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What Foreign Investors Need to Know About Doing
Deals in China

China First: A Growing Venture Capital Business Case, Clearer Challenges 2

Understanding the current venture capital landscape in China is the first step to successful deal-making. Learn more about Chinese investment trends, exit opportunities for Chinese companies, investor classifications and operational models, as well as the growing business case for incorporating China into your investment strategy.

China FAQ: The Top Ten Questions For Foreign Investors 7

There are a number of questions that investors frequently ask when considering opportunities in China. Drawing on the insights of Ernst & Young’s Transaction Advisory Services and Transaction Tax teams in China, we offer answers to some of the most important questions that investors should think about before making the leap.

What Investors Need to Know About the Differences Between China GAAP and US GAAP 10

If you are considering an investment in China with a view to an exit on a U.S. stock exchange or via a trade sale to a large corporate buyer, it is important to understand the impact of converting Chinese portfolio company financials from China GAAP to US GAAP—it can impact the bottom line significantly. Find out what the key differences between China GAAP vs. US GAAP can mean for a Chinese portfolio company’s reported financial performance.

Due Diligence Success Factors in China 13

The due diligence process is usually where the business cultures of the foreign investor and the Chinese management team meet intensively for the first time. The appropriate cultural understanding, expectations, and process orientation are critical due diligence success factors for foreign investors. Learn more about due diligence best practices in China from Ernst & Young’s Transaction Advisory Services and Transaction Tax teams.

China First: A Growing Venture Capital Business Case, Clearer Challenges

By Gil Forer and Adj. Prof. Dr. Martin Haemmig

CHINA'S VENTURE CAPITAL INDUSTRY has experienced strong growth in recent years, both in scale and breadth of activity. Existing foreign and local venture capitalists have stepped up the pace of investment, both in early-stage and private equity deals, while new entrant investors join the market as a China strategy becomes increasingly essential. Venture-backed M&A and IPOs meanwhile have provided profitable exits and created the success stories needed to fuel further investment. The business case for venture capital investment in China is clearly growing, driven by a virtuous cycle of investment and returns, corporate activity, and overall economic growth. At the same time, the increasing activity is pressing against regulatory and structural barriers, bringing the challenges faced by the venture capital industry in China into clearer focus.

Growing Venture Capital Investment

Venture capital investment in China increased sharply over the past several years. Research from Zero2IPO shows that venture capital investment in China grew from just \$418 million invested in 226 companies in 2002 to \$1.27 billion invested in 253 companies in 2004. This level of venture capital investment makes China the third-largest venture capital market, behind only the United States (\$21 billion) and a second group consisting of Canada, Great Britain, and Israel (about \$1.4 billion each). In terms of geography, there are two main investment hotbeds in China: Shanghai, with 39 percent of deals in 2004; and Beijing, with 28 percent. Shanghai has a concentration in companies related to online gaming, Internet, and semiconductors, while Beijing companies bring a focus on software and communications.

In the first half of 2005 Chinese companies raised \$402 million in 81 financings, a drop of 13.8 percent in amount invested compared to the second half of 2004 – a decline many attribute at least in part to the enforcement of a new regulatory initiative by China's State Administration of Foreign Exchange (SAFE). Known as SAFE Circulars 11 and 29, the regulations are intended to close a tax loophole but in effect make it difficult for Chinese entrepreneurs to establish the corporate structures needed for a Chinese company to conduct an IPO on a foreign exchange. In a survey by Zero2IPO, 80 percent of foreign venture capitalists reported that the SAFE measures would have negative or strongly negative effects on their investment activities. Although most observers consider this to be a temporary setback that will be resolved by the Chinese government, the unexpected SAFE regulations could have important negative impacts

since the majority of venture capital investment in China comes from foreign sources.

Disparity Between Local and Foreign Venture Capitalists

Only 35 percent of the venture capital invested in the first half of 2005 came from domestic venture capitalists, with 65 percent coming from foreign firms. The foreign share in 2001 was only 50 percent, showing that domestic venture capital firms, hampered by a regulatory structure that prevents capital formation in-country and does not provide for effective operational structures, are losing ground to foreign firms. Foreign VC firms also represent much deeper pockets in China, averaging \$200 million per fund—about seven times larger than the average local VC fund. It is important to note, however, that the Chinese govern-

ment intends to revise the venture capital laws in China to decrease government involvement in local funds.

Investor Classifications

Zero2IPO identifies Softbank, Doll Capital Management, Acer Technology Ventures, and JAFCO as some of the top foreign firms. Top domestic firms include IDG, CDH Investments, New Margin Ventures, Legend Capital, and Shandong High Technology Investment. The active foreign and domestic venture capitalists in China can be classified into four groups, each defined by unique characteristics:

- ◆ **Overseas Investors:** These are primarily leading U.S. venture capital and private equity firms that may or may not already have an office in China but spend significant amounts of time in the market. This group includes firms such as Doll Capital Management, Granite Global Ventures, NEA, Com-Ventures, GSR Ventures and Greylock. Most of the investment directors have an operational background in start-ups and market-leading companies. Deals range from start-up to growth and expansion stages.
- ◆ **Global Investors With Taiwan/Hong Kong Offices:** This group is represented by leading global investment houses, pursuing both venture capital and private equity strategies, and are likely to have offices in China already. This group consists of firms such as Warburg Pincus, 3i, Carlyle, Softbank, and JAFCO, as well as the oldest investors in China who all have offices on the mainland—Walden International,

WI Harper, and H&Q Asia-Pacific. Investment directors in this group tend to come from the investment banking sector. Most deals are in the growth or expansion stages.

