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China Mergers & Acquisitions Playbook.

Your reference guide to planning and executing deals

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Foreword

China's economy has recorded substantial growth over the past few years. As the economy continues to boom, the market environment will continue to transform. Already we have seen changes in regulations such as those relating to foreign exchange payments to offshore holding companies and stock exchange reforms that may affect ownership structures. Competition is also increasing as membership in the World Trade Organisation (WTO) continues to open restricted industries to foreign investors. All these have implications on both domestic and foreign organisations seeking to remain competitive in the Chinese marketplace.

Yet where there is change, there is opportunity. Investment and deal activity have seen a significant take off in China. Mergers and Acquisitions (M&A) in a number of industries ranging from retail chains to financial services have become a way for foreign investors to enhance competitiveness or gain local presence.

Whether the goal is to achieve strategic and/or financial goals through acquisitions or divestments, opportunities exist to enhance shareholder value to both the acquirer and the acquired. Selecting the right "partner" and setting up appropriate structures are considered essential to the success of mergers/divestitures. Knowing what issues are common in China and preparing in advance for such issues will make the transaction a smoother one. Proper integration to achieve operational synergies and satisfy customer needs is also considered important for consolidated and merged entities to reap the benefits in the long term.

This reference guide focuses on the key phases of the M&A process, the common challenges in each phase, and suggestions for achieving success in China. We hope you will find this guide useful in helping to make your M&A transactions in China a success.

Lawrence Chia
Managing Partner, M&A Services

Executive summary

Deloitte's China Mergers & Acquisitions Playbook will guide the reader in four main chapters through the complexities of implementing an M&A strategy in China. The four major phases of Deloitte's M&A Lifecycle^{SM} (Planning, Screening, Execution and Integration) are discussed, thoroughly detailed and illustrated in each of the four main chapters. Each chapter begins by asking a number of salient questions that will be discussed in detail through the course of the chapter and concludes having answered the questions top-of-mind for a potential buyer. Chapters are further illustrated through case studies and lessons learned by Deloitte who have been advising clients in China since 1917.

In the first chapter we take a top level view of Deloitte's four-phase M&A Lifecycle^{SM} and consider where within the lifecycle senior management need to be involved in making critical decisions.

In planning an M&A deal, one needs to better understand the corporate and strategic objectives of the company. Whatever the company's growth strategy, the M&A strategy must be consistent with these. The second chapter explores M&A strategy planning and considers the issues which may be relevant in selecting an appropriate M&A advisor in China. The guide goes further to outline the roles and responsibilities of a suitable M&A advisor as well as providing a check-list of issues both on sourcing and assessing a target for the buyer.

The third chapter of the Playbook guides the reader through a three-level approach for screening targets that includes how they may be prioritised. The chapter considers in greater detail how to structure, select and approach both targets and buyers and considers what cost-saving and revenue enhancing synergy opportunities are available; this being a fundamental consideration in a detailed screening of an M&A target. A number of valuation techniques are discussed together with challenges typically faced in China and their possible solutions.

The fourth chapter looks at key considerations in the execution of the M&A deal. Due diligence is discussed with specific focus on Financial and Tax, Business, and Internal Controls and the chapter outlines the areas a thorough due diligence should generally cover. Financing considerations in making an M&A deal are examined in greater detail including both tax structuring issues for foreign investors in China and the major implications of asset acquisitions in China. The chapter also discusses deal structuring in terms of tax implications and exit strategies a buyer may want to consider. The roles and responsibilities of the M&A lead advisor in the execution phase are presented and significant elements from the Sales & Purchase Agreement that may arise on completion of the transaction are discussed.

The fifth and final chapter of the Playbook offers readers an overview of several key considerations for merger integration, outlining critical success factors in integrating acquired organisations. Deloitte's six-tier approach to managing a merger integration is discussed and considerations for re-engineering the Finance & Administration, Human Resources and Information Technology segments of the business are provided. Having planned, screened, executed an M&A strategy and integrated it within the organisation, this reference guide concludes looking at intellectual property management, ongoing tax and internal controls compliance issues such as the Sarbanes-Oxley (SOX) Act of 2002. A SOX readiness approach is presented examining the challenges foreign investors may face in China that must not be overlooked.

Deloitte's M&A Lifecycle[SM]

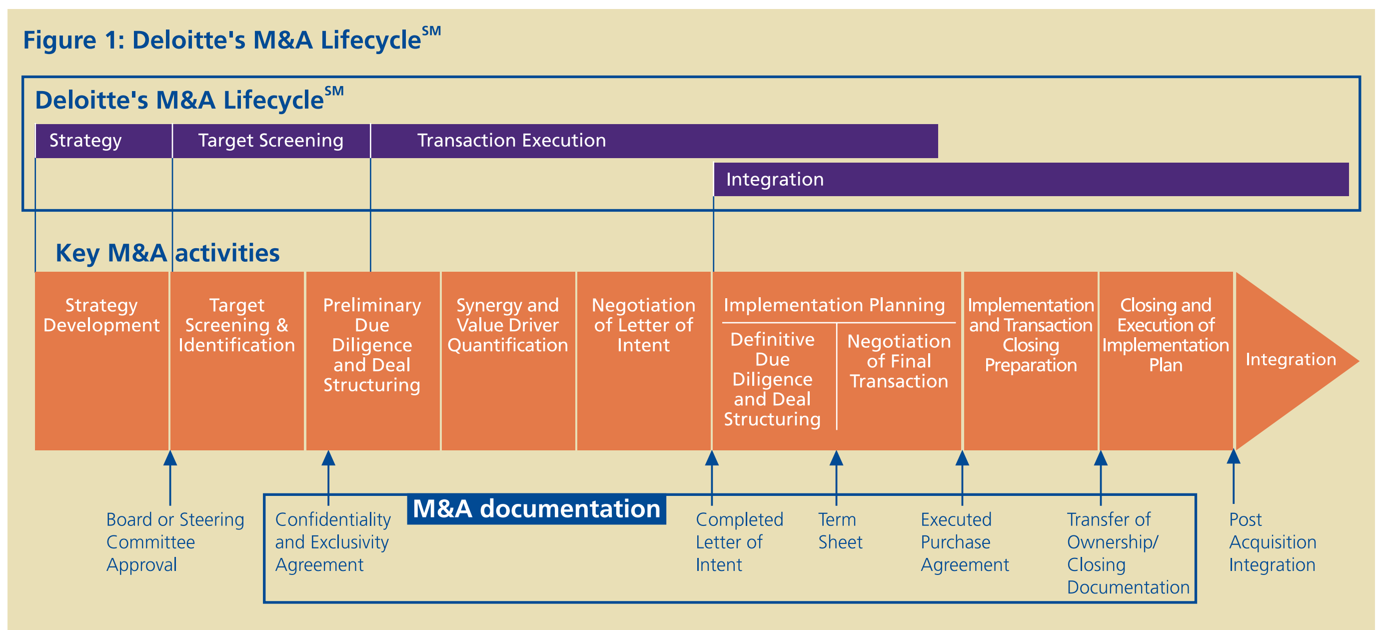
1. Deloitte's M&A Lifecycle℠

Deloitte's M&A Lifecycle℠ has four phases:

1. M&A strategy development
2. Target screening
3. Transaction execution
4. Integration and re-organisation

Each of the four phases requires senior management to make critical decisions and involves activities ranging from reviewing business objectives, performing due diligence, conducting negotiations, closing a transaction to integrating business units.

Figure 1: Deloitte's M&A Lifecycle℠



Questions that will be addressed through the M&A process:

- Is M&A the right approach for a company?
- Why should a company acquire/divest a business organisation?
- Who should participate in the M&A process?
- What may be the most appropriate investment vehicle to defend, grow, fix or exit a business?
- What may be the options to finance the deal?
- What are the activities that may be involved in an M&A transaction?
- When should the acquisition/divestment occur?
- How should an M&A transaction be conducted to improve the probability of success?
- How will the operations of the two entities be integrated?

When a company considers an acquisition, senior management should develop an M&A strategy that complements the overall corporate strategy and that is consistent with its business model. The strategic objectives should be clearly articulated and understood, at which point focused target screening can begin. Acquisition candidates who meet specific criteria to achieve the M&A strategy are then identified.

Once a target is approved for pursuit, a multi-functional approach to manage the transaction execution takes place. This phase involves external specialists to conduct in-depth analysis of the target and to facilitate negotiations. An M&A transaction is complete when the Sales & Purchase Agreement is executed and transfer of ownership takes place. The process does not end here however. Integration efforts to plan and manage the combination process are critical to capture the anticipated value and mitigate risk.

The buyer and target company may "walk away" from a deal any time before the transaction is completed, though there may be certain financial penalties during the later stages of the process. Typically these terms are negotiated and agreed to in a Term Sheet.

The success of an M&A transaction process will more likely result from engaging a dedicated M&A team comprising internal and external specialists who can oversee the M&A process. The M&A process can be tedious, intensive, time-consuming and complex and having internal resources take part in an M&A exercise whilst focusing effectively on daily operations may prove to be a challenge. Involving different professionals and expertise at different stages of the lifecycle will be necessary to enhance the level of success of the transaction.

M&A strategy development

2. M&A strategy development

Key issues considered in this chapter:

- What is your company's corporate strategy and objectives, both globally and in China?
- Is M&A in line with your corporate strategy and the right option for your company?
- How should your company identify potential acquisition candidates, conduct assessments and approach targets?
- In the case of a divestment, how should your company identify and approach potential buyers?
- Why is a lead advisor for M&A necessary? What should a company consider when selecting an advisor?

2.1 M&A strategy planning

2.1.1 Understanding corporate objectives

In considering whether M&A is the appropriate method to improve shareholder value, performance and market competitiveness both in China and globally, a company should first review its corporate strategy. Corporate strategy makes the company greater than the sum of its business units, and sets the organisation's direction and goals, business portfolio, resource allocation and growth plans.

A corporate strategy review is critical for success; however, it is often neglected by executives under pressure to achieve short-term results. One of the primary causes for acquisition failures is often the lack of insight regarding the company, its core competencies and own limitations, and changing market conditions.

The rigorous analysis conducted in a strategy review enables a company to understand its internal strengths and external market conditions at home and in China for the next few years. This analysis helps to develop a set of prioritised options, such as an acquisition or divestment, to achieve its objectives.

As challenges and opportunities for growth are defined, options to defend, grow, fix or exit can be assessed and prioritised based on company goals, capabilities and financial position. Generally, companies can choose from a myriad of strategic objectives such as:

- **Profitable growth** – to increase business breadth or depth through revenue growth, market share capture, margin enhancement or improved asset utilisation;
- **Skill strengthening** – to acquire necessary talent to remain competitive (e.g., personnel, technology, capability, geographies, etc.);
- **Portfolio management** – to manage a portfolio of businesses in order to maximise existing and evolving capabilities, reduce risk, or reposition a business;
- **Defensive action** – to ward off potential take-over attempts or fix existing business/operational problems;
- **Opportunistic posture** – to capitalise on a unique market/competitive opportunity or a developing business formula;
- **Globalisation** – to expand market share and sales in international venues.

Depending on a company's strategy, acquisitions may serve as a way to quickly achieve strategic and financial objectives.

2.1.2 Developing an M&A strategy

Acquiring or divesting a business can be considered as an agent serving a corporate strategy and as such, an M&A strategy should be closely linked with corporate and business unit strategic plans. When developing an M&A strategy, a company may wish to consider:

- portfolio management alignment;
- make versus buy considerations;
- regulatory challenges;
- competitive landscape;
- capital availability;
- barriers to entry;
- capability requirements; and
- cultural hurdles.

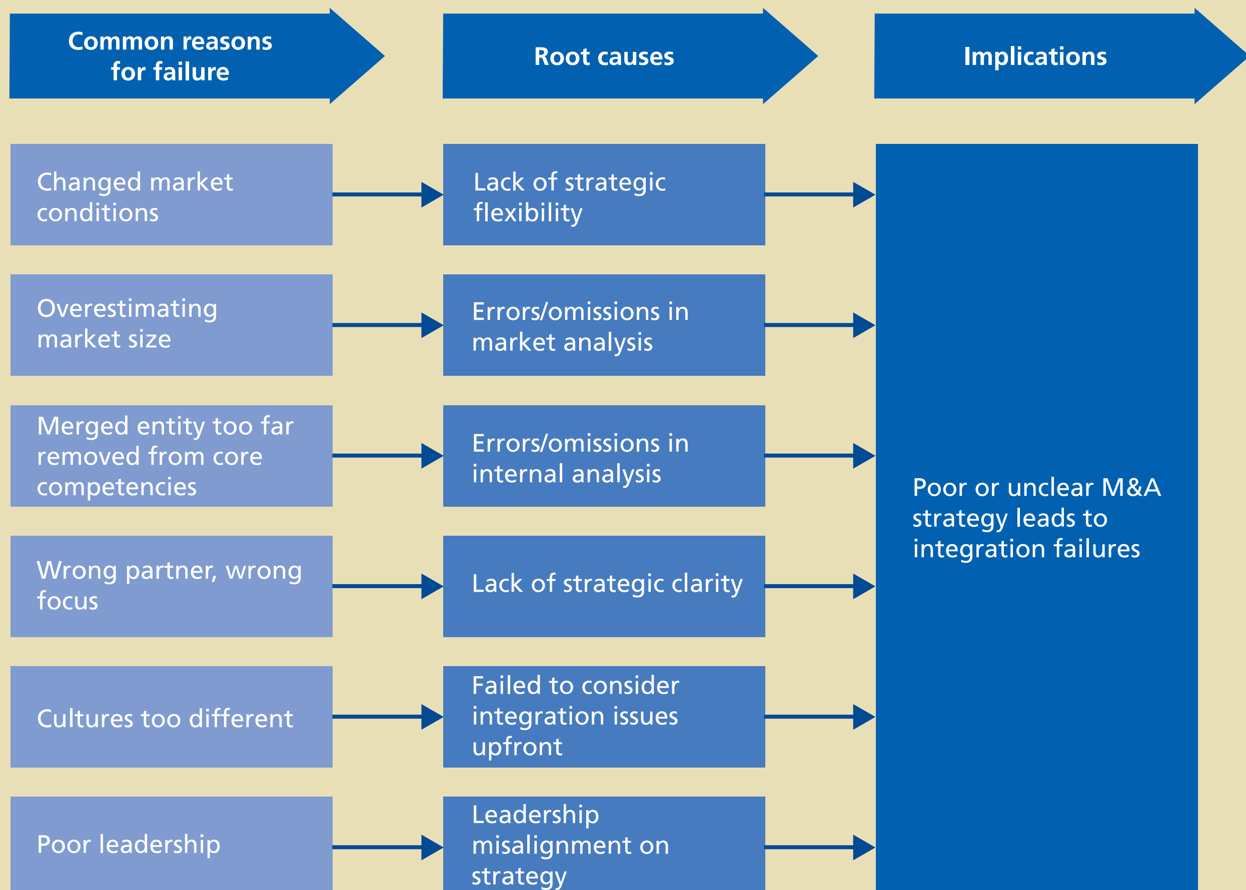
To address these issues, prior to acquiring any new business, all available resources must be identified and their limitations understood. From a financial point of view, companies should estimate working capital and capital investment requirements through cashflow forecasts. This will help to determine if a company has the financial capacity to undertake an acquisition strategy. Notwithstanding, a company should also assess the sufficiency and availability of other critical resources, such as human resources, to gauge the level of support available for integration and the future business.

Unfortunately, many mergers in China fail due to poor strategy formulation as a result of:

- changed market conditions;
- overestimating the market size;
- selecting the wrong partner or having a wrong focus;
- differences in cultures;
- poor leadership; and
- merging an entity that is too far removed from core competencies.

To facilitate and properly manage an M&A exercise, a company should consider engaging a dedicated team of professionals early on to manage the alignment of corporate goals and the M&A strategy, provide appropriate skills to analyse markets and the M&A potential, and advise on the availability of capital funding.

Figure 2: Reasons mergers fail



Five cornerstones of an M&A strategy in China

- Have an M&A strategy that is consistent with the overall corporate strategy
- Have visible leadership and consistent communications throughout the process
- Create and manage a team skilled in strategy, industry and capital market analysis, legal affairs, accounting, tax, finance and valuation, business and IT functions and processes, human resources, negotiations, and project management
- Be willing to embrace open and objective debate about the realities of China's external market forces and the company's internal core competencies
- Implement measurement formulas and processes that track the efficacy of the M&A strategy and process

2.1.3 M&A alternatives

There are different ways to achieve strategic and financial goals. After conducting an initial assessment, a company may realise that an M&A transaction may not be the best option to achieve its goal in China and therefore, will need to consider alternative strategies to M&A.

Some alternative strategies may include:

- Organic growth: For foreign companies seeking to expand in China, wholly foreign-owned enterprises (WFOE) is a popular structure, where wholly owned subsidiaries are set up to hold the assets or businesses enabling the company to fully control their own investments. Organic growth allows a company to use its own resources to expand while keeping control of the process. However, planning the requisite financial resources may be a difficult exercise and achieving the desired results may take a long time.
- Joint venture: A joint venture is an entity owned, operated and controlled by a small group with the mutual benefit of the shareholders in mind. As China restricts control over important or "strategic" industry sectors, Sino-foreign joint ventures have historically been the country's most preferred investment vehicle. The entity is usually formed to give access to complementary competencies, share risk and expertise, with each party participating in the overall management. Significant decisions commonly require the consent of each shareholder (regardless of ownership percentage) so that no individual shareholder has unilateral control.

  The selection of an appropriate Chinese partner is generally the most demanding and important step. The following factors should be considered when choosing a joint venture partner:

  - a potential partner's political clout;
  - its access to domestic financing;
  - its ability to provide a domestic market for products;
  - the level of skills of its workforce; and
  - its integrity and strength of management.

  Unlike WFOEs, foreign investors of joint ventures need to spend a lot of effort and time to cultivate relationships with Chinese partners; the success of a joint venture is largely dependent on the degree of cooperation between the parties.
- Strategic alliances: Strategic alliances are generally used for research, marketing or distribution purposes. They do not involve equity or debt transactions, but they offer the advantage of being an inexpensive way to access new markets. They do, however, limit a company's control, and may result in a loss of intellectual property. Although most of the legal framework in China satisfies international requirements, foreign businesses and governments are generally dissatisfied with the enforcement of Intellectual Property Rights regulations.
- Licensing: Licensing is a form of strategic alliance that minimises capital investment. A company will receive an up-front payment from an interested party for the right to produce or market one or more of its products. Like strategic alliances, licensing is an inexpensive way to access new markets. The licensor can retain limited control.
- Franchising: A franchiser will be compensated by an up-front payment plus a continuous future royalty stream. In certain instances, there will be an agreement where the franchiser will sell materials or supplies to the franchisees. Franchising remains an easy way to expand a business rapidly where other parties invest the capital. However, a franchiser will generally have no control in the franchisee's business and the growth in returns is limited, if any.
- Contract processing: A foreign entity may engage local low cost manufacturers to produce products for an overseas market by supplying the materials, technologies, and supervision required to ensure the quality of the products being produced. This strategy avoids heavy capital investment in China especially when most of the products are sold to the overseas market. However, it may create quality control and intellectual property protection issues, and it is often not a preferred long term strategy for companies seeking to penetrate the local market.

When considering the best methodology to grow, companies should align their acquisition strategies to their corporate and business unit strategies.

Table 1: Comparison of market growth alternatives in China

Lever/transaction type	Description	Benefits	Costs
Mergers, acquisitions, divestitures	Buy or sell a company to achieve corporate goals	• Usually quicker than organic growth • Established market position • Easy access to sites/distribution channels • Local competencies immediately available	• Integration costs • Integration risks • Requires discipline, rigor, right skills
Organic growth	Focus on building market share with new or existing products in new or existing markets	• Build internal capabilities • No integration risk or costs	• Slow • May be costly (relative to acquisition)
WFOE	Wholly-owned subsidiaries set up to hold assets or businesses of foreign entities in China	• Control • Flexible structure • Common culture	• Significant mobilization of resources • High regulatory constraints • Higher risk • Lengthy process
Joint ventures/ Partnerships	Two or more entities pool resources for cooperation (often in relation to a particular project)	• Complementary skills and resources • Risk sharing • Local knowledge • Local culture maintained	• Rewards are split • Increased operational and intellectual property risk • Conflict • Exit costs • Complex legal and commercial structure
Strategic alliances	Formal cooperation between entities across a broad range of functions	• Release capital intensive activities and redeploy capital to achieve higher returns	• Complexity of managing third party relationships • Sharing of information can lead to risk exposure (domination by one party)
Licensing/ Franchising	Grow by allowing other parties to use brand or other proprietary capabilities	• Low capital commitments	• Outside parties may damage brand equity (reputation risk) • Give up control • Intellectual property protection issues
Contract processing	Utilize low cost local manufacturers to produce products for overseas market	• Low capital commitments	• Limited control over quality • Intellectual property protection issues • No local market access

2.1.4 Financing options

Companies will generally use debt or equity to finance an acquisition.

Equity financing consists of a company raising money by issuing additional ordinary or preferred shares to existing or new shareholders. The amount of equity financing will mainly depend on the amount of funds that existing or new shareholders are willing to make available for the proposed transaction. Hence, the amount of equity will depend on the investors' perception of the value brought by the transaction to the business.

The alternative is **debt financing**, when a company borrows money. Debt raised can be either traded in the capital markets (i.e., "bonds") or lent directly by a bank or via syndication. Bonds and bank debt can be subordinated or senior, straight or structured. Debt financing is attractive because financing costs can be deductible from taxable income if properly structured and interest costs are relatively stable. There is also the possibility of decreasing financing costs by using assets as collateral. The amount of debt raised will, however, be limited; it will actually depend on the amount of cashflow available to service debt.

The choice between debt and equity or a combination will depend on many factors:

- the macroeconomic situation;
- financial considerations such as the cashflow model, leverage ratios, credit ratings, and tax considerations;
- management issues such as the inclination to keep flexibility in a business;
- shareholder preferences; and
- whether the company is listed and publicly traded or privately held.

Table 2: Comparison of financing options

	Equity financing	Debt financing
Pros	• Provides flexibility • A relatively cheaper way to raise money when the share price stands up well in stock markets	• Interest payments are generally tax deductible • RMB loans from a local bank are generally not restricted, although foreign guaranteed RMB loans may require registration with State Administration of Foreign Exchange (SAFE) • May create tax savings at the foreign investment enterprise (FIE) level
Cons	• Amount of financing depends on the willingness of existing and new shareholders to provide funding • Dependent on macroeconomic conditions and stock market sentiment • Shareholders will suffer from dilution of their existing equity interest • Potential loss of control	• Restrictions on maximum foreign currency debt based on debt-to-equity ratio requirements • Fixed interest commitment will increase cashflow burden, especially in a rising interest rate environment

Listed companies should also consider recent price performance and current market sentiment. Questions a buyer should ask when considering fund raising efforts include:

- Are investors currently upgrading or downgrading the company's shares?
- Are the company's shares under- or over-valued?
- How is the market currently evolving?
- Is it a good time to place new shares?
- Are the current shareholders disappointed with the new issue of shares, since they will, comparatively, suffer from a dilution of their equity interest?

Privately-held companies may require assistance to approach the right investors and market their projects. While existing shareholders should be approached first, they may not have the desire or capacity to commit new funds. In seeking new investors, the amount of equity raised will, however, require the approval from existing shareholders and depend on their willingness to share management control.

Financing considerations for M&A deals in China

When considering financing options for M&A deals in China, the following need to be observed:

- investment regulatory restrictions;
- foreign exchange control issues; and
- potential tax incentives.

2.1.5 Divestment strategy

The process for divesting non-core businesses is very similar to that for acquiring a new business, though managers tend to pay less attention on divestments. However, it is important to pay the same level of attention so that the process is effectively and expeditiously managed.

Proper management of divestments will minimise the impact from rumors on employee morale, customer and supplier uncertainty and overall operations.

Timing is critical for getting an attractive offer when disposing a business. Economic and industry upturns will offer the selling company a better price for its assets compared to downturns. Hence, there may be an optimum period of time to exercise a divestment. With this said, the timing to sell should be balanced against the risks from uncertainty and the urgency to dispose of an asset, all which would affect the selling price of a business.

2.1.6 Selecting lead advisors

M&A is a complicated exercise involving professionals from different areas of expertise. Hence, managing the M&A process requires a systematic approach. As such, it is often beneficial for a company considering M&A activities, whether an acquisition or a divestment, to engage lead advisors during the first three phases of the M&A Lifecycle℠ (i.e., Strategy, Target Screening, and Transaction Execution) to assist in establishing priorities among opportunities and challenges, to align strategic and financial objectives with corporate missions, and to manage the M&A process.

Table 3: Reasons for engaging lead advisors

Challenges companies face	Strategies taken by lead advisors
• Unable to find satisfying acquisition targets in the market	• Review and redefine screening criteria and objectives, and act accordingly
• Selected targets are not accessible or may show no interest to be acquired • Selected targets may consider such a move as a hostile approach, especially when they are competitors, suppliers or customers	• Lead advisors are able to manage conflicting relationships
• Selected targets are not willing to provide sufficient and reliable information so that a reasonable offer can be made	• Lead advisors can facilitate the process of developing the right offer by conducting a preliminary, high-level due diligence exercise
• Owners of selected targets are asking for an unrealistic premium on the market price	• Lead advisors can assist in the negotiation process bringing in expertise and market knowledge

In managing the M&A process, a lead advisor is generally responsible for helping companies in four major areas:

- defining the appropriate M&A strategy;
- leading the implementation of the strategy;
- closing the deal within an appropriate timeframe; and
- appointing other supporting advisors throughout the process if necessary.

Figure 3: Roles and responsibilities of lead advisors

Table 4: Roles and responsibilities of major advisors

Type of advisor	Roles and responsibilities
Legal advisors	• Draft legal agreements (Letter of Intent, Sales & Purchase Agreement, Shares Subscription Agreement and Shareholders Agreement, etc.) • Review all aspects of legal documentation • Assist in legal procedures including those relating to shareholders meeting (particularly if a listed company is involved) • Perform legal due diligence on the target company • Assist in obtaining regulatory approvals
Professional accounting firms	• Review significant items in financial statements • Analyse the quality of assets • Analyse the exposure of debt, liabilities or contingencies • Review relevant contracts and agreements which might have a financial impact on the potential transaction • Assess the impact on the acquirer's account (cost of acquisition, goodwill, pre-acquisition profits) • Review tax implications • Assess the non-compliance exposure and issues in the tax area • Evaluate the validity of any tax benefits that the target is currently entitled to and to assess whether such benefits can be carried over post-acquisition • Enquire with the relevant authorities on any unusual tax treatment adopted by the target company and its validity • Assist in the drafting of the tax specific warranty and indemnity clauses • Assess transactional tax cost • Recommend tax-efficient acquisition structures (including financing alternatives, etc.) • Review the existing corporate structure, analyse the impact post-acquisition, and suggest efficient integration or restructuring steps, if necessary
Valuers	• Provide valuation of tangible assets such as property and machinery, and intangible assets such as brand, patents and goodwill

Engaging the right lead advisor will firstly, improve the overall management of the M&A process, secondly, provide professional advice and guidance to support senior management decision making, and thirdly, provide the skills required to conduct analysis.

Capabilities a company should consider in selecting an advisor:

- the level of deal flow available;
- an advisor's network to source potential targets;
- professionalism;
- ability to access potential targets;
- reputation and M&A expertise; and
- industry experience and track record on both in-bound and cross-border M&A transactions.

2.2 Preliminary research of potential acquisition candidates

In assessing investment opportunities, a company should evaluate the attractiveness of the sector in which it plans to conduct an acquisition by:

- understanding the industry structure and leverage points, where value can be captured;
- appreciating the market scale, and growth potentials;
- understanding the key players, both domestic and foreign-owned, along with competitive dynamics;
- envisaging any technological trend; and
- identifying entry barriers.

Once the decision is made to pursue opportunities in a sector, the company can begin preliminary research on potential acquisition candidates.

2.2.1 Developing the acquisition candidate pool

The first step in a target selection process is to develop a long list of potential acquisition candidates. This involves a high-level search based on criteria including:

- sector/industry;
- competitive position within the industry/product mix;
- revenue/size;
- market capitalisation; and
- location of operations.

Often a search will come up with 100+ potential candidates in the long list. These potential candidates will be further screened and profiled. The way in which these targets may be screened is discussed in Chapter 3.

2.2.2 Sourcing potential acquisition candidates

Finding the right candidate, a buyer or a seller, requires time and patience. A search for a target requires an extensive review of potential candidates before finding one that fits a company's strategic needs while being fairly priced.

A company could identify potential acquisition targets by conducting internal analysis or using its own network. Some business owners would search openly for a buyer whilst others would identify potential candidates through:

- examining the financial position of potential companies. Financial problems such as cash shortages or excessive debt may indicate that a sale may be necessary;
- investigating the potential company's shareholding and management. Indications of possible future sales include an owner nearing retirement with no heirs in key management positions, absentee owners, or financial investors potentially interested in an exit strategy.

2.3 Financial assessment of the buyer

To prepare for future negotiations, a company should first value itself ahead of an acquisition and develop an acquisition budget.

It is beneficial for the company to understand its financial position by assessing its working capital and capital investment requirements through cashflow forecasts. This will enable the company to assess its own value, its ability to access markets and extend its competitive position, and its capacity to absorb an acquisition and create value – the "2+2 = 5" formulae.

Developing an acquisition budget is equally important for the company. Having a budget will help a company to decide whether it should use equity, debt or a combination of both to finance an acquisition. This budget should include costs relating to potential transaction expenses such as due diligence costs, restructuring costs and professional advisor fees.

Before considering debt financing, a company should have a clear idea about its current gearing position and borrowing capacity within the lending sources available. When considering equity financing, investor/shareholder concerns relating to the dilution of ownership and financial measures such as return on investment, cashflow and earnings per share (EPS) should be understood.

Conversely, if a company is about to divest its non-core businesses, valuing them will provide information on the fair market value and the price a company can ask for from an investor.

The different valuation methodologies available are discussed in detail in Chapter 3: Target Screening.

Summary

- Develop an M&A strategy that is aligned with the strategy and growth objectives of the company
- Consider different financing options when acquiring a company
- Engage a lead advisor to assist with the M&A process
- Divestments should receive the same level of attention as an acquisition
- Leverage external advisors to search for potential targets
- Know the company's value and prepare a budget before conducting M&A activities

Target screening

3. Target screening

Key issues considered in this chapter:

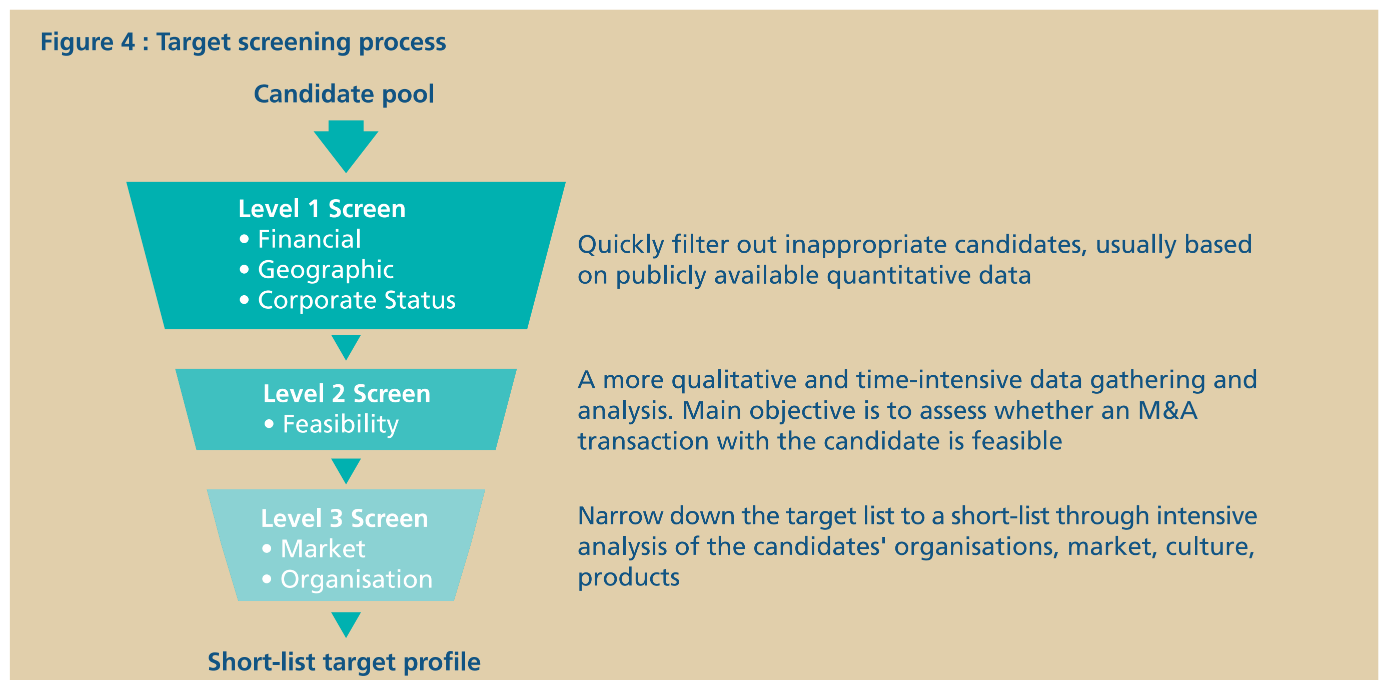
- What criteria should be considered when a company selects acquisition targets?
- How should a company prioritise targets?
- What should a company look for during the initial due diligence and preliminary valuation?
- What is the potential deal structure and financing options for an acquisition/merger?
- What is the strategy to gain approval from all stakeholders of your company?

3.1 Target screening process

After developing a long list of potential acquisition candidates, the next step is to conduct research and analyse the profile of the selected targets. The main objective of this process is to narrow down to a short list of prioritised targets.

The screening process applies a set of criteria to screen for candidates that will best realise the M&A (and corporate) strategy. It is a systematic approach to identifying the most suitable candidates through an iterative process. Proper target screening lays the foundation for successful execution and integration. The figure below illustrates the increasing intensity of analysis to filter down to a short list of suitable targets.

Figure 4 : Target screening process



The three levels of screening in such an approach are:

- Level 1 Screen – to quickly filter out inappropriate candidates based on pre-established criteria and reduce the candidate pool to a manageable size for qualitative analysis. It is usually based on publicly available quantitative information, and can include examining the candidate's financial performance, geographic presences and corporate affiliations and status.
- Level 2 Screen – to conduct a feasibility screening to answer the question "Is an M&A transaction possible?" and to reduce the number of candidates sufficiently to enable a more in-depth qualitative and quantitative analysis. The data gathering and analysis required at this level is more time consuming and expensive and is harder to find than in Level 1. It is likely that the assessment will include relative ranking in addition to quantitative data.
- Level 3 Screen – to arrive at a short-list through intensive analysis of the candidates' organisations, markets, culture, products, etc. This is the most time-intensive of all screens, to narrow down to a short-list of targets.

Developing target profiles

A target profile is a comprehensive, succinct analysis of each short-listed target remaining after the Level 3 Screen. Customised target profiles should be developed for the transaction at hand, however, the major sections of analysis should most likely include:

- business strategy;
- product summaries/assessment analysis;
- major news announcements and new ventures;
- customer data (as publicly available);
- consolidated financial data;
- regional/international performance data;
- cultural assessment;
- organisation assessment;
- integration options: absorb, stand alone, or partial; and
- list of subsidiaries, affiliates, properties, directors and executives.

Target profiles of short-listed candidates will be the basis for prioritising targets – determining which candidates to pursue and in what order.

3.1.1 Defining screening criteria

The criteria used for screening in the process should be developed based on the M&A strategic objectives. As screening criteria are defined, the buyer should spend time prioritising them. By going through such an exercise, a company will establish a clear view of the benefits it plans to achieve through the M&A effort.

Screening criteria should be developed based on the company's strategic plan, financial plan, budget, and resources requirements.

The set of screening criteria can include:

- affordable price range – i.e., estimate the size of potential acquisition targets in terms of market capitalisation, revenues, net assets value;
- profitability requirements – i.e., determine EBITDA/EBIT, net margin and free cashflows requirements;
- shareholding preferences – i.e., determine the desired level of control over the target and define a criteria for either a majority or a minority shareholding;
- transaction structure preferences – i.e., acquisition of shares against assets; and
- management requirements – i.e., take into consideration leadership style, expertise, receptivity to change, compatibility of culture, and modality of management after the completion of the transaction.

In addition, a buyer should define a set of operations-related criteria. These would include establishing:

- marketing criteria in terms of product lines, customer base, brand reputation, geographic area, distribution channels;
- R&D requirements, for example licences, patents, R&D centres, product pipeline, R&D expenses; and
- production criteria, such as facilities, labour supply, production techniques and capacity.

Short-listed targets should be further screened to determine:

- their fit into the buyer's current business portfolio;
- their competitive position and future prospects; and
- the value they create for the buyer.

3.1.2 Collecting target data

Collecting information in China is comparatively more difficult than in other developed countries. This is especially the case for privately-held companies. A financial advisor can assist in this process. In addition to using publicly available information, financial advisors can tap into their industry contacts and network of professionals both in China and overseas.

The table below illustrates some typical issues investors face in China and the potential solutions to overcome them.

Table 5: Data collection issues faced by investors in China

Typical issues	Possible solutions
• Lack of sufficient data, especially those from the private sector	• Need to develop own projections
• Data integrity (especially the reliability of financial statements)	• Cross-check data acquired from multi-sources for accuracy
• Lack of local equity and industry research	• Need to gather information from company management or industry players

3.1.3 Prioritising targets

Buyers should prioritise potential targets according to the number of screening criteria the target companies fulfil. In performing this exercise, the buyer will need to rely on its knowledge of the target answering questions such as, "How well is the potential target company performing?" and, "Do we know the management?" At the same time, the buyer should consider the reliability of the information used to answer such questions. Taking this all into consideration, a buyer will be able to prioritise targets and determine who should be approached first. This is also an opportunity to establish parameters for deciding under what circumstances would the company walk away from one target and move on to pursue the next.

It is advisable that target companies not be approached at the same time. Not only will this create a substantial amount of work for a buyer's management team and affect daily operations, it will also increase the likelihood of creating a rumour which would ultimately raise price expectations of targets.

Prior to approaching the target company, additional research and information gathering should be conducted by a financial advisor to provide a more complete picture of the candidate. This would include information on ownership and management teams in the target companies, and include subjective elements such as family situations and succession plans (e.g., the willingness of children to take over the business). Very often, negotiation leverages are identified during this process.

An experienced lead advisor will:

- assist in prioritising the targets;
- develop appropriate strategies and tactics to approach the targets;
- prepare appropriate Confidentiality and Exclusivity Agreements; and
- develop the right time frame for negotiations and due diligence.

3.2 Initial due diligence

When a short-list of potential candidates that match a company's growth strategy has been identified, a reassessment should be conducted matching the target's characteristics with the buyer's pre-defined acquisition criteria. In addition, a buyer should perform an initial valuation of its prioritised targets to determine whether the acquisition is a viable option. If the pricing criteria cannot be met, further pursuit of such a target may not be feasible.

As a buyer updates its interest in pursuing a potential target, an initial due diligence should be conducted so that the acquisition decision is based on sound information and analysis. Embarking upon such an exercise will also facilitate the acquisition process.

Among others, an initial due diligence will aim to provide reasonable answers to the following questions:

- What are the preliminary issues identified from the preliminary assessment of the target? Are they deal breakers?
- What is the financial position of the potential target?
- Has a background check of the potential target's management and shareholders been conducted?
- What is the reputation of the potential target?
- Are the financial conditions and track record of the potential target consistent with the buyer's risk tolerance?
- What is the impact of regulatory matters on the potential target's future operation?

Commonly encountered issues during initial due diligence in China

Performing an initial due diligence exercise helps to reveal problems investors may face during an M&A process in China. The following list provides issues commonly encountered.

- The process of obtaining relevant government or regulatory approvals for wholly or partially foreign-owned entities and projects may be lengthy and time consuming.
- Potential targets are often unwilling to cooperate to conduct a due diligence review; this is due to a lack of M&A transaction experience on the part of the target candidate.
- Financial statements may not be transparent and could be questionable in terms of accuracy due to differences in accounting policies (PRC GAAP vs. IFRS).
- Due diligence information is not always readily available.
- There are differences in valuation methodologies. PRC companies tend to use asset-based valuation and may not be familiar with international valuation methodologies.
- Potential candidates may have non-transferable assets.
- There may be a need to address complicated tax regimes and potentially unauthorised arrangements with local tax authorities.

It will be helpful to address these issues at an early stage so that they can be properly evaluated for their impact on the deal and the final price of the asset.

3.2.1 Synergy opportunities

An initial part of due diligence is identifying potential synergy opportunities between targets and the buyer. Only targets that bring additional value to a company should be considered in an M&A exercise.

A synergy may be defined as the increase in performance of the combined company over what the two companies are already expected or required to accomplish as independent companies. Put simply, synergy is either the increase in revenue (revenue enhancing) or decrease in expenses (cost savings) achieved as a result of integration.

Revenue enhancing synergies

A revenue enhancing synergy results in additional revenue above and beyond what the two companies are expected to accomplish independently. In identifying revenue enhancing synergies, the following should be considered:

- What are the value drivers and how will each driver create additional revenue?
- On what assumptions are these revenue enhancements based?
- Has the company achieved similar revenue enhancements during past acquisitions? Why or why not?

Revenue enhancements promote higher returns and facilitate long-term growth more than cost savings, but they tend to be difficult to quantify. Most initiatives that can enhance revenue can be grouped into:

- **Market expansion:** entering new markets and expanding market share;
- **Margin improvement:** by implementing a better pricing strategy;
- **Asset utilisation:** enhanced performance through better and more efficient use of existing assets;
- **Investments:** better return on investment (ROI) on existing investments. For example, the acquiring company has an extensive IT infrastructure which the target company can also access;
- **Products and services:** increasing product portfolios and service portfolios by creating better product mixes, or removing a potential substitution option.

Cost savings synergies

Cost saving synergies can generally be categorised into:

- **Duplication avoidance:** avoidance by consolidating functions on a centralised basis, i.e., shared services, or by combining similar expenditures, e.g., licences;
- **Economies of scale:** increase in purchasing power, e.g., improved pricing on contract services;
- **Expenditure avoidance:** for instance, avoidance of expenses related to new distributor relationships and/or the duplication of existing capabilities such as IT systems;
- **Operational efficiency:** increased control of processes, e.g., maintenance scheduling;
- **Practices adoption:** utilisation of technology from target company, i.e., technology transfer;
- **Organisational streamlining:** reduction in organisational layers and breadth, e.g., spans of control, substitution of external/internal labour sources; and
- **Performance realignment:** consideration of more efficient structures, e.g., centralisation of certain departments, outsourcing.

Compared to revenue enhancing synergies, cost reduction synergies tend to be more readily identifiable, more accurately quantified and measured. They can also be significant in terms of value.

Identifying and reviewing synergy opportunities are critical to determining whether a candidate company should be further considered as an acquisition target. Selecting the appropriate target will enhance the performance of the buyer after integrating the entity.

3.3 Valuation

3.3.1 Financial modelling

Building a financial model is a useful tool for buyers in an M&A process. It is the first but essential step towards an accurate valuation of the target, and will enhance the appraisal of the enterprise or equity value. By going deep into the target's financials, buyers will be able to make well-informed decisions by assessing its real growth potentials and associated risks.

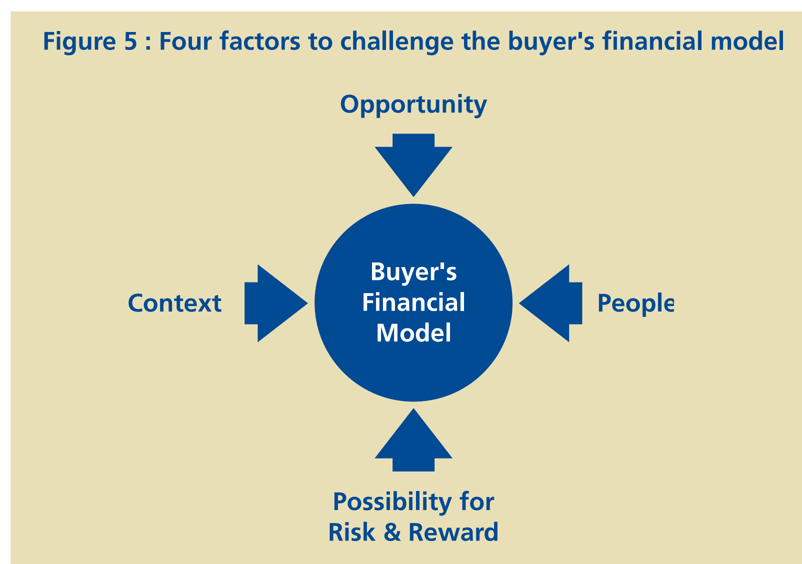
Buyers should compile three elements from the target financials: an income statement, a balance sheet and a cashflow statement with historical, current and forecasted figures. Forecasted figures should be looked ahead at least five years and include three scenarios with different sets of assumptions:

- most likely;
- most pessimistic and;
- most optimistic.

