



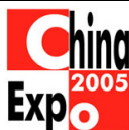
Issue June 2005

# Peeling the Onion

Peeling the Onion provides an in-depth analysis of the major issues facing multinationals doing business in China in today's environment. It features a regular update of regulations, taxation, business environment and accounting legislation affecting foreign invested enterprises in China.

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## LEHMANBROWN at the CHINA EXPO 2005 - Trade & Investment CONFEX

Monday 27th June 2005, Earls Court Exhibition Centre, London ([map](#))

### How to get your money out of China

The event, will feature an extensive Seminar Programme where prominent speakers will cover all the facets required to successfully conduct business between the UK and China. Mr. Russell Brown, Managing Partner of LehmanBrown will speak on "How to get your money out of China". This is an event not to be missed. Please fill the "Visitor Registration Form" and email / fax back on [sales@expoces.com](mailto:sales@expoces.com) / +44 (0) 208 345 5112.

## CHINA SEMINAR - LONDON - 28th June

### "Doing Business in China"

LehmanBrown is holding this seminar in association with its London partner firm, Mercer & Hole. It will cover various aspects and considerations of cross board business between UK and China, and in particular transfer pricing, a current hot topic of both countries tax regimes.

For further details, please contact Virginie Debaud at [vdebaud@lehmanbrown.com](mailto:vdebaud@lehmanbrown.com) or +86 10 8532 1720.

feature article

## China's Financial Markets

### Introduction

The main function of any financial market is, in combination with an effective banking system, to allocate capital efficiently to those groups who will use that capital in the most productive manner. If this occurs, funds are guided into businesses that will produce a fair return to investors with respect to the individual project's risk. This consequently provides a benefit to the overall economy as a sound system is created where funds can be invested by the public and corporations which are then put to good use in the business world. Is this happening in China?

### Equity markets

The answer is not really. Since their inception, the Chinese stockmarkets have had a somewhat turbulent time and have generally been seen to not function in an efficient manner. Outside observers are still somewhat puzzled by the existence of such a capitalist institution in a socialist market economy. This is particularly notable given the booming economic growth of China which seems little to do with the country's financial markets. Whereas in developed economies the stock market and banking sectors have an equal role in provide corporate financing, in China 95% of funds are still sourced from the banking system. The two Chinese stock markets are amongst the worst performing in the world, with the Shanghai Composite Index dropping 25% and its Shenzhen counterpart not faring much better in 2004. In recent months, the markets have reached a six-year low. The markets are sizeable, with the two exchanges listing more than 1,200 companies with a combined market capitalization of around RMB 4,100 billion (US\$500 billion). In terms of size, they rival the Hong Kong Stock Exchange in the competition for the second largest regional exchange behind the Tokyo markets.

Not all share classes are tradable in China (notably the state-owned shares) which has hampered a free "market for corporate control" but two significant share classes are actively traded on the exchanges. The A-Share market consists of Renminbi denominated shares which are available for purchase by Chinese individuals and legal persons (domestic securities companies and state-owned enterprises with at least one non-state owner). The B-share market was initially created for foreign investors and consisted of shares denominated in foreign currency. Though the markets in isolation have not worked effectively, many see solutions arising from the merger of the two share classes or allowing share ownership requirements to be loosened. One of the architects of China's stockmarket, Economist Liu Jipeng, recently stated in a China Daily interview that having the two share classes was a fundamental cause of the lack of development in the capital market over the last four years. However, recent steps have been made in this area with selected insurance companies and qualified foreign institutional investors being allowed to invest in the A-share market for the first time.

### Debt markets

The domestic debt markets have lagged behind the equity markets and are still considered to be somewhat illiquid and immature. There is an existing preference for corporate debt gained from the banking system which will be difficult to change. This results from interest rates on this debt being set administratively instead of being allowed to vary with investment risk. The banks take on the risk in a clear case of moral hazard which has caused various problems to arise including the problematic non-performing loan (NPL) situation in China.

At the present time, there is significant activity in the government debt market but hardly any in the corporate debt market. As a result, the market is frequently used for central government and provincial financing yet corporate investors generally stay away. Corporate bond issuance is stifled by the need to gain approval from three separate authorities before they can go ahead. This is not healthy for the Chinese financial system as investors need to have access to a variety of debt instruments to effectively tailor investment portfolios to the needs of the corporation or individual. The bond markets have also been described as being too focused on the short term rather than the long term. Again, the increased availability of medium to long-term debt will allow companies to alter their financial asset structures more freely, improving the efficiency of corporate structuring. As a result, recent steps such as allowing organizations like International Finance Corp. (a subdivision of the World Bank) to issue renminbi denominated bonds is helpful in building the foundations of a well-functioning system. However, there is much progress still to be made.

