The Risks of the Rewards

Avoiding major headaches in the China business world just requires care and attention

By Peter Humphrey

China's first year in the WTO has witnessed a new surge in the investment and commitment of multinational companies, but foreign firms are also facing significant security risks in this fast developing marketplace.

China is rapidly standardizing its laws and regulations, many investment and trade barriers are coming down, and intellectual property protection is being strengthened. Enforcing the new laws and making them part of a national mindset, however, will take many years. The reality, as many companies continue to learn the hard way, is that China remains a highly complex business environment, and the potential rewards are matched by the risks.

In a recent case, a multinational investment company had a Chinese JV partner alleged to have rival business interests and falsified financial statements. Inquires revealed the partner had built his business through smuggling, tax fraud, bogus transactions and by siphoning off funds into his other businesses. The multinational investor had failed to conduct a diligent background check into this Chinese partner before getting into the venture, and now faced the prospect of a major bust-up and huge losses.

The fact is, in an environment still far from transparent, many firms are failing to do basic homework before getting into deals. The result is they are hit by frauds and other losses that cause major setbacks to their business aspirations in China.

Multinationals must pay special attention to a number of vital issues that could have a serious impact on their profitability in China.

Brand protection and the strategic management of intellectual property remain issues confronting foreign firms despite moves by China to beef up legal protection. As much as 30 percent of the revenues of foreign firms are lost because of counterfeiting. Well-known Chinese brands are also being severely impacted. Crackdowns by the authorities over the past year have done little to dent the activities of counterfeiters. Some of the worst affected industries are personal hygiene, food, computers, automobile parts, music, and electronic gaming, where counterfeits dominate the market in many parts of China.

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Distribution network leakage is another major headache. Foreign firms are gradually being allowed to establish their own logistics and dis tribution networks as a result of WTO. But many are tempted to buy up established distribution companies, some of which have deeply embedded corruption problems. Distribution networks in China are plagued by kickbacks and other leakages caused by company staff acting in collusion with outside parties. Smuggling is another problem, and firms can easily get into trouble with the increasingly assertive customs authorities that regard fines and other penalties as an important means of boosting revenue. A number of multinationals have been caught up in the Customs and Tax Bureau crackdowns this year and have been ordered to pay significant penalties for underpaid or unpaid taxes.

Hidden costs and lack of transparency remain problems. Although WTO membership should create more transparent legal and financial systems, this change is likely to take a long time. In the near-term, there will continue to be many hidden costs to doing business that could hurt foreign firms, including administrative charges, corruption, red tape, and the need to cultivate suitable political and business connections.

Corruption remains a major problem in China. We have seen a number of companies this year become concerned over their past and present practices in China, fearing punishment and reputation damage if their low corporate governance should become known to the authorities. Foreign and domestic firms need to implement effective business controls to prevent such abuses.

Although corruption comes in many forms, the vulnerable tiers of a company that are prone to graft are mid-level management, and often those working in financial-related areas. In some business sectors, foreign firms are presented with a hard choice – lose a business opportunity or pay kickbacks. This is especially tricky for the heads of American and OECD headquartered companies as they can face charges in their home territory under the Foreign Corrupt Practices Act (FCPA) or the OECD anti-bribery convention.

The limited pool of qualified lo-cal management poses a constant problem. Multinationals are under constant pressure to cut costs and localize management. In China, there is a growing need for experi-

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enced local senior and middle-level managerial talent, but there is a limited supply of qualified personnel. Some firms have undertaken no background screening of candidates and, as a result, have been victims of fraud. It is vital to check the backgrounds and qualifications of candidates, to vet their integrity and to ensure that they are who they claim to be.

Detailed due diligence is another critical risk mitigation measure. Investment and other business opportunities are multiplying, but the danger of making a bad decision could outweigh the advantages because of China's complex business environment. Detailed due diligence is of crucial importance for firms operating in China, given its relative non-transparency. It is essential to check the background, reputation and track record of companies and their shareholders and directors before investing. In a recent case, a Japanese appliance maker contemplating a deal with a company in western China avoided a major disaster by carrying out investigative due diligence inquiries and finding, to its shock, that the prospective partner had orchestrated frauds and bankruptcies at a group of Chinese enterprises that he previously controlled.

Macro-economic and political risks should also not be underestimated. China's economic reforms look likely to proceed apace in the coming years, leading to new macro-economic and political risks that could produce some instability in the business environment. This includes – and the government is the first to acknowledge it – the threat of social unrest caused by unemployment.

There is likely to be a confusing regulatory environment in China in the near term as authorities come to grips with interpreting and implementing the complex and voluminous rules of the WTO. Companies will need expert counsel to ensure they understand the workings of this rapidly changing system, especially as some developments may have a direct impact on their bottom line.

Clarifying the risks from the outset can mean the difference between profit and loss. Foreign firms must therefore carefully assess their risks and implement appropriate business controls before executing any plans in China. These steps can range from undertaking detailed background investigations and business intelligence research to establishing comprehensive business control and monitoring programs, such as vendor integrity and employee integrity systems that provide channels to identify and mitigate the risks of fraud and corruption.

Without these measures, the likelihood of graft and other business-threatening problems taking root will be high. Foreign firms should know that their risk mitigation procedures cannot simply be copied from standard practices used in developed economies, but must take into account the more complex and less transparent environment in China.