Due Diligence in China
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To
My Family
For your unreserved support with my stay in
China for so many years

To
Kelvin Fu
Joshua Lim
For your talents and hard work
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CONDUCTING DUE DILIGENCE IS BOTH an art and a science. We argue that the due diligence process in China is more art, as there are more subtleties but less black-and-white, number-crunching processes. Due diligence checklists are frequently relied on by many legal, accounting, and financial institutions as a methodology to conduct due diligence in companies, these checklists typically cover the basic due diligence areas, and some firms may have refined the checklists based on their own in-house expertise and experience in the industry. Yet, judging from the number of financial blowups and fraud cases in China and around the world, one inadvertently comes to the conclusion that the due diligence checks conducted by these professional services accounting and financial institutions are inadequate and have failed to uncover these spectacular financial disasters. To this end, the central position of this book is to argue that one must go beyond the due diligence checklists in order to attain a more comprehensive and more reliable assessment of the target company in China.

Due Diligence in China: Beyond the Checklists is the first book that goes beyond the scope of what most readers are familiar with in a typical checklist. Going beyond the checklists requires an in-depth understanding of the relationships between all the entities present in a typical Chinese company. This could run the gamut of personal, professional, political, and social relations between internal peoples/groups and external parties. This book utilizes real-life case studies that were developed specially for this book. These case studies are meant to provoke the readers to delve deeper into the intricacies of conducting due diligence in companies operating in China and also to provoke the readers to garner valuable lessons from the colorful history of companies and deals gone badly.

The first chapter of this book, “The Business Landscape in China,” sets the stage for the rest of the book. In this chapter, we discuss the business landscape in China. Indeed, there are many books out there that attempt to describe this topic. However, this chapter is meant for readers who are relatively new to
China and want to have a basic understanding of the basic business environment and the unique characteristics of doing business in China. A discussion of the business landscape of China includes the political, social, and cultural aspects that are often neglected when one considers doing business in China. Understanding the business landscape will provide readers with a good contextual understanding of why conducting due diligence in China needs to be deliberately and meticulously planned and why it is so critical prior to deal making to maximize the chances of success in the deal.

In the second chapter, “Due Diligence in China,” we discuss the basic due diligence process in China. We also discuss the differences in the types of due diligence conducted. It is critical to understand that the nature of the due diligence will affect the type of due diligence conducted. There are significant differences between conducting due diligence on M&A transactions and on private equity investments, for example. We also identify the shortcomings of these checklists pertaining specifically to Chinese businesses, so as to provide readers with a good understanding that relying on checklists alone to conduct due diligence is not advisable, and could be also highly risky, as the results of the due diligence would not be an accurate reflection of the true state of any Chinese company. This chapter also includes a discussion of the differences of due diligence conducted in China versus the West. Readers will find that while the processes for due diligence are generally similar in different countries, there are significant differences in the approaches and mind-set that one must adopt in conducting due diligence in China especially, because of the differences in the business landscape and political system.

In the third and fourth chapters, “Financial Due Diligence” and “Operational, Commercial, Legal, and Other Due Diligence,” we discuss the conventional due diligence checklists that are typically involved in deal making. There are many different types of checklists used by different service providers for different industries. These two chapters list items on the checklist that are most pertinent to conducting due diligence in China and what are the key things to look out for when going through the checklists.

The fifth and sixth chapters discuss in depth the ways to overcome the shortcomings of the conventional checklists—that is, how to go beyond the checklists in order to get a truer reflection of the state of the Chinese company. We will be introducing many different applications of these unconventional methods of due diligence and its impact on the company. The fundamental basis of a due diligence that goes beyond the checklists is to ensure that no stone is left unturned no matter how uncomfortable or awkward the process can be. However, this oversimplifies things. Readers, by now, should be asking the key
question: Are there other stones that we did not know of in the first place? This is a fundamental question that any type of due diligence that goes beyond the checklists should ask and explore deeply.

