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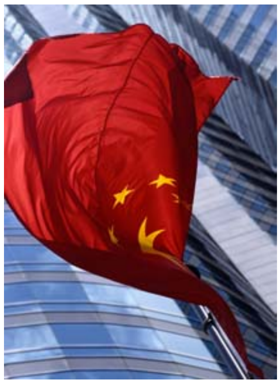
International Accountants

"PEELING THE ONION - Part 8"



SMEs join the race to China, but have they done the required training?

The race to get into China is on. Foreign manufacturing companies have bunkered down in the South, international banks and insurance companies are vying for territory in Shanghai's new financial playground, global technology firms are flocking to 'state-of-the-art' high-tech parks in Beijing and a multitude of NGO's are gearing up to provide much needed education and poverty-relief programs in the West.

Yet, where and how do the small-medium sized foreign enterprises (SMEs) fit into the picture? How do smaller companies who want to tackle the largest potential consumer market in the world play with the big-boys?

Unfortunately many such companies have learnt their China lesson the hard way - through Joint Venture partner arrangements gone wrong, through losing their one core asset, Intellectual Property, and even having their investment eaten away from under them through over-trust and under management.

So, what are the danger signs for SMEs to beware of? What is to stop them from investing in a rotten venture when they don't have the resources to protect themselves? How do they compete without the huge PR budgets or government connections? In a nutshell - how can SMEs tell what is a rotten onion and what is not?

Safeguarding against buying a rotten onion!

There are essentially 6 key rules to abide by:

1. **Conduct appropriate research** - The market research and 'credit check' industries in China are booming. Greater publicly-available information, more open government channels and a more mature services industry, ensure that companies now have access to greater insight about the market, geographical segmentation, consumer behaviour and competitor analysis.

Aside from understanding the market, it is also a pre-requisite in China to intimately know your partner (whether business partner or simply a key supplier) and also possibly key employees. The most effective way to do this is through "background checks". This can be done efficiently and discretely.

Checks should be prepared from **two angles**:

> a) Personal checks - With political connections playing an integral role in business in China it is almost mandatory for investors to evaluate their partners, suppliers or key personnel to understand possible government relationships. Many companies have partnered with a seemingly influential 'business person', only to find out later that the same person is the Mayor of the city and once he resigns (and his connections follow) they are harassed by tax authorities to pay back enormous tax liabilities previously disregarded.
>
> b) Company checks - This is particularly important when venturing with or potentially purchasing a local (Chinese) company. Under current accounting and auditing regulations, there are different requirements for Foreign Invested Enterprises (FIEs) and local firms. One important distinction is that local firms are not required to be audited by an independent CPA firm. As a result, many investors have jumped into bed with, or entered into supplier arrangements with theoretically bankrupt partners or those with a lot of skeletons in the closet.

2. **Know the regulatory environment** - In China there are essentially four structures that investors can use to set-up operations:

> a) Representative Office;
>
> b) Joint Venture;
>
> c) Wholly Foreign Owned entity; or,
>
> d) Domestic company

Whilst the first three are available to foreigners, the last is only available to Chinese citizens (or through the equivalent of a nominee-holding structure).

In deciding which structure is best for your operation there are, of course, business decisions to be made and also legal issues to consider.

The key ones for SMEs to consider are:

> a) What will your business scope be?
>
> b) What structures are allowable in your industry and business scope?
>
> c) Who will your clients be - local or international?
>
> d) Do you wish to trade in China or is the entity purely for sourcing opportunities?

e) Are you required to invoice in China or will your business be conducted offshore?

f) How will you repatriate profits?

g) How much do you wish to invest - There are certain "minimum capital requirements" for certain structures, depending on your business scope.

h) How will you pay your payables (offshore or onshore)?

Adding to this complexity is the decision on how to enter the structure. With China's developing Merger and Acquisition market, a massive sell-off of State Owner Enterprises (SOEs), new tax changes to China Holding Companies (CHCs) and the ability to hold operations offshore, it is no longer a requirement for foreign SMEs to establish "Greenfield" operations in China.

3. **Where to set up your operations** - This decision will not only depend on your business requirements (e.g. being close to suppliers), but more importantly, on government policies in different locations and available preferential tax policies.

In Beijing alone there is "one district and five parks" all offering foreign investors with substantial tax concessions. Where as concessions were once a despised word in China (Shanghai) after the Opium Wars, they are now back in flavour. Special Economic zones, coastal cities, high-tech parks, manufacturing bases and government "Go West" policies are proving enormously successful in luring foreign investment.

However, it must be warned that there is still a cloud of uncertainty over the authority of some districts offering these incentives. Therefore, it is highly recommended that advice is sought before agreeing to something that the local tax authority is not actually authorized to deliver.

4. **Setting up the business** - Companies in more developed nations (such as Hong Kong, Australia, USA) can be established within hours. This is not possible in China. The maze of government bodies and approval processes are simply mind-boggling and add to the costs and time to actually establish a legal entity.

Once a company's business license has been approved (which in itself can be a complicated process), there are still nine government bodies (depending on location and the business) which the company must register with! All must be completed in a specified order and they all require separate applications and approvals.

As such, the length of time between deciding to invest in China and actually having an established enterprise may take a number of months.

5. **Intellectual Property (IP)** - China's IP protection is improving. Whilst many companies still find themselves being caught out with their partners or competitors running off with their brand name, trade secret or product plan, it is very often the own fault of the company itself. In China you must register all trademarks and patents. It is that simple.

This is a relatively inexpensive and trouble-free task. China operates on a 'first-to-file' basis and, as such, companies should undoubtedly register their IP before they even think about setting foot in the country. This is particularly important for SMEs which may not have world-wide registered IP.

Many foreign firms, especially SMEs, decide that their first enclave to China will be through setting up a stand at a trade fair. This may indeed prove invaluable for establishing business relations and 'getting a product out there', but it also provides invaluable opportunities for unscrupulous businesses to take a brand name or product idea and cash-in on it, albeit legally, through registering the IP first. In fact, many foreign companies have shown up to the same trade fair the next year only to see their brochure, let alone their brand name and a similar product, in the next booth.

6. **Operations** - China is undergoing rapid reform of accounting, taxation and legal systems. The end result of this will see a more transparent operating environment. However, in the meantime the changes (with new legislation being produced about every 6 days) is proving near impossible for SMEs (with limited internal accounting, finance and law departments) to keep abreast of.

China is, as most large multinationals will 'unwillingly' admit, a difficult enough place to make money without having to worry about corporate compliance and nosy taxation authorities. Long lunches with officials, use of government connections, and unnecessary trips to the tax departments should be a thing of the past … but unfortunately for many it becomes their "core business".

It is easy enough to comply with regulations in China if the correct procedures and expertise are put in place. Things, though, can turn very unpleasant if rules and regulations aren't adhered to - regardless of whether they are broken innocently or in contempt.

An efficient and effective method for small-medium sized enterprises to ensure that their operations are in compliance in China is to either:

a) Outsource part or the entire accounting function; and/or,

b) Engage an external professional services firm to act in a financial oversight (CFO) role.

This allows the enterprise to concentrate on their core business and not be concerned with the constantly changing corporate regulations in China.

The final word

As the 2008 Olympics draws nearer, the race for the China market, and a place on the world podium is certainly there for many SMEs to take. The biggest hurdle for such companies still remains understanding the playing conditions, adjusting to the prevailing winds and keeping onside with the umpire.

By following these simple rules you may avoid your company being the one caught with the rotten onion when the final whistle blows!

Cameron Hume, LehmanBrown, Beijing

"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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