

# Cash Matters

Cash and working capital  
management in China

ADVISORY



## Introduction



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The global economy is emerging from one of the most difficult times for eighty years, yet domestic and multinational corporates in China continue with their growth investment plans. As organisations strive for more market share in China's expanding economy, increasing pressure is being placed on their cash resources. These pressures for additional resources provide an opportunity to implement new and effective cash management strategies.

According to KPMG's 2009 China Cash Management Survey, in excess of 90 percent of respondents highlighted management of cash as one of their top priorities for their organisation. However, only 14 percent said they had adequate visibility of their cash.

This startling contrast in results, suggests that whilst most corporates recognise the importance of effective cash management, very few of them have the necessary tools, processes and structures to provide them with the visibility they require to execute an effective cash management strategy.

Regardless of industry or economic cycle, this report and its underlying research demonstrates the importance of effective cash management and highlights the benefits that can be derived. Recognising the somewhat uniqueness of the China economy, we have looked beyond the traditional areas of cash management and also focussed on issues impacting growing domestic and multinationals, particularly in the areas of treasury, tax, technology and regulations – all of which impact on developing a cash management strategy for a flourishing new, yet highly regulated economy.

I would like to thank Oracle for their generous support and assistance with the publication of this report. I would also like to thank all of our contributors for their insights and input.

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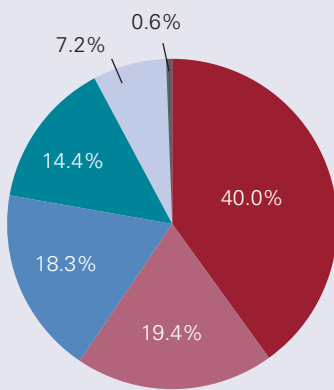
# Executive summary

In 2009, KPMG China conducted a survey of executives involving 180 multinational and large corporates based across mainland China. Two-thirds of respondents were from PRC domiciled companies and one third from multinationals. The respondents spanned a range of industry sectors, but with close to 60 percent operating in either the Industrial or Consumer Markets.

Respondents had an average turnover between USD 500 million and USD 5 billion. Fifty-nine percent of respondents' businesses operated in either the Industrials or Consumer markets; 51 percent of respondent businesses' latest consolidated turnover in China was under USD 1 billion; 68 percent of those interviewed worked for companies domiciled in the PRC; 89 percent of respondents' organisations are sensitive to changes in commodity pricing.

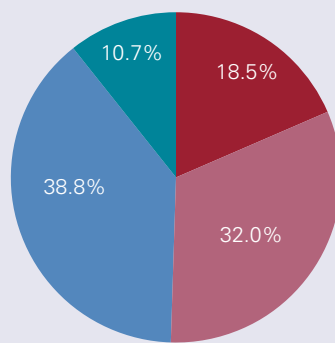
The survey was developed in order to gauge the level of importance that organisations in China place on cash, as well as to determine how they execute their cash management strategies.

**In what industry does your organisation operate?**



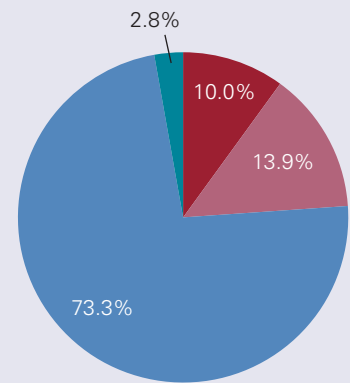
- Industrial Markets
- Consumer Markets
- Other
- Information, Communications & Entertainment
- Property & Infrastructure
- Financial Services

**What is the consolidated annual turnover of the group in China in USD million?**



- <US\$500m
- US\$500m-US\$1bn
- US\$1bn-US\$5bn
- >US\$5bn

**What percentage of your business operations are based in China?**



- 0-25%
- 26-50%
- 51-75%
- 76-100%

Source: Unless stated otherwise, all graphs and statistics are based on research conducted for KPMG China by mergermarket.



## Key findings

Corporates that performed stress testing of cash flow forecasts were less impacted by the credit crisis than those who did not. Organisations with strong visibility and control over their cash and working capital have fared better in recent times due to performing scenario planning, stress tests and cash flow forecasts.

Profitability pressures and tight financing conditions in the current economic downturn have meant that visibility into cash and working capital and improvement programmes around these areas are a top priority for corporates in China.

However, in managing their cash only 43 percent of respondents said they use cash pooling in China. Those that have not used cash pooling, said this was because they do not understand the concept.

A large majority, 74 percent, expect to see a decline in customer demand in China over the coming twelve months, despite continued GDP growth in the PRC.

The property and infrastructure sector, which sees more of an emphasis on large, capital-intensive projects, is the most common user of cash pooling, with 61.5 percent of respondents having used entrustment loans in the past. This compares to an average 43 percent of corporates from other sectors.

Just under 90 percent believe that Chinese growth fundamentals are still in place. Of these, 94.7 percent also say that their company is going to expand their cash operations in China in the future, in terms of investing in treasury management technologies.

48.3 percent said they plan on increasing their investment in cash and treasury management technology. Meanwhile 54.2 percent expect to see reduced access to finance while 41.6 percent have highlighted the risks of increased bad debt exposure in the coming 12 months.

# Liquidity in China

Companies around the world are placing more emphasis on cash and working capital as they tackle the ongoing credit crunch while positioning themselves for an expected upturn in the global economy.

The situation in China, however, has been somewhat different, where an abundance of liquidity would seem to have caused working capital levels to rise substantially over the last 12 months. This has led to less of a focus on active cash management and is contrary to what is being seen elsewhere, i.e., a tighter management of cash and working capital<sup>1</sup>.

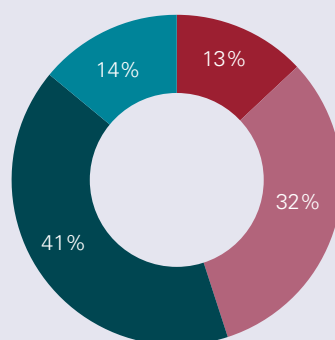
While much of the world has been grappling with a severe credit crunch, in China money supply levels have risen significantly, in part triggered by stimulus measures. These developments are helping to fuel current liquidity growth and add an interesting dynamic to the efforts of Chinese organisations to improve their cash management strategies.

This is still important because China has not been immune to the global credit crisis and economic downturn. China's economy has maintained strong momentum over

the past year, achieving 8.7 percent GDP growth as at the end of 2009.<sup>2</sup> However, many of its key export destinations are still struggling to cope with falling consumer demand and rising unemployment.

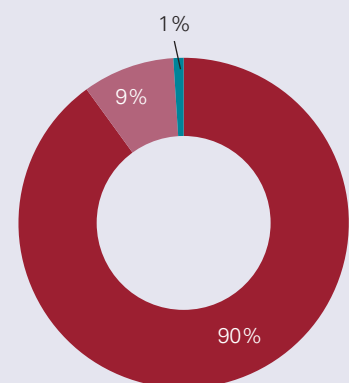
The changes in the global environment have provided additional impetus for finance executives to review their cash and working capital management strategies.

