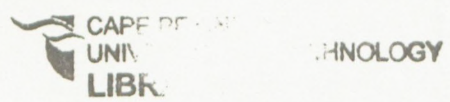
RISKS ASSOCIATED WITH MERGERS AND ACQUISITIONS IN BUSINESS: A CHINESE PERSPECTIVE

PING PING YANG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RISKS ASSOCIATED WITH MERGERS AND ACQUISITIONS IN BUSINESS: A CHINESE PERSPECTIVE

by

PING PING YANG

Thesis submitted in fulfilment of the requirements for the degree

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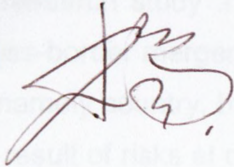
Signed  Date 14. 03. 2013.

ABSTRACT

The rapid growth of Chinese cross-border mergers and acquisitions have attracted global attention to Chinese businesses. As new mechanisms of Chinese expansion in the international business arena, cross-border mergers and acquisitions have necessitated in-depth academic studies of the risks associated with these activities from a Chinese business context. The influence of the Chinese government's domination of Chinese business is not only presented as different merger and acquisition tactics, but also as styles of operation and management in the process of integration. In cooperating with different counterparts, the shareholders of both acquiring and acquired companies are seeking solutions to related structural and operational changes. This relies on an effective risk management system to achieve a successful synergistic alliance for value creation.

In this research study a conceptual framework was developed to identify risks associated with cross-border mergers and acquisitions. The framework aims at identifying risks at threes levels, namely country, business and management. Risks at business and management level are the result of risks at country level, while risks at country level reflect risks at business and management levels. Therefore, risks identified in Chinese inbound mergers and acquisitions will be valuable risk parameters to Chinese outbound mergers and acquisitions.

Cooperation during integration is pivotal to successful mergers and acquisitions. Operational and managerial styles of Chinese businesses are profoundly affected by factors such as the Chinese government's role in business, economic policies, laws and regulations, culture, and so forth. This research identifies risks associated with Chinese post- inbound mergers and acquisitions that are impacted upon by Chinese government domination, from a Chinese business perspective.

In approaching this objective, this research studied 34 Chinese inbound mergers and acquisitions using a multiple case study method. The research adopted methodological triangulation for collecting evidence, and aimed at using in-depth case analyses to identify risk factors to add academic value to the field of study. As a result, the research findings strongly indicate that the Chinese government's domination has an extensive and intensive impact on risks associated with Chinese businesses in cross-border cooperation. These identified risks include business strategies and operation, policy implementation, legal compliance, and management performance. Consequently, risks associated with Chinese inbound mergers and acquisitions will mirror the risks of Chinese outbound activities.

The research results contribute to the practical application for managing risks associated with both Chinese inbound and outbound mergers and acquisitions. As a solution, mitigation of risks is recommended in the process of both pre- and post- mergers and acquisitions. The research provides valuable insights for both risk management and practitioners in mergers and acquisitions, and facilitates the achievement of process synergy.

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TABLE OF CONTENTS

DECLARATION II

ABSTRACT III

ACKNOWLEDGEMENTS V

TABLE OF CONTENTS VI

LIST OF TABLES X

LIST OF FIGURES XI

1 CHAPTER ONE: SCOPE OF THE RESEARCH 2

1.1 Introduction 2
1.2 Background to the Research Problem 3
1.3 Statement of Research Problem 4
1.4 Research Question, Sub-questions and Objectives 5
1.4.1 Research Question 5
1.4.2 Research Sub-questions 5
1.4.3 Research Objectives 5
1.5 Research Design 6
1.6 Contribution of the Research 6
1.7 Conclusion 8

2 CHAPTER TWO: MERGERS AND ACQUISITIONS - A HOLISTIC PERSPECTIVE 10

2.1 Introduction 10
2.2 Mergers and Acquisitions: Definitions 11
2.2.1 Mergers 11
2.2.2 Acquisitions 11
2.2.3 Cross-border Mergers and Acquisitions 11
2.3 Categories of Mergers and Acquisitions 12
2.4 History of Mergers and Acquisitions 13
2.5 Drivers of Mergers and Acquisitions 15
2.5.1 Business Expansion 16
2.5.2 The Rise of Globalisation 17
2.6 Synergy and Value Creation 18
2.7 Process of Conducting Mergers and Acquisitions 20
2.7.1 Strategic Objectives – Initial Target Organisation Approval 20
2.7.2 Locate Investigation – Strategic Rationale Approval 21
2.7.3 Due Diligence □ Executive Approval 22
2.7.4 Approach and Negotiation □ Board of Directors' Approval 23
2.7.5 External Approvals 23

2.7.6 Execution □□ Integration 24
2.8 Due Diligence 24
2.8.1 The Content of a Due Diligence 25
2.8.2 The Process of Due Diligence 26
2.9 Valuation 27
2.10 Integration 30
2.11 Factors Determining the Success and Failure of Mergers and Acquisitions 32
2.11.1 Factors Impacting on Merger and Acquisition Success 32
2.11.2 Factors Impacting on Merger and Acquisition Failure 33
2.12 Conclusion 34
3 CHAPTER THREE: RISKS ASSOCIATED WITH MERGERS AND ACQUISITIONS 37
3.1 Introduction 37
3.2 Risk Definition 38
3.3 Risk Management of Cross-Border Mergers and Acquisitions 39
3.3.1 Risk Management Strategy 40
3.3.2 Risk Identification 41
3.3.3 Risk Evaluation 41
3.3.4 Risk Control 41
3.4 Identifying Risks Associated with Cross-Border Mergers and Acquisitions 43
3.5 Risks at Country Level 43
3.5.1 Role of Government 44
3.5.2 Political Risk 46
3.5.3 Economic Risk 48
3.5.4 Policy and Regulation Risk 49
3.5.5 Legislative Risk 51
3.5.6 Cultural Risk 54
3.6 Risks at Business Level 56
3.6.1 Strategic Risk 56
3.6.2 Accounting Risk 57
3.6.3 Currency Risk 59
3.6.4 Taxation Risk 60
3.6.5 Human Resource Management Risk 61
3.6.6 Legal Risk 62
3.6.7 Information Technology Risk 62
3.6.8 Business Culture Risk 63
3.7 Risks at Management Level 64
3.8 Ethical Risk 66
3.9 Conclusion 68

4 CHAPTER FOUR: PERCEIVED RISKS ASSOCIATED WITH CHINESE MERGERS AND ACQUISITIONS 70
4.1 Introduction 70
4.2 Introduction to Foreign Investment in China 71
4.3 Chinese Cross-border Mergers and Acquisitions 74
4.3.1 Chinese Inbound Mergers and Acquisitions 75
4.3.2 Chinese Outbound Mergers and Acquisitions 81
4.3.3 Trends in Chinese Cross-Border Mergers and Acquisitions 83
4.4 Risks Associated with Chinese Cross-border Mergers and Acquisitions 85
4.5 Risks at Country Level 86
4.5.1 The Roles of the Chinese Government 86
4.5.2 Political Risk 88
4.5.3 Economical risk 91
4.5.4 Policy and Regulation Risk 94
4.5.5 Legislative Risk 100
4.5.6 Chinese Culture Risk 108
4.6 Risks at Business Level 114
4.6.1 Accounting Risk 115
4.6.2 Currency Risk 118
4.6.3 Human Resource Risk 119
4.6.4 Legal Risk 121
4.6.5 Business Culture Risk 122
4.7 Risks at Management Level 123
4.8 Conclusion 126

5 CHAPTER FIVE: RESEARCH METHODOLOGY AND DESIGN 128
5.1 Introduction 128
5.2 Research Question and Context 129
5.3 Research Methods and Approaches 131
5.3.1 Research Methods 131
5.3.2 Data Collection Methodologies 132
5.4 Case Study 133
5.4.1 Sources of Data 136
5.4.2 Interviews 138
5.5 Sampling Procedure 139
5.5.1 Unit Selection 139
5.5.2 The Size of the Units 140
5.6 Data Collection 140
5.6.1 Qualitative Data Collection 141
5.6.2 Quantitative Data Collection 143

5.7 Data Analysis 145
5.7.1 The Process of Data Analysis 145
5.7.2 The Approaches of Analysis 146
5.8 Research Ethics 147
5.9 Conclusion 148
6 CHAPTER SIX: RESEARCH RESULTS, FINDINGS, MODEL CONCEPTUALISATION AND RECOMMENDATIONS 150
6.1 Introduction 150
6.2 Research Report on Primary Data Collection 150
6.3 Research Results from Secondary Data Collection 154
6.3.1 Research Demography 154
6.3.2 Research Results Pertaining to Political Risks 157
6.3.3 Research Results Pertaining to Economic Risks 163
6.3.4 Research Results Pertaining to Policy and Regulation Risks 165
6.3.5 Research Results Pertaining to Legal Risks 168
6.3.6 Research Results Pertaining to Business Risks 172
6.3.7 Research Results Pertaining to Cultural Risks 181
6.3.8 Research Results Pertaining to the Management of Risks 183
6.4 Model Conceptualisation and Recommendations 189
6.5 Conclusion 201
BIBLIOGRAPHY 203
APPENDICES 216
i. Current Tax Categories (source: Jin & Chen, 2006) 216
ii. Excerpts of preferential treatment to Foreign-invested enterprises regarding income tax (Ma *et al.*, 2004:234) 218

LIST OF TABLES

Table 2.1: Five Mergers and Acquisition Waves (Summary) 13

Table 2.2: Expansion Motives of Mergers and Acquisitions 16

Table 3.1: Government and Industrial Policy (Source: Lynch, 2003:149) 50

Table 4.1: Chinese Economic Statistics (Source: National Bureau of Statistics of China, 2011) 91

Table 4.2: Summary of Chinese Laws and Regulations Applying to Mergers and Acquisitions (Source: Rui, 2007:33) 101

Table 5.1: Comparison of Quantitative and Qualitative Research Strategies (Summary) 132

Table 5.2: Methodologies of Quantitative and Qualitative Data Collection (Summary) 133

Table 5.3: Sources of Evidence: Strengths and Weaknesses (Source: Yin, 1994:80) 137

Table 5.4: The List of Companies Representing the Secondary Research Cases 144

Table 6.1: Successful Cases 156

Table 6.2: Research Results Pertaining to Political Risks 158

Table 6.3: Economic Risk Factors 164

Table 6.4: Risk Factors Associated with Policy & Regulation 165

Table 6.5: Risk Factors of Legal Issues 169

Table 6.6: Research Results of Business Strategic Issues 172

Table 6.7: Chinese Business's Strategies and Results 173

Table 6.8: Research Results Pertaining to Operating Issues 176

Table 6.9: Research Results Pertaining to Labour Issues 178

Table 6.10: Risk Factors Pertaining to Culture Issues 181

Table 6.11: Research Results of Management Issues 183

Table 6.12: Results of the Integrations 190

Table 6.13: List of Measuring Business Performance 199

LIST OF FIGURES

Figure 2.1: Conceptual Model of Mergers and Acquisitions 10
Figure 2.2: Merger Wave: Transaction Volumes Worldwide (UD$ Billion) 14
Figure 2.3: Cross-border Mergers and Acquisitions Volumes Worldwide (UD$ Billion) 15
Figure 2.4: Porter's Five Forces (Source: Borghese & Borgese, 2002:26) 21
Figure 3.1: Conceptual Model of Risks Associated with Cross-border Mergers and Acquisitions 37
Figure 3.2: Exposure to Political Risk (Source: Czinkota *et al.*, 2005:113) 47
Figure 3.3: Sources of an Organization's Code of Ethics (Source: Jones & George, 2009:93) 66
Figure 4.1: Risk Logic: Three Dimensions in Chinese Business Context 71
Figure 4.2: Increase of Chinese Overseas Mergers and Acquisitions 81
Figure 4.3: Conceptual Model of Risks Associated with Cross-border Mergers and Acquisitions 86
Figure 5.1: Research Design 128
Figure 5.2: Research Scope 129
Figure 5.3: Multiple Cases Strategy 136
Figure 5.4: Research Question Model 141
Figure 6.1: Nantong Baogang Oil & Fat Development Co., Ltd 151
Figure 6.2: Distribution of Types of Chinese Businesses 155
Figure 6.3: Countries Representing the Acquiring Companies 155
Figure 6.4: Results of Integration 156
Figure 6.5: Trend of the Deal 157
Figure 6.6: Conceptual Model of Risks in Chinese Business for Cross-border Mergers and Acquisitions 191
Figure 6.7: Integration Compatibility Measurements 196
Figure 6.8: Risk Mitigation Approaches 197

Synopsis: Chapter One

Cooperation between Chinese and foreign businesses entail different risks compared with that between Western businesses. This is due to the complexity of the Chinese way of managing business and the Chinese government's domination of cross-border mergers and acquisitions. As a result of Chinese economic development, a surge in demand for Chinese outbound investment has emerged. This calls for an urgent academic study on cross-border mergers and acquisitions within a Chinese business context, as these high-risk activities are new investment alternatives for Chinese businesses. Risks associated with these transactions are therefore unknown from a Chinese global businesses perspective.

The research objectives are to identify risks associated with cross-border mergers and acquisitions impacted upon by the Chinese government, and to structure a risk management conceptual framework that can be applied to risk mitigation of mergers and acquisitions from a Chinese business context. The risk identification is conducted in Chinese businesses and management from Chinese inbound mergers and acquisitions. The study adopted a mixed research methodology to study relevant cases.

The Chinese government's domination impact profoundly on Chinese business practices, and this is then transferred to the Chinese business culture and management. Risk identification of Chinese business and management in cross-border mergers and acquisitions indicates the 'Chinese way' of management and a plethora of associated risks. Consequently, the 'Chinese way' of doing business and embedded risks in Chinese businesses will be carried into the global business context. From a risk management perspective, results of this research can contribute significantly to the body of knowledge regarding successful cross-border mergers and acquisitions and benefit both Chinese and foreign businesses. The study is also an emphasis of synergy achievement for both acquiring and acquired companies.

The research comprises six chapters. Chapter One comprises the introduction, which includes the research background and research questions; the sub-questions and the research objectives. The chapter also describes the research design and its significance with respect to the associated academic contribution. Chapters Two, Three and Four are literature reviews on mergers and acquisitions and perceived risks associated with transactions in global and Chinese business contexts. Chapter Five introduces the research methodology adopted and explains how the research was conducted. Chapter Six presents the research results, conclusion and recommendations.

CHAPTER ONE: SCOPE OF THE RESEARCH

1.1 Introduction

Cross-border mergers and acquisitions have long been a popular mechanism for investing in a foreign country or a foreign business. It is acknowledged that cross-border mergers and acquisitions involve many uncertainties and risks. However, the interests and profits generated from these transactions motivate businesses to undertake such ventures.

This research study focuses on risks associated with Chinese cross-border mergers and acquisitions in business from a Chinese perspective. Research studies in this field have emphasised identifying risk factors and risk mitigation across borders. However, cooperation between Chinese and foreign businesses encounters different risks compared with those between Chinese or Western businesses. The complexity of Chinese business behaviour, combined with Chinese government intervention, contributes to the failure of mergers and acquisitions. Moreover, identifying risks associated with Chinese mergers and acquisitions is mainly determined from the perspectives of procedure, regulation and the Chinese government's policy on foreign trade. Nevertheless, this superficial identification of risks cannot fully determine the root cause of failure or forecast the likelihood of potential loss without taking cognisance of the distinctive characteristics of Chinese businesses.

The characteristics of Chinese businesses are cultivated within their particular trading environment, where the Chinese economic development background and Chinese government's intervention on business are influential. Therefore, reviewing the Chinese economic development background and analysing the aims of Chinese government policies, can provide deeper insight into identifying the real risk factors associated with the activities within a Chinese business context.

The current worldwide economic recession has resulted in a decline of merger and acquisition activities in the Western world. However, it has accelerated Chinese outbound mergers and acquisitions as a result of the strong Chinese economic growth. Many Chinese businesses have amassed abundant capital and are eager to invest overseas. Reciprocally, the recession provides the best investment opportunities for Chinese businesses to enter into global markets. As a result, the political features and economic system of China have been the focus of economic controversy for decades.

China is a developing country subjected to communist idealism, which led to a socialist economic system in the form of economic structures, laws, regulations, distribution of wealth, and business cultures. The current Chinese economic development is a unique economic

phenomenon in human history. The country's fast growth and escalating economy in the last thirty years are attributed to the ongoing economic reform and the successful attempt of combining the country's actual economic conditions with the theory of socialist market economy by the Chinese ruling party. The results have proved to be beneficial and have accorded China worldwide recognition. The reform is a milestone for China resulting in the country gradually becoming part of the world's economic system, and is now the second largest economic entity in the world.

Governments have an obligation to balance the interests of a country's different industries. Therefore, interference in business is necessary at a certain level. Government domination is fundamental. On the other hand, government domination can create risks to business, and the latter have to face unavoidable risks in this regard. As a consequence, risks associated with business activities reflect the level of government domination. Regarding the objectives of this research study, the researcher was aware that the Chinese government's control of business could be an obstacle to the data collection process, as businesses could be sensitive about the topic and research content, and thus dissociate themselves from the investigation. However, if the research data collection failed because of this reason, the process itself could serve as a good example to prove, and thus address, the research objectives. Furthermore, the results could also serve as the parameters to benefit cooperation between Chinese and foreign businesses, to add academic value.

1.2 Background to the Research Problem

Mergers and acquisitions are considered a mechanism to achieve a company's strategies such as diversification, market entry, or new technology integration. During the 1980s, mergers and acquisitions became a worldwide growth industry, the global value of which rose exponentially from £60 billion in 1984 to £355 billion in 1990 (Cartwright & Cooper, 1996:1). According to Cartwright and Cooper (1996:1), thirty-seven percent of the 1990 figures related to cross-border mergers and acquisitions. In 2007, merger and acquisition activities reached the highest peak on record with an estimated deal value of US$ 4011billion (Park, 2010:8).

This exponential growth in merger and acquisition activities occurred despite the seemingly high risks associated with the concept (Cartwright & Cooper, 1996:1). Owing to the significant amount of time and tremendous investment capital involved in mergers and acquisitions, mitigating potential losses calls for risks to be managed with great care.

The aims of a merger or acquisition are focused on the provision of improved organisation through integrated partnerships to achieve increased profitability; such tactics should be implemented within the context of a company's goals, objectives and strategies (Cobb, 1988b:3). As the biggest market in the world, it is acknowledged that business in China differs from that in the West. Cross-border mergers and acquisitions have been one of the most significant activities in China in recent years. By the end of 2004, 289,000 foreign enterprises had invested US$ 562.1 billion in China. This figure increased to US$ 650.8 billion in the first six months of 2006 (Rao, 2008:15). These figures show that the trend of foreign investment growth in spite of the world economic downturn in China is still strong. As a result, risks associated with mergers and acquisitions are of particular concern for companies envisaging a cross-border merger or acquisition in China. Controversially, the ambition of internationalisation drives mature Chinese companies to enter into global markets. The number of Chinese companies, which merge with or acquire international companies have increased year on year from US$1.6 billion in 2003 to US$18.7 billion in 2007 (Ye, 2008:2). This surge in growth also calls for the need to identify in advance the risks of being merged with or acquired by a Chinese company.

The rapid growth of Chinese inbound and outbound mergers and acquisitions are greatly attributed to the Chinese government's policies and encouragement toward foreign investment. The following salient factors related to mergers and acquisitions are taken into account from a Chinese business context: The Chinese government's role; political issues; economic environment; policy and regulation issues; cultural compatibility; and management level and capacity. From a Chinese perspective, wishing to merge with or acquire a company outside China, or from a foreign perspective, wishing to merge with or acquire a Chinese company in China, the road to a successful merger or acquisition is marred with complexity and complex phenomena. This calls for a specialist approach to mitigate the associated risks, which will form the crux of this research study.

1.3 Statement of Research Problem

Against the background outlined in the previous section, the research problem to be researched within the ambit of this thesis, reads as follows: "Risks associated with mergers and acquisitions within a Chinese businesses context differ significantly from those of global mergers and acquisitions. This creates process complexity and associated complex phenomena, to the extent that the business venture could fail if not structured appropriately".

1.4 Research Question, Sub-questions and Objectives

1.4.1 Research Question

The following question, which forms the crux of the research, will be researched to address the research problem: "What structured approach can be applied to post-mergers and acquisitions with processing complexity and associated complex phenomena created as a result of mergers and acquisitions when Chinese companies merge with or acquire global companies or vice versa?"

1.4.2 Research Sub-questions

The research sub-questions in support of the primary research question are listed as follows:

- What are the risks associated with cross-border mergers and acquisitions?
- What are the perceived risks associated with Chinese cross-border mergers and acquisitions?
- How does the Chinese government dominate Chinese cross-border mergers and acquisitions?
- What are the risks associated with post cross-border mergers and acquisitions as a result of Chinese government domination?
- Can these risks be mitigated, and how?

These sub-questions address the research question, and fall within the parameters of the research objectives. The first three questions are answered by reviewing the literature, and the last two via a multiple case study.

1.4.3 Research Objectives

Correlating with the research questions, the objectives of this study are:

- To review academic literature in the field of risks associated with cross-border mergers and acquisitions.
- To review academic literature in the field of risks associated with Chinese cross-border mergers and acquisitions.
- To identify the key elements of Chinese government's domination in Chinese cross-border mergers and acquisitions.
- To identify risks associated with Chinese post-mergers and acquisitions that are impacted by Chinese government domination.
- To analyse these identified risks and determine how they can be mitigated.

1.5 Research Design

Research includes ontological and epistemological assumptions in gaining a full understanding of the research context and objectives. Research is also a process of discovery and logical deduction in pursuing the principle of a phenomenon from its existence. In accordance with the research objectives, this study employs mixed research methodologies as the most suitable approach for a multiple case study.

The concept of 'mixed methodologies' (also known as methodological triangulation) represents a taxonomy of research approaches which can be applied to a diverse range of research studies. Methodological triangulation refers to research where both quantitative and qualitative research approaches are used for data collection. This culminates in diverse data collection techniques, for example, questionnaires, interviews, surveys, and field studies, which are juxtaposed to collect quality data (Yin, 1994:92).

From a qualitative research perspective, interviews are proposed to obtain a deeper understanding of the risks associated with Chinese cross-border mergers and acquisitions and how they arise. A quantitative research perspective to verify the results from an established conceptual framework, which is to provide an outline of managing risks associated with businesses activities.

Epistemology in research generally recognises four approaches to discernment, namely: intuitive (when coming up with an initial idea for research); authoritative (when reviewing the professional literature); logical (when reasoning from findings to conclusions); and empirical (when engaging in procedures that lead to these findings). Adhering to these four aspects, methodological triangulation in research suggests that subjective, argumentative, descriptive, and interpretative approaches are applied to the identified objects of the research in order to develop an insightful overview of the subject studied.