- ◆ **Domestic Chinese Investors:** Mainland-based, domestic Chinese investors fall into two types: a minority of new firms using a Silicon Valley-style approach, often staffed with returnees and employing an offshore LP structure; and more traditional funds structured on corporate lines, funded mostly by the government and managed by ex-government officials or former investment bankers. The first group includes firms such as IDG Ventures, NewMargin Ventures, Legend Capital, CDH Investments, Gobi Ventures, and Shandong High Technology Investment. Typical fund size is between \$10 million and \$50 million, with the capital provided mostly by the government. Deals are mainly in the \$0.25 million-to \$1-million range, focused on early-stage investments.
- ◆ **Foreign Corporate Investors:** This group uses the full range of strategies, from direct financial investment, to investments in funds operating in China, to pure strategic investments and business development/corporate partnering. Prominent examples of corporate investors active in China include Intel, Siemens, Acer, Qualcomm, and IBM.

A Virtuous Exit Cycle

The year 2004 marked what York Chen, president and managing partner of Acer Technology Ventures Asia Pacific, calls “a

virtuous circle of fundraising-investing-exit.” The venture-backed IPO and M&A exits of 2004 demonstrated that venture capital profits were possible in China and will spur further fundraising, investments and portfolio management, and ultimately more exits. Twenty-one venture-backed IPOs by Chinese companies raised \$4.3 billion in 2004, including four of the top ten global technology offerings.

Foreign listings by Chinese companies showed continued strength in the first half of 2005 with 25 IPOs raising slightly over \$6 billion. These figures don’t include the meteoric IPO of Baidu.com, the Chinese search engine company that raised \$86 million on NASDAQ in August 2005 and whose stock rose over 350% on the first day. Yahoo’s \$1-billion investment in Alibaba.com, the Chinese auction site, in August 2005 is also notable, as it could well be the prelude to an eventual IPO.

Venture Capital Business Case Continues to Grow

Linked as it is to China’s overall market potential, the venture capital business case for China only continues to grow. With an increasingly affluent population of 1.3 billion, China represents a potent source of demand and a market where scale can be realized. China’s average per capita income surpassed \$1,000 in 2003 (up from \$100 in 1990) and reached as high as \$5,000 in the Shanghai region. Four percent of the population had an income greater than \$20,000, which might not sound like much but actually translates into 52 million people—a population on par with that of the United Kingdom—with high purchasing power.

Underlying the increase in personal wealth in China is its rapid economic growth. China's gross domestic product grew by 9.5 percent in 2004, with 8.3 percent GDP growth anticipated this year. Exports in 2004 grew by 36 percent to \$594 billion, while imports grew by 30 percent to \$588 billion. Helping to fuel the growth is about \$60 billion per year in foreign direct investment, making China the world's largest recipient of FDI.

While there are macro risks in investing in China, foreign investors take comfort in the government's stable pro-growth and pro-investment policies as demonstrated by the rapid privatization of state-owned enterprises, huge investments in infrastructure, and the liberalizing of controls on media and advertising. The pro-growth orientation is also found at all levels of Chinese government as job creation and local economic growth have become the measure of success for local and provincial councils—there is little of fear of loss of investments through arbitrary policy reversals. The country's accession to the World Trade Organization will continue to open new sectors to foreign investment.

From Manufacturing Center to Innovation Center

This commitment to growth and investment is accompanied by an intent in the Chinese government and the broader Chinese tech community to move up the value chain by changing from the “world's manufacturing center,” based on labor cost and efficiency advantages, to a “world-class innovation center.” And China has the resources required to make the intent a reality:

- ◆ A huge base of engineering talent and universities producing three million knowledge workers yearly.
- ◆ “Returnees” bringing their managerial talent back from Taiwan, Hong Kong, and the United States.
- ◆ R&D centers being established by multinationals such as Microsoft, Cisco, and Nokia.
- ◆ A risk-taking culture that encourages entrepreneurship and permits failure.
- ◆ A huge and increasingly affluent domestic market for innovation.

Lacking the legacy systems of other countries and accompanying technology inertia, China has many early adopters and can jump into new technologies. China already has 320 million mobile telephone users, 86 million Internet users, and 20 million broadband users. The domestic market presents a huge sales and brand-building opportunity that will drive innovation as products are designed for specific domestic needs.

Innovation in and for China

We can expect to see classic disruptive innovation originating in China as new technology is offered at relatively low cost to domestic markets, undermining incumbents at home and abroad. Business model innovation will arise as companies find new ways to sell to over a billion consumers. Application innovation will also become more important as intellectual property protections are strengthened and existing technologies are adapted to the Chinese market.

“The Chinese invented gun powder, fireworks, the magnetic compass, the water-tight vessel, and the list goes on,” says Claude Leglise, former vice president of Intel Capital and former director of the International Sector for Intel Corporation. “My expectation is that we will soon see the emergence of technologies developed in China to address a purely Chinese opportunity that over time will be exported. There will be some really exciting investment opportunities, based on real invention, real intellectual property, and real intellectual contribution to the world of technology.”

While little core development is being carried out today, there is great potential for it in China. One recent breakthrough was British Telecom's announcement that Huawei joined the BT Preferred Supplier list for its 21st Century Network—the first time that a Chinese corporation was chosen to join this innovation-based supplier network that includes Fujitsu, Alcatel, Cisco, Siemens, Ericsson, Ciena, and Lucent. Government initiatives, top universities, and returnees from the United States and Europe will accelerate the establishment of the needed infrastructure to develop core technology. In the next five to ten years, however, the big money will primarily be made in application innovations as technology from overseas is adapted to the huge scalable market in China. There will be significant opportunities for foreign venture capitalists to bring in technology from their portfolio companies, build and finance new Chinese start-ups, and exit them overseas. Acer's York Chen sees opportunities for entrepreneurs in mobile value-added services, broadband content, Internet applications, media and advertising, and other consumer sectors related to daily life.

