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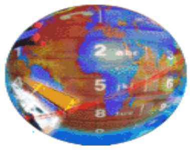
International Accountants

"PEELING THE ONION - Part 1"



Don't let inept due diligence bring tears to your China operations!

In Western society, ulterior motives are like the skin on an apple, peel it off and you've found the hidden motive. **Not so in China, now you're dealing with an onion, with many layers.**

Does your company invest or donate its money? Street-smart Western multinationals would no more invest in a company without due diligence than give a blank corporate check to a druggie, or would they?

Not in the Western markets perhaps, but mention investment in China, and all the MBA taught caution is caste to the winds. Company after company are currently pulling out of China, usually with losses in the area of forty to a hundred million dollars.

One of the latest victims of the "Chinese Benefit Scheme", a World leader in domestic white ware, is presently taking action to terminate its joint venture investment in China after only three years, leaving the Chinese partner with a world-class plant capable of competing with post-WTO Western imports well into the future.

Why? Well, the Western company invested **US$70 million in the Chinese joint-venture**, built a state-of-the-art plant, and left the running to the local partner. The plant never reached more than eight percent of capacity, supposedly because the local partner couldn't operate it. Yet, Chinese are generally known globally for their business acumen!!!!

Management was left entirely up to the local partner with the foreign partner providing only technical support and a financial supervisor. Only in the **third year** did they put in a Western manager. By that stage, the Chinese partner effectively had control over the operation and was utilising the facilities for their own business plans. Needless to say, after a great deal of frustration and irreconcilable differences in business objectives and motives, the Western firm decided it was easier to write-off a loss of **US$42 million** rather than pursue the lucrative China market in their current form.

So, was this necessary? Is investment in China, the World's biggest market, something to be avoided?

Not at all, 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. The MBA courses may quote this as a case study, but will anyone tell students how much, or how **little due diligence was done**? The truth is, that it is unlikely, as the mother-company's board will rationalize everything into corporate history, citing the Chinese as the bad guys. Perhaps they should cite them as the smarter partner.

Due diligence is much wider in scope than is generally realized. Making a substantial investment in getting to know the prospective Chinese 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, legal issues, overall concept, market, capital requirements and financial statements.

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 China legal? Are there any restrictions imposed on that particular industry within China? Is the company operating within the **scope of the business** (i.e. is the company acting ultra vires?)? Has the Chinese partner's fixed assets, to be used as capital injection into the new company, in fact 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?

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

China is not a country where the Rule-of-Law predominates. Many regulations are contradictory and often rely on the goodwill of a bureaucrat who may have other interests at stake. Although corruption is widely believed to be endemic in China, it is often sublime to outside observers and the Government is actively fighting to control it from surfacing in the business community.

Given all of that, time is a very real factor, and 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.

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

Capital requirements. How much **funding will be required now, 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 important to have three to five year 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 International Accounting Standards? In other words ... "**are the books cooked?**"

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

So how do foreign companies sort out this Gordaean Knot?

Firstly, by getting the right advisors. With China's outdated accounting system, bureaucratic controls, lack of legal transparency and its fast changing regulations to make improvements, seeking sound professional advice is paramount in setting up any China operation. In the post-WTO China it is easy to be confused. Whilst it is certainly recommended that you seek the expertise of international firms for such advice, it is also just as important that such advisors have **proven China experience** and market-specific knowledge.

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

Otherwise it could end in tears!

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"Peeling the Onion" is a series of newsletters designed to assist in the financial and accounting control of your China operations. We would love to hear what issues you would like to know about in coming articles, so please contact us with any questions."

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