The Hidden Costs of Doing Business in China

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Executive Summary

Many companies are being pulled into the China market by international forces, i.e., their markets and customer base require it. For small and medium-sized enterprises (SMEs), setting up shop in China can significantly strain resources. The potential rewards are great, but so are the risks. This huge step should not be taken lightly.

Companies entering the Chinese market, using the same strategy as in other international markets, will find they have entered into a very unique situation. China is a country that values personal relationships over contracts, has disparities between central government policy and local enforcement and in general, leaves much up to individual interpretation. Even as China continues to move towards a market economy, there are significant obstacles for foreign companies. China continues to have an inefficient distribution system, less than transparent regulatory system, a weak banking system, continued restrictions on the availability of foreign exchange, a weak currency flow and a weak legal structure. Due diligence and learning to navigate these roadblocks is critical to success in China.

Many companies have found that the best way to learn about the Chinese market and mitigate many of these risks is by using Hong Kong as a gateway. Ease of doing business in Hong Kong is on par with the U.S., and Hong Kong Chinese can provide experience, knowledge and important contacts in China.

Understanding the Market

The key to a China market entry strategy is conducting the appropriate research or due diligence. This may not be as simple as it sounds. Getting information out of China is not always easy, often it is not available and sometimes it is misleading. An SME must understand and often navigate, significant cultural, political and economic differences.

For example, each of China's eight economic regions is characterized by marked differences: different investment climates, different ethnic groups, different infrastructures, different dialects and different raw material resources, to name just a few. Understanding the difference between central government policy development and provincial policy enforcement is one element of building a successful China strategy.

What attracts many companies to China is its sheer size. The U.S. has a population of 295 million versus 1.3 billion for China. China has at least 40 cities with populations over two million and is the fastest growing economy in the world, growing at an annual rate of

9.5%. It has been called the world's factory. Large potential markets, low land and labor costs make China very attractive.

Getting Paid

Getting paid in Mainland China is not the same as getting paid in the U.S. Payment cannot be made directly because of foreign exchange restrictions. In order to complete international transactions a "window company" is used. The U.S. company enters into a formal sales contract with the "window company" and the Chinese company signs as a third party beneficiary to assume liability. It is important to ensure this "window company" has an import license. All terms of the contract are negotiated with the Chinese company and the contract should specify payment in U.S. dollars. To complete the transaction, the goods are shipped to the "window company" who delivers the goods to the Chinese company, who then pays the "window company" in RMB. The "window company" completes all import documentation and presents the original invoice to the bank for payment. At this point, the bank converts the RMB to U.S. dollars to enable the "window company" to make payment to the U.S. entity.

It is important to note that the value-added tax (VAT), which is 17% of invoice, insurance and freight costs, must be paid before an invoice can be issued. An invoice is generally issued after goods are delivered. If there is uncertainty about payment and the invoice is not issued, but the goods have already been delivered, this obviously leads to a tricky situation.

Selling to mainland Chinese customers on credit can be a dangerous proposition. Transactions should be done by letter of credit to ensure that the vendor receives payment upon fulfilling the contractual agreement. While this can be an expensive undertaking, this minimizes the risk of nonpayment. Letters of credit issued from Chinese banks are not guarantees. Sometimes banks may find fault with the documentation or ask for clarification, which can delay payment to the U.S. entity. One hundred eighty (180) days past due is not unusual in China and some accounts receivable can linger for two years.
There are some banks in Hong Kong that will now issue back-to-back letters of credit to overcome this obstacle.

Foreign exchange is heavily regulated in China and foreign currency cannot be held. This regulation can prove difficult if the enterprise wants to move profits out of China. To repatriate money out of China requires compliance with the regulations of State Administration for Foreign Exchange (SAFE). All applicable taxes must be paid beforehand. It is important to note that loans denominated in foreign currency made to the Chinese entity must be registered with SAFE. Without this registration, payments of principal and interest cannot be made from China. There are no foreign exchange restrictions in Hong Kong, however. An overnight transaction in Hong Kong will actually take place overnight, whereas it may take 5 days in China. Furthermore, Hong Kong is the only place in the world outside of China where you can hold RMB accounts and some stores accept RMB for payment. This is one of the top reasons cited for companies to set up managerial functions there.

Business Transactions

In completing business transactions, it is important to understand the role of “guanxi” and “chops”. Both of these are significant in completing a business transaction.

In all business relationships, there is a combination of legal requirements, business practices and personal relationships or guanxi, as it is called in China. The cultural setting will determine how these three are balanced in practice. In the U.S., for example, the rule of law carries more weight than it does in China, where guanxi carries more weight. Guanxi is a fundamental notion of relationships in China. It is the process of cooperation and support among various parties–exchanging favors. Making the investment of time and money necessary to establish a strong network with suppliers, retailers, bankers, local government officials, etc., is well worth the effort. These contacts could well provide some significant services and favors in the long run, which is how guanxi must be approached.