**Is the credit crunch impacting the growth of your operations in China?**



- Significant impact on operations
- Some impact on operations
- Slight impact on operations
- No impact on operations

**Are you of the view that growth fundamentals are still in place in China?**



- Yes
- Don't know
- No

<sup>1</sup> KPMG LLP's survey of large European and US organisations ('Cash is back in fashion, but it is here to stay?') Insights from 2009 research into cash and working capital management

<sup>2</sup> The National Bureau of Statistics of China ([www.stats.gov.cn](http://www.stats.gov.cn))



According to KPMG's China cash management survey, a majority (74 percent) of respondents expect to see a decline in domestic demand for their products and services over the coming twelve months, despite continued GDP growth.

There could still be excess capacity in China due to low consumer demand in Europe and the US, as indicated by the December 2009 retail figures. In addition, many companies in China – both multinationals and large local corporates - have grown significantly in size over the past decade. They now have turnovers of hundreds of millions of dollars and thousands of employees. In many cases, the finance function and other supporting processes may not have grown and developed at the same pace.

Regulatory issues tend to impact large organisations doing business in China, as they are not "in theory" permitted to lend inter-company without the use of entrustment loans.

Executives in China, however, are far from complacent about the prospects for the year ahead. Fifty-four percent of respondents said they expected to see reduced access to finance while

42 percent highlighted the risks of increased bad debt exposure in the coming 12 months. The downturn is impacting some more than others. Export-oriented businesses such as textiles and manufacturing have suffered, for example, while industries serving the domestic market, including petrochemicals and the IT sector, have fared relatively better.

The rising importance of managing working capital as liquidity tightens, not least in precarious economic times, is a message that has not been lost on Chinese companies of late. A corollary of this is that cash management is

# 74%

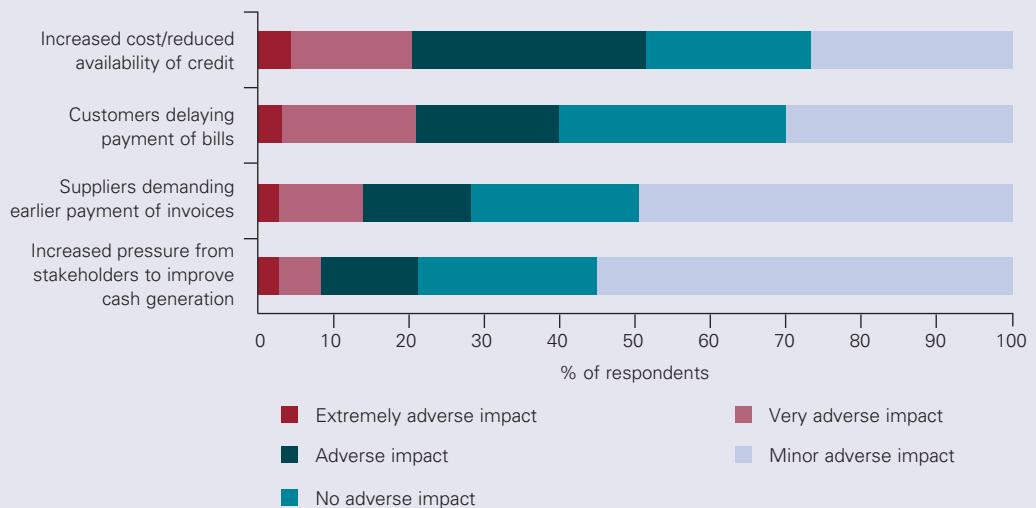
of respondents expect to see a decline in domestic demand for their products and services over the coming 12 months, despite continued GDP growth



*"Organisations tend to miss opportunities to release liquidity through improving working capital management, as they do not consider the implications for the entire cash conversion cycle. For example, a sole focus on payments efficiency, fails to address liquidity implications or supply chain risk."*

– Philippe Jaccard - Managing Director, Liquidity and Investments Asia Pacific, Global Transaction Services, Citi

**Please rate the following scenarios stemming from the financial crisis in terms of their adverse impact on your business**



becoming an increasingly important component of the day-to-day running of Chinese businesses. The survey results also confirm that many of its respondents recognise the strategic importance of cash management to their operations, as the lending momentum slows.

According to the China survey, 97 percent of respondents said cash management was of strategic

importance to their operations. This point resonates with the results from a similar KPMG survey conducted across Asia-Pacific in 2008. At that time, 81 percent of China and Hong Kong-based respondents said they viewed cash management as a matter of strategic importance.

**Case study:**

# Simcere Pharmaceutical Group's view on liquidity management in China

Zhao Zhi-gang, Chief Financial Officer



Simcere Pharmaceutical Group is a manufacturer and supplier of branded generic and innovative pharmaceuticals in China. The group listed on the New York Stock Exchange in 2008 and has been continuously expanding through acquisitions. Its most recent acquisition, in Q2 2009, saw it buy a 37.5 percent stake in Jiangsu Yanshen Biological Technology, which recently became one of the six licensed producers of the H1N1 vaccine in China.

The CFO of Simcere Pharmaceutical Group is Zhao Zhi-gang, who joined the company in 2006.

When asked about his views on cash management in China, Zhao said that he remains committed to maintaining a strict and robust liquidity regime despite the fact that Simcere is essentially a defensive play. "As a healthcare company, I'm not particularly worried about falling customer demand. Healthcare is a rapidly developing sector in China and we are supported by government policies. As a result, I'm optimistic about the future prospects for Simcere, as well as the sector as a whole."

However, Zhao is keen to note that his optimism should not be mistaken for complacency. "I understand that some industries will be more adversely impacted by the expected fall in customer demand over the near future.

Therefore, while liquidity and cash flow management isn't much of a problem for our company, I staunchly advocate the continued development of Simcere's cash management strategy."

In line with Zhao's commitment to Simcere's liquidity management programme, his budgeting team conducts cash flow forecasts on a monthly basis with a forecast period of one month. Every quarter, these estimates are published in Simcere's

financial statements. These forecasts are stress-tested with an average variance of 10 percent.

Zhao also notes that Simcere's various departments all utilise key performance indicators, allowing his team to further examine cash flows within the company and – ultimately – produce accurate budgeting and cash flow forecasts.

However he does not believe that cash flow forecasting practices are being widely used across China. "Chinese businesses are, in particular, not doing enough stress-testing, which I think should be conducted on at least a monthly basis in order to effectively manage cash. At the moment, most

firms are conducting forecasts on a quarterly basis and are not stress-testing their findings."

With regards to entrustment loans, Zhao says: "We utilise entrustment loans frequently and work closely with our banking partner, who supports our transfers by providing various instruments and structural deposits for us. At the same time, we enjoy an enhanced flexibility when it comes to cash transfers, as well as preferential interest rates.

All in all, I'm a big advocate."

"Entrustment loans deserve more attention in China. I agree that

the concept might be difficult to understand but it is definitely useful for large-sized businesses insofar as it allows for their better allocation of cash and, ultimately, more streamlined cash management processes," he adds.

Zhao's strong support for cash flow management processes extends to incentives for employees. While staff remuneration schemes are not explicitly related to working capital performance, Simcere's senior management's salaries and bonuses are correlated to benchmarks including the company's cash flows over the previous period.

# The need for cash flow forecasting

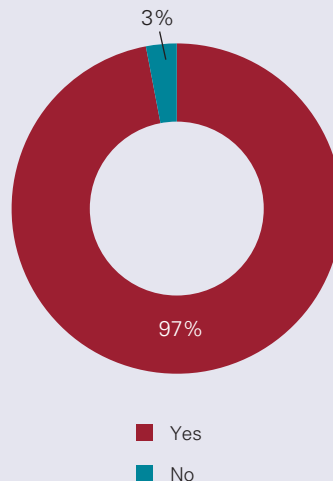
Visibility and control of cash is the single biggest issue around managing cash in China. In the absence of freely available debt, working capital and trapped cash on the balance sheet can help to provide corporates with an opportunity to unlock much needed cash. According to the survey, 45 percent of respondents said they had limited or inadequate visibility of their cash flows.