1.6 Contribution of the Research

Despite mergers and acquisitions being acknowledged as risky, they are de facto popular mechanisms for business expansion worldwide, including China. Chinese inbound mergers and acquisitions have increased exponentially in the last ten years. Simultaneously, outbound demands have likewise experienced a surge in global markets. Owing to Chinese businesses' lack of mergers and acquisitions experience in international markets, these new demands call for an urgent study on risks associated with Chinese outbound mergers and acquisitions. The obstacle to studying outbound cases for this research is that a single transaction of a cross-border merger or acquisition may take a period of three months up to

three years from negotiation to accomplishment. The outcome of integration takes even longer. To identify risks from an integration perspective, very few examples are available, which cannot serve to address the research objectives. Thus, it is reasonable to undertake the fulfilment of risk identification specifically from inbound transactions. The fact is that past Chinese inbound mergers and acquisitions are outstanding examples, of which the integration performance can provide valuable and material evidence for the research study. Consequently, the identified risks of Chinese inbound transactions may also be applicable to the risks of outbound transactions.

Cross-border mergers and acquisitions can have a measurable impact on a host country's market, which necessitates intervention by the host government. As a matter of fact, regulations and policies tailored for cross-border mergers and acquisitions differ between countries. This is determined by the impending economic impact and the government's economic policies. Transformation of regulations and policies is based on the transaction impact on the host country's economy and the government's intention. A thorough understanding and thus accurate forecast of a host country's intention of policy and regulation change is crucial, as it provides pre-emptive solutions to potential investment loss. China, being one of the most important economies, complete with controversial economic characteristics, structures and policies, has also received additional attention from the world on mergers and acquisitions.

Since China opened its market to the world, the trade conflicts between China and Western countries have never stopped. These conflicts are not only due to business interests, but also political issues and unbalanced trade conditions. The level of Chinese business has also played an important role. Business conduct is shaped mainly by the business environment in which the Chinese government is dominant. Identification of risks associated with Chinese business can significantly reduce risks to both Chinese and foreign businesses. Synergy of mergers and acquisitions is achieved via integration performance and subject to creating value for shareholders. As a result, associated risks presented at the level of business and management indicate the probability of success or failure of integration.

Regarding business and management in research, Remenyi, Williams, Money and Swartz (2002:39), state that economists often distinguish between two main types of 'value', which are described as 'value in use' and 'value in exchange'. 'Value in use' means business and management practitioners or academics will be able to obtain valuable ideas from the concepts and theories generated by the research. 'Value in exchange' refers to the possibility of earning revenue from the results of the research.

From the 'value in use' point of view, this study proposes to inspire both Western and Chinese businesses to achieve successful synergetic strategies in global business contexts. Regarding 'value in exchange', the research results can provide valuable insight to risk management, which ultimately add value to shareholders. Furthermore, the research results can significantly contribute to preventing loss to both investing and invested companies, and add to the academic body of knowledge of risk management of cross-border mergers and acquisitions.

1.7 Conclusion

This chapter provides an overall introduction to the research study. It provides a brief background to the research, research problem, questions, objectives, and research methods. The introduction highlights the study field of cross-border mergers and acquisitions and associated risk management. Risks associated with Chinese businesses have been studied widely from a Western perceptive, identifying risks associated with the activities from a Chinese perspective in a Chinese business context, is the core of this research.

The research questions culminate from the trend of an increased number of Chinese cross-border mergers and acquisitions and the unknown risks associated with these transactions. The Chinese government's leading position in business (especially state-owned enterprises) is fundamental in managing mergers and acquisitions in a Chinese business context. Furthermore, its influence is deeply rooted in Chinese business. This raises the key question of what risks associated with Chinese cross-border mergers and acquisitions result from the domination of the Chinese government. Regarding China's ongoing economic reform, the Chinese government aims to enforce its domination of Chinese outbound transactions as consistently as that of inbound transactions.

Synopsis: Chapter Two

Mergers and acquisitions have characteristic attributes that map to economic development. This suggests that risk associated with mergers and acquisitions is presented differently at various economic stages. Regarding risk mitigation, a holistic review of mergers and acquisitions can return insight into specific levels, degrees, or tendencies of risks associated with mergers and acquisitions.

With reference to the achievement of successful mergers and acquisitions, this chapter introduces concepts and principles associated with mergers and acquisitions. The highlighted elements include: History, drivers, process, due diligence and valuation of mergers and acquisitions. From a shareholder's perspective, mergers and acquisitions should take place when financial gain can be created by both acquiring and acquired companies. Synergy achievement and value creation are therefore the key prerequisites for transforming two companies' valuable resources into strategic objectives. As a result, it is necessary to identify the characteristics of current mergers and acquisitions in terms of an understanding of mergers and acquisitions, the reasons for their popularity, and the trends they are subjected to.

In the process of mergers and acquisitions, due diligence and valuation are two influential parameters that can significantly affect the results of a deal. Therefore, the principle of conducting due diligence and proper valuation needs to be emphasised in the approach to a successful transaction. The decisive factor of conducting successful due diligence and valuation is obtaining accurate information from the internal and external business environments of the contracting parties. Owing to mergers and acquisitions having a high failure rate, it is of importance to highlight the factors impacting on the failure and success of mergers and acquisitions.

Special note to the reader: for the purpose of clarity, in this thesis the term 'target organisation' refers to an organisation which has been identified as an organisation which has the potential to be the subject of an interest to be merged with or to be acquired by another organisation in a cross-border deal.

CHAPTER TWO: MERGERS AND ACQUISITIONS - A HOLISTIC PERSPECTIVE

2.1 Introduction

Driven by globalisation and strategic development, mergers and acquisitions are considered as one of the preferred financial mechanisms to achieve a rapid growth for business. The high return rate of such investments also indicate that mergers and acquisitions have high risks. To avoid and mitigate any associated risks, it is necessary to understand the concepts and principles of mergers and acquisitions, as well as the categories and their history.

Mergers and acquisitions are strategic approaches, with synergy achievement being the key indicator of value creation for the shareholders of both acquiring and acquired companies. Businesses have motives in pursuing mergers and acquisitions; associated risks raise the issue of synergy achievement. The process of mergers and acquisitions is another important factor, as uncertainties, tensions and conflicts are inherent in the entire process. It is especially risky in cross-border transactions. As a result, a clear understanding of the process is essential for embedding risk management into the strategy of a merger or acquisition to mitigate associated risks. Figure 2.1 provides a graphical depiction of the merger and acquisition process.

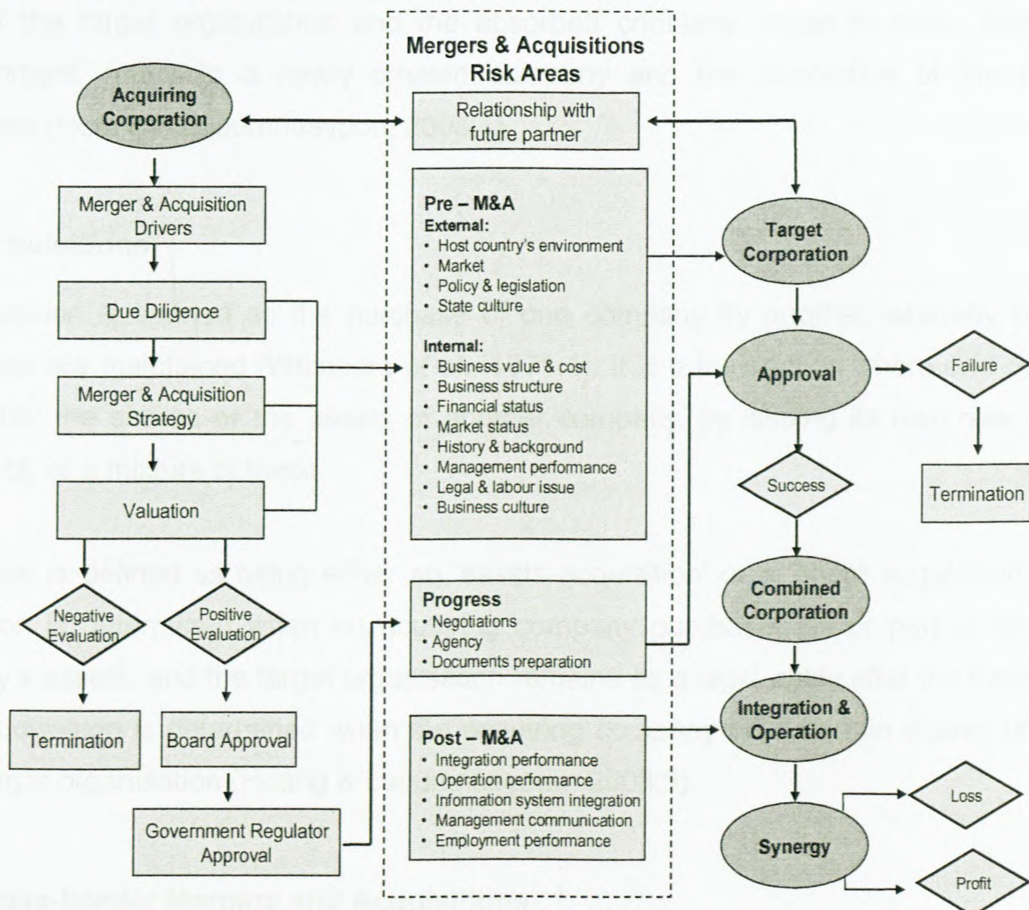


Figure 2.1: Conceptual Model of Mergers and Acquisitions

Certain key factors are highlighted in the Figure 2.1 calling for these aspects to be subject of closer scrutiny, such as drivers, due diligence and valuation of mergers and acquisitions. Figure 2.1 links these key factors in the process and the associated risk areas. This chapter comprises the literature review of the above-mentioned elements that are associated with mergers and acquisitions.

2.2 Mergers and Acquisitions: Definitions

2.2.1 Mergers

Weinberg, Blank and Greystoke (1971:4), define a merger as a combination of two companies becoming absorbed in or under the control of one company, which may exist as a new company or one of the two original companies. It is affected by the shareholders of both the merging companies exchanging their shares for the shareholding of the merged company spread between the shareholders of the two companies (Weinberg *et al.*, 1971:4; Cobb, 1988a:37).

The concept of a merger is distinguished as either being a 'merger by absorption' or a 'merger by establishment'. 'Merger by absorption' occurs when one company buys all the stock of the target organisation and the absorbed company cease to exist. 'Merger by establishment' refers to a newly created company and the dissolution of the merging companies (Hoang & Lapumnuaypon, 2008:4).

2.2.2 Acquisitions

An acquisition is defined as the purchase of one company by another, whereby both the companies are maintained (Weinberg *et al.*, 1971:4). It is a transaction where one company buys either the shares or the assets of another company, by issuing its own new shares, cash, debt, or a mixture of these.

Acquisition is defined as being either an 'assets acquisition' or a 'share acquisition'. Asset acquisition is determined when an acquiring company purchases all or part of the target company's assets, and the target organisation remains as a legal entity after the transaction. Share acquisition is determined when the acquiring company buys certain shares of stocks of the target organisation (Hoang & Lapumnuaypon, 2008:5).

2.2.3 Cross-border Mergers and Acquisitions

According to Weinberg *et al.* (1971:491-492), the definition of a merger is not always interpreted the same internationally. In the Netherlands for example, if all the company's

shares are acquired, it will become a subsidiary of the acquiring company, and thus cannot be dissolved. In a situation where a company acquire assets of an acquired company for shares, these shares can only be attributed to the shareholders of the acquired company at liquidation, which would be financially more expensive (Weinberg *et al.*, 1971:491-492).

2.3 Categories of Mergers and Acquisitions

Mergers and acquisitions can be categorised from various perspectives, such as a company's position in the value chain, the degree of cooperation, or relationship with the target and economic area. These individual perspectives are elaborated upon below:

From a value chain perspective: Mergers and acquisitions can be categorised into the following four types (Weinberg *et al.*, 1971:6; Cartwright & Cooper, 1996:3; Correia, Flynn, Uliana & Wormald, 2005:Ch.17-2; Hoang & Lapumnuaypon, 2008:5):

- **Vertical** mergers and acquisitions involve the combination of two organisations from successive processes within the same industry. For example, a manufacturer acquiring a series of retail industries.
- **Horizontal** mergers and acquisitions involve a combination of two similar organisations in the same industry. The observed tendency of this type of transaction occurs in industries such as pharmaceuticals, automobiles and petroleum.
- **Conglomerate** mergers and acquisitions refer to the situation where the acquired organisation is in a completely unrelated field of business activity.
- **Concentric** mergers and acquisitions involve the acquired organisation in an unfamiliar but related field into which the acquiring company wishes to expand. For example, a producer of sports goods might acquire a leisure-wear manufacturer.

From the degree of cooperation perspective: Whether an offer will be accepted by the shareholders of the acquired company, may culminate as a result of an agreement right after the offer, after negotiations, or after public scrutiny. It is possible to identify the dominant party in a transaction according to the degree of cooperation between the boards of directors of the two companies (Weinberg *et al.*, 1971:7-8). As a result, mergers and acquisitions can be classified as:

- **Agreed mergers or acquisitions**. The shareholders of the target organisation accept the offer in respect of their own shareholdings, and recommend that other shareholders reciprocally accept the offer.
- **Unopposed**. The shareholders of the target organisation do not oppose the offer.
- **Defended**. The intention to defend may be to stop the deal, or persuade the acquirer to

improve its terms.

- **Competitive**. An acquired company may invite a second or even third party to join in a rival bid if the acquisition is inevitable.

From a target organisation perspective: Mergers and acquisitions can be classified as ***friendly*** or ***hostile*** (Hoang & Lapumnuaypon, 2008:5). When a merger or acquisition transaction is undertaken in a friendly manner, the board of the target organisation is more likely to agree to the transaction. In a hostile deal, the offer is opposing the wishes of the target organisation, so that the board of the target organisation refuses the offer (Hoang & Lapumnuaypon, 2008:5).

From an economic area perspective: Mergers and acquisitions can be classified into two types: namely ***domestic*** or **cross-*border***. In domestic mergers and acquisitions, the acquiring company and the target organisation are launched and operate in the same country. In cross-border mergers and acquisitions, the acquiring company and the target organisation are located and operate in different countries, or they operate in one country but belong to different countries (Chunlai Chen & Findlay, 2003, cited by Hoang & Lapumnuaypon, 2008:6).

2.4 History of Mergers and Acquisitions

Mergers and acquisitions across borders differ from each case, but they share common tendencies and follow business environmental changes. Therefore, a determination of such trends is necessary in understanding the essential features of current merger and acquisition activities, which can be utilised in the actual performance.

Cross-border mergers and acquisitions have experienced 'six waves' of evolution since their first occurrence. Table 2.1 below provides a summary of statements made by Brakman, Garretsen and Van Marrewijk (2008:6) and Kusstatscher and Cooper (2005:11), which reflects the evolutionary background of mergers and acquisitions:

Table 2.1: Five Mergers and Acquisition Waves (Summary)

Wave	Period	Strategic background
1st wave	1898 - 1920	Horizontal transactions mostly in America
2nd wave	1926 - 1939	Vertical integration to gain control of the complete value chain
3rd wave	1966 - 1970s	Anti-cyclical portfolio building to harmonise different industry-driven economic downturns
4th wave	Mid 1980s -	A worldwide industry, 'back to core businesses' through divestures

	1990	and carve-outs. Speculative gains from financial acquirers (e.g. leveraged buy-out)
5th wave	1993 - 2000	Increasing shareholder value and globalisation. Talents technology and consolidation of the 'New Economy', ended with the collapse of the 'New Economy' and largely involved companies from continental Europe
6th wave	2004 onwards	Taking place now

Brakman *et al.* (2008:6), state that each wave increases the value of the merger and acquisition deals (measured by firm's market capitalisation), and is positively correlated with an increase in share prices and per-earning ratios, which invariably results in overvalued shares.

The increase in volume of cross-border mergers and acquisitions has been significant since the 5th wave. Based on the annual volumes (in billions US$) of worldwide merger and acquisition transactions, from 1992 to 2007, the trend of mergers and acquisitions is shown in Figure 2.2 below:

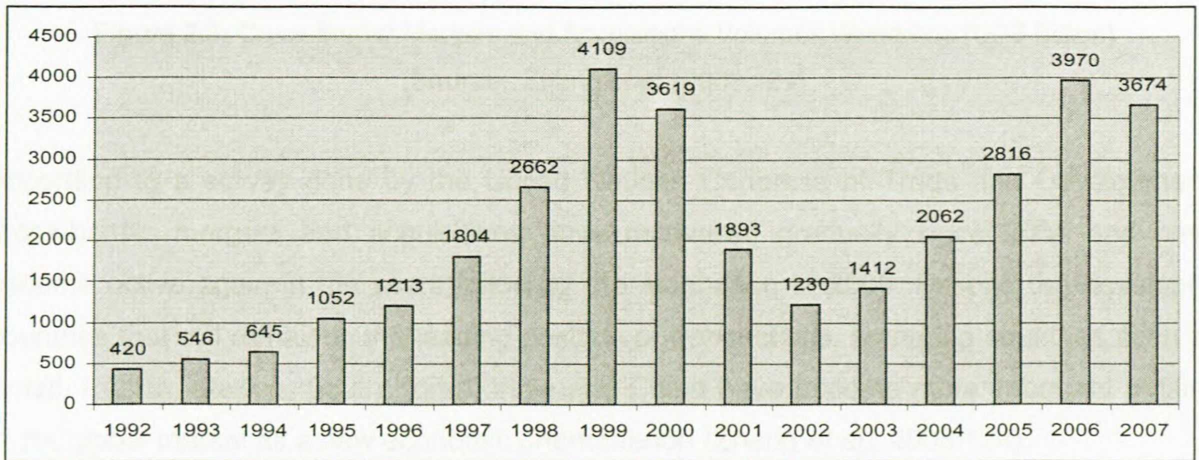


Figure 2.2: Merger Wave: Transaction Volumes Worldwide (UD$ Billion)

Source: (Zhang, Wang & Xiong, 2008:124)

Figure 2.2 reflects a rapid volume increase of cross-border mergers and acquisitions from 1998 to 2000. The volume of 1998 is double that of 1996 and reached US$2.6 trillion; it exceeded US$4.1 trillion in 1999, which was the highest record ever. The trend in this period is summarised by Brakman *et al.* (2008:6), namely that the correlation between target organisations and acquirers are high in horizontal mergers and acquisitions involving industries such as chemicals, electronics, machinery, instruments and food, which are the most active sectors. Zhang *et al.* (2008:128), disagree with this view in that the activities in industries such as computer networks, telecommunications and other advanced technologies appear to be higher in volume, with the numbers of transactions confirming this feature.

Mergers and acquisitions were primarily focused on obtaining control of undervalued assets, which could be either broken-up or traded (known as 'asset-stripping'), or developed as autonomous units. Currently, mergers and acquisitions are more focused on business long-term strategy or operation, and emphasis is on achieving industrial consolidation or accessing new markets (Downey, 2008:4). Strategic changes drive companies to merge or acquire across borders. In the last ten years, the volume of global capital inflow and outflow has doubled, and transactions follow the trend of worldwide transactions as graphically depicted in Figure 2.3 below.

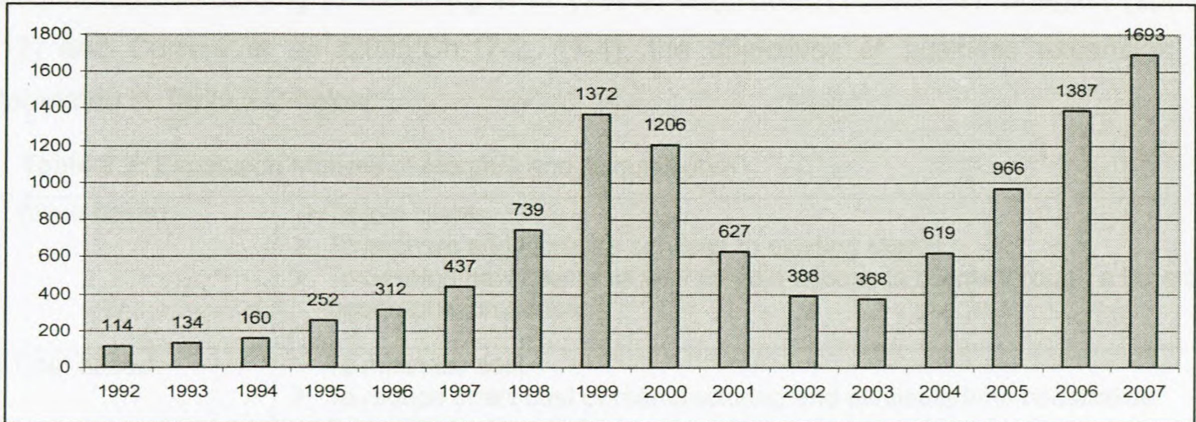


Figure 2.3: Cross-border Mergers and Acquisitions Volumes Worldwide (UD$ Billion) (**Source**: Zhang *et al.*, 2008:124)

According to a survey done by the United Nations Congress of Trade and Development, cross-border mergers and acquisitions have recovered gradually since 2004 and have become active again in the years following the stagnation in 2000. Despite the developed countries that still remain in the leading position of transactions, emerging countries such as Brazil, Russia, Mexico, South Korea, India and China have become more important entities in the global market as a new economic phenomenon (Zhang *et al.*, 2008:124).

2.5 Drivers of Mergers and Acquisitions

The prevalence of shareholders taking increased risks to execute cross-border mergers and acquisitions is to gain added value to their investment. Some specific conditions have been formulated in promoting current cross-border mergers and acquisitions, such as advanced information technology and telecommunications. Using such facilities, companies are able to perform business activities in different regions, specifically in emerging countries, which are providing more opportunities to the world economy.

There are various motives for launching into cross-border mergers and acquisitions, which can be categorised broadly into two main drivers, namely 'business expansion', and 'engaging in globalisation'. Business expansion is the internal driver of demands for capital,

resources and labour; while engaging in globalisation is the external driver of pressure for maintaining or improving industrial competitive capabilities. As a result of engagement, multinational corporations can maintain a strong leading position in cross-border mergers and acquisitions in size and region (Zhang *et al.*, 2008:122).

2.5.1 Business Expansion

Business expansion is regarded as the internal motivation for cross-border mergers and acquisitions. According to Weinberg *et al.* (1971:7-23), Cobb (1988b:1-2), Shapiro, (2003:5-12) and Correia *et al.* (2005:Ch.17-2; 17-4), the objectives of business expansion are tabulated in Table 2.2 below:

Table 2.2: Expansion Motives of Mergers and Acquisitions

Client based	➢ To join clients. ➢ To improve and increase services to existing clients. ➢ To develop new clients as well as gain access to clients through a broad geographic presence.
Cost based	➢ To minimize cost. ➢ To reduce direct cost of manufacturing and eliminate time constraints through target market awareness. ➢ To reduce uncertainty and transaction costs by upstream and downstream linkages in the value chain.
Market based	➢ To seek new markets. ➢ To stabilise and increase sale and supply in a broader market. ➢ To enhance the competitive position in the market.
Resources based	➢ To employ spare resources of capital or management. ➢ To seek raw materials. ➢ To enhance technological development.
Financial based	➢ To take financial advantage. ➢ To take taxation advantage. ➢ To use excess liquidity. ➢ To diversify and reduce the volatility of earnings. ➢ To obtain greater stability of earnings.
Management based	➢ To reduce volatility and potential risks. ➢ To increase managerial skills and levels. ➢ To increase management security.