The fifth chapter, “Beyond the Checklists: Founder and Management,” focuses on the conduct of due diligence on key executives of the company. This human due diligence is especially critical in China, as the founders and high-level management wield enormous influence in the company. We also examine in detail the personal lives and relationships of the executives, which may turn out to be potential liabilities and risk factors to the company.

The sixth chapter, “Beyond the Checklists: Hard Facts,” lays out the importance of verifying the hard facts through face-to-face meetings, site visits, and proportion checks. These methods require investing a significant amount of resources, time, and experience to carry out. We also discuss about the four deadly A’s that one has to contend with during the due diligence process: Authorization and control; Abnormalities; Anti-corruption and bribery; and Accounting frauds and cheats. Lastly, we would introduce the Anti-Corruption Investigate Due Diligence (ACID) framework and show how it could be utilized to guide the process of doing due diligence that is beyond the checklist.

The seventh chapter, “Implementing a Due Diligence Workflow,” features a useful practical guide for readers who may be conducting a first-time due diligence exercise in China, or for readers who want to deepen and broaden their knowledge about the effective ways of doing due diligence in China from the planning stage and forming a team onwards.

The eighth chapter, “Post Due Diligence and Case Studies,” deals with the tasks upon completion of the due diligence formal process—namely, the preparation of the due diligence report, conducting the post due diligence review, and, if the deal were to go through, the conducting of the post deal monitoring process. Additional case studies have been included to allow readers the opportunity to apply the methodologies introduced in going beyond the checklists and to compare and contrast both outcomes. Through this exercise, the readers will be able to better appreciate the comprehensiveness and detail required when conducting due diligence in China.

Throughout the book, some terms are used interchangeably, for example, investors and acquirers, founders and entrepreneurs; they are in general referring to the buyer or the seller side of an acquisition or investment deal respectively.

As usual, case studies used in this book are to demonstrate main points highlighted and discussed in the chapters. It is not a show of good or bad decision making, strategy, or management on the part of those parties involved.
There is also no right or wrong “answers” to these cases. Furthermore, remember that one does not have the full insider information of the situation. They only serve as a trigger to the readers to think deeper into any similar scenario they may face, and as far as possible, the readers should try to apply the methodologies and models discussed in this book to these case studies and maybe go one step further, applying them to the readers’ own cases.

A good due diligence needs to be highly customized according to the objectives and nature of the investment or acquisition. There are two Appendices on the companion website. In Appendix A, we have included due diligence checklists on financial, tax, operational, legal and environmental that could be used as guides for the due diligence process.

In Appendix B, we have included proprietary tools and diagrams that go beyond the checklist (Appendix A) that readers could use to enhance their due diligence process. These tools and diagrams are only the skeletal framework and deliberately kept blank so that readers could utilise them as worksheets. In order to utilise these checklists, tools and diagrams effectively, readers must go through individual chapters to understand its context and how they could be applied for their own use.

Lastly, readers can visit the author’s Website at http://www.ddinchina.com for the latest updates on the book, due diligence related information and to download the soft copies of the checklists, tools and diagrams. Likewise, the book’s companion Website is http://www.wiley.com/go/ddinchina and the password is yong123.
Writing this book was more difficult than I thought it would be, but I am really fortunate to have a group of very capable professionals and friends who helped me along the writing journey.

Once again, I am most grateful and indebted to Kelvin Fu and Joshua Lim. This is the second book we have worked together on. They were both instrumental in getting this project sailing smoothly. Kelvin and Joshua helped me tremendously in the structure and content of this book and gave me invaluable suggestions and constructive comments during the writing and editing process. I know very well that they both have sacrificed lots of personal time for this book. In fact, the many methodologies and models used in this book were also the hard work and brain child of Kelvin and Joshua’s field work with me in China, when we went through the due diligence process of many Chinese companies in different cities and sectors. They were the ones who transposed many difficult and complicated due diligence processes into easy-to-understand yet rigorous models that we are still using today. Time has proven that our models worked so well that we do not have a single failure in our investment history in China. I dedicate this book wholeheartedly to these two extraordinary young friends of mine.