Accurate forecasting is a crucial tool in cash management as accurate cash flow forecasts can help companies to achieve more efficient use of capital through management of receipts and payments. It also enables more proactive management of cash, helps

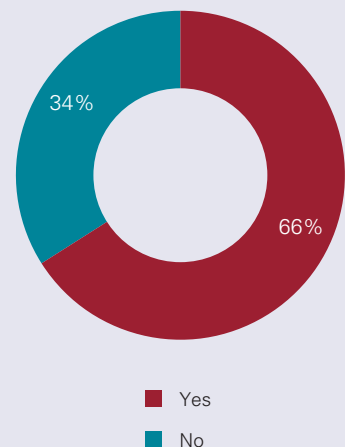
to identify seasonal trends and risks and assists in managing stakeholder expectations.

Companies should therefore revisit forecasts more often, monthly rather than quarterly, for example, and

**Do you think the management of cash is of strategic importance to your operations?**

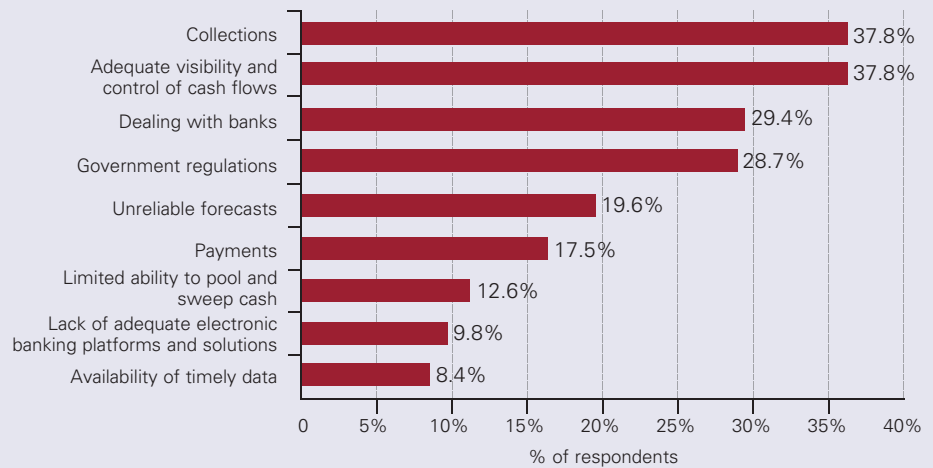


**Are cash flow forecasts subjected to stress testing or sensitivity analysis?**





### What are your organisation's three biggest challenges in terms of managing cash?



towards shorter-term forecasts and rolling forecasts.

Stress testing is also a critical component of cash flow forecasts. The KPMG survey confirmed that those companies that have conducted stress tests and maintained a strong cash culture have fared better in the economic downturn, compared to those that have not.

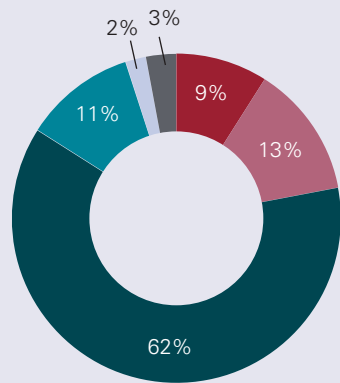
Companies with strong visibility and control over their cash and working capital have also fared better in recent

times due to performing scenario planning, stress tests and cash flow forecasts.

According to the survey, 97 percent of respondents noted that they now prepare cash flow forecasts. It also highlights that 47 percent of respondents who stress-tested their cash flow forecasts reported that the credit crisis had more than a slight impact on their Chinese operations, compared to 60 percent of those who did not.



**How often does your organisation prepare cash flow forecasts?**



- Daily
- Weekly
- Monthly
- Quarterly
- Annually
- Don't prepare cash flow forecasts

Meanwhile companies with higher turnovers are more likely to stress test their cash forecasts – 86 percent of businesses with over USD 5 billion in turnover do so, compared to just 55 percent of firms with turnovers of less than USD 500 million.

Smaller companies may have less access to expertise or resources to carry out cash flow forecasting. They may also have simpler business models, which may suggest forecasting is less important to them. Conversely however, they may also have weaker balance sheets which make accurate forecasting of cash flows all the more necessary. Smaller companies may also be more vulnerable to the effects of any disruptions in cash flow, such as delays or shortfalls.

*“We are observing a renewed focus in improving cash management processes through enhancing visibility of cash flows and managing liquidity risk by stress testing the balance sheet. In essence, companies realise that no firm is immune to the challenging market conditions, but many still operate with rudimentary cash management processes.”* – Philippe Jaccard  
 - Managing Director, Liquidity and Investments Asia Pacific, Global Transaction Services, Citi





Cash flow forecasting plays an important role in effective cash management and raising profitability. Being able to better forecast the amount of available cash needed at any given time, helps companies to better plan and execute their

liquidity management and identify opportunities for improving cash flows. A regular cash flow forecasting review process also enables a company to assess how closely its forecasts match the actual flows of cash.

Companies with higher turnovers are more likely to stress test their cash forecasts

# 85.7%

of businesses with over USD 5 billion in turnover tend to do so compared to just

# 54.5%

of firms with turnovers of less than USD 500 million



# Managing cash and working capital

The formation of working capital programmes and accurate, accountable forecasts are all ingredients of efficient cash management, which can directly link through to improved profit margins and share price.

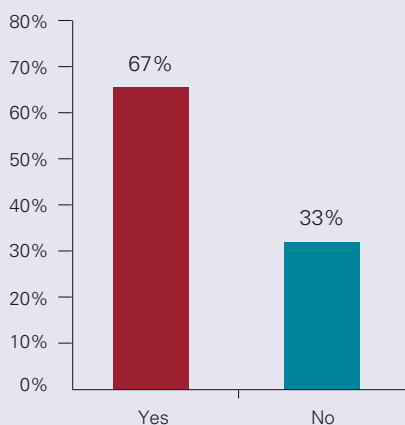
Over the past few years, expansion through acquisitions has left some companies in China with high trade receivables and inventory. To realise improvements, companies are turning their attention to working capital levers: inventories, receivables and payables. And as pressure increases on CFOs in China to strengthen their companies' cash measures, managing working capital is increasingly a focus.

An additional challenge in China is that of over-trading. Around 85 percent of respondents said they plan to expand their operations in China; while their working capital is increasing, other facilities are being drawn down. This leads to heightened risk, particularly in the export sector, of over-trading, as the global economy recovers. This therefore enhances the need for greater visibility over cash flows.