Within a broad range of circumstances, each individual company has different motives for performing cross-border mergers and acquisitions. The above list comprises all categories of business activities, which indicates that shifting a cross-border merger or acquisition within a business strategy alliance is wide. From an acquiring company perspective, whether a strategy can be accomplished or not, the result of synergy achievement after integration is the obvious aim. Compared with establishing a new company across borders, mergers and acquisitions can save enormous time and costs in attaining the size of a target organisation.

However, the associated investment risks are also high, and managing an unknown company is certainly challenging at all levels.

2.5.2 The Rise of Globalisation

Shapiro (2003:12, 27) and Hill (2007:24), state that globalisation is entering a new and more complex phase from which change is the rule rather than the exception. Companies, who have the ability to manage and adjust to faster changes, will be able to win from the surge of global competition (Shapiro, 2003:12). Characteristics of globalisation are listed as follows (Shapiro, 2003:4-12):

- Production tends to move more rapidly to search for high returns.
- Small businesses participating in global markets obsolesces the old economic analytical framework.
- Capital investment opportunities are sought around the world.
- Markets become more efficient, which are quicker to respond to economic policies.
- Skilled labour in some countries no longer can be considered fundamentally different.
- Information technology allows skilled work to flow regardless of borders.
- Technology and 'know-how' are rapidly becoming a global pool.

Globalisation challenges all nations' business structures, management principles, political fundamentals and regulations. By following the trend of globalisation, companies are experiencing international levels of co-operation on production, marketing, technology and financial investment. The identified causes of globalisation include:

- **Capitalism:** Capitalism has had the greatest impact on globalisation, from which production and distribution are privately or corporately owned, and the development is proportionate to the accumulation and reinvestment of profits gained in a capitalist system (Needle, 2004:49-50).
- **Competition:** Competition results in an increase in complex and dynamic business environments, which drive companies to operate abroad. As a phenomenon, new products are developed at more frequent intervals because of shortened product life-cycles, and therefore costs have become paramount (Needle, 2004:50).
- **Technological innovations:** Development of information technology in transport, communication and data processing, and a decline in the cost of information storage, transmission and procession, are particularly significant challenges to changing the traditional ways of trade (Needle, 2004:50).
- **Regulations:** The role of government is crucial in the promotion of standardisation and integration. The achieved agreements on global standards such as computer systems,

civil aviation, and intellectual property rights serve as examples of approaching globalisation. Global and regional organisations such as the United Nations (UN), the World Trade Organisation (WTO), the European Union (EU), the North American Free Trade Association (NAFTA) and the Association of South East Asian Nations (ASEAN), have contributed mainly to such standardisation (Needle, 2004:50).

- **Multinational corporations:** Multinational companies are both products and drivers of globalisation, and contribute towards the diffusion of technology and ideas, and the convergence of processes and management practices.

Businesses that expect to survive and develop in the fast-changing global business environment have to keep up with the pace of globalisation. The above-mentioned causes motivate companies to take risks in seeking business opportunities globally, therefore cross-border mergers and acquisitions will continue to be considered as some of the best choices to make.

There are also other factors in the likes of markets offering more companies for sale, easing regulations to access, increasing the availability of capital, the possibility to create a monopoly or to get tax relief, the need to share risk, the existence of complex inseparable problems and increased business specialisation, which would drive companies to globalise and enter into cross-border transactions (Kusstatscher & Cooper, 2005:13). Kusstatscher and Cooper (2005:13), further state that there are also some tacit and widely unrecognised reasons that may be the motives to globalise, namely the hidden fear of obsolescence; bored CEOs looking for some excitement or the satisfaction of personal purpose; egoistical needs of powerful individuals to gain collective influence; or simply the urge to follow the current trends. Whatever motives drive business to strategise a cross-border merger or acquisition, it will require great effort and attention to support and sustain the associated complexity (McCarthy & De Reya, 2007:14), of the deal to achieve synergy for both acquiring and acquired company.

2.6 Synergy and Value Creation

Synergy brings two companies under a single control mechanism to generate more profits to a corporate conglomerate (Weinberg *et al.*, 1971:22). As a result, mergers and acquisitions are undertaken to create value for shareholders (Hitt, Harrison & Ireland, 2001:83). Hitt *et al.* (2001:83), emphasise that such activities will take place only when gains will accrue to the acquiring firm shareholders, whereas enhancing the value of shareholder's ownership positions in the acquired firm should be of interest to the acquiring firm when seeking to create synergy through acquisitions.

The expected result of mergers and acquisitions is that the consolidation can increase efficiency, economies of scale, widening of markets and greater purchasing power to substantially increase profitability (Cartwright & Cooper, 1996:23). Value creation is the primary achievement of synergy, and synergy accomplishment in turn is the evidence of successful mergers and acquisitions.

Trautwein (1990), cited by Luypaert and Huyghebaert (2007:Online) and Shapiro (2003:81), distinguish three types of synergies that can improve earnings from mergers and acquisitions:

- **Operating synergy:** The enlarged organisational entity can result in increased levels of business activities, lower unit costs, and expand internal and external markets.
- **Financial synergy:** Capital costs can be reduced from merged or acquired organisational entities if the debt capacity is well managed.
- **Managerial synergy:** Merger and acquisition activities can mitigate the weakness of unequal managerial capabilities.

Koller, Goedhart, Wessels and Copeland. (2010:451), state that identifying specific acquisition strategies may create value for shareholders. Based on their experience in acquisitions work with companies, the authors list five archetypes to confirm value creation for shareholders:

- Improve performance of the target organisation.
- Consolidate to remove excess capacity from an industry.
- Create market access for the target organisations' (or, in some cases, the buyers'), products.
- Acquire skills or technologies more quickly or at lower cost should it be built in-house.
- Pick winners early and help them develop their businesses.

Koller *et al.* (2010:452), suggest that 'the strategic rationale (for a merger or acquisition) should be a specific articulation of one of these archetypes, not a vague concept in the likes of growth or strategic positioning', as they need to be translated into combined strategies, which are more tangible. If an acquisition does not address one or more of these archetypes, it is unlikely to create value. However, if the acquisition does address one of the listed archetypes (yet overpay), it still cannot create value (Koller *et al.*, 2010:452).

To determine created value from an acquisition Hitt *et al.* (2001:84), suggest that a firm's share price is one indicator of the value that is generated by an acquisition. This opinion is supported by Koller *et al.* (2010:445), that stock markets respond to the expected impact of acquisitions on intrinsic value, not accounting results. However, many managers focus on the

exponent of earnings brought about by an acquisition, rather than the value it could create (Koller *et al.*, 2010:465). As a result, it is dangerous and easily leads to poor decision making.

2.7 Process of Conducting Mergers and Acquisitions

Owing to the complexity and huge amount of investment involved in mergers and acquisitions, considerable effort and attention to the entire acquisition process is required. Any negligent execution may lead to failure or loss (Boeh & Beamish, 2007:xii-xiii). According to Aiello and Watkins (2000, cited by Hoang & Lapumnuaypon, 2008:6); and Borghese and Borgese (2002: 23 *ff.*), the process of a merger or acquisition followed by internal approvals, can be summarised in five stages:

- Strategic objectives – initial target organisation approval.
- Investigation – strategic rationale approval.
- Valuation and evaluation – due diligence – executive approval.
- Approach and structuring – negotiation – board of directors' approval.
- Execution – integrating.

The first three stages are pre-deal phases, while 'negotiation' represents the deal phase, which ends when the above approaches are achieved. The post-deal phase only contains the last stage, termed 'integration'. The phases in the process of achieving a merger or acquisition, due to its importance, are expanded upon in detail below.

2.7.1 Strategic Objectives – Initial Target Organisation Approval

Establishing a merger or acquisition strategy before processing the deal is essential as companies need to understand their competitive advantages and support applications such as technology, financing and marketing. On the other hand, merger and acquisition tactics must be planned, executed and integrated, thus aligning with the context of the company's goals, objectives and strategies (Cobb, 1988b:3) in order to determine acquisition criteria, is considered an absolute prerequisite

Borghese and Borgese (2002:25), who introduce Porter's Five Forces industry analysis, shown as Figure 2.4 below, which could serve as a mechanism to accomplish this first phase of the project.

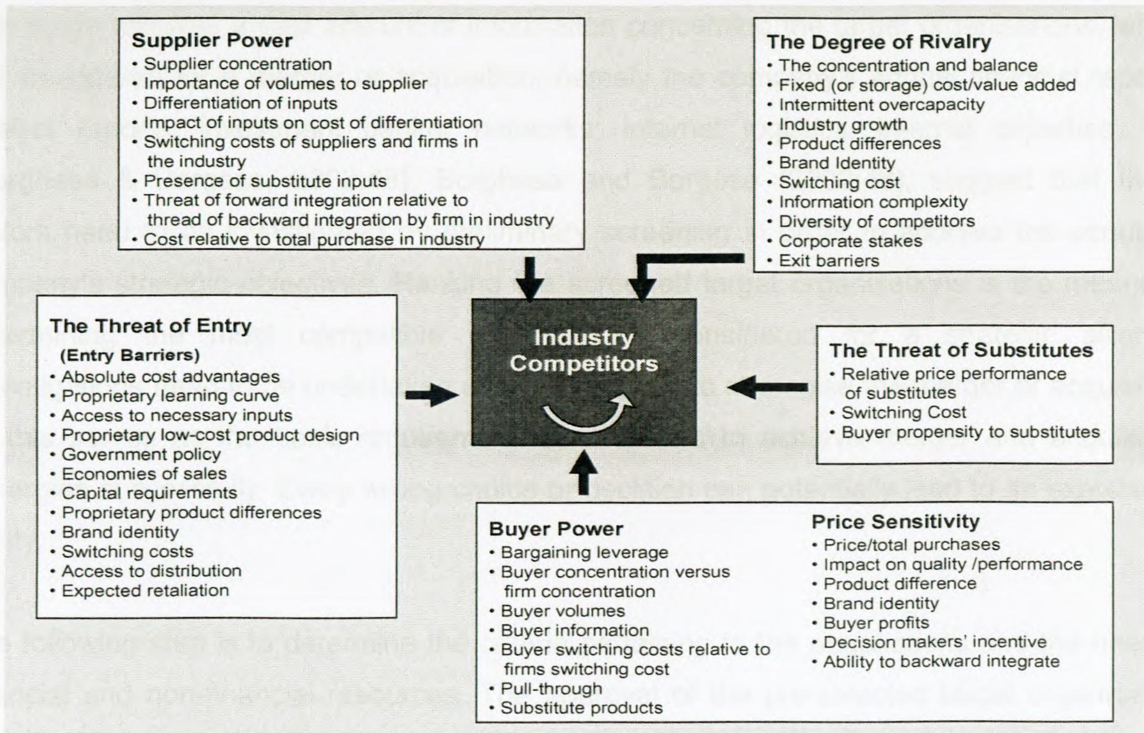


Figure 2.4: Porter's Five Forces (**Source**: Borghese & Borgese, 2002:26)

Five elements of analysing the target industry based on Porter's Five Forces are highlighted in Figure 2.4, namely the degree of rivalry in the industry; the threat of substitutes; barriers to entry; supplier power; and buyer power. To properly complete the analysis of Porter's Five Forces, is a challenge for executives in predetermining industry entry of thresholds and costs of the target organisation. Combined with a SWOT analysis (Strengths, Weaknesses, Opportunities, Threats), it can strengthen results and offset weakness as Borghese and Borgese (2002:28-29) claim.

Porter's Five Forces and a SWOT analysis are fundamental criteria in analysing the industry of a target organisation during the strategic planning stage involving a merger or acquisition. Industrial predetermination is critical at an early stage of strategising an objective, because the thresholds and industrial position in various countries are different. To avoid losses, the acquiring company needs to identify the circumstances and the cost of entering the proposed industry in that country. This formulated strategy analysis will significantly impact each subsequent step in the acquisition process. With respect to the results, a list of potential target organisations for a merger or acquisition needs to be approved by the board for further scrutiny.

2.7.2 Locate Investigation – Strategic Rationale Approval

Once the location of the investing industry has been approved in terms of the first screening, the next step is to identify potential target organisations by using a detailed strategic plan.

This stage requires a vast amount of information concerning the target organisations, which are considered for a merger or acquisition, namely the company's annual financial reports; analyst reports; investment banker networks; internet logistics, internal expertise, etc. (Borghese & Borgese, 2002:48). Borghese and Borgese (2002:48), suggest that these factors need to be investigated by preliminary screening in order to address the acquiring company's strategic objectives. Ranking the screened target organisations is the means of determining the most compatible organisations considered for a strategic alliance. Investigations need to be undertaken with the purpose to strategise the merger or acquisition, as this serves as the basic requirement for acquirers to achieve merger and acquisition synergies successfully. Every wrong choice or decision can potentially lead to an exercise in futility.

The following step is to determine the criteria pertaining to the negotiations and the needed financial and non-financial resources. The approval of the pre-selected target organisation candidates are made by the executive team to continue with the next step of due diligence (Borghese & Borgese, 2002:48-49). To obtain more detailed information for analysis purposes, initial contact with the target organisations are made, and followed by the issuing of a letter of intent and letter pertaining to confidentiality.

2.7.3 Due Diligence □ Executive Approval

To determine whether the top selected target organisations are worth acquiring, an elaborate in-depth analysis of each are needed. There are many issues that can impact on cost and the result of such an enquiry. Borghese and Borgese (2002:52), note that to uncover and analyse all the issues related to the business activities of a target organisation, due diligence is paramount. Gathering sufficient and accurate financial, legal, operational and market information to value the top-ranked potential target organisations are the focus of due diligence (Borghese & Borgese, 2002:51-62). Aspects calling for valuation during a typical due diligence exercise are asset valuations, historical earning valuations, future earning valuations, growth rate valuations, and capital structure valuations.

A due diligence analysis is a critical step in assessing the value of the target organisation and the potential viability of a possible merger or acquisition. This must be managed cautiously in order to achieve a successful investment (Borghese & Borgese, 2002:51). As a result of the due diligence, the following objectives need to be addressed: Obtaining information for further negotiation, identifying synergies and possible costs, developing a basis for post-merger or acquisition integration plan, and setting negotiation parameters (assessing, planning, and forecasting value).

When due diligence is applied, the acquiring company should have a clear view regarding the strengths, weaknesses, opportunities and threats (SWOT) of the target organisations from a strategic alliance and synergy analysis perspective. Therefore, as the result of a due diligence, a documented draft for possible merger or acquisition negotiations can be provided for executive approval. Due to the critical importance of a due diligence exercise in preparation of a merger or acquisition, this aspect calls for closer scrutiny and is elaborated upon below.

2.7.4 Approach and Negotiation Board of Directors' Approval

A positive result resulting from a due diligence of the target organisation leads to the next stage of the negotiation process. During the progress of negotiation, a strong team with varied experience and from diverse backgrounds need to be assembled for the deal, namely attorneys, merger and acquisition experts, financial experts in taxation, treasury, accounting, environment and risk management experts, etc. At this stage, the acquiring company still needs to undergo a final due diligence assessment to determine the ultimate price offering.

A definitive agreement can only be made after several negotiations to the satisfaction of both parties. The most significant milestone is when the two transacting firms sign the agreement, close the deal and enter into the integration stage (Hoang & Lapumnuaypon, 2008:6). Before closing the deal, some important activities still need to be performed of which an internal communication plan with the local community and investors; antitrust and/or government filings; interim management of operations; pre-closing due diligence; and transfer of funds serve as examples.

2.7.5 External Approvals

Countries around the world have different regulations pertaining to foreign businesses to purchase domestic firms; however cross-border mergers and acquisitions may face additional scrutiny and requirements to gain approval from regulatory bodies (Boeh & Beamish, 2007:403), which may differ from country to country. Clarifying issues such as jurisdiction from each country, filing and disclosure requirements, as well as the process timelines, are some of the difficulties that make the process of cross-border mergers and acquisitions onerous (Boeh & Beamish, 2007:403). The final agreement, signed by the board of directors of both acquiring and acquired companies, indicates the accomplishment of the deal. In addition, in cross-border mergers and acquisitions, external approval from the host country's government is indicative of this accomplishment.

2.7.6 Execution □□ Integration

Having attained external approval does not constitute that synergies across board have been achieved between the contracting parties. Once all the approvals are obtained, the next important approach is to execute the deal. To integrate two businesses into one, both the acquiring and target organisation needs to develop a plan for each functional area involved, which includes sales, marketing, finance, information technology, human resources, business culture, and operations. Regarding both acquiring and acquired companies' structures and management capacity, the agreed procedures and execution synergies must ensure that agreement can be reached on the integration plan (Hoang & Lapumnuaypon, 2008:49-50).

The purpose of evaluating synergies of post-mergers and acquisitions are to determine the final outcome of the integration. However, in mergers and acquisitions, successful instances are significantly fewer than failures. The process of the activities contain many uncertainties and risks, among which due diligence is the most significant step contributing to ultimate success. As a result, conducting a due diligence adequately and accurately is essential. The following section deals with the content, the process and some important aspects of due diligence.

2.8 Due Diligence

Proper due diligence is critical for mergers and acquisitions. Lack of an appropriate due diligence is the most common cause of failure in mergers and acquisitions. It is essential to devote special attention to the process and methods of performing a due diligence (Hitt *et al.*, 2001:17).

All merger and acquisition activities encounter the same issues involving cost, redundancies, organisational structure, reporting processes and channels (Gadiesh, Ormiston & Rovit, 2003:36). Issues, which need to be addressed during a typical due diligence of the target organisation include according to Simmons (1988b:15) and Borghese and Borgese (2002:51-54), the following:

- Size of firm: Fee earners and non-fee earners as well as the age and brief details of professional experience and equipment.
- Structure: Level of concentration in current market segments.
- Industry position: Growth status, product or services substitutes, industry profitability.
- Types of work undertaken.
- Client base.
- General indication of turnover and profitability.
- Brief detail of firm's premises and equipment.

- Reason for the desire to merge.
- Any other unique attributes that can complement the merger or acquisition.

A thorough understanding and comprehensive evaluation of potential target organisations can reduce the risks of the acquiring company. Therefore, an experienced and professional team needs to be appointed from the outset (Simmons, 1988b:15). It may include industry competent professionals, key disciplines, internal and external auditors, lawyers, accountants, and human resource specialists with adequate experienced senior staff (Simmons, 1988b:15).

2.8.1 The Content of a Due Diligence

A due diligence requires important and confidential information to amicably evaluate the target organisation, such as the extent of assets, liabilities, contingencies, prospective purchaser opportunities, legal issues, etc. (Baker & McKenzie 2005:32). The aspects typically included in a due diligence are elaborated upon below (Hitt *et al.*, 2001:18; Borghese & Borgese, 2002:54-105; Boeh & Beamish, 2007:105):

➢**Financial due diligence:** Includes annual and quarterly financial information for at least the past three years, which would include the balance of equity and debt; transfer of shares; financial statements; account analysis, sales, accounts receivable, returns and allowances; good will; liabilities; inventory etc.. Financial events and projections, including very detailed schedules, breakdowns, and explanation of procedures and policies, are essential. Tax issues, including tax structure and contributions need to be clarified. Furthermore, a ratio analysis of financial performance over time mapping to industry benchmarks is fundamental to the due diligence. The results need to be compared with the company ratio analysis and the industrial average. The financial due diligence should analyse the ratios of profitability, liquidity, leverage and market value for the target organisation and its industry, and determine the extent of generated revenues and growth of earnings internally. Earnings and cash flow determine the value of the target organisation and should be considered with care.

➢**Operational (non-financial) due diligence**: Borghese and Borgese (2002:6-66), point to the fact that operational due diligence often fail to return adequate information for decision making. Operational due diligence includes:

- ➢Detailed internal information of products and services in the market and competitive information and plans pertaining to market share.
- ➢Lists of customers and sales data of the various distribution channels pertaining to customer, product, and geography.

➢Research and development strategy, major organisational activities, key personal and performance data.

➢Information on structure and background of administration, management and key personnel, especially that which is considered to be critical to the value of the organisation.

➢Technology with detailed technological descriptions, patents, tests, software codes, testing results, and data.

➢Senior management, employee relations and existing compensation arrangements.

➢Insurance and culture related issues and other material matters which may have an influence on the value of the company.

➢**Legal due diligence**: The objective in reviewing all legal actions from the past to present, is to identify all undisclosed liabilities of the target organisation. This is because threats may affect the results of the ultimate value of the target organisation if the transaction agreement is entered into. Legal, technical, and other specialists should be involved during the process, owing to the comprehensive and technical nature of the due diligence. Key issues include corporate and shareholder documentation; antitrust laws; labour/employment safety and liability issues; litigation; intellectual property issues; tax liabilities; insurance; environment issues; asset title transfers; and other relevant legal issues. Notwithstanding, the acquiring company still requires representation and warranties from the counter-partner for the inspection of such legal documentation.

The above requirements for due diligence pertain to confidential information, in an effort to obtain more enhanced information from the target organisation. Conducting a proper due diligence is a complex process and maps to all managerial areas of a target organisation, however differ in nature from case to case (Hitt *et al.*, 2001:18). In addition, the background of the majority shareholders of the target organisation and its parent company history, including financial history, also needs to be evaluated, as these elements could contain some material evidence.

2.8.2 The Process of Due Diligence

Due diligence of mergers and acquisitions is generally performed by accountants, investment bankers, lawyers, and other specialised management consultants (Hitt *et al.*, 2001:19; Boeh & Beamish, 2007:104). More often than not, specialists are employed to assist with the analysis and processing of data (Hitt *et al.*, 2001:19). The general process of due diligence as a rule would involve the following elements:

➢ Initial contact.

- Non-disclosure agreement.
- Initial business due diligence valuation.
- Letter of intent.
- Executing the deal.
  - Continuing business due diligence.
  - Legal due diligence.
  - Negotiation of transaction agreement.
- Signing / Announcement.

Because of the significant cost and large investment involved, mergers and acquisitions require focussed attention in respect of what information is exchanged and/or conveyed. To initiate such activities require sufficient and precise information of the target organisation to support a detailed analysis. The quality of the required information and the transparency of the target organisation are intrinsic to a practical and trustworthy valuation.

2.9 Valuation

The most critical step of a due diligence is determining the value of the target organisation. There are many techniques, which can be deployed to facilitate a financial valuation of a merger or acquisition. Suitable techniques will depend on the industry, type of company, stage of company growth, structure of deal proposed, strategic plan, and private or public status (Boeh & Beamish, 2007:101).