All too often, people take a binary view: either they underestimate uncertainty or they overestimate it and go with their "gut instinct". Building three different models (base, good and bad cases) will help to come up with reasonably satisfying forecasts by spreading the risks and adopting a disciplined method.

It is not easy to compose a great financial model. This is largely because the focus is often on inputting figures rather than appreciating the underlying. As seen in the diagram below, buyers have to challenge their financial model with at least four major areas related to factors critical to the success of every new venture: the people, the opportunity, the context, and the possibilities for both risks and rewards.

Figure 5 : Four factors to challenge the buyer's financial model



Deriving forecasts when they are not available remains a hard exercise, particularly if the potential target is out of a company's core sector(s). To build a suitable financial model requires buyers to raise the necessary questions, make critical assumptions, and develop an in-depth understanding of the context in which the target operates, for example, is the market rapidly growing? Is the industry structurally attractive?

3.3.2 Valuation approaches

Three approaches are commonly used in the valuation of a company. The first approach uses the future cashflow of the company, the second examines market comparables and the third analyses the balance sheet to arrive at a fair value of net assets. Combinations of these approaches may be used to obtain an appropriate range of fair market value.

Figure 6: Major valuation methodologies

Discounted Cashflow Income approach	Market comparison	Net Assets Approach Balance sheet methods
Discount rate	Price/Earnings	Net book value
Growth rate	Price/Revenues	Adjusted book value
Terminal value	Price/Net worth	Liquidation value
Margin improvement	Enterprise Value/EBITDA	
	Enterprise Value/EBIT	

- DCF (Discounted Cashflow method)

  From a financial point of view, the value of a business or business interest is the sum of the expected future economic benefits to its owner at a present value. The discounted cashflow method, or DCF, is namely based on the notion that the value of the company is equal to the amount of free, after-tax cashflows generated by the company and discounted at a rate that is commensurate with its risk profile.

  The advantage of the discounted method is that future earnings potential becomes the investment criterion, thus taking into account the time value of money. Disadvantages include the fact that, like any other estimate, future earnings cannot be projected with certainty.

- Market comparison

  The peer-group or multiples method is a comparative approach that sets the company to be valued against other companies of similar size and business. In this approach, the value of the company is estimated via a multiple of its profit-generating capacity. A number of financial statement variables can be used as "value measures":

  - net revenues;
  - net income;
  - earnings before interest and taxes (EBIT);
  - earnings before interest, taxes, depreciation and amortisation (EBITDA).

  The multiple used can be either:

  - a market multiple (comparable company method), by dividing the market price of the guideline companies stock by the relevant financial statement variables, or
  - a transaction multiple (comparable transaction method), by dividing the transaction price by the relevant financial statement variables.

The comparable company method analyses the multiples at which listed companies with similar operations and characteristics to the subject company are traded in the stock market. The limit of the comparable company method relies on the possibility to find truly comparable companies. Companies in the same industry might not share the same operational characteristics or customer base.

The comparable transaction method analyses the multiples at which similar companies have been recently put on the market. This method assumes a great deal of M&A activity and the availability of information regarding the target financials and the terms of the transaction. A limitation of this method is that different buyers have different reasons for buying a company.

- Net Assets approach

  Balance sheet methods of valuation are based on the concept that a buyer basically purchases the net assets of a company.

  The asset approach estimates the value of the company based on the company's underlying assets and liabilities. It considers the value of the enterprise as the aggregate value of the individual assets less the aggregate value of the individual liabilities of the company.

  Net assets valuation methods include:

  - Net assets book value, using the company's financial statements. However this method does not reflect the fair market value of assets and liabilities; rather, it expresses historical value only and is significantly impacted by the company's accounting policies.
  - Net assets adjusted book value, using the book value adjusted for major differences between the stated book value and the fair market value of the company's assets and liabilities. However, one of the most difficult and significant adjustments remains that of the value of a company's intangible assets.
  - Net assets liquidation value, estimating the cash remaining after the company has sold all its assets and paid off all its liabilities. In practice, only a business that is in severe financial difficulty or one that must be sold quickly can be purchased at liquidation value. However, it is important to know this value during negotiations, since financial institutions commonly use this method to determine the value of assets used as collateral to secure financing.

  The assets approaches are generally most relevant where:

  - the value of the company is derived from the disposition of its underlying assets; or
  - when a significant proportion of a company's assets are liquid (e.g., a holding company); or
  - when the fair value of its net assets can represent the value of the company.

The above valuation methodologies aim at determining the fair market value, although it may not represent the final transaction price. Valuation is an art. While the use of formulas in a valuation implies exactness, it is very difficult to set the worth of a company at a single figure.

To establish a market value, "hard" figures such as historical earnings, cashflow, assets and liabilities are used. But "soft" or subjective figures such as projected earnings, future cashflow, and the value of intangibles (e.g., patents, brands, know-how, and leases at below-market rate) are also considered.

The "deal environment" may influence the final transaction price; factors such as the current market conditions, industry popularity, acquisition structure, tax attributes, and the objectives of the seller or buyer often have an affect on pricing.

Indeed, the final transaction price is largely influenced by the eagerness of the buyer to buy and the seller to sell, the demand and supply for targets, the form of consideration paid (e.g., shares, cash) and the negotiation skills of the parties.

3.3.3 Valuation challenges

Performing a valuation on assets in China can be a challenging exercise. Often, buyers attempting to conduct their own valuation on targets may find it difficult to access accurate and reliable information for financial modelling, make appropriate assumptions on operations and market conditions, and comply with statutory requirements. Table 6 summarises common valuation issues in China and provides potential solutions to address these challenges.

Table 6: Valuation challenges in China

Challenges	Potential solutions
• Difficulties in assessing regulatory and market risks due to rapidly changing market and regulatory environment	• Identify relevant risks and assess their impact through research on trends and regulatory updates • Engage external experts in the relevant industry with strong research capabilities
• Unreliable historical financial problems relating to the quality of earnings • Collections of trade debts • Inappropriate capitalisation of expenses • Non arms-length transactions • Insufficient provisions on inventories/receivables • Hidden costs (e.g., labour benefits)	• Identify issues through insightful due diligence carried out by dedicated and experienced M&A professionals • Conduct non arms-length transaction resolution • Conduct transfer pricing resolution • Factor in potential financial issues in valuation • Negotiate for a better acquisition price as a result of potential problems
• Financial projections are not supported by reasonable assumptions	• Build a sensible financial model by engaging financial modelling experts, supported by sensitivity analysis of impacting factors
• Presence of: - unproductive assets (e.g., investments in non-core business or social facilities) - significant contingent liabilities (e.g., tax-related issues, guarantees to third parties, etc.)	• Structure the deal to exclude unwanted assets and liabilities • Identify accounting and tax issues and resolve them satisfactorily
• Statutory requirements for valuation to be performed by local valuers, who tend to focus on net assets value in the valuation process	• Ascertain reasonable valuation results by nominating a local valuer • Review the work performed by the local valuer

For transactions that involve state-owned assets, approval from relevant Chinese authorities is required. In such cases, valuation of the state-owned assets is required to be performed by a licensed local valuer. The valuation report also needs to comply with a special format and layout as stipulated by the authorities.

Valuation of intangible assets is also a challenge in China. The situation is more severe when the Chinese party is represented by a local valuer who tends to adopt an asset approach in valuation and attach little value, if any, to the intangible assets. For some start-up and high-tech companies which own a small amount of fixed assets, the difference between the value concluded by a local valuer and a foreign valuer may be quite significant.

A buyer should also be aware that recent M&A rules in China require domestic-owned (non state-owned) enterprises to perform independent valuation on assets. As a result, when considering an acquisition price and conducting deal negotiations, it is beneficial for the buyer to understand the potential differential in valuation and the issues involved.

3.4 Approval process and approach strategy

3.4.1 Approval strategy

Having an approval strategy is critical to the success of a transaction. In closing a deal, the buyer and seller may require approval from various regulatory bodies or entities. This process, however, can be time-consuming. A well-planned approach to obtain approval may facilitate the completion of the transaction. This may involve engaging experts in regulatory advisory to assist with examining regulations related to the identified deal structure and to coordinate and liaise with other professionals to obtain the required approvals.

Typically, approval may be required from the following bodies before a deal can be completed.

- Shareholders – if the buyer is a publicly-listed company, it may need to obtain shareholders approval before any major or substantial transaction can take place. Particularly, the buyer may be required to seek approval from minority shareholders if the transaction involves a connected party.

- Governmental entities – in China, government approval may be required under certain circumstances:
  - most transactions involving a foreign investor will require approval from the relevant regulatory body;
  - the transaction will necessitate the approval of the appropriate authorities if the business operates in certain regulated markets (such as banking, insurance and telecommunications); and
  - the transaction will require the approval of the relevant authorities if the business operates in an industry critical to the public's interest, and where the transaction would create a monopoly situation (anti-trust regulations).

3.4.2 Target approach strategy

The strategy for approaching a target can be different based on whether the target is a public or private company.

If the target is a public company, it is often possible to conduct an initial due diligence and initial valuation based on publicly available information and data. In such instances, the buyer may be ready to approach a potential target with a preliminary indication of deal/offer.

If the target is a private company, the buyer or its advisor will need to approach the candidate earlier in the process. For example, initial due diligence may not be feasible without access to the target's information, which may only be available after signing a Non-Disclosure Agreement with the target.

The buyer should consider the following questions when approaching the target:

- Who makes the contact?
- How is contact made?
- What should be communicated to the target?
- Who is contacted at the target?
- How should hostile reactions be handled?

An advisor would be able to assist in developing the appropriate strategy to approach a target.

3.5 Initial deal structuring

After initial due diligence, the buyer and the seller will need to have a preliminary idea of how the deal will be structured, taking into account the needs and objectives of both parties. **The main objective: to reach a mutual agreement that is acceptable and feasible for both the buyer and the seller.**

There are various methods to structure and specify the terms for a transaction. In the initial discussion, the seller and buyer would probably have raised a number of critical issues that will need to be addressed. Some of the critical concerns may include:

- Will the seller participate in the post-acquisition organisation as a partner? If so, in which format? As a shareholder, or as key management team?
- Whether to set up a new joint venture entity or a WFOE to take over the business of the target (asset deal) or to have the buyer purchase the equity interest in the target (equity deal)?
- Whether to purchase real estate or fixed assets or to lease from the target?
- What form of consideration is desirable? Cash only, all up-front or with earn-out provision?
- Which entity will be the seller (onshore transaction or offshore transaction)?
- From the buyer's perspective, whether it needs to consider a special holding vehicle for the target and how to finance the transaction?

From a tax perspective, initial discussion relating to the deal structure is extremely important between the buyer and seller to align their expectations. Depending upon the structure of the transaction, the tax costs for both parties could be significantly different which may impact the economics of the deal. Tax is one of the most critical considerations in evaluating the feasibility of a potential acquisition.

In addition to the tax-related issues, the regulatory approval process should also be considered to determine initially what types of approvals are needed to close the transaction and at what level (provincial or central) to better understand the feasibility of the structure and approximate the timing needed to bridge the expectation gap between both parties.

When structuring a deal, it is common practice to receive indication on whether the owners/shareholders of the target company are interested in continuing the process. Generally, a Letter of Intent (LOI) will be signed to confirm the interests of the two parties and outline the basic terms that have been agreed upon in the initial phases of negotiation. The LOI does not contain all matters upon which an agreement must be reached in order to complete the acquisition, but will draft the key points discussed to date. It will validate and summarise the key terms agreed (for example, stock versus assets purchase, amount and form of consideration) which will be followed by further negotiations.

To some extent, the LOI will also protect a buyer in case the deal drops. As a legally-binding document, the LOI confirms the interest of the two parties in engaging themselves in an M&A transaction. After signing the LOI, both parties should have reasonable opportunities to step back from the deal. Taking this argument further, the target company may include some "drop dead fees" in the LOI to compensate the buyer in case it steps back from the deal for any unreasonable reason.

Summary

- Proper target screening lays the foundation for successful execution and integration
- Develop screening criteria based on internal capabilities in terms of financial, shareholding and management preferences and operational requirements
- Prioritise acquisition candidates based on defined criteria to achieve the M&A strategy
- Conduct initial due diligence to understand short-listed candidates, valuate potential targets and identify synergy opportunities. Obtaining reliable and accurate information in China can be a challenge – engage experienced professionals to assist with the process
- Develop an approval strategy to facilitate the completion of the transaction early on as obtaining approval can be time-consuming
- Engage in an initial discussion on alternatives for deal structuring to reach mutual agreement on an option that is feasible and acceptable to both parties
- Confirm the interests of both parties and outline the basic terms of the deal with a Letter of Intent

Transaction execution

4. Transaction execution

Key issues considered in this chapter:

- How can a buyer determine that the acquisition target is the "right" choice and the acquisition price is both fair and reasonable?
- What does due diligence involve and what areas should due diligence cover?
- What should a company consider during negotiations? How should a company deal with issues such as pricing and financing strategy, deal breakers, valuation, regulatory and approval requirements, post-integration considerations?
- What are the key considerations when structuring the deal?
- What are the deal completion mechanics, transaction documents and key elements of agreements?

Transaction execution generally entails due diligence, valuation, negotiations and deal structuring. These activities occur in parallel and a multi-functional approach helps maintain focus on the most critical elements of the deal on a real-time basis.

Due diligence provides vital information for deal structuring, valuating a target and conducting negotiations. The financial, operational and legal aspects are often considered the three vital components for making the final decision to do the deal. An analysis of the target company in greater depth is necessary to determine whether the disclosed information has been represented properly. This analysis will help the buyer determine whether it indeed wants to buy the target company, and, if so, the appropriate price to pay.

During the execution of a deal, synergy opportunities should be transformed from the value envisioned in the initial due diligence to value captured in the combined organisation. The best way to achieve this is for the buyer to have an in-depth and comprehensive picture of the target company. Therefore, in addition to conducting financial, operational and legal due diligence, it is important to conduct due diligence in the areas of tax, internal controls, integrity, market, human resources, and information technology. It is also essential that the buyer verifies the financial, commercial, operational and strategic assumptions used in the preliminary stages of the deal.

In China, a company conducting due diligence on an acquisition target may face many challenges as a result of the culture, business environment and regulatory requirements.

The execution challenges of conducting due diligence in China, if not properly addressed, may expose the buyer to risks which may significantly impact operations and financial performance. These hurdles and risks can range from expectation gaps, communications issues to internal controls and compliance matters. Many companies in China are not accustomed to due diligence activities. While closely examining the operations of a company is common practice in developed economies, cultural sensitivities should be managed so as not to create a feeling of distrust between the buyer and seller. In some instances, a lack of cultural sensitivity could potentially become a deal breaker for the buyer.

Figure 7 provides a high-level summary of the common challenges of conducting due diligence in China. Specific areas of concern are further discussed in the various sections of this chapter.

Figure 7: Common due diligence challenges in China

Execution Hurdles

- **Expectation Gap** between the investor and the target with regards to due diligence scope and the necessary due diligence information
- **Cultural and Language Barriers** between the investor and the target causing miscommunication and delay of the due diligence process
- **Negotiation Issues** between the investor and the target leading to delay of due diligence process and additional due diligence costs
- **Insufficient Communication** between top and local management of the target causing different perception of the transaction
- **Unavailable and Incomplete Information** owing to unsophisticated information system leading to doubts in reliability of target's financial statements/information
- **Degree of Centralisation/Decentralistion** resulting in different accounting centres and data flow

Risks

- **Basis of Preparation of Financial Statements:** GAAP compliance; GAAP differences between IAS/US with PRC standards; disclosures
- **Fixed Assets:** unclear land use rights; legal titles; valuation issues
- **Related Parties:** difficulties in identifying related party relationships and transactions; non-arm's length terms; corporate guarantees given to related parties
- **Human Resources:** funding of social insurance contributions; post-transaction staff continuity issues; quality and capability of staff
- **Compliance:** relating to various local and national laws and regulations, such as safety, health, and environmental regulations
- **Quality of Sales:** revenue recognition policy; sales cut-off, receivable collection issues
- **Internal Controls:** management's capability and integrity

For a typical M&A transaction, due diligence usually occurs after target screening is completed and before the transaction is executed. There are three different levels of due diligence: preliminary/initial, detailed and final due diligence.

Depending on the stage, the focus and the level of details will be different.

- Preliminary/initial due diligence occurs in the initial stages of the M&A process where time is spent collecting and analysing preliminary data and identifying business risks.
- Detailed due diligence takes place during transaction execution and is the most rigorous stage. Site visits and interviews are conducted with further information collection, and information is fed to the valuation, negotiation and integration planning processes.
- Final due diligence occurs at a later phase in the M&A process when favourable deal closing terms and final pricing are reached. It is part of the integration planning and post-transaction review.

External professionals may be engaged to perform due diligence for acquisitions in China. External services are valued for their experience and objectivity, and can act as a second/objective opinion to a company's initial assessment.

Lessons learned in conducting due diligence in China

- Ensure experienced professionals are available locally to put findings in the right context
- Do not under-estimate the importance of cultural due diligence and integration planning, especially if this is your first investment in China
- Language and translation will be a challenge if your team is not bilingual and/or your corporate culture requires all information to be available in English
- Availability of information may not be as complete and as timely as you like. Prioritise due diligence areas so that efforts can be focused on key areas, especially for time-sensitive transactions

4.1 Financial, tax and legal due diligence

4.1.1 Financial due diligence

The buyer's screening analysis has been, up to now, principally based on limited available information. To proceed with an acquisition, a buyer should conduct an objective in-depth due diligence of the target company to ensure it makes well-informed and timely decisions.

When evaluating target candidates, the buyer should assess the reliability of the financial figures upon which the pricing strategy is based. In the case of a leverage buyout (LBO), this will provide a clear picture of the company's gearing and help to determine the ability to service debt based on cashflows.

In a financial due diligence, assets and liabilities accounts are reviewed to assess if assets and liabilities are properly stated. Such an exercise will involve studying the financial statements, account details and supporting documents provided by the target company.

Given the complexity in the financial, commercial, operational and strategic information involved, it is often helpful to engage local experienced professionals to assist in the process. These professionals will:

- consider the sources of value in the target and focus the deal team during due diligence;
- develop a detailed due diligence question list;
- conduct on-site due diligence and interview management;
- perform detailed financial due diligence, particularly focusing on addressing key concerns; and
- execute the due diligence objectively, effectively and expeditiously.

Performing a financial due dilligence

Financial due diligence typically includes:

- General questions, such as
  - corporate background;
  - financial reporting and policies;
  - corporate governance and controls;
  - management and human resources;
  - audit findings and opinion.
- Financial statement analysis
  - quality of earnings;
  - pro-forma/normalised income statement;
  - quality of assets;
  - off-balance sheet assets;
  - exposure of liabilities and commitments.
- Tax position review
  - tax audit;
  - review of inter-company transactions.
- Related parties transactions

Buyers may work with professional advisors to determine the extent and scope of due diligence. The scope of work is typically tailored and adapted to the nature of the transaction, and will depend on variables such as:

- the buyer's concerns regarding the target financial transparency and reliability;
- complexity of the transaction;
- deal size;
- the target's industry.

Financial due diligence in China is often challenging due to a lack of transparency of the financial information and uncertainty of the reliability of information. Some typical issues and suggestions on how to overcome them are listed in section 3.1.2.

Examples of issues uncovered during financial due diligence in China

- Uncertainty on the availability and reliability of information, for example, there may be inconsistent accounting methodologies and standards
- Presence and/or lack of transparency of related party transactions
- Issues relating to the ownership of assets

4.1.2 Tax due diligence

The tax due diligence exercise is critical and together with the financial due diligence, provides a more complete picture of the financial position of the target. In China's ever changing business environment, especially when tax rules and regulations are still under development and the local authority's interpretation and practical application of the rules may not be consistent, a tax due diligence will help to identify tax exposures of the target.

The statute of limitation is not very clearly defined in China's tax rules and therefore, imposes extreme difficulty in isolating the past tax exposures in an M&A transaction. These exposures may cast significant doubt on the viability or the ability to sustain the financial position of the target. These exposures may also change the acquisition mode from an equity deal transaction to an asset deal in order to avoid any contingent tax liabilities that exist in the target.

In a tax due diligence review, the focus is to review major applicable taxes relating to past operations of the target, such as:

- corporate income tax;
- value added tax;
- business tax;
- withholding tax;
- individual income tax;
- land value-added tax;
- real property tax;
- stamp duty; and
- customs duty.

In addition to the underpayment of tax liabilities, a tax due diligence will also identify whether the target (taxpayer) failed to pay tax within a set period or whether a withholding agent failed to withhold and remit tax within a set period, as the tax authority will have ordered the taxpayer to pay or remit tax within a given time limit. As of August 2006, there is a daily surcharge for delayed payment or remittance of 0.05 percent of the tax unpaid or not remitted from the date the tax payment or remittance becomes due. If a taxpayer fails to make declaration of tax, fails to pay or underpays the amount of tax payable, the tax authority will seek the payment of the amount of tax unpaid or underpaid as well as the surcharge for the delayed payment, and concurrently impose a fine exceeding 50 percent of, but not exceeding five times, the amount of tax unpaid or underpaid.

In the event of unpaid taxes or underpayment of taxes due to computing resource errors made by the taxpayers, the tax authority is granted the right to collect the unpaid or underpayment of taxes with surcharge within three years or to five years under special circumstances. If such unpaid taxes or underpayment of taxes are caused by the errors made by the tax authority, the tax authority has the right to collect the unpaid or underpayment of taxes within three years with no surcharge. There is no statute of limitation for tax invasion or similar acts.[1]

In addition to assessing major risks and exposures relating to any underpayment of tax liabilities or non-compliance issues, it is equally important to identify any major tax schemes which cannot be rationally supported by the current tax law and regulations. This would impact the projected financial modelling that the buyer would conduct on the target's future business.

During the tax due diligence process, various transaction and business risks associated with the proposed acquisition may be identified. Having identified these risks, both the buyer and the seller may be able to take certain remedial actions to lessen or safeguard against such risks. It is crucial for potential deal breakers and risk areas to be identified and resolved early on in a transaction.

The following table outlines some of the common issues and risks that can be identified through the tax due diligence process.

Table 7: Common issues and risks identified through tax due diligence in China

Complicated and unofficial ownership structure	Chinese companies often operate under an unofficial legal structure with respect to ownership of the assets used in the business. This can create exposures with respect to the inaccurate recording of revenue/expenses in the respective entities which would impact the tax position of each entity
Related party transactions	Related party transactions in China may sometimes not be very transparent • Terms may not be arm's length • Off-balance sheet guarantees of subsidiary/affiliate transactions or other liabilities may be present • Transactions are completed for the benefit of the "Group" rather than commercial reasons • Profits/losses are manipulated to minimise taxes on a group basis, and the related transactions are not supported by reasonable transfer pricing methodologies
Special deals with local tax authorities and unofficial tax concessions	Chinese companies may have special arrangements with local tax authorities for certain tax treatments which are not entirely consistent with current laws and regulations. In addition, tax concessions are often offered to companies without any written documentation or paper trail
Tax compliance	There may be tax compliance issues in Chinese companies. For example, not all required tax adjustments are made to the book for computing income taxes; claiming expenses without official invoices (i.e. the fapiaos); under-reporting of individual income tax liabilities; and under-reporting of VAT and customs duty
Aggressive tax schemes	Chinese companies may have implemented certain aggressive tax schemes to understate revenue and/or overstate expenses with the objective of minimising tax costs

[1] These guidelines are valid as of August 2006.

Case study - Necessity of tax due diligence on small-scale subsidiaries

A US-based company acquired a company that has a small operating subsidiary in Northeast China. A due diligence exercise was performed on the US company but did not include a tax review on the Chinese subsidiary because it is relatively small in size.

Two months after the acquisition, the buyer found irregularities in the VAT and corporate income tax reported by the local management in China. After a post-acquisition tax due diligence of the Chinese subsidiary, the buyer discovered that the under-reported tax liabilities, the associated interest and penalties amounted to several million US dollars. The exposure exceeded the expected amount the buyer had set aside in an escrow account.

4.1.3 Legal due diligence

A legal due diligence provides the buyer a view of the legal aspects of the target. The exercise involves an examination of, but not limited to, the legality of asset ownerships such as licences, property rights, titles, land leases; compliance status; outstanding legal issues; and regulatory requirements. A legal review is especially important for a buyer making an acquisition in China as there may be:

- a lack of clarity on ownership;
- intellectual property infringement risks;
- complicated titles;
- expiration on land leases;
- restrictions on foreign investors holding certain licences.

Legal due diligence is generally conducted by legal advisors. They typically will review all aspects of legal documentation and conduct research and interviews as necessary.

4.2 Business due diligence

Business due diligence provides information relating to a target's operations, commercial environment and business conduct. Generally, it covers integrity due diligence, commercial (market) due diligence, operational due diligence, information technology due diligence and human resources due diligence.

4.2.1 Integrity due diligence

Integrity due diligence provides a buyer key information on the target and its principals, and identifies potential risks related to Foreign Corrupt Practices Act (FCPA) compliance, fraud, reputation, litigation, tax evasion, and financial loss. It is an important exercise as issues identified are often deal breakers.

Generally, an integrity due diligence exercise will focus on:

- the target's business history and reputation;
- the track record of the principals and senior management of the target;
- sources of capital;
- involvement in litigation;
- central, provincial and local government licences, contracts and political connections;
- any conflicts of interest or non-arms length transactions or relationships;
- any side or competing businesses by existing or former employees or stakeholders; and
- where relevant, any links to organised crime or illegal activity.

Information is often gathered and analysed by external professionals through a combination of public record research, enquiries through well-placed and confidential external sources, and technical analysis on transactions and computer systems. Engaging professionals that have domain knowledge and experience is essential to obtaining reliable information and identifying anomalies.

Performing an integrity due diligence

Typically, four areas are covered by an integrity due diligence:

- Integrity due diligence

  This exercise focuses on the areas previously mentioned, and involves checks of public filings on the target and its legal representatives, extensive searches of public domain open source information, site visits and enquiries with confidential resources.

- FCPA compliance review

  This review provides information that can assist in assessing the target's compliance with FCPA and China's local anti-bribery and corruption legislations. Key activities may include:

  - collating information on employees, agents and consultants who may interact with government officials on behalf of the company, and departments, agencies, bodies and officials to whom payments were made by employees, agents and consultants;
  - engaging analytic and forensic advisors and technology to analyse data to identify suspicious transactions;
  - reviewing relationships with contractors, consultants and/or agents, assessing whether proper due diligence was undertaken and verifying that agreements are in writing containing appropriate anti-bribery clauses.

Case study – FCPA infringement in China

A US multinational pharmaceutical company in China engaged external resources to investigate potential FCPA infringement in China. The professionals found that over RMB10 million of product promotion expenses were fabricated and proceeds were used to bribe doctors to meet sales targets. The company was exposed to FCPA compliance, fraud and reputation risk.

The FCPA review resulted in a voluntary disclosure to the US SEC regarding FCPA infringements by the company. The company also implemented remedial actions including a thorough integrity due diligence on distributors, contractors, agents and third parties; improvements to controls, procedures, ethical reporting mechanisms; and development of a fraud response plan.

- Fraud risk review (FRR)

  FRR provides a buyer with a pre-transaction "health check" on the target entity. The aim is to identify, assess and evaluate fraud and corruption risks associated with the organisation and its key management and employees. It involves a review to understand business operations and processes.

  In China, a pre-transaction review enhances a buyer's ability to prevent, deter and detect fraud and illegal acts, thereby helping to avoid costly mistakes, regulatory sanctions and reputation damage post-transaction.

- Forensic data gathering and analysis

  This entails utilising fraud detection software to extract, interrogate and analyse financial and electronic data to identify and detect anomalies, fraud and malfeasance. Often, data analytic technology is deployed to search for suspicious transactions or dirty data in electronic files and records. Valuable data and digital evidence, even if deleted, may be retrieved in a non-intrusive and evidentially admissible manner.

Case study – Fraud in China

A European food products manufacturer in China was concerned that some expenses related to the promotion of products in retail outlets throughout Guangdong were fraudulent. An investigation by external advisors found forgery of sales vouchers, receipts and chops, and unofficial and unconnected receipts for the tax bureau which were giving a false impression of legitimacy. In addition to financial loss, the company faced potential legal and reputation risk.

To prevent future fraudulent behaviour and mitigate risk, the advisors suggested remedial actions. These included improvements to controls and procedures, implementing training programs to develop an ethical culture, developing a fraud response plan and "whistle-blowing" reporting mechanisms.

4.2.2 Commercial (market) due diligence

While China promises to be a growing and dynamic market for many businesses, it is also intensely competitive with a rapidly changing macro-environment that impacts not only a company's potential acquisition, but its customers and suppliers.

Commercial due diligence (CDD) focuses on a company's market, industry, competitors, and the likelihood of it achieving (or exceeding) its forecasts in the coming years. Typically, a well developed CDD approach will be based on the demands of financial investors and looks for potential post-transaction gains as well as identifying key risks. When conducting a CDD in China, the approach and output should also be modified where necessary to suit the Chinese market.

By conducting a commercial due diligence, the buyer is able to identify key risks in management plans and opportunities that may have been overlooked. Typically, the buyer will gain first hand insight into customer and supplier relationships and some benchmarking information to assist in the negotiation process. The buyer will also be able to develop potential action steps for post acquisition management.

Scope and approach of a commercial due diligence

The scope of a commercial due diligence is highly customisable to meet the specific needs of a transaction. A typical CDD might include a review on:

- Market

  A market assessment as part of the commercial due diligence would typically provide an overview of the market in which the target operates and plans to develop. This may include identification of the key demand drivers, market segmentation, volatility drivers, regulatory issues, cost drivers, trends and other industry specific items.

- Competition

  The evaluation of the competition typically starts with defining the competitive environment in which the target company operates. This may include industry profitability drivers such as the customer buying power, ease of entry, supplier strength, availability of substitutes and competitive intensity. This facilitates the identification of critical success factors and how the target and its competitors benchmark.

- Company-specific items

  The company review initially focuses on the business model, strategy and its core capabilities. This enables the development of a sensitivity model and identification of potential areas of opportunity and risk.

In conducting a commercial due diligence, the approach is highly geared towards primary research conducted in a compressed timeline. Much of the effort is spent on primary data and competitive intelligence gathering; the remainder is spent on analysing company specific information. This helps to overcome the relative absence of detailed market research reports.

Case study – Information accuracy

A manufacturing company was considering an acquisition in a new field. To determine how much manufacturing capacity existed in the target company, the buyer engaged experts that utilised a primary research approach coupled with local agencies and site visits to assist with the assessment.

The nature of information available in China makes it possible to access information that would not typically be available in western markets, but with suspect reliability. Experts with an ability to understand market drivers will provide insights to correct for reliability concerns.

Case study – Brand and distribution

A buyer was evaluating a potential acquisition in the retail sector in China and was concerned about brand and distribution. By utilising a mystery shopping approach, professional experts were able to quickly assess the current distribution channels, product range versus competitors and conduct an 'in-store' customer brand survey to advise the buyer on potential challenges and opportunities it would face post-acquisition.

4.2.3 Operational due diligence

Operational due diligence is part of the evaluation process to determine whether the potential target has the capability to meet a buyer's strategic objectives. It covers every aspect of a target's business operation, including:

- management;
- sales and marketing;
- procurement and supplier management;
- manufacturing;
- service delivery;
- supply chain;
- research & development (R&D);
- finance operations;
- information technology (see section 4.2.3 IT Due Diligence for more details);
- human resources (see section 4.2.4 HR Due Diligence for more details).

For all of the above, a buyer should gain a thorough understanding of the who, what, where, why, how, together with the corresponding costs, quality and time frames. The evaluation should be based on what the target is supposed to do for the acquiring company (for example, the synergy and the added capabilities) and not how it is doing as a standalone business. In other words, a target might be a solid company, but it might not be able to complement the business of the buyer (e.g., unsuitable market positioning and customer base).

The findings of an operational due diligence can be used to:

- validate assumptions of the financial projections (e.g., can the CAPEX investment level and staffing level support the projected growth, any commitments and potential contingent liabilities identified);
- identify gaps and synergy points of acquiring the target; and
- assess the level of difficulty to integrate.

Conducting an operational due diligence

A range of functional teams are involved in an operational due diligence initiative. Members of an operational due diligence team should be objective, and should be subject matter experts for their respective business area. Upon completion of information gathering and analysis, findings will be consolidated into a final report for review. Key due diligence deliverables that may result from an operational due diligence include but are not limited to the following:

- Comprehensive implications worksheet (executive level) – This worksheet is used by the due diligence team and acts as an issues log, tying a summary list of due diligence findings from the functional areas directly to possible implications for negotiation, valuation, deal structure, and integration planning.

- Due diligence output report (detailed level) – This report is a standardised summary of due diligence findings and includes issues by function, the criticality significance or impact issues have on valuation, integration, negotiation and deal structure. The report consolidates critical information for senior management to make final decisions.
- Function due diligence final report – This is a comprehensive report based on a functional perspective. It is written during detailed due diligence and contains assumptions and recommendations for acquiring the target company. The due diligence findings from each function will be used to develop the valuation model and assist with negotiations.
- Function due diligence communications plan – A communications plan should be specifically designed to outline necessary communications from a functional perspective, for example to notify target employees of pre-closing changes.
- Function minimum integration standards – These are guidelines that are defined to expedite the integration planning process, and may include non-negotiable integration requirements. Examples include the migration of financials for reporting, migration or interconnection of the IT systems to a common platform defined by the buyer, and the renegotiation of licenses and maintenance contracts.

Basic project tools that may be used for conducting an operational due diligence

- Cost/Budget worksheet – This worksheet is a project management aid that measures expenditures on due diligence efforts by individual and/or team, especially in efforts requiring significant team scale and international travel.
- Project work plan templates – These are planning tools used to coordinate activities of due diligence teams and to facilitate handoffs.

4.2.4 Information Technology due diligence

Information technology (IT) due diligence is a comprehensive assessment of the IT aspects for issues that affect the valuation, transition, and the overall value of the acquisition. However, IT is often overlooked in the M&A due diligence process. Without completing a proper assessment of the IT infrastructure and capabilities of a target, a buyer may significantly underestimate the magnitude, complexity, and cost of IT-related issues. There have been instances where companies have been forced to incur millions of dollars in additional costs during integration to address IT-related complexities that were not fully comprehended.

In essence, a comprehensive IT due diligence will generally allow a buyer to gain an understanding of:

- issues relating to the IT organisation of the target company that may affect the valuation, transition and the overall value of the acquisition;
- a target's information and telecommunications costs, risks and opportunities that will be important input into the pre-integration, negotiation and valuation processes; and
- areas where the target company can make improvements to increase the probability of success, i.e., to mitigate or avoid risks.

Scope of a typical IT due diligence

Most IT due diligence efforts will cover the following IT aspects of the target company. The exact scope may vary depending on the time and budget allocated to the project.

- In-flight projects – These are IT projects that are still in progress, which have not been completed at the time of the merger.
- IT costs (budget and actual) – This addresses the difference between the planned versus actual IT spending.
- IT approach/strategy – This entails an examination of the overall IT strategy for the organisation, both short- and medium-term.
- IT skill sets – An assessment of the skill sets of the current IT employees will highlight if there are any major differences between the skill sets of the target company and that of the buyer.
- Major application areas – This entails a review of both the hardware and software used in a target company, and includes ERP systems such as SAP, operating systems and databases, and the network architecture or topology.
- IT-related contracts – This involves an examination of the clauses and terms of any contract, long or short-term which may have a negative impact or present a risk to the buyer. An example would be an unfavourable service contract for the next 10 years.

IT due diligence execution

A comprehensive IT due diligence assessment involves developing a well-planned approach and may generally include:

- Scoping and planning

  In this stage, the IT due diligence team will determine the completion time, framework, desired depth, breadth as well as the focus of the review. The team will also conduct an initial review of the availability of information resources.

- Understand the business context

  It is important for the buyer to understand the industry trends and pressures, business and project objectives, and what effect these may have on the planned merger.

- Understand major IT areas

  Part of an IT due diligence is to review the various applications currently in use, and gain an understanding of future IT strategies of both companies.

- Identify risks and opportunities

  A buyer should understand the technology required to support business operations, the IT budget, and financial data of the target company. It is also important for the buyer to obtain information regarding a target's IT resources, processes and people. Occasionally, a buyer may want to review the financial and technology viability of the target's IT vendors as this could potentially pose a major risk in the long run if applications are no longer supported. Opportunities for cost savings, such as downsizing, outsourcing or establishing shared services, should also be considered.

- Assess magnitude/impact

  To assess the magnitude of the opportunities or better understand the risks, the due diligence team needs to have a discussion with IT personnel and conduct site visits, and review financial statements and IT documents. Benchmarking a target's IT operations against best practices through consultation with outside consultants and industry experts is also recommended as part of the assessment.

Lessons learned in China

- Appoint senior IT resources to every due diligence effort, to ensure that the output of the due diligence is comprehensive and can be used in the planning stage of the IT integration itself
- Do not shortcut IT due diligence as it can be the source of expensive surprises later
- Check whether there are specific rules requiring that data stored in a target's systems need to be onshore, in particular if your target is in a regulated industry and there are integration plans to share regional/global databases. China has specific requirements on whether certain data can be stored offshore
- Voluntary turnover for IT talent with ERP implementation experience in China is over 20 percent, so be sure to assess the target's IT capabilities, make a retention plan for critical staff early in the process, and assume a higher degree of turnover
- Assess the extent of Chinese font data and reporting in a target's systems, especially if there are plans on centralising/integrating IT platforms post-acquisition. Plan for multi-byte language support and testing post-acquisition early on so that integration efforts can be properly managed

4.2.5 Human Resources due diligence

Human resources (HR) due diligence, although often neglected, is a critical exercise that should be conducted for all acquisitions, and especially in China. The labour laws and rules are complex and may differ depending on locality. Failure to conduct a proper HR due diligence exercise can result in damaging the future operations and integration of the two merged parties. For instance, there could be:

- potential penalties due to non-compliance with government laws or regulations;
- under/over provision of social securities;
- an inappropriate labour cost structure;
- potential severance liabilities;
- potential culture conflicts.

Many successful M&A transactions rely heavily on the comprehensive delivery of the HR due diligence exercise. Research

Case study

An American electronic appliances company was preparing to engage in a joint venture with a Chinese enterprise and conducted an HR due diligence. In the investigation of the joint venture partner, a number of HR issues were raised, including employee retirement issues, under-provision of social insurance, and non-compliance with local labour regulations. Based on these findings, the US company was able to negotiate a more favourable deal and minimise risk.

conducted to measure M&A performance has suggested that HR issues identified and addressed early not only improves the chance of a deal's success, but also enables key issues that may occur during the post-M&A period, such as talent retention, HR policy and process integration, and the development of HR management programs, to be resolved earlier. This is particularly important in the Chinese market as people management can be a challenging task and is often overlooked in businesses.

Some of the main activities covered in an HR due diligence initiatives may include:

- HR management policy and processes review;
- organisation effectiveness assessment;
- corporate culture assessment;
- labour cost analysis;
- a review of management practices in regards to compensation and benefits;
- legal compliance review; and
- HR information system review.

Common issues identified in China through the HR due diligence process

- Unclear HR policies may be in place
- Lack of employment contracts or director service contracts for key management
- Statutory employee welfare requirements may not be fully met
- Possible under-reporting of liable Individual Income Tax

4.3 Internal controls due diligence

Internal controls of some Chinese companies may not be sophisticated. Therefore, an internal controls due diligence may need to be performed to evaluate the target company's control environment, processes and procedures and the internal controls embedded therein for key business areas. This assessment will validate whether a target company has:

- set the right tone at the top in terms of the control environment, e.g., ethical values, integrity, commitment, governance, management philosophies, authority assignment;
- an appropriate governance structure;
- process and procedures to capture business transactions; and
- transaction data that is recorded and reported correctly, completely and timely, and that the recorded transactions are valid.

By conducting an internal controls due diligence, the buyer will be able to understand and make acquisition decisions based on the level of integrity and reliability of the financial information provided by the target company, and the underlying risk attached to the financial figures where adjustments may need to be made to the financial statements. This exercise can also identify potential control weaknesses and risks, and provide insights on the areas for improvement in the target company.

The findings from an internal controls due diligence often are used as points for negotiating deal terms and price. They also provide the buyer the ability to assess the costs and efforts required to improve the deficiencies post-acquisition.

Internal controls due diligence is typically conducted on two levels of controls: entity level controls and process level controls.

- Entity level controls

  Entity level controls are internal controls relating to the overall management of a company. An entity level control review usually involves interviews and/or questionnaires, and where necessary, a review of selected company documents. Areas for consideration when conducting a review should include:

  - Does management commit to character, integrity, and high ethical values when presenting company financial data?
  - Does the company have a corporate governance structure that promotes an authorised decision-making process, monitors decision execution and prevents management override?
  - Is accountability and control aligned with responsibility and authority assigned?
  - For group companies, how does the parent company govern its subsidiaries?
  - How well does management understand internal controls requirements?
  - Does the company have a risk assessment mechanism?
  - Does the company have effective and efficient communications channels?
  - Does the company have an effective monitoring mechanism?

- Process level controls

  Process level controls relate to control activities in major business processes. Similar to an entity level review, a process level control assessment involves interviews and documentation reviews.

  A typical process level control assessment will:

  - identify major business activities and group them by business cycles. Major business cycles may include revenue, procurement, fixed asset management, inventory management, treasury, financial reporting and closing, human resources and payroll, and general computer controls;
  - review company processes and procedures to determine the accuracy, reliability and validity of the data generated from business transactions and processed for financial reporting. The analysis is often conducted for major classes of transactions identified for each business cycle including routine and non-routine business transactions, and related party and inter-company transactions;
  - evaluate controls embedded in processes and procedures to determine if they are effectively designed to address identified risks;
  - document identified control deficiencies, potential issues and risks, and recommend solutions to improve internal process controls.

4.3.1 Performing an internal controls due diligence

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) issued an internal control integrated framework in 1992. The COSO internal control framework has since been widely adopted in China by enterprises to better control their business activities to achieve established objectives and goals. The COSO internal control framework consists of five control components – control environment, risk assessment, control activity, information and communication, and monitoring.

An internal controls due diligence review is generally conducted based on the five COSO components covering both entity level controls and process level controls.

- Control environment

  The control environment is the control consciousness of an organisation. It is the environment in which people conduct business activities and fulfill their control obligations. The control environment includes both intangible and tangible elements such as integrity and ethical values; commitment to competence; governance and organisation structure; management philosophy and operating style; assignment of authority and responsibility; human resource policies and practices etc.

  An effective control environment exists when employees understand their responsibilities, authority, and are committed to acting ethically.

  Management influences the control environment of an organisation by setting the “tone at the top.” This involves implementing standards through actions and effectively communicating written polices and procedures, a code of ethics, and standards of conduct.

- Risk assessment

  One of the most critical challenges management face is to determine how much risk the company is prepared to accept as management strives to achieve business goals and objectives. Risk assessment starts with identifying risks associated with business objectives linked through all levels of the organisation. It requires an evaluation of external and internal factors to understand the impact on operations, financial reporting, and compliance, distinguishing between opportunities and risks.

  Risks are analysed to determine how they should be managed. Risk responses to avoid, accept, reduce or share risk should be selected in line with a company's risk tolerance and risk appetite. Accordingly, policies and procedures should be established to effectively carry out the risk responses.

  There are a number of techniques that can be employed in risk assessments. The most common approaches include the Control Self Assessment (CSA) and the COSO Enterprise Risk Management Integrated Framework (COSO ERM framework).