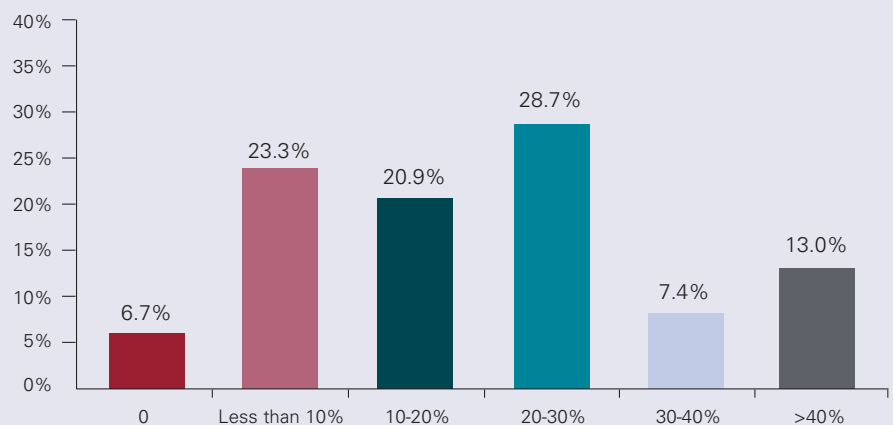
According to the survey, 60 percent of multinational respondents have undertaken a working capital improvement programme in China; 71 percent of PRC domiciled businesses have also done so.

Of those respondents whose businesses prepare cash flow forecasts on a weekly basis, 50 percent note that their working capital performance improved by more than 30 percent after the implementation

## Have you implemented/are you implementing a working capital improvement programme in China?



## If so, by what percentage are you expecting to improve working capital performance?





of a working capital programme. The comparative percentage for those who prepare forecasts on a quarterly basis is 14.3 percent.

Implementing and enhancing working capital programs can benefit Chinese based firms in a variety of ways. For example, anecdotal evidence from the survey shows that those firms who have implemented a working capital programme are more likely to be able to source local funds. Furthermore, over half of those surveyed this year who stress tested their cash flow forecasts went on to say that the credit crisis had only a slight impact on their operations, compared to 40 percent of those that did not perform stress testing.

Organisations that conduct stress testing and scenario planning in times of crisis, have fared better and subsequently may have less need for additional funds. Stress testing also helps to mitigate the risk of covenant breaches.

Demonstrating strong cash management can also help organisations secure more competitive lending rates if credit is required, and may help to persuade lenders to extend credit even in an economic downturn.

Nonetheless, managing working capital has undoubtedly become more difficult in the current economic climate, even for China-focused businesses who have implemented working capital

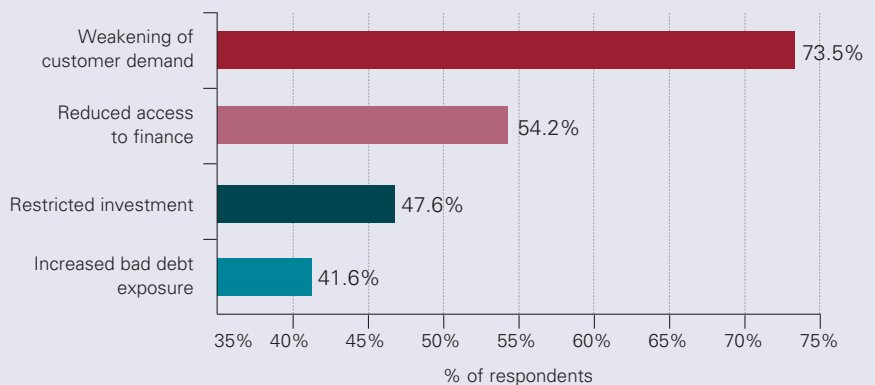
programmes. More than one-quarter of respondents (30 percent) stated that despite implementing a working capital programme, capital performance improved by less than 10 percent. When asked the same question in the KPMG 2008 Asia Pacific survey, just 13 percent of those polled noted that capital performance had been enhanced by less than 10 percent.

The survey results suggest that working capital programmes come into their own during an economic slowdown, even when they cause capital improvement of less than 10 percent – which, in this climate, could mean the difference between a business's survival and its ultimate demise.

# 50%

of respondents note that their working capital performance improved by more than 30 percent after the implementation of a working capital programme

### Which of the following scenarios do you expect are likely to occur to Chinese corporates over the next 12 months?



# Working capital metrics for Chinese-listed companies

Given the abundance of liquidity, it would seem that Chinese companies have loosened their control of working capital in the past 12 months. No doubt much of this has been forced upon them as a consequence of the global financial crisis. Going forward however, as liquidity tightens, it will be important for these companies to retain tight control and visibility in order to maintain performance and sufficient levels of liquidity.

A recent year-to-date assessment of working capital metrics for listed companies in China<sup>3</sup> show a significant deterioration in the Days Sales Outstanding (DSO) from 2008 to 2009, compared to previous years. For year 2009, listed companies in China took 20 percent longer to collect their debts.

At the same time, there has been deterioration in the time taken for companies to pay suppliers. The numbers point to a 39 percent increase in the time taken to pay suppliers, as companies attempt to stretch payment terms. This may be because they are facing difficulty in paying or may have requested more favourable terms.

Companies also need to be aware of having too much cash tied up in inventories or receivables, as the cost of financing those inventories can erode profit margins.

Many organisations in China are engaged in exporting goods offshore. They may not however, have factored in how to properly assess or manage their inventory levels. Chinese corporates have therefore perhaps taken their eyes off the ball on inventory and supply chain management as they may be more focused on sales and production.

The turnover of inventory in China eroded by 20 days in 2009 from 2008, according to Capital IQ statistics, indicating companies are becoming less efficient in managing their inventory. In 2007 the average inventory turnover for Chinese companies was 100 days while in 2009 it leapt to 121 days. This indicates that it took companies 20 percent longer to turn over their inventory in 2009 compared with two years ago. This represents a significant opportunity for Chinese corporates to assess their inventory management practices with a view to more efficient management.

Companies need, therefore, to look at the balance sheet and improve internal processes in order to get a better grip on receivables and payables. This involves looking at the end-to-end process and understanding how cash flows around the business to look for opportunities in the various cash cycles. For instance this may include looking at the collections process and may involve assessing whether or not to extend credit to a customer who does not necessarily have the ability to pay back at the start of the sales process, rather than dealing with a delinquent debtor problem down the