China Not Optional

For the global venture capital community, the China venture market is not optional. China is the only country outside the United States that can support the creation of multiple billion-dollar market-cap companies in a purely domestic market. Chinese firms not only benefit from low-cost labor but also economies of scale. When expanding internationally, they have a cost-advantage from day one. The vast opportunities in China have already accelerated the transformation of the venture capital operating model—both portfolio companies and investors are forced to be more global, and sooner than in the past. Many American venture-backed portfolio companies have established or are setting up operations in China—Silicon Valley venture capitalists are especially bullish on the market prospects, as are Taiwanese investors. Israeli venture capitalists are forming the next wave, while European venture capitalists and their portfolio companies have only started to test the waters.

Operating in China: Emerging Models for Investors

As more and more foreign, (mainly U.S.-based) investors increase their activity in China, we can identify several emerging operating models. The following models do not represent the only options—each fund will choose the right operating model for its objectives, team, and limited partners—and none is necessarily better than another:

- ◆ **Formal Alliances or Joint Funds:** Formal alliances between foreign

funds and China-based funds are based on joint investments in deals and mutual deal sourcing. The recent Doll Capital Management/Legend Capital announcement is a good example of a formal alliance, while the Accel/IDG agreement provides an example of a joint fund.

China team typically includes a China-designated team in the home country.

- ◆ **Frequent Flyers:** Many venture capitalists are still operating in China without having a local office on the mainland or other arrangements in place. As it is almost impossible to source deals, manage local invest-

We can expect to see classic disruptive innovation originating in China ... undermining incumbents at home and abroad.

- ◆ **Joint Cooperation:** These are not formal alliances, but joint cooperation on deal opportunities, assistance in local networks, and potentially joint investments with local funds.
- ◆ **Affiliate Funds:** These are established China-focused affiliate funds in the home country. There are several examples of Silicon Valley-based venture capitalists that have affiliate independent funds focused on China. The affiliate funds are based both in Silicon Valley and China and mainly serve as the deal sourcing arm of the U.S. funds in China.
- ◆ **Branch Office in China:** Foreign venture capitalists are increasingly establishing an office in China to pursue business development for home country portfolio companies and/or source Chinese deals. Configurations vary, from having an associate in the branch office to having multiple general partners—both Chinese and foreigners—as the China team. The extended

ments, and serve as a board member from overseas, it is anticipated that frequent-flyer venture capitalists will soon choose to open a local office or one of the other strategies above.

Challenges in Clearer Relief

The recent venture capital activity and success in China has served to highlight some of the barriers restraining the Chinese venture capital industry. The potential is vast, but the Chinese VC-entrepreneur ecosystem and GP-LP structures are still immature and face regulatory and structural challenges. The Chinese regulatory environment, although it has improved substantially in recent years, still does not support the venture capital in industry in several important respects. Weak intellectual property regulation and protection makes it hard to capitalize on innovations. Modes of transferring technology from research institutions, most of them government-sponsored, to companies able to commercialize it are

also not fully developed. A lack of comprehensive venture capital law, both in terms of structures and taxation, is hobbling the domestic players, particularly the inability of local venture capitalists to raise money on domestic institutions and pension funds.

For all the high-profile venture-backed IPOs last year, none took place on a domestic exchange because no NASDAQ-like exit platform exists in China, forcing companies to go to NASDAQ, the NYSE, HK Main, or Singapore Main. The Shenzhen SME board is not a good fit for venture-backed companies. Chang Sun, the chairman of the China Venture Capital Association, calls the dependence on foreign exchanges “the main obstacle that the industry has to overcome.” Moreover, the SAFE regulations, as mentioned previously, threaten even the foreign IPO exit rout. In addition to limited public market exit options, the M&A market is underdeveloped, making it difficult to find alternative exit routes.

Despite the venture capital flowing into China, start-up entrepreneurs have limited access to risk capital and liquidity. Venture capitalists in China tend to focus on short-term profitable ventures, as evidenced by the growing average deal size, and focus on later-stage deals, requiring entrepreneurs to seek capital from friends and family for innovative start-up companies. It is also difficult for start-ups to secure bank loans for expansion. Furthermore, complex offshore corporate structures are required to be able to offer stock options to employees, raise foreign venture capital, tap overseas capital markets, and create personal wealth.

Conversely, venture capitalists operating in China face “a significant execution challenge,” according to Bob Partridge,

leader of Ernst & Young’s China Venture Capital Advisory group, who observes that “investors trying to evaluate opportunities run into issues of transparency, quality of revenues, and the timeline for completing a deal given the due diligence cycle required. Venture capitalists typically have to visit ten companies for every one that they find worth spending time on—it is difficult to find and close on good deals. Since investors increasingly have to go outside of Shanghai or Beijing to find companies, this becomes a drain on resources.”

Finally, building a management team in China is difficult. While domestic managers are entrepreneurially oriented, they typically do not have global experience. “For a long time it was difficult for Chinese citizens to travel due to visa restrictions, which prevented them from developing international business skills, particularly in sales and marketing,” explains Yang Zhao, the chairman and CEO of Memsic, a semi-fabless semiconductor company headquartered in Boston with engineering and production facilities in China.

The returnees, in contrast, bring the experience but lack the local networks and understanding of the local market. “It’s a mistake not to include a local guy in your senior team because it is hard to get your operation up running without the local contacts,” warns Zhao, who notes that although he was born and raised in China, his years in the United States have built up subtle differences between him and local Chinese. More effort will be required to develop a qualified management corps, by establishing role models, celebrating success stories, and finding ways to transfer knowledge and best practices.

