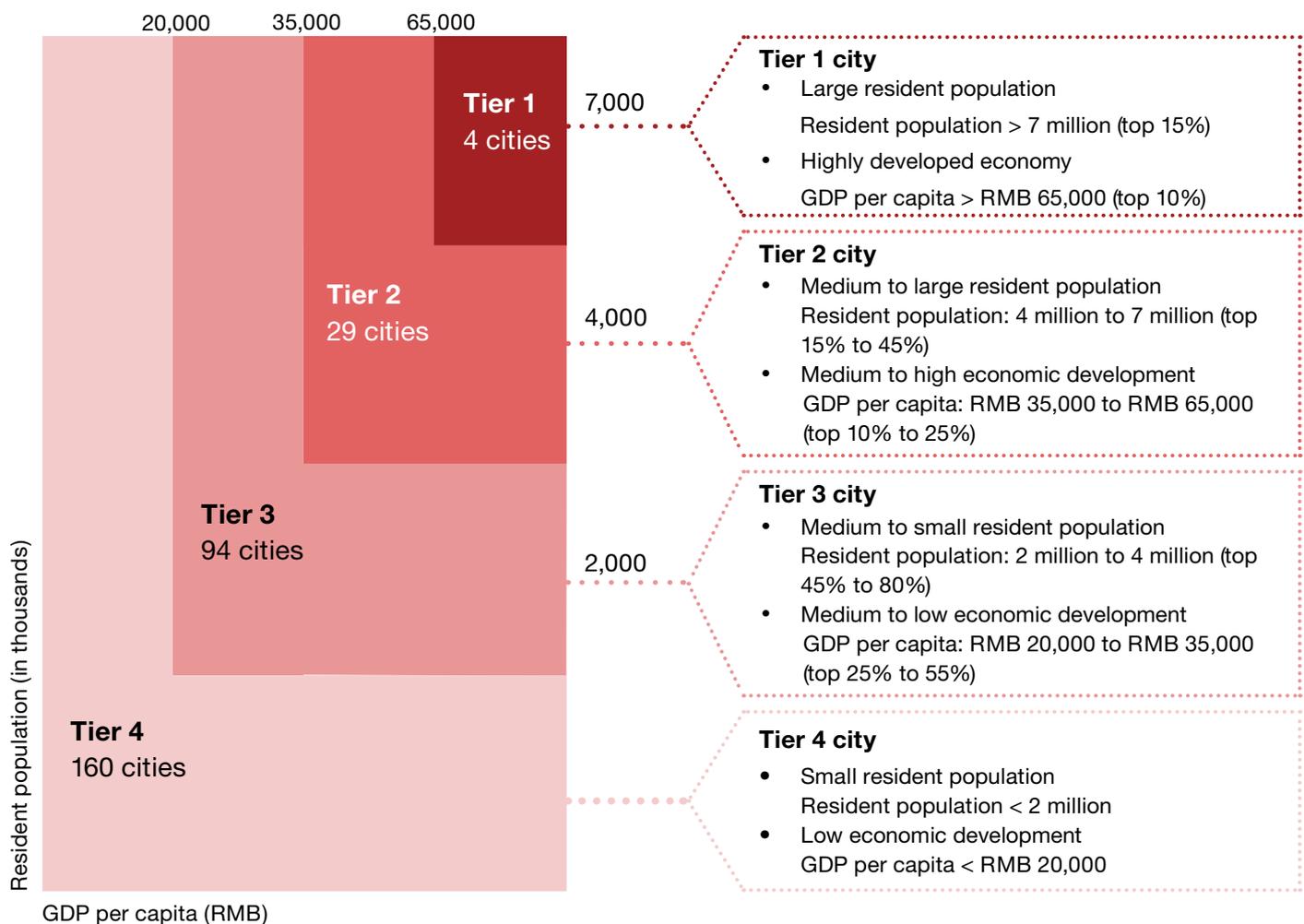


Appendices

- *City tier and regional overview*
- *Comparison of index of CAS 2006 and IFRS*
- *Illustrative financial statements under CAS 2006*
- *Brief summary of China tax categories, tax rates and tax bases*
- *Brief summary of tax filing patterns*
- *Summary of withholding taxes for corporations resident in treaty countries/regions*
- *Minimum registered capital of a foreign-invested enterprise (FIE)*

City tier and regional overview

According to PwC methodology, Chinese cities (prefecture level and above) can be grouped into four tiers, based on resident population size and GDP per capita



Population measurement:

- Resident population is used here in our methodology as it more accurately reflects the cities' population size
- The GDP per capita data from National Statistics Bureau is also calculated based on resident population