It took Chinese companies

# 20%

longer to turn over their inventory in 2009, compared to 2008

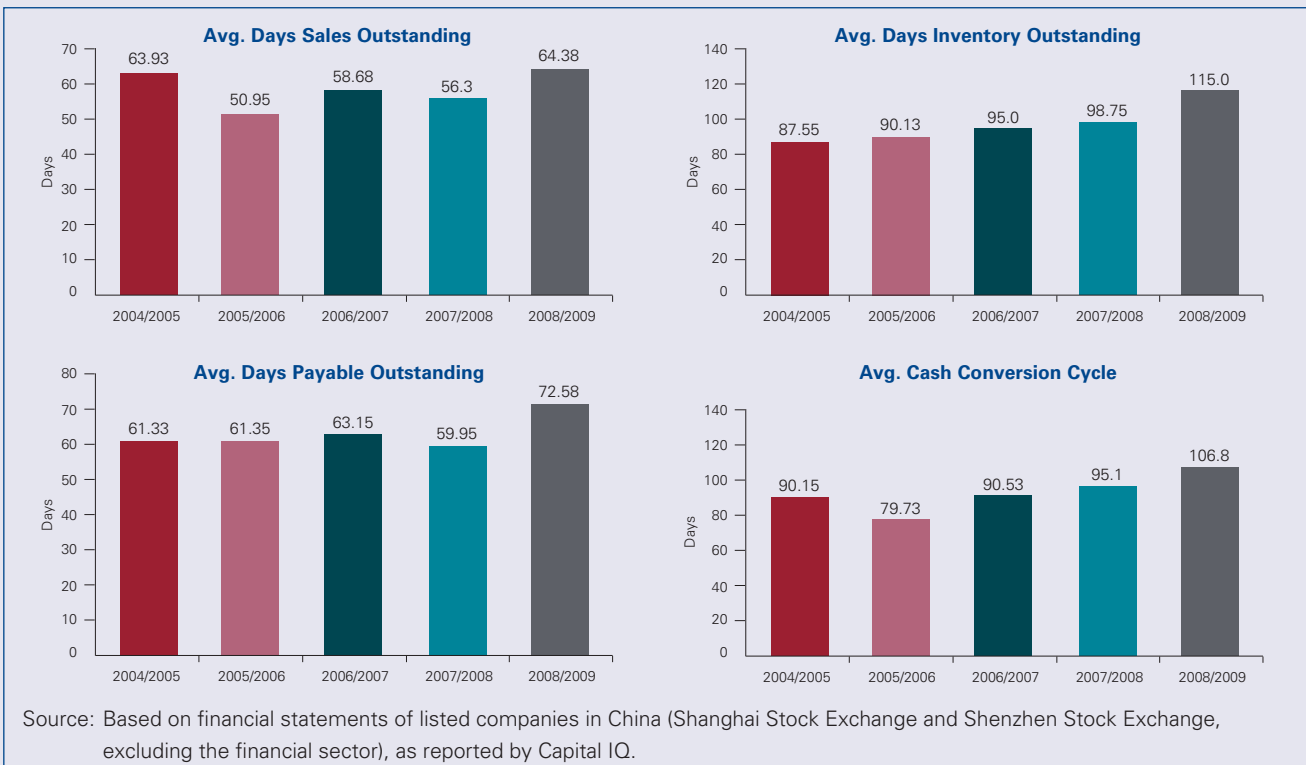
<sup>3</sup> Based on financial statements of listed companies in China (Shanghai Stock Exchange and Shenzhen Stock Exchange, excluding the financial sector), as reported by Capital IQ



track. In this example, a company may introduce a process whereby customers are segmented in terms of their credit risk and managed accordingly.

The strongest and most resilient organisations are those that adopt a continuous sustainable improvement regime. This enables them to respond quickly to changes in market conditions. Our analysis indicates that working capital presents a real opportunity for companies to unlock cash and improve profitability.

*“As a result of the economic crisis, we are focusing on collections more so than in the past. Our sales people are told to go out and collect, so our Days Sales Outstanding (DSO) is actually better. Then we work Days Payables Outstanding (DPO) and we try to extend as do other companies. I think therefore there is more focus now on the balance sheet and our cash flow is significantly stronger as a result.” – Regional treasurer of an electronics company in China*



# Treasury for corporates

From a liquidity management perspective, China has a raft of regulations in place, including monetary exchange controls, tax regulations and general trade regulations, which have implications on organisation structures.

Control over interest rates by the central bank, the People’s Bank of China and restrictions governing inter-company lending are challenges for organisations trying to establish an optimised liquidity structure in China. With the evolving market in recent years, a few major foreign and domestic banks have been successful in providing effective cash-pooling solutions to help companies improve their liquidity management.

Conceptually, cash pooling allows companies to move cash freely amongst their legal entities and their business units. In China, however, in order to move cash to other legal entities within the group, companies must utilise the entrustment loan framework which is facilitated by financial institutions such as banks, while pricing is at arm’s length.

Cash pooling in China can be used without the need for an entrustment loan, if an organisation has one legal entity with operating subsidiaries or units which are part of that entity – in this instance it is possible to move cash freely amongst those business units.

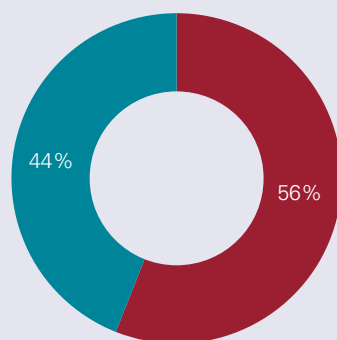
However, if a company plans to move cash to a separate legal entity within the group or a joint venture operation then it must utilise the entrustment loan framework.

Multinationals and large Chinese corporates have tended to expand in China via acquisitions or joint venture arrangements, which create multiple legal entities and joint venture relationships. Therefore the majority of organisations use the entrustment

loan framework in order to pool cash amongst the different entities.

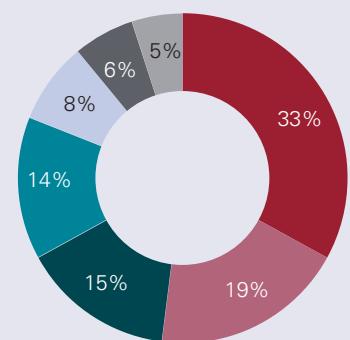
KPMG’s recent survey found that in managing their cash, over 56 percent of respondents said they do not use cash pooling in China. Businesses with larger annual turnovers are more likely to have utilised entrustment loans in the past, with 67 percent of those corporates with a combined annual turnover in China of USD 5 billion or more having done so. On the other

**Have you used cash pooling in China (cash entrustment loans)?**



■ No  
■ Yes

**If no, what was the main reason why?**



■ Do not understand the concept  
■ Administrative burden  
■ Cost outweighs any benefit  
■ Complexity  
■ Absolute cost  
■ Bank fees and charges  
■ Tax issues



hand, only 30 percent of businesses with annual turnovers of USD 500 million or less have previously used entrustment loans.

China-based companies are comparatively less likely to be dissuaded from utilising entrustment loans because of their complexity – only 35 percent of China-based firms who have not used them ascribe this to the fact that they found the process complex and/or difficult to understand.

A number of foreign-based respondents noted that their business has not previously utilised entrustment loans. Other businesses noted that they did not require entrustment loans because they generated enough operational cash flow from local operations to fund themselves.

In addition, organisations that are less sensitive to commodity price fluctuations, meanwhile, are more likely to use cash pooling or cash entrustment loans, as they may get margin calls or need to have cash on call if they are using hedging techniques.

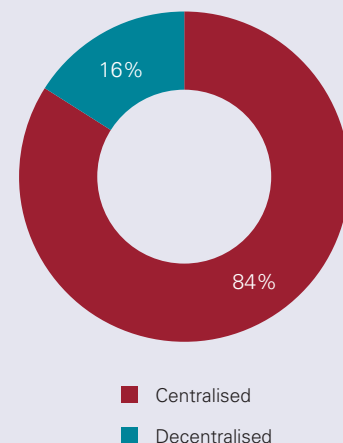
Banks, therefore, play an important role in educating their customers on the benefits of cash pooling, as there tends to be a general lack of

understanding. In fact, eight years after they were first introduced, entrustment loans in China still continue to divide cash management specialists. Some believe that the entrustment loan process – while helpful in allowing businesses located in China to transfer funds between subsidiaries – is unduly complex and, as a result, inefficient.

In contrast, others believe that such a process forms a crucial component of China's cash liquidity landscape compared to other transfer procedures such as transfer pricing and leading and lagging techniques, ultimately allowing firms to use cash pooling techniques in China.

