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PROVIDING CHINA INSIGHT SINCE 1982



# Corporate Governance in China

## Korruption, Betrug und Vetternwirtschaft

**Jürgen Kracht**  
Managing Director  
Fiducia Management Consultants

München, 2. Februar 2009

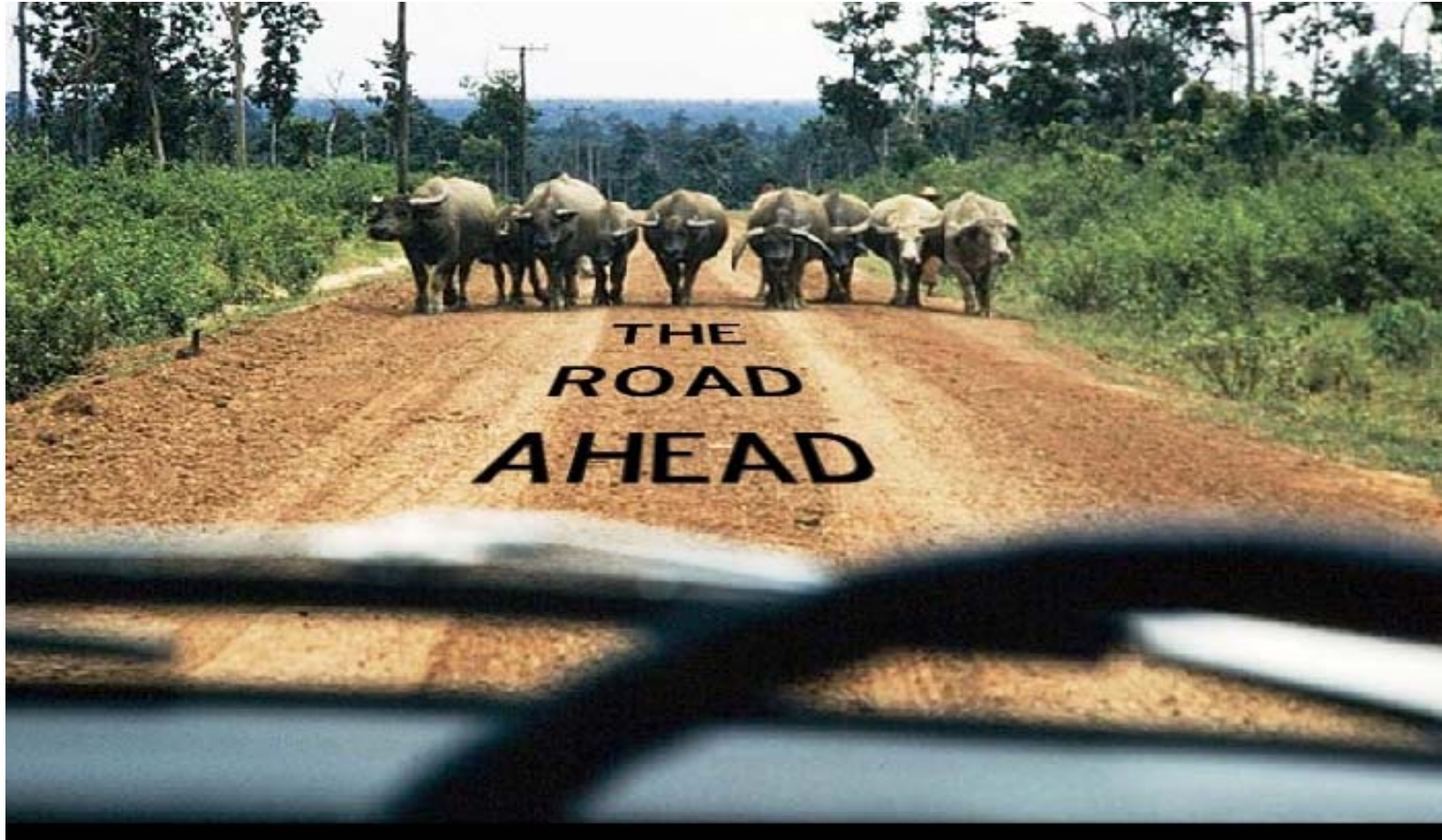
## Erinnern Sie sich?