Source : China City Yearbook 2010, PwC analysis

Most Tier 1 and 2 cities are located in the eastern and central regions

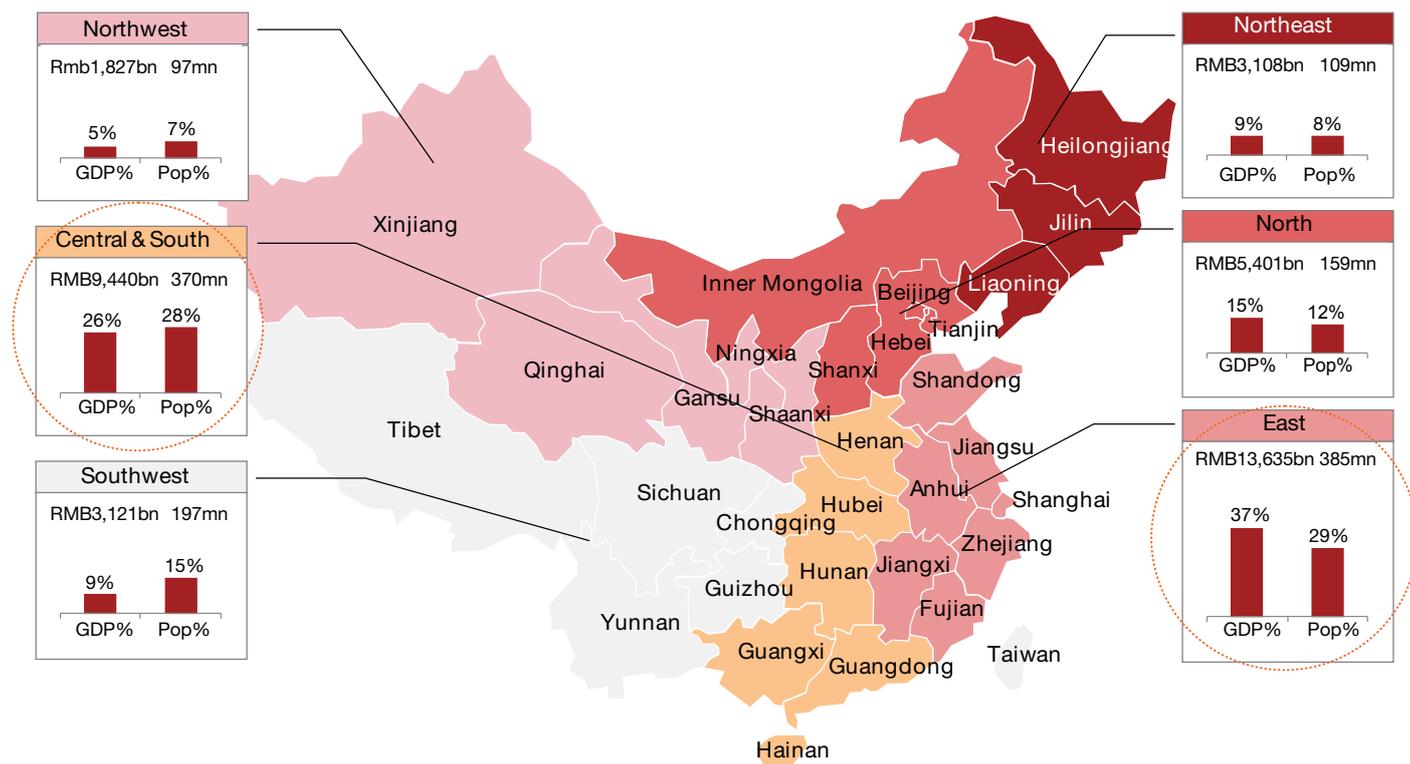


Source : China City Yearbook 2010 (2009 figures), PwC analysis

Tier	City			
Tier 1	Beijing	Shanghai	Guangzhou	Shenzhen
Tier 2	Changchun	Shenyang	Tianjin	Tangshan
	Dalian	Yantai	Qingdao	Jinan
	Zibo	Zhengzhou	Nanjing	Yangzhou
	Wuxi	Nantong	Suzhou	Jiaxing
	Hangzhou	Shaoxing	Ningbo	Taizhou
	Hefei	Wuhan	Nanchang	Changsha
	Fuzhou	Quanzhou	Dongguan	Foshan
	Chengdu			

From a regional perspective, the “East” and “Central & South” regions account for over half of China’s population and an even larger proportion of GDP

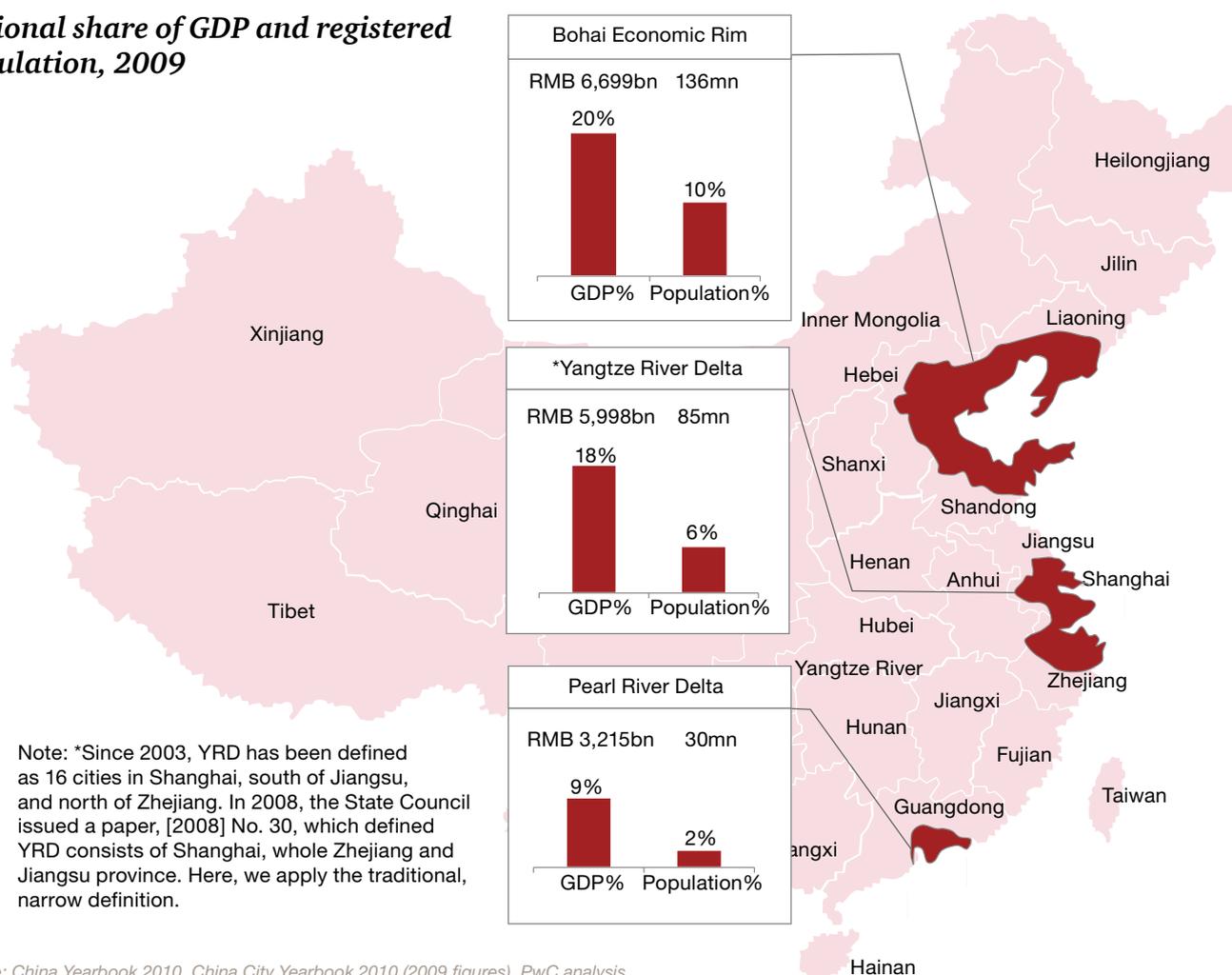
Regional share of GDP and resident population, 2009



Source: China Yearbook 2010, China City Yearbook 2010 (2009 figures), PwC analysis

The Yangtze River Delta (YRD), Pearl River Delta (PRD) and Bohai Economic Rim (BER) constitute nearly 50% of GDP with approximately 18% of the population