I have an excellent research team who helped me in researching all of the case studies featured in this book. I am very thankful to Yeo Zhi Wei and Zhou Peng Hui, who have spent many sleepless nights discussing cases with me after our busy daily schedule in Shanghai or anywhere in the world when we were traveling together. They are both the most talented, energetic, and passionate young professionals we have in our office.

Joshua Lim and Zhou Peng Hui will be living in Philadelphia and Boston respectively for the next few years. I wish them a good stay and enjoyable learning experience.
Whenever I received drawings from Kenny Ng for the illustration of some major points in this book, I had a jolly good laugh. I noticed Kenny’s talent in drawing many years ago and I am so privileged and thankful for the bit of humor Kenny adds to this book.

Thanks also go to Chen Heng Hui and Evan Foo for their assistance with the case studies, and James Guk for the nicely drawn diagrams and flowcharts.

I thank Kelvin Koh for his warm hospitality when I was in Seoul writing the final part of the first manuscript for submission to my Wiley editor.

I sincerely appreciate and felt the professionalism from the John Wiley & Sons team. This book would have been absolutely impossible without the support from Nick Wallwork and Nick Melchior. Gemma Rosey is the most helpful and greatest editor, who has guided me through the writing process and Chris Gage, has been so patient and thoughtful during the production stage. Thank you very much.

To my family again, I sincerely thank them for letting me living in China for more than a decade. Without this experience in China and the long stay there, this book would not be possible.
This chapter is designed to provide a broad overview of the business landscape in China. Without a fundamental understanding of the key components that make up the business landscape, readers may find it hard to understand the intricacies of doing business in China and how it relates to the core topic of conducting due diligence in China.

Conducting due diligence in China requires an intimate understanding of the business landscape in China and understanding how these various factors interact together to pose challenges. An in-depth due diligence is critical in helping potential buyers to identify the workings of a company and its strategy, and to uncover any hidden issues.

In this chapter, we discuss the characteristics of Chinese political, business, and social landscapes and their relevance and impacts to the due diligence process. The three landscapes are inherently wide in scope and cannot easily be exhaustively covered as they are also dynamic and changing with the times. The purpose is to inform readers to pay attention to the context and unique circumstances that surround Chinese due diligence. The landscapes described may share some similarities with other regions or countries, but, seen as a whole, the Chinese characteristics of these landscapes are unique to China.

First, we cover the macro and structural domains that include a discussion on the macroeconomic conditions and system of rules and laws in China. We
also cover the level of corruption in China and the significant number of fraud cases that plague business dealings in China.

Second, we cover company-specific issues such as the lack of internal controls of Chinese companies that have made it more susceptible to corruption, backroom dealings, and dubious related-party transactions. We would also discuss the current state of how Chinese businesses operate in general, which is to say that they rely heavily on manually intensive record keeping. Moreover, we discuss the cultural and social aspects of the Chinese businesses, which include the corporate culture and environment, the powerful influence of Chinese founders, and their peculiar characteristics that shape their own corporate landscapes.

The aspects discussed in this section are merely snapshots and highlights of the highly complex business landscape in China. As such, readers may find many other peculiar aspects of doing business in China that may complicate the due diligence process that are not covered here. Nevertheless, the purpose of describing the business landscape in China is to provide readers with a contextual understanding and appreciation of the complexities of doing business in China. These insights will provide readers with a good background and allow them to understand and appreciate the importance of conducting a full diligence prior to any deal making in China.

MACRO AND STRUCTURAL DOMAINS

This section covers selected macroeconomic conditions in China that have contributed to the challenges that one may encounter when doing due diligence in China. Some of these conditions, such as the systemic low-compensation schemes, may have exacerbated the level of corruption and fraud cases in China.