### China's investment environment

Part of the problem lies with the investment environment in the PRC. Investor confidence in China's markets is low and the situation has not been helped by a recent flurry of Initial Public Offering (IPO) activity. When this occurs, though firms are using the markets to raise capital, which is a key function of a financial market, such firms are perceived as only using the market the

quickly raise capital with little concern for ongoing corporate performance. Such moves do not help in promoting the market to be a place where Chinese investor's funds will be properly managed despite increasing regulatory efforts to control such behaviour.

China's market regulator, the China Securities Regulatory Commission (CSRC), has been faced with tough challenges, particularly in terms of the market's immaturity. Corruption still occurs with insider trading being a problem that had not been fully eradicated. Current investor protection law is frequently described as having many provisions to deal with companies that act in a fraudulent manner of which few are enforceable, and hardly any cases reach a final verdict in the Chinese courts. Efforts are being made to correct this situation with an impending review of the 1999 Securities law. Corporate governance is also problematic with much scope for improvement in terms of process transparency, internal controls and the availability of non-executive directors. The strengthening of the Accounting industry in China in combination with future legal reform will serve to shore up the foundations of the financial system so the market can move forward from its current position. However, until these more fundamental problems are fixed, the absolute levels of funds in the markets will not be as high as they should be.

## Conclusion

The financial markets in China are struggling somewhat but there are several signs that suggest that an improvement in the situation may be in the pipeline. Progress is being made in the areas of corporate governance and the framework of the investment environment. This will provide deeper benefits which will undoubtedly improve the situation over time through the stronger foundations for the overall system. Innovations in the financial markets are also occurring such as the recent launch of a unified composite index to encourage index-based financial products. Innovation and the broadening of financial instruments availability are important to fully develop capital flow efficiency in the PRC. However, securing the systems foundations is the key hurdle to overcome which would then allow the financial product innovation to have its full and positive impact.

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economy

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### Ministry of Finance: "At least 5 years before the unification of tax rates"

When the long-awaited harmonization of tax rates occurs, foreign invested enterprises (FIE) will have a "grace period" of at least 5 years to facilitate the change to the new system according to an announcement from Jia Kang, director of the Fiscal Studies Institute of the Ministry of Finance. The harmonization of the tax rates will be a long-awaited, significant change which is required under the WTO requirements for equal tax treatment in terms of domestic and foreign companies.

In terms of tax breaks, foreign companies will be adversely affected by the change as they are the group that are favourably treated under the existing system, as exemplified by a recent petition to extend the grace period to allow foreign companies to make the transition successfully. The Chinese authorities have responded by hinting that the staggered changes to tax may extend over 6-7 years in all before the likely equilibrium tax rate of 24% is imposed. Jia also added that the tax harmonization was an inevitable event and if various administrative problems could be overcome then the system may be in place as early as 2007. *Source: Hong Kong Trade Development Council*



[Australia grants China "market economy" status](#)

China and Australia have agreed to begin talks aimed at forming a free trade agreement (FTA) after Australia formally recognized China as a market economy. A Memorandum of Understanding to that effect was signed on April 19th after discussions between China's president Wen Jiabao and his Australian counterpart John Howard. Australia is now the largest developed country seeking to reach a FTA with China.



### Tough times ahead for China's steel industry

China is taking concrete steps to construct a more mature foreign exchange market, as part of efforts to improve its exchange rate forming mechanism.

The China Foreign Exchange Trade System (CFETS) said it will soon select a further eight banks to act as market makers for the new products it plans to launch in May, after it signed up Bank of China as the first market maker earlier this week.

The new products in the pipeline are eight types of transactions between foreign currencies, including trading between the euro and US dollar and between the euro and Japanese yen. Currently, only transactions between the Chinese currency, the renminbi, and four overseas currencies - US dollar, euro, the Hong Kong dollar and Japanese yen - are permitted in China's foreign exchange market.

The other eight prospective market makers reportedly include one Chinese bank and seven foreign banks, including HSBC and Deutsche Bank. Market makers are responsible for a continuation in trading, by simultaneously offering buying and selling opportunities to market participants.

While the new types of transactions and their market maker system will help activate trading in the domestic forex market and meet domestic companies' trading needs, analysts say what is also significant is that the moves will pave the way for the launch of a market maker system for trading between the renminbi and the US dollar, which the local currency is pegged to.

*Adapted from China Daily*



### China to expand energy production

China will continue to expand its energy production capacity according to a recent news release from the website of the Ministry of Land and Resources. China plans to build new production capacity of 1.1 billion tons of coal and 150 million kw hydraulic power generation by 2020, equivalent to the construction of a Three Gorges Project every two years. Oil production will be also be a key area of focus.