Conclusion

While significant, the venture capital challenges are clearly outweighed by the opportunities—a China strategy is the top issue for every venture capital firm and corporate investor with anything more than local aspirations. We can expect to see the number of active foreign investors, strategic investors, and acquirers increase substantially, many of whom will open an office in China. Given the recent success stories and fundraising activity, venture capital investment will likely continue to increase; now that a path to exit via overseas exchanges has been mapped, at least for foreign and Taiwan/ Hong Kong investors, we can also expect to see more Chinese IPOs. This positive momentum is threatened in the near-term by the SAFE regulations, but the venture community is focused on arriving at a solution with the Chinese government to what is, at heart, a tax problem. Continued positive returns from exits are apt to increase an appetite for more risky, and ultimately more rewarding, early-stage ventures. Positive returns, by providing proof of the venture capital model, will also persuade LPs to reallocate capital to venture capital firms active in China. A virtuous cycle indeed. ■

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China FAQ: The Top Ten Questions for Foreign Investors

CHINA'S UNIQUE BUSINESS CULTURE AND ENVIRONMENT means that foreign investors face many more uncertainties than they would in familiar home markets. While every deal is unique, foreign investors considering Chinese opportunities typically ask many of the same questions related to Chinese business culture, exits, taxes, government, company structuring, and corporate governance. Drawing on the insights of our China-based Transaction Advisory Support and Transaction Tax teams, we have assembled a list of China FAQ for foreign investors.

1. What should foreign investors be aware of as they consider investing in China?

It is important for foreign investors to understand that they cannot enter a deal in China with the same expectations and operational processes that they could rely on at home. The due diligence process typically takes significantly longer to complete in China; for this reason, a lot of deals do not reach completion. U.S. investors must work through the deal process patiently and not make any commitments without the appropriate due diligence. While “guanxi,” or contacts, make it more efficient to do business in China if you know the right people—and this rightfully should be a commercial consideration—it should have only a small impact on planning due diligence.

Management teams in China also require significantly more oversight and hands-on mentoring. Local management teams will not necessarily know which way to grow the company in order to provide an appropriate exit strategy for investors. From an internal company operations standpoint, the local management will also likely require significant guidance

in implementing the corporate governance, financial reporting and other processes that are so critical to successful exits in the Sarbanes-Oxley environment.

A successful investment approach includes all the proper due diligence discipline, a thorough understanding of management’s capabilities, and a patient, deliberate process orientation. Make sure you do dot all the i’s and cross all the t’s to protect your fund post-closing.

2. Are there any special investment vehicles, aside from the U.S. VC entity, required or useful in China?

The use of an investment vehicle depends on an investor’s objectives in China. Investors with long-term objectives in China, such as acquiring manufacturing capability or Chinese brands, might opt to invest without any special investment vehicle. On the other hand, investors seeking an exit within a defined period of time by an IPO or trade sale should consider establishing an offshore investment holding vehicle for the company before making the investment. Such structures typically rely on tax treaties with Mauritius or Barbados to establish the

company offshore so that the investment is not made directly into a Chinese company. This provides the advantage of not having to pay Chinese capital gains tax. More importantly, these structures facilitate a rapid change of ownership—essential for an IPO on a foreign exchange—by avoiding the lengthy government approval process that would otherwise be required.

Offshore structuring is important for M&A exits as well. Many foreign entities want the flexibility of holding an offshore investment, so that if it doesn’t work out for them they can dispose of it more easily. By having an offshore structure in place when the trade sale is transacted, normally no onshore government approval is required to get the deal done. The offshore structure gives investors the flexibility of being able to quickly close the deal when shareholders come to terms offshore, as opposed to having them go through the rigorous regulatory approval process in China.

Early in 2005, the Chinese government put a stop to the corporate structuring used to take a company offshore and facilitate a listing on a foreign stock exchange. The government’s action was taken mainly

for tax reasons—to prevent Chinese tax payers from avoiding tax by structuring capital gains offshore. While tax-driven, the regulation has had a chilling effect on VC investment in China in the first half of 2005 because it deprives foreign venture capitalists, who represent the largest source of Chinese VC investment, of an effective exit strategy. The issue is a top priority for the venture capital community in China, but it will take some time for the government to put alternative measures in place.

3. When is the right time to put offshore structuring in place?

Whether an early-or later-stage investment, most investors seeking an eventual IPO or M&A opt to have the offshore structure in place before completing the financing. While it is possible to restructure a company later, the process takes time; having the right structure in place for your exit goals at the outset reduces transaction risk.

4. What government agencies does an investor have to deal with in closing an investment?

A variety of central government agencies have control over certain investments and over certain industry sectors, usually resulting in different approval processes from investment to investment. For example, the media sector, manufacturing, and network equipment all have different investment approval requirements. Investors also have to deal with local government, sometimes not only officially but also unofficially, to make sure that the appropriate relationships are built locally. While people on the ground will have developed a good working knowledge of the appropriate approval

process, foreign investors still need to use outside legal and tax advisors who can help them navigate the ever-evolving regulatory environment in China.

5. What domestic tax laws need to be factored into the early days of a company?

China has a very complicated tax system involving national, provincial, city, and even district tax authorities—each with its own regulations. The major business taxes include: corporate income tax, business

liabilities that impact the bottom line and can delay the transaction. There is also no statute of limitation in China—a disgruntled employee can report tax violations to the authorities at any time, exposing a company to potential prosecution.

The key is to conduct thorough tax due diligence before investing to avoid any hidden tax time bombs and to ensure that ethical tax compliance is built into the company from the very start.