From Planned Economy to Market Economy

China has advanced tremendously economically ever since Deng Xiaoping’s economic reform that began in 1978. That reform was accelerated by China’s accession into the World Trade Organization in 2001. Since then, China has been transitioning from a planned economy to a market economy (Figure 1.1). China’s economic growth has been so tremendous that it had surpassed Japan as the world’s second largest economy, and it is poised to surpass the United States by 2027, according to Jim O’Neill, the head of Goldman Sachs Asset Management.\(^1\)
China had been known as a cheap manufacturing haven among investors and businesses looking to leverage the country’s cheap factors of production, such as labor, and government policies. As China’s economy embarks onto the next stage of growth, since its identity as a manufacturing hub, it is gradually evolving into an economy that is more service centric and higher up in the supply chain. The Chinese government has embarked on deliberate measures in the form of strategic economic goal setting using the Five-Year Plans that outline its economic development initiatives. These Five-Year Plans serve as critical benchmarks that the Chinese government strives to achieve, and these changes present great opportunities to investors and businesses.

China’s economic reforms and open-door policy has provided a conducive investment environment for business and investors. Foreign investments into the country were seen as an important source of injection of capital and technology to enable economic growth. China’s investment attraction strategy comprises the liberalization of trade with its key partners using free trade agreements (FTAs) to reduce supply chain costs and to enhance price competitiveness. In addition to the FTAs, China has signed various partnership agreements that seek to mirror the benefits of an FTA such as the Economic Cooperation Framework Agreement with Taiwan.

As China increasingly moves closer to become a capitalistic society, there is a need to implement structural reforms to strengthen the foundations for a market-based economy. China’s economic growth had been propelled primarily
through fixed-asset investments. There is a prevailing recognition that China will have to rebalance its economy by shifting into a consumption-driven economy. However, the general consensus is that China will find it challenging to shift into this mode and will rely on investment spending, which it has heavily relied on for its rapid progress. China has sufficient resources to support this move into a consumption-based economy. According to Jefferies projections, consumption in China is expected to reach 73 percent of GDP by expenditure by 2025, up from 49 percent in 2012. In terms of GDP by output, tertiary industries (services) are projected to reach 67 percent of GDP, up from 44 percent in 2012. Secondary industries (manufacturing and construction) are expected to fall to 27 percent of GDP, down from 47 percent in 2012.

China’s massive state-owned enterprises (SOEs) have dominated the economy since its economic reforms and the massive earnings have been crucial in funding China’s investment-led growth. The revenues from SOEs account for approximately half of China’s economy. Jefferies estimated that listed blue chip SOEs could pay out dividends of up to 35 percent. However, SOEs have only paid a portion of it, at around 5 to 10 percent. The large retention in earnings of the SOEs has led them to look for other sources of investments and even led to speculation in the real estate and stock markets. The Chinese government has started to look deeply into the reform of the SOE sector in order to curb excessive speculation and to redeploy capital into the other national objectives such as economic rebalancing and improvement of social welfare. Government revenues can be significantly increased if SOEs are forced to pay proper dividends, which could result in an additional 692 billion yuan ($111 billion). Apart from raising dividend payout ratios, China may embark on a privatization drive for SOEs or increase the public float.

**Rising Income Inequality**

There is growing social tension and political risk in Chinese society. Chinese officials had not published the country’s Gini coefficient since 2000 when it was 0.412. A score of 0 would represent perfect equality; a score of 1 would mean one individual controlled 100 percent of income. The Gini coefficient measures income distribution on a scale of zero to one. A Gini index between 0.3 and 0.4 indicates a relatively reasonable income gap. A Gini index between 0.4 and 0.5 indicates a large income gap. The Chinese government has claimed that there is insufficient and inaccurate data on high-income groups, which may skew the results. China’s wealth gap raised concerns about China’s development path. The income gap between urban and rural areas,
between communities, and the lack of a middle class are factors that could affect social stability. A growing divide between the haves and the have-nots has far-reaching implications for China’s future growth. In addition to the difficulties of narrowing income gaps, the Chinese government also has to contend with the immense task of creating sufficient jobs. In order to maintain the employment rate and to absorb the large numbers of people coming into the labor force, the Chinese government has targeted an economic growth rate of 8 percent. Chinese leaders have prioritized building a “harmonious society” to ease social and political tension. In January 2013, the chief of China’s National Bureau of Statistics revealed that China’s Gini coefficient stood at 0.474 in 2012, down from 0.477 in 2011. The peak was 0.491 in 2008. The large income disparity is a contributing factor to the large number of corruption and cheating cases in China.

