

China Business Start-Up A Different Ballgame

If you have decided to start a new business in China, understanding fundamental differences in business entity start-up and management is an early critical success factor. If this is your first start-up in China, you will be focused on the operations, getting the necessary equipment and infrastructure in place, and hiring your new team in China. You probably don't realize it yet, but those will be the easiest challenges that you will face starting your new China business.

Countless aspects of doing business in China are very different than those in the West. The critical mistake Western companies make is failing to understand and adapt to the differences. Companies mistakenly port their successful Western business practices and experience to China, assuming that the same business formula will work in China – only to be disappointed. None of China's differences are insurmountable, but every company must adapt their Western business processes to achieve success.

Starting a company in China is not like setting up shop in another state in the U.S. You are starting a new legal corporation in a new country where institutional and governmental support is immature by Western standards. Your new China Company has to perform all the legal, financial, commercial and regulatory compliance functions of an independent company in China.

You will need to learn how to manage concepts and principles unique to China, including VAT, tax laws, employment laws and many other differences that are not extraordinary, but require careful understanding and integration into your business processes.

Application Process

The differences start with unique attributes of business formation. At the simplest level, it takes far longer and involves a methodical sequence of activities and filings. Consider that in the U.S., you can call an attorney and have a new limited liability company formed in a few hours. Open a business bank account requires a couple of days at most. In China, the process takes on average 4-5 months

and longer if special business permits are required or requires a designated U.S. manager to travel to China for in-person filings. While this process of starting a business in China is very different, it can be structured with a formal step-by-step process to minimize the start-up execution challenges.

The legal filing requirement to start a new company in China is actually the easy part of the process. There are over 20 individual actions and document filings that must be executed with various China government agencies in the district where the business is to be located. In almost all cases, the critical decisions for each of these filings are not legal interpretations, but rather business decisions by client management about a range of operating and financial issues. Each form and document that must be filled carefully because making a wrong choice during start-up can be costly and difficult to correct later.

Location

Where will you locate? The industrial base, the supply chains and the professional skill sets available vary widely between even the most developed regions such as the Beijing-Tianjin-Bohai Region, the Yangtze River Delta, the Pearl River Delta or one of the rapidly developing cities inland. It is important to match the city location with the operational efficiency of your supply chain, sales distribution, and industry concentration.

Within a city, there are many development zones and non-development zones to choose from. Development zones can provide additional support infrastructures and greater rules than locating outside a development zone. There are many types of development zones - high technology zones, free trade zones, industry-specific zones, export processing zones, and bonded logistics centers. There are national, provincial and city level zones. Each type has distinct advantages, incentives and restrictions. There is a one-time opportunity to analyze the options and make the right location choice because a business license is issued by district within a city. Relocating is not as simple as it is in the U.S.

Legal Entity

What kind of legal business entity will you establish? Will you need to set up a JV, a WFOE (manufacturing, trading or

a combination), or a Representative Office? While Representative Offices are infrequently used today, because of higher tax burdens, they are still possible. Each type of entity has different capabilities, registration requirements and tax treatments. Picking the right one for your business model also dictates the format of investment commitment, employment structure of your workforce and many other detailed requirements of your new business.

Business Scope

What will be your “business scope”? This is an alien concept to Western professionals. You need to define the exact activities your business will conduct at a detailed level and obtain government approval. Your Legal Scope of Business will both enable and limit what your company can legally do in China. A company is prohibited from engaging in activities outside the boundaries of the Legal Scope of Business. You need to consider not just what you want to do at company start, but also the reasonable range of activities you may add in the future. A Legal Scope of Business may be changed, but it requires a formal refiling process and the new desired activity may not be started until formal government approval is received and the revised business license re-issued.

Organizational Structure

What organizational structure and controls will you use? If you simply transfer your Western organizational structure model you are asking for trouble. The nature of your Chinese workforce will be different. Reporting relationships needs to be direct. Matrix management is usually not workable in China. This is especially true if you are starting with a small team where proper separation of critical control tasks is not possible.

Business Processes

How will you modify your business processes for implementation in China? Every manufacturing business can be defined in five functional disciplines (not including sales and marketing): 1) Quality and Business Systems; 2) Finance and IT; 3) Operations; 4) Engineering and Technical Support; and 5) Human Resources. Companies are actually more similar than different across industries. What does vary is how they have to be implemented in China. Due to many differences in China, many processes and management activities used successfully in the West need to be adjusted for use in China. Careful consideration of

these issues and engineering efficient and effective process adjustments across the range of enterprise processes is strongly recommended to avoid unexpected challenges.

Hiring

What should you expect when hiring employees? The average Western management experience level of Chinese employees will be much less than in the U.S. Jobs often need to be restructured from their Western templates due to general experience/skills deficiency and recruiting experience requirements.

Employee Compensation

How will you structure compensation programs in China? Do you know about “thirteenth month” pay? Will you use it? China is transitioning rapidly to performance-based compensation programs, but these programs are still not broadly used in the same way they are in the West. Creating an effective compensation plan requires careful analysis and thought with experienced guidance or you risk setting organizational expectations that are harmful to your business model which are difficult to change.

Employment Contracts

Chinese Employment Law requires that all employees have a contract. While there are strict employment regulations with which you must comply, you have significant latitude to infuse your Company’s culture and processes into the employment relationship.

Internal Company Policies

Your new China Company must comply with local China regulations and even select U.S. regulations (e.g. Foreign Corrupt Practices Act and others). Additionally, your company undoubtedly has specific policies and controls that you will want to have followed at your new China business. Developing those policies that are compliant with China regulations and including the Employee Handbook. You have only one chance to make a first impression with a new staff and the precedent you set in the HR policies and Employee Handbook from day one could not be more important.

Financing

How will you finance your China Company? The concept of capitalizing a China company is very different than in the U.S. Did you know that unlike in the West, you are limited in the amount of capital and sources of capital according to the terms of your business license and terms of the entity's Articles of Association? Your business license will define the amount of equity you must invest. The license documents also define the maximum amount of loans from foreign sources. Local debt sources will be impractical in most cases without a profitable entity track record. The only other legally permissible source of capital is internally generated cash. To exceed the limits of equity or debt defined in the business license and Articles of Association requires re-filing and re-approval of a revised business license. Modeling your capital needs carefully – usually monthly for a multi-year period based on your best assumptions – is a highly recommended approach. It is possible to change capitalization once a business is formed, but that requires filings and can take months to complete. It is advisable to invest the time up front to be as complete as possible in the process.

This capitalization modelling analysis also protects against over-capitalizing which risks trapping cash in China with few options for repatriating cash over-invested in China.

To debunk a common perception that getting cash out of China is hard, it is actually (in a sense) easier for a foreign company – properly capitalized – to get repatriate retained earnings from China than it is for a foreign company to repatriate retained earnings from the U.S. Essentially all the same dividend requirements exist in China as in the U.S. For example, there must be positive accumulated retained earnings. Taxes must be paid, and other standard filings must be executed. The difference is that the withholding tax rate on foreign dividends from China is 10% while it is 30% in the U.S.

Starting a business anywhere can be approached as a process. Actually, filing the documents to obtain your business license is the simple step in the process. Planning and optimizing all of the other issues in an integrated program is the meat of the process and most often the determinant between success and underperformance.