The language barrier and cultural differences mean that more work must be put into the relationship in China.

tax, value added tax, real property gains tax, stamp duty, deed tax, and social security. How these taxes affect a particular company depends on its industry, location, and corporate structure. Understanding a company's tax obligations and preparing a tax-efficient strategy (see next question) is clearly important.

From a U.S. investor's perspective, there is perhaps an even more important angle on taxes: understanding what tax obligations the company is not fulfilling, or under-reporting, and the possible implications. Most Chinese companies take a tax-avoidance approach, preparing one set of books for the tax authorities and another set of books for management, sometimes reaching the point of illegality. The conversion of a company's financial statements to US GAAP with a view to an IPO or M&A exit often exposes significant hidden tax

6. How can foreign investors maximize returns in a liquidity event?

While the fundamentals of building the company value realized in a liquidity event are the same in China as in the West, there are two important ways that foreign investors can position themselves to maximize their benefit from an exit.

First, the deal structure in China is critical for ensuring the right kinds of returns in a liquidity event. In the West, the deal structure is intended to maximize returns and provide downside protection. In China, the deal structure is fundamentally for facilitating an exit strategy because foreign investors don't want to be trapped in an onshore investment that doesn't provide a hard-currency liquidity event.

Second, investors can help to maximize returns in a liquidity event by ensuring that

their portfolio company is employing the right tax strategy in China. Although Chinese tax law is complicated, it allows foreign companies a certain degree of latitude in terms of where they establish their tax presence, a choice that can have a significant impact on the bottom line. There are numerous tax zones in China, each offering a different corporate income tax rate that can be as high as 33 percent or as low as 15 percent. Tax holidays are often offered in various industries and locations. Local governments also compete to attract foreign investments using use tax rebates and refunds. By choosing the most advantageous tax area for their portfolio company, and negotiating favorable treatment with authorities, investors can minimize tax costs and improve returns.

7. What can kind of corporate governance can foreign investors expect to find in China?

Corporate governance in China is very often weak or non-existent. Financial and accounting functions are not held in high regard in the Chinese business culture. As a result, Chinese companies usually have not developed the types of business practices, whether in terms of corporate governance or financial reporting, that are customary in the West to help management build value and protect shareholder interests. It is also an environment where there is an overwhelming practice of tax avoidance and where unethical or even illegal business practices—such as payments to induce sales—are common. Because the corporate governance environment is so different, Western investors must spend a lot more hands-on time when they are nurturing a Chinese investment but also start embedding strong corporate governance and

financial reporting values and practices from day one after the closing. In the post Sarbanes-Oxley environment that we live in today, you can't wait until later in the life of the business to fix corporate culture problems.

8. What is the best approach for establishing U.S.-style corporate governance in a new portfolio company?

Investors have a natural tendency to want to defer the costs required to build a more robust accounting department. In China—and really in any emerging market—investors need to factor in the cost of building financial functions from day one; failing to do so increases risk substantially. As a deal closes, investors should ensure that they have the appropriate financial or financial control function in place—a qualified professional in a controller or higher-level position who is there at the outset and can build a strong financial function with good corporate governance. Ongoing monitoring of corporate governance practices is also important. Chinese management teams are often not used to Western corporate culture and might be tempted to continue practices that put the company at legal risk or jeopardize the quality of an exit.

9. How much does Sarbanes-Oxley impact M&A transaction in China?

Sarbanes-Oxley compliance has become a critical due diligence area for corporate buyers, and increasingly private companies, when they consider an acquisition in China. No matter whether a venture-backed Chinese company's exit strategy is going public in the United States or being

acquired by a U.S. company, they often need to be Sarbanes-Oxley – compliant. Investors should recognize that they need to start building the foundations of Sarbanes-Oxley compliance from the outset to ensure their ability to exit. The last thing investors want when they are on track to realizing an exit is to suddenly hit a thunderstorm of activity related to Sarbanes-Oxley because they waited too long to start cleaning up the portfolio company's corporate governance practices.

10. What is the most common mistake that foreign investors make in China?

Missteps by foreign investors in China are usually related to cultural misunderstandings. Chinese regulations often limit the shareholdings of foreign investors, especially in restricted sectors such as telecommunications where foreign investments cannot be made on a wholly owned basis. This means that investors are frequently working with a Chinese joint venture partner or do not have the level of control they would in the United States. Understanding the needs and viewpoint of the Chinese partners is essential. This is no different from business relationships in Western countries, but the language barrier and cultural differences means that more work must be put into the relationship in China. ■

What Investors Need to Know About the Differences Between China GAAP and US GAAP

U.S. VENTURE CAPITAL AND PRIVATE EQUITY INVESTORS are increasingly looking to China for investment opportunities with a view to exiting those investments through an IPO on a U.S. exchange. One of the challenges of investing in China for U.S. investors is being able to understand and compare investment opportunities from a familiar frame of reference: US GAAP. Moreover, conducting an IPO on a U.S. exchange requires the conversion of a company's financial statements from China GAAP to US GAAP. Knowing the likely impact of this conversion is therefore important in assessing both investment and exit opportunities.

Many changes have been made to China GAAP in the last ten years as a result of China's rapid economic growth and the significant reforms made to its economic system. While business processes in China have historically not been as sophisticated as those in more developed economies, this situation is changing rapidly. Although China GAAP is increasingly convergent with US GAAP (and IFRS), key differences remain in practice.

In general, US GAAP is more restrictive in a number of areas than China GAAP, particularly in areas such as revenue recognition and consolidation. There are also more alternative accounting treatments under China GAAP, allowing companies greater latitude. The conversion of financial statements from China GAAP to US GAAP can often result in:

- ◆ Significantly lower reported revenues, and other revenue recognition issues.
- ◆ Unexpected charges related to business combinations.
- ◆ Reduced net profit due to stock option accounting.