On the face of it, entrustment loans offer an effective way for business subsidiaries located in China to transfer funds between themselves as well as overseas divisions. The entrustment framework is considered more efficient than alternative transfer methods on the basis that it reduces interest and administrative costs, ultimately resulting in better liquidity management. Interest costs fall because cash surpluses in one area of the business can now supplement cash deficits in others, ultimately removing the need for external financing. At the same time, entrustment loan rates can also be set at a discount to the country's benchmark rate – as long as they are

#### Does your treasury division follow a centralised or decentralised model in China?



set 'at arm's length'. However, given that the rates used for entrustment loans generally match the PBOC rates, arm's length pricing issues should in most cases not arise.

One of the tax issues to be mindful of is that business tax of 5 percent will be payable on interest charged on funds on-lent by the bank to the associated entity. Interest received on deposits placed with banks are not subject to business tax, therefore, the additional tax charge needs to be factored in to the overall cost of the entrustment loan arrangement.

One China-based firm surveyed stated that "our enterprise is an old state-owned company and the management



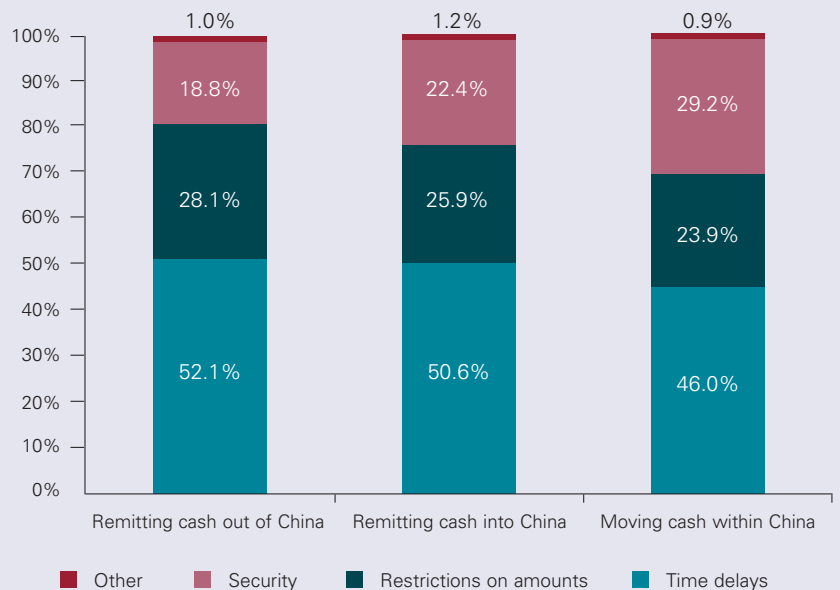
model is traditional”, which effectively meant that cash pooling was too much of an administrative burden to be worthwhile. Some respondents explained that cash pooling had not been used in the past because entrustment loans require a high level of credit worthiness, precluding their firms from utilising the process. Another respondent noted that “cash pooling is too complex a procedure to coordinate over a business with 20 subsidiaries”.

Furthermore, the introduction of the Pudong Nine measures (where selected businesses headquartered in the Pudong District of Shanghai would benefit from relaxed foreign currency restrictions) has also done little to boost entrustment loan utilisation by foreign-based companies.

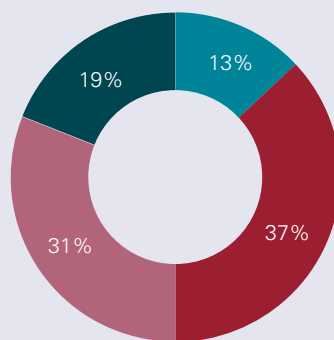
It is therefore clear that while the entrustment loan framework is – in theory – a simple and robust process,

practical considerations may mean that implementation is anything but. Corporates looking to enhance liquidity through such a framework should ensure that they fully understand the underlying complexities of the process before embarking on such an exercise, preferably seeking professional advice in order to avail of China’s entrustment framework.

**What practical difficulties do you face when moving cash within China, remitting cash out of China or remitting cash into China?**

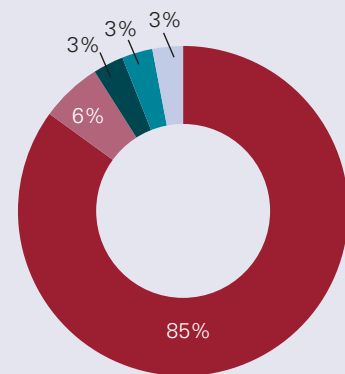


**If you have used cash pooling outside China, has the introduction of the new PRC tax rules concerning controlled foreign companies, impacted how you manage your cash outside China?**



- Significant impact
- Marginal impact
- Minimal impact
- No impact at all

**If you are required to submit surplus funds to parent businesses outside China, what form will this take?**



- Dividends
- Service fees
- Interest
- Royalties
- Entrustment loans

*“We have had cash pooling in China since 2005. The investment holding company in Shanghai runs the cash pooling for our group of companies. We have found that cash pooling is a very critical component for us for managing cash in China. We can centralise the cash in one location to support various corporate objectives. We also found that after setting up two-tier cash pooling, we are in a much more effective position to manage counterparty exposure.”* – Henry Ma, Treasury Director, Emerson Electric Asia-Pacific





## Focus on tax efficiencies



Companies need to pay attention to efficiencies when managing and moving the cash on a group basis rather than on an isolated individual company basis. They also need to be aware of tax leakages associated with moving their cash as this action could involve business tax and/or other charges in China.

There may be certain restrictions on companies to combine and use capital-account foreign currency cash with their current account foreign currency cash on settlement of certain liabilities. Corporates in China therefore may need to manage these two separate pools of cash tax effectively. This tax could be punitive if companies are not receiving cash revenue due to timing of cash receipts but incurring cash tax expenses. Any internal transaction incurring such a cost needs to factor it into the cost benefit analysis.

Managing tax leakages should be structured at different levels - companies need to ensure that profit repatriation tax leakage is minimised, by placing an appropriately structured intermediate holding company to hold the China operations. There is also an operational level of tax planning which needs to be structured to ensure that cash movements, goods movements and income flows are taxed efficiently.

China corporates are increasing their focus on this issue as they expand operations across China and overseas. They need to pay attention to latest regulatory developments as the rules are evolving fast. This creates both challenges and opportunities.

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## China regulatory developments



While the Chinese government has been relaxing foreign exchange controls on the current account for several years now, China's foreign exchange regulator (SAFE) took significant steps this year to liberalise foreign exchange controls on the capital account as well. As part of the Chinese government's efforts to encourage outbound investments by Chinese companies, new rules were issued that make it easier for companies in China to set up or acquire offshore companies and make loans to their offshore subsidiaries.

Previously, Chinese companies were required to obtain SAFE approval to use onshore funds for offshore investments prior to applying for approval from the Ministry of Commerce and making the investment. Under the new rules, Chinese companies are now only required to register with SAFE after obtaining outbound investment approvals. The sources of foreign exchange that may be used to make outbound investments have also been expanded. Moreover, Chinese companies that meet certain requirements are now allowed to provide debt financing to their offshore subsidiaries, using their foreign exchange reserves or by converting renminbi.

In addition to benefiting the outbound investments by Chinese companies, these new rules have also opened new channels for foreign investors to access the cash of their PRC subsidiaries. In cases where loans are made from China to overseas subsidiaries to fund offshore investments, two key tax issues to consider are whether tax credits for foreign taxes paid will be available to offset against PRC tax when the profits are remitted back to China, and whether PRC tax will be imposed on profits that are 'parked' offshore.