- Control activities

  Control activities are policies and procedures that help to ensure identified risks are properly managed and corresponding actions are executed in a timely matter. Control activities focus on the prevention, detection and correction of risks, and should be embedded within the operations of a business so that risks can be managed to reasonable levels.

  Control activities may include:

  - setting approval, authorisation, and verification levels and requirements, e.g., delegation of authority;
  - performing specific functional or activity management activities, e.g., reconciliations;
  - reviewing performance indicators, e.g., key performance indications, operational and financial metrics;
  - establishing physical controls, e.g., securing physical assets;
  - segregation of duties, e.g., custody, authority, recording;
  - implementing information systems controls, e.g., security access to data;

  In addition, as part of control activities, disciplinary actions should be documented, communicated, and consistently administered for non-compliance.

- Information and communication

  In a well managed organisation, relevant external and internal information is identified, captured, processed, and communicated throughout the organisation in a timely manner. This includes communicating employee duties and responsibilities and developing open communications channels with customers, suppliers and other external parties.

  Management is responsible for ensuring that communication is fluid upwards, downwards, and laterally throughout the organisation. Different forms of communications are used to effectively distribute information within an organisation, and can include verbal communications (e.g., meetings, feedback), written communications (e.g., policies, procedures, job descriptions), and actions taken by management.

  The integrity and quality of information communicated and shared within an organisation is imperative for making business decisions. Hence, internal control mechanisms are required to provide reasonable assurance that the information obtained is appropriate, current, timely, accurate, and easily accessible.

- Monitoring

  Monitoring activities should be built into normal, recurring operating activities of an organisation. The scope and frequency of monitoring activities depends on the risks identified, and should take into consideration the level of impact they have on operations and the controls established in reducing them.

  The performance of internal controls should be assessed through ongoing monitoring of operations over a period of time and by separate evaluations conducted periodically.

  A well-defined escalation process for reporting deficiencies should be established so that accountabilities are assigned and appropriate corrective actions are conducted to improve internal controls.

A report will generally be compiled for the buyer upon completion of the internal controls due diligence. This report will document deficiencies, corresponding impacts on operations and potential risks, and recommendations for improving internal controls.

4.3.2 Other considerations related to internal controls

A listed company should understand whether there are regulations on internal controls that it must comply with before and after the M&A transaction is completed. Accordingly, the company will need to consider compliance costs and efforts needed during transaction execution. Key questions for consideration include:

- Will the company be able to get ready on time?
- What is the likelihood that the company will fail the compliance? What would be the impact/risk if compliance is not met?
- What are the major challenges and obstacles to achieving compliance?
- Does the company have enough resources and capabilities to achieve compliance?

It is common practice to have an internal controls due diligence performed by external resources. Professionals with the knowledge and experience in internal control, risk assessment and M&A transactions may be engaged to provide the buyer a comprehensive and high quality analysis of the situation.

Case study

A US-listed paper and wood products company that was in the process of acquiring a medium-density-fibre (MDF) manufacturer in China engaged risk and control professionals to execute an internal control due diligence review. The exercise included interviews, observations, review of documents and walk-through tests.

A comprehensive report on the target’s overall control environment, significant control deficiencies, and a general process description of all major business cycles provided the US company an understanding of the target’s major risks and control weaknesses as well as the potential impact on the target’s financials. This became an important consideration for business projections and thus in deal price negotiation.

The due diligence also helped the company in assessing the target’s ability to comply with Sarbanes-Oxley Section 404 and helped form the post-acquisition integration plan at an early stage.

4.4 Negotiations

4.4.1 Role of the lead advisor

The lead advisor plays a key role in the negotiation process. In addition to managing the many professional advisors involved, including legal advisors, accountants, tax advisors and valuers, the advisor provides negotiation support throughout the deal execution. In supporting the buyer, an experienced lead advisor will generally help to understand and evaluate risks, advise on deal structuring techniques as a competitive advantage, consider the maximum purchase price that can be paid for the target, and compare the premium with the expected value creation to maximise shareholder value.

During negotiations, the lead advisor generally should support a buyer by:

- developing the initial strategy to be applied to kick off the negotiation process;
- mapping the sequence of steps to be used in the negotiations;
- advising on the transaction details proposed and counter-proposed;
- developing responses to counter-offers made by counter-parties.

4.4.2 Forms of negotiations

The objective of negotiations is for the buyer and seller to agree on a fair price and structure that is acceptable to both parties.

For a **privately-held company**, there are two ways of conducting negotiations:

- Private negotiation

  This form of negotiation maintains a high level of confidentiality whereby a buyer will request to have exclusive rights to negotiate with the potential target for a defined period of time. The buyer will also be the only party that will have access to confidential company information.

- Private auction

  A private auction amplifies competition between buyers, and contains more restrictions for the seller.

Private auction and state-owned assets

The disposal of state-owned assets in China is mostly carried out through auction. The PRC government maintains a host of restrictions on the selling procedure. The most common restriction is the limiting of exposure on representations and warranties given. Furthermore, if the number of final bidders for any auction is less than an ideal number and the final offer price is less than its pre-set minimum price, the government will have the right to terminate the selling process.

If the target is a **publicly-listed company**, the acquisition can only be conducted through a public offer where special considerations apply.

- Public company offer

  Regulations require that an offer to acquire a public company be open for a minimum period of time to allow shareholders the opportunity to evaluate the price offered by the bidder. During this time, shareholders often compare the offered per share price to the pre-announcement share prices in their decision-making process. However, very often, rumours on a potential offer may exist prior to the official announcement. Regardless of the nature of the bid (friendly or hostile), such rumours may cause a rise in the share price, and make a bid less attractive when the public announcement is made.

Deal breakers

Despite efforts in negotiations, in some instances, a deal may not be carried through completion when agreement cannot be reached between the buyer and seller.

Common reasons that may lead to a termination in negotiations include:

- a gap in price expectations;
- disagreement in the forms of payments (e.g., cash versus shares);
- inability to agree on payment terms (e.g., bullet or in instalments);
- differing preferences on specific structures (e.g., earn-outs payment, put option, etc.);
- inclusion of demanding representations and warranties in the Sales & Purchase agreement;
- unresolved issues or irregular findings from the due diligence exercise.

4.4.3 Financing structure

At this stage of the deal process, a buyer should determine the appropriate financing structure. With a clear view of the target's financial position and a purchase price determined, a buyer should review its own financial resources and consider if additional funding is required. A buyer should also bear in mind the total funds required for the transaction, which include costs relating to due diligence, restructuring, advisory fees, and integration efforts.

While looking for the most appropriate way to secure financing, a buyer may consider liquidating or selling specific assets of the business to partially finance the transaction. In such cases, professional advice should be sought to obtain optimal pricing for such assets within a reasonable timeframe.

4.4.4 Pricing strategy

After completing the due diligence process, a buyer may modify a deal structure or the projected financial model to incorporate findings and outstanding issues to achieve an optimal pricing structure.

Some common modifications in pricing strategy that a buyer may undertake include incorporating:

- a **put-option** if the target cannot justify financial objectives;
- **drag-along** or **tag-along rights** to include minority shareholders into the negotiation;
- an **earn-out clause** to attach a portion of the transaction price to company performances in the upcoming years. However, under the current regulatory framework in China, regulations may limit the utilisation of an earn-out clause in an M&A transaction by requiring all consideration to be paid within a certain timeframe. Therefore, care should be exercised and planning would be necessary to structure the earn-out provision to meet both parties' objective while still in accordance with the existing rules and regulations in China.

By using these tools, a buyer will be able to negotiate concessions into the final transaction price.

4.4.5 Synergies and post-acquisition issues

Upon completion of the due diligence process, it is possible for the buyer to identify major post-acquisition issues.

Operational issues such as HR, IT systems and internal control processes are areas that should generally be planned prior to deal completion. For example, retention of key personnel is usually critical for the integration of the newly-acquired company during the period following the acquisition. Similar kinds of issues should be addressed early in the acquisition process.

Other post-acquisition issues, such as non-transferable assets, service agreements, supplier and vendor arrangements, non-compliance of tax-related issues, to name a few, should also be addressed so that the purchase price, or value of a target, can be adjusted accordingly to take into consideration issues that may arise from the transaction.

4.4.6 Purchase price adjustment mechanisms

When negotiating the terms of an acquisition, a buyer should always consider the need for a purchase price adjustment mechanism. **A purchase price adjustment modifies the price paid to purchase a company based on a comparison of a preliminary, predetermined value with a value calculated at a later time.** For example, an investor finalises a bid price based on (i) a valuation which incorporates a balance sheet value as of the end of December in one year but does not expect to close the transaction until sometime in the following year, or (ii) an expected balance sheet value to be delivered at closing. The investor should have a right to adjust the bid price based on the value of the balance sheet ultimately acquired.

Typically, purchase price adjustment clauses included in a definitive purchase agreement should provide for the preparation of a closing date financial statement (e.g., a closing date balance sheet) from which a financial measure such as working capital or net assets is derived. That closing date measure is compared to the historical or predetermined balance sheet upon which the original bid price was based (the "reference" balance sheet) and the purchase price is adjusted (often, dollar for dollar) based on the increase or decrease between the two measures.

Example of a purchase price adjustment

As a simple example, assume a negotiated purchase price of US$50 million is based on a multiple of EBITDA and working capital at closing of US$25 million. However, when the transaction closes several months later, the actual working capital delivered to the buyer is US$22 million. Under the terms of a plain vanilla purchase price adjustment, the contractual purchase price would be reduced by US$3 million to a final purchase price of US$47 million.

Some of the issues generally considered with respect to purchase price adjustment mechanisms include:

- what metric to use – net assets, working capital, etc.;
- what balance sheet account to include/exclude;
- how to define net assets or working capital;
- what basis of accounting (i.e., GAAP) to use – IFRS, US GAAP or some other basis;
- consistent application of accounting rules (i.e., conflict between historical practices and pure application of GAAP);
- whether or not to require an audit;
- need to create an escrow account (holdback of purchase price) from which to settle purchase price adjustment;
- protocol with regard to how to resolve any adjustment dispute(s) between buyer and seller.

The issues that can arise in the design of provisions for a purchase price adjustment are frequently numerous and complex, especially in a cross-border environment. This is also true for the proposed mechanism to resolve any resulting disagreements about a purchase price adjustment (e.g., arbitration).

In summary, purchase price adjustment mechanisms can be extremely tricky but may be **an effective means by which to preserve value.** When negotiating and structuring purchase price adjustment mechanisms, buyers can seek counsel from their financial advisor, accountant and legal counsel.

Purchase price adjustments may seem to be mere true-up calculations. However, they can also be used as part of an overall M&A strategy. When protected by an effective purchase price adjustment mechanism, a buyer can offer a higher “headline” purchase price with an intention to partially recoup some of these funds after closing.

4.5 Regulatory considerations

As of August 2006, regulations that apply to mergers and acquisitions in China include, but are not limited to:

- Administrative Measures on Strategic Investments in Listed Companies by Foreign Investors《外国投资者对上市公司战略投资管理办法》(see Appendix 1 for details);
- Provision on Merger and Division of Foreign Investment Enterprises《外商投资企业合并与分立的规定》(see Appendix 2 for details);
- Regulations on the Acquisition of Domestic Companies by Foreign Investors《关于外国投资者并购境内企业的规定》(see Appendix 3 for details);
- Administration of the Takeover of Listed Companies Procedures《上市公司收购管理办法》(see Appendix 4 for details).

Consent from the relevant regulatory body is required in some instances for:

- a change in control;
- the acquisition of a minority interest; and
- the disposal or amalgamation of a regulated business.

China has continued to encourage mergers to create large, competitive local conglomerates that can compete with large foreign enterprises. This creates a massive drive for thousands of private and state-owned enterprises to be merged and acquired in the coming years. Foreign investors will likely be invited to participate in this development program. Under PRC regulations for cross-border transactions, a foreign investor may acquire PRC companies either by acquiring the target's equity or assets.

If the buyer wants to acquire the Chinese target's **equity** directly (existing or newly issued shares), the foreign investor will be subject to various registration, validation or approval procedures from different approval authorities, e.g., CSRC, SAFE, MOC, SAIC, etc. In the case of an **asset acquisition,** certain approval may also be required. When an indirect acquisition is conducted off-shore, the foreign investor may acquire equity in a special purpose vehicle (SPV) which may hold the business in China. Although the transaction is outside the PRC jurisdiction, it may still need to obtain certain relevant government approval as the main assets of the SPV are in China.

Depending upon the size of the investment and the industry the business operates in, approval authorities may be elevated to the Central Government in Beijing, which may lengthen the time required to obtain approval. Therefore, these issues should be considered at a very early stage.

If the transaction involves a state-owned enterprise (a number of SOE's are being made available for restructuring or partnering with foreign firms), then special approvals may be required. When SOE's or state-owned assets are involved, a valuation process by an official valuer may be required to determine the purchase price of the deal. The purchase price cannot be significantly different from the appraised value by the official valuers. In practice, the discrepancy may need to be limited to 10 percent of the appraised value in certain locations.

China is still a foreign exchange controlled country. Therefore, foreign exchange-related regulations must be complied with when structuring and executing an M&A transaction. For example, a government approval and registration process must be completed before a SPV can be set up outside of China by Chinese nationals (including Chinese corporations and individuals) to purchase businesses or operate businesses in China. If such initial approval or registration process is not complied with by the original Chinese owners, a foreign investor's indirect purchase of the SPV (which owns the business in China) may present certain legal validity issues. Legal advice should be sought in this type of situation.

Furthermore, following China's accession to the World Trade Organisation, many industry sectors which were previously restricted for foreign investment have since been opened. However, majority ownership in a few industries is still restricted, including rail freight transportation and telecommunications. Compliance with the Catalogue on Industries for Foreign Investment must be met.

Finally, special approvals from the Ministry of Commerce and the State Administration for Industry and Commerce are required if the foreign investor and its affiliates already have an annual turnover exceeding RMB1,500 million in the PRC; acquired more than 10 related PRC enterprises in one year; controlled not less than 20 percent of the PRC market already; or will have PRC market share exceeding 25 percent after acquisition.[2]

[2] Regulations are valid as of August 2006.

4.6 Financing considerations for foreign investors

An acquisition of a Chinese target can be financed by the foreign investors directly, as a form of direct investment, or indirectly through an intermediate holding company (including the Chinese operating company, a Chinese Holding Company (CHC), or an offshore holding company among others). However, each structure requires careful analysis with respect to its regulatory and operational feasibility and tax efficiency.

4.6.1 Debt-to-equity ratio

In China, certain regulations exist which provide guidelines (limits) as to the ratio between the amount of equity and debt that can be used to finance a business. For most foreign businesses in China (except for joint stock companies, whose capital is represented by shares), capitalisation is represented by the amount of registered capital. The amount of "registered capital" is different from the "total investment", which generally refers to the total amount needed for business operations (including capital expenditure and working capital). **A company's registered capital and its total investment amounts must be registered with the PRC authorities at the time of business formation.**

Generally speaking, the maximum foreign currency borrowing capacity of a company is the difference between the total investment amount and the minimum registered capital. The minimum registered capital for foreign invested enterprises in China are as follows:

Table 8: Investment amount versus minimum registered capital requirements in China (as of August 2006)

Total investment amount (in US$)	Minimum registered capital (in US$)
0 – 3 million	70% of total investment
3 – 10 million	50% of total investment, but no less than 2.1 million
10 – 30 million	40% of total investment, but no less than 5 million
> 30 million	33-1/3% of total investment, but no less than 12 million

The maximum allowed foreign debt-to-equity ratio can be calculated from the above.

For example, for a company with a total investment amount of US$2 million, the minimum registered capital requirement would be US$1.4 million, and the maximum foreign debt-to-equity ratio would be 3:7 (maximum foreign currency borrowings of US$600,000). For a CHC, the requirements are slightly different. CHCs with a paid-up capital of less than US$100 million have a debt-to-equity ratio cap of 4:1. For CHCs with a paid-up capital of US$100 million and above, the ratio should not exceed 6:1.

4.6.2 Loans

Loans are one method of financing an M&A project. The buyer can take out a loan overseas, and then inject the capital into China for the acquisition. A foreign investment enterprise (FIE), whether it be an operating company, a holding company, or any other structure, can also take out loans in either RMB or foreign currency, up to the total amount as allowed under the aforementioned debt-to-equity ratio.

In China, there are generally two kinds of loans – foreign and local. Foreign debt consists of loans denominated in foreign currency, loaned through foreign banks by foreign parties. All foreign currency loans must be registered with and approved by SAFE[3]. It is important to note that whether the maximum amount of foreign loan can be borrowed depends on the percentage of registered capital already contributed, and whether it has been contributed according to the schedule as prescribed by law. If not, the SAFE will not allow the registration of the loan, which means that remittance of the interest and principal repayment would not be allowed. In practice, RMB loans from a local bank are generally not restricted, although foreign guaranteed RMB loans can, in the case of default, require registration with the SAFE as foreign debt.

The interest payment on cross-border loans generally causes the company to incur a 10 percent withholding tax (WHT) on the gross amount, although this may differ slightly in certain countries where its tax treaty with China dictates otherwise. Debt funding may create tax savings at the FIE level, as interest expenses may be tax deductible. For companies whose income tax rate is higher than 10 percent, the difference between the deductible interest expense and the 10 percent withholding tax rate could translate into potential tax savings. For companies enjoying a tax holiday, possibilities exist for interest deferral or stepped interest arrangements in which a higher interest is paid out in the later years of the loan. However, such structures require careful planning that takes into account transfer pricing and related issues, and would generally require clearance from the local tax authorities prior to implementation.

4.6.3 Profit re-investment

Profit re-investment may be another way of funding acquisitions. Profit re-investment refers to the investing of profits from an FIE directly back into the FIE to increase its registered capital, or as capital investment to establish another FIE. According to PRC regulations as of August 2006, when a foreign investor of an FIE re-invests its share of profits, or uses it to establish another FIE to operate for a period of at least five years, it will, upon approval by the tax authorities, receive a refund of 40 percent of the corporate income tax paid on the re-invested amount. In addition, a 100 percent income tax refund may be available if a foreign investor makes a direct re-investment to establish or expand an export-oriented enterprise or a technologically-advanced enterprise in China.

Under current regulations[4], no refund will be granted if the profits are used to directly acquire existing entities in China. It may be possible, however, to use the re-invested profits to acquire Chinese target(s) through the setup of a structure involving intermediaries and still qualify for the tax refunds.

All profits to be re-invested must be contributed to the new FIE or back to the original FIE directly, with no cash being remitted outside of China or received by the investor. Profit re-investment can assist in the expansion of a company's Chinese presence without the need to bring in additional foreign capital, which may be difficult to repatriate in future, as well as enjoy tax refund(s) which decrease the cost of capital. However, the re-invested capital may very well become a cash trap, as capital reduction is subject to the approval of relevant authorities, and may be difficult to obtain in practice.

[3] As of August 2006.

[4] As of August 2006.

4.6.4 Foreign exchange restriction/profit repatriation

Companies that cannot or do not wish to use the incentives from profit re-investment to fund the M&A project may still use the repatriated profit from an FIE to do so. However, there are certain PRC laws that regulate foreign exchange and cash repatriation.

Generally speaking, the **repatriation of any and all PRC earnings to a foreign parent is restricted**[5]. The SAFE and its local branches and designated banks serve as the approval authorities for such remittances. For certain types of trade payments, bank review and approval is sufficient. For non-trade payments, approval requirements differ depending on the amount of the remittance. The following chart provides a general guideline:

Table 9: Approval requirements (as of August 2006)

Amount of remittance (in US$)	Requires approval by:
0 – 50,000	The remitting bank
50,000 – 500,000	The local branch of the SAFE
> 500,000	The central SAFE in Beijing

In general, remittance items that are clearly permitted and regularly processed (e.g., dividends) are usually approved and processed with few obstacles. For other items, especially where potential taxability is an issue, approval and processing may take quite some time, if granted at all.

The probability of a successful approval may rest on the local tax authority, the SAFE, and the individual remitting bank's attitude towards the item at hand.

As mentioned above, dividends are a clearly permitted and regularly processed method of profit/cash repatriation. PRC WHT is currently not levied on dividend distributions to foreign investors, as long as the conditions for dividend repatriation are satisfied. Dividends are generally distributed annually; interim dividend distributions are rarely done in practice due to unclear guidelines and difficult implementation, though allowable in theory.

4.6.5 Debt pushdown

In instances where the foreign company does not wish to increase its amount of debt or cannot benefit from further interest expense deductibility, debt pushdown, or the "push down" of debt to a local Chinese entity is a potential arrangement. This can be done both directly and indirectly, possibly through holding companies in jurisdictions with favourable tax treaties. However, as stated above, the debt-to-equity ratio restrictions must be observed.

By pushing the debt down to the local Chinese level, the Chinese company may enjoy tax deductions, and the foreign company may get easier access to cash (repatriation of principal and interest payment on debt is much quicker and less restrictive than the foreign exchange remittance process as described above). The increased freedom of repatriation frequency and timing when compared to a dividend distribution is another benefit of debt pushdown arrangements.

Points to note on debt pushdown

When pursuing a debt pushdown arrangement, it is important to note the related regulations in the countries involved. Also the parent company must consider whether the interest payments from the loan arrangement can be tax exempt at the parent company level. For the Chinese entity, the 10 percent WHT on interest payments generally apply. For debt pushdown schemes, the benefits and applicable regulations depend on the countries and entities involved in the arrangement as well as any applicable treaties between the countries.

[5] As of August 2006.

4.7 Deal structuring

4.7.1 Overview

A buyer should generally structure the transaction taking into account the needs expressed by the seller as well as its own requirements. There are many ways to structure and specify terms for a transaction. Essential to formulating the optimal transaction structure, the buyer and, in most instances, with the assistance of a financial advisor should:

- conduct a scenario analysis on different possible transactional structures;
- evaluate the financial impact on the company for each scenario; and
- identify and determine the appropriate deal structure.

A buyer can either buy the shares from existing shareholders or directly acquire the assets from the target company. Acquiring shares tends to be more popular than acquiring assets because:

- all shareholders of the acquired entity will share the risks of the merger;
- an asset acquisition may require obtaining consent from third parties not directly involved in the transaction; and
- tax considerations (see section 4.7.2 Tax Structuring for more details).

As of August 2006, PRC laws pose certain restrictions on structuring foreign investments depending on the nature of the investment as well as the industry it operates in. There are also complex laws and regulations on foreign-owned enterprises where foreign ownership exceeds 25 percent, and possible SPV's where the entire transaction is kept offshore.

In addition to the financial structure of the deal, buyers may also consider management, assets, tax and financing issues so that the transaction can be structured to better meet the needs of all parties.

- Continuity in management

  The continued employment of management is often subject to considerable negotiation. A buyer often considers the management team as a key asset in an acquisition, particularly if the buyer is a financial investor. Under such circumstances, employment agreements are often negotiated with key people, specifying terms, responsibilities, remuneration, and equity participation. Buyers should recognise that retaining existing management would provide continuity in business operations while slowing down cultural integration differences.

- Real estate

  In China, many owners may structure their business so that the company owns the operating assets (e.g., inventories and receivables) while the owner personally owns the non-operating assets (real estate). Owners would then lease the real estate back to the operating company. Hence, buyers may want to consider the lease terms as part of the negotiation.

- Consideration

  The consideration a prospective buyer can offer to a seller may be in the form of cash, notes, stocks, shareholders loans, or a combination of the above. Since each form of consideration has different implications and liquidity, the transaction price may be subject to further negotiation depending on the form of consideration offered. The two most common forms of consideration are cash and stock. Table 10 summarises the characteristics of each.

Table 10: Key characteristics of cash and stock considerations

	Key characteristics
Cash	• A liquid financial instrument • Simple exit for target shareholders • Increases bid credibility and attractiveness • Can be paid in instalments – but will create a collection risk and a discount for time value of money
Stock	• A less liquid financial instrument, particularly if the company's shares are not publicly traded, or is not liquid enough for a small cap stock • Increased complexity as there is a need to determine both the buyer's share value and the target's fair market value • The seller will share benefits and risks of the transaction by: - assuming the risk that the buyer's shares are over-valued - taking benefit of future synergies

- Contingent payouts

  During price negotiations, point of views might diverge on business forecasts. The buyer may believe the growth rate will be lower than what the seller presents. Considering that the price might be based on forecasts provided by management, it is critical to make sure that the figures are as accurate and achievable as possible. One way to break the impasse may be a contingent payment agreement, where additional payments will be made only if the company meets certain pre-defined goals after the transaction is completed.

- Exit strategy – tax consideration

  Evaluating tax effects can be complicated when exiting an investment or operations in China. An investor not only needs to consider local (China) tax consequences, but also home country tax effects, and the effect on its global tax situation, if any. Good planning will help to reduce the ultimate liabilities upon exit as different structures may yield vastly different tax results.

Before signing any Sales & Purchase Agreement, both parties should understand that there is a chance the deal may not happen for the following types of reasons:

- a potential candidate may receive a better offer after the exclusivity period ends;
- the shareholders of the target company may ask for a higher price; or
- findings from due diligence may reveal issues or may not meet expectations.

There are many reasons which may stop the M&A process. Whether a company will want to search and pursue another target will depend on a number of factors – strategic need, business conditions, morale of the M&A team, and time already spent.

4.7.2 Tax structuring

A foreign investor can acquire a Chinese entity either directly or indirectly by acquiring the shares of the Chinese entity, its overseas intermediate holding company or by acquiring its assets.Various factors should generally be considered in determining whether to acquire the shares (directly or indirectly) or the assets of the Chinese entity. The following is a summary of characteristics typical of a share acquisition and an asset acquisition.

Table 11: Characteristics of a share acquisition and an asset acquisition

	Share acquisition	Asset acquisition
Operations	Business operations will continue after acquisition. Various business contracts, licences and employment contracts will remain unchanged. Interruption to the business and additional operational costs that may be incurred due to the acquisition could be minimised.	Various business contacts, licences and employment contracts need to be re-negotiated and re-signed by the buyer of the assets, which may result in business interruption. In addition, the business interruption will be prolonged if a new entity needs to be set up to acquire the assets of the target.
Step up	The buyer's basis in the shares of the target is the purchase price while the inside basis of the assets carries over. The buyer will not be able to achieve any step up in basis in the assets of the target through a share acquisition.	The assets acquired would be stepped up to the fair market value which may result in a higher tax deductible depreciation expense. Additionally, the premium paid by the buyer is considered as a goodwill which could be amortised and deducted over a 10-year period in general.
Liabilities	The buyer will inherit any hidden liability of the target which existed at the time of acquisition.	The buyer will not inherit any hidden liability of the target which existed at the time of acquisition other than liabilities assumed pursuant to the acquisition agreement. Additionally, the buyer has the option of not acquiring any undesirable assets.
Tax	Any tax attributes of the target will carryover and will not be affected by the change of ownership of the target. As of August 2006, there are no provisions under PRC tax laws prohibiting the utilisation of taxable loss already existing in a company following ownership changes. For example, if the target has any unutilised taxable loss carry forward, such loss may be used to offset any post-acquisition profit of the target. In the event a non-FIE target is transformed into a FIE after an acquisition, the new FIE can potentially enjoy a new set of tax holidays as other newly established qualifying FIEs.	In general, an asset acquisition may result in a higher tax cost to the seller which may inevitably affect the purchase price paid by the buyer. No tax attributes of the target will carryover. However, if the foreign acquirer establishes a new entity to acquire the assets of the target, the new entity may potentially enjoy a new set of tax holidays as other newly established qualifying FIEs. For a target which is an FIE, any preferential tax treatment already enjoyed by it may be subject to claw-back if all the assets of the target are sold and the target ceases operation within 10 years of it being established.
Government approvals	Government approvals are usually required for changes in shareholders. Approval may not be necessary if the foreign investor is acquiring the share of the overseas intermediate holding company, thus effectively gaining ownership of the Chinese operation without any changes in the shareholder of the Chinese operation.	No government approval is required for the asset acquisition of any privately-owned target; however, the incorporation of the new entity requires extensive government approvals. In general, an asset valuation needs to be conducted by a valuer and the consideration paid for these assets needs to be within a certain range of the valuation report.

Tax implications

The tax implications for the buyer and the seller in a direct share acquisition are different from that in an assets acquisition. Generally speaking, **an asset acquisition could result in a higher tax cost to the seller** which may ultimately affect the final purchase price.

The following two tables summarise various tax implications to the buyer and the seller on a direct share acquisition versus an asset acquisition.

Table 12: Major PRC tax implications of a direct share acquisition (as of August 2006)

		Corporate Income Tax	Stamp Duty
Seller	Non-PRC resident (individual or entity)	10% withholding tax on capital gain	0.05% on selling price
	PRC resident (individual or entity)	Capital gain is taxed at the applicable individual or corporate income tax rate	0.05% on selling price
Buyer		N/A	0.05% on purchase price

In an **indirect share deal** where the buyer acquires the equity interest of the overseas intermediate holding company, thereby acquiring control of the Chinese operation, there is no PRC tax effect on the buyer as the entire transaction is carried out offshore. The tax implications for the seller will depend on the tax regime applicable to its country of residence.

Table 13: Major PRC tax implications of an asset acquisition (as of August 2006)

Assets	Value Added Tax	Business Tax	Corporate Income Tax	Stamp Duty	Land Appreciation Tax	Deed Tax
Seller						
Accounts receivable	N/A	N/A	Gain/loss subject to income tax (at the applicable income tax rate)	0.05% on selling price if there is a separate agreement for the transfer	N/A	N/A
Inventory	Collect 17% from the Buyer	N/A	Certain loss (e.g., loss on disposal of fixed assets and accounts receivable) need to be reported to the tax bureau at year end with supporting documents in order to treat such loss as allowable loss	0.03% on selling price	N/A	N/A
Real property & land use rights	N/A	5% on the gross or net (depending upon how the property is acquired)		0.05% on selling price	30%-60% on land appreciation	N/A
Fixed assets (includes cars but excludes real property)	If selling price <= cost, no VAT; otherwise, 2% on selling price allocated	N/A		0.03% on selling price	N/A	N/A
Intangibles	N/A	5% on selling price		0.05% on selling price	N/A	N/A

Assets	Value Added Tax	Business Tax	Corporate Income Tax	Stamp Duty	Land Appreciation Tax	Deed Tax
Buyer						
Accounts receivable	N/A	N/A	N/A	0.05% on selling price if there is a separate agreement for the transfer	N/A	N/A
Inventory	Pay 17%, which is creditable against future output VAT	N/A	N/A	0.03% on purchase price	N/A	N/A
Real property & land use rights	N/A	N/A	N/A	0.05% on purchase price	N/A	3%-5% on the purchase price

In summary, whether a foreign investor should acquire the shares or the assets of a Chinese target depends on various considerations including but not limited to business, operations and costs. In general, a Chinese seller may prefer a share deal for the following reasons:

- to avoid immediate recognition on revaluation gain of the assets;
- to avoid turnover taxes on transfer of assets, such as real property and land use rights (with the exception of transferring the entire business as a whole under which turnover taxes may be avoided);
- to avoid any claw-back on preferential tax treatment enjoyed; and
- to obtain the sales proceeds immediately without going through liquidation of a target.

However, a foreign investor may prefer an asset deal to avoid any historic problems of the target and to obtain the step-up basis in the assets acquired (including intangibles).

Withholding taxes on profit repatriations and use of holding companies

China imposes a 10 percent withholding tax on capital gains from the disposal of equity interest in a Chinese company by a non-resident equity holder. Although dividends payable to non-resident equity holders by Chinese companies (which are regarded as FIEs) are currently exempt from withholding tax in China[6], it is envisaged that new dividend withholding tax treatments may be introduced as part of forthcoming tax reforms. Other passive income such as royalty and interest income received by foreign companies from Chinese companies are also subject to a 10 percent domestic withholding tax rate.

To mitigate the above withholding taxes on profit repatriations, subject to the investor's home country tax rules and its existing double taxation treaty provisions with China, **it may be tax efficient for a buyer to establish a legal holding structure using an intermediate holding company** located in a jurisdiction that has favourable double taxation treaties with China for an acquisition. Intermediate holding companies can also act as a transaction mechanism for other passive income. By using a holding company, the overall effective tax rate of the transaction may be reduced thereby increasing after tax investment returns.

[6] As of August 2006.

Using an intermediary holding company for a transaction may also minimise the time and bureaucratic processes often needed when seeking approval to transfer ownership of a Chinese company.

China has entered into double taxation treaties or agreements with 82 countries and territories[7]. The following table summarises the withholding tax rates of several common holding company locations (treaty and non-treaty countries) used for acquisitions of Chinese companies.

Table 14: Withholding tax rates of common holding company locations (as of August 2006)

Jurisdictions	Dividends	Royalty	Interest	Capital gain
Barbados	5%	10%	10%	Not taxable in China[8]
Bermuda[9]	0%[10]	10%	10%	10% [11]
BVI[12]	0%[13]	10%	10%	10%
Hong Kong	5% / 10% [14]	7%	7%	Not taxable in China[15]
Ireland	5% / 10%[16]	10% [17]	10%	Not taxable in China[18]
Luxembourg	5% / 10% [16]	10% [17]	10%	Not taxable in China[19]
Mauritius	5%	10%	10%	Not taxable in China[20]
Netherlands	10%	10%	10%	10%
Singapore	7% / 12% [21]	10%	7% / 10% [22]	10%

[7] As of August 2006.

[8] The treaty is subject to renegotiation where exemption of PRC withholding tax on capital gain may be revised.

[9] No double taxation treaty with China.

[10] Pursuant to PRC tax law and regulations, dividends earned by the foreign entities are tax exempt.

[11] Pursuant to PRC tax law and regulations, withholding income tax on capital gain is 10 percent.

[12] No double taxation treaty with China.

[13] Pursuant to PRC tax law and regulations, dividends earned by the foreign entities are tax exempt.

[14] If the beneficial owner is a company which directly holds at least 25 percent of the capital of the company paying the dividends, the lower tax rate would be applied.

[15] Only if the equity in the Chinese company that is being disposed of is not more than 25 percent of the company and it does not involve a real estate company share disposal. The new Double Taxation Arrangement signed between China and Hong Kong will become effective in China from January 1, 2007.

[16] Where the recipient is a company or a partnership which directly holds at least 25 percent of the shares of the company paying the dividends, the tax charged shall not exceed seven percent of the gross amount of the dividends.

[17] For industrial, commercial and scientific equipment royalties, the 10 percent tax rate applies to the adjusted amount of the royalties, i.e., 60 percent of the gross amount. For other cases, the 10 percent tax rate applies to the gross amount of royalties.

[18] It does not apply to the disposal of real estate company shares.

[19] Only if the equity in the Chinese company that is being disposed of is not more than 25 percent of the company and it does not involve a real estate company share disposal. A tax treaty between China and Luxembourg with this provision is in force.

[20] Only applicable to non real estate company shares, and only if the seller's equity in the Chinese company that is being disposed of is not more than 25 percent for the 12 months immediately before the sale. (This treatment is based on a new treaty signed on September 5, 2006 which is currently awaiting ratification from both countries. It will be in force on the day both countries ratify the treaty, and will have effect on income derived in China during the taxable year beginning on or after the first day of January following its entry into force, and in Mauritius during the taxable year beginning on or after the first day of July following its entry into force.)

[21] Five precent of the gross amount of the dividends if the beneficial owner is a company which directly holds at least 25 percent of the voting power of the company paying the dividends; 10 percent of the gross amount of the dividends in all other cases.

[22] If the interest income is recevied by a bank or financial institution, the lower tax rate would be applied.

4.7.3 Exit strategies

Buyers seeking to invest in a business that may not be integrated into current operations should consider exit strategies before committing to an acquisition. As exit options are formulated, acquisition strategies should be revised according to the best way to sell the acquired business.

For example, a financial investor should consider whether the acquired company or business unit may be of interest to other strategic investors, or whether an exit via listing the company on a stock exchange is preferred. In the case of a public offering, more stringent target selection criteria would be used to assess potential candidates and in turn, more preparation is expected from the target in terms of presentation of financials and management capabilities to address financial market requirements.

Table 15: Exit options and characterisitics

	Trade sale	IPO
Price of company shareholding	Higher than an IPO, especially when a premium is required for a controlling interest	Lower than a trade sale; normally will value current shareholding at a minority shareholder level
Timing	Faster, direct process	Longer time involved. Time is needed for: • stock exchange vetting and approval • preparing documentation and enlisting underwriters, etc. • waiting for the appropriate market sentiment
Costs	Lower	Higher • requires additional professionals (e.g., stock brokers, underwriters, etc. to prepare listing documentation)
Structure	Straightforward sale of minority or majority stake	Less than full exit; listing of new common shares only leads to ownership dilution

Taxation on capital gain

When formulating exit strategies, a buyer should also take into consideration tax implications on capital gain. A direct sale of shares in a Chinese company is subject to tax in China. The statutory rate is 20 percent; however, as of August 2006 it has been temporarily reduced to 10 percent by an administrative circular. Double taxation treaties may offer an even lower rate for holding companies located in specific countries (see Section 4.7.2, Table 14 for more details). Hence, a buyer should assess the benefits of various structures and determine the most suitable holding location prior to executing the transaction to minimise future capital gains tax.

4.8 Implementation

Role of the lead advisor

In general, the role of the lead advisor is to coordinate the various professionals and advisors in preparing the closing documentation, assist in obtaining regulatory approvals if required, and make certain that all relevant parties adhere to the closing schedule. In addition, the lead advisor will generally:

- list and manage all the required documents and the responsible parties before closing;
- determine and revise the completion date according to work progress;
- analyse the hurdles of the transaction closing and resolve issues;
- arrange financing;
- conduct post-transaction planning;
- assist the buyer (or seller in the case of a divestment) on finalising settlement arrangements;
- obtain share ownership and documentation from lawyers; and
- ensure the completion of the Sales & Purchase (S&P) Agreement.

Role of legal advisors

Legal advisors are generally responsible for drafting and finalising the definitive S&P Agreement based on the agreed terms from the negotiation process. S&P Agreements can be lengthy as it will include clauses that address all the key issues raised during the due diligence process.

Legal advisors should also advise the buyer on issues concerning the effectiveness of translations on legal terms, the jurisdiction of agreements, and the impact of the PRC legal system on the deal when finalising the agreements.

Reviewing the Sales & Purchase Agreement

The representations/warranties and indemnifications sections are two of the most important elements of S&P Agreements. It is essential for the buyer (or seller in the case of a divestment) to ensure that sufficient warranties and indemnifications are obtained to minimise unexpected liabilities (financial, tax and otherwise) that may arise upon completion of the transaction.

- Representations and warranties

  The representation and warranties section represents the foundation of the transaction. They make reference to other documents and information such as financial statements, patents, pending litigation or outstanding liabilities. This section lists what the buyer and seller is aware of concerning the business at the time of the transaction. From the buyer's point of view, the representations are clauses to achieve maximum disclosure about the seller's business and operations. If the buyer discovers a material fact that was not represented, he may be relieved from the obligation to close the transaction or claim for indemnification.

  From the seller's point of view, providing a full disclosure may be time-consuming and difficult to achieve. The seller will want to minimise the number of representations to limit his indemnity exposure. Materiality limits are often established by qualifying representations "to the best of the seller's knowledge".

- Indemnification provisions

  The indemnity section specifies the damage and rights the buyer and the seller can claim if the representations and warranties are misrepresented or the contract is breached. It clarifies each party's responsibilities and obligations.

The above provisions can often be a place to resolve difference in opinions on certain contentious potential exposures that may be discovered during the due diligence process. Instead of reducing the purchase price to cater for such potential exposures, if the seller is confident that its view is correct and that certain potential exposures identified will not materialise, the seller may be willing to make a full disclosure of the facts in these provisions and provide the buyer with some recourse in the event such exposures do materialise following the closing of the deal.

In addition, various transaction type taxes may be payable by each party to the contract and the amount of some of these taxes may be quite substantial, especially in an asset acquisition with real properties involved. Assistance from professional advisors may be needed to make sure that the seller is responsible for his/her own tax liabilities and that these are not passed on to the buyer because of ambiguous wording in the S&P Agreement.

Required approvals

Under a share acquisition, government approvals are usually required for a change in shareholders. The need to obtain approval will not be necessary if the foreign acquirer acquires the shares of the overseas intermediate holding company and thus effectively gains ownership of the Chinese company without changing the shareholders of the Chinese company.

Under an asset acquisition, although no government approval is required for the asset acquisition of a privately-owned target, the incorporation of a new company requires extensive government approval by, including but not limited to:

- the local foreign trade and economic committee;
- the local administration of industry and commerce;
- the local security bureau;
- the local technical supervision bureau;
- the local administration of foreign exchange;
- the local tax authorities;
- the local statistics bureau;
- the local finance bureau;
- the local customs bureau.

For some specific industries, the application for setting up a new company must be approved by the Central Government in Beijing.

Obtaining regulatory approval may be the most challenging condition to complete the deal in a timely manner. If the parties can not obtain the relevant approval before the prescribed long-stop date (i.e., the deadline), a supplementary agreement to extend the completion time frame may be needed.

Summary

- In addition to financial, operational and legal due diligence, tax, internal controls, integrity, market, information technology and human resources due diligence should also be conducted. Issues identified should be taken into consideration when negotiating and valuating the target
- Verify assumptions used in the preliminary stages of the deal
- Engage external services for conducting due diligence in China; they are valued for their expertise and objectivity
- Determine the form of negotiations, financing structure and pricing strategy to achieve an optimal pricing structure
- Assess the pros and cons of different deal structures – e.g., share acquisition versus asset acquisition, tax implications. Professional advisors can help choose the appropriate structure based on the nature of the acquisition
- Obtain the consent of relevant regulatory bodies before completing the deal – foreign investors in China are subject to various registration and approval procedures from various authorities
- Consider exit strategies before completing the deal to ensure expected financial gains are achievable; bear in mind there may be tax on capital gains
- Consider a purchase price adjustment mechanism as part of the M&A strategy
- Bear in mind that both parties can “walk out” of a deal anytime before the S&P Agreement is executed

Integration and reorganisation

5. Integration and reorganisation

Key issues considered in this chapter:

- Who will lead the integration effort – who will be the Integration Director?
- What does a merger integration effort involve in terms of resources, planning and activities?
- What areas within an organisation should integration take place?
- What should a company do to ensure smooth Day One operations?
- What compliance requirements need to be addressed?
- How should a company support tax compliance and planning?

5.1 Integration planning and strategy

The integration and reorganisation aspect of the M&A process is often the longest and the most challenging. A poorly managed integration often will not provide the returns and benefits to increase shareholding value.

Studies show that about 85 percent of mergers do not realise value as expected due to integration problems. M&A surveys conducted by Deloitte found the following:

- Synergies are not achieved in 60 percent of cases
- Only 23 percent earn their cost of capital
- 47 percent of executives leave in the first year of integration; 75 percent leave by the third year
- Productivity in the first four to eight months is generally reduced by 50 percent
- When value is not created, poor integration is to blame in 70 percent of cases

Realising the value of an M&A deal will depend on how the buyer addresses and mitigates integration risk factors and how the buyer manages an extremely complex integration project.

5.1.1 The importance of integration

Merger integration and reorganisation is a complex exercise. It entails change in all functions, simultaneously, with interdependencies that have to be managed day-to-day in an environment where people are anxious about their futures. Integration generally involves but is not limited to:

- strategy and organisational consolidation;
- business process standardisation;
- human resources integration; and
- information technology infrastructure integration.

When integrating two business organisations, the merged entity needs to ask a number of organisation and operations-related questions:

- What is the best structure for the new entity?
- What can be done to facilitate a fast and successful integration?
- How can a company ensure a successful Day One operation?
- How can a company identify and capture merger benefits?
- How should the changes within the organisation be managed?
- What can be done to minimise potential conflicts among locations during the integration?
- How should processes be redesigned to capture integration benefits and support IT implementation?
- How will products and infrastructure be integrated?
- Do people have the skills and capabilities required to perform in the new organisation?

An important determinant of merger success is the ability to develop and execute an integration plan that addresses these issues. The principal challenge is how the post-M&A organisation can capture benefits from redesigned processes/shared services while integrating processes, and building a strategic platform of new processes without negatively impacting financial performance. Therefore, while planning, the merged entity should consider options available and select those that will enable the organisation to perform effectively.

Integration is not conceptually difficult, but it requires a ruthless focus on execution, appropriate cadence, and an ability to avoid being overwhelmed by the enormity of the effort.

Critical factors for merger success may be grouped into three categories: clarity of purpose, control and people, as are depicted in the figure below.