Boeh and Beamish (2007:101-104); and Borghese and Borgese (2002:78-82) illustrate some common valuation techniques listed below:

➢**Contribution analysis:** This method is used to measure the relative contribution (e.g. 40% and 60%) of each party to the merger or acquisition. The measurements often include revenue, cash flow, earnings, profits, and assets and liabilities. Preferable the contracting parties should be equal in size, deal with similar trading partners, with transparency of their financial projections (Boeh & Beamish, 2007:101-102).

➢**Comparable analysis:** This method has been adopted especially for an acquirer who plans to reposition or refocus the target organisation into a new industry or a different business model where value may differ. By comparing itself to competitors in the same industry, a more appropriate valuation can be executed, although there is a possibility of the market misinterpreting the value of a firm (Boeh & Beamish, 2007:102). Common comparative metrics include measurements of market capitalisation; enterprise value,

multiple revenue streams, cash flow, price-to-earnings; growth rate ratios for the last 12 months including the next two or three years' forecast (Boeh & Beamish, 2007:102). Therefore, it is critical to find a peer group of firms that are direct competitors in the same or closely related industries of comparable size and growth stages, with basic information of capital structures, growth rates, and financial year ends to serve as target organisations (Boeh & Beamish, 2007:102). Fail to choose appropriate competitors and gather adequate information, will impair the meaning of the method applied.

➢**Precedent acquisition:** This approach compares the acquisition premiums paid, based on other recent acquisition transactions in the market. The efficient comparison includes deals in a similar industry, of the same size, same business model, same stage of growth, and same capital structure, and is considered one of the best techniques to use. These are often the best to use (Boeh & Beamish, 2007:102). Owing to the difficulty to match the diverse criteria, this method is rather used to review a spectrum of deals and analyse how the deals are valued (multiplies of revenues, cash flows, and profits; and premiums paid). Such deals may vary in size of the target organisation, industry, and deal type, in order to get several perspectives of the most appropriate valuation to use (Boeh & Beamish, 2007:102). This method can help the company develop strategic insight into their competitors, revealing patterns of deals and consolidations, which are of strategic importance to the envisaged merger or acquisition (Boeh & Beamish, 2007:102).

➢**Discounted cash flow:** This is the most common technique used for evaluation, which is based on the theory of discounted cash flow generated from future earnings. The critical aspects of this technique are period, the cost of the investment (which includes cash, debt and equity), and the cash generated. The significance of this technique is to ensure the amount of investment is not more than the present value of the future cash flows (Sahaf, 2009:441). In conducting this technique, attention needs to be paid to the proportion of the terminal value and how it is affected by the analysis to discount rates and value. Luypaert and Huyghebaert (2007:Online), note that combining two cash flow streams for valuation is less risky than the sum of the separated cash flow streams, as it can avoid duplicated calculation of highly correlated items. However Weinberg *et al.* (1971:305), argue that the value of discounted cash flow technique for valuing non-controlling shares, overlooks the issue that "...any system of valuing stock market shares must involve a mixture of convention and approximation, and the use of a precise mathematical tool in an imprecise environment may result in more confusion than clarification".

➢**Leveraged-buyout model:** The basic structure of this analysis is to determine if the target organisation can produce sufficient cash flow to support the required debt payments and

equity returns to the acquirer. The deal usually has high debt requirements with a ratio of 90% debt to 10% equity (Boeh & Beamish, 2007:103). This method is used for the purchase of another company by using a significant amount of borrowed money (bond or loans), to meet the cost of the acquisition. Often the assets of the target organisation are regarded as collateral for the acquirer to obtain loans. The purpose of a leveraged buy-out model is to allow companies to make large acquisitions without having sufficient capital. However, this method has had a notorious history of failures, especially in the 1980s, as the large interest payment on the loans impact adversely on future cash flows.

➢ **Non-financial valuation:** Non-financial business analyses can offset the pitfalls of financial valuation techniques. Aspects could include the number of customers, new products, website visitors, subscribers, headcount, and a comparison of operating ratios such as inventory and turnover, from which the analyses can generate critical information for the evaluation of mergers and acquisition strategic decisions (Boeh & Beamish, 2007:104).

Weinberg *et al.* (1971:302-304), list the following factors that may affect the movement of the share price from a market perspective in terms of mergers and acquisitions:

- The price-earning ratios of other companies in that industry reflecting the expectation of the prospects of that industry.
- The appraisal of the prospects of that particular company in relation to other companies in the same industry. (In this case, it's about the quality and continuity of its management, products and research, its planning and capital resources).
- The gearing of the company's capital structure (the gearing of ordinary share capital is high enough to produce attractive results from future growth in earnings, without being too high in relation to the risk factor).
- The company's size. A larger company will generally have a greater ability of riding out problems while a smaller company may have more speculator growth within a phase of significant growth. A company with significant degree of diversification of its business, will therefore tend to have a higher price-earning ratio.
- The policy of the directors with regard to the proportion of earnings distributed.
- The net asset value attributable to each share.

Considering the above factors, determining the price of purchasing shares, security of capital and income, long-term income growth, speculation in capital growth and size, and attitudes to price, are important concerns (Weinberg, *et al.*, 1971:299). The authors further state that external factors such as the future prospects for the economy, the pressure of industrial pay

claims and strikes, or the current balance of payment situation, also play important roles in determining the general price levels for shares (Weinberg *et al.*, 1971:299).

A thorough and valuable result from a due diligence exercise contributes to positive and correct decision making. In identifying potential merger and acquisition partners and financial projections for firms can be impacted upon by many factors and are often suspect (Boeh & Beamish, 2007:104). For instance, the numbers provided by outside analysts may be based only on public information, therefore, may not fully reflect the real intrinsic value of the shares. Similarly, a comparable analysis may not include private firms due to the lack of information availability (Boeh & Beamish, 2007:104).

Obtaining quality information for support becomes the determinant of successful mergers and acquisitions. There are many examples that indicate mergers and acquisitions fail because of inadequate due diligence. Some errors or mistakes made during the execution of the due diligence may only be identified later during the integration process, such as extra liabilities, contingencies, legal matters, or under-valued assets etc. However, the challenges of mergers and acquisitions are not only in the process of due diligence, but also the integration thereof.

2.10 Integration

After the completion of a merger or acquisition, the next most difficult and important step is to integrate the acquired organisation into a new organisational dispensation. Integration failure is a major risk of mergers and acquisitions. Cross-border integration involves additional challenges such as different business cultures, accounting standards, human resource management, intellectual property management, core assets protection, resource sharing, language and communication. Integration may also take months or even years to reach completion. Detailed objectives for integration must be determined and planned with clear responsibilities and measurable achievements before the transaction closes (Borghese & Borgese, 2002:106). Acting quickly and responsively prior to the integration on aspects pertaining to achieve integration will ensure a successful synergy achievement in the combined entity. The longer the integration takes, the more costs will be involved. Pandey (2009:689), contends that if the intention of mergers and acquisitions is total integration of manufacturing, marketing, finance, and personnel, integration can become quite complex.

Pandey (2009:689) and Borghese and Borgese (2002:106-117), highlight some common guidelines in respect of merger and acquisition integration, as follows.

- **Integration plan**: Based on the acquiring and the acquired company's strengths and weaknesses, the acquiring company needs to prepare a detailed strategic plan with clear objectives and a clear formulated process of integration.
- **Employee communication:** Management needs to communicate the transaction and required staff involvement during the transitional term to the employees. This will assist with the integration in order to obviate any ambiguity or fears in the minds of staff.
- **Authority and responsibility**: Clarifying authority and the responsibility of employees are essential to avoid any confusion and indecisiveness in a structured entity.
- **Culture integration**: People management is one of the most critical steps in the integration process. Management must have a proper understanding of two cultures to integrate the employees of the merged organisations. Clear communication and training can help to bridge culture gaps.
- **Skill and competencies upgrading**: Differences in skills and competencies of company employees, requires management to prepare a plan for skill and competency upgrading through training.
- **Structural adjustment**: In the restructure design of combining and redefining roles, authority, and responsibilities of employees, management should be prepared to make adjustments to accommodate the aspirations of the acquired company's employees.
- **Control system**: Management should ensure that all resources and activities of the acquired organisation are under control, specifically in the financial sector, so that resources are optimally utilised and wastage obviated.

Lind and Stevens (2004:10), clarify that leadership in mergers and acquisitions can make a difference: Leaders need to develop the minds and skill sets of these responsible for the merger or acquisition integration to successfully identify the strategy and style that is appropriate to each merger type and to understand that the deal integration process is a unique and complex undertaking. The authors further summarise the common denominators of successful leadership during due diligence and integration, as follows (Lind & Stevens, 2004:13-14):

- Giving due thought regarding the move to merge, or acquire precipitously.
- Willingness to look honestly at the organisation's current and likely future status, extending to assessing the future of its executives.
- Honest and clear communication should be effected about everything including issues such as required competencies and job selection criteria.
- Thorough planning for integration should take place, which normally are executed via integration teams.
- Seeking the best processes and systems.

The differences in management concepts, business contexts and cultural background between acquiring and acquired organisations naturally create disagreement, conflicts or controversy in the combined entity. To achieve a successful integration, a clear mission and strategy of synergies is the key for both organisations.

Above all, synergies of mergers and acquisition can create value for shareholders. To reach the expected return on investment, it is valuable for executives to learn from previous examples of integration error.

2.11 Factors Determining the Success and Failure of Mergers and Acquisitions

The following aspects could be deterministic of the success or failure pf a merger or acquisition.

2.11.1 Factors Impacting on Merger and Acquisition Success

Referring to a report by Mckinsey, Correia *et al.* (2005: Ch.17-6), aver that companies who acquire much smaller companies in related businesses attain the biggest success. The authors also noted a survey done by Anslinger and Copeland of leveraged buy-out companies, and found that these activities were equally very successful (Correia *et al.*, 2005: Ch.17-6).

Successful mergers and acquisitions take place in two stages, namely the front-end successful stage, and the integration successful stage (DiGeorgio, 2002, and 2003, cited by Hoang & Lapumnuaypon, 2008:29). The front-end success is the stage starting from strategically selecting the right target organisation until completion of the transaction agreement, which includes the formulation of a strategic vision, due diligence, deal structure and pre-merger planning (Hoang & Lapumnuaypon, 2008:29). This stage contains many elements, which have a direct bearing on success, such as characteristics of leadership, the facilitating climate within the stakeholder team, adequate time and resources, tools employed to facilitate the merger and acquisition analysis, possessing mechanisms, and understanding culture and organisational structure differences (Hoang & Lapumnuaypon, 2008:29).

The successful outcome of the second stage is the achievement of objectives, which involves strong leadership for structuring the integration after a merger or acquisition (Hoang & Lapumnuaypon, 2008:29). To sustain a competitive advantage within the context of successful mergers and acquisitions, the following factors identified by Schraeder and Self (2003:511-518), calls for specific attention:

From a strategic perspective:

- Measurable goals and objectives set by boards when strategising a deal.
- A capable leadership team from top-level executive management, dedicating time and focus to the process of the deal.
- Determination of the required or desired degree of integration.
- A highly respected and capable integration leader.

From a management performance perspective:

Businesses should:

- Focus on the core business.
- Conduct a due diligence in the financial and human capital-related areas.
- Speed up decisions as apposed to focusing on precision.
- Clearly define the approach to integration.
- Manage progress effectively.
- Launch an efficient progress tracking system.
- Have capability of achieving financial and operational goals.
- Minimise negative reaction and maximize opportunities.

In mergers and acquisitions, the conditions of each case are unique making the above listed principles for success difficult in practice. Fundamentally, companies with strong leadership, and who are committed to the shareholder interests, are more likely to succeed.

2.11.2 Factors Impacting on Merger and Acquisition Failure

Gadiesh *et al.* (2001:188) cited by Hoang and Lapumnuaypon (2008:28), report that '50 - 70% of acquisitions actually destroy shareholder value as apposed to achieving cost and/or revenue benefits'. This rate of unsuccessful mergers and acquisitions culminating in a downturn in cost and/or benefits could reach up to 80% of deals (Kusstatscher & Cooper, 2005:3). Many mergers then fall apart as they fail to integrate (Hoang & Lapumnuaypon, 2008:28). Schraeder and Self (2003:511), support the opinion that failure is the greatest obstacle during the integration process of a merger or acquisition, culminating in the obvious analogy that such pitfalls should be avoided at all cost.

According to Simmons (1988b:15), Cartwright and Cooper (1996:24), Hoang and Lapumnuaypon, (2008:28) and Correia *et al.* (2005:Ch.17-6), excluding financial and economic failure, the most common mistakes of mergers and acquisitions pertain to:

From a strategic perspective:

- Improper management and unclear strategic vision created by the board of directors.

- Merger and acquisition as part of an outdated strategic plan.
- Risk management strategy inefficiently implemented.

From a management performance perspective:

- Over-optimistic appraisal of market potential.
- Over-estimation of synergies.
- Poor understanding of target organisation's business.
- Organisational conflicts. The organisational culture of the acquired organisation may be totally alien to the core values of the acquirer.
- Too much energy is being devoted to 'doing the deal', as opposed to post-acquisition planning and integration.
- Insufficient due diligence and assessment of target organisation.
- Slow or lack of post-merger integration. The first 100 days are critical as they 'set the tone' not only for initial integration, but also for the future of the new business.
- A loss in the value of brands.
- No experience in the integration of the two entities.

From a financial perspective:

- Excessive financial leverage.
- Poor decisions of over-inflated purchase price being paid.
- Higher transaction costs than expected.

From a communications perspective

- A lack in executive leadership and strategic communication.
- Delays in communication.
- The skills transfer by which the merger/acquisition integration process is managed.

From an employment perspective

- De-motivation of employees of the acquired organisation.
- Departure of key people from the acquired organisation.

According to Hoang and Lapumnuaypon (2008:28), rushing to find a quick 'fix' through mergers and acquisitions, has caused the failure of many such deals. From the above analysis, the analogy can be drawn that management capacity and performance are critical to mergers and acquisitions. These failures may be caused by the failure of managing associated risks, as they are inherent in mergers and acquisitions. Risk management needs to be implemented over the spectrum of the entire process to mitigate the risks.

2.12 Conclusion

This chapter focused on the principles of mergers and acquisitions, including the definition of mergers and acquisitions, the categories of mergers and acquisitions, and their history.

Organisations, who pursue mergers and acquisitions as a rule have a plethora of valid business reasons, which drives the initiation including business expansion needs, globalisation pressures or other management reasons.

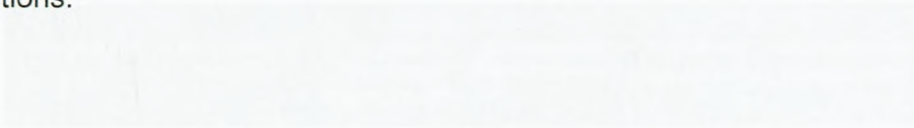
In this chapter some important issues were raised regarding the process of mergers and acquisitions, which need to be addressed by acquiring companies. Whether the strategy of a deal can generate synergy to value creation for shareholders of both acquiring and acquired companies, is fundamental to accommodating such activities. When a merger or acquisition is planned, due diligence and evaluation of the target organisation are two important steps that must be highlighted in the management decision process. Furthermore, integration of the two entities is yet another important consideration to ensure success. In many instances, businesses can successfully close a deal with the appropriate target organisation, conduct sufficient due diligence and negotiate reasonable purchase price, but fail to integrate with the target organisation. This results in a loss of synergy and further fails to create value for shareholders.

In addition, this chapter introduced the factors that lead to successful or unsuccessful mergers and acquisitions, which points to the fact that risk management is a critical element in conducting cross-border mergers and acquisitions, and thus needs to be embedded into the entire process.

Synopsis: Chapter Three

Investment diversity indicates that risk management of cross-border mergers and acquisitions face expanded risks than that of traditional investment portfolios, which calls for a greater degree of awareness of risk when embarking on such investment. It is a strategic approach to manage risks associated with cross-border mergers and acquisitions, which calls for a comprehensive knowledge and thorough understanding of the investing country and target organisation. Executives need to have extraordinary discernment and foresight to execute risk management and complexities associated with cross-border mergers and acquisitions.

Business enterprises are called upon to deal with a wide range of risks when conducting cross-border mergers and acquisitions, in order to determine the extent of risks associated with cross-border mergers and acquisitions. The diversity and variety of the host country's laws, regulations, policies, and culture indicate that cross-border mergers and acquisitions face risks also at a country level. The purchase and integration process by implication creates risks at a business and management level for the acquiring organisation. The conceptual framework for risk management dealt with in this chapter addresses the major concerns in integration, such as the diversity of the investing region, the value of the target organisation, and the management capability of the target organisation. Each level of risk has clear tangent planes of risk with other levels. Therefore, identifying associated risks is fundamental when risk management is applied to the entire process of cross-border mergers and acquisitions.



CHAPTER THREE: RISKS ASSOCIATED WITH MERGERS AND ACQUISITIONS

3.1 Introduction

In the current global business environment, the concept of rapid change is a distinct characteristic thereof, as a response to activities are indicative of an organisation's competitiveness. Successful cross-border mergers and acquisitions can strengthen businesses' capacity to compete globally and to create value to shareholders. This chapter introduces a structured risk management framework of risks associated with cross-border mergers and acquisitions at three levels, namely risks at country, business, and management level. From a holistic perspective, the categories of risks that pertain to cross-border mergers and acquisitions are graphically depicted in Figure 3.1.

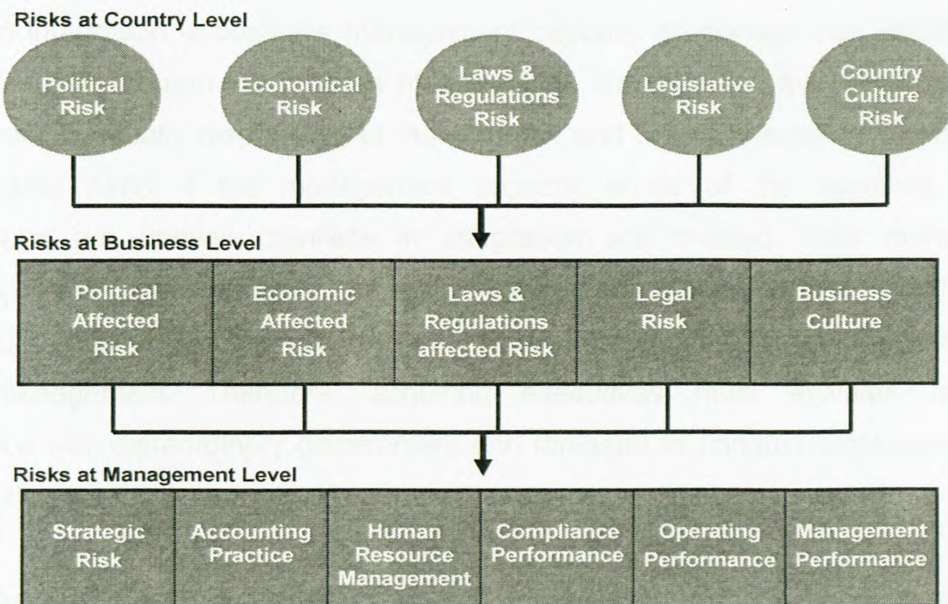


Figure 3.1: Conceptual Model of Risks Associated with Cross-border Mergers and Acquisitions

Within these three levels, risks at country level generally occur in all businesses, and can significantly affect the return on investment because a host country's business environment is the primary environment for foreign business to operate within. At this level, factors such as government's role and political orientation in business, stability and policy of economy, legislation, and culture, can significantly affect the results outcome of an investment. The management practice of cross-border mergers and acquisitions is subject to different laws, policies, regulations and cultures in different countries. Thus to perform mergers and acquisitions in such diverse environments, appropriate and effective risk management is essential. A well-structured risk management framework can benefit management to execute cross-border mergers and acquisitions efficiently and effectively.

However, country risks can also affect the way that businesses conduct their daily activities. A country's policies, regulations and laws for business (as a rule) are promulgated to direct business operations in the way that a government dictates. It is the nature of business to pursue maximum benefits by utilising available operating conditions. Therefore, risks presented at a business level react to the risks at country level. More specific, risks at a business level are the consequences of risks at a country level. Foreign businesses with a limited knowledge of a host country's business environment and a poor understanding of the target organisation's business will be adversely impacted upon in terms of risk.

Risks at business level are the explicit result of managements' capability. This is due to management being the operator, conductor and decision maker of business, and responsible for all business activities in planning, organising, leading and controlling business resources, including resources at country level. The determinative factor for successful post merger and acquisition integration is business management capacity to manage risk effectively, which can be identified through the process of evaluation. Reciprocally, the target organisations' management is equally responsible to manage risk and to return superior business results. On the other hand, if the management capacity levels of the acquiring and target organisations are uneven, conflicts in integration are created. Risk management in conducting cross-border mergers and acquisitions needs comprehensive knowledge and a thorough understanding of the host country and the country of the target organisation, as well as its management. Therefore, acquiring executives must evaluate management competence with extraordinary discernment and foresight to conduct cross-border mergers and acquisitions.

In this chapter, definitions of risk and risk management of cross-border mergers and acquisitions are introduced to provide an improved understanding of managing risks at the identified three levels of risks as depicted in Figure 3.1. Merging or acquiring business across borders is a complex procedure, which is applied to entire business activities. Therefore, this three-level classification covers all risk areas within the realm of business activities from an external and internal business perspective, thus providing a holistic approach to identifying risks associated with cross-border mergers and acquisitions.

3.2 Risk Definition

The meaning of risk varies in different contexts. In business Tchankova (2002:290), defines risk as an uncertain event or condition, which can have a positive or negative effect. It is an inherent part of business and public life, which covers all aspects of business activities, including management (Tchankova, 2002:290).

From a business development perspective Carey and Turnbull (2001:11), are of the opinion that a company with an aversion to risk is unlikely to get a high rate of return and may even result in a loss. Effective evaluation and control of risks will ensure that opportunities are not lost, competitive advantage is enhanced, and less time is spent on management (Carey & Turnbull, 2001:10). In integrating with a completely unknown company with a vast investment involved, cross-border mergers and acquisitions face significant uncertainties and risk.

3.3 Risk Management of Cross-Border Mergers and Acquisitions

Risk management is aimed at assisting corporations in achieving management performance, protecting assets, preventing loss and generating profits. Risk management can provide decision makers with a systematic approach to coping with risks and uncertainties (Williams, Bertsch, Dale, Van der Wiele, Van Iwaarden, Smith & Visser, 2006:67). In many companies, risk management has been widely used in accessing new business environments because of the uncertainty of unknown business environments (Williams *et al.*, 2006:68).

Williams *et al.* (2006:68) define risk management as,"... a process affected by an entities board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives".