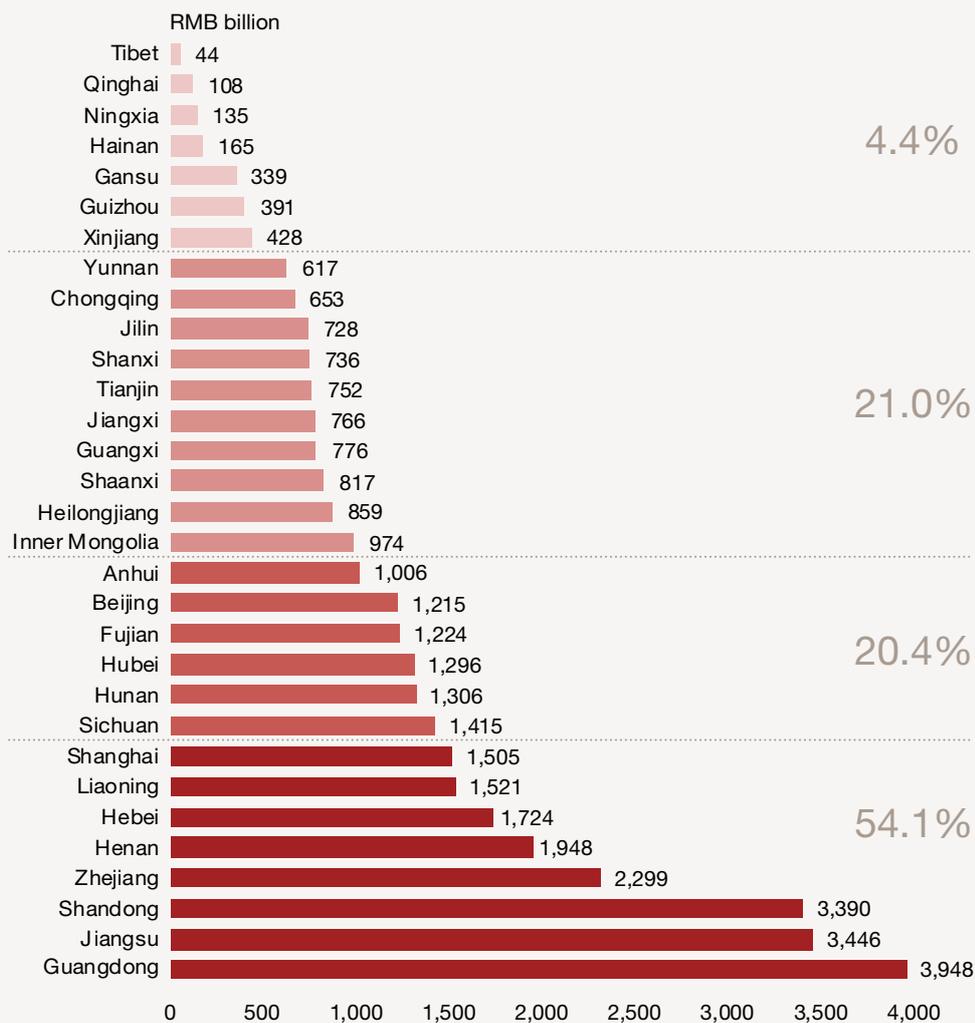
Regional share of GDP and registered population, 2009



Source: China Yearbook 2010, China City Yearbook 2010 (2009 figures), PwC analysis

Zone	City
BER 26 cities	<ul style="list-style-type: none"> Beijing, Tianjin Liaoning province: Dalian, Dandong, Yingkou, Panjin, Shenyang, Fuxin, Jinzhou, Huludao, Chaoyang Hebei province: Shijiazhuang, Qinghuangdao, Chengde, Tangshan, Cangzhou, Xingtai, Langfang Shandong province: Qingdao, Yantai, Weihai, Jinan, Binzhou, Dongying, Zibo, Weifang
YRD* 16 cities	<ul style="list-style-type: none"> Shanghai Zhejiang province: Hangzhou, Ningbo, Jiaxing, Zhoushan, Shaoxing, Taizhou (in Zhejiang), Huzhou Jiangsu province: Suzhou, Wuxi, Nanjing, Yangzhou, Nantong, Changzhou, Zhenjiang, Taizhou (in Jiangsu)
PRD 9 cities	<ul style="list-style-type: none"> Guangdong province: Guangzhou, Shenzhen, Zhuhai, Foshan, Huizhou, Zhaoqing, Jiangmen, Zhongshan, Dongguan

GDP by province, * 2009



* Excludes Taiwan, Hong Kong and Macau

Source: China Yearbook 2010 (2009 figures), China City Yearbook 2010, PwC analysis

Comparison of index of CAS 2006 and IFRS

Type	China Accounting Standards (CAS)	Type	International Financial Reporting Standards (IFRS)
R	Basic standard		Framework for the preparation and presentation of financial statements
R	Inventories	G	IAS 2 Inventories
R	Long-term equity investments	G	IAS 27 Consolidated and separate financial statements IAS 28 Investments in associates IAS 31 Interests in joint ventures
N	Investment property	G	IAS 40 Investment property
R	Fixed assets	G	IAS 16 Property, plant and equipment IFRS 5 Non-current assets held for sale and discontinued operations
N	Biological assets	I	IAS 41 Agriculture
R	Intangible assets	G	IAS 38 Intangible assets
R	Exchange of non-monetary assets	G	IAS 16 Property, plant and equipment IAS 38 Intangible assets IAS 40 Investment property
N	Impairment of assets	G	IAS 36 Impairment of assets
N	Employee benefits	G	IAS 19 Employee benefits
N	Enterprise pension funds	I	IAS 26 Accounting and reporting by retirement benefit plans
N	Share-based payment	G	IFRS 2 Share-based payment
R	Debt restructurings	G	IAS 39 Financial instruments: Recognition and measurement
R	Contingencies	G	IAS 37 Provisions, contingent liabilities and contingent assets
R	Revenue	G	IAS 18 Revenue
R	Construction contracts	G	IAS 11 Construction contracts
N	Government grants	G	IAS 20 Accounting for government grants and disclosure of government assistance
R	Borrowing costs	G	IAS 23 Borrowing costs
N	Income taxes	G	IAS 12 Income taxes
N	Foreign currency translation	G	IAS 21 The effects of changes in foreign exchange rates IAS 29 Financial reporting in hyperinflationary economies

G	General standards
I	Specific industry standards
RD	Reporting and disclosure standards
N	New standards
R	Revised standards