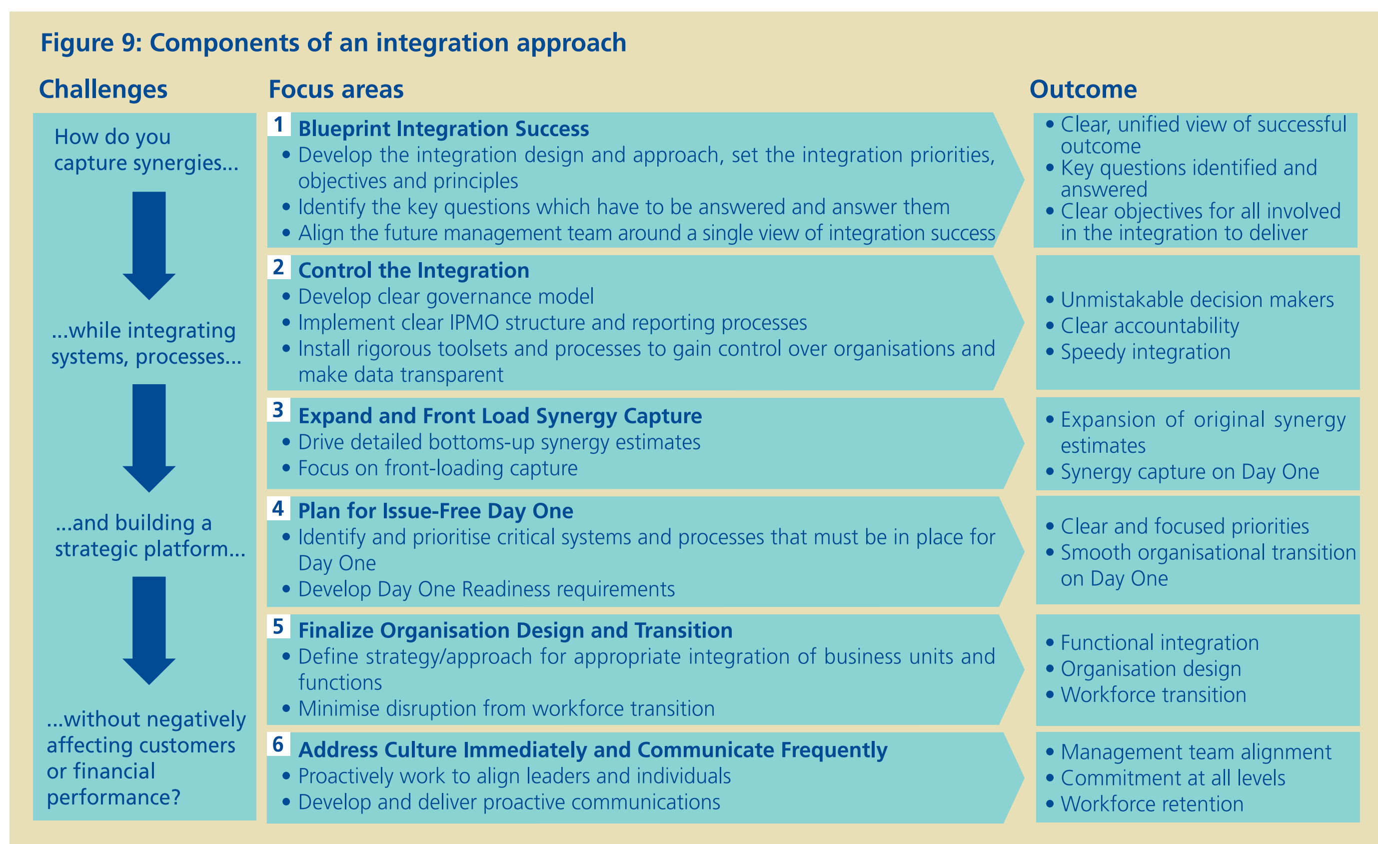
Figure 8: Critical success factors for successful merger integration

Clarity of purpose	Control	Managing people
• Build a clear understanding of the rationale for the merger (full integration, stand-alone) across all areas of the business • Define clearly the vision for the integrated organisation for Day 1 • Select strong leaders to sponsor and manage the program • Build the "blueprint" for the acquisition as early as possible • Define and implement the top-level organisation structure as soon as possible • Identify the sources of synergy benefit and drive to achieve them as quickly as possible	• Don't let the program divert attention from managing day-to-day operations • Allocate your best resources to manage the program • Give careful consideration to the appointment of an Integration Director • Implement robust planning and program management processes • Make planning and reporting frameworks as practical as possible • Tackle risks and issues quickly and make the tough decisions early • Track benefits rigorously and ensure only one set of numbers	• Recognise that mergers increase uncertainty and ambiguity for employees on both sides • Remove uncertainty and ambiguity by implementing the new organisational design as quickly as possible • Prepare the HR team early on and ensure it is skilled and fully resourced • Identify and recognise cultural differences at an early stage and take the best from both organisations • Plan for change at all levels • Implement best in class communications

5.1.2 The overall integration approach

The overall integration approach involves pre-close planning and post-merger integration efforts. An integration approach for consideration can be broken down as follows:

- blueprinting success;
- controlling the integration;
- expanding and front loading synergy capture;
- planning for issue-free Day One;
- finalising the organisation design and transition;
- addressing people and culture issues immediately and communicate frequently.



Phase 1: Blueprint integration success

This phase lays the groundwork for the integration, provides clarity and the maximum amount of direction, which can be set from the small number of people responsible for creating a deal before a much larger number of people become involved in implementing the deal and trying to make it work.

The key is to identify the important questions that will set the direction for the merger and then answer as many as possible, whilst identifying how the balance will be answered.

The questions typically include:

- Why are the companies merging, and what is the vision for the new organisation?
- What will integration success look like and how would it be measured?
- To what degree are the companies merging/staying apart, i.e., status quo versus seeking best of both?
- What are the key milestones that have to be met, either set internally or externally?

- What principles are going to be adopted in order to manage the integration and how will these be communicated?
- What is the integration program structure and who will take the key roles in the integration, i.e., degree of central control versus delegated responsibility?
- What are the "must be" answered questions for the short and medium-term?

Choosing the integration approach

As part of defining the blueprint, it is vital to select a specific integration approach and define how it will apply to your situation. There are three different integration approaches, which are summarised in Table 16 below:

Table 16: Types of integration approaches

Integration approaches	Status quo	Take-over/ Reverse take-over	Best of both
Description	Merger or acquisition with minimal integration, perhaps only for financial reporting purposes	Outright acquisition and integration of target into buyer	Merger or acquisition focused on integrating best people, processes, products/services, and technology of both companies
Level of integration	Low	Medium	High
Level of synergy potential	Low	Medium	High
Level of risk to be managed	Medium	High	High
Pros	• Fast and limits debate • Strengths of both organisations are retained • Minimal interruption to each business • Limited resources required for integration	• May be able to incorporate a significant portion of the strengths of the acquired • Effective at capturing near term synergies • Effective at gaining upside	• Combined company benefits and supports consensus building • Allows identity of acquired company to remain visible in new company • Generates feeling of worth among acquired employees • Maximises synergy retention
Cons	• Limits cost synergy capture • Limits interchange of culture and skills • Requires coordination processes for overlapping, market facing areas • Worst practices of both companies are retained • Limits revenue synergy potential	• Potential risk in losing acquired capabilities and customers • Potentially alienates acquired employees and reduces productivity	• Time-intensive – must make key integration decisions quickly • Risks in choosing lowest common denominator rather than best practices • Best from both can be hard to define – "Best" accounting system may not work with the "Best" billing system which may not work with the "Best" customer management system

In reality most integrations are a mixture of these, depending on which part of the business and how value will be created. Successful integrations are clear about these from the start.

Executive alignment

One very important and deliberate side effect of going through the process of creating a blueprint is the development of executive alignment around the key elements of the integration.

In creating a deal, the leaders have to move very quickly and let each other focus on their respective roles and responsibilities. For this reason slightly different views get developed. Combining this with the range of views for the new leaders from the target organisation increases the disparity. It is vitally important that, before the number of people involved in the integration process increases, a single common view be developed and documented, for the avoidance of doubt. This then becomes the platform from which all other aspects of the integration will flow and will guide items such as:

- internal and external communications;
- defining the benefits and setting objectives for line managers and integration managers;
- the new organisation design and the composite roles and responsibilities;
- prize tracking;
- transition.

In total, the blueprinting process sets the framework and context for the integration in five main phases. These phases are discussed in more detail below:

- Control;
- Synergy capture;
- Day One;
- Migration to the future organisation structure; and
- Communications and culture.

Phase 2: Control the integration

This phase lays out the mechanisms for controlling and managing the integration, critical to the delivery of a merger integration. The outcome from this phase will generally include a project team and a roadmap.

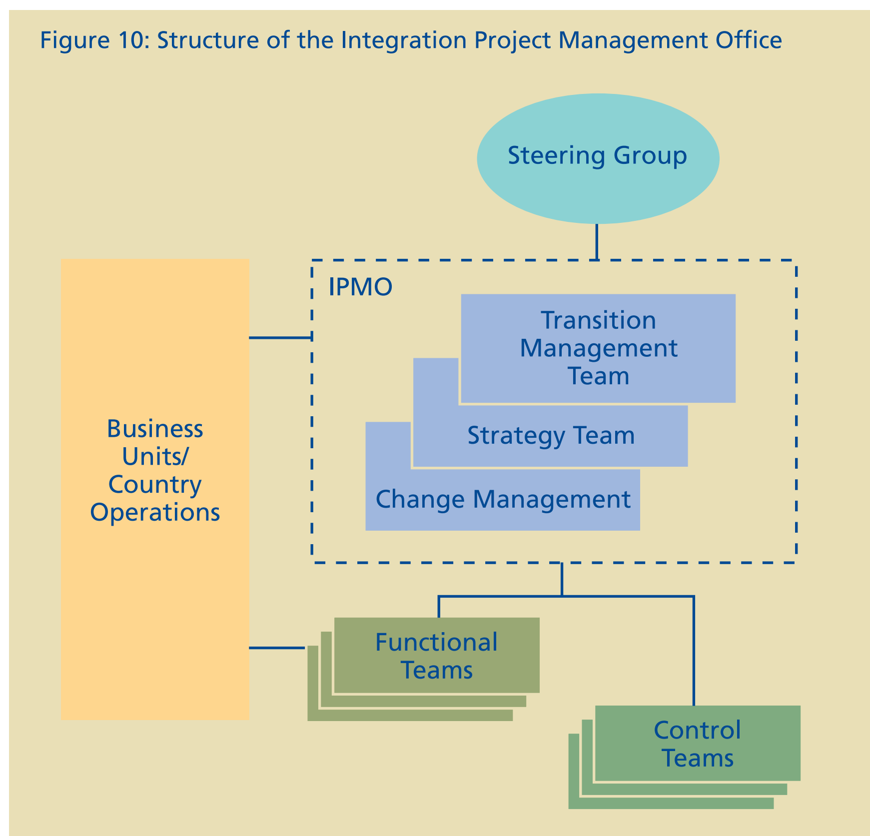
After a company has analysed the options and the needs of the organisation and it has decided upon the integration strategy, management should define a program management structure to coordinate the entire integration effort.

Effective program management is a critical success factor for any project, but it is particularly relevant in complex projects such as merger integration initiatives. Project management ensures that the direction and project objectives are met, and that potential deviations from the objectives are identified and resolved at the earliest possible time.

Setting up the Integration Program Management Office (IPMO)

The program management structure generally includes a steering committee, a full-time Integration Director, an integration project management office, a set of integration project teams, functional teams and control teams. The steering committee sets the overall strategic direction of the project and guides the work of the Integration Director. The Integration Director, supported by the IPMO, is the heart of the project. The IPMO coordinates the work of various project teams. Each project team will be accountable and responsible for a stream of work across the organisation, such as transition management, strategy development, and change management. Functional teams focus on functional related matters and value delivery while the control teams focus on internal controls and compliance issues.

Figure 10: Structure of the Integration Project Management Office



Determining the level of governance

After the integration roles and project organisation structure is defined, the new company should determine the level of control each decision-maker who is involved should have and what type of decisions can be made by different levels of staff.

In particular, a company that is in the process of integration should consider the following in determining the level of governance for the project team.

- What are the level of executive sponsorship and the level of authority of the Integration Director?
- Will the organisation comply with IPMO standards (e.g., processes and tools)?
- Who owns the scope of the integration?
- Does the culture support compliance with the defined "integration scope control guidelines"?
- Who is typically accountable for managing the program budget?
- Who is responsible for tracking benefits and costs of the merger?
- Who is accountable for the realisation of benefits in the merged entity?
- Are decisions typically made rapidly in either/both of the acquirer and target organisations?
- Are decisions frequently revisited in either/both of these organisations?
- Who is responsible for setting the principles that will be applied in the integration and what are these principles?

Case study: M&A integration planning and program management

A US-based and world leader in medical devices had to prepare both internally and externally for a global merger.

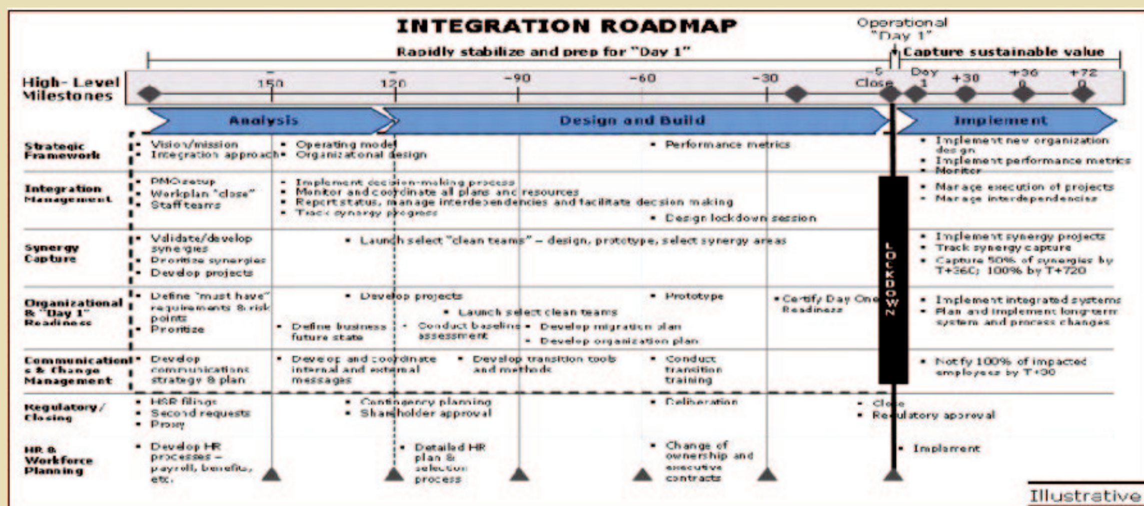
Regional teams were formed to plan and execute tasks to manage internal organisational, processes and systems changes for both companies following global strategies and guidelines. The planned integration date posed a tight schedule for the teams and delays in obtaining official approvals from the US and Europe imposed challenges in managing external events and employee expectations.

To facilitate integration planning and manage challenges, key representatives from the two companies involved in China were brought together for the initial identification of integration tasks. Departments involved included Sales, Marketing, Supply Chain (Customer Service), Finance, Legal, Medical Affairs, Public Relations, Information Management and Human Resources. A dedicated Program Management Office in China was also established to monitor internal and external progress and issues resolution, and to facilitate communication among local parties.

Creating an integration roadmap

With an integration strategy and a project management team in place, the management team of the new organisation should generally be ready to complete a high-level integration roadmap (see Figure 11 for an example). An integration roadmap in essence is a high-level project plan. It has the major milestones defined for each major stream of work and deadlines for each phase of the work. The lockdown date refers to the first day after the integration occurs (Day One). Integration does not only require significant preparation pre-closing, it also requires significant support after the official merger date.

Figure 11: Sample integration roadmap



Lessons learned in China

- Have sufficient governance in place. China has a particular working culture, employees expect specific direction so having the right governance and roles and responsibilities will improve efficiency
- Build a commercial integration plan, then be prepared to review and optimise it from a tax perspective
- Suppliers, customers (and staff) may not be familiar with M&A and integrations – take time and effort to assure and engage them (even though the main initial message may be that they should continue doing exactly the same thing as before)
- Develop and adopt a systematic way of prioritising initiatives
- Responsive decision making enables the integration initiative to keep moving
- It is important to establish small, full-time teams to manage the integration process; clear governance provides fairness and clarity
- Integration teams require a sufficient amount of resources with adequate "cover" for their ongoing responsibilities
- Integration teams must be staffed appropriately; make sure that the right people are represented from both organisations

Phase 3: Expand and front load the synergy capture

The third phase of the project aims to explore and capture key synergy opportunities across the to-be integrated organisation. Synergy capturing should perferably be analysed early in the integration process to build momentum and credibility amongst employees, investors and analysts.

Examples of cost saving synergies

- Operations materials savings

  Company A's Strategic Sourcing Initiative provided Company B with lower materials costs resulting in US$11 million in savings over four years
- Finance headcount reductions

  The combination of two companies resulted in redundancies within the finance department so that multiple positions could be eliminated. Savings realised totalled US$8.4 million

Identifying synergy opportunities

To identify successful synergy opportunities, the integration team should clearly understand the existing business market of both the target and buyer. The teams may find it helpful to review the due diligence report, and conduct any additional interviews if necessary. With the guidelines presented in the sections above, the team should be able to identify a set of potential revenue enhancing and cost-saving synergy opportunities, and then allocate necessary funding to achieve them.

Synergies can be identified by function or across functions. Good examples of this include supply chain management and customer relationship management (CRM). Table 17 summarises potential synergy opportunities across key functions in an organisation.

Table 17: Synergy opportunities in various organisation functions and areas

Functions	Opportunities
Supply Chain Management	Reduce COGS through scale and consolidation efficiencies
Information Technology	Reduce IT costs by consolidating systems and leveraging them over larger business base
Customer Relationship Management (CRM)	Strengthen customer relationships with breadth of offerings and improved channel positioning
Finance & Administration	Reduce Finance and Administrative costs by leveraging resources over larger business base
Product Development	Create end-to-end product and service solutions
Tax	Tax savings from transaction and resulting enterprise structure
Human Capital	Reduce HR costs by integrating and streamlining HR processes
Valuation	Constantly monitor and adjust valuation
Corporate Real Estate	Realise both quick cost reductions and longer-term optimisation strategies when integrating the corporate real estates of both companies

Capturing synergies

Once synergy opportunities are identified, a "prioritisation exercise" should be performed with the initial focus on the high-value, quick hit projects because these generate the greatest momentum. For each individual synergy-capturing project, the integration team should develop a plan with detailed tasks, milestones, dates and accountability so that expected results can be monitored and achieved.

Key lessons learned in China

- Overall synergy realisation will be the accountability of the Integration Director
- To be positioned for synergy capture success, each validated synergy must be assigned to a specific owner. It will be the responsibility of each synergy owner to deliver the benefits associated with the synergy opportunity
- The Integration Director is responsible for identifying synergy targets for the overall effort as well as assigning targets for each functional area
- In China, assigning ownership and accountability is particularly important. Identifying the key performance indicators (KPI) and timelines will ensure initiatives stay on track and in budget
- Local managers may not have been targeted on EBITDA, or cash, or efficient use of capital, let alone ROI or ROCE. Education may be required to train managers on what is important to a company, and their role in delivering it

Phase 4: Day One readiness

The fourth phase of the integration process aims for a successful Day One by identifying and managing risk, managing the links and dependencies between projects, and synchronising critical systems and processes.

Day One is the first day that the acquirer has ownership and control of the target, and is the first day that the acquirer and the target officially becomes one organisation. In order to have a Day One transition that is smooth without disruption to business operations, management of the new organisation may consider the following four points:

- **Key risks:** this involves identifying what is legally required, required by the regulator, commercially critical or desirable in order to ensure that plans are put in place to address them and manage risk.
- **Identify key requirements:** this involves defining key requirements for customers, suppliers and employees, and developing the proposed projects that will meet those requirements.
- **Prioritise:** this entails identifying "must haves", "should haves", and "nice to haves".
- **Design & execute:** this involves identifying the project leaders, key activates, and timeline for all Day One projects, planning and agreeing the interdependencies and developing implementation solutions.

In general, the IPMO and/or functional teams will need to prioritise the necessary activities. All "absolutely must have" items and other activities that will result in significant benefits to the merged organisation are given a priority as Day One items. Activities that cannot be completed within the Day One window will be planned as scope for the second milestone date. The third and final milestone date is considered the company's End-state, the stabilising point for the integrated organisation.

It is important to note that the IPMO is responsible to draft the Day One requirements for each of the functional groups for approval by the Steering Committee. Any cross functional Day One requirements will also need to be taken into consideration. Table 18 summarises several "must have" considerations to prepare for Day One operations. These examples are categorised into finance, legal, customers, suppliers, and employees.

The requirements in Table 18 can be further broken down by function. Depending on the line of business, functional teams may include:

- **Information Management –** This function deals with systems integration, data centre and help desk consolidation, targeting both Day One readiness and efficiency improvements;
- **Human Resource –** This function deals with the integration of HR-related processes including organisation design, benefits, salaries, retention, training and recruitment;
- **Finance –** This function deals with the integration of financial-related processes, including accounting, tax, budgeting and planning;
- **Supply Chain –** This function deals with the integration of supply chain related components including procurement, logistics, warehousing, and manufacturing. It ensures that products are delivered to customers;
- **Communications –** This group of professionals should handle all the communication-related activities across all the functional areas. It will also deliver change leadership guidance throughout the entire process.

Table 18: Guidelines to achieve Day One requirements

Functions	Activities
Finance	• Corporate insurances in place, including officer insurance • Reporting capability in place, covering management reporting, risk reporting, relevant accounting jurisdiction, treasury, tax and others • Delegation of authorities in place
Legal	• Boards resigned and reappointed • Contracts novated/cancelled/replaced • Regulatory approvals received and documented • Confirmation conditions precedent completed
Customers/Sales	• Rationalised customer definition with integrated customer data and teams • Cross-sell playbooks developed for account teams to enhance cross-selling opportunities • Strategy to rationalise and strengthen partner program • Identify specific areas in both companies to improve customer satisfaction and decrease churn • Existing program terms and pricing policy overlaps/conflicts identified and documented
Affiliates/Partners/ Suppliers	• Completed strategy to address technology migration path issues for affiliates and partners • Redefined Customer Care, Billing and other support arrangements with all affiliates as needed • Branding/marketing strategy and required supporting collateral for use by affiliates • Contract strategy for pending or impaired contracts, e.g., renegotiation, termination, status-quo
Employees/HR	• Retention of critical employees across all areas • Motivated workforce who individually understand their role in the new company • Workforce transition and relocation programs determined and completed for affected people

Phase 5: Finalise target integrated organisation design and manage transition

The fifth phase is to finalise the target organisation design and processes, and manage the transition. The challenge in designing a new structure is in adopting best practices and valuable contributions of both organisations combined with a management agreement on how to implement them. The new organisation design will meet the organisation's day-to-day business objectives, as well as position the new integrated organisation for future success. Many elements of this phase are covered as part of the HR and communication functions.

An approach to finalise the target organisation design includes:

- **Define strategy and vision:** entails clearly defining the functions, target culture, leadership roles and responsibilities.
- **Define structure:** involves developing a detailed plan of the new organisation and its functions, including defining a reporting chain and realigning jobs and responsibilities.
- **Develop a detailed design of the new organisation:** involves developing a detailed functional organisation design, making sure that the right people are in place, and establish a transition program to the new organisation.
- **Develop a transition plan:** includes preparing a budget, establishing processes to continuously align systems and processes, and quantifying synergies.
- **Launch implementations.**

Lessons learned

- Reporting lines may not have worked the same way in a local company as in the acquirer. Significant coaching and management development may be required to make the new structure work
- Legacy relationships may have more importance and be harder to change than official reporting lines
- Influence can be exerted by people who have left the business, so exit strategies should incorporate local understanding and sensitivities
- Fundamental changes must be made to processes to reduce real workload
- Develop and apply an "objective" method to evaluate competing business units and systems
- Adopt best practices among merging entities to bring out merger synergies
- Best practice and benchmark data solidifies the need to change and supports the recommendations of integration teams
- Centralisation and standardisation need to be quantitatively justified
- Focus process change efforts on the "biggest bang" for the buck. Align organisation roles and responsibilities
- Develop senior level organisation structure to establish clear ownership of synergy capture
- Establish clear roles and responsibilities for senior management
- Avoid "lame duck" positions – this is catastrophic for building strong organisational buy-in

Phase 6: Address culture issues and communicate

Communications and culture are two intrinsically linked management issues and as such, they need to be planned together. Addressing the communications needs of employees through each phase of the integration from the onset of the official merger announcement can help address potential culture issues and humanise the merger. Poor attention to communications and insufficient focus on addressing culture can be very damaging to the integration.

Table 19: Examples of merger issues

Issue	Merger integration results
Management disagreement over control and differences between culture deemed too difficult to effectively overcome	Deal cancelled
Clash over culture and management control	Divestiture of the acquired company
Stiff imposition of management control over the acquired company and integrating new multinational workforce with distinct cultures	Departure of key managers

Communications is one of the most difficult aspects of merger integration and is especially the case with Chinese companies. Their management styles, culture, priorities and mindsets may differ from companies in developed economies and management decisions may not be communicated across an organisation.

Designing a change management and communications strategy that takes into consideration the culture of the target company and the differences is important in an M&A exercise. A well-developed strategy will help minimise the integration risk while creating an adaptive operating style for the long-term.

Identifying and addressing an organisation culture

There are four steps to gaining an understanding of the culture of the acquired organisation and developing a plan to address it.

- **Understand the target's current operating style.** This can be achieved by administering a culture diagnosis, conducting interviews and analysing results with leadership involvement.
- **Determine the future operating style of the merged organisation.** It is beneficial for senior management in the merged organisation to conduct an end-state workshop to identify the long term strategic organisation culture and business objectives, and conduct an operating gap assessment.
- **Develop a plan to narrow gap.** A change management plan that involves communications and initiatives should be developed to ensure that key objectives and the intended culture can be obtained. The new organisation should select leaders, which may or may not be managers, who are influential within the organisation and obtain their buy-in to start the culture and strategy alignment process.
- **Implement solutions and monitor progress.** Prior to commencing operations integration, it is beneficial to communicate the vision and strategy of the new organisation to all employees according to the change management plan. Broadly communicating the changes taking place will help to alleviate concerns and set appropriate expectations. It also ensures that all levels of the organisation get the same unfiltered message.

The objective is to take an approach where the acquirer gains an understanding of the culture of the target organisation, identifies potential challenges early on, and develop a change management plan for the merged organisation to address the issues and align visions and expectations at the beginning of the integration effort. Proper monitoring of progress will enable management to make adjustments to the integration and address issues detected early on.

Managing stakeholders through effective communications

Different messages are required for different stakeholders of the acquirer and target organisation. By developing separate messages and delivery formats (e.g., open forum meeting, official letter, memo, e-mail, newsletter and media), effective communications can be achieved. Key stakeholders of the acquirer and the target company may include:

- customers;
- internal staff;
- sales prospects;
- alliance partners and service providers;
- business forums and media; and
- regulatory bodies.

Critical success factors should be considered when integrating operations after a merger. The following highlights several related to communications.

- **Communicate early and often**

  It is nearly impossible to over-communicate during a merger or acquisition. Constant communication – even if it is a repetition of the same message – prevents uncertainty.

- **Communicate openly and honestly**

  Tell employees as much as possible, even if it means saying, "I don't know" or "We are still looking in to that."

- **Communicate consistently, both internally and externally**

  Employees will compare notes. Make sure that everyone is receiving the same message to create trust. Employees will also listen to the media. Public messages should not be different from internal messages. This means delivering the tough messages to the staff at the same time as the "good" messages to shareholders.

- **Communicate proactively**

  Telling people that things are not changing is still valuable communication. It is important to deliver the right message to employees.

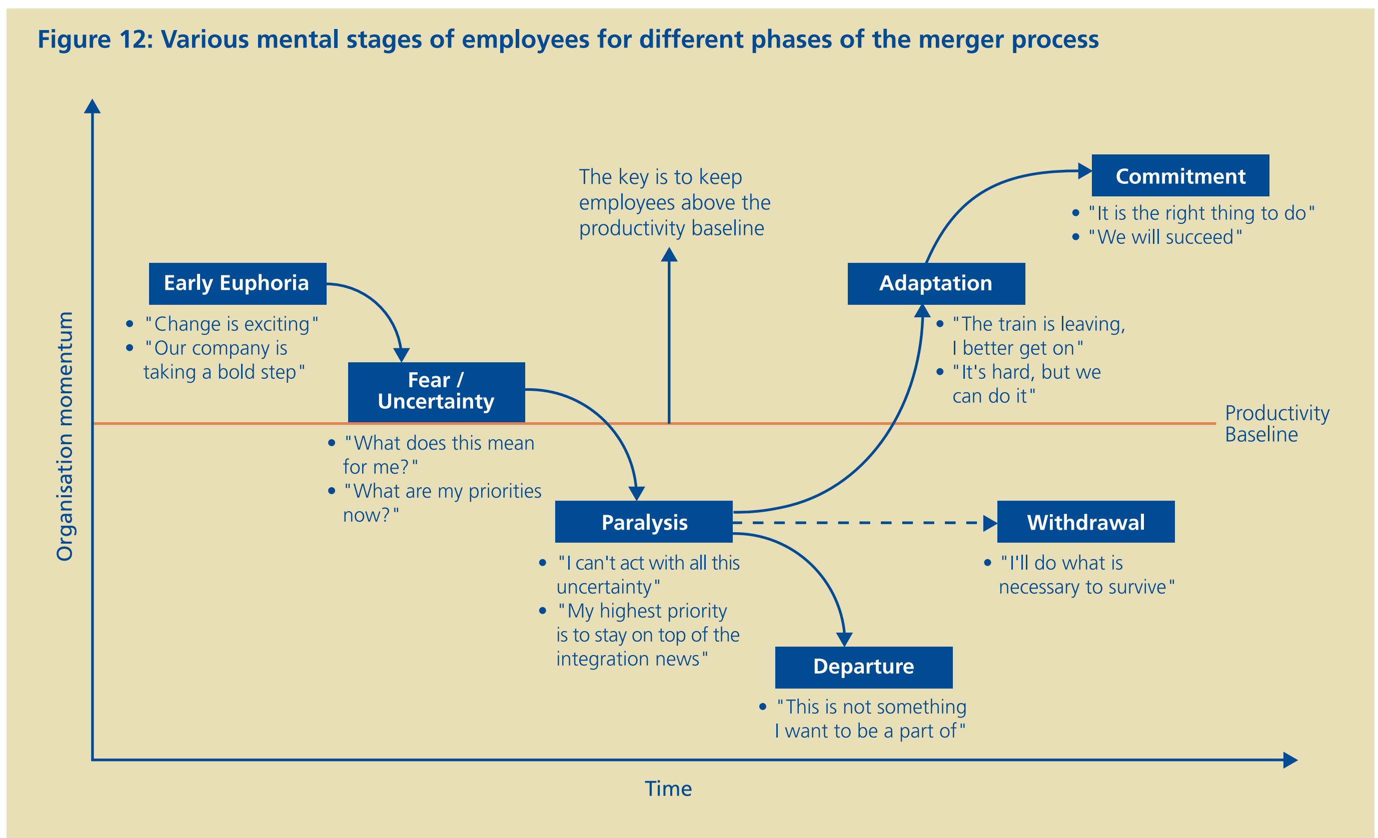
- **Communicate face-to-face**

  Employees are more open and receptive to face-to-face communications. Face-to-face communication provides the opportunity for immediate feedback from employees which can be used to tailor future messages. This also sets the tone for how important the integration is to senior management.

Delivering the message

Understanding the various mental stages that an employee goes through over the course of the merger process will help identify the type and timing of communications. In China, employees often go through a large set of emotions, both productive and unproductive over the course of the integration process. Figure 12 illustrates communication mechanisms for each set of emotions to manage productivity.

Figure 12: Various mental stages of employees for different phases of the merger process



Executing a communications plan

Different phases of the merger integration process have different communications needs. A communications plan that is well-developed will outline the key tasks and delivery mechanisms to be performed at each stage. Table 20 provides a summary of the main communication tasks in a communications plan for each phase of integration.

Table 20: Key tasks in a communications plan

Integration phase	Main tasks
Integration kick-off	Charter team and develop plans for communication during integration
Signing day	Announce merger to external and internal audiences through a range of delivery mechanisms Develop talking points for employee, customer and suppliers to ensure the message delivered is consistent
Transition	Update external and internal audiences on the progress of the integration, using appropriate written and face-to-face communications channels and activities
Day One	Announce closing of merger and celebrate the combined company. Key mechanisms may include press releases, a welcome package, “Fast Start” manager workshops, a short-term operating manual and a help desk

Lessons learned for communication and change in China

- Pay particular attention to managing change with core functions in China, specifically sales & marketing, supply chain, and finance & administration
- Identify critical talent employees early in the M&A process. Communicate to them early and often as they will have many other employment opportunities in China throughout the integration process
- Cultural incompatibility can stop a merger - even one with sound economics
- Clear communication and a sound, structured decision-making infrastructure will provide the foundation for every change initiative within the merger integration process
- It is the people in the company who make the integration successful
- If the core elements of leadership, workforce, process, and technology do not adapt and reinforce each other throughout the merger process, the new organisation will not function effectively

Case study

A Korean tire-manufacturing joint venture in China was facing low staff morale due to cultural differences in management styles and inefficiencies in operations. The company engaged external professionals to diagnose people issues via employee surveys, leadership interviews, and employee focus group meetings.

Nine key areas were found as barriers to organisational changes, and five individual task forces were formed to design and implement a change management plan. These areas included performance measurement, leadership, talent management, culture and communication.

The project focused on analysing and managing complexities relating to cultural differences. In implementing the change management plan, different language skills and cultural sensitivities were recognised which provided the local HR function knowledge that was valuable to a foreign company.

5.2 Finance and administration integration

In a merger, the finance function creates value by partnering with business units and provides leadership throughout the process so that the new organisation can realise value. The challenge is in capturing the benefits from integration without negatively impacting financial performance. Integrating finance functions could involve redesigning and/or integrating processes, implementing shared services, and building a strategic platform of new processes.

5.2.1 Redesigning financial management and budgeting processes

One of the key tasks of the finance function is to reorganise the financial management and budgeting processes. A successful M&A should fully integrate and standardise processes to capture performance improvements (e.g., consolidating corporate and overlapping business unit finance and accounting functions) and synergies (e.g., identifying cost reduction synergies, like reducing finance costs by leveraging resources over a larger business base).

In redesigning or implementing new financial management and budgeting processes to realise integration benefits, the merged organisation should consider conducting a process redesign exercise which entails documenting, analysing and redesigning the current processes. Proper program management, communications planning and change management should be conducted so that the value from improvements and synergies are captured.

Financial planning and budgeting are generally built upon financial accounting information, with few operational and revenue performance indicators. Rarely will planning be tied to non-financial targets. The top-down approach is the most common management style and budgeting method, and integration efforts in these instances are less complex. For companies that have very advanced financial planning and budgeting models or have adopted a bottom-up or mixed mode budgeting approach, the integration effort will be more challenging, especially if the target is not familiar with these methods. In a bottom-up approach, managers, supervisors and front line sales will be required to submit their own plans as they are more familiar with the market and operations. Where a target company is to integrate into an organisation using this approach, significant efforts will be required to educate staff.

Having the senior management buy-in from the acquisition target is often required before financial and accounting processes can be reviewed. Once this is achieved, middle management will need to be educated on the integration process and participate in the redesign exercise.

5.2.2 Re-engineering financial, accounting, and tax-related processes

Financial business process re-engineering (BPR) is to re-engineer financial, accounting, and tax related processes (e.g., sales to accounts receivable cycle, purchases to accounts payable cycle, investment to fixed assets cycle, book-closing cycle, tax compliance process) for the new company. The process for re-engineering entails documenting, analysing and redesigning the current processes.

The business benefits resulting from BPR may include:

- re-engineering (automating and/or streamlining) processes for better efficiency;
- re-evaluating control and checking control against the risks being mitigated;
- increasing the authority of staff/officers/managers to match their level of competency;
- identifying and removing overlapped and unclear responsibilities;
- exploring areas for potential shared services and outsourcing opportunities.

Key considerations for conducting a financial BPR effort in China

Several key considerations should be taken into consideration when integrating the finance function of an acquired organisation. These include but are not limited to the following:

- The financial processes should be able to handle multiple GAAP reporting requirements and tax reporting requirements
- Integrated accounting systems should support multi-byte language, chart of accounts should be consolidated and standardised, and financial systems of the target company should interface with the acquirer's systems. The PRC requires all accounting systems to be certified
- If the target is a small company with simple financial processes, extensive training and change management will be needed
- If significant automation of previously manual processes is expected, there may be a need to re-deploy resources or handle redundancies
- In all BPR projects, proper change management (beyond training) by people who speak the language and understand the different corporate cultures is essential

5.2.3 Financial shared services

Shared services centres are a popular model adopted in the re-engineering of finance functions to reduce costs. Implementing a finance, accounting and tax shared services centre generally involves:

- formulating a solid business case for a shared services centre;
- designing the integrated finance organisation;
- identifying financial, accounting and tax-related processes and those that will be provided by the shared services centre;
- designing, standardising and improving financial, accounting, and tax-related processes; and
- developing the implementation plan.

The business benefits derived from having a finance, accounting, and tax shared services centre generally include:

- an increase in efficiency and better management controls through process standardisation;
- cost savings through economies of scale in operations;
- the ability to improve and maintain consistent service levels; and
- improved accuracy and timeliness of reporting through centralised information access.

Key considerations for setting up shared finance functions in China

In addition to the considerations for financial BPR, setting up a finance shared services centre in China should include:

- A thorough review of the overall legal and regulatory requirements. Certain practices and conditions taken for granted elsewhere may not be practicable in China, for example, there may be limitations on the use of electronic supporting documents and tax implications on cross-entity billing
- Location selection. Conditions vary significantly across China even among large cities. Selecting the most suitable location to host a shared services centre is therefore important to the realisation of benefits. The criteria used to evaluate potential locations should include:
  - the availability of the workforce in terms of affordability and stability of skilled labour (e.g., technical and multi-language capabilities)
  - infrastructure support
  - the cost, availability and quality of suitable real estate
  - the provincial legal and regulatory environment, such as the level of simplicity and transparency, and any local government tax rebate or benefits, and
  - the cost of operations
- An understanding that requirements and tax benefits for each location are not cast in stone. A company should be prepared to negotiate specific arrangements for its operations

5.2.4 Executing the financial integration plan

Integrating the financial organisation of an acquired company will require time. A long-term strategy for the one to two years following the acquisition should be put in place to ensure that the end-state of the merged organisation is world-class. Table 21 is an example of a financial integration roadmap.

Table 21: Sample financial integration roadmap

Strategy	Day One	2nd Milestone	End-state
People	• One identified leader with single function accountability	• One identified leader with single function accountability • Consolidated management team	• One identified leader with single function accountability • Consolidated organisation
Process	• Aligned processes, policies and procedures	• Streamlined processes, policies and procedures in concert with organisational change	• Integrated best practice processes, policies and procedures in concert with organisation consolidation and system simplification
Technology	• Parallel transaction and supporting systems • System migration plan in place	• "Adopt and Go" migration and implementation for selected systems • Rapid progress toward full system integration	• Common, integrated and simplified systems
Synergies	• Synergy targets and required projects identified at the functional accountability level	• Synergies targets being aggressively delivered at or before project milestone	• Synergies met or exceeded • Continuous improvement capability enabled

5.2.5 Engaging external service providers

It is beneficial when implementing shared services to engage external service providers to assist with the initiative. Establishing shared services centres is a complex and time consuming process requiring a significant amount of resources and skills. As the process involves changing the way employees currently perform their duties, external service providers are perceived to bring objectivity to the project. They serve as a temporary resource and their experience in local requirements and culture, proprietary tools and knowledge base are generally valuable.

5.3 Human Resources integration

Addressing human resource issues is critical to the overall success of a merger. People challenges are frequently under-emphasised and must be addressed early on in the integration process. Nearly half of unsuccessful M&A deals are unable to achieve the anticipated value due to people issues. As a crucial determinant for the success of integration efforts, it warrants significant attention before, during and after the deal transaction. The HR team is typically one of the first to become overloaded with work if insufficiently resourced from the beginning.

The objectives of the human resources team are to retain and attract the best employees, and ensure cost effectiveness by leveraging business processes, technology and partnerships to manage HR-related costs.

5.3.1 Guiding principles for HR merger integration

A typical HR integration will involve five major areas: organisation design; employee compensation; employee compliance; retention of key talent; and severance and redundancy.

- Organisational design and development

  The IPMO and HR integration team should work closely to identify the criteria and principles for the merged organisation design, and establish an organisation accordingly. Ideally, the design principles must be identified as soon as possible after completion of due diligence, and the top two levels and divisional Management Committee should be completed within 30 days after the signing of the Sales & Purchase Agreement.

  An assessment of the target company culture should be conducted prior to deal closing. Every effort should be made to identify potential cultural integration barriers, and a plan to achieve cultural alignment should be part of the integration process.

- Employee compensation and selection

  Part of the HR integration effort is to make decisions regarding employee compensation and employee selection for the newly integrated organisation. The new combined organisation should be staffed with the best talent available from either the target organisation or the acquirer. In international integration efforts, local legal employment laws and practices should be reviewed as they may influence the staffing and selection process and selection criteria. In addition, severance payments and lay-off arrangements will need to be considered carefully.

  Generally, the target company will convert to the HR policies and practices of the acquirer. This includes benefits, compensation, pensions, employee policies and applying the same Human Resource Information System (HRIS) within 100 days after deal closing. A short-term strategy should be developed to receive and track employee data if the target is using a different HRIS system and if data is not readily available.

- Employee compliance

  To achieve employee compliance, the HR team should define corporate ethics, security, and anti-trust compliance rules for the new organisation. Intellectual property (IP) protection and compliance will be a major concern for foreign companies investing in China. A communications program should be in place by Day One so that all target employees have a clear understanding of the corporate compliance standards early on.

- Retaining key talent

  Key talent from the target must be identified in the early stages of the M&A process, preferably during due diligence or as soon as possible after the signing of the Term Sheet. It is customary to request the target to have agreements in place to retain key talent for a defined period, typically for at least six months to one year. A broader use of retention incentives can also be applied, and may take the form of individual incentives based on individual talent and attrition risk, or a group incentive linked to performance to support the integration effort.

- Redundancy and severance

  With any integration, inevitably there will be redundancies in the organisation. These redundancies need to be handled with care, as it is an extremely sensitive topic. Assessments should be conducted to ensure the right staff is retained, and a program should be in place to provide new opportunities for redundant staff. For staff that is made redundant, appropriate severance packages must be provided in accordance with local regulations. It is often invaluable to compile a headcount baseline on closure of the deal to understand who is in the business and which function is responsible for them, and against which to track changes through the integration.

While performing the HR integration, the work team should bear in mind the key objectives of the exercise is to facilitate a successful merger. This may include:

- minimising the disruption to the workforce;
- supporting the other integration functions on HR issues;
- retaining critical talent;
- maintaining employee morale;
- smoothly transferring all critical HR functions;
- integrating HR policies quickly;
- fully migrating the acquired company into HR enabling systems at the close of the deal; and
- enabling business to continue and grow.

Case study

Properly developed transition plans encompassing HR and financial integration can result in substantial financial rewards. Two major pharmaceutical companies achieved merger headcount and synergy targets while delivering financial commitments with a 60 percent appreciation in share price.

5.3.2 Executing HR integration

A suggested approach to executing an HR integration plan is to involve the right people early in the process, and have the appropriate change management and communication mechanisms in place to support initiatives.

The key steps a buyer should take to address the HR issues in a merger are:

- Define a long-term HR strategy for the new organisation. This includes a talent management strategy and a plan for senior executive integration.
- Define top challenges and categorise these issues into critical/high/medium/low. HR-related areas to consider are:
  - organisation design/governance;
  - total rewards – compensation and benefits;
  - labour relationships;
  - employee terms and conditions alignment;
  - human resources service delivery;
  - recruiting and staffing;
  - training;
  - performance management;
  - redundancy;
  - retention and recruitment;
  - severance policy; and
  - pensions and other retiree costs management.
- Address the challenges by taking appropriate action.
- Measure and track progress.
- Always keep employees informed and communicate regularly.