As a popular investment mechanism, cross-border mergers and acquisitions are attractive for business expansion purposes. However, the huge amounts invested in mergers and acquisitions means that failure can significantly harm shareholder interests of the acquiring companies. This calls for discretion in risk management in creating value for shareholders, rather than hastening completion of the deal. In cross-border mergers and acquisitions, the diversity of the host country's laws, regulations, cultures, policies, etc. towards foreign investment should be of particular concern to the acquiring company.

From strategising a merger or acquisition to synergy achievement, its conclusion may take many years before the deal can be finally concluded. Based on the progress of the activities, risks associated with cross-border mergers and acquisitions takes place in two stages, namely a **target approach** and an **integration approach**, which are also the two main reasons of why mergers and acquisitions fail.

Businesses face different challenges in selecting and integrating with a target organisation which leads to diverse focuses in the management of risk. There are four risk management strategies, which could apply to cross-border mergers and acquisitions, namely

- Risk management strategy.
- Risk identification.
- Risk evaluation.
- Risk control.

Managing risks associated with cross-border mergers and acquisitions is a process of managing a series of complex activities in one project for an uncertain period of time, with at least two or more different corporations with diverse organisational backgrounds involved. It is essential to establish a risk management framework, as cross-border merger or acquisition deal is embarked upon which call for the integration of the process over the spectrum of business strategies.

3.3.1 Risk Management Strategy

The strategy of managing risks associated with cross-border mergers and acquisitions is a systematic process of identifying and managing potential threats and potential damages in the processes of targeting and integrating organisations. The aim of risk management is to protect the value of the shareholders. Only a holistic risk identification approach can lead executives to a higher level of conducting cross-border mergers and acquisitions.

Risk contains circumstances such as unforeseen events, uncertainties, threats and potential damages. A quick and effective response to risks can affect the consequences of a particular risk (Frigo & Anderson, 2011:22). Therefore, reliability of information is essential in determining the nature of the risk, and the decision making associated with risk management (Frigo & Anderson, 2011:22). Companies who have risk management systems and who are more flexibly structured in their business operations will be able to minimise potential loss effectively (Frigo & Anderson, 2011:22). Schaper and Volery (2004:36), support the opinion that businesses that wish to succeed in the long term need a stronger risk strategy.

Within an organisation, an established risk framework will contribute to the identification of risk areas in the process of mergers and acquisitions. Appointing key personnel with a clear mandate to identify risks will ensure that the framework remains operational. As a result, the integrity and functionality of a structured risk management system is essential to a cross-border merger or acquisition risk management strategy.

3.3.2 Risk Identification

Risk identification in the context of cross-border mergers and acquisitions is essential to determine what could harm or threaten shareholder interests and determining whether the cost of taking on the risk is greater than the profit being generated. As a result, identifying risks is the basic foundation of a risk management system in cross-border mergers and acquisitions (Carey & Turnbull, 2001:11). Furthermore, identifying the causes of risks and analysing possible results can minimise the potential damage and losses (Williams *et al.*, 2006:70). Williams, Smith and Young (1998) cited by Tchankova (2002:292), believe that identifying risk is a continual process, and businesses should continuously seek to identify new risks, which is a major characteristic of risk management.

The identification of potential threats and/or damages is subject to stringent ongoing risk analysis and evaluation, which ultimately contribute to the effective control of risks. Based on risk identification, the decision of determining what risks can be avoided and/or mitigated and how, can then be made.

3.3.3 Risk Evaluation

Having been identified, risks must be prioritised to ascertain the level thereof. This can be done by initially evaluating the risks associated with events or situations (Dunn, Cherrington & Hollander, 2005:435). The risk analysis should be based on the likelihood and consequence thereof. In this respect, Williams *et al.* (2006:69), explain: "Likelihood depends on the probability of occurrence and the frequency of activity. The consequence can be measured in many ways, such as effects on results or on the enablers of results".

There are many factors that potentially affect the results of cross-border mergers and acquisitions, such as the host country's polices, economy, laws, tax, foreign exchange, accounting standards, culture, the value of the candidate target organisations, the target organisations' business performance etc. The evaluation of identified risks needs to be subsequently addressed. Carey and Turnbull (2001:11), state that the evaluation of the identified risks is another foundation stone of effective process control in risk management. As risk evaluation is not the focus of this study, the detailed methods of evaluation of cross-border mergers and acquisitions will not be addressed in this thesis.

3.3.4 Risk Control

Businesses who strategise to embark upon cross-border mergers and acquisitions are faced with numerous risks. The intention of risk taking is to create profit over and above the

involved costs. Once the risks have been evaluated, a risk profile can be drawn. Based on the evaluation, a decision can be made as to either accept or eliminate the risk (Frigo & Anderson, 2011:61).

It is recognised that different types of businesses require different types of risk management. In this regard Carey and Turnbull (2001:13), suggest four main controls that can be used to handle risks, namely:

- **Avoidance**: Not undertaking the activity giving rise to 'risk reduction'.
- **Reduction**: Reduce the probability of a risk event occurring, and/or the impact of that event.
- **Transfer**: Transfer of risk in whole or part to another party.
- **Retention**: Accept the risk and therefore the consequences should it eventuate.

Avoiding risks and exploiting opportunities are critical to survival and prosperity of a business (Ottesen & Grønhaug, 2006:100). Risk management in cross-border mergers and acquisitions means that the acquiring company goes into a deal that is unable to create value for shareholders. Transferring risk is a constructive approach. Insurance is a form of risk transfer, and is a normal part of conducting business.

To implement a risk management process, there are two interactions that must be undertaken consistently throughout the entire process. One interaction is communicating and consulting on resources and information that are related to risks, and taking the necessary steps to marginalise risk possibilities. The other interaction is monitoring and reviewing, which relates to all business activities so that they can be monitored and reviewed with regard to the feedback provided from each step. Carey and Turnbull (2001:13), believe that continuously monitoring risk is a critical part of a sound management process, in that decision makers should regularly receive and review feedback to manage risks effectively.

Risk management is a strategic process, and managing this process includes management style and organisational goals (Conrow, 2000 as cited by Archbold, 2005:31). In addition, risk management ensures that the acquiring company achieves its strategic aims, and avoids pitfalls and unexpected issues along the way.

Cross-border mergers and acquisitions involve a plethora of uncertainties, as increased complexity and pressure requires extra effort in risk management (Gatigon & Anderson, 1988 as cited by Reuer, Shenkar & Ragozzino, 2004:20). The following section identifies generally perceived risks that are associated with cross-border mergers and acquisitions. In essence, these structured risks need to be managed properly and effectively.

3.4 Identifying Risks Associated with Cross-Border Mergers and Acquisitions

Cross-border mergers and acquisitions by implication carry various levels of risk in the process. Therefore, risk management performance approaches directly affect the consequences of cross-border mergers and acquisitions (Hoang & Lapumnuaypon, 2008:64-65).

It is a challenging process for a company to choose, and combine a new partner with complex issues such as effective management, communication, coordination, acquiring costs and services (Cobb, 1988b:5). The approach of selecting the correct company to merge with or acquire, is the core mission for businesses entering into foreign markets. Without a well structured risk management strategy that will legitimise a merger effort, it is highly probable that one of the following adverse consequences will result (Cobb, 1988b:4):

- Increased investment of time and money.
- Venture capital with no 'golden handshake'.
- Seeds of spin-off.
- Number and complexity of decisions increase exponentially with the acquisition of each new partner.

In order to avoid failure, risks associated with mergers and acquisitions can be classified into three levels of risk, namely country, business, and management level risk. Each level highlights a different level of scope of risk control. Country level risk indicates the investment region and market conditions; business level risk suggests the value of the potential partner; and the management level risk evaluates the management capability of integration and cooperation. Pre-mergers and acquisitions focus on risks at the country and business levels. Post-mergers and acquisitions suggest a focus on integration at business and management levels. According to the acquiring company's investment orientation, risk management capability and risk tolerant capacity, a comprehensive result of risk evaluation at the identified three levels can influence the decision on whether the target organisation is worth merging with or acquiring.

3.5 Risks at Country Level

The territory of an independent nation forms a country with a distinctive population, culture, language, education, and economy. A country as a rule can be defined as a politically organised body of people under a single government that provides public services and policing power. A business environment is shaped by the policies of that country. Environmental changes in business may adversely affect business profits or the value of

assets invested nationally. For example, financial factors such as currency control, devaluation or regulatory changes; stability factors such as riots and civil war all contribute risks to business. Country risks generally refer to risks that affect all companies operating within a particular country.

The stability of a country's macroeconomic policies, an ordered relaxed market and a rigid legal structure stimulate the development of a country's free market, and are enticements to foreign investors to invest across its borders (Shapiro, 2003:215). From a foreign investment perspective, investing in a developed country is correspondingly less risky than in a developing country. However, in the current economic dispensation, developing countries, especially emerging countries, have a higher economic growth rate, and can provide more opportunities to investors. Analysing and assessing risks associated with an investing country and its business environment becomes critical elements for investors to consider.

Identification, evaluation and control of risks at country level are important steps for companies to invest across their borders. Identifying risks associated with cross-border mergers and acquisitions at country level includes political, economic, policy, legislative, and cultural risks. Under these factors, investment conditions are formed by a series of activities of the host country's government. Understanding of the host country's government domination of foreign investment is important to decision making on cross-border mergers and acquisitions.

3.5.1 Role of Government

Adam Smith, a pioneer of political economics, suggested that market systems can adjust economic activities. Smith lists four main functions for government, namely national defence, maintaining law and order and internal security, judicature, and money supply (Dwivedi, 2008:633). In the current economic dispensation, government's role in addressing the increasing diversity of economic forms is controversial. In Dwivedi (2008:632-633)'s view, there is a demand for government control and the regulation of economies, owing to the shortcomings of a free market mechanism (Dwivedi, 2008:630-633), which include:

- Optimal distribution of goods and job opportunities.
- Perfect competition does not exist.
- Individuals are not necessarily the best judge.
- Profit is the sole motivating force.
- Public utilities get low priority.
- Growth of monopolies.
- Externalities.

As a result, the free market mechanism has failed to achieve optimal distribution of goods and services, optimal allocation of resources, maximum efficiency and maximum social welfare (Dwivedi, 2008:632). It has instead caused the growth of monopolies, unequal income distribution, unemployment and poverty (Dwivedi, 2008:633). As a controlling mechanism, government's intervention is necessary to protect domestic industries from foreign competition, foreign exchange reserves, state security, unfair trade remedies, consumer rights, and employment (Venter, Erwee & De Lange, 2007:30-31).

Mankiw (1998:10), states that there are two broad reasons for a government to intervene in the economy, namely to promote markets in order to allocate resources efficiently, and to promote a more equitable distribution of economic outcomes. With these two aims, governments wish to improve market outcomes via public policies, for example, taxation and welfare. The degree and extent to which a government should intervene in the economy, has been the subject of much discussion between politicians and economists.

The degree and extent of a government's intervention in the business sector differs according to each country's economic system, which means that a government plays different roles depending on the economic system of that country. Dwivedi (2008:633), states that the issue of an appropriate economic role for a government is an ideological issue and a matter of collective social choice. The nature and extent of government interference is determined by the political ideology of the society (Dwivedi, 2008:636). This implies that societies endow the government with the scope of interference of that economy. Dwivedi (2008:633-636), broadly categorises three economic systems in the world for performing the role of government, namely a capitalist economy, a socialist economy and a mixed economy. These three economic systems call for closer scrutiny.

Capitalist economy: To restore and develop conditions; to remove all necessary restrictions on the operation of a free, competitive market; to provide a background through necessary government interventions and controls in which free competition can work effectively, the motivational force is private profit (Dwivedi, 2008:634).

Socialist economy: State ownership of producers plays a major role in the economy, rather than private ownership. All economic activities are centrally planned, controlled and regulated by the state; all decisions regarding production, allocation of resources, employment, pricing, etc., are centralised in the hands of the government. The motivational force is social welfare (Dwivedi, 2008:635).

Mixed economy: Represents a combination of features of both a capitalistic economic system and a socialist economic system, where private ownership coexists with state ownership. The public sector is created by reserving certain industries, trades, services and activities for government ownership, management and operation. The government's role is wider than in a capitalistic economic system, but narrower than in socialist economic system. The motivational force is the sole responsibility of the state (Dwivedi, 2008: 635).

All economic systems coexist with both private and state sectors. Lynch (2003:147), states that governments have the power to stimulate national economies, impose taxes and enforce many initiatives that can affect businesses' ability to develop a corporate strategy. To analyse a host country's value for strategising cross-border mergers and acquisitions, Lynch (2003:147), suggests three points for consideration:

- **Environment:** Background characteristics of a country.
- **System(s):** The country's system of government.
- **Policies:** Government policies.

By using political mechanisms, governments can influence and attract foreign investment. The latter is recognised as an economic mechanism to benefit the invested country by stimulating economic development, increasing employment, and improving advanced technology. However, the profitability of a foreign company is affected profoundly by the host country government's regulation of foreign investment. Therefore, the trend of increased international trade calls for cooperation between governments in promoting global business. A functional government with efficient service performance can add value to attracting cross-border mergers and acquisitions to that country.

3.5.2 Political Risk

Political risk of cross-border mergers and acquisitions refers to risks associated with the political environment in a proposed investing country. It is an unanticipated likelihood that a foreign investment will be constrained by the host country governmental policies for political purposes (Luthans & Doh, 2009:314). Political risks comprise of two forms, namely macro political risks, which may affect all businesses in a country, and micro political risks, which only affect specific businesses or specific industries in a country. These often take the form of industry regulation, taxes on specific types of business activities, restrictive laws and so on (Griffin & Pustay, 2007:71-78; Luthans, & Doh, 2009:317).

A systematic analysis of political risks of cross-border investment determines the value of the business environment, where risks can be divided into three categories (Czinkota, Ronkainen & Moffett, 2005:112; Griffin & Pustay, 2007:71; Luthans & Doh, 2009:322):

- Ownership risk, in which the property of a firm is threatened through confiscation or expropriation.
- Operating risk, in which the ongoing operations of a firm and/or the safety of its employees are threatened through changes in laws, environmental standards, tax codes, terrorism, or armed insurrection.
- Transfer risks, in which the government interferes with a firm's ability to shift funds in and out of the country.

Political risks are related to government actions, which increase the operating cost, and devalue the country's currency. In addition, nongovernmental actions can cause security issues in that country (Griffin & Pustay, 2007:71). Czinkota *et al.* (2005:113), list the various political risks in Figure 3.2 below.

	Loss May Be the Results of	
Contingencies Include	The actions of legitimate government authorities	Events caused by factors outside the control of government
The involuntary loss of control over specific assets without adequate compensation	• Total or partial expropriation • Forced divestiture • Confiscation • Cancellation or unfair calling of performance bonds	• War • Revolution • Terrorism • Strikes • Extortion
A reduction in the value of a stream of the benefits expected from the foreign-controlled affiliate	• Nonapplicability of 'national treatment' • Restriction in access to financial, labour, or material market • Controls on prices, outputs, or restrictions • Currency and remittance restrictions • Value-added and export performance requirements	• Nationalistic buyers or suppliers • Threats and disruption to operations by hostile groups • Externally induced financial constraints • Externally imposed limits on imports or exports

Figure 3.2: Exposure to Political Risk **(Source:** Czinkota *et al.*, 2005:113**)**

A country and its various institutions and agencies can pose a direct threat to cross-border businesses as a result of policy changes. By evaluating political risks, foreign businesses should adjust their strategies and practices to accommodate new perspectives and actual requirements (Luthans & Doh, 2009:314). Political risks occur especially in emerging economies, which continue to struggle with political and institutional instability (Luthans & Doh, 2009:314). Examples of risk activities include freezing the movement of assets out of the country; placing limits on the transfer of dividend, profits or capital; devaluing the

currency; appropriating assets, and refusing to abide by the contractual terms of agreements previously signed with the foreign business (Luthans & Doh, 2009:314).

Businesses who contemplate gaining access to a foreign market need to acquire knowledge of that country's political structures and political stability in order to control related risks (Griffin & Pustay, 2007:71). In constantly assessing the degree of change of investment conditions, empowerment and interference from an investing country's government to foreign investors, is critical not only for survival, but for normal business operations (Shapiro, 2003:198-2002).

3.5.3 Economic Risk

A significant change in a host country's economic structure or growth rate indicates a major change in the expected return of a cross-border investment. In such a situation, potential risks shift to actual risks. Losses may come from fundamental economy policy goals, such as fiscal, monetary, and wealth distribution; or a significant change in a country's comparative advantage, such as resource depletion, industry decline, and demographic shift (Meldrum, 1999:Online). As a result, economic risk often overlaps with political, fiscal and policy and regulatory risk.

Cross-border mergers and acquisitions require predetermination and evaluation of the investing country's economic environment and structures. The following aspects point to a country's economic risks (Shapiro, 2003:214).

- A large government deficit relative to GDP.
- A high rate of money expansion, especially if it is combined with a relating fixed exchange rate.
- Substantial government expenditure yielding low rates of return.
- Price controls, interest rate ceilings, trade restrictions, rigid labour laws, and other government-imposed barriers to the smooth adjustment of the economy to changing relative prices.
- High tax rates that destroy incentives to work, save, and invest.
- A citizenry that demands, and a political system that accepts, government responsibility for maintaining and expanding the nation's standard of living through public-sector spending and regulations (the less stable the political system, the more important this factor will likely to be).
- Pervasive corruption that acts as a tax on legitimate business activity holds back development, discourages foreign investment, breeds distrust of capitalism, and weakens the basic fabric of society.

- The absence of basic institutions of government, while implies a well-functioning legal system, reliable regulation of financial markets and institutions, and an honest civil service.

A host country's economic stability and employment conditions are essential considerations for foreign investment strategies. A free trade for foreign investment is advocated by government to boost the economy, and its epiphenomena such as job creation, taxation contribution and GDP increase are acknowledged. On the other hand, the potential negative effects of foreign investment to a country's state security, emerging industries, unfair competition and protection are of consequences (Mankiw, 1998:189). These are obstacles that impede the access to and progress of cross-border mergers and acquisitions. Needle (2004:2), supports the notion that the role of the state, politics, the labour market, trade unions, social and cultural factors, as well as technology, are in the domain of economic risks.

3.5.4 Policy and Regulation Risk

A government's role in the economic system determines its scope of control on policy orientation and development strategies of that country, as fiscal, monetary and industrial policies serves as the major policy instruments used by a government (Dwivedi, 2008:677). Cross-border mergers and acquisitions must obey the laws of both the home country and host country in which they operate (Griffin & Pustay, 2007:58). Policy orientation, the rule of law, the role of lawyers, the burden of proof, the right to judicial review, and the laws pertaining to foreign investment are complex, and differ from country to country (Griffin & Pustay, 2007:58).

Dwivedi (2008:636-637) and Venter *et al.* (2007:25-29), summarise the scope of regulatory policies of a country that can significantly impact on an organisation's gain on profits from a foreign market, as the following:

- Foreign exchange policy.
- Import and export policy.
- Industrial and licensing policies.
- Industrial safety and environment policy.
- Prohibitive and restricted goods policy.
- Standard of products quality.
- Control and regulation of monopolies.
- Pricing policy.
- Taxation policy.
- Monetary and credit policy.

- Income and wage policy.
- Policy regarding technology and employment.
- Labour policy.

The fact that regulatory policies differ from country to country creates additional risks for cross-border mergers and acquisitions. For instance, acquiring state-owned business differs from private business; acquiring business in the retail industry differs from that in the communications industry. Similarly, traditional industries differ from emerging industries. Therefore, cross-border mergers and acquisitions need to have a clear understanding of policies, which they have to apply in a host country, and further to estimate the investment profitability based on these policies.

Table 3.1 depicts a summary of the areas that are most relevant to the development of a corporate strategy, and which draw business attention to the investing country.

Table 3.1: Government and Industrial Policy (**Source:** Lynch, 2003:149)

Laissez faire: Free-market approach	Dirigiste: Centrally directed approach
Low entry barriers	High entry barriers
Competition encouraged	National companies' support against industrial competition
Little or no support for industry	
Self-interest leads to wealth creation	State ownership of some key industries
Belief in laws of supply and demand	Profit motive benefits the few at the expense of the many
High unemployment levels	Failure in market mechanism will particularly affect the poor, which can only be corrected by state intervention.
Profit motive will provide basis production and high quality	Need to correct monopolies control by private companies.

Thobani (1999:50-53), warns that cross-border investors often request guarantees from an investing country's government. However, when political change or regulatory climate change occurs in that country, risks are more likely to occur. For a cross-border investment, factors such as expropriation, and currency inconvertibility and non-transferability, are strictly controlled by a host country's government. Regulation changes are at times in favour of politicians' agendas, and many adversely affect investment, especially in countries with a history of weak implementation of policies and regulations (Thobani, 1999:50-53).

Various regulatory bodies have jurisdiction over cross-border mergers and acquisitions. From a local business protection perspective, government policy intends to dictate thresholds for cross-border mergers and acquisitions. For example, a country restricts the investing

business's size and market access, and sets high requirements on national security scrutiny. The UK Economist White Paper (2008:1-2), contends that regulation is a complex issue for businesses investing in other countries, "...which bears a significant cost in its efforts to comply with the rules promulgated by governments and regulatory bodies". Therefore, regulations and their applications of cross-border mergers and acquisitions in the investing country must be clearly understood.

3.5.5 Legislative Risk

It is a government's responsibility to control and regulate the conflicts between business and society, and certain undesirable economic activities and behaviours of business. Through a system of regulating business, government enacts economic legislation to minimise loss to society (Dwivedi, 2008:678). The changes in laws and regulations have the purpose of balancing the interests of business and society, and enhancing the control of power. Business must fulfil a duty, an obligation, and a promise of compliance.

A well-structured legal system of a host country serves as a form of business protection. The legislation of monopolies, foreign exchange control, intellectual property protection, and environment protection create problems that may threaten cross-border mergers and acquisitions.

Monopolies Legislation: A 'monopoly', from an economic perspective, is identified as having sole possession or control of an economic advantage by one or more companies in a particular sector of trade or business by substantially manipulating prices of products or services (Dwivedi, 2008:323). The forms of monopoly include absolute control of major resources or products in a particular industry, superior technology or patent of a product or process of a production, which holds a major proportion in the market, or a granted government permission to be the sole producer in a given area (Dwivedi, 2008:324). A monopoly is often regarded as harmful to the public sector, as it can obstruct and suppress the channels of free competition via rigid determination of price, product quality and services that are offered to the public, for the purpose of obtaining additional profits in the long term. A monopoly as a rule limits the promoting of society's economic welfare (Dwivedi, 2008:678).

The criteria that apply to a monopolistic society differ from country to country. The same apply to the practices of the Department of Trade and Industry and the Monopoly Commission. One important feature of monopolistic legislation is that there is no onus on the parties of a proposed merger or acquisition to prove that the merger or acquisition will be in the public's interest, nor does the fact that the merger or acquisition has been referred to the

Monopolies Commission create an assumption that it is against the public interest (Weinberg *et al.*, 1971:221).

