Are you sure you know enough about due diligence in China?

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During the recent years, the news have regularly been reporting financial and accounting scandals about Chinese companies, whether the company is listed abroad or acquired by international players in China. Since 2010, more than 10 Chinese companies[1] listed on the North America stock markets have been one after another accused of misleading the markets with false information or committing financial frauds. These companies' stocks were either suspended or delisted from their respective stock exchanges, yielding serious economic losses to both institutional and public investors.

Yet, although already under the crisis of confidence on international stock markets, Chinese companies are once again involved in financial and accounting frauds in 2013: After paying US$734 million to acquire Zhengzhou Siwei in China, Caterpillar had to account and report a significant write down of US$580 million due to accounting misconduct engaged by Zhengzhou Siwei's senior manager over several years. That represents a huge loss for the investor. Such a serious M&A failure is just the visible part of the iceberg. There are many other undisclosed failures about investment in Chinese small and medium sized companies[2].

These scandals deteriorate the confidence level in the investment environment. The work quality of renowned international auditing firms is even questioned. As a consequence, the investors have to pay more attention to the scope and the quality of the due diligence. By excluding the cases in which the auditing firm has the intention to help the target company to cover up the accounting misconduct, why is it so difficult to find out potentially serious issues

[1]Including but not limited to Rino International Corp., China Intelligent Lighting and Electronics Inc., CCME, Nivs IntelliMedia Technology Group Inc., Longtop Financial Technology Limited, Puda Coal Inc., SinoTech Energy Limited, China Medical Technologies Inc., Universal Travel Group, ChinaCast Education Corporation, SinoForest Corporation, etc.

[2]As of September 2012, the number of registered private companies reached 10.598 million in China (http://news.xinhuanet.com/fortune/2013-02/01/c_114587467.htm).

and risks even by carrying out a professional and rigorous audit or due diligence? While third party research companies such as Muddy Waters LLP manage to find out evidences about accounting misconduct within America-listed Chinese companies, what should be done to avoid potential pitfalls in an investment or an acquisition project in China?

These questions are worth being investigated and answered. Besides the inherent issues and difficulties of the due diligence work itself, other factors such as the specificities of the Chinese national conditions and business environment, or possible defects in the execution of the due diligence, etc. may lead the investors to overlook some unexpected issues that are at the origin of unbearable consequences.

Based on the analysis of the above mentioned reasons and the narrative of a few illustrative cases (personally experienced in small and medium sized Chinese companies acquired by European firms), some personal thoughts and recommendations about doing due diligence on Chinese private small and medium enterprises will be provided, as references to professionals or readers interested by this topic.

With the sustained economic growth and the fast development of the capital market in China, overseas and domestic corporations or investment funds all have one after another been looking for high return investment or partnership targets with a footprint in China.

In any kind of investment or partnership deal, after sealing the term sheet or the letter of intent, the buy-side will carry out a due diligence on the sell-side, either by an internal team or by an objective and qualified third party (e.g. certified public accountants, lawyers, investment banks and other professional organizations).

The actual scope (breadth) and content (depth) of the investigation depends on the nature and the objectives of the transaction. For the purpose of this paper, the focus is on the Chinese domestic mergers & acquisitions, private equity or venture capital investments, since the targets of these types of transactions are often small and medium enterprises that have a certain history, foundations, and size of operations. The information transparency of such targets is lower than those in the course of or already went through the IPO processes. The non-listed small and medium enterprises potentially have more issues and risks to dig into and to audit, increasing the difficulty level of the due diligence, and therefore with direct impact on the quality of the due diligence outcome.

Generally speaking, prior to an investment decision, the aim of a due diligence is to help the investors to: (1) collect all the important and relevant information required for the investment decision making, (2) determine whether the investment is in line with the buy-side company's strategic objectives and principles, (3) make preliminary valuation of the target company and assess the investment feasibility (various key success factors are considered, while ensuring there is no deal breaking factors), (4) avoid or minimize as much as possible the potential investment risks, (5) facilitate the integration and the transition work post-acquisition.