Compensation Schemes in China

Low civil service pay has been widely accepted as an important contributing factor for corruption. This is especially so in less developed nations. The assumption is that when salaries are low but expectations for service remains high, government officials may demand more compensation from informal or even illegal channels than what is officially sanctioned; hence, corruption arises.  

In China, civil servants refer to public employees in people’s governments, people’s congresses, people’s political consultative conferences, and courts at various levels. In recent years, the number of people in China’s civil service has grown fast. By the end of 2011, the total number of public servants had reached 7.02 million, according to Wang Jingqing, deputy head of the Organization Department of the Communist Party of China (CPC) Central Committee.

The civil service in China is quite lowly paid as compared to more developed countries. Currently, the country’s civil servants receive a basic salary, bonuses, subsidies, and allowances. According to the National Bureau of Statistics (NBS), civil servants enjoyed, on average, an annual salary of 33,869 yuan ($5,435.97) in 2008, higher than the 29,758 yuan average earned by those working in state-owned enterprises and the national average of 28,359 yuan for all urban workers. In total, the regular pay received by civil servants, combined with their annual bonuses—which typically range from 21,000 to 40,000 yuan—costs the state between 404.26 billion and 537.67 billion yuan per year.  

Due to the relatively low official compensation scheme of civil servants and public officials, there is a higher propensity for officials to seek alternative forms
of compensation in order to make up for their pay and to sustain their lifestyles. These additional forms of compensation could come from many sources, and it is not surprisingly that many officials have many unofficial sources of income other than their official salary from the government.

Although there may be a higher propensity to accept bribes, this in no way suggests that all officials are corrupt or susceptible to these additional compensatory temptations. However, the critical thing is to acknowledge and accept that corruption and bribery is not uncommon in China.

Seen in this context, the due diligence process will have to factor these facts of life into the calculation and process. As such, it should not be surprising that, during the due diligence process, there may be challenges and obstacles presented by officials who purposely put up roadblocks to slow down or inhibit the process.

**CORRUPTION IN CHINA**

It is widely known that China suffers from widespread corruption. According to Transparency International’s Corruption Perception Index, China was ranked 80th out of 176 countries. China scored 39 out of a possible 100 points, behind countries like South Africa and Italy. Corruption cases extend across the private and public sector and it can come in many forms such as graft, bribery, embezzlement, backdoor deals, and many others. Corruption is not a new phenomenon in modern-day China. However, it has become more pervasive and lucrative as China transitioned from a planned economy to a market economy. The market liberalization reforms that were initiated by Deng Xiaoping created unprecedented lucrative opportunities for people to exploit and profit from them. Corruption becomes more entrenched as the private and public sectors increasingly intersect and business deals rely more heavily on the positive relationships developed with government bodies that wield significant authority in the approval process for projects and deals.

That said, corruption is not unique to China. Indeed, there have been numerous corruption and fraud cases that have happened all over the world. As such, readers need to be mindful that this book was not written as a China-bashing book. In order to put things into perspective, this section will also highlight some case studies of high-profile corruption and fraud cases that have happened around the world. In fact, the magnitudes of damages of these global cases were often many times larger than any fraudulent cases that have ever occurred in China to date.
CASE STUDY 1.1: OLYMPUS FRAUD

Michael Woodford, then-Chief Executive Officer, of Olympus, sounded the alarm bells on the company in 2011 about the company’s accounting fraud. Olympus had falsified financial statements for two decades to hide over $1 billion in losses. It started in the early 1990s when Olympus created a special purpose vehicle to buy battered securities at market value after the company lost money due to the yen strength and the slowing economy. This scheme would gradually increase over time and become increasingly costly.