Ein bewegender Moment bei den Olympischen Spiele - 8 August 2008



# “Mit der Kraft des Büffels gegen die Krise”

(FAZ 26. Januar 2009)



GONG XI FA CAI /// KUNG HEI FAT CHOY



# The “golden times” with unlimited growth have stopped

## Review your China engagement and take action

**The uncertain economic environment gives priority to review China engagement and to take action**

- **Focus on business fundamentals**
- **Strengthen the corporation, increase transparency**
  - Review and evaluate
    - Processes & efficiency
    - Risks
    - Cost - remove unnecessary cost
    - Operational structure
  - Take action
  - Restructure operations
  - Close country offices that were “nice to have”
- **Overcome complacency or resistance to change**
- **Communicate with stake holders**
- **Have a “Plan B”**



# Corruption Perceptions Index 2008

Rank	Country	Index
1	Denmark	9,3
12	Hong Kong	8,1
14	Germany	7,9
43	Macao	5,4
72	China	3,6

10 = no corruption

1 = high corruption level

Source: <http://www.transparency.org>



# Corruption in Hong Kong

## **PUBLIC SECTOR**

Very low due to strict anti-corruption legislation and ICAC (Independent Commission Against Corruption)

## **PRIVATE SECTOR**

Very low due to strict anti-corruption legislation and ICAC, but still existing in certain sectors such as property dealings

# Corruption in China

## Public sector

### Forms of corruption:

- Individual corruption
- Organised corruption whereby leaders of organisations (government departments, state-owned companies, etc.) take the lead
- “Money for power” exchanges by withholding access to public resources
- Lower level government or company officials bribe high level officials, in order to get more financial support or more favourable policies

### The main areas are:

- Tender, contracts
- Politics
- Judiciary
- Government operational licenses and permits
- Utilities: water and transport
- Promotion to higher positions
- Drug \*
- Food safety \*
- Pollution \*
- Land acquisition \*

\* Identified as key corruption areas in 2009 by the CCP Central Committee and the Central Commission for Discipline inspection



# Corruption is everywhere

## Headlines in a week

- Zheng Shaodong, assistant minister of Public Security and director of the Economic Crime Investigation Bureau has been detained. The detention has been linked to allegations involving Mr. Huang Guangyu, founder of Gome electronics group - Mr Huang was named the wealthiest person in China with an estimated fortune of 4.9 billion Euro
- Shandong: Liacheng Real Estate Administrative Bureau Chief Pan Hongcai took bribes of more than 10 million RMB
- Zhejiang: Yiwu Land and Resources Bureau Deputy Chie Wu Houzheng got sentenced to 11 years jail for accepting bribes and abusing his authority
- Sichuan: Xuanhan County Construction and Planning Bureau Chief Yuan Han was jailed for 10 years for taking bribes
- Zheng Jinchun, 61, former Communist Party vice-secretary of Chenzhou took bribes for construction and mine contracts, career promotions and help in resolving disputes. He was sentenced to death for taking bribes of more than 31 million Yuan
- Almost every medicine prescribed to patients earns money for doctors



# Corruption in China

## Private sector

- School admittance
- Test certificates
- Prescription medicine  
The commercial bribery laws applies to doctors and teachers only since December 2008
- “Tipping” doctors before major operations to ensure best care
- ETC.



# Risk areas - examples of corruption

## Fraud in China exists and can seriously affect business

### **Purchase: Pre-qualification, tender and negotiations**

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

### **Sales, project execution**

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



# Risk areas - examples of corruption

## Fraud in China exists and can seriously affect business

### Operations, finance & accounting

- No “checks and balances”
- Outsourcing profitable business
- False claims by staff
- Misappropriating or stealing of funds

### Personnel

- Employment, job application
- Promotion, salary increase

# Corruption in China

## Consequences

### **Corruption should be avoided because of:**

- the risk of criminal prosecution; commercial bribery is a crime punishable by up to 10 years of imprisonment
- the risk of financial losses
- the moral argument
- foreign companies are under the watchful eye of Chinese authorities and they can use this as a tool to achieve other aims
- foreign companies increasingly face scrutiny by the authorities in their home country
- black mailing by former employees