		Matters Considered by the Target Company		Matters Not Considered by the Target Company
		Disclosed Information	Undisclosed Information	Undisclose Information
Matters Considered by the Investor	Audited Matter	(1) Limited issues and risks	(2) May not be able to dig out some issues Certain level of risks may exist	
	Unaudited Matter	(3) Overlooked the audit of some issues Certain level of risks may exist	(4) Potentially significant issues with serious risks	
Matters Not Considered by the Investor	Unaudited Matter			

Chart 1：Due diligence's inherent issues and potential risks

The due diligence work mainly pays attention to the target's accounting, financial, operational, and legal aspects; careful and proper analyses are carried out on the investigated matters. The nature and the extent of the due diligence work is generally limited to the information deemed necessary to be investigated. That means the investigation, the analyses, and the risks assessments are made on the matters considered and identified by the investors.

Responding to the investors' requirements, the target company only provides the information it is willing to disclose to the other parties. Besides, for responsibility limitation reasons, the third party carrying out the due diligence generally indicates in the disclaimer section of the final due diligence report, the scope of the investigation while assuming that all the information provided by the target company is comprehensive, complete, sincere, and true, without concealment, alteration or fraudulency.

In fact, this is not the case in general. Since both parties have asymmetric information, the both parties do not take into consideration the same matters during the due diligence phase. The related party does not necessarily disclose completely or investigate thoroughly all the relevant information. Therefore, in most of the time, some important issues may be overlooked or neglected, yielding various levels of risks (see Chart 1: Due diligence's inherent issues and potential risks).

In an ideal situation (case (1) of Chart 1), both parties consider the same investigation matters at the same time: the buy-side investigates the matters being considered while the target company cooperatively discloses all the related information. Thus, the buy-side would be able to effectively assess and control the occurrence of potential issues and associated risks.

In the worst scenario with insufficient breadth and depth of investigation coverage (case (4) of Chart 1), regardless of whether the both parties have considered the matters being covered by the due diligence or not, when there are undisclosed relevant information associated with the matters not being investigated by the buy-side (whether intentionally or not), potentially significant issues with severe risks may occur after the closing of the transaction.

In other situations (cases (2) and (3) of Chart 1), the buy-side does not investigate some matters or the target company does not disclose some relevant information, some issues may also occur with associated risks and consequences.

Overall, when “you don’t know what you don’t know” matters occur, there is unpredictable exposure to the risks and the consequences. At last, both parties (investors and the target company) may be subject to potential losses.

In addition to the above mentioned issues that are inherent to the due diligence work itself, another intrinsic problematic shall not be neglected. It is about the national (or local) conditions, the business environment, and also the ways of doing business in China.

Since its reforms and opening up, despite China’s rapid economic growth, the overall pace of development and the distribution (and re-distribution) of resources are uneven. That has lead to inconsistencies in terms of organizations, processes, decisions and execution power between agencies at different levels of hierarchy across regions. That brought regional differences to the overall environment.

Also, the Chinese culture is human-centric. Therefore, the human factor has a preponderant importance. In addition to complying with principles, dealing with any business in China has also to cope with relationships and friendships. Sometimes it is even necessary to play “unspoken rules” to effectively achieve the goals.

According to Transparency International’s 2012 Corruption Perception Index, China is ranked no. 80 (over 174 countries), lagging far behind the developed countries while comparable to some undeveloped countries in Africa, Asia or Central and South America. Recently, the news frequently reported anti-corruption cases in China. More than a thousand officials, from ministerial to county levels, have been arrested and sentenced for corruption conducts. That clearly reflects the phenomenon of corruption throughout China.

Under such an environment, private companies that successfully develop the businesses have likely played “unspoken rules”. Standard due diligence usually checks the personal background of the target company’s top managers, or even investigates the likeliness of the target company to be involved in briberies. Especially if the target company is submitted to the British or American laws, their commercial behavior is under close scrutiny and strict supervision, so to avoid violating criminal laws defined in their respective bribery acts.

Even with strict preventions, bribery incidents still cannot be avoided. The GlaxoSmithKline’s large scale bribery case in China is a representative example. This leading global pharmaceutical company’s Chinese subsidiary has paid bribes to Chinese doctors through a local travel agency (Shanghai Linjiang International Traval Co.).