Type	China Accounting Standards (CAS)	Type	International Financial Reporting Standards (IFRS)
N	Business combinations	G	IFRS 3 Business combinations
R	Leases	G	IAS 17 Leases
N	Recognition and measurement of financial instruments	G	IAS 39 Financial instruments: Recognition and measurement
N	Transfer of financial assets	G	IAS 39 Financial instruments: Recognition and measurement
N	Hedging	G	IAS 39 Financial instruments: Recognition and measurement
N	Direct insurance contracts	I	IFRS 4 Insurance contracts
N	Reinsurance contracts	I	IFRS 4 Insurance contracts
N	Extraction of oil and natural gas	I	IFRS 6 Exploration for and evaluation of mineral resources
R	Changes in accounting policies, estimates and corrections of errors	G	IAS 8 Accounting policies, changes in accounting estimates and errors
R	Events after the balance sheet date	G	IAS 10 Events after the balance sheet date
N	Presentation of financial statements	RD	IAS 1 Presentation of financial statements IFRS 5 Non-current assets held for sale and discontinued operations
R	Cash flow statements	RD	IAS 7 Cash flow statements
R	Interim financial reporting	RD	IAS 34 Interim financial reporting
N	Consolidated financial statements	RD	IAS 27 Consolidated and separate financial statements
N	Earnings per share	RD	IAS 33 Earnings per share
N	Segment reporting	RD	IFRS 8 Operating segments
R	Related party disclosures	RD	IAS 24 Related party disclosures
N	Presentation and disclosures of financial instruments	RD	IFRS 7 Financial instruments: Disclosures IAS 32 Financial instruments: Presentation
N	First-time adoption of accounting standards for business enterprises	G	IFRS 1 First-time adoption of international financial reporting standards

Illustrative financial statements under CAS 2006

(XYZ Co. Ltd.) Balance sheet

As at 31 December 2013
(in RMB thousands, unless otherwise stated)

	2013	2012
Assets		
Current assets		
Cash at bank and on hand	22,228	-
Financial assets held for trading	14,839	-
Notes receivable	9,449	-
Accounts receivable	3,672	-
Advances to suppliers	2,123	-
Interest receivable	331	-
Dividends receivable	423	-
Other receivables	3,456	-
Inventory	24,700	-
Current portion of non-current assets	311	-
Total current assets	81,532	-
Non-current assets		
Available-for-sale financial assets	10,015	-
Held-to-maturity investments	7,800	-
Long-term receivables	2,322	-
Long-term equity investments	13,373	-
Investment properties	3,000	-
Fixed assets	149,895	-
Construction in progress	23,000	-
Construction materials	346	-
Intangible assets	20,631	-
Development costs	2,233	-
Goodwill	2,100	-
Long-term prepaid expenses	458	-
Deferred tax assets	3,319	-
Total non-current assets	238,492	-

	2013	2012
Liabilities and owners' equity		
Current liabilities		
Short-term borrowings	9,524	-
Financial liabilities held for trading	595	-
Notes payable	5,200	-
Accounts payable	12,470	-
Advances from customers	316	-
Employee benefits payable	2,788	-
Taxes payable	2,942	-
Interest payable	678	-
Dividends payable	758	-
Other payables	1,230	-
Current portion of non-current liabilities	992	-
Total current liabilities	37,493	-
Non-current liabilities		
Long-term borrowings	100,825	-
Long-term payables	3,259	-
Provisions	4,231	-
Deferred tax liabilities	12,370	-
Other non-current liabilities	320	-
Total non-current liabilities	121,005	-
Owners' equity		
Paid-in capital	25,300	-
Capital reserves	16,092	-
Surplus reserves	14,699	-
Undistributed profits	84,535	-
Total owners' equity	140,626	-
Total liabilities and owners' equity	299,124	-

Note: comparative figures are not presented in these illustrated financial statements

(XYZ Co. Ltd.) Income statement

For the year ended 31 December 2013
(in RMB thousands, unless otherwise stated)

	2013	2012
Revenue	211,034	-
Less:		
Cost of sales	(76,737)	-
Tax and surcharges	(5,416)	-
Selling and distribution expenses	(46,940)	-
General and administrative expenses	(28,786)	-
Financial expenses-net	(7,073)	-
Asset impairment loss	(4,650)	-
Add:		
Gains/(losses) from changes in fair value	(550)	-
Investment income/(losses)	(174)	-
Operating profit	40,708	-
Add: Non-operating income	1,963	-
Less: Non-operating expenses	(90)	-
Total profit	42,581	-
Less: Income tax expenses	(10,005)	-
Net profit	32,486	-
Other comprehensive income	350	-
Total comprehensive income	32,836	-

Note: comparative figures are not presented in these illustrated financial statements

(XYZ Co. Ltd.) Statement of changes in owners' equity

For the year ended 31 December 2013
(in RMB thousands, unless otherwise stated)

	Paid-in capital	Capital reserves	Surplus reserves	Undistributed profit	Total
Balance	24,350	15,742	11,441	69,189	120,722
Net profit	-	-	-	32,576	32,576
Fair value gains on available-for-sale financial assets	-	350	-	-	350
Capital contributed by owners	950	-	-	-	950
Profit distribution	-	-	-	-	-
1. Appropriation to surplus reserve	-	-	3,258	(3,258)	-
2. Dividend distribution to owners	-	-	-	(13,972)	(13,972)
Balance at the end of year	25,300	16,092	14,699	84,535	140,626

(XYZ Co. Ltd.) Cash flow statement

For the year ended 31 December 2013

(in RMB thousands, unless otherwise stated)

	2012	2013
Cash flows from operating activities		
Cash received from sales of goods or rendering of services		-
Refund of taxes and surcharges	2,210	-
Cash received related to other operating activities	1,420	-
Subtotal of cash inflows	3,630	-
Cash paid for goods and services	(69,203)	-
Cash paid to and on behalf of employees	(4,509)	-
Payments of taxes and charges	(10,317)	-
Cash paid relating to other operating activities	(101,706)	-
Subtotal of cash outflows	(185,735)	-
Net cash flows from operating activities	(182,105)	-
Cash flows from investing activities		
Cash received from disposal of investments	880	-
Cash received from returns on investments	448	-
Net cash received from disposal of fixed assets, intangible assets and other long-term assets	474	-
Subtotal of cash inflows	1,802	-
Cash paid to acquire fixed assets, intangible assets and other long-term assets	(12,205)	-
Cash paid to acquire investments	(1,331)	-
Subtotal of cash outflows	(13,536)	-
Net cash flows from investing activities	(11,734)	-
Cash flows from financing activities		
Cash received from capital contributions	950	-
Cash received from borrowings	58,500	-
Subtotal of cash inflows	59,450	-
Cash repayments of borrowings	(71,000)	-
Cash payments for interest expenses and distribution of dividends or profits	(21,503)	-
Subtotal of cash outflows	(92,503)	-
Net cash flows from financing activities	(33,053)	-
Effect of foreign exchange rate changes on cash and cash equivalents	535	-
Net increase in cash and cash equivalents	(226,357)	-
Add: cash and cash equivalents at beginning of year	36,212	-
Cash and cash equivalents at end of year	(190,145)	-

Note: comparative figures are not presented in these illustrated financial statements

