

Mitigating Business Risk in China



By Steve Vickers

International Risk

Doing business in China presents a unique challenge for foreign investors. The opportunities are undoubtedly vast, given the size of the domestic market and the country's low-cost manufacturing prowess. But not every company is able to profit from these opportunities. While few firms admit to losing money, corporate returns are often far lower than originally projected and longer in arriving than anticipated. The principal reason is the sheer scale of risk that businesses encounter in China, a consequence of the country's rapid transition from a state-controlled command economy to an increasingly privatized free market.

Business risk in China stems from a myriad of sources. One difficulty is that the regulatory framework governing business is a work in progress: the accounting system is being revamped and the tax code is being simplified and uniformly enforced. Meanwhile, industrial regulations are slowly coming in line with World Trade Organization standards, as part of China's membership commitments. Also, despite pretensions of being a centrally-planned economy, China is in fact quite decentralized and has provincial and local authorities that are increasingly assertive and independently-minded. This makes for both regulatory uncertainty and potential conflicts between the federal and local governments.

The legal system is also in an embryonic state. While the government is making every effort to align domestic regulations with international best practice, the rule of law is at best patchy and courts are subject to extra-judicial and often political compulsions. Contract enforcement is poor and often problematic and legal remedies are difficult to enforce. Foreign investors are often aware of these shortcomings and typically rely on local business partners to help them negotiate these obstacles. However, it is their dealings with Chinese companies that foreign investors face their most serious challenges.

Investigative due diligence

When foreign companies move into China, it is important that they know and understand the risks involved and how to eliminate or at least minimize them. It is easy for business partners to appear greater than they really are and for potential rewards to be exaggerated. Companies cannot just rely on introductions and middle men, as there has to be a process of due diligence.

Investors across the world are discovering the danger of relying on audit reports and certified statements to measure the true financial health and status of companies. In China, the risk is significantly higher, as adherence to standard international accounting practices is not to be taken for granted. When establishing a partnership with a Chinese company, it is important to make sure that it comes with just one set of accounts. Even then, however, it is rare to find accounts and audited numbers that are in line with international standards.

The recent and highly publicized corporate scandals in Singapore, the United States and China have highlighted the unfortunate fact that a major risk in business comes from off-balance sheet issues. To avoid major problems, it is critical to examine not only the company's spreadsheets and legal documents but also to closely examine the workforce and organizations. Investigative due diligence leads to better deals.

Common problems that foreign firms operating in China face include being overcharged for raw materials (often supplied by companies run by staff), billing discrepancies, unauthorized disposal of materials, fraudulent staff welfare claims and dummy employees, sweatshop labour, high 'transaction costs' and other corrupt practices. To protect against these risks, it is not enough to just conduct background checks on employees and potential business partners.

Recent public disclosures in China of corporate fraud, unexpected company failures and business malpractice and corruption continue to highlight the need for transparency and a solid understanding of the off-balance sheet risks which can affect any investment. This issue is especially keen in China, where reliable and accurate business information is not often available and where heavy reliance is placed on personal relationships and consequently on personal integrity.

The lesson is that it is more vital than ever to know new business partners and how they actually operate. Specifically, the goals of investigative due diligence should be:

- (i) to unmask misrepresentation;
- (ii) to reveal the undisclosed;
- (iii) to clarify who is being dealt with, and
- (iv) to assess associated political and security risks.

Investigative due diligence should therefore be a critical part of the evaluation process before any major transaction. Essentially, this identifies issues that have not been disclosed or other business and

political risks that are not visible or obvious. The key focus must be on the people and entities involved in any given transaction or potential joint venture, examining their background, reputation, track record or litigation history.

There are currently many new entrepreneurs in China who have excellent qualifications, skills and appropriate connections. Unfortunately, the opposite is also true and it is therefore vital to correctly identify the best business connections.

Whether a potential business partner is a listed company, private firm, former state-owned enterprise or an entrepreneur, focused inquiries need to be conducted to gain a deeper insight into possible risks. Companies require a level of comfort to support strategic decisions. Issues such as the new connection's reputation, history, business ethics, and individual officers' integrity, business acumen and actual influence in its local environment can be the key to a successful deal. Unfortunately, it is also necessary to identify potential problems, labour disputes, criminal history, undisclosed indebtedness and potential regulatory or environmental breaches.

Equally important are bribery-related considerations or potential money laundering exposure.

Managing risks

Off-balance sheet risk is manageable if companies are willing to adopt a robust approach to due diligence. Negative information acquired through investigative due diligence need not be a deal-killer. Such information often offers opportunities for deals to be negotiated on more favourable terms and structured to mitigate the risks identified.

Investigative due diligence is particularly cost-effective when undertaken in the early stages of a project and not as an afterthought, as it will identify issues to be addressed before committing to invest considerable financial and management resources. It can identify potentially serious disclosure failures which could lead to expensive delays, cancellations or, most costly of all, damage to corporate reputation.