By using a systematic approach to carry out the due diligence, this service provider would probably not attract the attention of the auditors because of GlaxoSmithKline’s large scale and its complex structures and operations; and also the total amount of service fees paid to this provider is relatively small compared to the main suppliers. Moreover, the business registration information of this travel agency appears to be normal; there is no violation record, or negative media coverage; it has not even been recorded by some professional database as a company with negative risks[3].

This example corresponds to the case (4) of Chart 1: potentially significant issues with serious risks and consequences. Besides paying a fine of CNY 20 billion, the future business development will be negatively impacted. Some people even predict whether GlaxoSmithKline would exit from the Chinese market!

Unlike the large corporations, the small and medium enterprises may often use their good relationships with local officials to attract and convince the potential investors, because they consider these good relationships as a competitive advantage or an attractive intangible asset. Of course, being able to get actual support and assistance from the local authorities may indeed improve the efficiency and the chances of success of the businesses, but this is a double edged sword.

For instance, in a tier-5 level township near the Nantong city, two nearby foreign companies bought lands to build their own factories. Because one of these foreign companies did not want to play local “unspoken rules”, is still struggling with the local authorities to get

[3] http://www.fcpablog.com/blog/2013/7/18/gsk-china-probe-shows-limits-of-due-diligence.html

the land property certificates. The other one exploited local connections and relationships to successfully get the whole set of property certificates very easily. This anecdote confirms the ill-regulated local business environment and ways of doing businesses, but it also reflects the value and the role of good relationships with the local officials.

In fact, similar cases are rampant in China, especially in under-developed areas. In order to maintain such a kind of relationships, there are certain costs to bear. In ill-regulated areas, in addition to personal bribes, local authorities may use seemingly legitimate means to collect “business protection fees" (e.g. ad hoc and useless magazines especially edited for sale to local firms, sponsorship fee levied on certain activities or events, etc.).

That’s why the due diligence must take into account the local business environment factors and the costs of playing local “unspoken rules” with the local stakeholders. In addition, the target company may lose the intangible competitive advantage or even be involved in the legal disputes, if the connections were transferred away or have committed violations.

Another personal case to illustrate the above statement: a medium sized French listed company (code: Fr0) entered into a joint venture with a small Chinese metal processing company. The boss of the Chinese firm had very good relationships with the head of a tax-free industrial zone located in the Jiangsu province, and got very attractive leasing conditions of a factory in that tax-free zone. However, two years later, the head of this industrial zone had been transferred away. Due to the lack of good relationships with the new head, the factory leasing fees doubled following the renewal of the leasing contract. Because the joint venture was located in the tax-free zone, it was difficult to move out from there: all invested equipments and assets that entered into the tax-free zone were exempted from paying the VAT, thus moving out these equipments and assets from that industrial zone would need to carry out import formalities at the local customs, and subsequently the tax bureau would require the payment of the initially unpaid VAT. The total amount was very high, making the stay or move out decision a dilemma. If Fr0 had carried out a due diligence on the background of the tax-free zone’s director, and had considered the possibility of this head’s replacement, Fr0 should have assessed the associated risks and consequences, and then integrate these parameters into the valuation of the target company, so to minimize the potential losses post-investment.

Another aspect to be discussed in this paper is about the execution quality of the due diligence. The execution defects result from 3 main reasons: (1) limited time and resource allocated to the due diligence, (2) inappropriate investigation matters and method, (3) due diligence team lacks knowledge of various local environment specificities and local on-the-ground experience.

Usually, the due diligence has to be completed within 4 to 6 weeks time and within a certain budget. The scope of investigation includes commercial due diligence, legal due diligence, financial and accounting due diligence, operational due diligence, etc. More and more, the human resource due diligence is also carried out.

Many Chinese entrepreneurs define the business development objectives based on the amount of money earned. For personal gains, they may falsify the operating results and present good corporate data in order to deceive the investors and the financial markets. To prevent from cooperating with unethical individuals, the human resource due diligence is even more important than ever.

Any investor agrees that the quality of the execution team has major impacts on the success of an investment deal. Despite a stronger focus on the human aspect, the actual due diligence on the execution team is mainly limited to the investigation of the top management or key employees' basic personal background. In addition to the private life, the personality, and the behavior of the top managers, it is also necessary to know and pay attention to the relationship status with other family members with influence power in the target company.