As a general proposition, credits against PRC tax for overseas tax paid on income remitted to the PRC may be available, however, circumstances may limit the amount of credits that may ultimately be allowed, for instance where the character of the income on which the overseas tax is paid differs from the character of the income remitted back to the PRC. For example, if dividends are paid from an overseas investment and this income passes through an offshore holding company funded with debt, and the holding company then on-pays the dividends in the form of interest to the PRC, no credits for overseas dividend withholding tax would be available in the PRC.

If profits received from an overseas investment are parked in an offshore holding company which taxes such profits at less than 12.5 percent, and there are no sufficient commercial reasons for keeping the profits offshore, then the controlled foreign company (or "CFC") rules will tax such profits on an accruals basis notwithstanding that the profits have not been remitted back to the PRC.

Li Qiang  
Partner, O'Melveny & Myers LLP

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# Investing in cash operations and technology

Developments in the technology sector have presented opportunities for companies to enhance systems and visibility over cash flows, by integrating ERP systems and improvements in clearing networks.

The key challenges for organisations operating in China, include lack of information regarding company transactions, multiple banking relationships, inefficient ERP systems, inadequate training which presents opportunities for banks to help educate their corporate clients to ensure that the systems they invest in are aligned with their business strategy.

One of the issues highlighted by survey respondents in China is a lack of visibility in the supply chain, the banking system and across all the clearing networks. On the one hand, a majority of transactions take place electronically which shows a level of sophistication but, conversely, there is also a lack of information that accompanies these transactions (for example, the absence of a beneficiary name in electronic funds transactions).

Many companies do not have up-to-date real time information regarding their debtors' position. The finance team cannot report to the sales team who cannot

manage their customers. Companies also face issues in respect to existing incongruous technology and outdated or non-existent treasury management systems. They need to be able to efficiently manage their receivables on time and provide accurate information.

The key, therefore, is for companies to have accurate information collected from all sources, managed properly and delivered in a timely manner. The banking system in China contributes, as it does not tend to have infrastructure in place to support robust information exchange. Additionally, companies also find it difficult to ask their clients to be clear, precise and timely when delivering crucial information.

According to the survey, 76 percent of companies with a turnover of more than USD 5 billion are planning to expand their cash management operations. In comparison, just 59.4 percent of firms with a turnover of USD 500 million or less are thinking of doing the same. Meanwhile, 55 percent of those who are planning to expand their cash operations are also

likely to increase their investment in cash management technology while of those who are not planning any expansion, the percentage drops to 40 percent.

Multinational businesses are less likely however than their PRC domiciled counterparts when it comes to investing in cash/treasury management technology. Organisations with larger turnovers are also less likely to invest in cash/treasury management technology. Just 38 percent of companies with a turnover of over USD 5 billion will increase investment into this area, compared with 61 percent of firms with a turnover of less than USD 500 million.

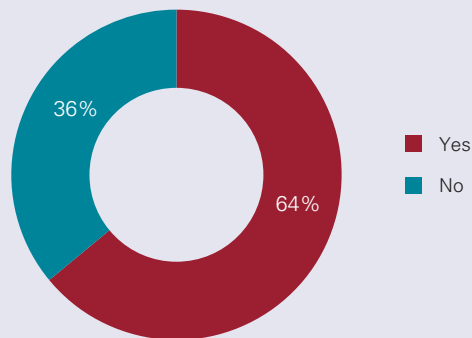
This means that larger companies tend to be ahead of the curve with existing robust technology systems in place. However, companies that have expanded through, for example, acquisitions, tend not to have had an opportunity to upgrade their systems in line with their expanded growth and size.



**48.3%**

of respondents plan on increasing their investment in cash and treasury management technology

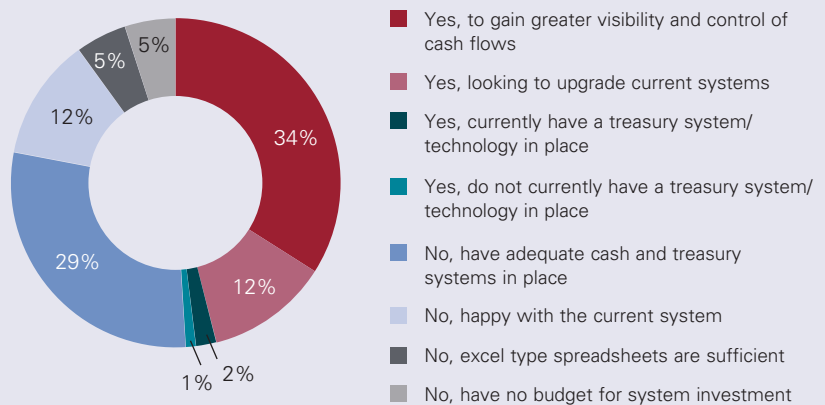
**Are you planning to expand your cash operations in China?**



**76%**

of companies with a turnover of more than USD 5 billion plan to expand their cash operations

**Are you planning to increase your investment in cash and treasury management technology?**





## Getting visibility over cash

Identifying and managing cash should be at the forefront of a corporate's business strategy. Companies need to have visibility to cash flows and to always be in positive net cash, particularly when considering acquisitions, investments or expansion. It is also important to establish awareness and disciplines of cash positions at the onset, as it is difficult to go back and analyse this position when adhoc processes have been set up.

Executives running their organisation must firstly have a strong understanding of the business model. Secondly they need to understand how this business model generates cash. Many businesses fail to recognise that they need to test their business model thoroughly to ensure the cash generation is clear.

Chinese entities have grown quickly, and sometimes do not have a clear understanding of their cash positions. They tend to over-rely on the use of spreadsheets or manual processes to assess where they are at. However, rapid expansion and growth in China has meant that many corporate entities are relatively new on the scene, and therefore this is a real opportunity for them to put in place proper governance and systems at the beginning of their business lifecycle. They can build in the disciplines to ensure they have visibility into these cash and risk positions.

Companies at the start of their life cycle have the advantage of being able to design and implement efficient IT platforms, to ensure underlying systems such as ERP, treasury and cash management are aligned and integrated. This includes opportunities for better straight-through-processing (STP). This will in turn, lead to increased visibility and more efficient management of cash on a group-wide basis.

As China moves in the direction of a more services-driven economy, companies need a more sophisticated means of understanding their cash flow. They are going to increasingly want systems that can help them understand and to improve their cash flows. And as they expand, they are looking for different ways of managing as well as finding cash, in addition to doing monthly cash flows and forecasting. Having improved visibility will enable them to manage their cash and working capital more efficiently.

It is important to have accurate real-time information collected from all sources, managed properly and delivered in a timely manner. Choosing the right IT system that fits your organisation and is aligned to a strategy is crucial, as it can produce significant savings.

In summary, organisations must clearly understand and document the business model. The second critical step is to conduct stress tests and clearly understand how the business model will generate cash. The third key step is to have the right business processes and systems in place in order to manage your cash flows.

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# Embedding a cash culture in China

Cash is at the heart of every business. Organisations that realise this are in a position to develop a culture where everyone takes ownership of cash issues and has a stake in seeing them managed effectively. Greater visibility and understanding of cash operating cycles can lead to better discipline and more accurate, informed decisions.

