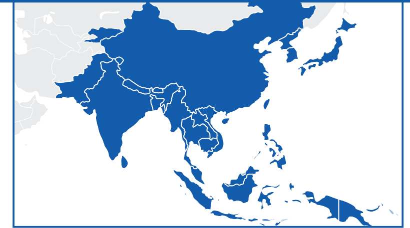
mgiasia



Why Due Diligence in China!

In Western countries as in China, it is imperative to carry out sufficient due diligence on whom you are going to be doing business with, to reduce the risks. Peeling back the layers though in some countries might be like the skin on an apple, peel one layer and you have found the information that you are looking for. In China, while the access to information has improved, you are still really dealing with an onion, with many layers.

Does your company invest or donate its money? Sensible companies or individuals would no more invest in a company without due diligence than give a blank corporate check to the first person with an extraordinary business proposition, or would they?

China is continuing to grow and is changing rapidly, while the business environment and ease of doing business have been steadily improving. As of April 1, 2019, a great VAT tax reform was implemented, seeing a reduction for Individual Income Tax, aiming to combat the rising costs in China. Meanwhile, in 2017, the State Council issued two "Circular on Several Measures to Promote Further Openness and the Active Utilisation of Foreign Investment" policies to cut down the government's administrative procedures and improve the regulatory environment for foreign businesses in China.

Further benefits come from the new Foreign Investor Law (FIL), which is intended to develop a level playing field for foreign investors. The law aims to eliminate the theft of Intellectual Properties (IP) in Joint Ventures (JV) and prohibit government officials from forcing companies to transfer technology as well as making such actions illegal in China. To make China more accessible, the government released a shortened Negative Lists allowing for opportunities in more sectors for foreign investments. Possible new industries can include the agricultural, mining, manufacturing, and services, and enable Wholly Foreign Owned Enterprises (WFOE) to engage in more sectors.

However, underneath the positive changes, many problems are still troubling the Chinese market. For example, there are cases of inconsistent regulatory interpretations or implementational guidelines, unclear laws and enforcement, and ever-growing risks regarding regulatory non-compliance for foreign businesses. Furthermore, foreign companies in recent surveys in China feel unfairly targeted when undergoing tax audits and work permit reviews, compared to their local competitors. To combat these issues, international companies and investors through political advocacy are pushing for the development of a level playing field and improved intellectual property security.

Produced by MGI member

LEHMANBROWN
雷 博 國 際 會 計
International Accountants

Dickson Leung, Senior Partner
dleung@lehmanbrown.com

LehmanBrown International Accountants is a member of MGI Asia with office locations in Beijing, Guangzhou, Hong Kong, Macau, Shanghai, Shenzhen and Tianjin, China. Dickson is a Senior Partner at the firm and also North Asia Circle Leader for MGI in Asia. Dickson has over 24 years China accounting and financial experience and the firm has been a member of MGI Worldwide for 10 years. For more information go to **www.lehmanbrown.com**

Political pressure and advocacy applied externally and internally in China can be seen with the EU and EU Chamber of Commerce in China. As of 2016, The European Commission adopted a new strategy on China changing the EU's relationship with China for the next five years proposing that the EU should promote reciprocity, a level playing field and fair competition across all areas of cooperation. While the EUCCC applies pressure from within as seen in their yearly Position Paper.

"We do not question the willingness of China's top leadership to continue to open up and reform, but a new approach is needed to implement change. It is not sufficient that the top leadership is committed to reform and opening-all levels of government need to embrace this direction. After all, many of the problems faced by international companies are not necessarily an expression of state policy, but instead result from poor regulations designed by lower-level officials that are inconsistently enforced. While the European Chamber recognises such difficulties, our member companies cannot wait indefinitely for these much-needed reforms."

Mats Harborn, President of the EUCCC, Executive Position Paper 2018/2019

So, is investing in China, the world's biggest market, something to be avoided?

Not at all, as long as you do your due diligence because taking a calculated risk is what business is all about. Note the word *"calculated"* is used advisedly, as business decisions inherently should be based on sound information. Any experts can brush off a case of a failed joint ventures or business as a bad investment. However, does anyone look at the quality of due diligence was done before entering in such an endeavour? The truth is, that it is unlikely, as the

VAT Reform

mgi asia

mother company's board will rationalise everything into corporate history, citing the Chinese as being protectionist. Perhaps they should mention them as the smarter partner, or that they did not do their homework.

