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


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.” 

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.

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.

Figure 1. Dimensions of an integrated China strategy

- **Strategic drivers**
  - Growth
  - Compliance

- **Value creation**
  - Cost rationalisation

- **Value protection**
  - Sustainability drivers
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

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.”

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. 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.

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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. 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.

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 workforce. 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.

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.”

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. 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.

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

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14. See also Doing deals chapter on conducting due diligence
15. See also Internal control chapter
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 sub-standard 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.

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 delaying 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 ease 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
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

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.

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