On top of expanding production of coal, hydropower and oil, China will speed up development of nuclear power and new energies. Two rounds of biddings have been conducted for wind power construction and a third is expected to start in April. Four sites have been chosen nationwide for bio-power tests. Exploration of natural gas and pipeline construction will be accelerated. A trial station receiving liquefied natural gas has started work in Guangdong, and more trial stations will be set up in Fujian, Zhejiang, Shanghai, Jiangsu, Shandong, Liaoning and Guangxi. *Adapted from People's Daily*



### Economic Indicators

China's economy grew by an unexpectedly rapid 9.5% in the first three months of 2005. The economy also grew by 9.5% in the fourth quarter of 2004. The government's official target for growth is 8% per annum. Inflation was moderate, with the consumer price index up 2.8% from the same period last year. *Source: National Bureau of Statistics*

China's M2 money supply expanded 13.9% in February when compared with the previous year's statistics. March's corresponding figure was 14.0% staying within the central bank's 15% target for the ninth consecutive month. *Source: Bloomberg News*

The State Administration of Taxation announced it collected RMB 756 billion (US\$91.4 billion) in taxes in the first three months of this year, an increase of more than 20% from the same period last year. Taxes from the country's economically-developed eastern regions stood at RMB 531.7 billion (US\$64.2 billion), up 18.9%, those from the central regions totaled RMB 119.8 billion (US\$14.4 billion), an increase of 22.5%, and the taxes from the less developed western regions came to RMB 104.4 billion (US\$12.6 billion), up 25.8%. *Source: Xinhuanet*

Foreign direct investment in China rose 9.5% in the first quarter of 2005. According to the Ministry of Commerce, overseas investment also rose to some US\$13.4 billion. Contracted foreign investment or investment pledged but not yet received rose 4.5% from a year earlier to US\$35.2 billion. *Source: Bloomberg News*

In the first quarter of 2005, China's investment in fixed assets hit RMB 1,099.8 billion (US\$132.99 billion), up 22.8% when compared with the same period last year. *Source: National Bureau of Statistics*

Guangdong Province, an economic powerhouse in south China, had a total foreign trade of US\$83.06 billion in the first quarter of this year, the highest among all provinces according to the General Administration of Customs. The volume represented a year-on-year growth of 14.4% and made up 28.1% of the national total for the same period. Guangdong had a trade surplus of some US\$7.46 billion in the three months, with its exports up 21.8% to US\$45.26 billion and imports up 6.6% to US\$37.8 billion. *Source: People's Daily*

In the first quarter of 2005, China imported 5.4 million tons of coal and 63.24 tons of iron ore, up 58.8 percent and 24.8 percent respectively. Due to concerns regarding the overheating steel production sector, iron ore-related statistics are particularly important in gauging how this situation will develop. *Source: General Administration of Customs (GAC), Beijing*



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legal

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### **Net widened in tax evasion clampdown**

China will launch tax inspections in nine areas including the real estate, steel and cement industries in 2005. In order to tackle problematic areas on a regional basis, local tax bureaus will be allowed to focus on two or three of the nine areas to give added flexibility in dealing with their particular local situation, according to officials from the State Administration of Taxation (SAT). The nine areas also include coal production and transportation, motorcycle production and sales, waste collection, farm products processing, and export companies which have asked for tax rebates.

China's tax departments at all levels audited 1.23 million taxpayers last year, which helped amass overdue taxes and fines of RMB 36.8 billion (US\$4.4 billion). Tax inspection departments above county level also uncovered 523,000 cases of improper tax practices in 2004. The majority of the illegal cases were related to fake value-added tax invoices. This widening of the net in terms of tax evasion comes hot on the heels of the increased scrutiny of individual income tax issues since January 2005.

*Adapted from China Daily*



## **Reorganisation of Hong Kong accounting rules to move closer to IFRS**

The Hong Kong Institute of Certified Public Accountants (HKICPA) announced that Hong Kong would adopt new accounting standards, which would fully comply with the International Financial Reporting Standards (IFRS), and be effective for financial reporting periods beginning on or after January 1, 2005. Although there are no major textual differences from relevant IFRS, several changes are significant including new regulations HKAS 26/36/38 and HKFRS 3/4/5/Int 1.

'Share-based payment' is a new standard, which requires the recognition of all share-based payment transactions in financial statements. In particular, shares or share options granted to employees as remuneration should be recognized as an expense and included in the operating results, using a fair value measurement basis. Previously, such share options were not expensed in the financial statements. Management will need to assess the impact on financial statements when planning to introduce share options schemes to employees or other parties.

'Business combinations' is also an important new change. Under this regulation, an acquiring company must initially measure at fair value the identifiable assets acquired, and the liabilities and contingent liabilities incurred or assumed, in a business combination.

Under the new standard, 'goodwill' will no longer be subject to periodic amortization, but instead will be subject to an impairment test at least on an annual basis.