As an example, a Chinese PE firm reflected on one of its portfolio companies: the chairman (and shareholder) of the invested company was in bad relationships with his spouse (already broken down before the investment), and had to divorce and split all the assets, including the company shares held by the spouse. This unfortunate event brought rather tremendous negative impacts to the investment of that Chinese PE firm.

Besides the due diligence on the top management, it is also useful to understand the background of the middle management and the basic level employees or workers, because their personality and behavior could reflect the enterprise culture and the usual methods used by the managers on the subordinates.

For instance, following the discussions with several basic level workers at the above mentioned company Fr0, it had been discovered that a team leader stole some valuable scrap metals[4] from the production lines, sold them and kept the money. Afterwards, further discussions showed several other workers were also involved (some of them even have family

[4] The value of scrap metals represents 2% of the materials cost at company Fr0. The material costs represent roughly 50% of the product selling price. Therefore, the value of the scrap metals contributes almost one percentage point on the net profit of the associated product sold, which may be quite significant.

relationships with the thief). Furthermore, this collective action was tolerated by the factory manager. Although this manager was at the origin of the Chinese business unit, he had contributed significant effort on the factory setup and product development. Nevertheless, his loose style of management still brought negative influences to the company in the end.

These two examples illustrate the importance of the human resource due diligence and the necessity of in-depth investigation. However, the overall capital market in China has been booming over the last decades, any interesting investment opportunity is in great demand and chased. Interested parties need to make their investment decisions as quickly as possible. Under the time and competition pressure, while betting on high market growth potentials in China, the investors believe that the return upside opportunities would override the downside risks. Thus, the due diligence time might be shortened at the expense of the breadth and depth of the investigation coverage, highlighting even more seriously the inherent issues and risks associated with the due diligence work.

Under the time and limited resource constraints, in accordance with the principles and the scope of due diligence agreed between the transaction's parties, the third party's investigation team will apply a systematic and standardized investigation approach and analysis methods to complete the due diligence tasks on schedule. These tasks include reviewing the information and documentation contained in the data room provided by the target company; interviewing the management to get relevant information, occasionally arranging on-site visits (in small or medium sized transactions, or at specific stages of larger transactions).

It is seldom to carrying out the due diligence work on-site, especially when the transaction is at the confidential stage. That means the due diligence work is generally focused on the documentations reviews and data analyses. Financial and accounting due diligence generally does not use the financial audit approach (confirmation, physical inventory count, double calculation, etc.), but rather uses trend and structural analyses or other analysis tools. Methods of analysis include the financial indicators analyses, the general quantitative analyses, the business analyses, and the investment case evaluation.

By using such methods, combined with broad due diligence experience, it is possible to dig out some unknown information, but this is still not comprehensive enough. Combining with the field research methods would be the best to get better due diligence results. For instance, the comprehensive and in-depth investigation approach used by Muddy Waters

LLP[5] is worth being considered and applied. It consists of collecting and reviewing any kind of public information about the target company; investigating and analyzing with a "follow the vine and get the melon method" (e.g. follow each clue) to track down the relevant information; and then using private detective approach to carry out field research to get evidences (e.g. observing the factory environment, equipment, and inventory; discussing with the workers or the neighbors; or even secretly observing and photographing the actual situation outside the factory; calling the suppliers and the customers for channel checks, etc.).

Adopting such an approach is undoubtedly very time-consuming (may require up to 6 months time). By allocating more human resources to the investigation team could help shorten the investigation duration, but that will inevitably increase higher due diligence costs. Decisions on spending higher due diligence costs would depend on the size of the investment and the balance between the return on investment and the potential downside risks to be borne.

In addition to the appropriate investigation and analysis methods, broad due diligence experience is very important, and also the knowledge about the local business environment and actual situation. Mixing these ingredients all together could really help to take into account the most matters and the necessary level of details for the investigation.

Generally speaking, internationally renowned certified public accountants, lawyers, or financial advisors have a standardized and systematic guidelines and methods for doing the due diligence. They also have strong project management skills and experience. However, they don't necessarily know well about the local business environment and the ways of doing business. That's why these international players usually partner with Chinese counterparts and let the counterparts carry out the due diligence, while they only take care of the project management and the results integration works.