Lessons learned for merger integration and human resources in China

- One of the most formidable and longest lasting obstacles to sustainable M&A success in China is human capital integration
- The increasing M&A activity in China leads to major people issues, including the retention of key staff, development of a new reporting organisation, non-alignment of compensation structures, cost and staff reduction, and culture differences and communication problems
- Accordingly, in an M&A transaction, key barriers and obstacles must be identified, change management plan designed, talent management program implemented, and new organisation and compensation structures created
- Local expertise in these sensitive areas is limited in China, so outsourcing these services is an effective solution many multi-national companies pursue

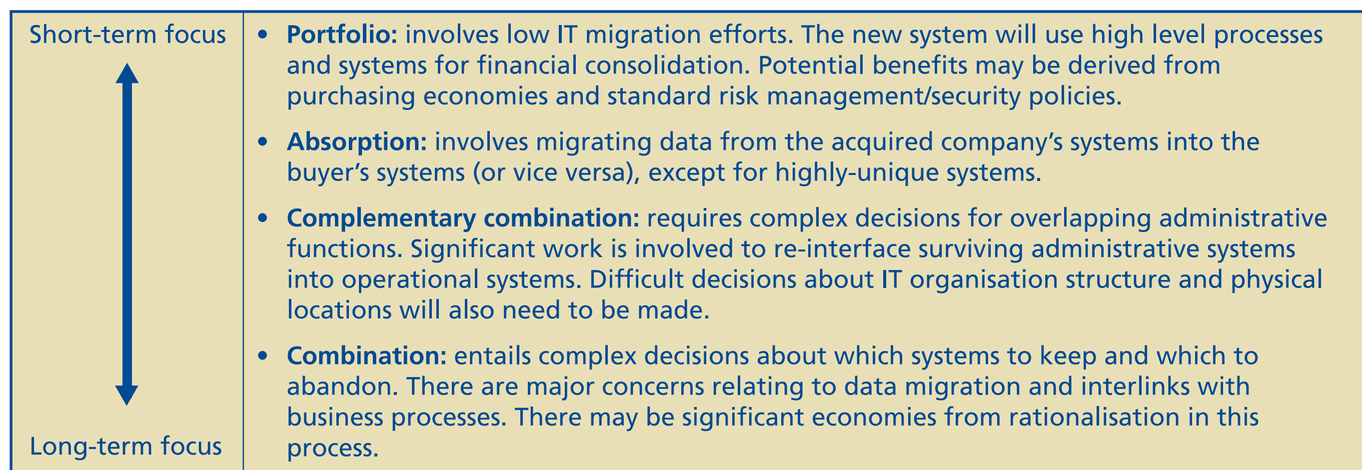
5.4 Information Technology integration

Many companies still place too little emphasis on IT in the early stages of the M&A lifecycle. This lack of early involvement can lead to lower than expected synergies and higher than expected costs to achieve integration benefits.

Information technology is critical to business operations and the vast majority of merger benefits are dependent on changes to IT systems and infrastructure during integration. For example, some process improvements will only be achieved with an enterprise resource planning (ERP) system while customer analysis is only available when the migration of a customer relationship management (CRM) system is completed. Generally, IT integration accounts for about 20 to 30 percent of the total benefits or synergies obtained in a merger. However due to the complexity involved, benefits are often slow to realise.

There are several common approaches to integrating IT systems, ranging in the level of complexity and effort required. Selecting the appropriate approach will depend on the nature of the acquired business operations and the preference of the acquirer.

Figure 13: Common approaches to integrating IT systems



5.4.1 Guiding principles for IT integration

There are several principles an acquiring company should incorporate when planning systems integration. Considering these rules-of-thumb may help to enhance the success of the effort.

- Accelerate benefit achievement
  - Perform systems changes that support Day One “must haves” regardless of whether there are concrete business benefits;
  - Optimise efforts based on the magnitude of business benefits gained per unit of effort; significant benefits can be captured through temporary or permanent bridges across systems;
  - For companies with significant operational overlap, full systems consolidation is inevitable; conduct integration deliberately with the goals of cost management, risk management, and speed to synergies in mind;
  - Assess whether hardware can be rationalised and if there are savings in support/maintenance costs.

- Manage risk and complexity
  - Maintain the balance between risks and benefits obtained;
  - Consider the new expanded business, geographic, and user scope;
  - Determine the degree of redesign that is necessary;
  - Consider the criticality of the system/application to consumers and the impact on revenue stream;
  - Consider the impact on the accuracy of management information provided internally and externally;
  - Assess the degree of interrelationship a system has with other IT and non-IT projects;
  - Evaluate the level of IT system support required by business operations.

- Don't ignore legacy systems
  - Manage linkages;
  - "Re-interfacing" will happen many times – it is a cost of doing business;
  - Strategic/major decisions can be avoided by thorough and clear front-end planning.

- Ensure the ability to run legacy systems
  - Plan for real demands over time;
  - Plan by skill types;
  - Manage total cost by optimising the speed to completion with the cost to achieve;
  - Multiple experienced vendors will be required; plan in advance so they are available as needed;
  - Warn executives of cost and complexity and possible delays to system availability.

- Consider your applications
  - Determine what applications are required to support the business process of each business segment and which application is the dominant/preferred system;
  - Determine the implications of a change in the systems on the business application and any additional costs that will be incurred in order to obtain compatibility.

- Establish an architecture that enables a faster merger/separation
  - Establish a process that enables quick response to "Day One" requirements;
  - Utilise middleware architecture to "modularise" applications, thereby reducing time commitment and risk of changing individual applications.

5.4.2 IT integration

IT merger integration is similar to other large-scale IT implementation efforts, except that it may include a rationalisation of two equally critically important applications. Typically the integration will have four phases: plan, design, build, and operate.

To facilitate the management of the project, activities related to each phase can be further categorised into different work streams. Typically, work streams will include IT merger program management, IT strategy and integration execution, and IT organisation and process integration. By detailing the activities involved with each work stream, a better picture of the scope and type of work required can be established.

In cases where two different IT strategies exist, i.e., two different ERP systems, the complexity and the potential risks associated with merging the two systems into one should be carefully assessed. In some instances, maintaining status quo for the first year may be in the best interest of the merged organisation. This will allow time to conduct a thorough analysis to determine if one of the platforms or systems, or a new system is more appropriate and in line with the IT strategy.

If a new system is required as part of the merger integration effort, implementation should occur only after the operations of the new business have stabilised. This will minimise the impact during transition. Generally, it is advisable to consider such enhancements one year after the day integration begins. It is important to consider the short and long term IT strategy of the new organisation, and plan for an approach that will maximise benefits and minimise risks.

5.4.3 Culture and communication in the IT department

The IT department in most organisations has its own cultural and professional characteristics. These features can act as a unifying force between those involved from either side of an M&A as IT people tend to “speak the same language” and approach things in similar ways.

However, when integrating IT departments from companies that use different technologies (the majority of cases), managing cultural differences becomes a challenge. Issues relating to potential job losses and resistance to change are more prevalent in these instances. Business processes and management practices can also affect the integration progress. When organisations from different sectors or different countries are merged, managing cultural gaps is a significant challenge. This is why comprehensive integration planning – especially considering HR integration, change management, and communication plans tailored for China – is vitally important for sustainable success.

Lessons learned in China

- If the integration project involves implementing a new technology or process in China, allow adequate time for retraining. Do not underestimate the change management effort
- Demand for system-skilled workers in China is very high and the turnover rate is in the vicinity of 20-25 percent
- In most cases, the companies that are being acquired in China are relatively small or are start-up operations so they may not have IT strategies. It is often unclear as to where IT fits in terms of the company strategy
- Implement a program organisation model that encourages a strong working partnership between IT and the business and proactively find out what the business is expecting from IT
- Accelerate IT scoping and planning
- Investigate creative options to complete IT-related integration activities, including migrating to the acquired company’s IT solutions, implementing outsource solutions as well as implementing new applications/packages
- Review, prioritise and rationalise all IT projects
- Keep the pressure on - maintain a consistent focus on the integration-related projects until the large majority of synergies are captured

5.5 Supply chain management

Organising and optimising a company's supply chain to continue operations from Day One will be an important part of planning. It is critical that there is an uninterrupted material flow throughout merger activities. In order to integrate quickly and minimise supply chain interruption, a supply chain process, either the one from the acquirer or the target, should be selected as the new process. Typical supply chain components that will be consolidated or rationalised include the following:

- transportation and warehouses networks;
- distribution centres;
- procurement;
- order management; and
- planning systems.

In addition to maintaining business continuity, significant savings can be obtained through the optimisation of supply chain management. A review to optimise or revamp the supply chain process in the merged organisation is generally recommended, but should only be conducted at least 100 days after Day One or closer to the end of the process.

Guiding principles for managing supply chains

- Build a world-class, integrated supply chain organisation with effective processes, operations, tools and technologies
- Drive procurement synergies across the organisation
- Minimise disruptions in the supply chain
- Support the needs of other business functions as supply chain decisions are made
- Proactively communicate the role of supply chain management (SCM) in supporting business objectives and business unit integration
- Maintain technical and operational flexibility and scalability
- Focus on rapid realisation of savings
- When merging operations, support subsidiaries throughout the integration process

5.5.1 Key areas of focus for the supply chain integration team

The supply chain functional team will focus on the following areas as part of the integration effort.

- **Strategic sourcing:** Establish optimal supply and sourcing arrangements to satisfy enterprise-wide requirements. With a China operation, this might be particularly relevant in setting up or re-enforcing a low cost sourcing centre;
- **Procurement:** Implement efficient purchasing policies, procedures and transactions while minimising transaction issues;
- **Logistics and distribution:** Effectively implement and manage processes for logistics support, planning and distribution of raw materials;
- **Supplier management:** Efficiently perform supplier management to:
  - achieve supplier performance standards and contract term compliance;
  - facilitate contract change management; and
  - enhance supplier diversity.

5.5.2 Executing supply chain integration

There are different phases to a supply chain integration work stream. Typically, for Day One operations, the team should generally try to minimise the risk by implementing the necessities to obtain an uninterrupted flow. During this phase, the team should define consistent processes, enable minimal integration, and conduct synergy design and planning for the future. The team may also want to conduct significant communications throughout this process to minimise the effect on employees.

After 100 days of operating as a merged organisation, the team can start implementing improvements to the process, and implement initiatives to realise the synergies planned earlier. Additional planning and design for further improvements should be performed. The objective is to strive for a stable and world-class supply chain management organisation.

In determining whether the supply chain integration was successful, a company should have achieved the following:

- a consolidated world-class supply base that creates innovative solutions, delivers superior results and provides a competitive advantage;
- true and effective integration of organisation, processes, systems and tools;
- exceeding integration synergy targets;
- day One requirements successfully met on-time;
- effective vendor consolidation and significant savings from sourcing; and
- new contracts and vendor relationships generating cost avoidance/cost savings.

5.6 Post-acquisition business processes and internal controls integration

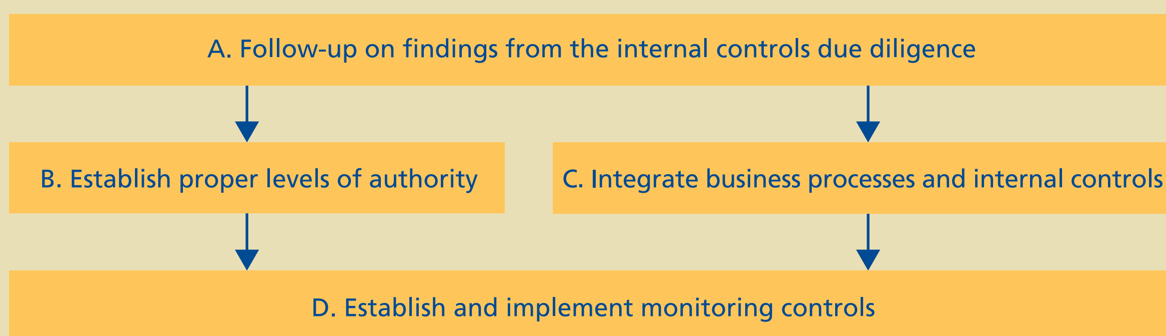
After an acquisition, the merged entity will need to roll out management and financial reporting requirements and consider whether the following three criteria are met:

- the finance and accounting team has the resources and competencies to support these requirements;
- the company has the necessary tools or technology to deliver these reports;
- the source data fed into the management and financial reports are reliable.

Equipping the company very often involves system implementation, recruitment and training activities, and reviewing business processes and internal controls in key business areas to achieve the desired reporting standards.

A transparent control mechanism is also necessary to facilitate the management of the merged entity. Having a transparent process will enable key decision makers, be it founders/owners of the acquired company or new management, to monitor progress and integration efforts.

Figure 14: Approach to establish monitoring controls



5.6.1 Improving deficiencies in internal controls

The internal controls due diligence conducted in an M&A exercise will often identify deficiencies in controls in a target organisation. During integration, these deficiencies should be addressed and prioritised so that appropriate remedial actions can be implemented in a timely and effective manner.

Issues that should generally be a priority are those that:

- concern the control environment;
- concern fraud;
- have significant impact to the reliability of financial data for management reporting, analysis and decision-making purposes; and
- have a pervasive impact to respective business areas.

Remediation may involve multiple tasks and often involve setting up new or revising existing policies and procedures, performing a business process review and re-engineering exercise, properly segregating duties and authorisation, and conducting training and workshops for employees. It may also involve significant resources and cause disruptions to daily operations. A cost-benefit analysis is therefore helpful before deciding on the corrective actions that need to occur.

Top level support is critical to effective implementation of remedial actions. Senior management involvement will help provide the appropriate messages and motivation to implement the internal control improvements. In addition, action plans should be established early on to systematically manage remedial activities. Regular status updates to all parties involved will facilitate progress monitoring.

It is often beneficial to engage external professionals to assist with remediation planning. These specialists can provide knowledge on internal controls and business practices that may be lacking. As a third party, these experienced professionals may provide a more objective view to the parties involved. Typically in M&A situations, companies will opt to engage the team that performed the internal controls due diligence.

5.6.2 Establishing proper levels of authority

As business operations, processes and policies change during a merger integration, the existing levels of authority in the company should be reviewed to align with business needs and internal control purposes. The review, which is performed from an internal control perspective, should provide recommendations to improve operational efficiency and effectiveness.

Generally, an assessment on the appropriateness of authority levels should consider whether:

- existing management can play a reasonable role to guide and oversee business operations effectively and efficiently;
- the current management structure and corresponding authority is appropriate, and would not be a hindrance to implementing an effective internal control system;
- current levels of authority promote core values within the company. Core values of a company may include, but not be limited to, transparency and fairness, consultation and mentoring, and responsibility and accountability.

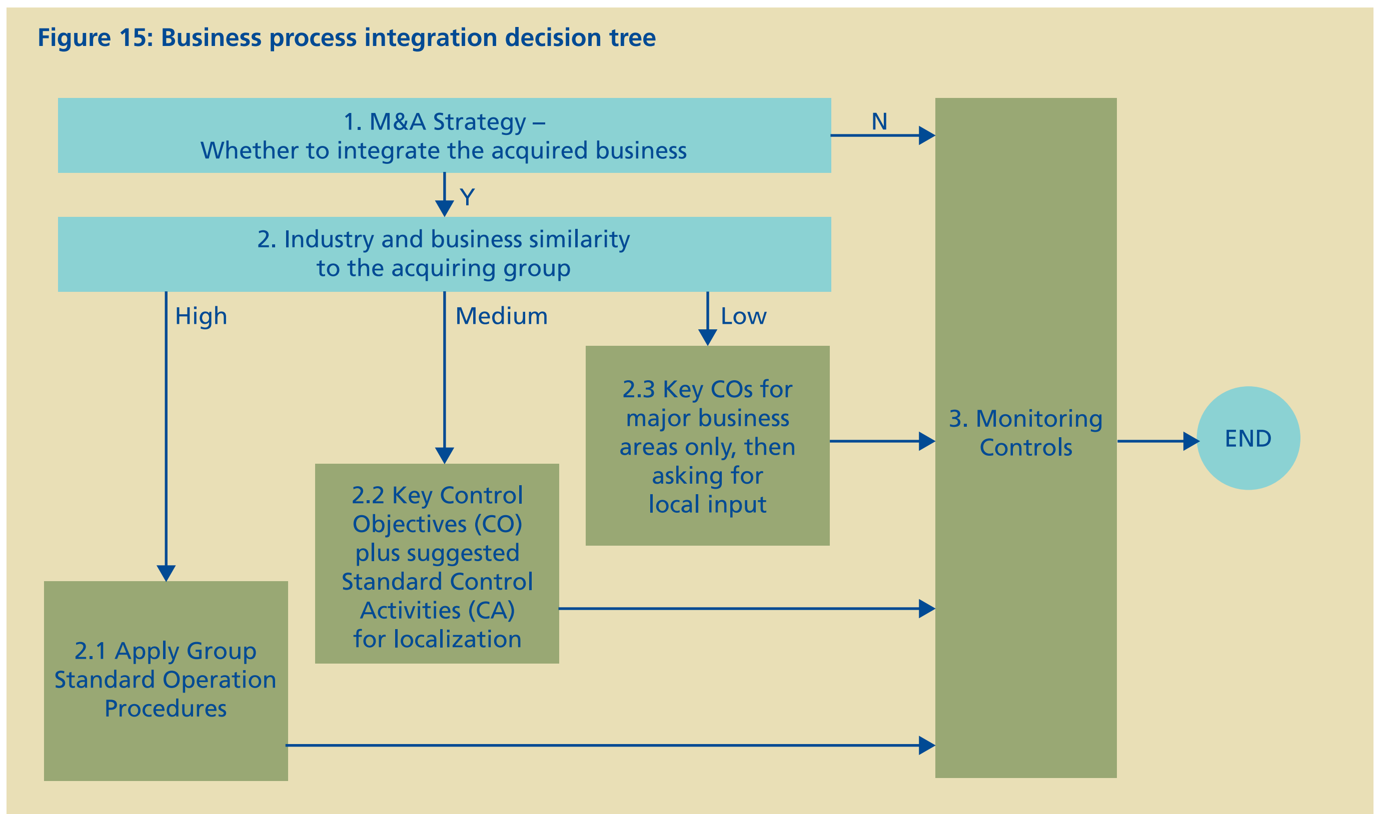
The involvement of an independent third party in conducting such an exercise can mitigate the tension between existing management teams in the target company and the acquirer. Training sessions or workshops and appropriate communications will convey the concept of proper internal control and minimise repercussions that may trickle through the organisation as a result of potential management changes.

5.6.3 Integrating business processes and internal controls

The degree to which an acquirer should integrate the business operations of the acquired company will depend on the acquisition strategy, the industry and business modules of the acquired company.

Figure 15 illustrates a general approach to determine the level of business process and internal controls integration.

Figure 15: Business process integration decision tree



1. M&A strategy - whether to integrate the acquired business

Whether the acquired business operations should be integrated is a decision that is made at the beginning of the M&A transaction. If the acquired company is purely a financial investment that will be sold in the future for capital gains, or there is no intention to get involved in the acquired business in-depth, it is often best to let the acquired entity operate on a stand-alone basis. However, proper monitoring mechanisms and appropriate controls should be implemented to monitor performance against financial and operational targets, and to enhance the ability to detect errors or fraud.

2. Consider industry and business similarities of the acquired company to the acquirer

When the acquired company is to be integrated into the acquirer, an assessment of the level of similarity between the business operations of both companies will need to be conducted. The degree to which the two are similar can be categorised into **high, medium** or **low**, where high represents significant similarities in operations and low represents few commonalities.

- **High:** If the outcome of the analysis is high, then standard operating procedures can be applied to the acquired company. This includes existing policies and procedures, standard operating procedures, and internal control manuals. However, minimal customisation of these operating procedures may be required to suit different business environments. Input from local staff should be obtained, while training and introduction sessions should be conducted to increase employee awareness and support.

- **Medium:** When the level of similarity in business operations is categorised as medium, the acquirer should:
  - compile a list of key Control Objectives (CO) and suggested best practices for Control Activities (CA);
  - present the CO and CA list to the acquired company and communicate to its management that the key CO's must be enforced. The best practice CA's are for reference to assist management in developing their own CA's to address the key CO's;
  - have the developed CA's reviewed by internal auditors and/or third party resources for effectiveness.

- **Low:** If there are few or no business similarities, it is suggested that the acquirer work closely with the management of the acquired organisation to identify major risks, develop COs to mitigate risks, and identify/establish CA's to address the risks in key business areas. Key business areas, regardless of industries, may include, but not be limited to:
  - financial closing and reporting;
  - tax reporting;
  - treasury and cash management;
  - purchase and expenditures, including capital expenditure;
  - sales and accounts receivables;
  - inventory management, production and costing (for manufacturing only);
  - human resource, payroll and employee benefits;
  - general computer control environment and information system.

  The developed CA's should also be reviewed by internal auditors and/or third party resources for effectiveness.

3. Monitoring controls

Monitoring controls should be established to facilitate the management of the acquired organisation. Monitoring controls are discussed in detail in the following section.

5.6.4 Establish monitoring controls

According to the COSO Internal Control - Integrated Framework (COSO framework), there are three components to monitoring controls. They are:

- ongoing monitoring;
- separate evaluations; and
- reporting deficiencies.

All three components should be adopted by the acquiring organisation to achieve efficient and effective monitoring controls. Some monitoring activities may already be embedded into business processes. Others should be in place to comply with corporate requirements.

Ongoing monitoring

Ongoing monitoring occurs in the ordinary course of operations, and includes regular management and supervisory activities, and other actions personnel conduct in performing their duties to assess the performance quality of internal control systems. For a newly-acquired company, functional or departmental leaders in the acquiring organisation may establish direct contact and reporting lines with the same functions/departments in the acquired company. Management may also conduct irregular visits to departments and perform periodical reviews on key documents as part of the monitoring process.

The COSO framework also recommends implementing the following ongoing monitoring controls in an organisation.

- Management should obtain evidence to ensure that the internal control system is functioning;
- Communications from external parties should be reviewed to corroborate internally generated information and to identify problems;
- Data recorded by information systems should be compared with physical assets;
- Training seminars, planning sessions and other meetings should be conducted to solicit important employee feedback to management on whether controls are effective;
- Periodically ask employees to state explicitly whether they understand and comply with the company's code of conduct.

Separate evaluations

Separate evaluations pertain to periodic checks on the internal control system, focusing on the design of internal controls and their operating effectiveness. The scope and frequency of separate evaluations will depend on an assessment of risks, and how effective the on-going monitoring procedures are. The appropriateness of the separate evaluation methodology and process should also be assessed on a regular basis.

Normally separate evaluations are in the form of control self-assessment (CSA) or internal audits.

CSA is a monitoring control performed by operating staff on their own, led by department or function leaders. Although this approach is less objective than an internal audit, it creates staff ownership to the monitoring process thus achieving buy-in, and is a cost-effective method to collect detailed information. The common tools for self-assessments include questionnaires and workshop discussions. The Control Self-Assessment is a well recognised mechanism in a healthy internal control system and is formally written in the Institute of Internal Auditor (IIA)'s practice manuals.

Conducting internal audits in China

The scope of an internal audit for a newly-acquired entity should be carefully designed so that key concerns are addressed. A well conducted internal audit in China should generally cover:

- an audit plan that takes into consideration the business environment in China
- an audit team that has the Putonghua language capabilities and appropriate knowledge of the local business environment so that source transaction documentation can be reviewed without misinterpretation and practical recommendations can be made to management for improvements
- audit notifications that are fully communicated with local management and line management beforehand
- audit findings that have been communicated to local management before formalising them into a report

After an M&A transaction, the merged organisation should determine how it will align internal audit resources in the most cost-effective and flexible way. Typical internal audit taskforces may include an in-house internal audit team, co-sourcing and outsourcing which are expanded upon further below:

- In-house internal audit team

  In this instance, the existing internal audit taskforce from the acquiring company will continue to play an important role to monitor the newly-acquired business operations.

- Co-sourcing

  An internal audit team can have resource restraints or suffer from a temporary workload bottleneck, especially if M&A activities are an on-going concern. One solution is to engage external professionals from a locally-based audit firm, and build a combined team consisting of internal audit staff and external resources to perform audit work. More companies are adopting this model of co-sourcing to staffing their internal audit needs because it provides greater resource flexibility, a reduction in travel costs, removes language barriers, and promotes knowledge sharing internally and knowledge transfer from external professionals.

- Outsourcing

  It remains challenging in the current dynamic business and legislative environment to maintain enough capacity in an internal audit function to cover global audit needs while keeping auditors up to date in all technical aspects. As a result, some companies outsource the entire or a portion of their internal audit function to external professional firms. This will enable them to quickly accommodate changes in priorities, resource needs, and areas of specialisation.

Reporting deficiencies

Internal control deficiencies should be reported upstream with certain matters reported to top management and the board. In implementing appropriate reporting processes, an assessment of the acquired entity should be conducted for:

- the existence of a mechanism to capture and report identified internal control deficiencies;
- the appropriateness of reporting protocols; and
- the appropriateness of follow-up actions.

5.7 Intellectual property rights protection and management

Intellectual property is recognised as one of the most important challenges of doing business in China.

When integrating the operations of an acquired organisation in China, a buyer may consider developing a plan to protect intellectual property (IP) and implement IP practices before transferring technology and business know-how to the acquired entity. Foreign companies are often sharing technological and business secrets with partners in China without considering the potential IP risk exposure. They often fail to factor IP properly into their strategic and operational decisions and think about protecting IP only after it is stolen.

To properly manage intellectual assets, a buyer may need to modify its business model and learn to compete in an environment where IP rights and related assets are uneven or lacking. The buyer should also consider taking strategic and operational action to protect IP. Often, this entails identifying the essential IP required for operations in China, implementing processes or business structures to limit the exposure of valuable IP, and assessing the use of alternative processes and non-critical assets if possible.

Lessons learned in China

- IP issues in China are complex and are rarely straight-forward
- Litigation is no substitute for business strategy
- Careful planning can reduce the risk of losing a company's most valuable IP
- Take strategic, operational and legal action to protect IP before it is stolen. This will likely lower litigation costs and improve the odds that IP will remain safe

5.8 Ongoing compliance

5.8.1 Tax-related compliance obligations

During the tax due diligence process, various tax issues may be identified. Having identified these issues, the buyer may be able to undertake remedial actions to mitigate or safeguard against such issues after the target is acquired and during the integration process.

Table 22: Remedial and corrective opportunities to address common issues identified during the tax diligence process

Issues identified	Initiatives
Special deals with local tax authorities and unofficial tax concessions	• If the technical position is clearly **not in compliance** with current PRC rules and regulations, corrective measures may need to be adopted and past exposures may need to be settled with the tax authority • If the technical **position is ambiguous,** it may be possible to approach the tax authority to discuss the tax issues in detail and obtain a written confirmation or lodge a meeting note. Although there is no guarantee that the target is completely free from any tax exposures from its past, this alternative can give some level of comfort and assurance. In the event that the tax authority wants to re-open the case, there may be a better position to argue for a better settlement, reduced or waived penalties and late payment interest • On a go-forward basis, carefully analyse technical positions and document supporting information if certain tax positions are taken in case positions are challenged
Tax compliance failure	• Review the tax **compliance control process** and integrate control processes during the merger and integration process • Implement **proper procedures to control the tax reporting process** to ensure tax compliance
Related party transactions	• Analyse the **pricing methodologies** for inter-company transactions • If not in compliance with PRC transfer pricing regulations and documentation requirements, proper procedures and steps need to be in place to achieve compliance • **Proactively conduct transfer pricing planning** to minimise tax costs for cross-border transactions and cross-entity transactions within China when the tax attributes of these entities are different (such as different tax rates, different tax incentives, etc.)

Compliance needs

Complying with the tax laws and regulations is a critical component of doing business in China. Therefore, a compliance control review is often recommended for a post-acquisition company. During the compliance control review, the major business activities will be analysed and the respective tax exposures under the existing model will be identified, based on which, potential tax improvement areas and control points from tax efficiency perspectives will be recommended. A compliance control review is different from a tax due diligence review, which aims to improve the control process of the post-acquisition company with a view to improving tax efficiency.

Integration needs

Once the post-acquisition company starts operation, it will be required to file tax returns after obtaining either a revised tax registration certificate in the case of a share acquisition, or a new tax registration certificate in the case of an asset acquisition when a new company is set up. The following are the major taxes an FIE may be subject to:

- foreign enterprise income tax (FEIT);
- value-added tax (VAT);
- business tax (BT);
- individual income tax (IIT);
- real estate tax (RET);
- stamp duty (SD);
- customs duty (CD);
- land value added tax (LVAT).

Tax return and payment deadlines for the above taxes are set out in the following table.

Table 23: Tax return and payment deadlines (as of August 2006)

Type of tax returns	Responsible persons	Filing and payment deadline
FEIT quarterly return	• FIEs and foreign enterprises with establishments in China	• Within 15 days of the end of each quarter - 15 January, 15 April, 15 July and 15 October
FEIT annual settlement return	• FIEs and foreign enterprises with establishments in China	• Within four months after the end of the tax year – accompanied by audited financial statements; final settlement shall be made within five months after the end of a tax year
VAT	• Seller of taxable goods and services	• Within 10 days of the end of the month or taxable period
BT	• Provider of taxable services; transferor of intangible assets and seller of real properties	• Within 10 days of the end of the month or taxable period
IIT	• Withholding agent/self-reporting taxpayer	• Within seven days after end of the tax month
RET	• Owners of real properties or mortgagees where the real properties have been mortgaged	• May be paid by instalments, quarterly or half-yearly, at the discretion of the local tax authorities
SD	• Parties to the dutiable documents	• When the dutiable documents are drawn up or received
CD	• Receivers of imported goods and senders of exported goods	• Within 15 days after the issuance of CD payment notice
LVAT	• Transferors of land, buildings and associated structures	• Within seven days after the signing of the transfer agreement

After the acquisition, restructuring of the existing company may be required from business as well as tax perspectives. Merger, division and liquidation may be some of the restructuring methods, each of which have very different sets of regulatory and tax considerations.

5.8.2 Internal controls-related compliance obligations

Sarbanes-Oxley compliance

For a listed company, especially one that is an SEC registrant, any newly-acquired business will likely be subject to a compliance obligation on internal controls.

Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) is currently the most comprehensive and rigorous law governing internal controls that has been widely applied. To meet SOX Section 404 compliance requires the management of US-listed companies to state the responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and to conduct an assessment of the effectiveness of the company's internal controls and procedures for financial reporting. It also requires an external auditor to attest to, and report on, the assessment by the management.

Upon completion of an M&A transaction, the buyer will need to determine whether and when the newly-acquired organisation should be scoped into the management assertion on internal controls over financial reporting.

Lessons learned in China

When the buyer is a US-listed company, to manage the SOX compliance risks arising from new M&A activities in China, the SOX compliance consideration should be taken from the initial stage of the decision making process, and be followed during the due diligence processes to obtain the answers to the following questions as early as possible:

- If the target company is to be financially consolidated with the acquirer after the transaction, how significant an entity would it be in the consolidated financial statements? Is there a possibility the total assets or total revenue of the target company make up five percent or more of the consolidated total assets or revenue?
- How good is the target company's existing internal control system? What are the major gaps compared to those of the SOX requirements?
- Accordingly, what would be the estimated SOX implementation costs in China after the M&A transaction?

Grace period

The SEC provides a buyer with an option to exclude the controls of the acquired business for a period of not more than one year from the date of the acquisition (refer to SEC FAQ Question 3)[23]. However, the acquirer's assessment of ICFR should include those controls related to the following considerations in the period in which the acquisition occurs:

- process and controls over the authorisation of the acquisition;
- control objectives and activities related to the valuation and recording of the purchase price, including the preliminary allocation of the purchase price and subsequent revisions of the acquired assets and liabilities;
- appropriate disclosures relating to the acquisition in accordance with generally accepted accounting principles (GAAP) and the SEC Regulation S-X Rules.

[23] As of August 2006.

In the event the buyer selects to exclude the newly-acquired business from its management assertion over ICFR at the end of the first fiscal year subsequent to the acquisition, external professionals can be engaged to assist with the readiness work and the disclosure, so as not to take up resources needed in the merger integration effort.

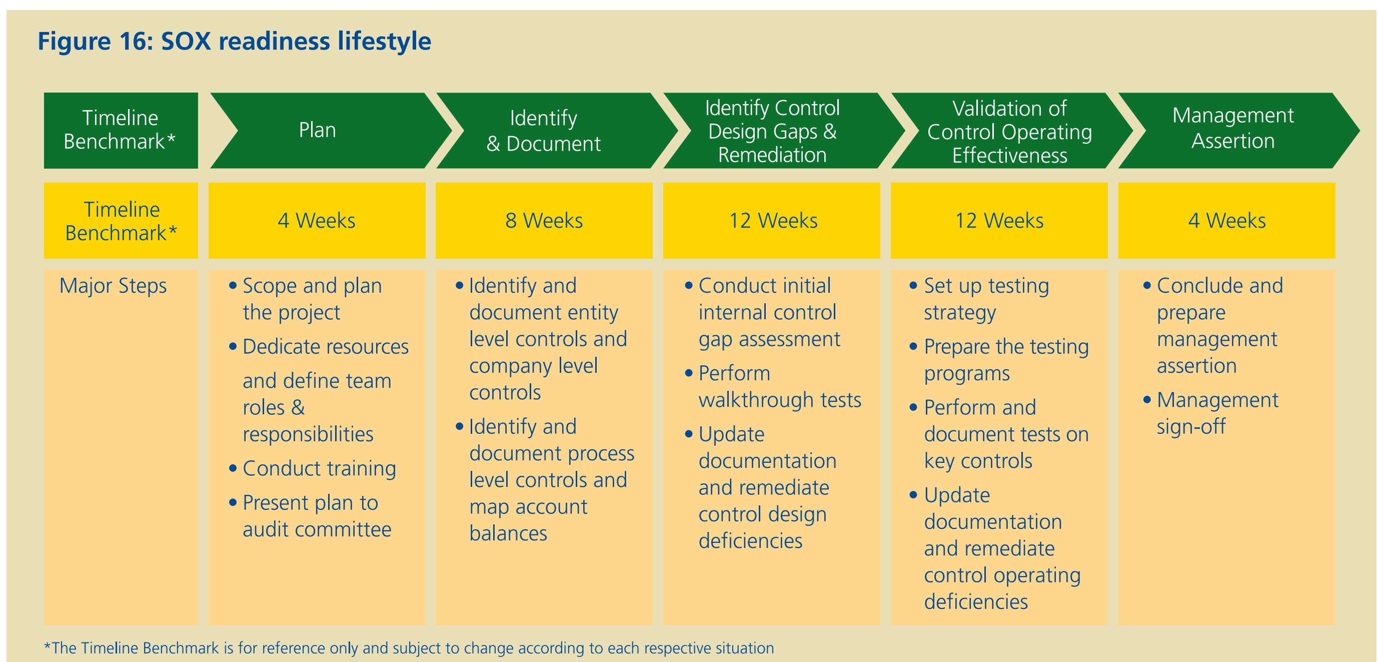
The design and operating effectiveness of the company-level controls to the newly-acquired entities should be identified and evaluated. Company-level controls are defined by the Public Company Accounting Oversight Board (PCAOB) auditing standard as controls that would affect multiple locations or entities, thus being more cost-effective and pervasive, and includes:

- controls within the control environment, such as tone at the top, organisational structure, commitment to competence, human resource policies and procedures;
- management's risk assessment process;
- centralised processing and controls, such as shared service environments;
- controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- period-end financial reporting process.

SOX implementation in China

For companies that are subject to SOX compliance, Figure 16 provides a view of a typical SOX readiness lifecycle project.

Figure 16: SOX readiness lifestyle



Timeline Benchmark*	Plan	Identify & Document	Identify Control Design Gaps & Remediation	Validation of Control Operating Effectiveness	Management Assertion
Timeline Benchmark*	4 Weeks	8 Weeks	12 Weeks	12 Weeks	4 Weeks
Major Steps	• Scope and plan the project • Dedicate resources and define team roles & responsibilities • Conduct training • Present plan to audit committee	• Identify and document entity level controls and company level controls • Identify and document process level controls and map account balances	• Conduct initial internal control gap assessment • Perform walkthrough tests • Update documentation and remediate control design deficiencies	• Set up testing strategy • Prepare the testing programs • Perform and document tests on key controls • Update documentation and remediate control operating deficiencies	• Conclude and prepare management assertion • Management sign-off

*The Timeline Benchmark is for reference only and subject to change according to each respective situation

The different phases of the SOX readiness lifecycle involves project planning, identifying controls and gaps, remediation of control deficiencies, validation of control operating effectiveness, and completing a management assertion.

- Phase 1: Plan

  A SOX readiness project plan should generally at minimum include a timetable, a team of key team members with defined roles and responsibilities, a project scope, a time and resources estimate, and training plan.

  Generally, a team will be comprised of professionals from internal audit teams, process owners and external professionals. One of the challenges of SOX readiness projects in China is to find sufficient resources with appropriate project management skills, SOX expertise and internal control knowledge.

  Awareness and support across the organisation should be generated by conducting training sessions and workshops to all levels of management. Engaging external experienced professionals to be involved may facilitate knowledge sharing and knowledge transfer to project team members and ease company resource constraints.

  A risk assessment exercise is used to define the scope of SOX projects and take into consideration both quantitative and qualitative factors, such as financial materiality, business complexity and specific identified risks. A well conducted risk assessment exercise should also cover locations where significant operations exist, and identify significant financial accounts and related business processes across the organisation, including the acquirer and the acquired entity.

  Once a plan is developed and approved by senior management, it should be submitted for Audit Committee approval.

- Phase 2: Identify and document

  In most instances, the acquired entities are considered significant in terms of SOX compliance. As a result, a top-down approach to manage compliance should be applied as recommended by SEC and PCAOB. The identification process should start from entity-level controls and company-level controls, and then focus on the process-level controls.

  Ideally, control identification and documentation is performed by experienced employees who fully understand the internal control concepts and have sufficient knowledge in the areas they are working. The documentation can include narratives, flowcharts, or risk-oriented matrixes. The control documentation should comply with SOX and auditing standard #2 issued by the PCAOB. Key control activities should be identified and stated in a clear and concise way, with a logical reference to facilitate management evaluation and testing.

  The language of the control documentation must be carefully chosen. Local staff in China needs to understand the document to guide their daily operations; management will use the document to perform ongoing evaluation and testing; and internal and external auditors will need to review the document to perform audits. Therefore, the appropriate language should be selected so that the needs of all parties are met.

- Phase 3: Identify control design gaps and remediation

  A control design gap analysis involves conducting an initial internal control gap assessment, performing walkthrough tests, and updating documentation and remediate control design deficiencies.

  Existing control activities are evaluated over the control objectives and walkthrough tests performed during this stage can confirm that the documented controls are in line with practice. Any control gaps or deficiencies noted will be raised for remedial actions.

- Phase 4: Validation of control operating effectiveness

  Controls should be tested to prove that they are operating effectively (OE). This requires the development of a testing strategy and testing programs to validate effectiveness.

  The next step is to perform and document tests on key controls. In performing this task, it is common practice to engage external resources in China. While selecting the appropriate service provider, it must be noted that the objectivity of the testing performer will affect the reliance strategy of the external auditor, and thus has an impact on audit costs. The more independent the testing performer is, the more reliable the testing results are regarded as, and in turn, the more audit costs saved. However, it should be noted that PCAOB standards require external auditors to perform independent tests on certain key controls regardless of whether such tests have been performed by another party.

  Before engaging testing performers, management should understand the different levels of independence offered by different service providers. The most common professionals engaged in descending order of independence are generally:

  - external consultants;
  - internal audit team;
  - operation staff who are not responsible for the areas under tests;
  - operation staff who are responsible for the areas under tests.

  In this phase, action plans to improve design and operating deficiencies should also be developed and implemented. Specific individuals within an organisation should be assigned accountability for the completion of remedial actions within a reasonable timeframe. To improve the effectiveness of the corrective actions, regular tracking and monitoring of the remedial status should be conducted.

- Phase 5: Management assertion

  The final step to SOX compliance is to conclude the management evaluation on control design and operating effectiveness based on the work that has been done in prior phases. A management assertion should be prepared and issued to the public by the CEO and CFO of the buyer. Within the buyer's organisation, divisional and regional management would usually be asked to provide a sign-off document to the company CEO and CFO and a sign-off would also be required from the newly acquired China entity.

SOX compliance challenges in China

Achieving SOX compliance is not a simple exercise. The following highlights several challenges that are more pervasive in Chinese companies working toward SOX Section 404 compliance.

- Lack of an enterprise-wide, executive-driven internal control management program.
- Lack of a formal enterprise risk management program.
- Inadequate controls associated with the recording of non-routine, complex, and unusual transactions.
- Poorly managed post-merger integration due to management culture and language barriers.
- Lack of effective controls over the IT environment.
- Ineffective financial reporting and disclosure preparation processes.
- Lack of formal controls over the financial closing process.
- Inability to evaluate and test controls over outsourced processes.
- Inadequate board and audit committee understanding of risk and control.

In addressing these challenges, it is common practice for many Chinese companies to engage experienced professionals to assist with the SOX readiness efforts. Areas where external resources have facilitated the process include:

- conducting training sessions or interactive workshops for management in the acquired entities;
- project planning, risk assessment, and process and location scoping;
- documenting"As-Is" controls, which is the foundation for management's control evaluation and testing;
- conducting control gap analyses by benchmarking control objectives, best practice control activities and local practices;
- providing recommendations on remedial actions; and
- performing control tests.

Other internal control compliance requirements

In China, in addition to SOX compliance, there are other local internal control compliance requirements that listed companies in the Shanghai, Shenzhen and Hong Kong stock exchanges may need to prepare for.

- In China, the State Council issued an *Advice on Improving the Quality of Listing Companies* 《关于提高上市公司质量意见》 that was submitted by CSRC in November 2005, followed by a detailed practice guidance titled *Internal Control Guidance for SSE Listed Companies* 《上海证券交易所上市公司内部控制指引》 released by the Shanghai Stock Exchange (SSE) on June 5, 2006. The Guidance includes requirements such as:
  - Listed companies should establish internal control systems to achieve operational, financial, and compliance objectives; the Board of Directors hold full responsibility to the design, operating, and monitoring effectiveness of internal control systems.
  - The Board of Directors should evaluate companies' internal controls and form an internal control self-assessment report as part of the annual disclosure; external auditors are required to review and evaluate the management's internal control self-assessment report and to provide an opinion.
- In May 2006, the Shenzhen Stock Exchange (SZE) released an exposure draft of the Internal Control Guidance similar to that of the SSE Guidance. This exposure draft would likely be finalised and formally published.
- Listing rules released by the Hong Kong Stock Exchange (HKSE) as of August 2006 requires that Directors of companies listed in the HKSE should perform an annual review of the effectiveness of material internal controls.

An approach similar to the one for SOX readiness should be established to prepare for compliance.

Lesson learned in China

If the target company is listed in any of the stock exchanges in China, i.e., SSE, SZE, and HKSE, the buyer should consider the relevant internal controls compliance requirements early in the M&A process. It is recommended that lawyers and external control professionals engaged by the buyer assess the impact of these compliance requirements on the transaction and assist with the compliance readiness work as part of the integration process.