Understanding the impact of China GAAP to US GAAP conversion will help U.S. investors to calibrate their expectations correctly and—with the assistance of professional financial advice—better evaluate investment opportunities in China. The impact is even more important if a public offering on a U.S. exchange or an acquisition by a non-Chinese company is a consideration. While each company's situation is unique, we briefly outline some of the most important differences in the two GAAP systems for U.S. investors to be aware of as they consider investments and exits in China.

Assessing China-to-US GAAP Conversion: Where to Start

The first question to ask is whether the company's financial statements are audited by a reputable international accounting firm. In China, if a company is not audited by a reputable international accounting firm with expertise in US GAAP, the quality of its financial statements should be carefully examined because the accounting practices of Chinese companies and

the auditing standards of local accounting firms in China generally do not meet even China GAAP standards.

Another question specific to the Chinese business environment is whether the company has two (or even more) sets of books. In China, audited financial statements are usually prepared for the tax authorities and are typically structured to minimize revenues and maximize expenses. Management will most likely operate from a different set of internal financial statements. It is very possible that even a third set of books for investors, maximizing the elements that drive valuation, has also been prepared. It is essential to obtain and review all sets of financial statements and understand the differences between them.

Bottom line for U.S. investors: If a prospective investee company does not employ an internationally recognized accounting firm, an adjustment to at least China GAAP by such a firm will usually have to be made as a starting point in assessing the company's financial situation. When the differences between the different sets of books are reconciled, there is often significant tax

exposure when the adjusted financial statements are reported to the government.

China-to-US GAAP Conversion: Significant Adjustment Areas

In converting from China GAAP to US GAAP, there are a number of areas of significant adjustment that can have a large impact on the bottom line and, by extension, a large impact on a company's attractiveness as an investment. One major adjustment area is revenue recognition for software and services companies. Another major area is accounting for business combinations—mergers or acquisitions. Lastly, accounting for stock options, a key incentive for technology start-ups, also presents potential pitfalls.

Revenue Recognition

While revenue recognition rules for manufacturing companies are very similar in China GAAP and US GAAP, the rules related to revenue recognition for software, long-term contracts and services are often very different. US GAAP provides certain industries, such as software, with specific guidance in revenue recognition where there is no similar guidance in China GAAP. Some of the key differences in revenue recognition between China GAAP and US GAAP include:

- ◆ **Recognition Timing:** US GAAP has stringent rules regarding when revenue resulting from sales transactions involving rights of return, warranties, extended payment terms, installation clauses, or post-support services can

be recognized; if requirements cannot be met in these cases, the revenue may need to be deferred. In China, there is no specific guidance; as a result, Chinese companies often recognize the revenue as soon as the key service component has been delivered. Converting from China GAAP to US GAAP could result in booked revenues being deferred.

- ◆ **Multi-Element Contracts:** US GAAP also has specific rules for recognizing revenue related to contracts that involve multiple elements, such as a systems integration project by a software company that combines hardware, software and integration services. Under US GAAP, the various elements included in an arrangement generally may be accounted for if (1) delivered items have standalone value and (2) reliable and objective evidence of fair value (based on either vendor-specific objective evidence or, in certain cases, third party sales of similar items) exists. Additionally, certain other criteria may be applicable. If these conditions are not met, revenue recognition is generally deferred until the last element included in the arrangement is delivered. In China GAAP, there is no such concept. As a result, recognized revenue might have to be significantly adjusted in a China-to-US GAAP conversion.
- ◆ **Gross vs. Net Recognition:** Under US GAAP, a company that acts as an agent, such as a travel business, can often only recognize net revenue based upon the net amount retained (that is,

the amount billed to a customer less the amount paid to a supplier)—their commission—but not the amount they collect on behalf of another party (e.g., airfare). In China, companies often book the entire transaction amount (e.g., the commission and airfare) as revenue, while booking the portion paid to the other party as an expense. As a result, reported turnover under China GAAP is often much higher than it would be under US GAAP.

- ◆ **Barter Transactions:** Under US GAAP, the fair value of goods or services exchanged in barter (non-cash) transactions is booked as revenue only in limited circumstances. For example, if a company receives a product in exchange for free advertising certain criteria must be met prior to revenue being recognized, including a determination of whether the fair value of the product or advertising can be made. China GAAP, however, permits an assumed value for the goods or services exchanged to be booked. In the product-for-advertising example, the company could just assume that the value of the product equaled the value of advertising, when the market might actually value them differently. As a result, where companies have engaged in significant non-cash based transactions, revenues could be substantially adjusted in a China-to-US GAAP conversion.

Bottom line for U.S. investors: Be aware that revenues will likely be significantly adjusted in the conversion from China to US GAAP, particularly in the case of software and service companies or companies that

have engaged in substantial exchanges of goods and services.

Business Combinations

Accounting for business combinations—mergers and acquisitions—represents another area where a significant adjustment would likely have to be made in a China-to-US GAAP conversion, most likely resulting in a change in net income.

In US GAAP, when a company acquires another company, the acquiring company must compare its consideration (the amount paid) to the fair value of the assets acquired. Along with the tangible assets, the fair value assessment must include intangibles, such as customer lists or brand names that came with the acquisition. The difference between the consideration and fair value assessment is then recorded as goodwill. That goodwill would then be reviewed for impairment.

In China GAAP, the consideration is simply compared to the net assets acquired with the difference recorded as goodwill that is then amortized over what is believed to be the useful life. Since goodwill in China encompasses intangibles (customers, brands, etc.), the amount of goodwill is often larger than it would be in the United States.