**One simple rule: DON'T DO IT!**



# Anti-corruption measures in China

- On 1 January 2006, China's procuratorate established a data research system, retrievable nationwide, for bribery cases, with bribery blacklists in such fields as construction, finance, education, health and medicine and government procurement.
- Once bribery information is put into the data bank, it will be undeletable.
- In a renewed push for reform, state-owned China Securities Index Company recently announced plans to introduce a new Corporate Governance Index on the Shanghai Stock Exchange
- The Index aims to provide a home-grown standard based on Chinese regulations for assessing listed Chinese companies.
- This initiative comes on the heels of the Finance Ministry's promulgation in January of 38 Basic Accounting Standards for Business Enterprises, which aim to standardise accounting practices of all listed companies
- Any person may report corruption of commercial sector entities to a local public security agency or procuratorate and under relevant laws these departments should protect and reward informants.



# Risk prevention

## Proven tools

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

**Small and medium-size enterprises (SMEs) may implement less formal and less structured controls, yet they still need them**



# Risk Prevention

## Proven tools

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



# Corporate Compliance and Risk Management

## Analysis for the period...

Example

Description of risk	Cause/ Loss potential	Likelihood (1=low; 3=high)	Counter measure	Person in charge
<b>GENERAL</b>				
Compliance with: - Environmental laws - Workers' safety law - Etc.				
Contract risks (suppliers, customers, commercial agents, tenancy agreement)				
Damage to premises or buildings, Break-in and larceny				
Misuse of company chops				
Personnel tax & S. Security				
<b>PURCHASE RELATED</b>				
Disruption due to insufficient purchase planning				



# Corporate Compliance and Risk Management

## Analysis for the period...

Example 1

Description of risk	Cause and Loss potential	Likelihood 1 = low 3 = high	Counter measure	Person in charge
<b>Sales related</b>				
Know your customer				
Price policy				
Discounts				
<b>Purchase</b>				
Know your supplier				
Pricing				
Discounts				
Returns				

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*We have a 25-year track record of serving international clients with business interests in China*

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



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## **Christina Fung**

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



## **Pinky Kwan**

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



## **Stefan Kracht**

- Degree in Management
- Worked as a consultant with Bain & Co. in London and managed a trading company in Shanghai
- Head of Fiducia's China Consulting department



# FIDUCIA MANAGEMENT CONSULTANTS

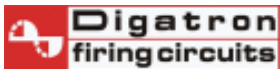
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# CLIENT REFERENCES

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



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### A route towards new sales?

FIDUCIA ANALYSES RECENT TRENDS IN THE BUSY TRADE FAIR ENVIRONMENT OF HONG KONG

During the Fall of 2008, the number of exhibitors at the biggest trade fairs in Hong Kong are sending a clear message. Whether at the Hong Kong Exhibition and Convention Centre, or the China Sourcing Fairs at the Asia World Expo, trade fairs present record numbers of exhibitors. The Global Sources Electronics fair has now grown fivefold in just five years, from 563 booths in its inaugural show in 2003 and 73% are from mainland China alone. Trade shows held in downtown Hong Kong are also bursting at the seams. With more than 2,600 exhibitors, the HKTDC Electronics Fair attracts tens of thousands of buyers from more than 150 countries in a period of five days. And while the quantity of trade booths and visitors is impressive, qualitative changes are noticeable.

#### IP protection

All fairs take an active approach towards IP protection. Taking photographs inside the exhibition halls is prohibited and large signs warn of the potential consequences for Intellectual Property Rights (IPR) violation. The show organisers offer on-the-spot legal advice from reputable law firms. Such professional legal advisors can assist in IPR disputes. Moreover, the event organisers publish IPR policies and procedures for supplier listings well ahead of the trade

plier in any one year supplier verification programme. During this programme a team visits suppliers in person at least three times, performing credit checks. Exhibitors also undergo a supplier audit by a professional audit firm. This ensures that those with innovative product ideas are protected, which guarantees demand for exhibiting space, not only from China manufacturers.

#### Shift from OEM to brand ownership

As the trade fairs are open to exhibitors from all countries, a substantial number of foreign-managed HK companies, who in the past had a strong focus on Original Equipment Manufacturer (OEM) business, have begun exhibiting their products under an own brand. Consequently these companies are getting access to new customer groups in markets that were previously not on their sales list. This two pronged strategy – developing an own brand name while continuing with OEM sales – can help to balance lower order volumes from established markets. Venturing into the unknown may hold concealed benefits. Learning from the OEM demand and applying the same design and colour patterns as well as requested design features to the own brand may help to improve value and boost sales.