Summary

- Merger integration should commence as soon as possible and start with pre-close planning and creating an integration roadmap
- Establish an effective integration project team with appropriate sponsors, a Program Management Office and functional and control teams
- Plan for a smooth Day One operations and focus on the "must haves"
- Manage operations transitions – adopt best practices when applicable
- Manage stakeholders through effective communications
- Consider implementing IP protection practices before transferring technology and business know-how to the acquired entity
- Ensure that the post-acquisition company complies with tax laws and regulations as FIEs may be subject to a number of taxes with specific filing and payment deadlines
- Ensure on-going compliance requirements are met – these may include tax compliance obligations, Sarbanes-Oxley compliance and other internal control requirements

Acronym reference list

Acronym reference list

BPR	Business Process Reengineering
BT	Business Tax
CA	Control Activities
CD	Customs Duty
CDD	Commercial Due Diligence
CHC	China Holding Company
CO	Control Objectives
COSO	Committee of Sponsoring Organisations of the Treadway Commission
CRM	Customer Relationship Management
CSA	Control Self Assessment
CSRC	China Securities Regulatory Commission
DCF	Discounted Cashflow Method
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, taxes, depreciation and amortisation
ERM	Enterprise Risk Management
ERP	Enterprise Resource Planning
FCPA	Foreign Corrupt Practices Act
FEIT	Foreign Enterprise Income Tax
FIE	Foreign-invested Enterprise
GAAP	Generally Accepted Accounting Principles
HR	Human Resources
HRIS	Human Resources Information System
IFRS	International Financial Reporting Standards
IIT	Individual Income Tax
IPMO	Integration Program Management Office
IT	Information Technology
KPI	Key Performance Indicators
LOI	Letter of Intent
LVAT	Land Value-added Tax
M&A	Mergers and Acquisitions
MOC	Ministry of Commerce
OE	Operating Effectiveness
PCAOB	Public Company Accounting Oversight Board
R&D	Research and Development
RET	Real Estate Tax
ROI	Return on Investment
SAFE	State Administration of Foreign Exchange
SAIC	State Administration for Industry and Commerce
SCM	Supply Chain Management
SD	Stamp Duty

SEC	Securities Exchange Commission
SOX	Sarbanes Oxley
SPV	Special Purpose Vehicle
VAT	Value-added Tax
WFOE	Wholly foreign-owned enterprise
WHT	Withholding Tax
WTO	World Trade Organization

Appendices

Appendix 1

Administrative Measures on Strategic Investment in Listed Companies by Foreign Investors 《外国投资者对上市公司战略投资管理办法》

Ministry of Commerce, China Securities Regulatory Commission, State Administration of Taxation, State Administration for Industry and Commerce and State Administration of Foreign Exchange Order No. (2005) 28

31 December 2005

Article 1

These Measures are formulated in accordance with the requirements of the *Guidelines on Equity Separation Reform for Listed Companies* and the provisions of State laws and regulations on foreign investment and governance of listed companies and the *Provisional Regulations on Foreign-funded Mergers and Acquisitions of Domestic Enterprises* for the purposes of regulating strategic investment by foreign investors in "A" shares listed companies (hereinafter referred to as the "listed companies") following the equity separation reform, safeguarding the order of the securities market, attracting advanced management expertise, technologies and funds from overseas, improving the governance structure for listed companies and protecting the legitimate rights and interests of listed companies and shareholders.

Article 2

These Measures shall apply to acquisition of "A" shares in listed companies which have undergone equity separation reform and new listed companies after the equity separation reform by foreign investors (hereinafter referred to as the "investors") through medium- and long-term strategic merger and acquisition investment of a certain scale (hereinafter referred to as the "strategic investment").

Article 3

Upon approval of the Ministry of Commerce, the investors may make strategic investment in listed companies in accordance with the provisions of these Measures.

Article 4

Strategic investment shall comply with the following principles:

1. comply with State laws and regulations and the relevant industry policies and shall not endanger national and economic security and public interest;
2. uphold the principles of transparency, fairness and equitableness, safeguard the legitimate rights and interests of listed companies and their shareholders, be subject to the supervision of the government and general public and the jurisdiction of Chinese judicial and arbitration authorities;
3. encourage medium- and long-term investment, safeguard the order of the securities market and speculation shall not be allowed; and
4. shall not obstruct fair competition or cause over-concentration in the relevant product markets in China or exclude or restrict competition.

Article 5

Investors making strategic investment shall satisfy the following requirements:

1. holding of "A" shares in listed companies through negotiated transfer, directed placement of new shares by listed companies and other methods stipulated by State laws and regulations;
2. the investment may be made in phases and the shareholding upon completion of initial investment shall not be lower than 10% of the issued share capital of the company, unless otherwise provided for special industries or approved by the relevant authorities;
3. holding of "A" shares in listed companies shall be subject to a three-year moratorium;

4. investors holding shares in industries where the laws and regulations stipulate foreign investment shareholding ratio shall comply with the relevant provisions in respect of such shareholding ratio for the industry; investors shall not invest in listed companies in industries where the laws and regulations prohibit foreign investment;
5. where the investment involves holding of State-owned shares in listed companies, the relevant provisions on administration of State-owned assets shall be complied with.

Article 6

Investors shall satisfy the following requirements:

1. foreign legal persons or other organisations duly established and operating with sound finance, good creditworthiness and sophisticated management expertise;
2. total overseas assets owned by the investor shall not be less than US$100 million or the total overseas assets managed by the investor shall not be less than US$500 million; or the total overseas assets owned by its parent company shall not be less than US$100 million or the total overseas assets managed by its parent company shall not be less than US$500 million;
3. it has a proper governance structure and good internal control system and operating norms; and
4. it has not been subject to severe punishment imposed by regulatory authorities in China and overseas during the last three years (including its parent company).

Article 7

Strategic investment by way of directed placement of a listed company shall be handled in accordance with the following procedures:

1. a resolution on directed placement of new shares to the investor and amendment of the articles of association of the company has been passed by the board of directors of the listed company;
2. a resolution on directed placement of new shares and amendment of the articles of association of the company has been passed by a general meeting of the listed company;
3. a contract on directed placement of shares has been concluded between the listed company and the investor;
4. the listed company has submitted the relevant application documents to the Ministry of Commerce in accordance with the provisions of Article 12; where there are specific provisions, such provisions shall be complied with;
5. upon issue of an in-principle approval reply from the Ministry of Commerce to the strategic investment of the investor in the listed company, the listed company shall submit application documents for directed placement to the China Securities Regulatory Commission and the China Securities Regulatory Commission shall verify and approve in accordance with the provisions of the law; and
6. upon completion of the directed placement, the listed company shall collect a Foreign Investment Enterprise Approval Certificate from the Ministry of Commerce and present the Approval Certificate to the industrial and commercial administration authorities for completion of change registration formalities.

Article 8

Strategic investment through negotiated transfer shall be handled in accordance with the following procedures:

1. a resolution on strategic investment by the investor by way of negotiated transfer has been passed by the board of directors of the listed company;
2. a resolution on strategic investment by the investor by way of negotiated transfer has been passed by a general meeting of the listed company;
3. a share transfer agreement has been concluded between the transferor and the investor;
4. the investor has submitted the relevant application documents to the Ministry of Commerce in accordance with the provisions of Article 12; where there are specific provisions, such provisions shall be complied with;

5. investors acquiring shares of listed companies shall, upon obtaining the aforesaid approval, complete share transfer confirmation formalities with the stock exchange, complete registration and transfer of title formalities with the securities registration and clearing organisation, and file records with the China Securities Regulatory Commission; and
6. upon completion of the negotiated transfer, the listed company shall collect a Foreign Investment Enterprise Approval Certificate from the Ministry of Commerce and present the Approval Certificate to the industrial and commercial administration authorities for completion of change registration formalities.

Article 9

An investor proposing to obtain actual control of a listed company through negotiated transfer shall, upon obtaining approval in accordance with the procedures stipulated in Article 8(1), (2) , (3) , (4), submit a listed company acquisition report and the relevant documents to the China Securities Regulatory Commission; upon passing the examination and verification by the China Securities Regulatory Commission, the investor shall complete share transfer confirmation formalities with the stock exchange, complete registration and transfer of title with the securities registration and clearing organisation. Upon completion of the aforesaid formalities, the matters stated in Article 8(6) shall be handled.

Article 10

Strategic investment by investors in listed companies shall comply with reporting, announcement and other statutory obligations in accordance with the provisions of the *Securities Law* and relevant regulations of the China Securities Regulatory Commission.

Article 11

Investors of listed companies who continue to make strategic investment in such listed companies shall complete the relevant matters and procedures in accordance with the provisions of these Measures.

Article 12

Listed companies or investors shall submit the following documents to the Ministry of Commerce:

1. application form for strategic investment;
2. strategic investment scheme;
3. directed placement contract or share transfer agreement;
4. sponsor opinion (in the case of a directed placement) or legal opinion;
5. investor's letter of undertaking for continuing shareholding;
6. a declaration that the investor has not been subject to severe punishment imposed by regulatory authorities in China and overseas during the past three years and explanation on whether it has been subject to any other non-severe punishment;
7. the certificate of incorporation of the investor and identity document of the legal representative (or authorised representative) duly notarised and certified;
8. audited balance sheets of the investor for the past three years;
9. the documents stipulated in (1) , (2) , (3) , (5) and (6) above shall be signed by the legal representative of the investor or his/her authorised representative, where the documents are signed by an authorised representative, the power of attorney signed by the legal representative and the corresponding notarisation and certification documents shall be provided; and
10. other documents stipulated by the Ministry of Commerce.

The original Chinese copy of all the aforesaid documents shall be submitted, except for documents stated in (7) and (8); the original copies of the documents stated in (7) and (8) shall be submitted together with the Chinese translation.

The Ministry of Commerce shall issue an in-principle reply within 30 days from receipt of all the aforesaid documents and the in-principle reply shall be valid for 180 days.

Article 13

Foreign companies (the "parent company") which satisfy the requirements stipulated in Article 6 may make strategic investment through their wholly-owned overseas subsidiaries (the "investors"); the investors shall, in addition to the documents stated in Article 12, submit to the Ministry of Commerce a irrevocable letter of undertaking by their parent company for joint liability towards the investment by the investors.

Article 14

The investors shall open a foreign exchange account in accordance with the relevant provisions on foreign-funded mergers and acquisitions within 15 days from the date of in-principle reply of the Ministry of Commerce. Investors remitting foreign exchange funds into China for use in strategic investment shall open a designated foreign exchange account (M&A category) for foreign investor with the foreign exchange bureau at the place of registration of the listed company in accordance with the relevant provisions on foreign exchange administration; the foreign exchange settlement of funds in the account and closing of account shall be handled in accordance with the relevant provisions on foreign exchange administration.

Article 15

Investors may present the approval document issued by the Ministry of Commerce for strategic investment by the investor in a listed company and their valid identity document to complete the relevant formalities with the securities registration and clearing organisation.

Securities registration and clearing organisations may, based on the application by the investors, open securities accounts for investors holding non-circulating shares prior to the equity separation reform of a listed company or shares held in a listed company prior to its initial public offer.

Securities registration and clearing organisations shall formulate the relevant provisions in accordance with the provisions of these Measures.

Article 16

Investors shall initiate strategic investment within 15 days from foreign exchange settlement of the funds and complete strategic investment within 180 days from the date of in-principle reply.

The in-principle reply of the examination and approval authorities shall become void automatically if an investor is unable to complete strategic investment based on the strategic investment within the stipulated period. The investor shall purchase foreign exchange using the proceeds from foreign exchange settlement and remit the foreign exchange funds overseas within 45 days from the date on which the in-principle reply became invalid.

Article 17

The listed company shall present the following documents to collect the Foreign Investment Enterprise Approval Certificate from the Ministry of Commerce within ten days from completion of strategic investment:

1. application form;
2. in-principle approval letter issued by the Ministry of Commerce;
3. certificate of shareholding issued by the securities registration and clearing organisation;
4. business licence of the listed company and identity document of the legal representative; and
5. articles of association of the listed company.

The Ministry of Commerce shall issue a Foreign Investment Enterprise Approval Certificate stating "foreign-invested shareholding company (acquisition of "A" shares)" within five days from receipt of all the aforesaid documents.

If an investor who holds 25% or more of the shares of a listed company undertakes to hold not less than 25% of shares continuously in the listed company within ten years, the Ministry of Commerce shall issue a Foreign Investment Enterprise Approval Certificate stating "foreign-invested shareholding company (acquisition of 25% or more of "A" shares)".

Article 18

The listed company shall complete change registration formalities with the industrial and commercial administration authorities for change of company type within 30 days from the date of issue of the Foreign Investment Enterprise Approval Certificate and submit the following documents:

1. application form for change signed by the legal representative of the company;
2. the Foreign Investment Enterprise Approval Certificate;
3. certificate of shareholding issued by the securities registration and clearing organisation;
4. valid and duly notarised and certified certificate of business commencement of the investor; and
5. other documents required by the State Administration for Industry and Commerce.

If the change is verified and approved, the industrial and commercial administration authorities shall indicate the wordings "foreign-invested shareholding company (acquisition of "A" shares)" at the column of "Type of enterprise" in the business licence; where the investor holds 25% or more of the shares in the listed company through strategic investment and undertakes to hold not less than 25% of the shares in the listed company continuously within ten years, the wordings "foreign-invested shareholding company (acquisition of 25% or more of "A" shares)" shall be indicated.

Article 19

The listed company shall complete the relevant formalities with the taxation, Customs and foreign exchange administration authorities, etc. within 30 days from the date of issue of the Foreign Investment Enterprise Business Licence. The foreign exchange administration authorities shall issue a foreign exchange registration certificate stating "foreign-invested shareholding company (acquisition of "A" shares)". If the investor holds 25% or more of the shares in the listed company through strategic investment and undertakes to hold not less than 25% of the shares in the listed company continuously within ten years, the wordings "foreign-invested shareholding company (acquisition of 25% or more of "A" shares)" shall be indicated on the foreign exchange registration certificate by the foreign exchange administration authorities.

Article 20

Except for the following circumstances, the investor shall not engage in securities trading (with the exception of "B" shares):

1. the "A" shares held by an investor through strategic investment in a listed company can be sold upon expiry of the period which the investor undertakes to hold the shares;
2. an investor acquiring shares by way of an offer in accordance with the relevant provisions of the Securities Law may acquire shares sold by shareholders of "A" shares of the listed company during the offer period;
3. the non-circulating shares held by an investor prior to the equity separation reform of a listed company can be sold upon completion of the equity separation reform and expiry of the moratorium;
4. the shares held by an investor prior to the initial public offer of a listed company can be sold upon expiry of the moratorium; and
5. where an investor has obtained the approval of the Ministry of Commerce to transfer shares prior to the expiry of the period which the investor undertakes to hold the shares for special reason such as bankruptcy, liquidation, mortgage, etc. which requires the investor to transfer its shares.

Article 21

In the event that the reduction in shareholding of an investor renders the foreign shareholding ratio of a listed company to fall below 25%, the listed company shall file records with the Ministry of Commerce within ten days and complete the relevant formalities for amendment to the Foreign Investment Enterprise Approval Certificate.

In the event that the reduction of shareholding of an investor renders the foreign shareholding ratio of a listed company to fall below 10% and the investor is not the single largest shareholder, the listed company shall file records with the examination and approval authorities within ten days and complete the relevant formalities for cancellation of the Foreign Investment Enterprises Approval Certificate.

Article 22

In the event that the reduction in shareholding of an investor renders the foreign shareholding ratio of a listed company to fall below 25%, the listed company shall complete change registration formalities with the industrial and commercial administration authorities within 30 days from the amendment of the Foreign Investment Enterprise Approval Certificate; the industrial and commercial administration authorities shall amend the "type of enterprise" on the business licence to read as "foreign-invested shareholding company (acquisition of "A" shares)". The listed company shall complete change formalities for foreign exchange with the foreign exchange administration authorities within 30 days from the amendment of the business licence; the foreign exchange administration authorities shall indicate the wordings "foreign-invested shareholding company (acquisition of "A" shares)" on the foreign exchange registration certificate.

In the event that the reduction of shareholding of an investor renders the foreign shareholding ratio of a listed company to fall below 10% and the investor is not the single largest shareholder, the listed company shall complete change registration formalities with the industrial and commercial administration authorities within 30 days from the cancellation of the Foreign Investment Enterprise Approval Certificate and the type of enterprise shall be changed to "company limited by shares". The listed company shall complete cancellation formalities for foreign exchange registration with the foreign exchange administration authorities within 30 days from the date of amendment of the business licence.

Article 23

Parent companies making strategic investment through a wholly-owned overseas subsidiary and having completed the strategic investment in accordance with the schedule shall report to the Ministry of Commerce before transferring the aforesaid overseas subsidiary and submit an application in accordance with the procedures stipulated in these Measures. The transferee is required to satisfy the requirements stipulated in these Measures and shall enjoy all rights and bear all liabilities of the parent company and its subsidiary in the listed company and report to the China Securities Regulatory Commission, make announcements and perform other statutory obligations in accordance with the law.

Article 24

An investor transferring the shares of a listed company through the "A" shares market may present the following documents to purchase foreign exchange with the foreign exchange bureau at the place of registration of the listed company for overseas remittance:

1. written application;
2. approval letter for foreign exchange settlement issued by the foreign exchange bureau for funds in the designated foreign exchange account (M&A category) for foreign investor for strategic investment purpose; and
3. documentary proof of securities trading issued by a securities brokerage.

Article 25

Where the shareholding ratio of investors in a listed company is less than 25%, the foreign debt of the listed company shall be handled in accordance with the relevant provisions on foreign debt of Chinese-funded enterprises in China.

Article 26

Personnel of the relevant government authorities shall be loyal to their duties and perform their duties in accordance with the law and shall not use their official powers to solicit improper gains and shall keep commercial secrets made known to them confidential.

Article 27

Investors from Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan making strategic investment shall refer to the provisions of these Measures.

Article 28

These Measures shall come into effect 30 days after the date of promulgation.

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Appendix 2

Provision on Merger and Division of Foreign Investment Enterprises《外商投资企业合并与分立的规定》

Waijinmaofafa (1999) No 395

Issued 23 September 1999 jointly by the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce

Revised and re-issued 22 November 2001 in accordance with the Decision of the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce to Revise the Provisions on Merger and Division of Foreign Investment Enterprises

Article 1

These Provisions are formulated, in accordance with the Company Law of the People's Republic of China and relevant laws and administrative regulations on foreign investment enterprises, in order to regulate activities in relation to merger and division of foreign investment enterprises, and to protect the legitimate rights and interests of investors in and creditors of enterprises.

Article 2

These Provisions apply to the merger and division of Sino-foreign equity joint enterprises, Sino-foreign co-operative enterprises with legal status, wholly foreign-owned enterprises, and foreign investment companies limited by shares (hereinafter referred to as companies), which are established within the territory of China in accordance with Chinese law.

A company merging with a Chinese domestic enterprise shall be handled in reference to relevant laws, regulations and these Provisions.

Article 3

The term "merger", for the purpose of these Provisions, refers to two or more companies that join together and become one company in accordance with relevant provisions of the Company Law and through agreement.

A company merger may proceed either through the absorption method or through the establishment of a new entity.

A merger by absorption refers to a company accepting another company or companies to join itself, where the accepting party continues to exist and the entering party dissolves.

A merger by establishing a new entity refers to two or more companies merging to establish a new company, upon which all merging parties dissolve.

Article 4

The term "division", for the purpose of these Provisions, refers to one company being divided into two or more companies in accordance with relevant provisions of the Company Law and by a resolution of the company's highest power organ.

A company division may proceed either through the continuous existence method or through dissolution.

Division through continuous existence refers to the situation in which one company is divided into two or more companies, whereby the original company continues to exist and one or more new companies are established.

Division by dissolution refers to the situation wherein one company is divided into two or more companies, upon which the original company dissolves and two or more new companies are established.

Article 5

A company merger or division must be carried out in accordance with Chinese law, regulations, the present Provisions and principles of voluntariness, equality and fair competition, and it shall not harm the public interests and the legitimate rights and interests of the creditors.

A company merger or division must comply with provisions of the Provisional Regulations on Foreign Investment Guidelines and the Guideline Catalogue of Foreign Investment Industries. It must not lead to a situation where foreign investors become the sole investor, controlling shareholder or dominant investor of a company in an industry in which sole foreign investment, foreign share-control or foreign domination is not permitted.

Where a company merger or division results in changes in the trade or business scope of the company, such changes must comply with provisions of relevant laws, regulations and state industry policies, and necessary examination and approval procedures must be carried out.

Article 6

A company merger or division shall comply with regulations issued by customs, taxation authorities, foreign exchange administration and other relevant authorities. After merger or division, the continuous company or the newly established company will, upon verification by the examination and approval organ, the customs, taxation administration and other relevant authorities, continue to enjoy the various foreign investment preferential treatments which the original company enjoyed.

Article 7

A company merger or division shall be approved by the original approval organ of the company, and shall carry out relevant procedures for the establishment, alteration or cancellation with registration organs.

If a company intending to merge has two or more original examination and approval organs or registration organs, the examination organ and registration organ shall be the organs authorised by the department in charge of foreign economic relations and trade and the State Administration for Industry and Commerce (referred to as SAIC) in the locality in which the merged company is located.

If the total amount of foreign investment of the companies intending to merge is not within the examination and approval power of the companies' original examination and approval organ or the examination and approval organ in the region in which the merged company is located, it shall be examined and approved by the examination and approval organ with appropriate power.

If one of the companies intending to merge is a company limited by shares, such a merger shall be examined and approved by the Ministry of Foreign Trade and Economic Cooperation of the People's Republic of China (referred to as MOFTEC).

Article 8

Where the original company is dissolved or new companies are established in other regions as a result of a company merger or division, the examination and approval organ in the region in which the company is to be dissolved or established shall be consulted.

Article 9

A company shall not be merged or divided before investors have made their investment in full and met cooperation conditions in accordance with provisions of the contract and Articles of Association of the company, and the company has commenced its production and operation. A company may be merged with a domestic enterprise if investors have made their investment and met cooperation conditions in accordance with provisions of the contract and Articles of Association of the company.

Article 10

Limited liability companies will become a limited liability company after their merger. Companies limited by shares will become a company limited by shares after their merger.

Where a merger occurs between listed companies limited by shares and limited liability companies, it becomes a company limited by shares. A non-listed company limited by shares merging with a limited liability company may become either a company limited by shares or a limited liability company after the merger.

Article 11

Where a merger occurs between companies limited by shares or a company limited by shares is established by merger, the registered capital of the merged company shall be the sum total of the registered capital of the original companies.

Where a limited liability company merges with a company limited by shares and becomes a company limited by shares, the registered capital of the merged company shall be the sum of the value of shares which are converted from the net capital value of the limited liability company on the basis of the value of each share of the company limited by shares, plus the total value of the shares of the original company limited by shares.

Article 12

Where a merger is made in accordance with paragraph 1 of Article 11 of these Provisions, the ratio of share rights of various investing parties in the merged company shall, in accordance with relevant state provisions, and after consultation among the investors or upon the results of valuation of the share rights of individual investors in the original company conducted by an asset valuation organisation, be determined in the contract and the Articles of Association of the merged company, but the ratio of the foreign investors' shares rights must not be less than 25% of the registered capital of the merged company.

Article 13

The amount of registered capital of a divided company shall be determined by the highest power organ of the original company, in accordance with relevant laws and regulations on foreign investment enterprise as well as relevant provisions of the registration organ, but the sum total of registered capital of divided companies must be the amount of the registered capital of the company before the division.

Article 14

The share rights of various investing parties in the company after the division shall be determined by the investors in the company contract and Articles of Association of the divided company, but the ratio of the foreign investors' shares rights shall not be less than 25% of the registered capital of the divided company.

Article 15

Where a company is merged through the absorption method, the date of establishment of the accepting company is the date of the establishment of the merged company. Where a company is merged through the establishment of a new entity, the date on which the registration of the company's establishment is approved and a business licence is issued by the registration organ shall be the date of the establishment of the merged company.

Where new companies are established as a result of company division, the date on which the registration of the companies' establishment is approved and business licences are issued by the registration organ shall be the date of the establishment of the divided companies.

Article 16

Where a merger or division involves listed companies limited by shares, it shall comply with relevant laws and regulations, and provisions of the securities supervision and administration department of the State Council concerning listed companies, and necessary examination and approval procedures shall be completed.

Article 17

A company merging with Chinese domestic enterprises must comply with provisions of Chinese law and regulations on the utilisation of foreign funds as well as industry policies, and must also meet the following conditions:

1. the Chinese domestic enterprise intended to be merged is a limited liability company or a company limited by shares whose establishment accords with provisions of the Company Law of the People's Republic of China;
2. the investors satisfy with qualification requirements for investors to engage in the relevant industry to which the merged company belongs, as provided by the law, regulations and departmental rules;
3. the ratio of foreign investors' share rights shall not be less than 25% of the registered capital of the merged company;
4. various parties in the merger agreement shall ensure that the existing staff and workers of the company intended to be merged are sufficiently employed or proper arrangements are made for them.

Article 18

Where a foreign investment enterprise is established after a merger between a company and a domestic enterprises, the total investment amount shall be the sum total of the total investment of the original company and the total enterprise assets of the domestic enterprise as stated in the enterprise financial auditing report, and the total registered capital shall be the sum total of the registered capital of the original company and that of the domestic enterprise. The ratio between the registered capital and the total investment of the merged company must conform with the Provisional Regulations on the Ratio between the Registered Capital and Total Investment of Sino-foreign Equity Joint Enterprises issued by the State Administration for Industry and Commerce. In special circumstances where such requirements may not be met, it must be reported to the Ministry for Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce for approval.

Article 19

Where enterprises established by a domestic enterprise which is merged with a company become enterprises whose shares are held by the merged company, the Interim Provisions on Investment Inside China by Foreign Investment Enterprises and other industry policies on foreign investment must be complied with. The merged company must not hold shares in enterprises in which foreign investment is prohibited.

Article 20

In cases of a company merger through absorption, the accepting company shall be the applicant; and in cases of a company merger through establishment of a new entity, the merging parties shall nominate an applicant through consultation.

An applicant shall submit to the examination and approval organ the following documents:

1. an application statement on the company merger signed by legal representatives of all merging companies and the agreement for a company merger;
2. resolutions of the highest power organs of the merging companies regarding the company merger;
3. contracts and Articles of Association of all merging companies;
4. approval documents and copies of business licences of all merging companies;
5. capital verification reports of all merging companies, produced by statutory capital verification organs of China;
6. balance sheets and property inventories of all merging companies;
7. the past year's audit reports of all merging companies;
8. the lists of names of creditors of all merging companies;
9. the company contract and Articles of Association of the merged company;

10. the name list of members of the highest power organ in the merged company;
11. other documents required by the examination and approval organ.

Where a company is merged with a domestic enterprise, the applicant shall also submit to the examination and approval organ photocopies of business licences of enterprises established through investment by the domestic enterprise involved in the merger.

Article 21

A company merger agreement must contain the following major items:

1. names, addresses and legal representatives of various parties to the merger agreement;
2. the name, address and legal representative of the merged company;
3. the total amount of investment capital and the registered capital of the merged company;
4. method of merger;
5. plans for absorbing debts receivable and debts payable by various parties into the merger agreement;
6. measures for arrangement of staff and workers;
7. liabilities for breach of agreement;
8. methods for dispute settlement;
9. date and place of the agreement signed;
10. other matters that various parties to the merger agreement deem necessary to be included.

Article 22

If a company intending to merge has two or more original examination and approval organs, the company intended to be dissolved shall, prior to the submission of relevant documents to the examination and approval organ in accordance with Article 18 of these Provisions, submit an application to its original examination and approval organ for dissolution as a result of the company merger.

The original examination and approval organ shall, within fifteen (15) days of receiving the application for dissolution as provided in the above paragraph, give a response on whether or not the dissolution application is approved. If the original examination and approval organ does not respond within fifteen (15) days, it shall be deemed that the original examination and approval organ has agreed to the dissolution of the company concerned.

Where the original examination and approval organ gives a response disagreeing with the company's dissolution within the time period stipulated in the above paragraph, the company intended to be dissolved may submit the company dissolution application to the competent department in charge of foreign economic relations and trade at a higher level, which is the next common authority over both the original examination and approval organ of the applicant and the examination and approval organ for the company merger. The competent department shall make its decision within thirty (30) days of receipt of the company's dissolution application.

Where the examination and approval organ disagrees or does not approve the company merger, the response to the company dissolution shall automatically cease its validity.

Article 23

A company intending to make a division shall submit the following documents to the examination and approval organ:

1. application for company division signed by the legal representative of the company;
2. the resolution of the highest power organs of the company on the company division;
3. the company division agreement signed by the continuing company and the companies to be established resulting from the company division (referred to as various parties to the division agreement);

4. the company's contract and Articles of Association;
5. the approval document and a copy of business licence of the company;
6. the capital verification report of the company, produced by a statutory capital verification organ of China;
7. the balance sheet and property inventory of the company;
8. the list of names of creditors of the company;
9. the company contracts and Articles of Association of various companies after the division;
10. lists of names of members of the highest power organs in various companies after the division;
11. other documents required by the examination and approval organ.

Where new companies are to be established in other regions as a result of the company division, the company shall, in addition, submit to the examination and approval organ the opinions on the establishment of new companies as a result of division, signed and issued by the examination and approval organs in the localities where the new companies are intended to be established.

Article 24

A company division agreement must include the following items:

1. names, addresses and legal representatives of various parties to the division agreement;
2. the total amount of investment and the registered capital of the company after the division;
3. method of division;
4. plan for division of company's assets drawn by various parties to the division agreement;
5. plans for absorbing debts receivable and debts payable drawn by various parties to the merger agreement;
6. measures for staff and workers' arrangements;
7. liabilities for breach of agreement;
8. methods for disputes settlement;
9. date and place of the agreement;
10. other matters that various parties to the division agreement deem necessary to be included.

Article 25

The absorbing company or the newly established company after merger shall fully assume debts receivable and debts payable of the companies being dissolved as a result of merger.

Companies after division shall assume debts receivable and debts payable of the original company according to the division agreement.

Article 26

An examination and approval organ shall, within forty-five (45) days of receiving the relevant documents listed in Article 20 or 23 of these Provisions, make a written preliminary response as to whether it agrees with the merger or division.

Where the examination and approval organ for the a company merger is MOFTEC, and where MOFTEC is of the opinion that the company merger has a potential for industry monopoly or a possibility of forming a market position dominating certain particular commodities or services and thereby obstruct fair competition, it may, after receiving the above mentioned documents, call upon relevant departments and organs to conduct a hearing process over the company intending to merger and carry out investigation on the company as well as on the relevant markets. The time period for examination and approval provided in the previous paragraph may be extended to one hundred and eighty (180) days.

Article 27

A company intending to merge or divide shall, within ten (10) days from the date that the preliminary response agreeing to the company merger or division is made by the examination and approval organ, deliver notices to all its creditors and make a public announcement in a newspaper of a provincial-level or above circulated nationwide for at least three (3) times in thirty (30) days.

The company shall state in the above mentioned notice and public announcement the plan for assuming the debts of the original company.

Article 28

A creditor of the company shall, within thirty (30) days of the receipt of notice mentioned in Article 27 of these Provisions or within ninety (90) days, where the creditors have not received notice of the first announcement, have the right to request the company to revise the plan for assuming debts or to settle a debt or to provide a relevant guarantee.

If creditors of the company fail to exercise the rights provided in the previous paragraph, it will be deemed that the creditors agree to the plan of the company intending to merge or divide for assuming debts receivable and debts payable, and the creditors' claim shall not affect the process of the company merger or division.

Article 29

Ninety (90) days after the company intending to merge or divide makes its first announcement, and the creditors of the company do not raise any objection, the applicant of the company intending to merge or the company intending to divide shall submit to the examination and approval organ the following documents:

1. evidentiary documents showing that the company has placed a company merger or division announcement in the newspaper three times;
2. evidentiary documents showing that the company has notified its creditors;
3. the company's explanations on the settlement of its debts receivable and debts payable;
4. other documents required to be submitted by the examination and approval organ.

Article 30

An examination and approval organ shall, within thirty (30) days of the receipt of the documents listed in Article 29 of these Provisions, decide whether or not to approve the company merger or division.

Article 31

Where a company merger is carried out through absorption, the accepting company must carry out procedures with the original examination and approval organ for the alteration of its approval certificate of foreign investment enterprise, and complete procedures with the registration organ for the registration of the alteration of the company. The absorbed company must carry out formality with the original examination and approval organ for the cancellation of its approval certificate of foreign investment enterprise and complete procedures with the registration organ for the registration of the cancellation of the company.

Where a company merger is carried out through the method of establishing a new entity, the various parties involved in the merger shall carry out formalities with the original examination and approval organs for the cancellation of their approval certificates of foreign investment enterprise and shall complete procedures with the registration organ for the registration of the cancellation of the companies. The applicant for the newly established company shall obtain an approval certificate of foreign investment enterprise from the examination and approval organ and complete procedures with the registration organ for the registration of the establishment of the company.

Where a company division occurs through the method of continuing existence, the continuing company shall carry out procedures with the original examination and approval organ for the alteration of its approval certificate of foreign investment enterprise, and complete procedures with the registration organ for the registration of the alteration of the company. The newly established companies shall obtain an approval certificate of foreign investment enterprise from the examination and approval organ and complete procedures with the registration organ for the registration of the establishment of the companies.

Where a company is divided through the dissolution method, the original company shall carry out formalities with the original examination and approval organ for the cancellation of its approval certificate of foreign investment enterprise and complete procedures with the registration organ for the registration of the cancellation of the company. The newly established companies shall obtain an approval certificate of foreign investment enterprise from the examination and approval organ and complete procedures with the registration organ for the registration of the establishment of the companies.

Where a company is merged with a domestic enterprise, the company shall carry out formalities to obtain an approval certificate of foreign investment enterprise.

Article 32

An applicant for a company intending to merge or a company intending to divide shall, with regard to matters of dissolution, continuing existence or establishment of new companies as a result of merger or division, carry out relevant procedures for the cancellation, alteration or obtaining of an approval certificate for foreign investment enterprise with appropriate examination and approval organs within thirty (30) days from the date the merger or division is approved by the examination and approval organ.

Article 33

A company shall, from the date of cancellation, alteration or obtaining of an approval certificate for foreign investment enterprises, carry out procedures with the registration organ for the cancellation, alteration or establishment, according to the Administrative Regulations of the People’s Republic of China Governing the Registration of Legal Corporations, the Administrative Regulations of the People’s Republic of China on the Registration of Companies and other provisions.

Registration of new establishments shall be carried out after the relevant company has completed the registration of the alteration and cancellation.

The plan for settling company assets and the plan for absorbing debts receivable and debts payable stated in the company merger agreement or division agreement, and the company merger or division approval document issued by the examination and approval organ, are regarded as the liquidation reports, which is required to be submitted for a cancellation registration.

Article 34

After a company has completed the registration of cancellation and alteration for its merger or division, concerned parties failing to complete registration of its establishment in accordance with the law shall bear corresponding legal responsibility.

Article 35

A revised company contract and Articles of Association signed by investors in the company merger or division, shall become effective from the date on which the approval certificate of foreign investment enterprise is altered or verified and issued by the examination and approval organ.

Article 36

The continuing company or the newly established company after a merger or division, shall, within thirty (30) days from the date of alteration or obtaining a business licence, notify creditors and debtors of the dissolved company of the alteration of creditors and debtors as a result of the merger or division, and make a public announcement in a newspaper of a provincial-level or above circulated nationwide.

Article 37

The continuing company or the newly established company after a merger or division, shall, within thirty (30) days from the date of renewing or obtaining a business licence, carry out relevant registration procedures with taxation administration, customs, land management administration, foreign exchange administration, and other relevant organs.

The continuing company and a new company to be established after the merger between a company and a domestic enterprise shall, in accordance with provisions on foreign investment enterprises, go to such authorities as those in charge of taxation, customs, land management and foreign exchange control to undertake relevant examination and approval procedures.

Article 38

Where a company merger or division involves transfer of ownership of shares, it shall be handled in accordance with relevant laws, regulations and provisions on the change of share ownership of investors in foreign investment enterprises.

During the process of merger between a company and a domestic enterprise, if the foreign investors are to purchase shareholdings held by the domestic enterprises, payment for such purchase shall be carried out in accordance with the Supplementary Provisions to the Certain Regulations on the Subscription of Capital by the Parties to Sino-foreign Equity Joint Enterprises.

Article 39

The merger or division of companies located in other regions of China, established by investors from Hong Kong, Macau and Taiwan, shall be handled in reference to these Provisions.

Article 40

MOFTEC and SAIC are responsible for the interpretation of these Provisions.

Article 41

These Provisions take effect upon promulgation.

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Appendix 3

Regulations on the Acquisition of Domestic Companies by Foreign Investors 《关于外国投资者并购境内企业的规定》

Unofficial translation for reference only

The *Interim Regulations on the Acquisition of Domestic Companies by Foreign Investors* has been amended and approved by the Seventh Ministerial Working Conference of the Ministry of Commerce. The revised version of the *Regulations on Acquisitions of Domestic Companies by Foreign Investors (the Regulations)* is now circulated and shall be effective from 8 September 2006.

Chapter I: General Principles

Article 1

These Regulations are intended to promote and regulate foreign investment in China; introduce foreign advanced technologies and management experience; improve foreign investment absorption; realize reasonable allocation of resources; ensure employment; and maintain fair competition and national economic security. These Regulations are formulated based on laws and administrative regulations on foreign-invested enterprises ("FIEs"), the *PRC Company Law* and other related laws and administrative regulations.

Article 2

The term "acquisition of domestic companies by foreign investors" mentioned in the Regulation shall refer to an acquisition during which a foreign investor purchases the shareholders' equity rights or subscription to increased capital in enterprises other than FIEs (hereinafter referred to as "Domestic Companies"), thereby converting the domestic company into an FIE (hereinafter referred to as "Equity Acquisition"); or an acquisition during which a foreign investor forms an FIE, then purchases and operates assets from domestic companies using the newly formed FIE, or an acquisition during which a foreign investor purchases assets from domestic companies and establishes an FIE to operate such assets (hereinafter referred to as "Assets Acquisition").

Article 3

Foreign investors who acquire a domestic company shall comply with the laws, administrative regulations, and rules and regulations of the PRC; observe the principles of fairness and reasonableness, fair compensation and good faith. It may not cause excessive consolidation, exclusion or restriction of competition, interfere with socio-economic order, impair social and public interests, nor result in loss of state-owned assets.

Article 4

Foreign investors intending to acquire a domestic company shall comply with all the requirements of PRC laws, administrative regulations, and rules and regulations concerning investor's qualifications; and industrial, land and environmental policies.

Pursuant to the *Catalogue of Foreign Investment Industrial Guidance*, where a domestic company operates in an industry which does not allow foreign investors to operate as wholly foreign owned enterprises, an acquisition shall not result in the foreign investor owning all of the equity interests of the acquired domestic company; in specific industries where the Chinese party is required to be in control or relative control, the Chinese party shall maintain control or relative control in such enterprise after the acquisition; where a domestic company is engaged in an industry in which operation by foreign investors is prohibited, such enterprises may not be acquired by foreign investors.

The original business scope of the domestic company to be acquired shall comply with relevant industrial policies for foreign investment; otherwise, adjustment shall be made.

Article 5

When a domestic company is acquired by a foreign investor and the transaction involves the transfer of state-owned assets and state-owned equity of a listed company, such acquisition shall comply with relevant guidelines on state-owned assets.

Article 6

When a foreign investor acquires a domestic company and as a result the domestic company becomes an FIE, approval shall be obtained from the examination and approval authority in accordance with the procedures for amendment of registration or establishment registration with the registration and administration authority.

If a domestic listed company is acquired, relevant procedures shall be undertaken with the securities regulatory authority of the State Council pursuant to the *Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors.*

Article 7

All parties involved in an acquisition of a domestic company by foreign investors shall pay taxes and be subject to the supervision of the tax authorities in accordance with PRC tax regulations.

Article 8

Foreign investor acquiring a domestic company shall comply with PRC foreign exchange laws and administrative regulations, in a timely manner, for forex approval, registration, filing and amendment with the relevant authority in charge of administration of foreign exchange.

Chapter II: Fundamental System

Article 9

If the foreign investor's contribution to the registered capital of the FIE formed is greater than 25% after the acquisition, the FIE shall qualify for preferential treatment for FIEs.

If the foreign investor's contribution to the registered capital of the FIE formed is less than 25% after the acquisition, such enterprise formed shall not qualify for preferential treatment for FIEs. Any foreign loans shall be handled in compliance with the relevant regulations concerning foreign loans borrowed by enterprise other than FIE. The examination and approval authority shall issue an Approval Certificate noted with "Foreign Equity Ratio Below 25%" (hereinafter referred to as "Approval Certificate"). The registration department, foreign exchange control authority shall also issue such enterprise the Certificate of Approval of a FIE and Foreign Exchange Registration Certificate noted with "Foreign Equity Ratio Below 25%".

An acquisition made by a foreign company that is affiliated to a domestic company or natural person shall not qualify for the preferential treatment of a FIE, unless such foreign company subscribes to the increased capital of such domestic corporation, or contributes additional capital to the FIE formed after acquisition, and the reinvestment is greater than 25%. If the contribution made by any foreign investors other than the actual controlling party is greater than 25%, the FIE formed under the aforementioned condition shall qualify for the preferential treatment of a FIE.

If a foreign investor acquires a domestic listed company, the preferential treatment of a FIE shall be governed by the relevant regulations of the PRC.

Article 10

The term "examination and approval authority" mentioned in the Regulations refers to the Ministry of Commerce ("MOFCOM") or the provincial level commercial department (hereinafter referred to as the "Approval Department at the Provincial Level"). The "registration administration authority" refers to the State Administration of Industry and Commerce of the PRC("SAIC") or its authorised local administrative authority. The "foreign exchange control authority" refers to the State Administration of Foreign Exchange ("SAFE") or its subsidiaries.

Article 11

The acquisition of any domestic company by a foreign company that is established or controlled by a domestic company shall submit application to MOFCOM for examination and approval of the acquisition.

The parties involved shall not avoid any requirements for the above by making domestic investment through FIEs or otherwise.

Article 12

If a foreign investor intends to obtain actual control of a domestic company after an acquisition, and such acquisition is involved in a major industry, or has or may have an impact on the state's economic security, or result in the transfer of the actual controlling interest of the domestic company owning any leading trademarks or historical Chinese brands to such foreign investor, applications should be made to MOFCOM for examination and approval.

If the parties involved fails to make such application to MOFCOM and its acquisition has or may have significant impact to the state's economic security, MOFCOM, in conjunction with relevant authorities in charge, could demand such party to terminate the transfers of relevant equity interests or assets, or take any other effective actions to eliminate the impact of such acquisition on the state's economic security.

Article 13

In an equity acquisition by foreign investors, the FIE formed as a result of the transaction shall inherit the creditors' rights and liabilities of the acquired domestic company.

In case of asset acquisition by foreign investor, the domestic company which sells its assets shall assume its original creditors' rights and liabilities.

When a foreign investor acquires a domestic company, the creditors and other parties may reach an agreement separately on the disposition of the assets and liabilities of the acquired domestic company. The agreement on disposition of the assets and liabilities shall not harm a third person's benefits or public interests, and shall be submitted to the approval authority.

The domestic company which sells assets shall notify the creditors and publish an announcement in a provincial or higher level newspaper 15 days before the investor submits relevant application documents to the examination and approval authority.

Article 14

The parties involved in the acquisition shall determine the transaction price based on the asset appraisal organisation's evaluation, which is referenced to the value of the equity interest to be transferred or the assets to be sold. The parties involved may reach an agreement concerning the engagement of the asset appraisal organisation, which is legally established in the PRC. The asset appraisal thus required shall adopt international generally accepted principles of appraisal. It is not allowed to assign equity interests or sell assets at a price that is significantly lower than the appraisal value in order to shift capital foreign in a covert manner.

When the acquisition of a domestic company by a foreign investor involves any change of equity interests of State-owned assets, or involves the transfer of the title of State-owned assets, it shall comply with relevant regulations on the administration of State-owned assets.

Article 15

The parties involved in the acquisition shall clarify whether there is any affiliation between them. If both parties are actually under the control of a common parent, they shall disclose this to the examination and approval authority in charge; and, shall also provide further explanation with regard to whether the acquisition's purpose and appraisal results comply with the fair market value. The parties involved shall not avoid the above requirements by means of trusteeship, intermediate holding or otherwise.

Article 16

Where a foreign investor acquires a domestic company and the acquired domestic company becomes an FIE, the foreign investor shall pay the consideration in whole to the shareholder(s) which transferred the equity interests or to the domestic company which sold the assets within three (3) months after the date of issuance of the FIE's Business License. In special circumstances which require an extension, it is subject to the approval of the examination and approval authority: the foreign investor shall pay at least sixty percent (60%) of the consideration within six (6) months after the date of issuance of the FIE's Business License, and pay the balance in full within one (1) year; and its share of the gains shall be proportional to the actual-contributed capital.

Where a foreign investor subscribes to any increased capital of a domestic company, the shareholder(s) of the domestic limited liability company or the domestic shareholding company established by means of sponsorship shall, at the time the domestic company applies for its FIE Business License, contribute at least twenty percent (20%) of the increased registered capital. The schedule for install contribution to increased registered capital of such enterprise shall comply with the *PRC Company Law*, relevant laws and regulations on foreign investment and the *Regulations on Administration of Company Registration*. Relevant stipulations of other laws and administrative regulations shall also be followed where necessary. When a shareholding company issues new stocks to increase its registered capital, its shareholders shall comply with payment of stocks for establishment of shareholding companies.