Poor cash habits can emerge over time, especially during a period of growth or when credit is readily available. From such a situation, embedding a cash culture within the organisation can require profound change and difficult choices. It can mean engaging functions such as sales, procurement and operations more meaningfully in the cash forecasting process, or restructuring entire departments. Short-term, quick improvements may be easy, but achieving sustained improvements can be more of a challenge. Management and company divisions tend to operate in silos and it is important that these are removed so that everyone understands all the processes in place.

While cash and working capital management has risen up the agenda, most organisations are still not incentivising their employees to take responsibility for these issues. A strong cash culture is important in ensuring that everyone

takes ownership of cash issues and has a stake in seeing them managed effectively. Employing a cash focus at the top and communicating it throughout the organisation is paramount. By linking KPIs and incentive regimes to cash, executives can be measured not only on sales and

margin but on ensuring that credit risks are assessed and debts are collected on a timely basis.

Therefore, linking compensation to working capital and cash management KPIs can be an important way to instill a strong cash management culture



*“Our focus has been about transforming the business through process simplification and driving free cash flow for this year. For example, using tactical incentive programs around key working capital measures can drive and shape the right behaviour if managed appropriately. We have also put in more controls at the front end for new customers, for example, by building risk profiles. This has allowed us to work with customers through these difficult times.”*

– Karl Davies, Vice President, RIS Finance, Asia Pacific, Avery Dennison



in an organisation, for example tying incentives to cash targets as well as revenue targets and enhancing visibility through supply chains.

A sustainable cash culture within an organisation is more than just hitting a target number each month. The goal of optimising working capital and cash should be a responsibility shared by all departments and employees of the organisation, with its associated responsibilities appropriately distributed.

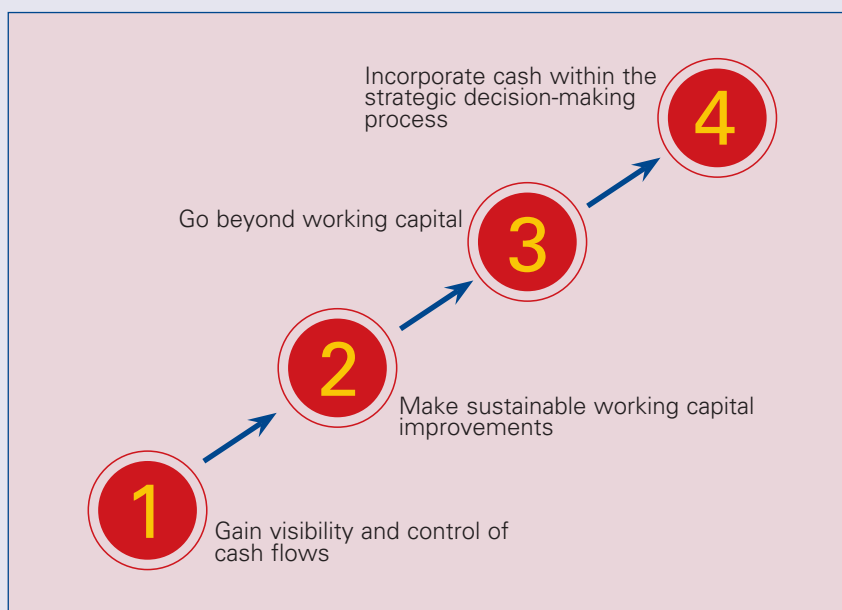
As finance increasingly includes operational managers in efforts to manage working capital, simple, standardised metrics can help the understanding of working capital throughout the organisation. For many firms, it is natural to opt for variable compensation to cash flow related measures.

However a cultural mindset shift is required in China, where a lot of companies are still playing catch-up when it comes to linking cash flow targets to management compensation. According to the survey, only 55 percent of PRC-domiciled businesses note that cash/working capital management is a component of executive compensation, compared to 78 percent of multinational respondents.

Just over half (53 percent) of respondents whose turnover was less than USD 500 million note that cash/working capital management is a component of executive compensation compared to 67 percent of respondents whose turnover was more than USD 5 billion.

# Steps towards effective cash management

## Steps to world-class cash and working capital management



### 1. Visibility and Control of Cash

**Flows:** The first and perhaps the most important step is to improve visibility and control of cash by developing a robust rolling cash forecast. This helps to provide accurate and up to date information so that businesses are able to respond quickly to changing circumstances.

### 2. Sustainable Working Capital

**Improvements:** This can help to achieve a higher level of accuracy and improves the reliability of future forecasts. By revealing peak cash requirements, forecasting can be an efficient tool for cash management.

Keeping on top of cash in this way also helps to avoid unnecessary surprises for the company, and helps a business to focus firmly on cash issues and provides early warnings of any funding issues.

### 3. Go Beyond Working Capital:

Cash flow maximisation often becomes the top priority in a crisis. Businesses should look into discovering new opportunities in this area. These include strengthening credit control, prioritising payments, and improving procedures for billing, cash collection and purchasing. Our experience shows that these and other timely measures can produce significant effects on cash flow.

### 4. Incorporate Cash within the Strategic Decision-Making

**Process:** After implementing the abovementioned measures, additional initiatives to increase cash flows may be analysed. Examples of medium-term opportunities include supply terms rationalisation, reduction in inventory, and asset sales. Longer-term initiatives include exiting unprofitable market segments, launching new products, changing pricing, reducing capital expenditures and reducing staffing cost.

Some of these measures may be painful, but they often allow a release of substantial cash through mobilising internal resources while helping a business stay within the limits of its banking facilities and reducing borrowing requirements.

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KPMG is a global network of professional firms providing audit, tax and advisory services, with an industry focus. With more than 140,000 people worldwide, the aim of KPMG member firms is to turn knowledge into value for the benefit of clients, people, and capital markets.

## KPMG's Cash Management Advisory Services

- Extensive experience in helping companies improve cash and working capital management
- A team of over 500 people globally focused on helping companies improve their operational performance
- Proven cash flow forecasting methodology that has been implemented in more than 100 companies
- Experienced in managing change to deliver quantifiable savings
- We focus on sustainable results through hands-on operational involvement leveraging joint teams to create ownership and buy-in within your business

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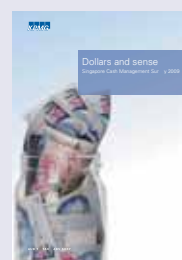
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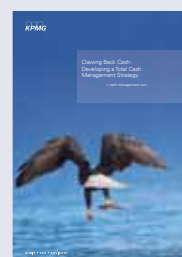
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Cash is back in fashion, but is it here to stay?



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Clawing Back Cash: Developing a Total Cash Management Strategy

# About Oracle

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## Oracle Cash Management

Oracle Cash Management is an enterprise-wide product for managing liquidity and controlling cash. Cash Management gives corporates direct access to expected cash flows from their operational systems.

An organisation can quickly analyze enterprise-wide cash management cash requirements and currency exposures, ensuring liquidity and optimal use of cash resources. Oracle Cash Management is part of the Oracle Financials family of applications.

## Benefits

- Forecast cash flows in any currency and in multiple time periods
- Streamline the reconciliation process
- Monitor for exceptions and fraud
- Forecast based on historical or future transactions
- Manage the cash cycle efficiently and with control

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Oracle operates through 13 branch offices and 16 representative offices in China.

It has four research and development centres (Shenzhen, Beijing, Shanghai and Suzhou), three partner solution centres (Shenzhen, Beijing and Chengdu), a customer support centre (Dalian) and a consulting services centre (Chengdu).

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