### CONTENT

A route towards new sales?

"A M&A deal in China rarely proceeds smoothly"

Hong Kong vs Shanghai vs Singapore

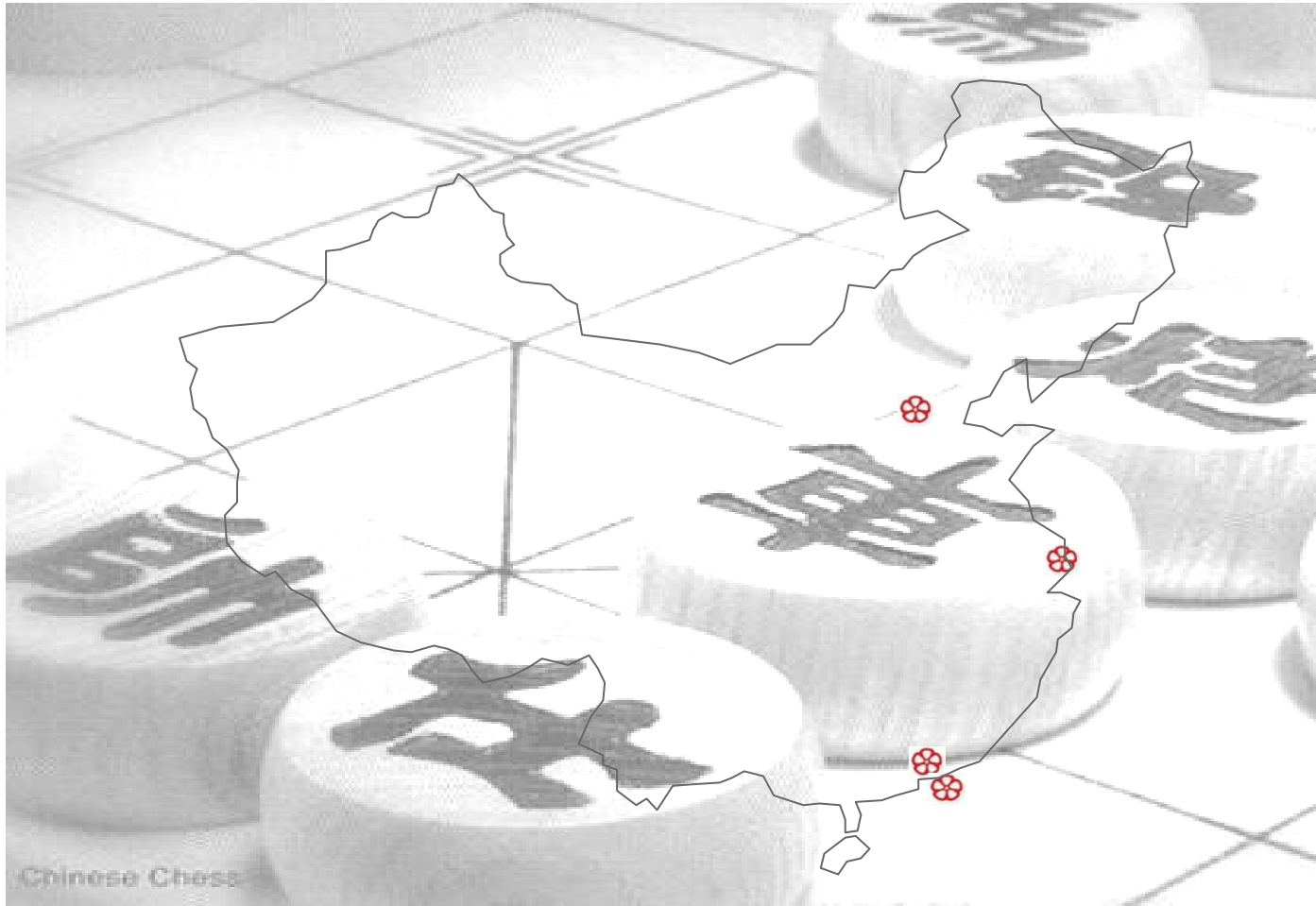
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