Between 2006 and 2008, Olympus spent $733 million to buy three Japanese start-ups that had no relation to the company’s core business. The three firms were:

1. Humalabo, a producer of nutritional supplements
2. Altis, a waste disposal and recycling firm
3. News Chef Inc, a seller of microwave cookware and asset-management firm*

The value of the firms were subsequently written down to just $187 million in 2009. According to internal documents and Cayman Islands records, the money spent on the acquisitions of these three firms were directed to Cayman Islands-based companies that were either dissolved or closed down shortly after receipt of the money.

It was later revealed in 2008 that Olympus had paid a $687 million advisory fee on its $2.2 billion purchase of British company medical firm Gyrus. This meant that more than a third of the purchase price went to services rendered by a New York firm AXES and a Cayman Islands incorporated firm, AXAM. The advisory fees charged were astronomical figures compared to the 1 to 2 percent of fees charged of the purchase price. An independent PriceWaterhouseCoopers (PwC) report that Michael Woodword had commissioned revealed that the acquisitions had led to a combined loss of $1.2 billion of shareholders’ value. In addition, the report highlighted possible false accounting, financial assistance, and breaches of duties by the board.

After Michael Woodford came on board in late 2011, he reported the suspicious fraudulent payments. Michael Woodford was subsequently fired on the basis that there were differences in management style as cited by the board of directors. However, Michael said that he was fired for challenging the board over irregular business practices. The Chairman, Kikukawa, resigned.

Chan Ming Fon, a former Commerzbank AG and Societe Generale banker, had secretly helped Olympus to liquidate hundreds of millions of

(Continued)
In China, becoming a senior government official might be seen as one of the easiest ways to get rich. The number of government officials that have been tried and prosecuted for corruption in China has become more widespread in recent years. One of the most high-ranking bureaucrats to be investigated so far is Li Chuncheng, the former deputy party secretary of Sichuan province, and an alternative member of the Central Committee, one of China’s highest-level state organizations. Li Chuncheng reportedly bribed his way to a senior post in the 1990s when he was an official in Heilongjiang province in northeast China. Moreover, as deputy party secretary in Sichuan, he reportedly sold lower-level government posts. It was also reported that Li was involved in a case involving Han Guizhi, who was a former deputy party secretary of Heilongjiang who received a suspended death sentence in 2005 for taking bribes in exchange for promoting officials.\(^4\)

Caijing reported that the investigation into Li may be linked to businessman Dai Xiaoming, the chairman of the state-owned Chengdu Industry Investment Group who was taken away in August 2012 for an internal party investigation.\(^5\) Dai worked under Li while in various positions—as party secretary of Qingbaijiang district, director of the Chengdu Economic and Information Commission, and then as chairman of the Chengdu Industry Investment Group.

From 2007–2012, over 660,000 government officials have been investigated for corruption of some sort, representing a significant percentage of all the party and state officials. There were many serious cases that involved phenomenal sums of money and officials at or above the ministerial level.\(^6\)
China’s top anticorruption watchdog, Chinese Communist Party Central Commission for Discipline Inspection (CCDI), reported in 2010 that 106,000 officials were found guilty of corruption in 2009, an increase of 2.5 percent from the year before. Moreover, the number of government officials caught embezzling more than 1 million yuan jumped by 19 percent over the year.\(^7\)

In 2009, Cheng Tonghai, the former chairman of the Chinese oil giant Sinopec, was convicted of illegally receiving 196 million yuan ($28.70 million) between 1999 and June 2007. Chen had helped others “seeking illegal interests” in company operations, land transfers, and contracts, according to the verdict from the Beijing No 2 Intermediate People’s Court. His sentence has been suspended for two years, which means it is likely to be commuted to life in prison.\(^8\)