Such a partnership may appear complementary, but the due diligence experience and quality of the Chinese counterparts cannot meet the international players' standard yet. Sometimes, the investigation team of the Chinese counterparts does not know well about the local environment and situation either. The final due diligence results might still not be satisfactory at all.

As an example, there is a WFOE (wholly foreign owned enterprise) that has leased manufacturing buildings in a Shandong province's county. On paper, the landlord is an

[5] Even though Muddy Water's "doing short" practice against the Chinese companies is controversial, their investigation methods is still worth being considered, details about their methods at the following website page: http://baike.baidu.com/view/6022031.htm.

industrial and trading company. In fact, the villagers of a township are the actual landlord of these buildings (i.e. through the township's representative committee, the villagers put their life-long savings into a special funds and mandated the village committee to make investments in manufacturing buildings and to manage the investments). Therefore, in case of a dispute, the opponent is not an industrial and trading company, but rather the villagers of a whole village! This case shows that only collecting and analyzing the registration and lease information is not enough. A due diligence team without good local knowledge or similar practical experience will not be able to dig out relevant information at that level of details.

Following the above discussions and analysis of the different issues regarding the due diligence, the next section provides the reader with a selection of personally experienced case studies, as references or warnings for future due diligence works:

(Case 1) Chinese legal system's flaws and its judiciary bodies' unprofessionalism

A European industrial group (code: Eu0) acquired a manufacturing company in the Shandong province. Due to mismanagement, the Chinese subsidiary cannot continue its operations any more. The group decided to file for bankruptcy at the (prefecture-level) city's Intermediate People's Court.

Even though the subsidiary complies with all the conditions defined in the Chinese enterprise bankruptcy law, the court has simply rejected the filing verbally, without providing any admissible reason or notifying the decision in written form. After several rounds of discussions between Eu0's lawyer and the different judiciary officials (including the bankruptcy judge), these officials just keep passing the buck back and forth to each other. Under such a situation and without any written document from the intermediary court, the local lawyer hired by the subsidiary is unable to appeal against the decision to the High People's Court, forcing the company Eu0 to face a deadlock dilemma.

Afterward, an analysis of this case yields the following main reasons as an explanation: (1) throughout all levels of the judicial system, the interpretation of the laws is not consistent and their enforcement is not standard either, sometimes even the application of local laws takes precedence over the state laws (of course, without being in conflict with the principles of the state laws); (2) the city's Intermediary People's Court mentioned they have never processed such cases in the past, that means they do not want to deal with knotty cases, and they would not have the competences to process even if they had accepted the case. In fact, they simply applied the principle of "the less trouble the better" and thus refused the bankruptcy filing.

This case study shows that the legal due diligence should also include the investigation and the assessment of the local legal system and environment, and the level of standardization (or consistency) and professionalism of its judicial bodies as well.

(Case 2) Different management concepts and issues-solving views

In a foreign investment project, the investors hired one of the big four accounting firms to carry out the financial and accounting due diligence. The investigation results show that the target company sells many products without issuing an invoice.

The target company's top management argued that their products would lose competitive advantages if their selling prices had to integrate the VAT and if in addition they had to pay corporate income taxes over the profit. Furthermore, as local ways of doing businesses, their customers do not want to buy their products with an invoice either.

Such business practices are common everywhere in China. The main reason is because entrepreneurs of small and medium sized enterprises usually lack of scientific management concepts and knowledge. Many of them do not understand the financial statements, or even the basic concepts of the finance and accounting. Their general ways of doing business is driven by the usage of cash. Also, these entrepreneurs would declare a specific set of financial and accounting data to the tax authorities in order to make their accounting books "look fine"[6], while without paying too many corporate taxes[7].

Since Chinese entrepreneurs consider they invested their own money, the cash goes in one pocket and comes out from another pocket; they would simply deduct the expenses from the revenues to compute their net profit. They do not really think about the invoicing associated to the products sold or the raw materials purchased. When they need an invoice, they would use other unrelated invoices to fulfill the numbers.