Brief summary of China tax categories, tax rates and tax bases*

(excluding tax treaty considerations, by order of frequency)

Tax categories	Tax rates	Tax base
Corporate Income Tax (CIT)	The standard CIT rate: 25%; Small and thin-profit enterprises: 20%; Qualified new/high tech enterprises: 15%; Income withholding tax rate for passive income derived by non-tax resident enterprises (TREs): 10%	Taxable income, in general cases
Individual Income Tax (IIT) for employment income	3% to 45%	Monthly salary as deducted by social security contribution, monthly deduction (standard deduction: RMB 3,500 per month; deduction for foreign individuals: RMB 4,800 per month), and tax-exempt income
Value-added Tax (VAT)	General VAT rate: 17% or 13%; VAT rate for transportation services: 11%; VAT rate for certain modern services: 6%; VAT rate applicable to small-scale taxpayer: 3%; VAT refund rate: 0% to 17%	Net sales for general VAT payers (VAT payable = output VAT – input VAT); Gross sales for small-scale taxpayers
Business Tax (BT)	3% to 20%	Business turnover
Consumption Tax (CT)	1% to 45%, and/or RMB 0.1 to RMB 250 per piece/litre/ton	Sales amount and/or sales volume
Urban Construction and Maintenance Tax (UCMT)	7% for urban areas; 5% for county areas; 1% for other areas	The amount of value-added tax (VAT), business tax (BT) and consumption tax (CT) actually paid
Educational Surcharge (ES)	3%	The amount of value-added tax (VAT), business tax (BT) and consumption tax (CT) actually paid
Local Educational Surcharge (LES)	2%	The amount of value-added tax (VAT), business tax (BT) and consumption tax (CT) actually paid

*The tax rates and tax base for each tax categories are based on the state policies, publicised as at 31 January 2012

Tax categories	Tax rates	Tax base
Customs Duty (CD)	General rates and preferential rates, charged in either “specific” or “ad valorem” terms	Quantitative amount of the goods; or customs dutiable value
Stamp Duty (SD)	0.005% to 0.1%; or RMB 5 per piece	Contractual amount
Real Estate Tax (RET)	1.2%; or 12%	70% to 90% of the original value of building; or 12% for the rental value
Deed Tax (DT)	3% to 5%	Transaction value or deemed value
Land Appreciation Tax (LAT)	Progressive rates 30% to 60%	Gain from transfer of real property
Vehicle and Vessel Tax (VVT)	Vehicle: RMB 36 to RMB 5400 per vehicle RMB 16 to RMB 120 per tonnage Vessel: RMB 3 to RMB 6 per tonnage RMB 600 to RMB 2,000 per metre	A fixed-unit amount per vehicle or deadweight tonnage
Urban and Township Land-use Tax (UTLT)	RMB 0.6 to RMB 30 per square metre, depending on the land location	Area of the land plot
Resource Tax (RT)	5% to 10% of sales turnover for crude oil and natural gas; or RMB 0.3 to RMB 60 per ton or per cubic metre for certain items	Sales turnover base; or Tonnage or volume base
Motor Vehicle Acquisition Tax (MVAT)	10%	Purchase price, plus additional charges; or Customs dutiable value plus customs duty (CD) and consumption tax (CT)
Vessel Tonnage Tax (VTT)	General rates: RMB 2.1 to RMB 31.8 per net tonnage; or Preferential rates: RMB 1.5 to RMB 22.8 per net tonnage (depending on the most-favoured-nation treatment or convention reached by China and the nationality of the taxable vessel)	Net tonnage
Tobacco Tax (TT)	20%	Purchasing value of tobacco leaves
Arable Land Occupation Tax (ALOT)	Rates: RMB 5 to RMB 50 per square metre, determined by the local government	Based on the space of area actually occupied

Brief summary of tax filing patterns*

Tax categories	Taxpayers	Withholding agent(s)	Filing periods	In-charge tax bureaus collecting the taxes
Corporate Income Tax (CIT)	Tax resident enterprises and non-tax resident enterprises (non-TREs) which derive income in the territory of China	For income derived by non-tax resident enterprises (non-TREs) which have no establishments or places in China, the payer shall be the withholding agent	Provisional reporting to be made on a monthly or quarterly basis (depending on the amount of tax payable) and payment in advance, to be settled within 15 days from the end of each month or quarter; Annual CIT return shall be filed on or before 31 May following the end of a year, subject to some earlier due date set by local level tax bureaus	State Tax Bureau in most locations, and the Local Tax Bureau in other locations
Individual Income Tax (IIT) (specific to Employment Income)	Individuals who have domiciles in China or individuals who do not have domiciles in China but have resided in China for one year (tax residents); and Individuals who do not have domiciles in China but have resided in China for less than one year (non-tax residents)	The unit or person that pays the taxable income to the taxpayer	Monthly basis; IIT tax return shall be filed within 15 days following the end of each month	Local Tax Bureau
Value-added Tax (VAT)	Enterprises engaged in the sales or importation of goods and the provision of repairs, replacement and processing services; and Enterprises engaged in the provision of transportation service and certain modern services in China (under the VAT reform pilot program)	Where an overseas entity/individual provides taxable services in China and does not have a business establishment, its agent in China shall be the withholding agent. In the absence of such an agent, the recipient of the service shall be the withholding agent	Monthly filing as general practice; Tax filing and payment shall be completed within 15 days following the end of each month/quarter	State Tax Bureau

*The tax rates and tax base for each tax categories are based on State Policies, publicised as at 31 January 2012.

Tax categories	Taxpayers	Withholding agent(s)	Filing periods	In-charge tax bureaus collecting the taxes
Business Tax (BT)	Enterprises or individuals engaged in the provision of taxable services, transfer of intangible assets or sale of immovable properties in China	Where an overseas unit/individual provides taxable services, transfers intangible assets or sells immovable property in China and does not have business establishments in China, its agent in China shall be the withholding agent. In the absence of such an agent, the transferee or the purchaser shall be the withholding agent	Monthly filing as general practice; Tax filing and payment shall be completed within 15 days following the end of each month/quarter	Local Tax Bureau
Consumption Tax (CT)	Units and individuals engaged in the production, subcontracted processing and importation of taxable consumer goods; units and individuals selling specific consumer goods as determined by the State Council	N/A	Monthly filing as general practice; Tax filing and payment shall be completed within 15 days following the end of each month/quarter	State Tax Bureau
Urban Construction and Maintenance Tax (UCMT)	Any unit or individual liable for value-added tax (VAT), business tax (BT) and consumption tax (CT)	N/A	Payment and filing simultaneously with VAT, BT and CT filing and payment	Local Tax Bureau
Educational Surcharge (ES)	Any unit or individual liable for value-added tax (VAT), business tax (BT) and consumption tax (CT)	N/A	Payment and filing simultaneously with VAT, BT and CT filing and payment	Local Tax Bureau