For Hong Kong, there are new accounting standards which represent a fundamental change to the accounting treatment of financial instruments. All financial assets and liabilities, including derivatives, are required to be recognized on the balance sheet, and many of these are based on fair value measurement. Changes in the fair value of financial instruments held for trading and others purposes should be recognized in the income statement. There may be significant implementation issues in practice. Banks, other financial institutions, and companies with various financial instruments (including derivatives such as forward contracts, futures, swaps, and options) will be affected by increased volatility with respect to their earnings. *Adapted from China Daily*



## **Changes to the retention of foreign exchange income**

A new Notice and a new Circular (Hui Fa [2005] No.7) have been issued by the State Administration of Foreign Exchange (SAFE) which came into force on the 1 March, 2005. In combination, these regulations allow selected firms to keep all of their foreign currency earnings and others to keep their foreign exchange income for longer periods of time. The question as to exactly which companies will be allowed to retain the full profits is still unanswered as SAFE has not yet elaborated on this point though it marks the continuation of a positive trend in this area. Previous SAFE Regulations issued in early 2004 only allowed firms heavily involved in foreign currency transactions to keep 50% or 30% of their profits.

Most internationally-oriented companies in China need to open a foreign exchange account through SAFE as part of the business registration process, which has a predetermined ceiling which should not be exceeded for long periods of time. Under previous regulations, any balance exceeding this ceiling had to be settled within 10 working days and as a result financial managers needed to keep a particularly sharp eye on this issue. Under the new regulations, this settlement period has been extended to 90 days and if settlement has not occurred by this time, the account opening bank will automatically settle the account within 5 working days and inform the account holder of this fact.

Economic factors may have had a significant role in the move as large amounts of foreign currency investment have been pouring into China in recent months forcing the central bank to issue large quantities of the RMB. As a result, increasing inflationary pressure has been caused by this increase in the money supply. By allowing foreign currency to be retained, this pressure should be notably reduced.



## **Management buyout reforms**

New rules have been issued to improve the market for corporate control in the area of management buyouts (MBO). These regulations state that share transfers from the state to management teams can only be conducted in small and medium sized state-owned enterprises (SOE) with such activity in terms of large SOEs being strictly prohibited. The regulation was jointly released by the State-owned Assets Supervision and Administration Commission (SASAC) and the Ministry of Finance on the 15th April. The National Bureau of Statistics set this small/medium size enterprise standard to refer to those corporations with a registered capital of less than RMB 400 million (US\$48.4 million).

Several other key details of the regulations are particularly notable. Top executives are not allowed to participate in financial auditing, assets evaluation or price setting during the management buyout process under the new rules. Buyout deals must also be completed through government-designated equity transaction exchanges, and information on the transfers must be made public, according to the rules. Executives who cannot identify the sources of funds used to buy state shares or who are responsible for corporate business losses are excluded from management buyout programs. The financial regulators also noted that big state companies and affiliates focusing on strategically important businesses are prohibited from conducting management buyouts because their involvement could cause social conflicts and the loss of important state assets. Reforms in this area are important to optimize the market for corporate control by allowing more efficient transfer of asset ownership to improve the overall competitiveness of the business. *Source: Shanghai Daily*



### **Scope expansion planned for high-tech product classification**

China will expand the number of high-technology products eligible for up to a 17% rebate on exports to shore up slowing growth of shipments overseas. Currently, there are 134 products, including such items as hard-disk drives and liquid-display crystals, that are entitled to this favourable treatment. However, Commerce ministry officials did not elaborate on which products will be affected by the move. High-technology export growth slowed to 26% in the first quarter of 2005 from 52% a year earlier. China shipped RMB 84 billion (US\$10.1 billion) of high-tech products overseas in the first quarter of 2005, accounting for 29% of total exports. *Source: Shanghai Daily*



### **Upcoming IIT regulation on stock option revenue**

China is to introduce an individual income tax on revenue earned from corporate stock options. A notice jointly released by the Ministry of Finance and the State Administration of Taxation stated that the new tax will come into effect on July 1 this year.

According to the new rule, investors will pay tax on money earned when exercising stock options by paying a percentage of the balance between the market price and the strike price. Analysts say that the new policy represents a step towards tighter control over individual taxation. However, the new rule has also been said to mainly target shares held by employees of the company concerned while ordinary shareholders will remain untaxed. *Source: CCTV*

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Mr. Jim Harkness, Chief Representative of WWF China

### LehmanBrown took part in WWF's 25th anniversary event

"The event has raised awareness about WWF China's nature conservation activities, while allowing the business community to interact and discuss corporate social responsibility issues in China. WWF China is proud to announce the support of Regus and LehmanBrown as major sponsors for the event."

We are interested in receiving your feedback on our articles and any suggestions as to future topics are more than welcome at [newsletter@lehmanbrown.com](mailto:newsletter@lehmanbrown.com).



"Providing an Alternative in China"

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