When an asset acquisition is made by a foreign investor, the investors shall specify the timeframe of capital contributions in the contract and in the articles of association of the FIE to be established. Where a FIE is established, and such FIE operates the assets purchased from a domestic company as agreed, then the part of the capital contribution that is equivalent to the consideration payable for the assets, shall be paid by the investors within the timeframe specified in the first paragraph of this Article. The balance of the capital contribution shall be made in accordance with the relevant provisions.

Where a foreign investor acquires a domestic company and the acquired domestic company becomes a FIE and contributed less than twenty five percent (25%) of the registered capital of such enterprise and the investor intends to contribute by cash, it shall pay in full within three (3) months after the date of issuance of the FIE's Business License; if the investor intends to contribute by industrial property, etc., it shall pay in full within six (6) months after the date of issuance of the FIE's Business License.

Article 17

The method of payment for an acquisition shall comply with relevant PRC laws and administrative regulations. Where a foreign investor makes payment with its legally owned RMB, it shall be verified by the foreign exchange administration authority. Where a foreign investor pays for the acquisition with stocks over which it has disposal right, it shall comply with the requirements provided in Chapter IV.

Article 18

Where a foreign investor purchase of equity rights of a domestic company and the acquired domestic company becomes a FIE: the registered capital of such FIE shall be the same as that of the original domestic company; the capital contribution ratio of the foreign investor shall be the same as the percentage accounted for, by the equity interests it has acquired in the original registered capital.

Where a foreign investor subscribes increased capital in a domestic limited liability company, the registered capital of the domestic limited liability which becomes a FIE shall be the total of the registered capital of the original domestic company and the increased investment. The foreign investor and other investors to the acquired domestic company shall identify their respective capital contribution ratios in the registered capital of the FIE based on the assets evaluation.

Where a foreign investor subscribes increased capital in a domestic shareholding company, the foreign investor shall determine the registered capital in accordance with the relevant regulations specified in the *PRC Company Law*.

Article 19

In cases of equity acquisition by a foreign investor, except otherwise regulated by the PRC, the maximum total investment of the proposed FIE shall be agreed upon according to the following percentage:

1. if the registered capital is less than US$2.1 million, the total amount of investment may not exceed seven-tenth (7/10) of the registered capital;
2. if the registered capital is equal or greater than US$2.1 million and less than US$5 million, the total amount of investment may not exceed twice (2) the registered capital;
3. if the registered capital is equal or greater than US$5 million and less than US$12 million, the total amount of investment may not exceed two and a half (2.5) times the registered capital;
4. if the registered capital is equal or greater than US$12 million, the total amount of investment may not exceed three (3) times the registered capital.

Article 20

In the case of asset acquisition by foreign investor, the total investment of the proposed FIE shall be determined based on the transaction price of the assets purchased and the actual scale of production and operation. The ratio of the proposed FIE's registered capital to its total investment shall comply with relevant regulations.

Chapter III: Examination, Approval and Registration

Article 21

In the case of an equity acquisition by a foreign investor, the investor shall, pursuant to laws, administrative regulations, and rules and regulations on the establishment of FIEs, submit the relevant examination and approval authority the following documents, which are related to the total amount of investment and enterprise type of the proposed FIE and the industry it is to engage in:

1. in the case of a domestic limited liability company to be acquired: unanimous shareholders' resolution in favor of the equity acquisition by the foreign investor is required; in the case of a domestic shareholding company to be acquired: resolution of the shareholders' general meeting in favor of the equity acquisition by the foreign investor is required;
2. an application to convert the domestic company being acquired into a FIE according to the law;
3. contracts and articles of association of the FIE formed after acquisition;
4. an agreement which specifies purchase of the equity of a domestic company or subscription of increased capital of the domestic company by a foreign investor;
5. an audited financial report for the latest fiscal year of the domestic company being acquired;
6. notarised or legally certified investor's identification documents or certificates of registration and certificates of credit worthiness;
7. introduction of the enterprises invested by the acquired domestic company;
8. (duplicates of) the Business License of the acquired domestic company and the enterprises it has invested;
9. employee arrangement plan of the acquired domestic company; and
10. other documents to be submitted pursuant to Articles 13, 14, and 15 hereof.

Where the business scope, scale and land use right of the FIE formed after acquisition requires approval from other relevant government authorities, the relevant approval documents shall be submitted together with the above mentioned documents.

Article 22

The equity purchase agreement and the agreement for increasing the capital of a domestic company shall be governed by PRC law and shall include the following key contents:

1. particulars of the parties to the agreement, including their business name (names) and domiciles, the names, positions and nationalities of their legal representatives, etc.;
2. percentage to the total amount of equity interest and price of the equity to be purchased or of the capital increase to be subscribed;
3. term and method of performance of the agreement;
4. rights and obligations of the parties involved;
5. liability for breach of contract and resolution of disputes; and
6. date and place of execution of the agreement.

Article 23

In the case of an asset acquisition by a foreign investor, the investor shall, pursuant to laws, administrative regulations, and rules and regulations on the establishment of FIEs, submit the relevant examination and approval authority the following documents, which are related to the total amount of investment and enterprise type of the proposed FIE and the industry it is to engage in:

1. resolution in favor of the asset sale passed by the owner of the domestic company or any organisation within the domestic company that has such decision making power;
2. an application for the establishment of FIE;
3. contract for and the articles of association of the proposed FIE;
4. asset purchase agreement executed by the proposed FIE and the domestic company or by the foreign investor and the domestic company;
5. (duplicates of) the articles of association and the Business License of the domestic company to be acquired;
6. proof of the fact that the domestic company to be acquired has notified and published an announcement for its creditors, as well as statements on whether its creditors have raised any objections;
7. notarised or legally certified investor's identification documents or certificates of commencement of business and certificates of creditworthiness;
8. arrangements made for the employees of the domestic company to be acquired; and
9. other documents to be submitted pursuant to Articles 13, 14, and 15.

If the purchase and operation of the assets of a domestic enterprise in accordance with the provisions of the preceding paragraph requires permission from other relevant government authorities, the relevant permission documents shall be submitted together with the above mentioned documents.

In cases where a foreign investor purchases assets as agreed from a domestic company and uses such assets to invest in and establish FIE, it may not operate business with such assets before the official establishment of the FIE.

Article 24

The asset purchase agreement shall be governed by PRC law and shall include the following key content:

1. particulars of the parties to the agreement, including their business name (names) and domiciles, names, titles and nationalities of their legal representatives, etc.;
2. list and price of the assets to be purchased;
3. terms and methods of performance of the agreement;
4. rights and obligations of the parties;
5. liability for breach of contract and resolution of disputes; and
6. date and place of execution of the agreement.

Article 25

Where a foreign investor acquires a domestic company and establishes a FIE, the examination and approval authority shall determine whether to grant approval within thirty (30) days upon the its receipt of the entire set of prescribed documents, unless otherwise specified differently in the Regulations in accordance with the law. If it decides to grant its approval, it shall issue an Approval Certificate.

When an examination and approval authority approves an acquisition by a foreign investor of the shareholders' equity interests in a domestic company, the authority shall send copies of the relevant approval document to the local foreign exchange control authorities of the transferor of the equity interests and the domestic company. The local foreign exchange control authority of the transferor shall handle the registration of the receipt of the foreign exchange related to equity transfer and shall issue relevant certificate(s) accordingly. The "registration certificate of receipt of foreign exchange related to equity transfer" refers to the effective documents attesting that the foreign investor has paid in the consideration for the Equity Acquisition.

Article 26

In the case of asset acquisitions, foreign investors shall register the establishment of foreign investment enterprises with registration authorities within 30 days from receipt of the Approval Certificate for Foreign Investment Enterprise and obtain the Business Licence for Foreign Investment Enterprise.

In the case of equity acquisitions by foreign investors, the acquired domestic company shall apply to the original registration authority for amendment of registration according to the Regulations and obtain a Business License of FIE. In cases where the original registration authority has no jurisdiction over the registration, the authority shall transfer the application documents to another registration authority that is qualified within ten (10) days after the date of receipt of the documents, together with the registration files of the domestic company. The domestic company to be acquired shall submit the following documents listed below and is held liable for their truthfulness and validity:

1. application for amendment of registration;
2. agreement under which the foreign investor purchases the equity of the shareholder in the Domestic Company or subscribes to the domestic company's capital increase;
3. the corporation's amended articles of association or the proposed amendments to the original articles of association and the contract for the FIE that needs to be submitted in accordance with the law;
4. FIE Approval Certificate;
5. foreign investor's qualification certificate as an entity and identification certificate of a natural person;
6. amended list of the directors, a document specifying the names, domiciles and the instruments of appointment of the new directors; and
7. other relevant documents and certificates specified by the SAIC.

The investor shall go through registration procedures with relevant authorities such as those for taxation, customs, land administration and foreign exchange control within thirty (30) days after the date of receipt of the FIE Business License.

Chapter IV: Acquisition of Domestic Company by Foreign Investor through Payment of Equity Interests

Section 1 - Conditions of Equity Acquisition

Article 27

The term “acquisition of domestic company by foreign investor through payment of equity interests” mentioned in this Chapter IV, refers to acquisition of any equity interests held by shareholders of a domestic company or additional stocks issued by such domestic company. Such acquisition shall be made through payment of equity interests held by shareholders of a foreign company or additional stocks issued by such foreign company.

Article 28

Any foreign company referred to in this Chapter IV shall comply with all the requirements of its lawful establishment. The locality where the foreign company is registered must have a well-established corporate legal system and the foreign company has had no penalty imposed by the relevant supervisory authority or its management in the past three (3) years. Except for any Special Purpose Vehicle (SPV) provided in Section 3 of this Chapter IV, a foreign company referred in the Regulations shall be a listed company and the place where it is listed shall have well-established system of securities exchange.

Article 29

Acquisitions of a domestic company by a foreign investor through payment of equity interests shall comply with the following:

1. the equity share is lawfully held and transferable by shareholders in accordance with law;
2. the equity share are not subject to any dispute of ownership or any lien or otherwise encumbrances;
3. the equity shares of the foreign company were lawfully listed for public trade on the foreign securities exchange market (not including any over-the-counter bulletin board);
4. the trading price of the foreign company’s equity shares for the recent one (1) year has been stable.

Sub-clauses (3) and (4) above shall not be applicable to Special Purpose Vehicles provided in Section (3) of this Chapter IV.

Article 30

For any acquisition of a domestic company by a foreign investor through payment of equity interests, the domestic company or its shareholders shall engage an agency registered in China as its advisor (hereinafter referred to as Acquisition Advisor). The acquisition advisor shall be responsible for conducting financial review with regard to the authenticity of the application documents and the foreign company’s financial status required for purpose of such acquisition, as well as whether such acquisition is in conformity with the Regulations of Articles 14, 28 and 29. It shall issue an Acquisition Advisor Report, explicitly providing its professional opinion with regard to the aforementioned reviews.

Article 31

The acquisition advisor shall meet the following qualification:

1. has good reputation and possesses related working experience within the industry;
2. no record of committing any significant illegal acts of violation of laws;
3. capable to conduct any investigation and analyse the legal system applied in the places where the overseas company is registered and listed

Section 2 - Application Documents and Procedures

Article 32

For any acquisition of a domestic company by a foreign investor through payment of equity interests, the foreign investor shall apply to MOFCOM for examination and approval, while the domestic company to be acquired shall submit, in addition to the documents required under Chapter III, materials as follows:

1. description of any major changes with regard to the equity interests and assets of the domestic company within the recent one (1) year;
2. the Acquisition Advisor Report;
3. certifications regarding the incorporation of the domestic company and the foreign company involved or identification information of their shareholders;
4. description of the status in regard to the equity shares held by shareholders of the foreign company and a name list of shareholders holding over five percent (5%) of the foreign company's equity shares;
5. articles of association of the foreign company and description of any external collateralization provided by such company;
6. audited financial reports of the foreign company for the most recent year and a status report regarding the transactions of its stocks for the recent half year;

Article 33

MOFCOM shall examine the acquisition application within thirty (30) days upon its receipt of all the completed documents submitted for examination and approval. An Approval Certificate shall be issued if all the requirements on the acquisition are met, which shall be specifically marked "this approval certificate for acquisition of domestic company by foreign investor through payment of equity interests shall be valid within six (6) months from the date on which the business license is issued" ("Marked COA").

Article 34

The acquired domestic company shall handle registration of such change with the relevant authorities in charge of registration and administration of foreign exchange within thirty (30) days upon its receipt of the Marked COA. These relevant authorities shall issue to the domestic company FIE Business License and FIE Foreign Exchange Certificate, respectively, both of which shall be marked "this certificate shall be valid within eight (8) months from the date of issuance" ("Marked BL" and "Marked FEC").

When the domestic company handles registration of changes with the relevant registration authority, it shall provide in advance documents signed by the legal representative of the domestic company for purpose of future restoration of its equity structure, if applicable, including but not limited to the application for change of equity interests, amended articles of association, and equity transfer agreement.

Article 35

Within six (6) months from the issuance date of the Marked BL, the domestic company or its shareholders shall, subject to their possession of any equity interests of the foreign company through such acquisition, apply to MOFCOM and the relevant foreign exchange control authority for examination and approval and registration regarding foreign investment and establishment of foreign enterprise.

In addition to the documents required by the *Regulations on Examination and Approval of Making Investment and Establishing Foreign Enterprise* when submitting to MOFCOM, the parties involved must also submit both their Marked COA and Marked BL. After the approval of the possession of the foreign company's equity interests by the domestic company or its shareholders, MOFCOM shall issue a new Approval Certificate for offshore investment by Chinese enterprise ("Foreign Investment COA") and a non-marked FIE Approval Certificate ("Non-marked COA"), which shall replace the original Marked COA.

After obtaining the Non-marked COA, the domestic company shall, within thirty (30) days, apply to the relevant authorities in charge of registration and foreign exchange administration, respectively, for issuance of a non-marked FIE Business License ("Non-marked BL") and a non-marked FIE Foreign exchange Certificate ("Non-marked FEC").

Article 36

If the Domestic company and the foreign company fail to complete the procedures for change of their equity interests, the Marked COA within six (6) months from the issuance date of Marked ML and the Foreign Investment COA shall automatically become null and void. The registration authority shall examine and approve to change the registration for restoration of the Domestic Company's equity structure back to such condition as it was before the acquisition in accordance with the relevant equity change documents submitted by the domestic company in advance regarding restoration of its equity structure.

In the event of failure in the acquisition of any additional stocks issued by the domestic company, before the relevant registration authority approves the change of registration regarding equity structure restoration under the provision, the domestic company shall reduce its registered capital accordingly and make public announcement in newspapers under the PRC Company Law.

If the domestic company fails to make such change of registration in accordance with the Regulations, it shall be handled by the relevant registration authority according to the *Administrative Regulations on Registration of Companies*.

Article 37

The domestic company shall not distribute any profit to shareholders, provide any guarantee to its affiliates, or make any payment incurred from equity transfer, reduction of funds, liquidation and any other accounts of capital-related items until obtaining the Non-marked COA and Non-marked FEC.

Article 38

With the Non-marked COA and Non-marked BL issued by MOFCOM and the relevant registration authority, the domestic company or its shareholders shall undertake the procedure for modification of tax registration with the relevant tax authority.

Section 3 - Special Regulations on Special Purpose Vehicles

Article 39

The term "Special Purpose Vehicle" (SPV) refers to an offshore company that is directly or indirectly controlled by a Chinese domestic company or a Chinese natural person. The purpose of this offshore company is for the listing of its equity interest in the domestic company.

Regulations in this Section shall be applicable to acquisitions of any equity interests held by shareholders of domestic companies or additional stocks issued by domestic companies through payment of equity interests by shareholders of the SPV or additional stocks issued by such SPV for purpose of foreign listing.

Where a foreign company holds any equity shares of a SPV is targeted as the main body to make offshore listing by the parties involved, such foreign company must meet the SPV requirements provided in this Section.

Article 40

Transactions for purpose of offshore listing of SPV shall be subject to approval by the relevant securities supervisory and administration authorities under the State Council.

The country or region where offshore listing of proposed SPV shall have well-established legal and supervisory systems, the local securities regulatory and administrative authorities shall have entered into memorandum of understanding on cooperation with the Chinese securities regulatory and administration authorities under the State Council, with effective cooperative relationship between them.

Article 41

A domestic company providing its share interests for offshore listing shall meet the requirements as follows:

1. the title of its property rights is clear without question and there is no dispute, existing or threatened, regarding its property rights;
2. it has well-established system for business operation and is capable of maintaining constant operation;
3. it possesses a healthy and well-established company operation structure and internal management system;
4. no record shows any commitment of any material violation of law by such company and its shareholders in the past three (3) years.

Article 42

Where a domestic company establishes any SPV overseas, it shall apply to MOFCOM for examination and approval. When undertaking procedures for examination and approval, the domestic company shall submit, in addition to those provided under the Regulations on Examination and Approval of Making Investment and Establishing Foreign Enterprise, documents as required below to MOFCOM:

1. identification certificate of the ultimate controlling party of the proposed SPV;
2. business plan of such SPV for foreign listing;
3. valuation report provided by the acquisition advisor regarding the issuing price of the SPV's stocks to be listed overseas.

After obtaining the Foreign Investment COA, the founder or controlling party shall apply to the local foreign exchange control authority for foreign exchange registration.

Article 43

The total value of stock issuing price for offshore listing of the SPV shall not be lower than the equity value of the acquired domestic company as appraised by the relevant Chinese assets valuation organization.

Article 44

In the case of an acquisition of a domestic company by a SPV through payment of equity interests, the domestic company must submit to MOFCOM documents as required below in addition to those required under Article 32:

1. relevant Approval Certificate and documents for making foreign investment and establishing foreign enterprise when such SPV was set up;
2. foreign investment foreign exchange registration form of the SPV;
3. identification certificate of the ultimate controlling party or the incorporation certificate and articles of association of the SPV;
4. business plan of the SPV for foreign listing;
5. valuation report provided by the acquisition advisor regarding the issuing price of the overseas listed SPV's stocks.

If a domestic company targets a foreign company holding any equity shares of a SPV as the main body through which offshore listing thereof will be made, the domestic company shall submit application documents as required below:

1. incorporation certificate and articles of association of the targeted foreign company;
2. detailed descriptions on the transaction arrangements and price conversion assessment made by and between the SPV and the foreign company regarding the equity interests of the acquired domestic company.

Article 45

MOFCOM shall issue an official reply of approval if it consents to the documents submitted under Article 44 after its preliminary examination. With such official reply, the domestic company shall submit listing application documents to the securities supervisory authority under the State Council, which shall determine whether it shall grant approval within twenty (20) working days.

After approval is granted, the domestic company shall apply to obtain the formal Approval Certificate from MOFCOM. MOFCOM shall issue such an Approval Certificate marked as "this is to certify the equity shares of the foreign SPV, valid within one (1) year from the issuance date of the business license." ("Marked COA").

In the event of any change in the equity interests of the SPV due to acquisition, the domestic company or the natural person holding equity shares of such SPV shall, with its FIE Marked COA, undertake formalities with MOFCOM for change of registration of the SPV in regard to foreign investment and establishment of enterprise, and also with the local foreign exchange control authority for change of registration of the foreign investment foreign exchange.

Article 46

Within thirty (30) days upon its receipt of the marked COA, the domestic company shall handle formation with the authorities in charge of registration and foreign exchange administration for change of relevant registrations. These authorities shall issue FIE Business License and FIE Foreign Exchange Certificate to the domestic company. Both documents shall be marked as "this certificate shall remain valid within fourteen (14) months from the date of issuance" ("Marked BL" and "Marked FEC").

When the domestic company handles change of registrations with the relevant registration authority, it shall provide in advance documents signed by the legal representative of the domestic company for the purpose of future restoration of its equity structure, if applicable, including but not limited to the letter of application for change of equity interests, amended articles of association, equity transfer agreement.

Article 47

Within thirty (30) days upon the completion day of the offshore listing of the SPV or its affiliated foreign company, the domestic company shall report to MOFCOM regarding the offshore listing and financing revenue repatriation plan, and also apply for issuance of a non-marked FIE Approval Certificate. Simultaneously, within thirty (30) days upon the completion day of the offshore listing, the domestic company shall report to the securities supervisory authority under the State Council regarding the offshore listing status and provide relevant documents for filing. In addition, the report of the financing revenue repatriation plan to the foreign exchange control authority is required, and shall be subject to the supervision by the foreign exchange authority. Within thirty (30) days after its receipt of the Non-marked COA, the domestic company shall apply to the relevant authorities in charge of registration and foreign exchange administration for issuance of a Non-marked FIE Business License ("Non-marked BL") and a non-marked FIE Foreign Exchange Certificate ("Non-marked FEC").

If the domestic company fails to report to MOFCOM within the time limit set forth above, its Marked COA shall automatically void and its equity structure shall be restored to such status as it was prior to the equity acquisition. The domestic company shall then undertake procedures for amendment of the relevant registration in accordance with the Regulations of Article 36.

Article 48

The repatriation of SPV's offshore-listing financing revenue shall, according to the revenue repatriation plan submitted to the foreign exchange authority and relevant regulations on foreign exchange administration, be arranged to be utilised in China. Such financing revenue can be repatriated through means as below:

1. by providing business loan to the domestic company;
2. by establishing new FIE in China; or
3. by acquiring a domestic company.

The repatriation of foreign financing revenue of a SPV shall comply with the Chinese laws and regulations with regard to administration of foreign investment and foreign debts. If repatriation of such revenue results in an increase in the equity interests of the SPV held by the domestic company or natural person, or an increase in the net assets of the SPV, the parties involved shall fully disclose such facts for examination and approval. The formality for foreign exchange registration and change of registration regarding foreign investment shall be undertaken after approval.

Profits, dividends and foreign exchange income obtained by change of capital, which are received by the domestic company and natural person(s) from a SPV shall be repatriated back to China within six (6) months from the day on which they are received. Profits and dividends can be deposited under a current account of foreign exchange or provided for foreign exchange settlement. Subject to approval of the relevant foreign exchange authority, the foreign exchange income incurred from capital variation can be maintained in a special account of capital items, or be provided for settlement.

Article 49

Within one (1) year upon the issuance date of the Marked BL, if a domestic company fails to obtain its Non-marked COA, its Marked COA shall expire automatically; formalities for amendment of the relevant registration is required according to Article 36 in the Regulations.

Article 50

After the SPV has completed the proposed offshore listing and the domestic company has obtained its Non-marked COA and Non-marked BL, where the parties involved proceeds to conduct any further acquisition of the domestic company through payment of equity interests of such SPV, Sections 1 and 2 of this Chapter IV shall be applied.

Chapter V: Anti-trust Review

Article 51

Where a foreign investor acquires a domestic enterprise, if any of the following circumstances applies, the investor shall report to MOFCOM and SAIC:

1. any of the parties to the acquisition has a business turnover over RMB1.5 billion.;
2. the foreign investor acquired more than 10 enterprises in related industries in China during one year;
3. any of the parties to the acquisition already controls not less than 20% of market share in China; or
4. acquisition leads to the market share of one of the parties to the acquisition in China reaching 25%.

At the request of a competing domestic enterprise or the relevant functional authority or trade association, if MOFCOM or the SAIC reasonably believe that the acquisition by the foreign investor would involve enormous market share or other important factors that would materially hinder market competition or otherwise are present, it may nevertheless require the foreign investor to file a report, even if the criteria in the preceding paragraph are not met.

The aforementioned “any of the parties to the acquisition” shall include affiliates of the foreign investor.

Article 52

If acquisition of domestic enterprises by a foreign investor involves any of the circumstances listed in article 51 of the Regulations, and MOFCOM and SAIC believe that the acquisition might lead to over-concentration, interference with fair competition, or impairment to consumer benefits: within 90 days upon receiving the complete set of documents requested, the two authorities shall, after consulting each other, call jointly or individually a hearing for the related departments, institutions, enterprises and other interested parties, and determine whether to approve the application according to law.

Article 53

If foreign acquisition involves any of the following circumstances, the parties involved shall, before publishing the acquisition plan or at the same time as reporting to their host country/region competent authorities, submit the acquisition plan to MOFCOM and SAIC. The two authorities shall review whether any existing circumstances would cause an over-concentrated domestic market, hinder domestic fair competition, harm the interests of domestic consumers, and therefore determine whether to approve the plan:

1. any of the parties to the foreign acquisition has assets of over RMB3 billion in China;
2. any of the parties to the foreign acquisition has a business turnover of over RMB1.5 billion in the Chinese market during the year of application;
3. any of the parties to the foreign acquisition and its associated enterprises has a market share of 20% in the Chinese market;
4. The market share of one of the parties to the foreign acquisition and its associated enterprises reaches 25% in China; and
5. any of the parties to the foreign acquisition participates either directly or indirectly in more than 15 FIEs in the related sectors in China.

Article 54

Any of the parties to the acquisition may apply to MOFCOM and SAIC for exemption from the anti-trust review, if any of the following is applicable:

1. the acquisition could improve the conditions for fair market competition;
2. the acquisition could restructure a loss-making enterprise and ensure employment;
3. the acquisition could introduce advanced technology, bring in management talent and could enhance the international competition abilities of the enterprise; or
4. the acquisition could improve the environment.

Chapter VI: Supplementary Provisions

Article 55

The Regulations shall apply to the acquisition of domestic companies by Chinese investment companies established by foreign investors.

Where acquisition of shareholders' equity of any FIE in China by a foreign investor or subscription to increased capital of FIE in China, it shall be governed by current laws and administrative regulations on FIEs and rules on change of equity interests of FIEs' investors. Any details not provided in such laws and regulations shall refer to the Regulations.

Where an acquisition of domestic enterprise through FIE established in China by a foreign investor, it shall be governed by relevant regulations on acquisition of FIEs and provisions on domestic investment by FIEs in China. Any details not provided in such laws and regulations shall refer to the Regulations.

In the case where a foreign investor acquires a domestic limited liability company, and reorganizes such entity into limited shareholding company, or the acquired domestic company was limited shareholding company, it shall be governed by relevant regulations on establishment of foreign-invested shareholding company. Any details not provided in such laws and regulations shall refer to the Regulations herein.

Article 56

When submitting documents, the documents shall be classified and a list of the documents shall be included in accordance with the Regulations. All of the prescribed documents shall be written in Chinese.

Article 57

Chinese natural person shareholders of the domestic company subject to any equity acquisition can remain Chinese investors of the formed FIE upon approval.

Article 58

Regardless the fact that any of its natural person shareholders changes his/her nationality, the nature of a domestic company shall remain unchanged.

Article 59

Staff of the relevant government departments shall act with integrity and perform their duties in accordance with the law. They shall not take advantage of their professional position to act wrongfully out of personal considerations, and shall have the obligation to keep all the trade secrets came to their awareness in confidential.

Article 60

Acquisition of enterprises in China by investors from Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan shall comply with the Regulations herein.

Article 61

The Regulations shall take effect from 8 September 2006.

Appendix 4

Administration of the Takeover of Listed Companies Procedures《上市公司收购管理办法》

Promulgated by the China Securities Regulatory Commission on 31 July 2006 and effective as of 1 September 2006

Part One: General Provisions

Article 1

These Procedures have been formulated in accordance with the *Securities Law,* the *Company Law* and other relevant laws and administrative regulations in order to standardize the activities of takeover of listed companies and the associated changes in share interest, protect the lawful rights and interests of listed companies and investors, safeguard the order of the securities market and the public interest and promote optimized allocation of securities market resources.

Article 2

Activities of takeover of listed companies and the associated changes in share interest must comply with laws and administrative regulations, and the provisions of the China Securities Regulatory Commission (hereafter, the "CSRC"). The parties shall act in good faith, observe social ethics and business ethics, safeguard the order of the securities market on their own initiative and accept supervision by the government and the public.

Article 3

Activities of takeover of listed companies and the associated changes in share interest must follow the principles of openness, fairness and impartiality.

A person with information disclosure obligations in the activities of the takeover of a listed company and the associated change in share interest shall fully disclose his interest in the listed company and the change thereof, and shall rigorously perform the reporting, announcement and other statutory obligations in accordance with the law. Before the relevant information is disclosed, he shall bear the obligation of maintaining confidentiality.

The information reported or announced by the persons with information disclosure obligations must be truthful, accurate and complete and may not contain any false record, misleading statement or major omission.

Article 4

Activities of takeover of listed companies and the associated changes in share interest may not jeopardize national security and the public interest.

If an activity of takeover of a listed company and the associated change in share interest involves matters such as the industrial policy of the State, access to industry and transfer of State-owned equity interests, and requires the approval of the relevant State authorities, it shall be carried out after obtaining such approval.

If a foreign investor carries out activities of takeover of a listed company and the associated change in share interest, it shall obtain the approval of the relevant State authorities, apply the law of China and submit to the judicial and arbitral jurisdiction of China.

Article 5

A purchaser may become the controlling shareholder of a listed company by means of acquisition of shares, may become the *de facto* controlling person of a listed company by way of an investment relationship, agreement or other arrangement, and may gain the control of a listed company by adopting the above means and ways concurrently.

A purchaser includes the investor and the person(s) acting in concert.

Article 6

No person may use the takeover of a listed company to prejudice the lawful rights and interests of the target company and its shareholders.

In any of the following circumstances, the takeover of a listed company may not proceed:

1. the purchaser owes a relatively large amount of debts that are matured, unpaid and continuing;
2. the purchaser has committed a major illegal act or has been suspected of committing a major illegal act within the most recent three years;
3. the purchaser has had a serious act of bad faith in the securities market within the most recent three years;
4. where the purchaser is a natural person and he falls within the circumstances specified in Article 147 of the *Company Law*; or
5. other circumstances specified in laws and/or administrative regulations and deemed by the CSRC that the takeover of a listed company shall not proceed.

Article 7

The controlling shareholder or *de facto* controlling person of a target company may not abuse its shareholder's rights to harm the lawful rights and interests of the target company or other shareholders.

If the controlling shareholder or *de facto* controlling person of a target company and its connected parties has harmed the lawful rights and interests of the target company and other shareholders, the said controlling shareholder or *de facto* controlling person shall take the initiative to eliminate the damage before the transfer of the control of the target company. If it fails to eliminate the damage, it shall make an arrangement to use the proceeds from its transfer of the relevant shares to eliminate the entire damage, provide an adequate and valid performance bond or arrangement for any part of the damage that is not sufficiently eliminated by the proceeds, and obtain the approval of the shareholders' general meeting of the target company in accordance with the articles of association.

Article 8

The directors, supervisors and senior management personnel of a target company owe a fiduciary duty and an obligation of due diligence to the company and shall treat all purchasers of the company fairly.

The decisions made and the measures taken by the board of directors of the target company with regard to the takeover shall be conducive to safeguarding the interests of the company and its shareholders. The board of directors may not abuse its power to create undue obstacles to the takeover, use the resources of the company to provide any form of financial assistance to the purchaser, or harm the lawful rights and interests of the company and its shareholders.

Article 9

When engaging in the takeover of a listed company, a purchaser shall hire a professional institution registered in China with qualifications for engaging in financial advisory business as its financial advisor. No purchaser may engage in the takeover of a listed company if it fails to engage a financial advisor in accordance with the provisions hereof.

The financial advisor shall act with due diligence, observe the industrial standards and professional ethics, maintain its independence and ensure the truthfulness, accuracy and completeness of the documents it produces or issues.

The financial advisor shall refuse to provide financial advisory services to the purchaser if it believes that the purchaser uses the takeover of the listed company to harm the lawful rights and interests of the target company and its shareholders.

Article 10

The CSRC shall regulate the activities of takeover of listed companies and the associated changes in share interest in accordance with the law.

The CSRC shall set up a special committee comprised of professionals and relevant experts. The special committee may provide consultancy advice at the request of the functional departments of the CSRC on whether a takeover of a listed company is constituted, whether there is a circumstance in which the takeover of a listed company may not proceed, and on other relevant matters. The CSRC shall make decisions in accordance with the law.

Article 11

The stock exchange shall formulate operational rules in accordance with the law to organise trading and provide services for the takeover of listed companies and the associated changes in share interest, to implement real-time monitoring of the relevant securities trading activities, and to supervise the conscientious performance of the information disclosure obligations by the persons with information disclosure obligations in the takeover of listed companies and the associated changes in share interest.

The securities registration and clearing institution shall formulate operational rules in accordance with the law to provide services in connection with the matters involved in the takeover of listed companies and the associated changes in share interest such as the registration, deposit and clearing of securities.

Part Two: Disclosure of Interests

Article 12

The interests held by an investor in a listed company shall include the shares registered in its name and the shares that, although not registered in its name, can actually be controlled by the said investor in respect of their voting rights. The interests held by an investor and the person(s) acting in concert in a listed company shall be calculated collectively.

Article 13

If, through securities trading on the stock exchange, the share interests owned by an investor and the person(s) acting in concert in a listed company have reached 5% of the issued shares of the listed company, the investor and the person(s) acting in concert shall, within three days of the occurrence of the fact, prepare a written report on the change of interests, submit the same to the CSRC and the stock exchange, submit the duplicates thereof to the CSRC agency of the place in which the listed company is located (hereafter, the "CSRC agency"), notify the listed company and make an announcement thereof. They may not continue to purchase or sell the shares of the listed company during the aforementioned period.

Once the share interests owned by the aforementioned investor and the person(s) acting in concert in the listed company have reached 5% of the issued shares of the listed company, the investor and the person(s) acting in concert shall give a report and make an announcement pursuant to the provisions of the preceding paragraph whenever there is a 5% increase or reduction in the proportion of the share interests owned by them to the issued shares of the listed company through securities trading on the stock exchange. They may not continue to purchase or sell the shares of the listed company during the reporting period and the two days after giving the report and making the announcement.

Article 14

If, through transfer by agreement, the share interests owned by an investor and the person(s) acting in concert in a listed company are expected to reach or exceed 5% of the issued shares of the listed company, the investor and the person(s) acting in concert shall, within three days of the occurrence of such fact, prepare a written report on the change of interests, submit the same to the CSRC and the stock exchange, submit the duplicates thereof to the CSRC agency, notify the listed company and make an announcement thereof.

Once the share interests owned by the investor and the person(s) acting in concert in a listed company have reached 5% of the issued shares of the listed company, the investor and the person(s) acting in concert shall perform the reporting and announcement obligations pursuant to the provisions of the preceding paragraph whenever there is a 5% increase or reduction in the proportion of the share interests they own to the issued shares of the listed company.

The investor and the person(s) acting in concert specified in the preceding two paragraphs may not continue to purchase or sell the shares of the listed company before giving the report and making the announcement. The transfer of the relevant shares and ownership transfer registration shall be handled in accordance with the provisions of Part Four hereof and the regulations of the stock exchange and the securities registration and clearing institution.

Article 15

If the share interests owned by an investor and the person(s) acting in concert by such means as administrative transfer or change, enforcement of a court ruling, succession or gift have reached the percentage specified in the preceding article, the investor and the person(s) acting in concert shall perform the reporting and announcement obligations pursuant to the provisions of the preceding article and handle the procedures for registration of the transfer of share ownership by reference to the preceding article.

Article 16

If an investor and the person(s) acting in concert are not the largest shareholder or *de facto* controlling person of a listed company but the share interests they own have reached or exceeded 5% but have not reached 20% of the issued shares of the listed company, they shall prepare a short-form report on the change of interests that shall include the following particulars:

1. the names and domiciles of the investor and the person(s) acting in concert; if the investor and the person(s) acting in concert are legal persons, their names, places of registration and legal representatives;
2. the purpose of holding the shares, and whether they intend to continue to increase the interests owned by them in the listed company within the next 12 months;
3. the name of the listed company, and the class, quantity and percentage of the shares;
4. when and how the share interests owned by them in the listed company have reached or exceeded 5% of the issued shares of the listed company or when and how the increase or reduction in the share interests has reached 5%;
5. a summary of the purchase and sale of the shares in the company through securities trading on the stock exchange within the six months prior to the occurrence of the change in interests; and
6. other particulars that the CSRC and the stock exchange require to be disclosed.

If the aforementioned investor and the person(s) acting in concert are the largest shareholder or *de facto* controlling person of the listed company, and the share interests they own have reached or exceeded 5% but have not reached 20% of the issued shares of the listed company, they shall also disclose the particulars specified in Paragraph One of Article 17 hereof.

Article 17

If the share interests owned by an investor and the person(s) acting in concert in a listed company have reached or exceeded 20% but have not exceeded 30% of the issued shares of the listed company, the investor and the person(s) acting in concert shall prepare a detailed report on change of interests and disclose the following particulars in addition to the information specified in the preceding article:

1. the controlling shareholder or *de facto* controlling person of the investor and the person(s) acting in concert, and a chart of their equity control relationship;
2. the price, amount of required funds and funding sources for acquiring the relevant shares, or other payment arrangement;
3. whether there is competition in the same business or potential competition in the same business between the business engaged in by the investor, the person(s) acting in concert and its controlling shareholder or *de facto* controlling person and the business engaged in by the listed company, and whether there is a continuing connected transaction; if there is competition in the same business or continuing connected transaction, whether a corresponding arrangement has been made to ensure the prevention of competition in the same business between the investor, the person(s) acting in concert and its connected parties, and the listed company, and to maintain the independence of the listed company;
4. the follow-up plan for adjustment to be made to the assets, businesses, personnel, organisational structure and articles of association of the listed company within the next 12 months;
5. the major transactions between the investor and the person(s) acting in concert and the listed company within the preceding 24 months;
6. none of the circumstances specified in Article 6 hereof exists; and
7. the relevant documents can be provided in accordance with Article 50 hereof.

If the aforementioned investor and the person(s) acting in concert are the largest shareholder or *de facto* controlling person of the listed company, they shall engage a financial advisor to issue a verification opinion on the particulars disclosed in the aforementioned report on the change of interests, except in the case of an administrative transfer or change of State-owned shares, a share transfer between the different entities controlled by the same *de facto* controlling person or an acquisition of shares by way of succession. If the investor and the person(s) acting in concert undertake to waive the exercise of the voting rights of the relevant shares for at least three years, they may be exempted from engaging a financial advisor and providing the documents specified in Item (7) of the preceding paragraph.

Article 18

If an investor and the person(s) acting in concert that have already disclosed a report on the change of interests need to report and announce a report on the change of interests again within six months following the date of the disclosure as a result of a change in the share interests owned by them, they may limit the reporting and announcement to the sections that vary from the previous report. If more than six months have passed since the date of the previous disclosure, the investor and the person(s) acting in concert shall prepare a report on the change of interests and perform the reporting and announcement obligations in accordance with the provisions of this Part.

Article 19

If a reduction in share capital by a listed company results in a change in the share interests owned by an investor and the person(s) acting in concert that falls under the circumstances specified in Article 14 hereof, the investor and the person(s) acting in concert shall be exempted from performing the reporting and announcement obligations. Within two working days of completing the change registration of the reduction in share capital, the listed company shall make an announcement of the resulting changes in the share interests owned by the shareholders of the company. If the reduction in share capital by the listed company may result in the investor and the person(s) acting in concert becoming the largest shareholder or *de facto* controlling person of the company, the investor and the person(s) acting in concert shall perform the reporting and announcement obligations pursuant to Paragraph One of Article 17 hereof within three working days of the date on which the board of directors of the company announces the resolution on reduction in the company's share capital.

Article 20

If, prior to the disclosure by the person with information disclosure obligations in the activities of the takeover of a listed company and the associated change in share interest in accordance with the law, the relevant information has been disseminated in the media and there is abnormality in the trading of the company's shares, the listed company shall immediately inquire the party concerned. The party concerned shall give a written reply in a timely manner and the listed company shall make an announcement thereof in a timely manner.

Article 21

A person with information disclosure obligations in the activities of the takeover of a listed company and the associated change in share interests shall disclose information in at least one media designated by the CSRC in accordance with the law. If disclosure is made in other media, the contents of such disclosure shall be consistent and the time of disclosure may not be earlier than the time of disclosure in the designated media.

Article 22

If the persons with information disclosure obligations in the activities of the takeover of a listed company and the associated change in share interests act in concert, they may agree in writing to name one of them as the designated representative in charge of preparing the information disclosure documents and to authorize the designated representative to sign and affix the seal on the information disclosure documents.

Each person with information disclosure obligations shall assume liability for the information in the information disclosure documents that concerns itself. In regard to the information in the information disclosure documents that concerns more than one person with information disclosure obligations, all persons with information disclosure obligations shall assume joint and several liability for the relevant part thereof.

Part Three: Takeover by Offer

Article 23

If an investor voluntarily chooses to acquire the shares of a listed company by means of an offer, it may issue to all shareholders of the target company an offer to acquire all of the shares held by them (hereafter, a "general offer") or an offer to acquire part of the shares held by them (hereafter, a "partial offer").

Article 24

If, through securities trading on the stock exchange, the shares held by a purchaser in a listed company have reached 30% of the issued shares of the company and the purchaser continues to increase its shareholding, it shall proceed by means of an offer and issue a general offer or partial offer.

Article 25

If a purchaser acquires the shares of a listed company by means of an offer in accordance with Article 23, Article 24, Article 47 and Article 56 hereof, the percentage of shares that are scheduled to be acquired shall not be less than 5% of the issued shares of the listed company.

Article 26

In the case of a takeover of a listed company by means of offer, the purchaser shall treat all shareholders of the target company fairly. The holders of the same class of shares shall receive the same treatment.

Article 27

If a purchaser issues a general offer for the purpose of terminating the listing status of a listed company or if it issues a general offer as a result of its failure to obtain from the CSRC an exemption it applied for, it shall pay the acquisition price in cash. If it pays the purchase price with legally transferable securities (hereafter, "securities"), it shall at the same time provide a cash alternative for the shareholders of the target company to choose.

Article 28

In the case of a takeover of a listed company by means of offer, the purchaser shall prepare a takeover-by-offer report and shall engage a financial advisor to submit a written report to the CSRC and the stock exchange and the duplicates thereof to the CSRC agency, notify the target company and, at the same time, issue a warning with a summary of the takeover-by-offer report.

After 15 days from the date on which the purchaser submits a takeover-by-offer report that comply with the provisions of the CSRC according to the provisions of the preceding paragraph and the relevant documents specified in Article 50 hereof, the purchaser shall announce the takeover-by-offer report, the professional opinion of the financial advisor and a legal opinion issued by a lawyer. If the CSRC expresses no objection to the particulars disclosed in the takeover-by-offer report within 15 days, the purchaser may proceed to make an announcement thereof. If the CSRC finds that the takeover-by-offer report does not comply with the laws, administrative regulations and relevant provisions, it shall notify the purchaser in a timely manner, and the purchaser shall not announce its takeover offer.

Article 29

The takeover-by-offer report specified in the preceding article shall contain the following particulars:

1. the name and domicile of the purchaser; if the purchaser is a legal person, its name, place of registration and legal representative, and a chart of the equity control relationship with its controlling shareholder or *de facto* controlling person;
2. the purchaser's decision on the takeover and the purpose of the takeover, and whether it intends to continue to increase its shareholding within the next 12 months;

3. the name of the listed company and the class of the shares to be acquired;
4. the number and percentage of the shares scheduled to be acquired;
5. the acquisition price;
6. the amount of funds required for the acquisition, funding sources and funding guarantees, or other payment arrangement;
7. the terms agreed in the takeover offer;
8. the time period for takeover;
9. the number and percentage of shares of the target company held at the time of submission of the takeover report;
10. an analysis of the impact of the takeover on the listed company, including whether there is competition in the same business or potential competition in the same business between the business engaged in by the purchaser and its connected parties and the business engaged in by the listed company and whether there is a continuing connected transaction; if there is competition in the same business or continuing connected transaction, whether the purchaser has made a corresponding arrangement to ensure the prevention of competition in the same business between the purchaser and its connected parties and the listed company, and to maintain the independence of the listed company;
11. the follow-up plan for adjustment to be made to the assets, businesses, personnel, organisational structure and articles of association of the listed company within the next 12 months;
12. the major transactions between the purchaser and its connected parties and the listed company within the preceding 24 months;
13. the purchase and sale of the shares of the target company through securities trading on the stock exchange within the preceding six months; and
14. other particulars that the CSRC requires to be disclosed.

If the purchaser issues a general offer, it shall make a full disclosure in the takeover-by-offer report of the risks of delisting, the time for completing the takeover following the delisting and the other follow-up arrangements for the remaining holders of the listed company's shares to sell their shares. If the purchaser issues a general offer for the purpose of terminating the listing status of the listed company, it shall not be required to disclose the particulars specified in Item (10) of the preceding paragraph.