Tax categories	Taxpayers	Withholding agent(s)	Filing periods	In-charge tax bureaus collecting the taxes
Local Educational Surcharge (LES)	Any unit or individual liable for value-added tax (VAT), business tax (BT) and consumption tax (CT)	N/A	Payment and filing simultaneously with VAT, BT and CT filing and payment	Local Tax Bureau
Customs Duty (CD)	The consignee of import goods; The consignor of export goods; and The owners of entry articles	N/A	The duty payer of the import goods shall, within 14 days of the vehicle of transport's entry declaration, submit a declaration to the customs office of the place of entry; The duty payer shall pay the duties at the designated bank within 15 days of the day when customs issues a duty payment notice	Customs Office
Stamp Duty (SD)	All enterprises and individuals who execute or receive "specified dutiable documents"	N/A	The taxpayer should calculate the payable amount, purchase and properly attach a sufficient number of duty stamps; Where the payable amount is relatively large or stamps are required often, the taxpayer may apply to use payment slips instead of duty stamps, or to calculate and pay the total amount due periodically	Local Tax Bureau
Real Estate Tax (RET)	Owners, users or custodians of houses and buildings	N/A	Calculated on an annual basis and paid by instalments, according to a filing schedule determined by the local government	Local Tax Bureau
Deed Tax (DT)	The transferee/assignee units or individuals on the transfer of ownership of land-use rights or real properties within China	N/A	Technically, payment to be settled within 10 days after the date of signing the property transfer agreement; However, in view of the practical difficulties, local practices may vary, depending on the in-charge tax authority	Local Tax Bureau
Land Appreciation Tax (LAT)	Units and individuals which derive income from the transfer of state-owned land-use rights, buildings and other structures on that land	N/A	Technically, the tax return should be filed within seven days of signing of the agreement for the transfer of the real estate property; However, in view of the practical difficulties, local practices may vary, depending on the in-charge tax authority	Local Tax Bureau

Tax categories	Taxpayers	Withholding agent(s)	Filing periods	In-charge tax bureaus collecting the taxes
Vehicle and Vessel Tax (VVT)	Owners or managers of specified vehicles and vessels within China	Insurance institutions engaged in the compulsory traffic accident insurance business	Filing and payment on an annual basis; specific filing period to be determined by the local government	Local Tax Bureau
Urban and Township Land-use Tax (UTLT)	Units and individuals who use land within the area of city, country, township and mining districts	N/A	Calculated on an annual basis and paid by instalments according to a filing schedule determined by the local government	Local Tax Bureau
Resource Tax (RT)	Units and individuals engaged in mineral exploration or salt production within the territory and territorial waters of China	Units and individuals who acquire untaxed mineral products	Resource tax payable may be assessed by the in-charge tax bureau by one day, three days, five days, 10 days, 15 days or one month, depending on the discretion of the tax bureau in charge, and to be paid within the prescribed timeline; Tax filing shall be completed within 10 days following the end of the month; Transaction-by-transaction basis is available if regular filing is not practicable	Local Tax Bureau
Motor Vehicle Acquisition Tax (MVAT)	Units and individuals who acquire and import motor vehicles	N/A	Filing and payment shall be completed within 60 days from the date of acquisition	State Tax Bureau
Vessel Tonnage Tax (VTT)	Vessels that enter the domestic port of China from overseas	N/A	Payment shall be settled within 15 days from the date when the Customs Office issues the tax payment notice	Customs Office
Tobacco Tax (TT)	Units purchasing the tobacco leaves within the territory of China	N/A	Payment shall be settled within 30 days from the date when the taxpayer purchases the tobacco leaves	Local Tax Bureau
Arable Land Occupation Tax (ALOT)	Units and individuals who occupy arable lands to build houses or carry out non-agricultural construction	N/A	Payment shall be settled within 30 days from receipt of the notice for going through the land occupancy procedures.	Local Tax Bureau

Summary of withholding taxes for corporations resident in treaty countries/regions

(Mainland China has signed 95 tax treaties with 95 countries and two arrangements with two Special Administrative Regions as at 31 Dec 2011)

No.	Jurisdiction (English)	Jurisdiction (Chinese)	Dividends %	Interest (1)%	Royalties (2)%	Place of signature	Effective date	Enforcement date
1	Albania	阿尔巴尼亚	10	10	10	Beijing	28 Jul 2005	1 Jan 2006
2	Algeria	阿尔及利亚	10, 5 (3a)	7	10	Beijing	27 Jul 2007	1 Jan 2008
3	Armenia	亚美尼亚	10, 5 (3a)	10	10	Beijing	28 Nov 1996	1 Jan 1997
4	Australia	澳大利亚	15	10	10	Canberra	28 Dec 1990	1 Jan 1991 (Mainland China)/1 Jul 1991 (Australia)
5	Austria	奥地利	10, 7 (3b)	10, 7 (4a)	10, 6	Beijing	1 Nov 1992	1 Jan 1993
6	Azerbaijan	阿塞拜疆	10	10	10	Beijing	17 Aug 2005	1 Jan 2006
7	Bahrain	巴林	5	10	10	Beijing	8 Aug 2002	1 Jan 2003
8	Bangladesh	孟加拉	10	10	10	Beijing	10 Apr 1997	1 Jan 1998 (Mainland China)/ 1 Jul 1998 (Bangladesh)
9	Barbados	巴巴多斯	10, 5 (3a)	10	10	Beijing	27 Oct 2000	1 Jan 2001
10	Belarus	白俄罗斯	10	10	10	Beijing	3 Oct 1996	1 Jan 1997
11	Belgium	比利时	10	10	10, 6	Beijing	11 Sep 1987	1 Jan 1988
			10, 5 (3i)	10	7	Brussels	Not yet in force	
12	Brazil	巴西	15	15	25, 15 (5a)	Beijing	6 Jan 1993	1 Jan 1994
13	Brunei	文莱达鲁萨兰	5	10	10	Beijing	29 Dec 2006	1 Jan 2007
14	Bulgaria	保加利亚	10	10	10, 7	Beijing	25 May 1990	1 Jan 1991
15	Canada	加拿大	15, 10 (3f)	10	10	Beijing	29 Dec 1986	1 Jan 1987
16	Croatia	克罗地亚	5	10	10	Beijing	18 May 2001	1 Jan 2001
17	Cuba	古巴	10, 5 (3a)	7.5	5	Havana	17 Oct 2003	1 Jan 2004
18	Cyprus	塞浦路斯	10	10	10	Beijing	5 Oct 1991	1 Jan 1992
19	Czech Republic	捷克	10, 5 (3a)	7.5	10	Beijing	4 May 2011	1 Jan 2012
20	Denmark	丹麦	10	10	10, 7	Beijing	10 Nov 1986	1 Jan 1987
21	Egypt	埃及	8	10	8	Cairo	24 Mar 1999	1 Jan 2000
22	Estonia	爱沙尼亚	10, 5 (3a)	10	10	Beijing	8 Jan 1999	1 Jan 2000
23	Ethiopia (6)	埃塞俄比亚	5	7	5	Beijing	Not yet in force	
24	Finland	芬兰	10, 5 (3a)	10	10, 7	Beijing	25 Nov 2010	1 Jan 2011
25	France	法国	10	10	10, 6	Paris	20 Feb 1985	1 Jan 1986
26	Georgia	格鲁吉亚	10, 5, 0(3c)	10	5	Beijing	10 Nov 2005	1 Jan 2006
27	Germany	德国	10	10	10, 7	Bonn	14 May 1986	1 Jan 1985
28	Greece	希腊	10, 5 (3a)	10	10	Beijing	11 Nov 2005	1 Jan 2006