Some companies even take over the responsibilities of the tax authorities in terms of collection and payment of VAT at once: the customer requiring an invoice would have to pay extra fees of 6%-9% on top of the VAT-exclusive amount. These extra fees correspond to an

[6]"Look fine" means to avoid drawing the attention of the tax authorities: According to the annual tax collection performances imposed by the Inland Revenue Department, each local tax bureau defines financial indicators to supervise and control the operational and financial performances declared by the firms. When these financial indicators are not respected, there will be red lights alerting the local tax bureau to go and visit the related company, with the possibility to audit their accounts or even to attribute fines.

[7]Usually, the small and medium sized enterprises in China prepares 3 sets of financial and accounting books: One reporting the actual situation for internal use, a second set is dedicated to the tax bureau, a third one is prepared for communication to the third party (e.g. shareholding partners or potential investors).

average value of the difference between the VAT inclusive sales amount and the VAT exclusive sales amount.

As for the investments in fixed assets, the Chinese entrepreneurs would rather consider such investments as sunk costs, instead of amortizing them as costs or expenses for the profit calculations.

The above mentioned practices are commonly in usage by Chinese entrepreneurs. They do not even think it is incorrect or illegal. In reality, that makes the costs and their allocation irrelevant and inconsistent, increasing the chance to mislead the analyses of the investors.

For that reason, in addition to understanding how the target company's top management deals with people and solves issues, it is also important to take into account the potentially huge gap between the parties in terms of concepts and viewpoints. Usually when we consider an approach as wrong, the counterparts would unintentionally believe everything is fine. Then, both parties would face difficult communications and tense co-operations. In the worst case, one party could be accused of financial fraud by the other party, with severe consequences.

(Case 3) Company's history characteristics and sequels caused by past labor disputes

The above mentioned company Eu0 invested in a target company that was originally a rural collective enterprise (an integral part of the public sector of China's socialist economy), then became a privately owned company after being acquired by a local entrepreneur.

Company Eu0 has kept all the employees after its investment in the target company, without renewing the labor contracts. Two years later, for restructuring reasons, Eu0 decided to lay-off one third of the acquired company. However, Eu0 did not follow the standard legal process to dismiss workers, and made the dismissed ones unhappy (because they should benefit from their seniority since working for the rural collective enterprise, and they believed they could also benefit from similar treatment and protection as an employee of a state owned enterprise). The case was reported to the local arbitration committee, which sentenced Eu0's subsidiary to pay the dismissed workers with double economic compensation.

A few years later, this same subsidiary had not performed well and needed to lay-off some workers once again. In order to avoid the past mistakes, the subsidiary followed the standard legal process and expected to lay-off the workers in an amiable way. Yet, the workers strongly opposed to this decision.

The main reason of this opposition is the lack of labor law's knowledge on the workers side. They still believe they lost a state owned enterprise job and they could get as much as the double economic compensation previously sentenced by the arbitration committee. Things did not turn out well. Eu0's subsidiary was involved in an arbitration dispute again and subjected to serious economic losses.

If the potential investor has carried out the legal due diligence before the second arbitration dispute, the records of the first labor dispute would have been found, indicating that the legal case had already been resolved. Theoretically speaking, the new investors would not have to bear any legal responsibility or risks. But who would have thought the first arbitration dispute had left ideas (unfavorable to the company) in the other workers' mind. That shows the importance of making more comprehensive and long-term thinking so to be able to consider various unexpected issues and consequences.

(Case 4) Imperfections and uncertainties of the tax laws

A foreign company (code: Fr1) invested in a Chinese subsidiary in a tier-5 village of the Jiangsu province. The subsidiary purchased a CNY 4-million worth equipment through a capital lease contracted with the leasing unit of an international bank.

According to the international, European or American accounting principles, the equipment can be amortized and is eligible to VAT deduction (around CNY 600,000) on the one hand; and the leasing amount can be accounted as long term debt (capital part) and financial expenses (interests part) on the other hand. The property right shall be transferred to the lessee after the payment of the last leasing rental.

However, various issues occurred in China with this financing model (commonly used in Western countries). Indeed, an independent leasing company is not allowed to provide loans services in China. Therefore, the invoices issued cannot explicitly indicate the capital part and the interest part. At the end, there is a difference between the total cumulative invoiced amount and the long-term debt amount (recorded in the lessee's accounts), corresponding to the total interests amount.