In 2010, the former head of the China National Nuclear Corporation, Kang Rixin, overseeing the country’s nuclear industry, was sentenced to life in prison for accepting bribes of 6.6 million yuan between 2004 and 2009.\(^9\) He was suspected of taking bribes from French nuclear power giant Areva to win a contract for a project in China’s southern Guangdong province. In November 2007, Areva announced an agreement to supply China with two third-generation nuclear reactors in a deal worth 8 billion euros ($11.9 billion at the time). Kang was a member of the 17th Central Committee of the Communist Party of China. He was stripped of his post and membership in the Chinese Communist Party for “serious violations of the law and discipline breaches” in December 2009.\(^10\)

Chinese top leaders have also publicly stated that corruption is the biggest problem facing China and failure to stop it will also threaten the legitimacy and longevity of the Chinese Communist Party. At the 18th National Congress held in November 2012, then-President Hu Jintao stated that if the corruption issue was not well handled, it “could prove fatal to the party, and even cause the collapse of the party and the fall of the state.” He also affirmed the government’s strong position that anyone who broke the law would be brought to justice regardless of “whoever they are and whatever power or official positions they have.”\(^11\)

The Chinese president, Xi Jinping, has vowed to crack down on both “tigers” and “flies”—powerful leaders and lowly bureaucrats—in his campaign against corruption and petty officialdom.\(^12\) In other words, all officials at all ranks were under scrutiny. In light of the numerous corruption cases and scandals exposed in the traditional and social media, the Chinese Communist Party is increasingly aware that its legitimacy is dependent to a large extent on its ability to stop corruption in order to regain the trust of the public especially in light of economic uncertainty and social conditions going forward.
Indeed, China’s anticorruption campaign is still in the nascent stage, and it would take a long time to stem out all the corruption cases and root causes. However, there are positive signs that the Chinese Communist Party and its top leaders are serious about rooting out corruption and institutionalizing reform in response to the Chinese citizens increasing pressure on its top leaders to crack down on corruption.\(^{13}\)

Despite the high number of prosecution of corruption cases in China in recent years, there is still a high level of corruption cases in China. Clearly, prosecution alone is not enough for fighting corruption as the roots of corruption need to be addressed. The critical aspect that needs to be addressed is the power structure of the system. In China, there is a blurring of lines between public and private sectors, as both are increasingly intertwined and dependent on each other for influence, power, and money. Large SOEs and banks have seemingly monopolistic power over the economy, which has stifled the business environment and made it more difficult for small and medium-sized enterprises to thrive. In addition, there is a general lack of control over government officials and their relatives in their personal capacities and their involvement in business activities that may be a conflict of interest.

According to Shujie Yao, head of the School of Contemporary Chinese Studies at the University of Nottingham, “dealing with corruption in China will rely on the party’s ability and willingness to reform the political system so that power is not highly concentrated and controlled by one person or a group of people. In addition, any political group with common economic interests should be broken up by moving people around to different positions on a regular basis. The media should be allowed to investigate and freely criticize wrongdoing by party and state officials.”\(^{14}\)

Apart from business deals, even other public institutions such as education, health care, and the media are plagued by this culture of rent-seeking behavior and corruption. It is not uncommon to find doctors expecting red packets of cash for performing operations or allowing patients to cut into the queue for consultation and operations. Doctors also sometimes prescribe expensive medication that the patient does not need. In this way, doctors are able to push and market expensive medications that pharmaceutical companies have provided to the hospitals for a percentage of the sales or they had informal agreements with the companies to receive side payments. Chinese hospitals generally charge very little for doctor consultations, and they make up a bulk of their revenue, up to 50 percent, by charging significant markups on medications from a range of 15 to 100 percent. Hence, in order to increase profits at their hospitals, doctors frequently overprescribe medicines. The pay for doctors in
Corruption in China

China is very low compared to developed countries. Doctors on average earn $1,000 a month, so many have to seek alternative sources of income by over-prescribing medicines, especially the expensive ones, to patients. The doctors then split the profits with the hospitals.