No.	Jurisdiction (English)	Jurisdiction (Chinese)	Dividends %	Interest (1)%	Royalties (2)%	Place of signature	Effective date	Enforcement date
29	Hong Kong SAR	中国香港	10, 5 (3d)	7	7	Hong Kong	8 Dec 2006	1 Jan 2007 (Mainland China)/ 1 Apr 2007 (Hong Kong)
30	Hungary	匈牙利	10	10	10	Beijing	31 Dec 1994	1 Jan 1995
31	Iceland	冰岛	10, 5 (3a)	10	10, 7	Beijing	5 Feb 1997	1 Jan 1998
32	India	印度	10	10	10	New Delhi	19 Nov 1994	1 Jan 1995
33	Indonesia	印度尼西亚	10	10	10	Jakarta	25 Aug 2003	1 Jan 2004
34	Iran	伊朗	10	10	10	Teheran	14 Aug 2003	1 Jan 2004
35	Ireland	爱尔兰	10, 5 (3b)	10	10, 6	Dublin	29 Dec 2000	1 Jan 2001 (Mainland China)/ 1 Jan 2001 (corporate tax in Ireland); 6 Apr 2001 (income and capital gain taxes in Ireland)
36	Israel	以色列	10	10, 7 (4a)	10, 7	Beijing	22 Dec 1995	1 Jan 1996
37	Italy	意大利	10	10	10, 7	Beijing	14 Nov 1989	1 Jan 1990
38	Jamaica	牙买加	5	7.5	10	Beijing	15 Mar 1997	1 Jan 1998
39	Japan	日本	10	10	10	Beijing	26 Jun. 1984	1 Jan 1985
40	Kazakhstan	哈萨克斯坦	10	10	10	Astana	27 Jul 2003	1 Jan 2004
41	Korea, Rep. of	韩国	10, 5 (3a)	10	10	Beijing	27 Sep 1994	1 Jan 1995
42	Kuwait	科威特	5	5	10	Kuwait	20 Jul 1990	1 Jan 1989
43	Kyrgyzstan	吉尔吉斯	10	10	10	Beijing	29 Mar 2003	1 Jan 2004
44	Laos	老挝	5	5 (in Laos) 10 (in Mainland China)	5 (in Laos) 10 (in Mainland China)	Beijing	22 Jun 1999	1 Jan 2000
45	Latvia	拉脱维亚	10, 5 (3a) 10, 5 (3a)	10	10 7	Riga Riga	27 Jan 1997 Not yet in force	1 Jan 1998
46	Lithuania	立陶宛	10, 5 (3a)	10	10	Vilnius	18 Oct 1996	1 Jan 1997
47	Luxembourg	卢森堡	10, 5 (3a)	10	10, 6	Beijing	28 Jul 1995	1 Jan 1996
48	Macau SAR	中国澳门	10, 5 (3a)	7	7	Macau	30 Dec 2003	1 Jan 2004
49	Macedonia	马其顿	5	10	10	Beijing	29 Nov 1997	1 Jan 1998
50	Malaysia	马来西亚	10	10	15 (5b),10	Beijing	14 Sep 1986	1 Jan 1987

No.	Jurisdiction (English)	Jurisdiction (Chinese)	Dividends %	Interest (1)%	Royalties (2)%	Place of signature	Effective date	Enforcement date
51	Malta	马耳他	10, 5 (a)	10	10, 7	Valleta	25 Aug 2011	1 Jan 2012
52	Mauritius	毛里求斯	5	10	10	Beijing	4 May 1995	1 Jan 1996
53	Mexico	墨西哥	5	10	10	Mexico City	1 Mar 2006	1 Jan 2007
54	Moldova	摩尔多瓦	10, 5 (3a)	10	10	Beijing	26 May 2001	1 Jan 2002
55	Mongolia	蒙古	5	10	10	Ulaan Baator	23 Jun 1992	1 Jan 1993
56	Morocco	摩洛哥	10	10	10	Rabat	16 Aug 2006	1 Jan 2007
57	Nepal	尼泊尔	10	10	15	Katmandu	31 Dec 2010	1 Jan 2011
58	Netherlands	荷兰	10	10	10, 6	Netherlands	5 Mar 1988	1 Jan 1989
59	New Zealand	新西兰	15	10	10	Wellington	17 Dec 1986	1 Jan 1987
60	Nigeria	尼日利亚	7.5	7.5	7.5	Abuja	21 Mar 2009	1 Jan 2010
61	Norway	挪威	15	10	10	Beijing	21 Dec 1986	1 Jan 1987
62	Oman	阿曼	5	10	10	Muscat	20 Jul 2002	1 Jan 2003
63	Pakistan	巴基斯坦	10	10	12.5	Islamabad	27 Dec 1989	1 Jan 1990 (Mainland China)/ 1 Jul 1990 (withholding tax in mainland China only)/1 Jul 1990 (Pakistan)
64	Papua New Guinea	巴布新几内亚	15	10	10	Beijing	16 Aug 1995	1 Jan 1996
65	Philippines	菲律宾	15, 10 (3g)	10	15 (5b),10	Beijing	23 Mar 2001	1 Jan 2002
66	Poland	波兰	10	10	10, 7	Beijing	7 Jan 1989	1 Jan 1990
67	Portugal	葡萄牙	10	10	10	Beijing	7 Jun 2000	1 Jan 2001
68	Qatar	卡塔尔	10	10	10	Beijing	21 Oct 2008	1 Jan 2009
69	Romania	罗马尼亚	10	10	7	Beijing	5 Mar 1992	1 Jan 1993
70	Russia	俄罗斯	10	10	10	Beijing	10 Apr 1997	1 Jan 1998
71	Saudi Arabia	沙特阿拉伯	5	10	10	Beijing	1 Sep 2006	1 Jan 2007
72	Seychelles	塞舌尔	5	10	10	Beijing	17 Dec 1999	1 Jan 2000
73	Singapore	新加坡	10, 5 (3a)	10, 7 (4a)	10, 6	Singapore	18 Sep 2007	1 Jan 2008
74	Slovak Republic	斯洛伐克	10	10	10	Prague	23 Dec 1987	1 Jan 1988
75	Slovenia	斯洛文尼亚	5	10	10	Beijing	27 Dec 1995	1 Jan 1996
76	South Africa	南非	5	10	10, 7	Pretoria	7 Jan 2001	1 Jan 2002
77	Spain	西班牙	10	10	10, 6	Beijing	20 May 1992	1 Jan 1993
78	Sri Lanka	斯里兰卡	10	10	10	Beijing	22 May 2005	1 Jan 2006
79	Sudan	苏丹	5	10	10	Beijing	9 Feb 1999	1 Jan 2000
80	Sweden	瑞典	10, 5 (3a)	10	10, 7	Stockholm	3 Jan 1987	1 Jan 1987
81	Switzerland	瑞士	10	10	10, 6	Beijing	27 Sep 1991	1 Jan 1990
82	Syria	叙利亚	10, 5 (3a)	10	10	Damascus	1 Sep 2011	1 Jan 2012