Second, in completing a business transaction with a mainland Chinese partner, it is important to understand the role of the “chop.” Historically, this was an ingenious solution to issues of illiteracy among business people, as the chop was used in lieu of a signature. A chop is simply a piece of plastic that has the company name carved in Chinese letters in the face. A signature on an agreement is not enough. For a document to be legally binding it must show the company chop. This is comparable to a company seal in the United States. In addition, companies generally use more than one chop. At a minimum, the company needs three basic chops – one chop for the company, one chop for the legal representative and one chop for the financial representative. This gives legal standing to transactions, but does not guarantee legal enforcement of contractual agreements.

It is important to note, that the legal profession in China has only been reinstated since 1980. The rule of law is still a work in progress. Judges are often ex-military or police personnel, vulnerable to political corruption and “guanxi”, rather than trained professionals. This leads to rather uneven interpretation of the law, which is difficult for many foreign companies to comprehend. Arbitration is sometimes sought by foreign business as a way to avoid the capriciousness of the courts but they often find that the same pressures that distort judicial justice are also evident here. It is a growing trend in cases adjudicated by the Hong Kong International Arbitration Center where both parties are from Mainland China. Chinese companies are comfortable with and trust Hong Kong, and this ensures rule of law. Any legal disputes in Hong Kong will be dealt with fairly and efficiently, as in most developed countries.

Financial Information

Interpreting financial information of foreign companies is a challenge, often due to different accounting rules and practices. Asking the right questions is critical, starting with whether the company is following Chinese, international or U.S. accounting rules or some other protocol. This is important to get a clear picture of the company's financial standing.

China understands that a sound financial reporting system is critical to economic development and to reducing the costs of raising capital. China's Ministry of Finance (MOF) is working on harmonizing accounting standards with the International Financial Reporting System (IFRS). However, there are still significant differences between national standards and International Accounting Standards (IAS). This is partially because financial statements serve the conflicting needs of investors and government agencies.

Any American enterprise trying to do business with a Chinese company should ask questions about how the financial statements have been prepared. If the company does not possess enough expertise to analyze the statements, it should find someone who does have the expertise. Particularly in an acquisition situation or identifying a local partner, understanding the numbers is critical. A Hong Kong company has the knowledge and resources to approach this situation with ease. Furthermore, they have the language and cultural understanding to achieve effective cooperation with the Chinese company.

Setting up in China

According to a World Bank Report, published in September 2005, China ranked 91st out of 155 countries in overall ease of doing business. This annual report is based on regulatory indicators such as business start-up, operating, trade, payment of taxes and the time and costs associated with various government requirements. By comparison, the U.S. is listed as 2nd and Hong Kong as 7th. The report further states that poor countries, such as China, have the highest business taxes in the world and more non-tariff barriers to trade.

There are a number of investment vehicles available to set up operations in China, e.g., representative office (RO), assembling and processing contract (APC), joint venture (JV), wholly foreign owned enterprise (WFOE), and Chinese holding company (CHC). Each of these vehicles has different requirements related to capital commitment, tax exposure and scope of activities.

The simplest method is to set up a representative office. This office is allowed to market and promote and be a liaison to the home office. It is not allowed to sell products or enter into contracts. It can provide sales information and collect information about the market and act as an intermediary with the home office.

In assembling and processing contract with a Chinese party, the SME does not own anything in China. The SME provides the technology, machinery, spare parts and raw materials to produce the product. The Chinese party provides the manufacturing facilities. Although this may seem attractive, if there is any propriety technology or machinery being used, intellectual property rights (IPR) must be taken into account. According to one report, 92% of the software used in China is pirated.

Protection of IPR continues to be a major hurdle in doing business on the Mainland. Even though the Chinese government has made efforts in enforcement and prosecution, there has not been a significant reduction in the availability of pirated products. This is a result of the provincial or local governments not enforcing edicts issued by the central government. The U.S. Department of Commerce has a comprehensive resource available called the IPR Toolkit (http://beijing.usembassy-china.org.cn/ipr.html). U.S. companies are encouraged to have their legal team review this information.

To set up production facilities in China, the company needs a legal entity to conduct business. This can take one of the forms previously identified. It is important to keep in mind that building a new facility in China can take a year or more due to multiple government approvals. A chief representative needs to be identified as the person responsible for complying with Chinese law. If any irregularities surface, this person will be prosecuted and, if found guilty, sent to prison. A local Chinese partner can be a tremendous asset, but in order for this relationship to be successful, a shared vision and an exit strategy are essential.

Again, it is important to understand all the costs of setting up facilities in China. For example, at first glance direct labor costs may seem to be significantly less. There may, however, be considerable indirect costs, as workers need to be trained, personnel from the home office may travel or relocate for the start-up, and there may be room and board costs. Higher start-up costs associated with hiring agents, capacity fees and local government charges may also be incurred.