What exactly does due diligence take into consideration?

Due diligence is much broader in scope than is generally perceived. Regardless of which country you are doing business in making a substantial investment in getting to know the prospective partner or the proposed market, is not money that should be begrudged. It is imperative to seek answers to vital questions in areas such as:

Management. Who are the management team? Have they worked together before and are their ideas compatible? What experience does each member bring to the table, and is it relevant? What is the focus of each member? Is the team complete?

Legal Issues. Is the investment in the country legal? Are there any restrictions imposed on that particular industry within the country? Is the company operating within the scope of the business (i.e. is the company acting ultra vires?)? Have the local partner's fixed assets, to be used as a capital injection into the new company, actually been pledged to the bank? Have the land rights been granted the appropriate land certificate? Are there any restrictions on the company's land-use rights? Who owns the IP, or will own the IP in the future, and has any IP being brought into China been registered already, and can it be registered?

Concept. What is the overall timetable for the project? Will the product have a competitive advantage in that specific market? Are there Intellectual Property or Patent and Trade Mark issues? What is the local business regulatory issues, and does the plan allow enough time for these to be resolved?

Expanding on the arguments of Concept, considering China's enormous economic growth and numerous reforms that occurred in the past decades, it is recommended for any would-be investor or business to maintain some level of due diligence. Like in any country the Rule-of-Law must be adhered to where ever you are operating in. However, unlike most countries, when reforms are finally enforced in China, the changes come swiftly often catching unsuspecting foreign business and investors by surprise. Staying on top of Government and local regulations is a constant necessity when operating anywhere in the world, in some cases, more so in China.

Given all of that, time must be factored in as well. Westerners used to the speed of business in developed nations are often frustrated by the multiplicity and the seemingly overly bureaucratic state of government departments. With proper due diligence, a project can set realistic timeframes reducing such frustrations from occurring in the first place.

Market. What about those cash flow and production projections? What data are they based upon? What are the estimates of the needs for the company's products or services? What market research has been done, and has it been analysed? What are the competitive advantages of the company's products/services in the Chinese market? What are the future marketing strategies? What is the pricing strategy? What about the competition?

Capital requirements. How much funding will be required presently, and into the future, and how will the financing be structured? Will additional funding be needed and, if so, when, at what stage in the project and from who?

Financial statements. It is essential to have three to five years projections, and for established companies, historical records going back for the same period. It is also imperative to understand the financial position of the Chinese partner, including whether the statements are presented in a "true and fair" manner. Similarly, are they in accordance with Chinese Accounting Standards (which is very close to IFRS)? Or, are their difference between management reporting and local books, and can these be explained.

Investigate. Last, but not least, investigate your proposed partner, using an investigator who can check through different channels. This is in addition to due diligence on the proposed joint venture partner and its owners.

So how do companies sort out this Gordian Knot?

Firstly, by getting the right advisors. With China's complex accounting system, rapidly changing legal and tax system and bureaucratic controls, seeking sound professional advice is paramount in setting up any China operation.

Secondly, by conducting due diligence. The key lesson learned is that in China, especially, it is imperative that an in-depth *"Complete Business Due Diligence"* be done before any firm begins in the China market.

Otherwise, it could end in tears!

About MGI Asia

MGI Asia is a member of the MGI Worldwide international accounting network with some 5,200 audit, accounting, tax and consulting professionals in more than 260 locations around the world.

www.mgiworld.com

Follow us

LinkedIn: linkedin.com/company/mgiworld.com

Twitter: twitter.com/mgiworldwide

Facebook: www.facebook.com/mgiworldwide

YouTube: Subscribe to MGI Worldwide

MGI Worldwide is the brand name under which certain member firms of Mint Alliance operate as a network of independent audit, tax, accounting and consulting firms. Mint Alliance is an Alliance of independent audit, tax, accounting and consulting firms. MGI Worldwide and Mint Alliance do not themselves provide any services and their member firms are not an international partnership. Each member firm is a separate entity and neither MGI Worldwide, Mint Alliance nor any member firm, accepts responsibility for the activities, work, opinions or services of any other member firm. Mint Alliance is a private company limited by guarantee incorporated in the Isle of Man with company number 0132238V.