No.	Jurisdiction (English)	Jurisdiction (Chinese)	Dividends %	Interest (1)%	Royalties (2)%	Place of signature	Effective date	Enforcement date
83	Tajikistan	塔吉克斯坦	10, 5 (3a)	8	8	Dushanbe	28 Mar 2009	1 Jan 2010
84	Thailand	泰国	20, 15 (3d)	10	15	Bangkok	29 Dec 1986	1 Jan 1987
85	Trinidad and Tobago	特立尼达和多巴哥	10, 5 (3e)	10	10	Port-of-Spain	22 May 2005	1 Jun 2005/ 1 Jan 2006 (Depending on the type of taxes)
86	Tunisia	突尼斯	8	10	10, 5 (5c)	Tunis	23 Sep 2003	1 Jan 2004
87	Turkey	土耳其	10	10	10	Beijing	20 Jan 1997	1 Jan 1998
88	Turkmenistan	土库曼斯坦	10, 5 (3a)	10	10	Ashgabat	30 May 2010	1 Jan 2011
89	Ukraine	乌克兰	10, 5 (3a)	10	10	Beijing	18 Oct 1996	1 Jan 1997 (Mainland China)/1 Jan 1997 (Ukraine)/17 Dec 1996 (dividends, interest and royalties in Ukraine only)
90	United Arab Emirates	阿联酋	7	7	10	Abu Dhabi	14 Jul 1994	1 Jan 1995
91	United Kingdom	英国	10	10	10, 7	Beijing	23 Dec 1984	1 Jan 1985 (Mainland China)/1 Apr 1985 (corporation tax in UK)/6 Apr 1985 (income and capital gain taxes in UK)
			5 (3e), 10	10	10, 6	London	Not yet in force	
92	United States	美国	10	10	10, 7	Beijing	21 Nov 1986	1 Jan 1987
93	Uzbekistan	乌兹别克斯坦	10	10	10	Tashkent	3 Jul 1996	1 Jan 1997
94	Venezuela	委内瑞拉	10, 5 (3h)	10, 5 (4a)	10	Caracas	23 Dec 2004	1 Jan 2005
95	Vietnam	越南	10	10	10	Beijing	18 Oct 1996	1 Jan 1997
96	Yugoslavia	南斯拉夫	5	10	10	Belgrade	1 Jan 1998	1 Jan 1998
97	Zambia	赞比亚	5	10	5	Lusaka	30 Jun 2011	1 Jan 2012

Source: State Administration of Taxation, China

Notes:

This table is a summary only, and does not reproduce all the provisions relevant in determining the application of withholding taxes in each tax treaty/arrangement.

The former Czechoslovak Socialist Republic is divided into the Czech Republic and the Slovak Republic.

The former Yugoslavia is divided into Bosnia, Croatia, Macedonia, Serbia, Slovenia and Yugoslavia.

There is no tax treaty signed between China and Bosnia and Serbia.

The numbers in parentheses refer to the following numbered notes.

- (1) Nil on interest paid to government bodies except for Australia, Brunei, Cyprus, Israel, Slovenia and Spain. Reference should be made to the individual tax treaties.
- (2) The lower rate on royalties applies for the use of or right to use any industrial, commercial or scientific equipment.
- (3a) The lower rate applies where the beneficial owner of the dividend is a company (not a partnership) that directly owns at least 25% of the capital of the paying company.
- (3b) The lower rate applies where the beneficial owner of the dividend is a company that directly owns at least 25% of the voting shares of the paying company.
- (3c) The lowest rate (i.e., 0%) applies where the beneficial owner is a company that owns directly or indirectly at least 50% of the capital of the paying company and the investment exceeding two million euros. The lower rate (i.e., 5%) applies where the beneficial owner is a company that directly or indirectly owns at least 10% of the capital of the paying company and the investment exceeding 100,000 euros.
- (3d) The lower rate applies where the beneficial owner of the dividend is a company that directly owns at least 25% of the capital of the paying company.
- (3e) The lower rate applies where the beneficial owner of the dividend is a company that directly or indirectly owns at least 25% of the capital of the paying company.
- (3f) The lower rate applies where the beneficial owner of the dividend is a company that owns at least 10% of the voting stock of the paying company.
- (3g) The lower rate applies where the beneficial owner of the dividend is a company that directly owns at least 10% of the capital of the paying company.
- (3h) The lower rate applies where the beneficial owner is a company (other than a partnership) which directly owns at least 10% of the capital of the paying company.
- (3i) The lower rate applies where the beneficial owner of the dividend is a company (not a partnership) that directly owns at least 25% of the capital of the paying company within at least 12 consecutive months before the payment takes place.
- (4a) The lower rate applies to interest payable to banks or financial institutions.
- (5a) The higher rate applies to trademarks.
- (5b) The higher rate applies to copyright of literary, artistic or scientific work including cinematograph films or tapes for television or broadcasting.
- (5c) The lower rate applies to royalties paid for technical or economic studies or for technical assistance.
- (6) These tax treaties have not yet entered into force as of 31 December 2011.

Minimum registered capital of a foreign-invested enterprise (FIE)

Amount of total investment	Minimum registered capital
US\$3 million or less	70% of total investment
US\$3-10 million	Higher of US\$2.1 million or 50% of total investment
US\$10-30 million	Higher of US\$5 million or 40% of total investment
More than US\$30 million	Higher of US\$12 million or 33.3% of total investment

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