The good news is that foreign investors may get preferential treatment if they build their operations in economic zones targeted by the government. This can mean tax exemption for two years and a 50% reduction in tax for some years following. This can be a very attractive deal as the normal tax rate on profits is 33%, and this preferential treatment is not offered to local companies.

The path many companies are choosing is to link their business through Hong Kong. About 90% of Hong Kong manufacturers have production facilities in China, mainly the Pearl River Delta (PRD). This amounts to approximately 70,000 manufacturing operations in China with management, finance, communication and coordination activities in Hong Kong. This integration has proven very efficient for many companies. In addition, there are currently 1,167 regional headquarters and 2,631 regional offices of international companies. Many companies choose Hong Kong as a location for regional operations because there is free port status, low taxes, free flow of information, a corruption-free government, absence of exchange controls, communication, transport and other infrastructure, and the second largest financial center in Asia. Using Hong Kong as the entry point can ameliorate many issues as the Hong Kong Chinese have many years of trading experience with both China and the West.

Given the potential of Mainland China, how does an SME minimize the risks of entering this market while developing a presence in the area? The consistent answer lies in using Hong Kong as the doorway to a larger China strategy.

Advantages of Hong Kong

There are a number of advantages to doing business in Hong Kong, not the least of which is its geographical location. Hong Kong is within a five-hour flight to all major destinations in Asia, reaching 3.3 billion people. For a company looking at Asian operations, Hong Kong is an ideal location for trading with Mainland China. Sitting on the mouth of the Peal River Delta (PRD), it has provided a door to Mainland China for more than 150 years. In addition, the Closer Economic Partnership Arrangement (CEPA), which took effect in 2004, provides Hong Kong companies with exclusive Mainland market access benefits. China is Hong Kong's largest trading partner as well as being the largest investor in all of China's provinces.

Hong Kong is one of the world's best examples of an "open market economy." There are no restrictions on the movement of goods, services or money. Companies are free to invoice from Hong Kong even if goods never enter Hong Kong. The government's economic policies are that of non-interference in commercial decisions. Therefore, there are no restrictions on ownership of enterprises and the process to register is short and low cost. Furthermore, profits can be freely repatriated.

Hong Kong has become one of the least corrupt business venues in the world. In fact, Transparency International ranks Hong Kong as #15 on the Corruptions Perception Index and the U.S. as #18. China ranked #78. The Independent Commission Against Corruption (ICAC) was set up in 1974 to investigate, prevent and educate in the fight against corruption. Every enterprise registered in Hong Kong is required by law to have an annual audit, which ensures transparency of financial practices as well as transparent corporate governance. Furthermore, Hong Kong has rule of law based on English common law. This provides for a transparent administration of legal procedures.

Hong Kong serves as an easy access the 50 million consumers in the PRD, the most affluent region of Mainland China, however Hong Kong is more than just the door to the Mainland. The city has a population of seven million people with 22 million annual visitors. Much that moves through Hong Kong to world destinations is mass-produced merchandise, but many Hong Kong residents and visitors buy high-end. There is huge spending power, split between local consumers at 80% and tourists at 20%. For example, this is a city that boasts seven Tiffany jewelry stores, eleven Ferragamo shoe stores and the most Rolls Royces per capita than any other country. The size of the market coupled with its spending power make Hong Kong a perfect place to test market products in order to localize them for Asian tastes. For example, U.S. mobile phone games and text messaging services were designed for the U.S. market. These products were tested in Hong Kong for the Mainland market and failed. With such success in the U.S., companies could not explain the difference in taste. Hong Kong market research revealed that it was a priority for the Mainland market to be able to perform all operations on their mobile phones with one thumb, as most are using the other hand to smoke. Without the ease of doing business in Hong Kong, this could have been a very costly discovery to make in China.

A Hong Kong partnership, in whatever form that takes, can mean the difference between success and failure. Hong Kong businessmen have much experience in dealing with China and there are many Hong Kong companies that are interested in partnering with foreign companies. This collaboration is a way for both parties to achieve their business objectives.

Comparison of PRC and Hong Kong

Factor	PRC	Hong Kong
Ease of Doing Business	91st out of 155 countries	7th out of 155 countries
GDP Per Capita	$5,600	$27,400
Tax on Profits	33%	17.5%
Value Added Tax (VAT)	17%	None
Import/Export Tariffs	Varies	None
Foreign Exchange Restrictions	Regulated	None
International Accounting Standards Compliance	Working towards	100%
Company Registration: • Name search fee • Processing Time	US$18 Regularly 30 days plus 10 days for name search	US$3 Maximum 6 days
Personal Tax Rates	Top marginal rate is 45%	Top marginal rate is 17%