Bottom line for U.S. Investors: If you are considering investing in a Chinese company that has made an acquisition, or your Chinese portfolio company is planning to make an acquisition, be aware that a China-to-US GAAP conversion could result in a significant change in net income due to the way goodwill is accounted for in the United States.

Stock Options

For investors considering an opportunity with a Chinese company with an IPO on a US stock exchange in their business plan, it is important to be aware of the differences in accounting for stock options between China GAAP and US GAAP. Without taking appropriate steps to structure the stock compensation plan, a China-to-US GAAP conversion could result in a significant hit to net profits.

In US GAAP, when a company grants stock options it must estimate the fair value of the grant using an option pricing model; as those options vest, the company needs to recognize that stock compensation cost—which may result in a substantial reduction in net profits.

In China GAAP, the treatment of stock options is much different. Stock options are recorded only when the options are exercised and shares need to be issued. The stock compensation plan of a Chinese company could therefore represent a “hidden liability” from the point of view of US GAAP because vested options will not have been recognized as an expense in the income statement.

Bottom line for U.S. investors: Take a close look at the stock compensation plan of potential or current investee companies in China to understand what will happen to profits when stock options are accounted for according to US GAAP—profits will often be reduced.

China-to-US GAAP Conversion Success Factors

There are several straightforward steps that can be taken to make the conversion process go more smoothly:

- ◆ **Start Early:** Generally speaking, Chinese companies should make the conversion to US GAAP at least one to two years before they list on a U.S. exchange. Many Chinese companies don’t have the internal control systems in place to support compliance with US GAAP, especially post-Sarbanes-Oxley. Putting the necessary business processes and internal controls in place is a time consuming exercise that could delay the IPO process if it is put off for too long.
- ◆ **Hire the Right Accounting Manager:** Hiring an accounting manager, whether controller or finance director, that has in-depth knowledge of US GAAP is key for making the conversion successfully. Since it is not easy to find someone with US GAAP knowledge in China, time to recruit the right individual must be factored in.
- ◆ **Involve an International Accounting Firm:** Involving an international accounting firm that can help management understand the key differences between their China GAAP numbers and their US GAAP numbers is also important as reported earnings will likely be very different after the conversion is made. ■

Due Diligence Success Factors in China

FOREIGN DIRECT INVESTMENT is flowing into China at a record pace as multinational corporations and venture capitalists capitalize on the opportunities that China presents—low cost manufacturing, burgeoning economic growth, a domestic market of 1.3 billion people, and much more.

M&A activity has soared since China's accession to the World Trade Organization in 2001. Recent changes in the strength of the U.S. dollar have also resulted in more European multinational corporations investing in China. Strong private equity and venture capital interest has further energized activity—China M&A is hot.

For U.S. and European investors seeking to participate in China's M&A opportunities, due diligence is a critical step, not only for risk reduction but also as a process hurdle—the great majority of Letters of Intent (“LOI”) never close. China's business culture is very different than what Western investors are accustomed to at home. Understanding what this difference means for due diligence—where the two business cultures meet face to face—will help Western investors approach the process with the appropriate expectations and enjoy greater transaction success.

China: The Wild, Wild East

China operated under a traditional planned economy for almost 40 years before it allowed market mechanisms to thrive in recent years (it is still taboo to use the word “capitalist”). As a result, many state-owned enterprises (“SOEs”) and other companies are still operating in

a business environment and system that are radically different from enterprises in western economies, raising numerous issues for foreign acquirers.

One common issue encountered by potential acquirers of SOEs, and most other Chinese companies, is that land is owned by the state, not companies or individuals. Questions related to the transferability of land-use rights often arise in due diligence and sometimes have significant financial implications as the state may require payments for the land use rights before allowing a transaction to close.

In addition, most SOEs in China operate as “social communities.” It is common to see acquisition targets that maintain employee housing, hospitals, schools, restaurants, and even roads on their books. As these are carved out from a target entity, foreign investors may be expected to continue to provide these social services post-closing.

A lack of good tax compliance is another common issue. Many companies often maintain inappropriate books in order to defer or avoid taxes, particularly value added tax, which is typically the largest form of taxation. In many cases, income tax may be insignificant due to historic or potential tax holidays.

Successfully Closing Deals

With the right preparation, expectations and process, it is possible to successfully close deals in China despite the pitfalls. We believe there are a few basic suggestions to maximize your chances of deal success:

- 1. Early involvement of advisors:** Engaging advisors prior to a Letter of Intent helps to increase a target's transparency, thereby accelerating the timeline to LOI execution. It's important not to intimidate the Chinese party by characterizing advisor involvement as “due diligence”



* Includes the downturn in FDI during Q2 03 due to SARS (Severe Acute Respiratory Syndrome); 2004 is estimated.

Source: Ministry of Commerce, PRC

Table 1: *Doing Due Diligence: U.S./Europe vs. China*

	U.S./EUROPE	CHINA
1. Level of transparency in financial information	High	Low, if any
2. Normal duration of due diligence	1–8 Weeks	3–12+ Weeks
3. Preparation time required by target company before due diligence	Minimal	May require extensive assistance
4. Basis of financial statements	US GAAP or IFRS	PRC GAAP, at best
5. Audited financial statements	By reputable standards	Typically not reliable from a US GAAP or IFRS perspective
6. Extent of related party transactions	Varies; typically fully disclosed	Usually extensive; inadequate disclosure
7. Disclosure of contingent liabilities	Usually transparent	High risk area and rarely disclosed
8. Reliance on computerized accounting systems	Typical	Evolving; dependence on manual processes
9. Reliability of representations and warranties	Normally reliable	Untested
10. Enforceability of indemnification	Strong; backed by courts	Untested; may need to consider “holdbacks”