In addition, according to the local (county level) tax authorities' interpretation of the tax rules regarding the capital lease, because the property right is transferred to the lessee at the end, the equipment supplier should not issue an invoice to the lessee. Without an invoice, it is not possible to deduct the VAT or to record the delivered equipment in the fixed assets. Conversely, once the invoice is issued, the equipment's price must be recorded in the accounts within 3 months, otherwise the VAT deduction right will expire. For that reason, company Fr1 discussed and agreed with the equipment supplier's European head quarter to exceptionally issue an invoice by their local unit for the purpose of VAT deduction in China.

Yet, because Fr1's Chinese subsidiary had not been paying VAT for a while to the local tax bureau (that was facing high pressure for tax collection from the Inland Revenue

Department), the company was forced to cancel the already accounted VAT deduction amount. The reason invoked by the tax bureau was another local company specialized in the shipbuilding business experienced the same verdict with equipment worth several tens millions of Chinese Yuan.

The top management of Fr1's Chinese subsidiary has no other solution than submitting this case to the state tax bureau, and requested explanations about the interpretation and the application of tax rules associated with the capital lease.

Few months later, maybe under the requests from many other companies in comparable situations and for the interest of the whole leasing industry, the Chinese national tax bureau issued a circular stating that the capital lease is eligible for the VAT deduction. Then, the local tax authorities were obliged to give back the right of VAT deduction to Fr1's subsidiary.

From that case study, the imperfections and the uncertainties of the Chinese tax rules might bring about unexpected issues and potential economic losses to a whole industry. Therefore, a simple tax due diligence is not enough. It is necessary to communicate and discuss with the local tax authorities in order to understand how they tackle with unusual tax issues in terms of interpretation and application. Only by doing this could the negative risks be minimized.

Through the above illustrated case studies, there is no doubt that each investment project may have "you don't know what you don't now" matters that might occur. Of course, these 4 case studies do no cover all the possible situations. They are provided as references to think about. A list of practical recommendations could be summarized as following:

(1) Perform a preliminary investigation on the accounting firm or the service provider in charge of the due diligence work: they have to know well the target company's businesses and the industry specificities; in addition they must have local practical experience and also understand the local environment and ways of doing businesses.

(2) Need to investigate issues comprehensively and in detail (broader scope, longer investigation duration); consider short term, mid and long term risks with their direct and indirect consequences.

(3) In addition to using standardized methods and tools, also apply field research approaches as conducted by Muddy Waters LLP (pay attention to not violating the Chinese laws, being accused of illegally acquiring Chinese companies or citizens personal information).

(4) Carry out in-depth investigation about the target company's internal and external environment (including local government bodies and policies), its history background, current situation, and future perspectives.

(5) Pay as much attention as possible to the employees at all levels (top and middle management, employees or workers), without forgetting the inter-relationships between the employees and in association with the historical events (including the labor disputes, especially the Chinese government pays lot of attention now to the social harmony, the national labor law protects more and more the workers).

Currently, carrying out due diligence on small and medium sized enterprises in China constitutes certain challenges. Following further economic development, such enterprises and their employees and environments will become more mature. That will reduce the gaps with respect to the standards observed in developed countries. The due diligence work should be less problematic in the future in China. That still needs some time to mature.

Conversely, Chinese investors doing due diligence on foreign companies may face other types of issues. For instance, the acquisition project of Sany Heavy Industry buying the US wind farm at Butter Creek, was rejected by the President Obama himself for national security reasons. Even suing Obama and his government for discrimination is useless because the US Court of Appeals at the Columbia district rejected the appeal from the Sany Group. The main reason is because the wind farm is too close to a Navy's bombing practice site, while Sany did not apply and get the approval from the CFIUS before making the transaction.

In this case, has Sany carried out enough in-depth due diligence on the wind farm's surrounding environment? If they knew about the proximity to a military base, have they thought about the potential rejection of the transaction from the US administration and government? Have they appropriately assessed the risks associated with this transaction?

All these issues are worth being followed with interest, analyzed, reflected, and lessons learned from. We hope to have the opportunity to analyze and discuss about the difficulties, issues, and risks faced by the due diligence on foreign companies in China out-bound investment projects.