As a consequence, the monopolistic behaviour of a business excludes other operators, disturbs orderly and free competition, and limits technology and economic development. From a government perspective, to control the monopolistic behaviour of a business is challenging. From a business perspective, significant costs are involved in complying with the demands of a monopoly.

Foreign Exchange Control: Economic activities are globally unified to an unprecedented degree in that changes in one country's economy can be rapidly transmitted to its partners (Shapiro, 2003:37). Such fluctuations in economic activities are reflected almost immediately in currency values, which impact cross-border business production and marketing operations, and receive greater attention via monetary devaluation or revaluation (Shapiro, 2003:37). Dwivedi (2008:688), states that foreign exchange is a complex issue in that the basic objective of foreign exchange regulation is to control and regulate the business activities of international companies, the flow of foreign capital, technology and managerial enterprises, and foreign collaboration. Government generally encourages foreign direct investment via policy, as it brings capital into the country, and can develop local industries and technology (Weinberg *et al.*, 1971:223).

Shapiro (2003:49), believes that the function of a currency is 'a store of value' and 'a store of liquidity'. Based on this theory, three economic factors that influence the value of a currency's foreign exchange are:

- **Usefulness,** which is regarded as a store of value, determined by its expected rate of inflation, and is dependent on that country's future monetary policy.
- **The demand of liquidity**, which is determined by the magnitude of transactions in that country.
- **The demand of assets**, which is regulated in a country, and is determined by the risk-return pattern on investment.

The last two factors depend on expected economic growth, and political and economic stability. More specific, uncertainties regarding a country's future economic and political course lead to risky assets, which will depress and volatilise the value of the currency (Shapiro, 2003:49).

A foreign exchange rate is an important dimension to capital markets. Within the complexity of a multicurrency economic environment, foreign monetary variables are linked to various

domestic currencies (Solnik & McLeavey, 2004:32), whereby financial flow is attracted by a high expected return from the investing country's current and financial account. By nature, cross-border mergers and acquisitions are averse to the fluctuation of foreign exchange rates. Solnik and McLeavey (2004:38-40), and Shapiro (2003:40-49) summarise the following factors that affect the stability of foreign exchange rates:

- **Inflation rate**: A country's high inflation rate will depreciate the country's currency, harm the return on the currency of foreign investment, and increase the cost of imported assets or goods.
- **Changes in real interest rates**: Many domestic and foreign monetary variables interact with interest rates; for instance the decrease in a country's real interest rate will lead to a depreciation of its currency.
- **Economic performance**: When the demand for a country's imports and exports are unbalanced, the lesser demand in exports will put downward pressure on the current account, which results in a depreciation of that country's currency.
- **Investment climate change**: Investment expects an environment which includes a stable political system; a rigorous but fair legal system, protecting the rights of investors; a tax system that is fair to foreign investors; free movements of capital; and monetary authorities that favour price stability. An improvement of these elements will increase a country's financial inflow and currency appreciation, and vice versa.

Currency movements is one of the risks that multinational companies face. Most of the above mentioned factors are affected by a government's polices such as monetary and fiscal policies. If a country adopts a more expansionary monetary policy, in the short term it will boost the country's economy, but in the long term it will harm the economy. In fact, it drops the country's real interest rate, accelerates inflation, and further results in the depreciation of the domestic currency relative to other currencies (Solnik & McLeavey, 2004:41). From the host country's viewpoint, a restrictive monetary policy will lead to an appreciation of the home currency (Solnik & McLeavey, 2004:41).

Intellectual Property Protection Risk: Intellectual property rights protection serves to legally protect a business's patents, copyrights, trademarks and designs registration. It is a major risk for many companies, especially in the research and design sector. Poor enforcement of intellectual property protection by a government leads to the risk of businesses losing their core competitive edge to foreign companies (Czinkota *et al.*, 2005:117). There are considerable risks, notably in Asian markets, such as China, Indonesia, Malaysia, Singapore, Taiwan, Thailand, and the Philippines, which have serious issues in respect of copyright piracy and intellectual property infringements. Although such behaviour

can benefit a country's local businesses in the short-term, it will reduce the incentive of local companies inventing, innovation and progress in the long run (Czinkota *et al.*, 2005:117). The slow pace of intellectual property protection legislation often fails to keep pace with the needs of a country's rapidly transforming economy in today's era of rapid technology development (Czinkota *et al.*, 2005:117).

Environmental Risk: Environment protection is a vital issue and as a result, companies are forced to avoid generating environmental hazards (Bateman & Snell, 2002:163). Environmental risk has captured business's attention globally with a management challenge of a mix of technical, ethical, social, and competitive issues. Industrial pollution risks include air pollution, smog, global warming, ozone depletion, acid rain, toxic waste sites, nuclear hazards, obsolete weapon arsenals, industrial accidents, and hazardous products (Bateman & Snell, 2002:164). A government can take further steps to improve the protection of the environment by tightening environment and industry laws and regulations (Thobani, 1999:50-53). Environmental issues can have an adverse impact on business operations and finances. Cross-border mergers and acquisitions need to consider environmental risk issues inclusively with risk management, as effective environmental management requires attention to efficiency, effectiveness, and long-term goals.

Many studies have been done to determine the differences between laws of home and host countries. It is more risky to international businesses if there is evidence of political corruption or if law enforcement is not implemented fairly. A sound legal system is a precondition for free trade in a host country, which favours an equitable business environment. Concerns invariable include whether there are strict laws on environment protection, whether the rigid implementation of law enforcement is in place, and whether local companies comply with laws and regulations. Above all, rigid law enforcement is a guarantee to attract foreign investment.

Legislative risk could significantly alter business prospects. Complying with an investing country's laws and legislation is challenging. However, it is even more of a challenge to identify the target organisation's legal performance, as it may create future conflict between the two companies and result in losses. Furthermore, the action and execution of a country's juridical administration can also affect the results of legislative compliance.

3.5.6 Cultural Risk

Culture represents all human activities that are 'socially', as opposed to 'genetically', transmitted (Needle, 2004:145). It is the collective programming of mind that distinguishes

the members of one group, or category of people, from others (Hofstede, 1994. cited by Needle, 2004:144). Culture is formed by the history of that nation and by their current living environment. It comprises population density, economic history, family/tribal structure, religion, topography, climate, laws, and news and information media (Bannon, Guy, Al-Omari, Pooley, Reed & White, 2003:24). Culture also presents values, norms, knowledge, beliefs, moral principles, laws and attitudes about business (Bannon *et al.*, 2003:24).

The way businesses operate is deeply entrenched by culture. For cross-border mergers and acquisitions, the investing country's culture challenges the way that business operates in that country in order to engage in terms of the local rules. The differences in culture calls for an in-depth discussion on cross-border cultures, as culture conflicts between acquiring and acquired companies can fail the synergy achievement of a merger or acquisition in negotiation and integration (Appelbaum, Lefrancois, Tonna & Shapiro, 2007b:192). According to Trompenaars and Woolliams (2003:104), cultural differences and the lack of trust contribute to 70 percent of cross-border merger and acquisition failures.

Based on attitudes and behaviours towards business, Bannon *et al.* (2003:76-78), list some dimensions to resolve paradoxes:

- **High power – distance:** Hierarchy of management rank is strictly classified.

  Low power – distance: Superiors and subordinates are colleagues.
- **Uncertainty – avoidance:** Clarity and order are needed; people work hard in stable careers and abhor deviance.

  Do not avoid uncertainty: People take a pragmatic view of rules and regulations, and are more mobile from job to job.
- **Universalism:** Defines good and bad characteristics for all circumstances.

  Particularism: Gives greater attention to the obligations of relationships and unique situations.
- **Individualism:** Leaves people free to contribute to the collective as and if they wish.

  Collectivism: Places the emphasis on shared benefits and judges individuals by what they contribute.
- **Neutral culture:** Spawns business relationships, which are instrumental and focuses on objects.

  Emotional business: Dealings involving anger, while joy and passion are acceptable.
- **Specific behaviour:** Places contractual before personal concerns.

  Diffuse behaviours: Overlaps the two sets of issues, and takes time to weave them together.
- **Achievement-oriented attitudes:** Judge people on what they have recently accomplished.

Ascription-orientation: Awards status according to birth, kinship, gender, age, connection, school, etc.

Another cultural element in business is communication cooperation. Communication transmits thoughts, messages, and information, and represents the fundamental principle of a successful merger or acquisition (Cobb, 1988b:5; Appelbaum *et al.*, 2007a:130). There are various communication concerns to a cross-culture transaction, for example information exchange and language understanding. Negotiation styles are emphasised as risky areas of cross culture, as it is always a challenge (Solomon & Schell, 2009:139-142). To achieve synergy by sharing the partnership and profits of the deal, mergers and acquisitions need proper communication (Cobb, 1988b:5; Appelbaum *et al.*, 2007a:130).

Country risks are considered as investment conditions of a host country. The transaction of cross-border mergers and acquisitions need to be secured in a business environment where protection is in place from a government perspective. However, risks appearing on this level will be transferred to risks at business level. Businesses are dominated by government, and they have an obligation to comply with administration, laws and regulations. Risks at businesses level is a reflection of risks at country level.

3.6 Risks at Business Level

Cross-border mergers and acquisitions also face risks within the target organisation at business level, such as risks of business strategy, accounting, foreign exchange, and taxation. Each company has different norms, perceptions, behaviours and adherence to legal compliance. Therefore, cross-border mergers and acquisitions need to identify and value risks at business level for assessing the value of the target organisation and dealing with future integration. As a result, the way business conducts daily activities is formed by that country's business environment. The way government dominates business leads to the styles of business management.

3.6.1 Strategic Risk

Determining a partner's business strategy is of importance in assessing the value of that business, which includes strategies in marketing, products or/and services, development, finance, investment, and profits. It is not unusual to find conflicts between the management of acquiring and acquired companies on issues of expansion, planning, organisation, operation and control. Luthans and Doh (2009:256), list four common approaches in formulating and implementing partner strategies:

- Focusing on the economic imperative.
- Addressing the political imperative.
- Emphasising the quality imperative.
- Implementing an administrative coordination strategy.

This list enumerates the key factors when measuring a partner's business strategy. To measure a business's strategic performance and capability, the strategic achievements from the past are essential. However, business strategies must be engaged with the operating capacity of a business from a short and long-term perspective. For cross-border mergers and acquisitions, measuring business strategic performance is an important parameter in determining the value of the target organisation.

3.6.2 Accounting Risk

Accounting standards measure the quality of the disclosure of accounting information, which differs from country to country and creates risk in financial results. Different accounting methods can also lead to a very large swing in reported earnings and in comparing the value of the shares of two companies (Weinberg *et al.*, 1971:303).

Gandy and Merritt (2006:Online), list the following in terms of financial reports that are deemed required for mergers and acquisitions:

- Consider execution risk.
- Request pro forma relating to cash flow reporting.
- Exercise care when using earning-based measures such as EBITDA (Earning Before Interest, Taxation, Depreciation and Amortisation).
- Analyse upfront charges for propriety.
- Request enhanced disclosure of acquirer's balance sheet on both a fair value and historical cost basis.
- Evaluate the quality of earnings and ability to convert it into cash.

In addition to the above-mentioned factors, analysis of a target organisation's accounting policies such as credit, foreign exchange, working capital, and financing, can determine its level of risk taking. If these policies need to be changed during integration, they may create conflict for customers, suppliers, and the target organisation's cash flow. From an accounting perspective, the selection of methods allowed in accounting could return widely differentiated earnings figures in respect of the same company (Weinberg *et al.*, 1971:303). These accounting methods include:

- Valuation of stock-in-trade and work-in-progress.
- Depreciation of fixed assets.
- Amortisation of goodwill.
- Allocation to particular years of profits from long-term contracts.
- Treatment of leasehold properties.
- Treatment of extraordinary or non-recurring items of revenue or expenditure (e.g. profit or loss on sale of capital items or on devaluation or revaluation of currencies).
- Valuation of investments.
- Writing-off of discounts on debentures issued by the company.

Companies can use these accounting allowances to achieve maximum price of earnings ratios or values. As a consequence, the results need to be adjusted by means of the acquirer's evaluation (Weinberg *et al.*, 1971:303). Detailed information of significant accounts and transactions is required in financial statements. Disclosure is of particular importance, as some hidden issues can harm the interests of the shareholders. In this situation, significant activities are deliberately neglected. In other situations, disclosure of insignificant activities is used to divert attention from the real transaction. In addition, complicating the transaction is a popular way to escape discovery. Since these hidden issues are normally secret, they are difficult to determine without sufficient information and evidence. However, ignorance may lead to financial disaster for an acquiring company.

During an evaluation for a future merger or acquisition, caution must be exercised when the following phenomena occur in a company's accounts (Jones, 2007:94):

- "Accounts might be a year or more out of date. For many schemes the long-term investment strategy creates huge funding volatility.
- Directors setting company accounts are not trying to ascertain fair value for a future transaction and might have bowed to other interests and pressures when setting the assumptions for pensions accounting.
- The mortality assumption is not disclosed, and the difference between mortality tables can have a very significant impact on the pension liabilities calculated.
- Other key assumptions are not shown in the accounts. For example, cash commutation allowance at retirement, expenses, early retirements and early leaver assumptions are not usually disclosed and might hide additional costs".

The purchase price in mergers and acquisitions refer to assets, and the excess over the net assets is attributed to goodwill. Accounting rules require identifiable assets and liabilities of an acquired company to be recorded at their fair market value (Gandy & Merritt, 2006:Online). According to the research of Rossi and Volpin (2003:3), the number of merger

and acquisition activities in countries with better accounting standards and stronger shareholder protection, is significantly larger. The authors state that, "...a more active market for mergers and acquisitions is the outcome of a corporate governance regime with stronger investor protection". Rossi and Volpin (2003:8), further state that accounting standards have the function of measuring corporate governance when evaluating the value of a target organisation, because corporate account transparencies can reduce the scope for expropriation.

3.6.3 Currency Risk

Currency risk, also referred to as 'foreign exchange rate risk', arises because of the value of a host country's currency fluctuations, which can cause direct loss to a business's cash flow, assets, liabilities, and net profits. Currency fluctuation is one of the risks that cross-border mergers and acquisitions face, in which the market is highly specialised and complex. A qualified experienced specialist in currency management is essential to manage currency risk. Schamotta (2009:Online), states that in mitigating currency risks, developed countries do better than developing countries. This is because foreign exchange rate hedges have been widely used for currency risk management in developed countries, but not in developing countries owing to the lack of a financial infrastructure. In fact, businesses conduct more trade with developing countries. Currency risk management specialists should be involved in supporting business leaders to focus on business core activities and comply with business strategies.

Managing foreign exchange risk is a challenging objective for international companies, as the exchange rate fluctuates according to the transactions in the exchange market. The commonly used methods for managing exchange rate risk include (Correia *et al.*, 2003:Ch.19:6-22):

- **Forward foreign exchange**: 'Lock' an exchange rate now for a specific time in the future, which enables one to plan for and budget business expenses with more certainty.
- **Flexible forward:** Provide protection against adverse exchange rate movements while giving business the opportunity to benefit from favourable exchange rate movements.
- **Currency options**: A currency option provides the buyer with the right (but not the obligation) to buy, or sell an amount at a specified exchange rate on a specified date.

Currency risk management will help to protect a business from the negative impact of currency fluctuations, while still benefiting from any favourable exchange rate movement.

From a valuation viewpoint Koller *et al.* (2010:621), point to the fact that the following exchange-rate issues in cross-border valuations need special attention:

- Forecasting cash flows in foreign currency and domestic currency.
- Estimating the cost of capital in foreign currency.
- Incorporating foreign currency risk in valuations.
- Using translated foreign currency financial statements.

Risk management of exchange rates is important for the acquiring company to avoid loss from transferring currency out of or into the investing country. This will demand knowledge of the foreign exchange rate policy of the investing country, management's capability of forecasting future exchange rates, and management's perceptions of and actions on risk management. The considerations relating to foreign exchange policy include the exchange rate of transferring invested capital into a host country, restrictions on transferring investment returns and dividends or individual received incomes out of a host country.

3.6.4 Taxation Risk

Taxation is a cost, but it can also be valuable to benefit cross-border mergers and acquisitions from deducting previous financial year losses of target organisations (Koller *et al.*, 2010:551). The acquiring company needs to pre-determine the detailed taxation policy of the host country, as it is not deductible in all countries. Weinberg *et al.* (1971:299), point out that it is important to realise that companies fall into many different classifications pertaining to their tax status, income tax, value added tax, surtax and capital gains tax, at a particular rate. Baker and McKenzie (2005:25), list the following applicable taxes:

- **Jurisdiction tax:** Related to enterprise Income Tax.
- **Transaction taxes:** Include: Stamp Tax/Stamp Duties, Value Added Tax, Customs Duties, Land Appreciation Tax, Business Tax and Deed Tax.
- **Specific tax considerations:** Differ for three types of investments, namely equity acquisitions (include direct acquisition and indirect acquisition), asset acquisitions, and mergers.

According to Weinberg *et al.* (1971:493), five risks regarding taxation associated with cross-border mergers and acquisitions are highlighted:

- Capital gains (gain from the book value and the value when transferred) of the transferred assets and related tax: Creates shareholder conflict between the two companies as the value rises.
- Transfer and turnover taxes: Whether to reduce the amount of such taxes differs from country to country.
- Treatment of past losses: Whether it is allowed to be carry forward.
- Treatment of reserves and provisions: Whether transferred without taxation.

- Shareholders receiving exchange shares: Whether capital gain is chargeable.

Businesses are accountable to comply with the taxation policies of the trading country. A form of merger or acquisition would have disastrous fiscal consequences, because it would involve an immediate liability for income tax, transfer and turnover taxes (Weinberg *et al.*, 1971:494). To avoid such losses, the following risk elements of a target organisation need to be identified: Categories of liable taxation, taxation clearance status, the history of tax performance, tax liabilities, content of deferred tax, ongoing tax disputes, government certificate, tax compliance, potential tax legislation, and period of taxation exemption if such exists.

3.6.5 Human Resource Management Risk

From a competitive viewpoint, human resources are regarded as intellectual capital to create value for companies, however are often attributed to the failure of post-merger and acquisition, as change and stress have a serious impact on organisations and their employees (Lin, Hung & Li, 2006:127; Appelbaum *et al.*, 2007b:192-195). Luthans and Doh (2009:62), claim that working conditions, expected consecutive work hours, and labour regulations are common challenges in employment practice to cross-border mergers and acquisitions.

Lin *et al.* (2006:138), conclude their survey, contending that the success of mergers and acquisitions depends on the local firm's human resource management capability. Balle (2008:58-59), points out two risky reactions from employees when a company is merged or acquired. One is exiting, detracting from value in the form of intellectual capital and customer relations which creates the cost of filling the position. The second is staying, but with diminished value in performance. The direct consequences of these two reactions are: diminishing the bottom-line and undermining the business goals; customers receiving poor service; and a negative influence on business reputation such as lack of control or incompetent management (Balle, 2008:59).

Schraeder and Self (2003:516), believe that human resource managers can shape the attitudes of the members of an organisation, by seeking, valuing and responding to input from individual employees, and suggest that to reduce the risks involved in human resources, communication is the key.

3.6.6 Legal Risk

A company has to comply with various laws. Generally a company is exposed to the following types of legal risks:

- **Product liability risk**: The product liability limitation clause clearly and categorically limits the liability of the manufacturer and fixes the liability on the sub-contractors. Manufacturing companies typically are exposed to this risk.
- **Employee liability risk**: This relates to the deduction and payment of employee welfare statutory dues such as a provident fund, employee's state insurance contribution, bonus, gratuity, and wages. Furthermore, the obligation to provide equal opportunity to all is of vital importance.
- **Compliance risk**: This is one major area where most companies fail. A company is required to comply with the provisions of various laws, for example, the Companies Act, Income Tax Act, labour legislation and industry-specific special legislation. Non-compliance with a provision entails penalties and exposes the company to legal action at the hands of regulatory authorities.
- **Tax compliance risk**: Tax is a government due, and timely payment of tax is obligatory for companies. Non-payment of taxes or short payment thereof results in severe penalties.
- **Environmental risk**: Causing danger to a fragile environment is an environmental offence. Environmental risk has captured global attention in the form of 'global warming' and every business entity is required to restrict carbon emissions.
- **Intellectual property compliance risk**: This risk is more serious in less regulated countries. A target organisation's breaching of intellectual property legislation in order to obtaining benefits from the rights of other companies, poses a great risk to the acquiring company. Furthermore, the acquiring company's intellectual property rights will also be encroached upon by either the target organisation or other companies in that country.

Legal risk can create significant cost to the acquiring company, and severely disturb normal business activities. It is even more risky when the acquiring company does not have knowledge of the investing country's laws and regulations in order to identify risk activities and protect the interests of shareholders when the above risks are incurred.

3.6.7 Information Technology Risk

IBM (2008:2), describes the importance of information technology for mergers and acquisitions as follows: "...Every merger and acquisition doubles the Information Technology infrastructure that must be managed and maintained to support the new organisation. The total data management responsibility is enormous, without the effective enterprise data management strategy and early IT environment to plan for integration challenges, the merger

or acquisition may be doomed to failure".

Stoneburner, Goguen and Feringa (2002:5) and Dunn *et al.* (2005:432-462), list the following risk factors for information technology:

- The functionality for management.
- Business processes.
- System design.
- Developed program.
- Security requirements.
- Data reliability and transition.
- System performance.
- System compatibility.
- User ability.
- Hardware and software control ability.

The integration of information technology generally facilitates the process of mergers and acquisitions after the two parties have signed the agreement. To avoid unexpected losses or failure of integration, the viability of information technology needs to be considered earlier, owing to the uncertainty of the time and significant investment involved (IBM 2008:5). Additionally, if the two companies are using different programming languages, copying the data from one system to another will be challenging and costly. Therefore, identifying the status of information systems of both companies and evaluating the potential cost of data transfer can mitigate unexpected cost.

3.6.8 Business Culture Risk

Business culture is an aspect of an organisational internal environment that dictates how a business operates. Owners and top managers bring values and norms into their organisation, which shape the culture of that business with their shared views of value and norms, actions and decisions in particular circumstances (Jones & George, 2009:66). Differences among business cultures imply that what one business believes in might be disavowed by another. Needle (2004:145), suggests three levels of general cultural content that interact with business:

- "At its most visible level, it represents those artefacts, goods and institutions that most readily distinguish one culture from another, such as architecture, food, ceremonies, language, and the different emphasis placed by different cultures on aspects of the educational system.

- At a deeper level, it comprises notions of 'right' and 'wrong', norms, 'good' and 'bad', values, things held to be true and beliefs. Many problems associated with the relationships between people of different cultures stem from variations in norms, values and beliefs.
- At it deepest level, culture comprises a set of basic assumptions that operate automatically to enable groups of people to deal with things of daily life without thinking about them. In this way, that is different from another group of people".