Table 2: *Possible Pre-LOI Initial Data Gathering*

POSSIBLE TASKS	OBJECTIVES
1. Screen historical auditor’s report	Understand key business drivers, quality of earnings and related issues, working capital requirements, etc.
2. Evaluate key accounting policies	Identify potential risky/sensitive areas that need additional attention in due diligence, valuation and structuring
3. Perform high-level overall analytical review	Assess integrity and quality of financial data
4. Assess financial/accounting environment	Understand the limitations of the current accounting software, set expectations of the extent of financial data available for further analyses
5. Review internal management reports	Identify useful business statistics that are instrumental to in-depth analysis
6. Understand businesses and their financial impact	Determine impact on valuation and identify areas for further detailed due diligence
7. Develop a comprehensive Information Request List for detailed due diligence	Ensure that sufficient information and data are available to facilitate appropriate analyses

because when translated into Mandarin this term means “investigation” which has a negative, even frightening, connotation in any language. It is better to refer to an “initial data gathering” process that is designed to “facilitate” the potential transaction.

2. **Understand there are significant differences between doing due diligence in the United States or Europe and China:** Going into the due diligence process with the right expectations is a critical success factor for U.S. and European investors. The quality of financial statements, financial infrastructure and business process will be lower than western investors are accustomed to, resulting in the need to explore more risk areas and take more time for due diligence. Some of the differences between due diligence in the United States or Europe and China are illustrated in Table 1.
3. **Listen for the word “no”:** Asian culture is less direct in some respects than Western culture, which often leads to misunderstanding in the business milieu. Western investors rarely hear their Chinese counterparts say “no,” even though they do not mean “yes.” Do not be drawn into a false (and drawn-out) process of assuming cooperation by the other side without defined actions and deadlines. When discussing potentially contentious items, reduce discussions to writing (English and Chinese) and agree on dates, if appropriate.
4. **Manage internal expectations:** Too often closing a deal in China becomes

the goal in and of itself for companies, losing sight of the business rationale. Corporate development officers say that one of their biggest challenges is managing their company's internal expectations. Start early to manage internal expectations and do not over-commit to the potential of a Chinese investment without fully considering the valuation shortcomings that may be found during due diligence.

5. **Be prepared to go the distance:** In any good investment market, deal success

Too often closing a deal in China becomes the goal in and of itself for companies ...

requires a certain degree of diligence and patience. This is particularly true in the case of China, a market which tests investors' stamina and where only 20 percent to 30 percent of LOIs ultimately close. There are three pri-

mary reasons for deals failing to close in China: quality of earning issues; lack of transparency in the due diligence process; and a timeline from LOI to closing that stretches from 6 to 18 months or more.

Table 3: Typical Post-LOI Due Diligence Procedures

POSSIBLE TASKS	OBJECTIVES
PHASE I	
1. Review audit workpapers	Identify risky areas that need special attention
2. Raise asset/liability questions	Validate book value of assets/liabilities and assess the impact on future earnings
3. Analyze income statement fluctuations	Understand the seasonality of the business, assess quality of earnings, etc.
4. Identify potentials pro forma adjustments	Ensure the historical profitability of the acquired business is truly reflected
5. Assess stand-alone matters	Evaluate the hidden costs of the NewCo
6. Identify contingent liabilities	Determine impact on valuation and identify areas for detailed due diligence
PHASE II	
1. Evaluate profitability by product/segment/geography	Develop in-depth understanding of the business, assess the quality of earnings
2. Analyze correlation between price and volume	Same as above
3. Identify key cost drivers and expenses variability	Same as above
4. Review capital expenditure history	Determine impact on valuation
5. Analyze working capital sensitivity and seasonality	Determine impact on valuation and buyer's financing needs
6. Analyze projections versus history	Assess the practicability of the projections and profitability of the NewCo
7. Evaluate the human resources and benefits issues	Determine impact on valuation
8. Quantify pro forma EBITDA	Same as above
9. Finalize due diligence report	Summarize our key findings and observations, raise alerts, if any, to facilitate client's purchase decision-making
10. Develop representations and warranties for purchase agreement from a financial perspective	Assist client in minimizing the investment risk

Conclusion

Making an investment in any foreign country can create anxieties for an investor. In China these anxieties are further exacerbated by language barriers, cultural differences and unfamiliarity with local business rules. In addition, China is undergoing a dual transition from a centrally planned economy to a market economy, and from an emerging economy into an industrialized economy, in which the business environment is in constant change. Understanding some of the main cultural differences, potential pitfalls and due diligence success factors will help you to approach investing in China with greater confidence as well as to determine when greater investigation and the assistance of a professional advisor is needed. ■

A Real-Life Example

One of the easiest accounting illustrations to understand is how allowances for doubtful accounts under PRC GAAP often do not adequately provide for old receivables (see table below). In almost every industry, Chinese companies' receivables are aged by years, not months. As such, the accounting due diligence should focus on identifying these types of issues early, and evaluating the quality of earnings and working capital implications thereto.

Typical PRC Accounts Receivable Aging

AGING	DELIVERABLES AT DECEMBER 31	
	AMOUNT	PERCENT
< 1 Year	5,500	55%
1-2 Years	1,000	10%
2-3 Years	1,000	10%
> 3 Years	<u>2,500</u>	25%
Total	10,000	<u>100%</u>
Allowance	(50)	= 0.5%
Net	<u>9,950</u>	

Note: A bracket groups the 1-2 Years, 2-3 Years, and > 3 Years categories with a value of 4,500. An arrow points from this bracketed total to the Total row's amount of 10,000.

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