In order to put corruption in hospitals under control, government officials have initiated reforms to realign the incentive structures that have plagued hospitals. For a start, they have started to put in place pilot projects to raise consultation fees of doctors in order to increase their revenue contribution and increase pay to doctors in order to create less incentives for over prescription. Drugs prices are also targeted to be lower. For example, at the Beijing Friendship Hospital, a patient would now pay a minimum of 42 yuan ($6.60), versus the old fees of 5 to 14 yuan for a consultation with a doctor. A visit to a specialist now costs 100 yuan. Drug prices have dropped an average of 30 percent.\(^{15}\)

Teachers Day in China, which falls on September 10, has in recent years been a lucrative time for teachers in China. In the past, Teachers Day in China was a day to show respect and appreciation to their teachers with greeting cards and small gifts. However, that tradition has evolved into an occasion for parents and students to lavish expensive gifts and red packets stuffed with cash on teachers. These gifts could range from a few hundred to thousands of yuan for middle-income families, and the wealthier families could give luxury goods such as branded watches and travel packages.

The motivation behind the expensive gift giving by parents and students to teachers is to allow students to distinguish themselves in a school environment in which competition is cutthroat and to seek more attention and better grades in school. China’s one-child policy has also contributed to this phenomenon because parents put so much of their hopes and aspirations on their only child.\(^{16}\)

U.S. Foreign Corrupt Practices Act

The U.S. Foreign Corrupt Practices Act of 1977 (FCPA) forbids any person (whether individual or entity, public or private) from giving foreign officials anything of value to obtain or retain business. There is an exception for facilitation payments for routine governmental actions such as administrative processes, which would not have any influence over the decision outcome of the businesses. The Department of Justice, for private persons, and the Securities and Exchange Commission, for public issuers, are charged with enforcing this law.\(^{17}\) In essence, the FCPA makes it illegal to bribe foreign officials in return for a business advantage directly or indirectly through third-party intermediaries.
Doing business in China poses significant risks that may violate the FCPA. The term foreign official refers not only to high-ranking government officials but also to employees of SOEs. This poses an issue in China as the major industries are dominated by SOEs. Moreover, the business culture in China relies to a large extent on building relationships and trust between partners. This is manifested outwardly as the giving of gifts and hosting of extravagant meals that are often used as means to demonstrate sincerity and a sign of mutual respect.

The strong tradition of gift giving in China creates a high-risk environment. Several U.S. companies had publicly disclosed their own investigations into potential FCPA violations in China of their Chinese subsidiaries in the first half of 2012.

Another issue is that doing business in China often leads to many interactions with government officials at all levels to seek their assistance, guidance, or approval. This level of interaction extends throughout the business process and begins at the business licensing and regulatory approval process in China.

**International Business Machines Corporation (IBM)**

On March 18, 2011, IBM Corporation—New York-based global information, technology, and services company—was charged by the SEC with the violation of the books and records and internal control provisions of the Foreign Corrupt Practices Act of 1977 (FCPA) as a result of the provision of improper cash payments, gifts, and travel and entertainment to government officials in South Korea and China. The SEC alleged that from at least 2004 to early 2009, employees of IBM (China) Investment Company Limited and IBM Global Services (China) Co. Ltd., both wholly owned IBM subsidiaries, engaged in a widespread practice of providing overseas trips, entertainment, and improper gifts to Chinese government officials. IBM paid a disgorgement of $5,300,000, $2,700,000 in prejudgment interest and a $2,000,000 civil penalty.18

**SL Industries, Inc.**

On May 10, 2012, SL Industries, Inc.—a New Jersey-based designer, manufacturer, and marketer of power electronics, motion control, power protection, and other related products used in a variety of industries—disclosed that it was conducting an investigation to determine whether employees of its indirect wholly owned subsidiaries incorporated and operating exclusively in China, SL Xianghe Power Electronics Corporation, SL Shanghai Power Electronics Corporation, and SL Shanghai International Trading Corporation, operating