Cross-border mergers and acquisitions integrate two different organisations, together with their existing cultures, into an overall product. Recognition of the target organisations' business culture is a prerequisite for mergers and acquisitions, as cultural conflicts between two different organisations will result in misunderstanding, miscommunication and misconduct (Appelbaum *et al.*, 2007b:192). Communication is derived from culture and transmits thoughts, messages, or information, and represents the fundamental principle of a successful merger or acquisition (Cobb, 1988b:5; Appelbaum *et al.*, 2007a:130). Communication concerning a cross-culture transaction depends on a variety of factors, of which information exchange, language understanding, and negotiation styles are the most considered challenges.

3.7 Risks at Management Level

In cross-border mergers and acquisitions, successful value creation requires all management activities to be aligned with the company's strategy, and encourages decisions for maximising shareholder value (Koller *et al.*, 2010:429). Correia *et al.* (2005: Ch.17-35), state that according to a survey done in South Africa, the level of management in the target organisation was found to be a critical factor in determining the success of mergers and acquisitions.

Cross-border mergers and acquisitions are extremely complex; hence requiring a high level of management skill and capacity. Management capability is of particular importance in post-mergers and acquisitions, as integration depends on whether management follows a centralised or decentralised management philosophy (Correia *et al.*, 2005:Ch.17-38). Planning, organising, leading, and controlling are four major fundamentals of efficient business management, which can be performed better within an innovative business culture environment (Bateman & Snell, 2002:2; Jones & George, 2009:65).

- **Planning:** A conscious, systematic process of a company to pursue short and long-term strategic value (Bateman & Snell, 2002:112).

- **Organising:** The process of integrating differentiated work units that work and which are coordinated by structuring and assigning different individuals and units to perform different tasks for implementing business strategies (Bateman & Snell, 2002:256).
- **Leading:** A process with the ability and vision in strategic planning for an organisation, orchestrating important changes, structuring and monitoring business daily activities effectively, and efficiently mobilising people (Bateman & Snell, 2002:382).
- **Controlling:** A process that directs business activities of participating individuals to achieve business goals, and the necessary ability for managers to plan and strategies (Bateman & Snell, 2002:506).

Managers are also the coordinators in achieving business goals with independent thinking capability (Bateman & Snell, 2002:383). An approach of evaluating management capability for business alliance has been developed by Medcof (1997) cited by Needle (2004:61-62), and it is presented as the model of the '4Cs', based on the concepts of 'capability', 'compatibility', 'commitment' and 'control'.

- **Capability:** Concerned with what each of the parties brings to the combined company and the expectations each has of the other.
- **Compatibility:** Considered as the problems that arise in the implementation of the merger and acquisition integration phase, which can be the result of differences in culture, information technology systems, management style and personality, and administrative and accounting procedures.
- **Commitment**: The extent of partners' willingness to contact on a continuing basis to invest resources and efforts; conflicts occur either in fulfilling expected objectives or between the partners themselves. Many alliances fail through the lack of staying power.
- **Control:** Where one partner is dominant, the other partner may have its core competences actually weakened, and hence threatening its future development.

The above '4Cs' focus on a thorough analysis of business partner selection. To achieve synergy creation of mergers and acquisitions in the global business environment, both acquiring and acquired management need to build a competitive advantage in the measurement of efficiency, innovation, quality, and responsiveness (Jones & George, 2009:19). By following the rapid change of today's business environment, management must be aware that changes are part of the world. Therefore, only forward thinking and creativity can keep a business competitive.

Evaluating potential target organisations need an excellent strategic justification, as an incorrect tactical choice pertaining to the merger or acquisition can cause the collapse of the

acquiring company. In addition to the above-mentioned risks at country, business and management levels, 'ethical risk' is paramount in dealing with risk as an entity.

3.8 Ethical Risk

In business, people are the foundation and basis of management and operations. Ethics pertain to the cognitive domain that controls people's mental processes of awareness, perception, reasoning, and judgement. "Ethics are the inner-guiding moral principles, values, and beliefs that people use to analyse or interpret a situation and then decide what is the 'right' or appropriate way to behave" (Jones & George, 2009:79). Ethical behaviour in business increases efficiency and effectiveness of production and trade, increases company performance, and the national standard of living, well-being, and prosperity (Jones & George, 2009:91).

Ethical standards of a country are based on the culture that created it, as moral concepts cannot be applied universally (Luthans & Doh, 2009:62). In international business, Luthans and Doh (2009:62), point out that ethical scandals and doubtful business practices have received considerable attention for their social impact on business operations. Often in the integration of cross-border mergers and acquisitions, dilemmas arise from conflict between ethical standards of two countries and businesses, or the moral code that guides employment and business practices and behaviour.

Ethics in a business is constructed by three related elements, which are social ethics, professional ethics and individual ethics, as shown in Figure 3.3 below (Jones & George, 2009:93).

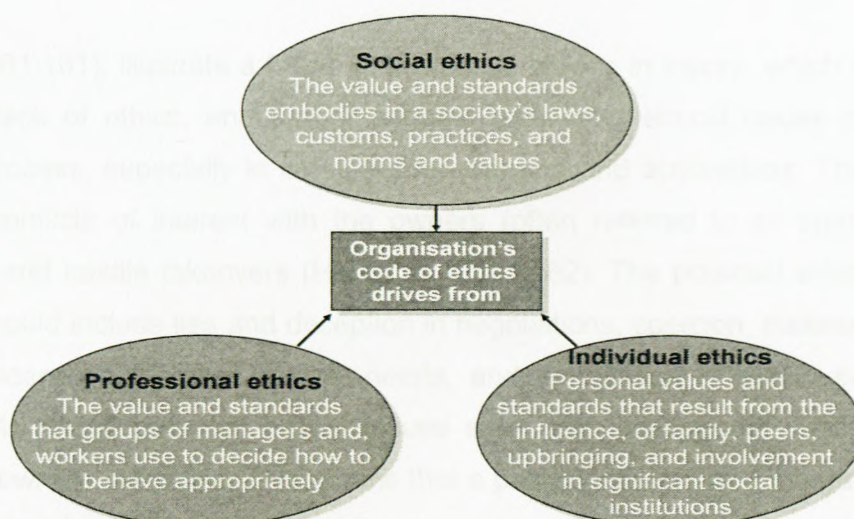


Figure 3.3: Sources of an Organization's Code of Ethics (**Source:** Jones & George, 2009:93)

- **Societal ethics** emanate from a society's laws, customs, and practices, and form the unwritten attitudes, values, and norms that influence how people interact with each other (Jones & George, 2009:92).
- **Professional ethics** are standards that govern how members of a profession, managers or workers make decisions when the way in which they should behave, is not clear.
- **Individual ethics** are personal values (both terminal and instrumental) and attitudes that govern how individuals interact with other people (Jones & George, 2009:94).

The principles, values and beliefs of ethics are different in all countries, societies, businesses and individuals. In the circumstance of cross-border mergers and acquisitions, a target organisation's ethics need to be addressed to in respect of social, professional and general individual ethics. Ethical problems can limit the success of an acquisition more than other factors could (Hitt *et al.*, 2001:183).

Hitt *et al.* (2001:183), focus on the risks to executives of an acquiring firm by stating that one of the typical factors is dishonesty on the part of executives involved in the merger or acquisition. Hiding relevant but damaging financial information and lying about the actual intentions of the deal are also risk factors. Another ethical factor comprises executives involved in giving a disproportionate weight to their own personal interests at the expense of other important stakeholders such as employees or even shareholders, may result in unnecessary layoffs or poor acquisition performance (Hitt *et al.*, 2001:183). Companies can also provide incentives such as stock options or cash compensation to mergers, who take actions consistent with the best interests of the stockholders. The primary responsibility for ensuring ethical behaviour falls on the shoulders of a vigilant board of directors.

Hitt *et al.* (2001:161), illustrate a failed acquisition in billions in losses, which was caused by a director's lack of ethics, and further suggest examining ethical issues in a merger or acquisition process, especially in cross-border mergers and acquisitions. These issues are managerial conflicts of interest with the owners (often referred to as agency problems), governance, and hostile takeovers (Hitt *et al.*, 2001:162). The potential ethical concerns in the process could include lies and deception in negotiations, coercion, maximisation of value without consideration of other parties' needs, and termination of employees (Hitt *et al.*, 2001:162-164). Many potential ethical issues stem from managerial conflicts of interest between the owners' agencies. This means that a primary reason for a merger or acquisition for top managers is stimulated by providing more discretion in their jobs as well as reducing risk to their careers.

3.9 Conclusion

This chapter provided general perspectives of risk associated with cross-border mergers and acquisitions, where risks are identified and classified at country, business and management levels. These three levels of risks are structured in a framework of managing risks associated with cross-border mergers and acquisitions, which follows the logical process of conducting a merger or acquisition. The first task is to choose an investing region, where risks at country level need to be measured. The second task is to select the most suitable company to merge with or acquire, where risks at business level need to be measured. The final task is to integrate with the target organisation, where risks at management level need to be measured.

Although risks associated with mergers and acquisitions exist at different levels, they are not isolated from one another. Risks occurring at country level can lead to risks at business level and further down to risks at management level, or vice versa. Risks that appear at management level indicate risks at business level, and further up to risks at country level. This upstream and downstream converse reflection does not apply to all risks, but most risks circulate through all levels.

The aforementioned analysis have shown that businesses face numerous risks when committed to cross-border mergers and acquisitions. It is management's responsibility to manage these risks adequately, calling for management to have acuminous discernment to suspect or detect the harms and threats to a cross-border investment at top level. Most importantly, ethics of management is the key to executing a deal. Negligence and incomprehension in the process of cross-border mergers and acquisitions will result in an investment disaster.

The next chapter introduces risks associated with cross-border mergers and acquisitions within a Chinese business context. These perceived risks will be structured in the same way as in this chapter, with the three-level risk framework applicable to mergers and acquisitions. Identifying risks associated with these activities in a Chinese business context has been of great interest to academies. Owing to the different characteristics of China, the review proposes to present greater background and a further history of risk factors. This will provide readers with a better understanding of the Chinese business context, as well as of Chinese businesses.

Synopsis: Chapter Four

This chapter introduces perceived risks associated with cross-border mergers and acquisitions in a Chinese business context. As one of the mechanisms of Chinese economic reform, cross-border mergers and acquisitions are structured and managed differently in a Chinese business context. Strong Chinese government domination and extensive participation in business, as well as frequent changes and confusing implementation of policies, laws, and regulations, and a challenging culture, are the risk factors that affect synergy achievement in Chinese cross-border mergers and acquisitions.

By reviewing Chinese business development backgrounds and foreign investment, this chapter identifies perceived risks associated with cross-border mergers and acquisitions at country, business and management levels. These three dimensions present risks with distinct causal relations. At the top level, the Chinese government's domination contributes to risk generation, owing to its unique role in stimulating the country's economic development, enacting laws, regulating business activities, and resolving social conflicts. The business environment creates risks to businesses, which implies that risks exist at country, business, and management levels. Simultaneously, the Chinese culture has also influenced business ideology at these three levels.

The Chinese way of operating is acknowledged by the West as risky to foreign business. In contrast, the Chinese business environment also directs foreign businesses to operate in the same way in China. The limitations of the Chinese business context are formed by various conditions and by the Chinese economic background.

The chapter in addition highlights China's political system, as some inherited risks related to political issues are unavoidable under the control of the Chinese government. In fact, the successful Chinese economic reform has brought the relationship between the Chinese ruling party and businesses closer. As a result of Chinese economic development, the government maintains two dominating directions, namely economic development and strong political control.

CHAPTER FOUR: PERCEIVED RISKS ASSOCIATED WITH CHINESE MERGERS AND ACQUISITIONS

4.1 Introduction

Chinese cross-border mergers and acquisitions were triggered in the middle of the 1990's with state-owned companies the major targets. Transactions have surged since China's accession to the World Trade Organization (WTO). In a Chinese business context, the Chinese government plays a significant role in transaction guidance, review and approval regarding cross-border mergers and acquisitions. Simultaneously, the government's influence on and interference in business is much more powerful and broader than that of the Western world, which may confuse Western business organisations operating in China, or cooperating with Chinese businesses. Such influence and interference have resulted in a complex Chinese business environment. Obtaining a thorough understanding of China's strong and unique political and economic backgrounds can significantly support decision makers with regard to the management of risks associated with Chinese cross-border mergers and acquisitions. Identifying risks associated with the integration of Chinese inbound mergers and acquisitions via past cases can contribute to the academic body of knowledge of risk management of Chinese cross-border mergers and acquisitions.

Chinese economic reform was a milestone in Chinese economic history; mooted as a result of socialist theory. The essence of the ongoing reform is an attempt at economic transformational development to adopt a socialistic market-orientated economic system to improve the country's poor economic conditions. The hub of the reform is to retain the leading position of state-owned enterprises in the markets; to allow individuals and collectives to trade as independent entities; and to allow various trading forms to participate in the country's economy development under the domination of the Chinese Communist Party. The transformation of the economic system creates two opposing situations for the Chinese government. Firstly, the government needs to retain market control to strengthen political control, and secondly, private and other business sectors demand freedom in the market, which requires minimal political control.

From a central planning economic system transforming to a market orientated economic system, the Chinese government has to address three major challenges, namely to transform the ruling party's socialistic regime structure; to widen the extent of market freedom; and to stipulate corresponding regulations. Based on the actual poor economic conditions in the country, the large population, unbalanced regional economy, poor infrastructure, and low levels of productivity, education and trading, the economic transformation has to be processed and performed gradually. As a result, the Chinese

government is faced with a political risk to promote the country's economy and to improve people's living conditions. As the advantages of the reform become apparent, it will strengthen the country's political rating and the Chinese Communist Party's status in the world.

When cross-border mergers and acquisitions were formally allowed by the government in 2002, Chinese economic reform had been in progress for 24 years. The continued and rapid GDP growth year on year has changed China's investment conditions dramatically. However, the transformation is a gradual process: the country's politics, economy, finance, policies, and legislation will still need improvement to reach international levels. Since mergers and acquisitions are still new economic alternatives in China, the Chinese government and Chinese businesses are likely to incur unknown risks.

The discussion of risks associated in a Chinese business context follows the established conceptual framework which was presented in the previous chapter. There are three dimensions drawn from the conceptual framework, namely country, business, and management level risk. Figure 4.1 below depicts the risk causal relations of the three dimensions. Risks at country level impacts on the behaviour of business; risk at business level is risk carrier and determines management performance; while risk at management level reflects the capability of collaboration. This structured risk logic model can be utilised for due diligence and valuation of mergers and acquisitions in a Chinese business context.

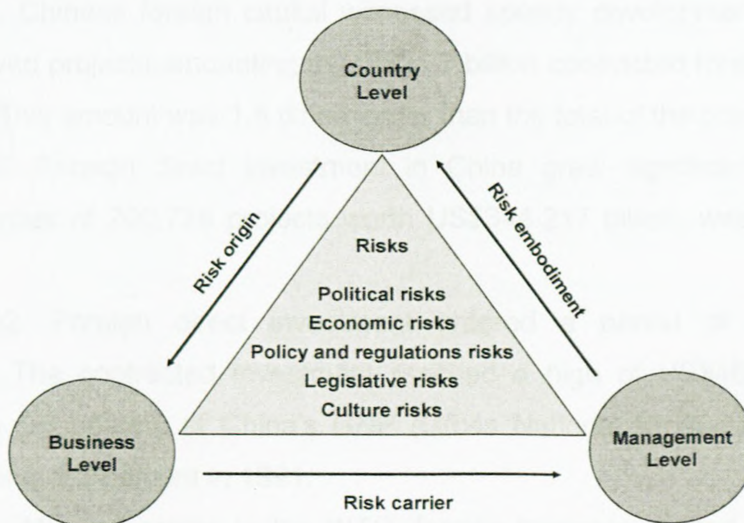


Figure 4.1: Risk Logic: Three Dimensions in Chinese Business Context

4.2 Introduction to Foreign Investment in China

Cross-border mergers and acquisitions were initially derived from Chinese foreign direct investment, and the regulations stipulated for foreign investment also applied to cross-border mergers and acquisitions.

Since China became a member of the World Trade Organization (WTO), trade between China and the rest of the world has been constantly expanding. Policies in respect of foreign trade in China are gradually being amended as markets open up. Despite the fact that China has become an important trading partner of the United States and Europe, many US and European multinationals still find that doing business in China can be a long and gruelling process (Luthans & Doh, 2009:140).

The Chinese economic reform commenced in 1979. Since then, the Chinese government has opened its markets to the world gradually, with a series of attractive policies. Utilising foreign investment is regarded as a major part of the reform (Chi, 2000:338). As a result, transformation promoted China as an important trading destination in the world. From a poor country to the second largest economic entity in the world, superseded only by America, China took just 30 years to achieve this status (Chi, 2000:338). Foreign investment contributes significantly to this great achievement.

Chi (2000:338-340), identifies four distinct periods of foreign direct investment in China from 1979 to 2002. Thereafter, foreign investment in China broadened in scope:

- 1979 to 1987 represents the initial period of introducing direct foreign investment. This initially opened regions, which were limited to five special economic zones in 1979, while very little foreign capital was invested. In 1984, fourteen coastal cities were declared open, with obvious interest from foreign direct investment.
- 1988 to 1991. Chinese foreign capital witnessed speedy development countrywide with 30,000 approved projects amounting to US$31.7 billion contracted foreign capital in a four years period. This amount was 1.5 times larger than the total of the previous eight years.
- 1992 to 1995. Foreign direct investment in China grew significantly after 1992, an estimated number of 200,728 projects worth US$344.217 billion, was contracted in this period.
- 1996 to 2002. Foreign direct investment entered a period of readjustment and improvement. The contracted investment reached a high of US$469.39 billion, which contributed to 5.6 percent of China's GNP (Gross National Product) increase in 1996, compared to only 1.1 percent in 1991.
- 2002 to 2008. After accession to the WTO, foreign business started to trade in a more relaxed investment environment. Mergers and acquisitions become the fastest growing form of foreign investment.

There are four legal forms for foreign investors represented in China (Baker & McKenzie, 2005:2), namely:

- a representative office.

- a sino-foreign joint venture.
- a wholly foreign-owned enterprise.
- a foreign-invested joint stock limited company.

Except for representative offices, other forms are regarded as foreign invested enterprises. Legal entities with at least 25 percent foreign investment are eligible to benefit from tax exemption or tax reduction, and preferential treatment under certain conditions. Based on the category of industries, foreign investment projects are compartmentalised in terms of 'encouraged', 'permitted', 'restricted' and 'prohibited' (Baker & McKenzie, 2005:4). Furthermore, Baker and McKenzie (2005:4), highlight the fact that identifying investment categories is important for foreign investors, as business activities and operating permissions are specified in China.

Long (2005:319), the senior researcher and deputy director general of the Department of Foreign Economic Relations of China, explains the intentions of the Chinese government in introducing international investors into China as follows:

- "To transform traditional agriculture, develop modern agriculture, and promote the industry of agriculture.
- To produce transportation infrastructure, energy sources, raw materials and other basic industries.
- To tap into cutting-edge, technology-oriented industries such as electronic information, bioengineering, new materials, and aviation and aerospace, as well as establishing local industries such as R&D centres.
- To encourage foreign businesses to utilise advanced and applicable techniques to transform traditional industries such as machinery, textiles, and consumption goods manufacturing industries as well as to upgrade their equipment and facilities.
- To use raw and renewable resources comprehensively, initiating environmental protection projects, and modernising public utilities.
- To encourage export-oriented foreign direct investment projects and build up the industries in China's western region".

Since the 1980s, the Chinese government has gradually opened certain economic zones to foreign investment, namely special economic zones, coastal zones, economic and technology development zones, high-tech industrial development zones, border economic cooperative zones, and export processing zones (Ma, Li, He, Wang & Weng, 2004: 215-225). The Chinese central government agencies stipulate special policies for attracting foreign investment in these special zones, economic zones and coastal cities, while the local governments of these regions have power over all major economic affairs (Ma *et al.*,

2004:216). These zones are proposed to encourage foreign companies to invest in the designated business sectors, and also to facilitate the constraints on and administration of foreign businesses (Luthans & Doh, 2009:220). Local governments in these zones are empowered to adopt special policies and measures pertaining to the application, examination and approval procedures, customs management, taxation, exchange management, business management, land use and labour management (Leonard, 2002:15; Ma, *et al.*, 2004:208; Luthans & Doh, 2009:220).

After China's entry into the WTO on 11 December 2001 (Kronick & Pu, 2002:25), the Chinese government made a number of specific commitments to liberalise international trade and investment. Foreign investment enjoyed a more relaxed environment in China. This also meant that when China commits fully to fulfilling its WTO undertakings, the terms of restrictions and prohibitions will also be transparent to foreign businesses (Leonard, 2002:15-18; Luthans & Doh, 2009:220). China's membership of the WTO boosted cross-border mergers and acquisitions in China. The Chinese government strategises on utilising such activities to upgrade capital size, assets, productivity, advanced technology and management levels of Chinese business, and to guide foreign investment participation in China's state-owned enterprise reconstruction reform. With the continued strong growth of the Chinese economy, cross-border mergers and acquisitions have become increasingly attractive alternatives to foreign investors.

4.3 Chinese Cross-border Mergers and Acquisitions

China's economic transformation over the past 30 years has led to major changes in the country's economy. A major shift in the country's economic policy was to diversify business types, from previous state-owned enterprises only, to collective, private, stock-listed, joint-venture, and foreign-owned enterprises. With China's strong economic growth, foreign investment is encouraged on a sustained basis by the government to meet financing demands and to keep up with developed countries. As important mechanisms of utilising foreign investment, cross-border mergers and acquisitions are becoming popular investment alternatives in China. The promulgation of the *Interim Provisions on the Utilisation of Foreign Capital to Restructure State-Owned Enterprises* on the 8th November 2002 implied that cross-border mergers and acquisitions became regulated economic mechanisms for foreign companies to enter into Chinese markets (Li, Qiao & Chen, 2010:559). Reciprocally, more and more Chinese companies have accumulated vast amount of capital, and strategise to merge and acquire foreign companies in a global market.

4.3.1 Chinese Inbound Mergers and Acquisitions

Since mergers and acquisitions were acknowledged as legal entities by the Chinese government, foreign investors, including joint venture partners, have shown a preference for such diversity, which have boosted Chinese inbound mergers and acquisitions. The changes to China's foreign direct investment include according to Chi (2000:340-341):

- Change to mergers.
- Change to selective mergers (focus on state-owned enterprises and well-performing enterprises).
- Change from scattered mergers to concentrated mergers (merge in same area or leading enterprise in same sector cross regions).
- Change from stock-partnership to controlling stakes through joint ventures, stock purchasing and an increase in capital.
- Change from export capital to export of commodities and brands.
- Change from joint ventures to solely foreign-funded enterprises.