Article 30

If the shares of a listed company that a purchaser proposes to purchase pursuant to Article 47 hereof exceed 30% and the takeover has to proceed by means of offer, the purchaser shall issue a warning with a summary of the takeover-by-offer report within three days of reaching the takeover agreement or making a similar arrangement, and shall perform the reporting and announcement obligations in accordance with Article 28 and Article 29 hereof. It shall, at the same time, be exempted from preparing, reporting and announcing the listed company takeover report. If an approval of the offer is required according to law, the purchaser shall specifically indicate in the announcement that the proposed offer may proceed only if the relevant approval is obtained.

If the purchaser fails to obtain approval, it shall submit a report to the CSRC to cancel the takeover plan within two working days of the receipt of the notice, submit the duplicates thereof to the CSRC agency and the stock exchange, notify the target company and make an announcement thereof.

Article 31

If, after a purchaser has submitted the takeover-by-offer report to the CSRC, it intends to cancel the takeover plan before it announces the takeover-by-offer report, it shall submit to the CSRC an application for cancellation of the takeover plan and a statement of the reasons therefor, and make an announcement thereof. The purchaser shall not carry out takeover on the same listed company again within 12 months from the date of announcement.

Article 32

The board of directors of a target company shall investigate the qualification, creditworthiness and takeover intention of the purchaser, analyze the terms of the offer, make a recommendation to the shareholders on whether to accept the offer, and engage an independent financial advisor to provide a professional opinion. Within 20 days of the purchaser's announcement of the takeover-by-offer report, the board of directors of the target company shall submit to the CSRC the target company's board of directors report and a professional opinion of the independent financial advisor, submit the duplicates thereof to the CSRC agency and the stock exchange, and make an announcement thereof.

If the purchaser makes a major change to the terms of the takeover offer, the board of directors of the target company shall, within three working days, submit the supplementary opinions on the change of the terms of the offer issued by the board of directors and the independent financial advisor, and shall give a report and make an announcement thereof.

Article 33

During the period after a purchaser has issued a warning and before the takeover by offer is completed, the board of directors of the target company shall not carry out any disposal of the company's assets, outward investment, adjustment to the major business of the company or any guarantee or loan that have a major impact on the assets, liabilities, rights and interests or business results of the company without the approval of the shareholders' general meeting, except that the target company may continue to engage in normal business activities and implement the resolutions already adopted by the shareholders' general meeting.

Article 34

No directors of the target company may resign during a takeover by offer.

Article 35

If a purchaser carries out a takeover by offer pursuant to the provisions hereof, the offer price for shares of a same class shall not be lower than the highest price paid by the purchaser for acquiring the shares of that class during the six months prior to the date of the warning of the takeover by offer.

If the offer price is lower than the arithmetic mean of the daily weighted average prices of the shares of that class in the 30 trading days prior to the date of the warning, the financial advisor engaged by the purchaser shall analyse the trading of shares of that class in the preceding six months and state whether there is manipulation of the share price, whether there is any person acting in concert that is not disclosed by the purchaser, whether there has been any other payment arrangement in connection with the purchaser's acquisition of the company's shares in the preceding six months, and the reasonableness of the offer price.

Article 36

A purchaser may pay the acquisition price of a listed company by legal means such as cash, securities or a combination of cash and securities. The financial advisor engaged by the purchaser shall state that the purchaser has the capacity for takeover by offer.

Where the acquisition price is paid in cash, the purchaser shall deposit not less than 20% of the total acquisition price into a bank designated by the securities registration and clearing institution as performance bond at the time of issue of the warning of the takeover by offer.

Where the purchaser pays the acquisition price with securities, it shall provide the audited financial and accounting reports of the issuer of the securities for the most recent three years and a securities valuation report, and shall cooperate with the due diligence work of the independent financial advisor engaged by the target company.

Where the purchaser pays the acquisition price with securities listed and traded on the stock exchange, it shall, at the same time of issue of the warning of the takeover by offer, transfer the securities to be used for payment to the securities registration and clearing institution for custody, with the exception of new shares issued by the listed company. Where the purchaser pays the acquisition price with bonds listed on the stock exchange, the tradable period of such bonds shall not be less than one month. Where the purchaser pays the acquisition price with securities that are not listed and traded on the stock

exchange, it must at the same time provide a cash alternative for the shareholders of the target company to choose and disclose in detail the method and procedure for the custody of the relevant securities and the delivery of the relevant securities to the shareholders of the target company.

Article 37

The takeover period agreed in a takeover offer shall not be less than 30 days or more than 60 days, unless there is a competing offer.

A purchaser shall not revoke its takeover offer during the undertaking period agreed in the takeover offer.

Article 38

In the case of takeover by offer, during the period from the issue of announcement by the purchaser to the end of the takeover period, the purchaser may not sell the shares of the target company, or purchase the shares of the target company in any manner and on any term other than those specified in the offer.

Article 39

The terms proposed in a takeover offer shall apply to all shareholders of the target company.

If the purchaser needs to change the takeover offer, it must submit a written report to the CSRC in advance and the duplicates thereof to the CSRC agency and to the stock exchange and the securities registration and clearing institution, and notify the target company. It shall make an announcement thereof after the change is approved by the CSRC.

Article 40

A purchaser shall not change the takeover offer within the 15 days prior to the expiration of the offer, unless there is a competing offer.

If there is a competing offer and the purchaser that issued the initial offer changes the takeover offer within 15 days prior to the expiration of the period of the initial takeover by offer, the period of the takeover shall be extended. The extended offer period shall not be less than 15 days and shall not continue beyond the expiration date of the last competing offer, and an additional performance bond shall be paid according to the specified proportion. If the acquisition price is to be paid with securities, a corresponding number of additional securities shall be handed over to the securities registration and clearing institution for custody.

The purchaser that issued a competing offer shall issue a warning of the takeover by offer no later than 15 days prior to the expiration of the period of initial takeover by offer, and shall perform the reporting and announcement obligations in accordance with Article 28 and Article 29 hereof.

Article 41

If there is a major change in a basic fact disclosed in a takeover-by-offer report, the purchaser shall give a written report to the CSRC within two working days of the occurrence of the major change, submit the duplicates thereof to the CSRC agency and the stock exchange, notify the target company and make an announcement thereof.

Article 42

Shareholders that agree to accept a takeover offer (hereafter, the "preliminary-acceptance shareholders") shall entrust a securities company to handle the relevant procedures for preliminary acceptance of the offer. The purchaser shall entrust a securities company to apply to the securities registration and clearing institution for temporary custody of the shares under the preliminarily accepted offer. The shares under the preliminarily accepted offer that are under the temporary custody of the securities registration and clearing institution may not be transferred during the takeover-by-offer period.

Preliminary acceptance specified in the preceding paragraph means the preliminary declaration of intent by a shareholder of the target company to agree to accept an offer, which does not constitute acceptance until it becomes irrevocable within the takeover-by-offer period. Until three trading days prior to the expiration of the takeover-by-offer period, a preliminary-acceptance shareholder may entrust a securities company to handle the procedures for withdrawing the preliminary acceptance. The securities registration and clearing institution shall release the shares under the preliminarily accepted offer from its temporary custody according to the withdrawal application of the preliminary-acceptance shareholder. A preliminary-acceptance shareholder may not withdraw its acceptance of the offer within three trading days prior to the expiration of the takeover-by-offer period. During the takeover-by-offer period, the purchaser shall announce the number of shares under preliminary acceptance on the website of the stock exchange on a daily basis.

Where there is a competing offer and the preliminary-acceptance shareholder that accepted the initial offer withdraws all or part of the shares under preliminary acceptance and sells the withdrawn shares to the competing offeror, the shareholder shall entrust a securities company to handle the procedures for withdrawing the preliminary acceptance of the initial offer and the relevant procedures for preliminary acceptance of the competing offer.

Article 43

Upon expiration of the takeover period, the purchaser that issued a partial offer shall purchase the shares under preliminary acceptance from the shareholders of the target company on the terms agreed in the takeover offer. Where the number of shares under the preliminarily accepted offer is greater than the number of shares scheduled to be acquired, the purchaser shall acquire the shares under the preliminarily accepted offer in the same proportion. Where the purpose is to terminate the listing status of the target company, the purchaser shall purchase all of the shares under the offer preliminarily accepted by the shareholders of the target company on the terms agreed in the takeover offer. A purchaser that issued a general offer as a result of failure to obtain exemption from the CSRC shall purchase all of the shares under the offer preliminarily accepted by the shareholders of the target company.

Within three trading days after expiration of the takeover period, the entrusted securities company shall apply to the securities registration and clearing institution for share transfer settlement and ownership transfer registration and for release of the shares in excess of the percentage of scheduled acquisition from temporary custody. The purchaser shall announce the result of the takeover by offer.

Article 44

Upon expiration of the takeover period, if the distribution of the equity interests of the target company does not meet the listing conditions, the stock exchange shall terminate the trading of the shares of the listed company in accordance with the law. Prior to the completion of the takeover, the remaining holders of the shares of the target company shall have the right to sell their shares to the purchaser on the same terms as those in the takeover offer within a reasonable period specified in the takeover report, and the purchaser shall acquire such shares.

Article 45

Within 15 days of the expiration of the takeover period, the purchaser shall submit a written report on the status of the takeover to the CSRC, submit the duplicates thereof to the CSRC agency and the stock exchange, and notify the target company.

Article 46

Except by means of offer, no investor may publicly request to purchase the shares of a listed company outside the stock exchange.

Part Four: Takeover by Agreement

Article 47

If, by means of agreement, the share interests owned by a purchaser in a listed company have reached or exceeded 5% but do not exceed 30% of the issued shares of the company, the matter shall be handled in accordance with the provisions of Part Two hereof.

If the share interests owned by the purchaser have reached 30% of the issued shares of the company and the purchaser continues to acquire shares, it shall issue a general offer or partial offer to the shareholders of the listed company in accordance with the law. In any circumstance specified in Part Six hereof, the purchaser may apply to the CSRC for exemption from issuing an offer.

If a purchaser intends to acquire more than 30% of the shares of a listed company by means of agreement, it shall proceed by means of offer in respect of the shares in excess of 30%. However, in any circumstance specified in Part Six hereof, the purchaser may apply to the CSRC for exemption from issuing an offer. After obtaining an exemption from the CSRC, the purchaser shall perform its takeover agreement. If it fails to obtain the exemption from the CSRC but intends to continue to perform its takeover agreement or if it does not apply for exemption, it shall issue a general offer before performing its takeover agreement.

Article 48

If a purchaser acquires more than 30% of the shares of a listed company by means of agreement and it intends to apply for exemption pursuant to the provisions of Part Six hereof, it shall prepare a listed company takeover report within three days of reaching the takeover agreement with the shareholders of the listed company, submit the exemption application and the relevant documents specified in Article 50 hereof, entrust a financial advisor to submit a written report to the CSRC and the stock exchange, submit the duplicates thereof to the CSRC agency, notify the target company, and announce the summary of the listed company takeover report. Upon receipt of the written report, the CSRC agency shall notify the provincial people's government of the place in which the listed company is located.

The purchaser shall announce its takeover report, the professional opinion of the financial advisor and a legal opinion issued by a lawyer within three days of obtaining an exemption from the CSRC. If the purchaser fails to obtain an exemption, it shall announce the decision of the CSRC within three days of receipt thereof and act in accordance with Paragraph Two of Article 61 hereof.

If the CSRC finds that the takeover report does not comply with laws, administrative regulations and relevant provisions, it shall notify the purchaser in a timely manner. If the purchaser fails to make the correction, the purchaser shall not announce the takeover report and shall not perform the takeover agreement before the announcement.

Article 49

The listed company takeover report prepared pursuant to the provisions of the preceding article must disclose the particulars specified in Items (1) to (6) and Items (9) to (14) of Article 29 hereof, the conditions for the takeover agreement to come into effect and the payment arrangement.

If a purchaser that has already disclosed the takeover report needs to give a report and make an announcement again within six months following the date of the disclosure as a result of a change of interests, it may limit the report and announcement to the sections that vary from the previous report. If more than six months have passed since the date of the previous disclosure, it shall perform the reporting and announcement obligations in accordance with the provisions of Part Two hereof.

Article 50

To carry out a takeover of a listed company, the purchaser shall submit the following documents to the CSRC:

1. the identity document of the Chinese citizen, or the documentary proof of the legal person or other organization registered in China;
2. a statement on the feasibility of the follow-up development plan of the listed company on the basis of the strength and business experience of the purchaser; if the purchaser intends to amend the company's articles of association, elect a new board of directors of the company, or change or adjust the main business of the company, there shall be an additional statement that it possesses the management capability of standardized operation of the listed company;

3. if there is competition in the same business between the purchaser and its connected parties and the target company, it shall provide a statement on the avoidance of conflict of interests such as competition in the same business and the maintenance of the independence of the target company's operation;
4. if the purchaser is a legal person or other organization, a statement that its controlling shareholder or *de facto* controlling person has not changed in the most recent two years;
5. a statement on the core enterprise, core business, connected enterprises and main business of the purchaser and its controlling shareholder or *de facto* controlling person; if the purchaser or its *de facto* controlling person is the controlling shareholder or *de facto* controlling person of two or more listed companies, it shall provide the details of the listed companies and financial institutions such as banks, trust companies, securities companies and insurance companies in which it holds 5% or more of the shares; and
6. a verification opinion of the financial advisor on the record of good faith of the purchaser in the most recent three years, the legality of the funding sources of the takeover, the capability of the purchaser to perform the relevant undertakings as well as the truthfulness, accuracy and completeness of the contents of the relevant information disclosure; if the purchaser has been established for less than three years, the financial advisor shall provide a verification opinion on the record of good faith of its controlling shareholder or *de facto* controlling person in the most recent three years.

If an overseas legal person or other overseas organization carries out a takeover of a listed company, it shall submit the following documents in addition to the documents specified in Items (2) to (6) of Paragraph One:

1. a verification opinion issued by the financial advisor on the purchaser satisfying the conditions for strategic investment of the listed company and having the capability to acquire the listed company; and
2. a statement of the purchaser on its submission to the judicial and arbitral jurisdiction of China.

Article 51

If the directors, supervisors, senior management personnel, employees or the legal person or other organisation controlled or entrusted by them intend to carry out a takeover of the company or acquire the control of the company through the means specified in Part Five hereof (hereafter, "management buyout"), the listed company shall have a sound and well operated organisation and an effective internal control system, and the ratio of independent directors in the board of the directors of the company shall reach or exceed one-half. The company shall engage an asset evaluation institution with securities and futures business qualifications to provide an evaluation report on the assets of the company. The proposed buyout shall be subject to a resolution made by the non-connected directors of the board of directors with the consent of two-thirds or more of the independent directors, submitted to the shareholders' general meeting of the company for consideration and adopted by the non-connected shareholders present at the meeting representing more than half of the voting rights. Before giving their opinion, the independent directors shall engage an independent financial advisor to issue a professional opinion on the buyout. The opinions of the independent directors and the independent financial advisor shall be announced together.

If the directors, supervisors or senior management personnel fall within the circumstances specified in Article 149 of the *Company Law* or if they have had any record of bad faith in the securities market in the most recent three years, they may not proceed with the takeover of the company.

Article 52

In the case of a takeover of a listed company by means of agreement, the period from the conclusion of the takeover agreement to the completion of the ownership transfer of the relevant shares shall be the listed company takeover transitional period (hereafter, the "transitional period"). During the transitional period, the purchaser may not propose, through the controlling shareholder, to elect a new board of directors of the company. If there are sufficient reasons to elect a new board of directors, the directors from the purchaser shall not exceed one-third of the members of the board of directors. The target company shall not provide guarantee to the purchaser and its connected parties. The target company shall not make a public share offering to raise funds and shall not undertake any major purchase, asset sale and major investment or enter into other connected transactions with the purchaser and its connected parties, except in circumstances where the purchaser comes to the rescue of the listed company that is in a crisis or facing serious financial difficulties.

Article 53

If the controlling shareholder of a listed company transfers by agreement to the purchaser the shares of the listed company held by it, it shall investigate the qualification, creditworthiness and takeover intention of the purchaser, and shall disclose the relevant information from the investigation in its report on the change of interests.

If the controlling shareholder and its connected parties have not fully discharged their liabilities to the company, or if the guarantees provided by the company for their liabilities have not been released, or if there is any other circumstance where the interests of the company are prejudiced, the board of directors of the target company shall promptly disclose such circumstances and adopt effective measures to safeguard the interests of the company.

Article 54

The relevant parties to a takeover by agreement shall apply to the securities registration and clearing institution for temporary custody of the shares to be transferred, and may deposit the cash to be used for payment into a bank designated by the securities registration and clearing institution.

Article 55

After the takeover report is announced, the relevant parties shall, in accordance with the operational rules of the stock exchange and the securities registration and clearing institution and upon confirmation of the share transfer by the stock exchange, apply to the securities registration and clearing institution, on the strength of the proof of the deposit of the full amount of transfer price in a bank account recognized by both parties, for release of the shares to be transferred from temporary custody and handle the procedures for ownership transfer registration.

If the purchaser fails to perform the reporting and announcement obligations according to provisions or if it fails to submit an application according to provisions, the stock exchange and the securities registration and clearing institution shall not process the share transfer and ownership transfer registration.

If the purchaser fails to complete the ownership transfer procedures for the relevant shares within 30 days of the announcement of the takeover report, it shall immediately make an announcement to state the reasons. During the period in which the ownership transfer of the relevant shares is not completed, it shall announce the progress of the ownership transfer of the relevant shares every 30 days.

Part Five: Indirect Takeover

Article 56

Where the purchaser is not a shareholder of the listed company but the share interests it owns in a listed company through investment relationship, agreement and other arrangement have reached 5% but do not exceed 30% of the issued shares of the listed company, the matter shall be handled in accordance with the provisions of Part Two hereof.

If the share interests owned by the purchaser exceed 30% of the issued shares of the company, the purchaser shall issue a general offer to all shareholders of the company. If the purchaser anticipates that it is unable to issue a general offer within 30 days of the occurrence of the fact, it shall procure the shareholder(s) controlled by it to reduce the shares held by them in the listed company to or below 30% within the said period of 30 days and shall make an announcement thereof within two working days following the reduction. If, subsequently, the purchaser or the shareholder(s) controlled by it intends to increase the shareholding, it shall proceed by means of offer. If it intends to apply for exemption pursuant to the provisions of Part Six hereof, the matter shall be handled in accordance with Article 48 hereof.

Article 57

If an investor is not a shareholder of the listed company but acquires the control of a listed company through investment relationship, and the shares held by the shareholder of the listed company controlled by it have reached the percentage specified in the preceding article and constitute a major effect on the assets and profits of the said shareholder, the investor shall perform the reporting and announcement obligations in accordance with the preceding article.

Article 58

The *de facto* controlling person of a listed company and the shareholder(s) controlled by it have the obligation to cooperate with the listed company in truthfully, accurately and completely disclosing the information about the change of the *de facto* controlling person. If the *de facto* controlling person and the shareholder(s) controlled by it refuse to perform the above cooperation obligation, and the refusal has caused the listed company to assume civil and/or administrative liabilities as a result of its failure to perform the statutory information disclosure obligations, the listed company shall have the right to institute an action against such person. If the *de facto* controlling person or controlling shareholder instructs the listed company and its relevant personnel to not perform the information disclosure obligations in accordance with the law, the CSRC shall investigate and handle the case in accordance with the law.

Article 59

If the *de facto* controlling person of a listed company and the shareholder(s) controlled by it fail to perform the reporting and announcement obligations, the listed company shall give a report and make an announcement immediately upon its knowledge thereof. If the *de facto* controlling person has not made the disclosure even after the listed company has made an announcement on the change of the *de facto* controlling person, the board of directors of the listed company shall inquire the *de facto* controlling person and the shareholder(s) controlled by it and may also engage a financial advisor to conduct the inquiry when necessary, and shall report the results of the inquiry to the CSRC, the CSRC agency and the stock exchange. The CSRC shall, in accordance with law, investigate and deal with any *de facto* controlling person that refuses to perform the reporting and announcement obligations.

If a listed company knows that there is a major change in the *de facto* controlling person but fails to report and announce the change in the *de facto* controlling person in a timely manner, the CSRC shall order rectification and, if the case is serious, deem the responsible director of the listed company as an unsuitable person.

Article 60

If the *de facto* controlling person of a listed company and the shareholder(s) controlled by it fail to perform the reporting and announcement obligations and refuse to perform the cooperation obligation specified in Article 58, or if the *de facto* controlling person falls within a circumstance where it may not acquire a listed company, the board of directors of the listed company shall refuse to accept the motions or ad hoc proposals submitted to the board of directors by the shareholder(s) controlled by the *de facto* controlling person, and shall give a report to the CSRC, the CSRC agency and the stock exchange. The CSRC shall order the *de facto* controlling person to carry out rectification and may deem the director(s) nominated by the *de facto* controlling person through the shareholder(s) controlled by it as an unsuitable person. Before rectification is carried out, the shareholder(s) controlled by the *de facto* controlling person shall not exercise the voting rights of the shares held by it/them. If the board of directors of the listed company does not refuse to accept the motions submitted by the *de facto* controlling person and the shareholder(s) controlled by it, the CSRC may deem the responsible directors as unsuitable persons.

Part Six: Exemption Application

Article 61

In the circumstances specified in Article 62 and Article 63 hereof, an investor and the person(s) acting in concert may apply to the CSRC for the following exemptions:

1. exemption from using the means of takeover by offer to increase shareholding;
2. if there is any restriction on the entity qualification or share class or any special circumstance stipulated by laws, administrative regulations or the CSRC, exemption from issuing a takeover offer to all shareholders of the target company may be applied for.

Where the investor and the person(s) acting in concert fail to obtain an exemption, they shall reduce the shares held by them or the shareholder(s) controlled by them in the target company to or below 30% within 30 days of receipt of the notice from the CSRC. If they intend to continue to increase their shareholding by means other than offer, they shall issue a general offer.

Article 62

In any of the following circumstances, a purchaser may apply to the CSRC for exemption from using the means of offer to increase shareholding:

1. the purchaser and the transferor are able to prove that the proposed transfer have not resulted in a change in the *de facto* controlling person of the listed company;
2. the listed company is facing serious financial difficulties, the restructuring plan proposed by the purchaser to rescue the company has been approved by the shareholders' general meeting of the company, and the purchaser undertakes not to transfer its interests in the company within three years;
3. the acquisition by the purchaser of the new shares issued to it by the listed company with the approval of the non-connected shareholders in the shareholders' general meeting of the listed company results in the share interests owned by the purchaser in the company exceeding 30% of the issued shares of the company, the purchaser undertakes not to transfer its interests in the company within three years, and the shareholders' general meeting of the company has agreed to exempt the purchaser from issuing an offer; or
4. other circumstances deemed by the CSRC as necessary for adapting to the developments and changes in the securities market and protecting the lawful rights and interests of investors.

If the exemption application documents submitted by the purchaser comply with the provisions and the purchaser has performed the reporting and announcement obligations in accordance with the provisions hereof, the CSRC shall accept the application. If the documents fail to comply with the provisions or if the purchaser fails to perform the reporting and announcement obligations, the CSRC shall not accept the application. The CSRC shall render a decision on whether or not to grant exemption to the specific item that the purchaser applied for within 20 working days of acceptance of the exemption application. If exemption is obtained, the purchaser may continue to increase its shareholding.

Article 63

In any of the following circumstances, the party concerned may apply to the CSRC for exemption from issuing an offer via summary procedure:

1. the proportion of the share interests owned by the investor in a listed company exceed 30% of the issued shares of the company as a result of transfer without consideration, change or consolidation of State-owned assets carried out with the approval of the government or the State-owned assets administration authority;
2. where the share interests owned by it in a listed company have reached or exceeded 30% of the issued shares of the company, the increase of the share interests owned by it in the company in every 12 months after one year of the occurrence of the above fact does not exceed 2% of the issued shares of the company;
3. where the share interests owned by it in a listed company have reached or exceeded 50% of the issued shares of the company, the continuous increase of its interests in the company shall not affect the listing status of the company;
4. the share interest owned by the party in a listed company exceed 30% of the issued shares of the company as a result of a reduction in share capital by the company following a repurchase of shares from specific shareholders at a specified price approved by the shareholders' general meeting;
5. a financial institution such as securities company or bank holds more than 30% of the issued shares of a listed company as a result of its engagement in businesses such as underwriting and lending within its scope of business in accordance with the law, but it does not have any act or intention to actually control the company and it has proposed a solution by transferring the relevant shares to non-connected parties within a reasonable time period;
6. the share interests owned by it in a listed company exceed 30% of the issued shares of the company as a result of succession; or
7. other circumstances deemed by the CSRC as necessary for adapting to the developments and changes in the securities market and protecting the lawful rights and interests of investors.

If the CSRC has not raised any objection within five working days of receipt of the application documents that comply with provisions, the relevant investor may apply to the stock exchange and the securities registration and clearing institution for share transfer and ownership transfer registration. If the CSRC disagrees with its application via summary procedure, the relevant investor shall submit an application in accordance with Article 62 hereof.

Article 64

If a purchaser applies for exemption, it shall engage a law firm and other professional institutions to issue professional opinions.

Part Seven: Financial Advisor

Article 65

A financial advisor engaged by a purchaser shall perform the following duties:

1. conduct due diligence investigation on the relevant details of the purchaser;
2. at the request of the purchaser, provide professional services to the purchaser, carry out full evaluation of the financial and business conditions of the target company, assist the purchaser in analysing the legal, financial and operational risks involved in the takeover, propose recommendations for the matters involved in the takeover plan such as the acquisition price, means of takeover and payment arrangement, and guide the purchaser in preparing the documents to be submitted in accordance with the prescribed contents and formats;
3. provide coaching to the purchaser on standardized operation in the securities market, have the directors, supervisors and senior management personnel of the purchaser familiarised with the relevant laws and administrative regulations, and the provisions of the CSRC and fully aware of the obligations and responsibilities that they shall bear, and urge its performance of the reporting, announcement and other statutory obligations in accordance with the law;
4. conduct full verification on whether the purchaser complies with the provisions hereof and on the truthfulness, accuracy and completeness of the contents of the submitted documents, and issue professional opinions on the takeover matters in an objective and impartial manner;
5. accept the entrustment by the purchaser to submit the materials to the CSRC, and organise and coordinate with the purchaser and other professional institutions in giving replies according to the examination and verification opinion of the CSRC; and
6. enter into an agreement with the purchaser to continue to supervise and guide the purchaser in compliance with the laws, administrative regulations, provisions of the CSRC, rules of the stock exchange and articles of association of the listed company, exercise of the shareholder's rights in accordance with the law, and conscientious performance of its undertakings or relevant covenants within the 12 months following the completion of the takeover.

Article 66

The financial advisor's report issued by the financial advisor engaged by a purchaser on the takeover shall give statements and analysis on the following matters and give an express opinion on each of such matters:

1. whether the contents disclosed in the listed company takeover report or takeover-by-offer report prepared by the purchaser are truthful, accurate and complete;
2. the purpose of the takeover;
3. whether the purchaser has provided all requisite supporting documents, and on the basis of a verification on the strength, main business, ongoing business conditions, financial status and creditworthiness of the purchaser and its controlling shareholder or *de facto* controlling person, state whether the purchaser possesses the entity qualification, whether it has the economic strength for the takeover, whether it has the management capability of standardized operation of the listed company, whether it needs to assume other additional obligations, whether it has the capability to perform the relevant obligations, and whether there is a record of bad faith;
4. the status of the coaching of the purchaser on standardised operation in the securities market, whether its directors, supervisors and senior management personnel are already familiar with the relevant laws and administrative regulations, and the provisions of the CSRC and fully aware of the obligations and responsibilities that they shall bear, and the status of urging its performance of the reporting, announcement and other statutory obligations in accordance with the law;
5. the equity control structure of the purchaser and the manner in which the purchaser is controlled by its controlling shareholder or de facto controlling person;

6. the purchaser's funding source for the takeover and its legality, whether there is any financing obtained by pledging the shares acquired in the takeover to banks and other financial institutions;
7. if the purchaser pays the purchase price with securities, a statement on whether the information disclosure about the issuer of such securities is truthful, accurate and complete and on the convenience of the trading of such securities shall be made;
8. whether the purchaser has performed the necessary authorisation and approval procedures;
9. whether an arrangement has been made to maintain the stable operation of the listed company during the transitional period and whether such arrangement is in compliance with the relevant provisions;
10. analyse the follow-up plan proposed by the purchaser; if there is competition in the same business and/or connected transaction between the business engaged in by the purchaser and the business engaged in by the listed company, analyse the purchaser's plan for resolving the conflict of interests such as competition in the same business with the listed company and for maintaining the business independence of the listed company, state the effect that the takeover may have on the business independence and continuous development of the listed company;
11. whether other rights have been created over the takeover target, and whether other compensation arrangements have been made in addition to the acquisition price;
12. whether there is business dealing between the purchaser and its connected parties and the target company, and whether the purchaser and the directors, supervisors and senior management personnel of the target company have entered into any agreement or tacit understanding on their future employment arrangement;
13. whether there is any liability owed by the original controlling shareholder or *de facto* controlling person of the listed company and its connected parties to the company that is not fully discharged or any guarantee provided by the company for their liabilities that is not released or any circumstance where the interests of the company are prejudiced; if there is such a circumstance, whether a feasible solution has been proposed; and
14. if the purchaser intends to apply for exemption, a statement on whether the takeover is in a circumstance where exemption may be obtained, and whether the purchaser has made an undertaking and whether it has the strength to perform the relevant undertaking shall be made.

Article 67

The independent financial advisor engaged by the board of directors or independent directors of the listed company shall not act concurrently as financial advisor to the purchaser or have any connection with the financial advisor to the purchaser. The independent financial advisor shall conduct due diligence investigation and issue professional opinions on the impartiality and legality of the takeover as appointed. The independent financial advisor's report shall make statements and analyses and give express opinion on the following matters:

1. whether the purchaser possesses the entity qualification;
2. an analysis of the strength of the purchaser and the effect that the takeover may have on the business independence and continuous development of the target company;
3. whether the purchaser has used the assets of the target company or whether the target company has provided financial assistance to the takeover;
4. in the case of a takeover by offer, analyse the financial status of the target company, state whether the acquisition price fully reflects the value of the target company, whether the takeover offer is fair and reasonable, and make recommendation on the acceptance of the offer by the holders of the public shares of the target company;
5. where the purchaser pays the acquisition price with securities, a valuation analysis shall be made on the relevant securities on the basis of the assets, business and profit forecast of the issuer of the securities, and professional opinion shall be given on whether the terms of the takeover are fair to the holders of the public shares of the target company and on whether to accept the terms of takeover proposed by the purchaser; and
6. in the case of a management buyout, a valuation analysis of the listed company shall be made, and a full verification shall be conducted and express opinion shall be given on the pricing basis of the takeover, the payment method, the funding sources of the takeover, the financing arrangement, the repayment plan and its feasibility, the implementation of the

internal control system of the listed company and its effectiveness, the business dealings of the aforementioned personnel and their directly related family members with the listed company in the most recent 24 months and the other contents disclosed in the takeover report.

Article 68

A financial advisor that is entrusted to submit documents to the CSRC shall make the following undertakings in the financial advisor's report:

1. it has performed the obligation of due diligence investigation according to provisions and has sufficient reasons to believe that there is no substantive difference between the professional opinion issued by it and the contents of the documents submitted by the purchaser;
2. it has verified the documents submitted by the purchaser and believe that the contents and format of the documents submitted comply with regulations;
3. it has sufficient reason to believe that the takeover is in compliance with laws and administrative regulations, and the provisions of the CSRC, and that the information disclosed by the purchaser is truthful, accurate and complete and does not contain any falsehood, misleading representation and major omission;
4. the professional opinion issued on the takeover has been submitted to its internal verification organ for review and has passed the review;
5. during the period in which it acts as financial advisor, it has adopted stringent confidentiality measures and rigorously implement the internal firewall system; and
6. it has entered into a continuing supervision and guidance agreement with the purchaser.

Article 69

In the course of the takeover and during the period of continuing supervision and guidance, the financial advisor shall pay attention to whether there is any circumstance in which the target company has prejudiced the interests of the listed company such as providing guarantee or loans to the purchaser and its connected parties. Where it discovers any illegal or inappropriate act, it shall report to the CSRC, CSRC agency and the stock exchange in a timely manner.

Article 70

A financial advisor may engage other professional institutions to assist in carrying out verification on the purchaser, but shall make independent judgment on the materials provided and the information disclosed by the purchaser.

Article 71

From the announcement of the listed company takeover report by the purchaser until 12 months after the completion of the takeover, the financial advisor shall pay attention to the operations of the listed company through routine communication and periodic visits, and perform its duties of continuous supervision and guidance of the purchaser and the target company in light of the matters disclosed in the periodic reports and extraordinary announcements of the target company:

1. urge the purchaser to handle the share ownership transfer procedures in a timely manner and perform the reporting and announcement obligations in accordance with the law;
2. urge the purchaser and the target company to operate in a standardised manner in accordance with the law and review their operation;
3. urge and review the performance of the undertakings made to the public by the purchaser;
4. verify, in light of the periodic reports of the target company, the implementation of the follow-up plan by the purchaser and whether the projected objectives have been achieved, whether the result of the implementation thereof is significantly different from what was disclosed before, and whether the relevant profit forecast or the target that the management expected to reach has been realised;

5. in the case of a management buyout, verify whether the implementation of the relevant repayment plan as disclosed in the periodic reports of the target company is consistent with the facts; and
6. urge and review the performance of other obligations agreed upon in the takeover.

During the period of continuous supervision and guidance, the financial advisor shall issue continuing supervision and guidance opinions in light of the quarterly, semi-annual and annual reports disclosed by the listed company and shall report the opinions to the CSRC agency within 15 days following the disclosure of the aforesaid periodic reports. During this period, if the financial advisor finds that the information disclosed by the purchaser in the listed company takeover report is inconsistent with the facts, it shall urge the purchaser to disclose the information according to the facts and submit a report to the CSRC, the CSRC agency and the stock exchange in a timely manner. If the financial advisor terminates the appointment contract, it shall give a written report to the CSRC and the CSRC agency in a timely manner, stating the reasons of its inability to continue the performance of the duties of continuing supervision and guidance, and shall make an announcement thereof.

Part Eight: Continuing Supervision and Administration

Article 72

During the 12 months following the completion of the listed company takeover act, the financial advisor engaged by the purchaser shall, within the first three days of each quarter, submit a report to the CSRC agency on any investment, asset purchase or sale, connected transaction or adjustment to the main business that has a relatively significant effect on the listed company, any replacement of directors, supervisors or senior management personnel, resettlement of employees and the purchaser's performance of undertakings during the preceding quarter.

If the place of registration of the purchaser is different from the place of registration of the listed company, the report on the aforementioned matters shall be copied at the same time to the CSRC agency of the place in which the purchaser is located.

Article 73

After the completion of a takeover, the CSRC agency shall carry out supervision and inspection on the purchaser and the listed company in accordance with the principle of prudent regulation through means such as talks with the accounting firm that undertakes the audit business of the listed company, review of the performance of continuing supervision and guidance by the financial advisor and periodic or non-periodic on-site inspection.

If the CSRC agency discovers that there is significant difference between the actual circumstances and the contents disclosed by the purchaser, it shall pay particular attention to the purchaser and the listed company, may order the purchaser to extend the financial advisor's continuing supervision and guidance period and shall investigate and handle the matter in accordance with the law.

If the financial advisor terminates the contract with the purchaser during the continuing supervision and guidance period, the purchaser shall engage another financial advisor to perform the continuing supervision and guidance duties.

Article 74

In a takeover of a listed company, the shares held by the purchaser in the target company shall not be transferred in the 12 months following the completion of the takeover.

Transfer of share interests owned by the purchaser in the target company between different entities controlled by the same *de facto* controlling persons shall not be subject to the above 12-month restriction but shall comply with the provisions of Part Six hereof.

Part Nine: Regulatory Measures and Legal Liability

Article 75

If a person with information disclosure obligations in the activities of the takeover of a listed company and the associated change in share interest fails to perform the reporting, announcement and other relevant obligations in accordance with the provisions hereof, the CSRC shall order rectification and adopt regulatory measures such as regulatory dialogue, issue of a warning letter and order of suspension or cessation of the takeover. Until rectification is carried out, the relevant person with information disclosure obligations may not exercise the voting rights attached to the shares held or actually controlled by it.

Article 76

If a person with information disclosure obligations in the activities of the takeover of a listed company and the associated change in share interest includes any false record, misleading representation or major omission in its reports or announcements, the CSRC shall order rectification and adopt regulatory measures such as regulatory dialogue, issue of a warning letter and order of suspension or cessation of the takeover. Until rectification is carried out, the purchaser may not exercise the voting rights attached to the shares held or actually controlled by it.

Article 77

If an investor and the person(s) acting in concert acquire the control of a listed company without engaging a financial advisor according to these Procedures, circumvent the statutory procedures and obligations or carry out the takeover of a listed company in a disguised form, or if a foreign investor circumvents jurisdiction, the CSRC shall order rectification and adopt regulatory measures such as issue of a warning letter and order of suspension or cessation of the takeover. Until the rectification is carried out, the purchaser may not exercise the voting rights attached to the shares held or actually controlled by it.

Article 78

If a purchaser that has issued a takeover offer fails to pay the acquisition price or purchase the shares under the preliminarily accepted offer upon expiration of the takeover offer period according to the agreement, it may not acquire any listed company within three years following the date of occurrence of such fact, and the CSRC shall not accept the documents submitted by the purchaser and its connected parties. If the purchaser is suspected of disclosing false information or manipulating the securities market, the CSRC shall commence a formal investigation on the purchaser and pursue its legal liability in accordance with the law.

If the financial advisor engaged by the purchaser specified in the preceding paragraph does not have sufficient proof for its performance of due diligence obligations, the CSRC shall pursue its legal liability in accordance with the law.

Article 79

If, at the time of transfer of the control of the company, the controlling shareholder and *de facto* controlling person of a listed company fail to fully discharge their liabilities to the company or fail to have the guarantees provided by the company for their liabilities released or fail to rectify any other circumstance in which the interests of the company are prejudiced, the CSRC shall order rectification or order suspension or cessation of the takeover activities.

If the board of directors of the target company fails to procure the rectification carried out by the controlling shareholder or *de facto* controlling person of the company in accordance with the law or fails to procure the performance of the undertakings, arrangements or warranties by the purchaser following the completion of the takeover, the CSRC may deem the relevant director as an unsuitable person.

Article 80

If a director of a listed company fails to perform its fiduciary duty and obligation of due diligence and takes advantage of the takeover to seek improper gains, the CSRC shall adopt regulatory measures such as regulatory dialogue and issue of a warning letter, and may deem the director as an unsuitable person.

If the clauses in the article of association of a listed company concerning the control of the company are in violation of laws, administrative regulations and the provisions hereof, the CSRC shall order rectification.

Article 81

If the securities service institutions or securities companies and their professional personnel that issue asset valuation reports, audit reports, legal opinions and financial advisor's reports for takeover of listed companies fail to perform their duties in accordance with the law, the CSRC shall order rectification and adopt regulatory measures such as regulatory dialogue and issue of warning letters.

Article 82

The illegal acts and the rectification thereof of the parties in the activities of takeover of listed companies and the associated changes in share interest shall be recorded by the CSRC in their files of good faith.

If a violation of the provisions hereof constitutes an illegal act involving securities, the legal liability thereof shall be pursued in accordance with the law.

Part Ten: Supplementary Provisions

Article 83

For the purposes of these Procedures, "acting in concert" shall mean an act or fact whereby an investor and other investors jointly increase the quantity of the share voting rights that they can control in a listed company through an agreement or other arrangement.

Investors that act in concert in the activities of the takeover of a listed company and the associated change in share interest are persons acting in concert with one another. Unless there is evidence to the contrary, investors falling within any of the following circumstances shall be persons acting in concert:

1. there is an equity control relationship between the investors;
2. the investors are controlled by the same entity;
3. a principal member among the directors, supervisors or senior management personnel of an investor serves concurrently as director, supervisor or senior management personnel of another investor;
4. an investor has an equity participation in another investor and may exercise a major influence on the major decision-making of the investee company;
5. a legal person other than a bank, other organisation or natural person has provided financing arrangement for the investors to acquire the relevant shares;
6. there is an economic interest relationship such as partnership, cooperation and joint venture between the investors;
7. a natural person that holds 30% or more of the shares in an investor and the investor both hold shares in the same listed company;
8. the directors, supervisors and senior management personnel that hold offices in an investor and the investor hold shares in the same listed company;
9. a natural person that holds 30% or more of the shares in an investor, the directors, supervisors and senior management personnel that hold offices in the investor and their relatives, including their parents, spouses, children, the spouses of their children, the parents of their spouses, their siblings and the spouses of their siblings, the siblings of their spouses and the spouses of the siblings of their spouses, and the investor hold shares in the same listed company;

10. a director, supervisor or senior management personnel that holds office in a listed company and a relative of his falling within the description in the preceding item hold shares in the company at the same time, or he and an enterprise directly or indirectly controlled by himself or by a relative of his falling within the description in the preceding item hold shares in the company at the same time;
11. a director, supervisor or senior management personnel or employee of a listed company and a legal person or other organisation controlled or appointed by him hold the shares of the company; and
12. there is other connected relationship between the investors.

The shares held by persons acting in concert shall be calculated collectively. When an investor calculates the shares it holds, it shall include both the shares registered under its name and the shares registered under the name of the persons acting in concert.

If an investor holds that it shall not be deemed a person acting in concert with another person, it may provide the contrary evidence to the CSRC.

Article 84

An investor shall be deemed having the control of a listed company if it falls within any of the following circumstances:

1. the investor is a controlling shareholder that holds more than 50% of the shares in the listed company;
2. the investor can actually control over 30% of the share voting rights of the listed company;
3. the investor is able to decide the appointment of more than half of the members of the board of directors through actual control of the share voting rights of the listed company;
4. the investor, by virtue of the share voting rights of the listed company it actually controls, is able to have a major influence on the resolutions of the shareholders' general meeting of the company; or
5. other circumstances recognized by the CSRC.

Article 85

If a person with information disclosure obligations is required to calculate its shareholding percentage, it shall calculate the portion of the securities issued by the listed company convertible into shares of the company that are held and exercisable by it and the shares held by it in the same listed company in aggregate, and shall compare its shareholding percentage with the percentage calculated with non-equity securities aggregated on an as-converted basis, and take the higher of the two as the percentage of its shareholding. Securities the rights of which have not been exercised upon expiration of the exercise period or that no longer meet the conditions for exercise of rights need not be calculated together.

The higher of the two as specified in the preceding paragraph shall be calculated in accordance with the following formula:

1. the number of shares held by the investor / the total number of shares issued by the listed company
2. (the number of shares held by the investor + the number of shares underlying the non-equity securities convertible into company shares that are held by the investor) / (the total number of shares issued by the listed company + the total number of shares underlying the non-equity securities convertible into company shares issued by the listed company)

Article 86

If an investor acquires the control of a listed company by lawful means such as administrative transfer, court ruling, succession or gift, it shall perform the reporting and announcement obligations in accordance with the provisions of Part Four hereof.

Article 87

The contents and formats of documents such as report on the change of interests, takeover report, takeover-by-offer report, target company board of directors' report and documents for application for exemption of takeover by offer shall be formulated by the CSRC separately.

Article 88

If the target company is listed domestically and offshore at the same time, the purchaser shall comply with the relevant provisions of the place of offshore listing in addition to these Procedures and the relevant regulations of the CSRC.

Article 89

If a foreign investor acquires a listed company or if the interest owned by it in a listed company changes, it shall comply with the relevant provisions on investment in listed companies by foreign investors in addition to the provisions hereof.

Article 90

These Procedures shall be implemented as of 1 September 2006. The *Administration of the Takeover of Listed Companies Procedures* (CSRC Order No. 10), the *Administration of Disclosure of Information on the Change of Shareholdings in Listed Companies Procedures* (CSRC Order No. 11), the *Issues Relevant to the Conditions for Listing and Trading of Shares of Target Companies in Takeovers by Offer Circular* (*Zheng Jian Gong Si Zi* [2003] No. 16) and the *Issues Relevant to Regulating the Acts of Transfer of Actual Controlling Power of Listed Companies Circular (Zheng Jian Gong Si Zi* [2004] No. 1) shall be repealed simultaneously.

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