China's inbound cross-border mergers and acquisitions emerged in the middle of the 1990's. After China's accession to the WTO, cross-border mergers and acquisitions increased exponentially, becoming a common and important feature of the Chinese economy. In terms of Chinese merger and acquisition regulations (Zhang, 2009:20), there are four types of mergers and acquisitions, which can be identified, namely:

- **Debt undertaken:** In the case of the equivalent value of assets and debts, the acquirer accepts the acquired company's assets and undertakes to settle its debt.
- **Purchase:** The acquirer purchases the assets of the acquired company in cash.
- **Absorbing shareholdings:** The owner of the acquired company invest its net capital in the acquiring company as share capital, and becomes one of the acquirer's shareholders.
- **Share control:** The acquiring company obtains control of acquired company via the purchase of its shares to achieve either a merger or acquisition.

Based on the 2002 interim provisions for foreign investment mergers and acquisitions, the Chinese government standardised the regulations, and issued the *Provisions on the Acquisition of Domestic Enterprises for Foreign Investors (2006)*. The regulations stipulate the key procedures pertaining to domestic equity purchase and assets acquisition, and the rules on the use of shares. The regulations also stipulate detailed approval procedures that foreign investors need to follow.

Approvals: There are two levels of Chinese inbound mergers and acquisitions, namely national and provincial. The approval of a deal is required according to the proposed structure of the deal, business type of the target organisation, industry entered, and the total

value of the transaction. Regarding the investment categories of 'encouraged', 'permitted', 'restricted' and 'prohibited', projects involving the 'encouraged' or 'permitted' sector with a total investment of US$300m or more, will require national level approval, while projects below this amount can generally be approved by provincial authorities (China Law, 2010:Online). 'Restricted' projects with a total investment of US$50m or more require national level approval, while smaller projects may be approved provincially (Webre, 2007:Online). However, if an offshore party merges with or acquires an inland company, it will be subject to national approval requirements (Li *et al.*, 2010:563). Special approval normally is more stringent and requests depend on the particular nature of the target. For instance, bank acquisitions take precedence over general ones, and approval is always required (Webre, 2007:Online).

The rules and regulations that apply to foreign investments are also applicable to foreign investment mergers and acquisitions. The 2006 regulations emphasise that the general foreign investment approval authorisations are applicable to merger and acquisition transactions (Webre, 2007:Online). The empowered authorities to verify cross-border mergers and acquisitions for issuing approvals are listed below (Baker & McKenzie, 2005:12-15; Quam Capital & Deacons, 2005:3; Webre, 2007:Online):

- Ministry of Commerce (MOCOM).
- The National Development and Reform Commission (NDRC).
- State Administration of Industry and Commerce (SAIC).
- State-Owned Assets Supervision and Administration Commission (SASAC).
- State Development and Reform Commission (SDRC).
- The Administration of Industry and Commerce (AIC).
- State Council.
- The China Securities and Regulatory Commission (sector-specific authority).
- China Banking Regulatory Commission (sector-specific authority).
- Provincial authorities.

According to the Chinese foreign investment regulations, the above listed authorities perform a variety of approval processes. Baker and McKenzie (2005:18), point to the fact that the approval process for foreign investors purchasing state-owned equity (other than state-owned equity in financial enterprises or listed companies) are treated separately, and call for investors to pay more attention to the process. The authors perceive that processes associated with foreign invested companies are complex and cumbersome (Baker & McKenzie, 2005:18). Pervasive approval requirements are a distinctive feature of mergers and acquisitions in China (Webre, 2007:Online).

Merger and acquisition structures: To choose the best way of merging with or acquiring business in China, the prudent investor would consider the financial situation of the target organisation, the request for government approval, the necessity of third-party consent, the transferability of assets and the tax consequences of the structure (Webre, 2007:Online). The range of permitted target organisations have been widely expanded by the Chinese government. It should be mentioned that regulations are applied distinctly to different types of businesses in Chinese cross-border mergers and acquisitions. Such entity-differentiated legal treatment remains fairly common in China.

A merger or acquisition transaction in China can be achieved through three recognised forms, namely an equity purchase, an asset acquisition or a statutory merger under Chinese law (Webre, 2007:Online). Foreign investors who wish to invest in China via mergers and acquisitions will be classified as one of the following authorised forms (Baker & McKenzie, 2005:6; Webre, 2007:Online):

Equity purchase:

- **Direct equity acquisition**: A direct equity acquisition is an onshore activity whereby a foreign investor acquires equity in a foreign enterprise or Chinese domestic enterprise from the existing foreign or Chinese equity holders in the form of an equity acquisition agreement or from the target organisation through a subscription to a new equity (Webre, 2007:Online). A direct equity acquisition requires the discretionary approval of the Chinese approval authorities. Any other investors will have a statutory pre-emptive right to acquire the interest being transferred (Webre, 2007:Online).

- **Indirect/Offshore acquisition**: An indirect offshore acquisition is when the ultimate target organisation is an offshore company's equity interest in a foreign company. In an indirect offshore acquisition, the foreign investor acquires the equity of the foreign company's offshore investor. Typically, Chinese government approval is not required for such acquisitions, since the foreign company's registered equity holder does not change. This acquisition structure is especially popular for Chinese entrepreneurs who restructure their domestic enterprise into a foreign owned offshore holding company. Such restructured entities are not entitled to foreign company benefits without the injection of additional foreign capital. As a result of the 2006 amendments, the approval of the Ministry of Commerce is now required in many related party restructurings and the listing of such offshore vehicles, and subject to the China Securities and Regulatory Commission's approval (Webre, 2007:Online).

Asset acquisitions: An acquirer acquires select assets and liabilities of the target organisation. It gives the target organisation an opportunity to rid itself of unwanted assets and liabilities. Consideration is paid to the maintenance of a target organisation's separate legal existence. In this type of transaction, creditors' notification is sometimes required, while worker settlement arrangements will be required and examined in the approval process. In some cases, formal consultation with the target organisation's workers may also be required. While the worker settlement issues are typically the responsibility of the target organisation, their handling of the matter may affect the progress of the transaction. Customs approval and the payment of supplemental duty may be required if any of the acquired assets are under customs' supervision (Webre, 2007:Online).

Mergers: Include absorption mergers and newly established mergers. Statutory mergers are also sanctioned under Chinese law. Mergers are subject to a multi-step approval process with preliminary approval required from both the surviving and the dissolving entities. Final approval required from the surviving entity's approval authority (Webre, 2007:Online). In a statutory merger, the acquiring entity acquires all the assets and liabilities of the target organisation, while the existing investors' equity is transformed into the merged entity (Webre, 2007:Online).

Target organisations: The range of permitted target organisations in China has been expanded, but the regulations on each type of entity are different, namely state-owned companies, domestic companies, listed companies and foreign invested companies.

State-owned companies: The *Interim Provisions on the utilisation of Foreign Investment to Restructure State-owned Enterprises* (2002) has established a framework for foreign acquisitions of state-owned enterprises (non-listed) and their transformation into foreign invested enterprise (Webre, 2007:Online). A foreign investor can acquire an interest in a state-owned enterprise through the acquisition of an existing equity interest, the conversion of existing debt or the acquisition of the assets of the state-owned enterprise. The acquisition application requires approval from the State-Owned Assets Supervision and Administration Commission. The resolution of employment-related issues is important of the validity of the transaction (Webre, 2007:Online).

Domestic companies: Acquisition of Chinese domestic companies is sanctioned in terms of the *Provision on the Acquisition of Domestic Enterprises for Foreign Investors* (2006). The regulations provide primary guidance on the acquisition of domestic equity or assets by foreign investors (Webre, 2007:Online). Complying with China's industrial policies for foreign

investment is essential for this type of transaction. An acquisition cannot be used to circumvent licensing or industry sector restrictions (Webre, 2007:Online).

Listed companies: There are two main types of domestically listed shares in China, namely A-listed shares for domestic investors, and B-listed shares for foreign investors. The capital structure of China's listed companies have generally consisted of a minority of tradable listed shares and a majority of non-tradable state-owned and legal entity shares. Foreign investors have been precluded from acquiring the largest class of listed shares (domestic A shares) and acquiring a controlling interest in the non-tradable shares (permitted since 2003), triggered a general tender offer requirement, which a foreign investor could not satisfy owing to its A share prohibition (Webre, 2007:Online). Foreign investors were largely limited to acquiring B listed shares. This class of share however was quite small and non-liquid, which precluded the control of the transactions. Legal entity and state-owned shares opened to foreign acquisition in 2003, but in limited controlled transactions. Recent regulatory changes however have expanded acquisition opportunities, so that control transactions are now technically feasible (Webre, 2007:Online).

- **Listed company share acquisitions:** Depending on the share classification, foreign investors may acquire shares through a negotiated acquisition, a private placement, an open market acquisition or a block trade transaction. Different rules and restrictions apply to each class of share, and each class has different ownership and transfer procedures. The China Securities and Regulatory Commission, State-owned Assets Supervision and Administration and Ministry of Commerce are heavily involved in these transactions (Webre, 2007:Online).
- **Listed company takeovers:** The *Administrative Measures on the Acquisition of Listed Companies* (amended 2006), is applicable to acquisitions of over 30 percent of the outstanding shares of a listed company. Once the 30 percent threshold is reached, any further acquisition must be made by general or partial tender offer. The minimum partial tender offer is for 5 percent of the outstanding shares. The China Securities and Regulatory Commission may grant exemptions from the tender offer requirements. The A share market has opened to foreign participation since the recent regulatory changes, which allow tender offers in certain circumstances (Webre, 2007:Online).
- **Acquisition of A shares:** The A share market is gradually opening to foreign investment. Since 2006, a qualified foreign institutional investor under the regulations can be permitted to hold up to a 10 percent interest in the A shares of any particular listed company, with the combined qualified foreign institutional investor holding not to exceed 20 percent in any company. These rights however have limited flexibility to operating investors (Webre, 2007). The *Administrative Measure on Strategic Investment in Listed Companies by Foreign Investors Procedures* (2006), permits strategic investors meeting certain criteria

to acquire class A type shares. The regulations do not limit the number of A shares that may be acquired, but require a minimum acquisition of 10 percent. A three-year 'lock-down' is applicable to the acquisition, and only listed companies that have undergone the share reform process for non-tradable shares, are eligible to benefit from such investment (Webre, 2007:Online).

Identifying the best investment structure can maximise benefits to investors. Baker and McKenzie (2005:29), point to the fact that mergers and acquisitions failing to maintain at least 25 percent foreign shareholdings, will lose their eligibility for tax concession as the foreign invested enterprise.

Government approval is perceived as onerous for foreign investors. Foreign companies need to comply with the applicable regulations, as well as with certain rules to improve the possibility of successful applications on mergers and acquisitions. Concerns about the process of a merger or an acquisition, are expanded upon below:

- **Valuation:** A valuation is required for most domestic asset acquisitions, which must be undertaken by a qualified organisation; separate regulations govern the valuation procedure. The government authorities may reject the application if the purchase price and valuation variance are too disparate (Webre, 2007:Online).
- **Related party transactions:** The rigid regulations require discourse on related party transactions with anti-avoidance provisions that prohibit the use of trusts and other arrangements to disguise such relationships (Webre, 2007:Online). Restructuring receives considerable attention under the amended regulations, and the tangent planes of related parties must be specified and reported during the approval process.
- **Special purpose vehicles:** Rigid specification has been requested for the use of special purpose vehicles for offshore/onshore restructuring for listing purposes. Approvals from the Ministry of Commerce and the China Securities and Regulatory Commission are required, and the listing must take place within one year, otherwise the transaction must be cancelled (Webre, 2007:Online).
- **Special reporting:** The amended regulations also provide room for public interest on any acquisitions that involve key industries; impact on national economic security or result in the change of control of an entity with a well-known domestic trademark. These issues need to be reported to the Ministry of Commerce (Webre, 2007:Online).

Huge population based markets, cheap materials, low labour costs, and attractive investment policies, have encouraged top global businesses to pursue investment opportunities in China. Chinese businesses have realised the gaps between China and the West in term of productivity, advanced technology and management capability. The desire to comply to or

attain Western standards and to extricate from poor economic conditions, inspired Chinese businesses to cooperate with the West. As a result, cross-border mergers and acquisitions have enormous potential to develop in China. By utilising foreign investment, China has created a win-win situation for both international and Chinese businesses, culminating in the outcome of China's economic development being noticeable and significant. With 30 years of continued rapid economic development, many Chinese leading companies have accumulated abundant capital and are eager for merger and acquisition opportunities in the global market.

4.3.2 Chinese Outbound Mergers and Acquisitions

The earliest recorded Chinese outbound merger and acquisition transaction was in 1984. The Bank of China Group Investment and China Resources Co., Limited spent HK$430 million to acquire 67 percent shares in Hong Kong's biggest electronic company, Kangli Investment Corporation (Jin & Liao, 2007:3, Gu, 2008:Online). In the 1980s, very few Chinese companies strategised to include overseas investment, including investing in Hong Kong. Chinese outbound mergers and acquisitions remained limited until 2001, when China's accession to the WTO stimulated Chinese companies' ambitions to invest overseas.

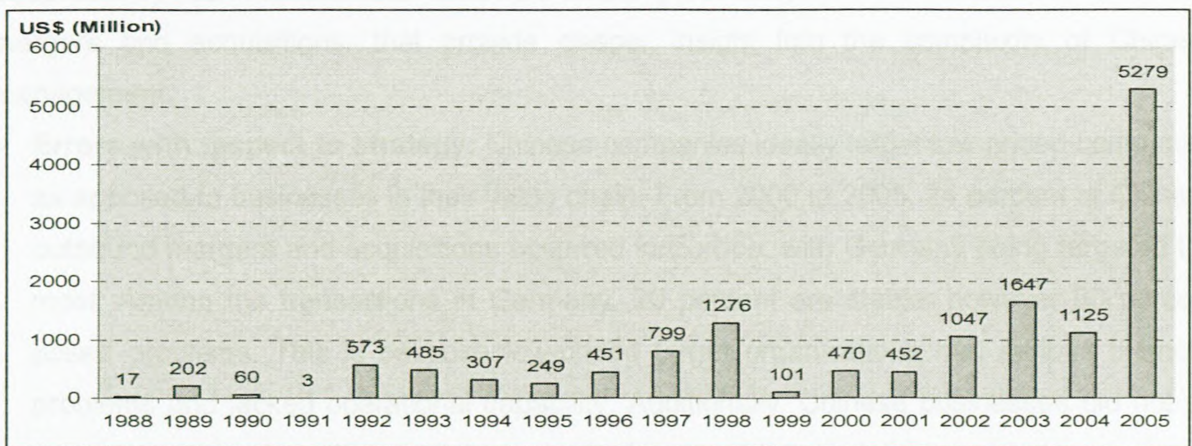


Figure 4.2: Increase of Chinese Overseas Mergers and Acquisitions

(**Source**: UNCTAD, World Investment Report 2003 - 2006, cited by Jin & Liao, 2007:11)

Figure 4.2 above reflects the number of transactions of Chinese outbound mergers and acquisitions from 1988 until 2005. Four outstanding characteristics is evident for this period, namely rapid increase in size and amount; expanded targeting areas from Asia, America and Canada to Europe; diversified transaction types from horizontal to vertical mergers and acquisitions; and varied acquiring sectors from exclusively state-owned enterprises to private companies (Jin & Liao, 2007:10-11). The proportion of Chinese outbound mergers and

acquisitions in the world's cross-border mergers and acquisitions grew from 0.55 percent in 2003 to 0.74 percent in 2005.

From a geographic perspective, 61 percent of Chinese outbound mergers and acquisitions were targeted in Asia. Kazakhstan, Hong Kong, Indonesia and South Korea have been the most popular destinations according to Jin and Liao (2007:17). The other investment countries include the US, Australia and other nations in South America, North America and Oceania (Chinanews, 2006:Online). From an industry perspective, the main targeted industries of Chinese outbound mergers and acquisitions are petroleum exploits and mining. Manufacturers of motorcars, electrical products and foodstuffs are also of interest to Chinese business, but in small numbers and amounts. Industries such as telecommunication, software, consultancy, advertising, financing, transportation and retail amongst others, are very rarely involved (Jin & Liao, 2007:20-21).

The increase in Chinese outbound mergers and acquisitions may be attributed to the robust domestic economic growth of China. As part of global mergers and acquisitions, the performance of Chinese outbound mergers and acquisitions have similar features to those of other countries. However, research published by the Boston Consulting Group (Chinanews, 2006:Online), summarises four common errors particularly evident in Chinese outbound mergers and acquisitions, that provide deeper insight into the complexity of Chinese management.

- **Errors with respect to strategy:** Chinese companies ideally target low-priced companies as apposed to businesses in their value chain. From 2000 to 2005, 24 percent of Chinese outbound mergers and acquisitions occurred in Europe, with Germany being targeted the most. Among the transactions in Germany, 20 percent are stable, however 80 percent posed problems. This is because low-priced target organisations had serious financial problems and lacked operational capability. Additionally, Chinese businesses did not do enough work on due diligence, which resulted in a problematic integration process.
- **No right of control:** A common phenomenon in Chinese outbound mergers and acquisitions is that Chinese companies generally purchase management control or a low percentage of shareholdings in target organisations to gain management experience, however without voting control as a result, Chinese companies can easily become investment victims when the target organisation has a financial crisis.
- **The negotiation is focused on price only:** The tactics of maximising investment profit and mitigating investment risk are neglected by Chinese negotiators. Chinese companies do not have the capability to utilise the host country's tax, laws and industry regulations to structure their investment benefits and reduce costs.

- **Misjudgement of the best time for integration:** Non-performance in the first two months after an agreement has been signed implies a failure in integration of Chinese outbound mergers and acquisitions. Typically, some Chinese companies transfer the purchased foreign companies to China, to become Chinese domestic companies.

The above errors of Chinese outbound mergers and acquisitions show the performance and capability of leading Chinese companies in a merger or acquisition. It is a reflection of the knowledge, cognition, behaviour and management skills of Chinese businesses and Chinese government officials. This indicates that Chinese outbound mergers and acquisitions are still far from a desired state.

Chinese outbound mergers and acquisitions have not proved to the financial world that Chinese companies can successfully conduct cross-border mergers and acquisitions. As a result, the Western world retains its bias against Chinese overseas transactions, an aspect which is expanded to state-ownership, natural resources and culture differences. It is foreseeable that Chinese outbound mergers and acquisitions will continually encounter controversy compared with that of the rest of the world. Despite the high failure rate of Chinese outbound mergers and acquisitions, seeking investment opportunities for global reach remains popular.

4.3.3 Trends in Chinese Cross-Border Mergers and Acquisitions

Chinese cross-border mergers and acquisitions have experienced a surge in growth. The first statute of Chinese inbound mergers and acquisitions was reflected upon the *Interim Provisions on the Utilisation of Foreign Capital to Restructure State-Owned Enterprises,* promulgated in 2002. This statute has promoted merger and acquisition activities exponentially and its contribution to the Chinese economy is evident. Chinese cross-border mergers and acquisitions will continue to flourish under the current investment conditions created by the Chinese government. The following reflect the forecast trends of Chinese cross-border mergers and acquisitions.

International approach: It is an acknowledged fact that the absorption of foreign invested funds in China is lower than the average in developed countries. Chinese markets however still need upgrading to reach higher levels, and as a result, the Chinese government will remain amenable to cross-border mergers and acquisitions, especially to those incorporating advanced technology.

Accelerate the restructuring of the Chinese economy: According to Xinhua News Agency (2006:Online), China's previous Vice-Premier, Wu Yi, has suggested that foreign investment should take place according to the requirements of China's economic restructuring, such as agriculture, research and development, service industries, new high-technology industries, advanced manufacturing, energy conservation, and environment sectors. Transactions involved in these areas will be more likely to succeed.

Investment policies to benefit the relatively poor Northwest areas: Northwest China has severely lagged in terms of China's economic development. Compared with the exponential growth of China's economy, limitations associated with this region have emphasised the economic divide between the Northwest and Southeast. Therefore, with continued development in the Southeast, foreign investment policy and regulation privileges are now concentrated in the relatively poor Northwestern areas (Xinhua News Agency, 2006:Online).

The need of the service sector: Businesses in the service industry now account for only 30 percent of China's total foreign invested businesses, while the proportion is as high as 60 to 70 percent among the EU nations and 87 percent in the Hong Kong Special Administrative Region. Worldwide, the service sector absorbs two-thirds of the global direct investment (Xinhua News Agency, 2006:Online). Most importantly, the level of service in China is very low, and foreign investment participation in this sector can address these needs.

Private companies are main targets for mergers and acquisitions: Up until 2008, the number of state-owned companies was reduced from 151 to 142, according to Li Rongrong, the official of the State-owned Assets Supervision and Administration Commission of the State Council. This number will be continually reduced through equity reconstruction, initially to 100 then to 80, in the industries that relate to state safety, such as resources, energy, metallurgy, automobile, heavy equipment and commerce (Li, 2009:Online). Although there are still numerous investment opportunities in state-owned enterprises, private companies in China have grown bigger and stronger, demanding an increase in financing.

China has development strategies in both inbound and outbound cross-border mergers and acquisitions. The 2008 global financial crisis has created opportunities for Chinese companies to act in the world economy. Meanwhile with abundant cash on hand, Chinese companies are more confident and expect to participate more proactively in cross-border mergers and acquisitions. The following perceived risks associated with Chinese inbound mergers and acquisitions can be regarded as important aspects to manage risks associated with cross-border mergers and acquisitions in a Chinese business context.

4.4 Risks Associated with Chinese Cross-border Mergers and Acquisitions

China has made considerable attempts to establish a coherent regulatory framework to facilitate cross-border mergers and acquisitions. These have pervasively infiltrated China's economic system, contributing to the current investment conditions, and are evident of the Chinese government's commitment to its WTO undertakings. Based on China's current economic status and the government's obligations to indigenous businesses development, it is forecasted with confidence that China will remain a stable economic business environment.

Not only the cross-border mergers and acquisitions regulatory framework, but other sectors as well, are still on the road to economic reform. As the world's second biggest economy, China remains a developing country. To compete with the West, there are many issues which need to be addressed. There are no examples from which China can learn from to address the problems in its socialist system. This means that China has to create a custom made system and structure to meet particular economic needs.

It is readily recognised that there are many loopholes in China's current regulating system, which needs to be addressed. China's fast economic development requires support from strict and sound regulations. However, complicated regulations create difficulties in practice. In Chinese cross-border merger and acquisition regulations, the complex acquiring methods and onerous approval requirements have made such practices extremely challenging to both acquiring and target organisations. Some foreseeable risks are inherent in the system of the country's political regime, while some risks are the result of economic policies and related to the nature of businesses and/or because of cultural differences.

It is difficult to standardise the measurements of these risks in Chinese cross-border mergers and acquisitions, as each case involves unique conditions that need to be evaluated separately. Perceived risks associated with Chinese inbound mergers and acquisitions are addressed in terms of the conceptual framework established in Chapter Three. For ease of reference this conceptual model of risks associated with cross-border mergers and acquisitions is repeated here as Figure 4.3.

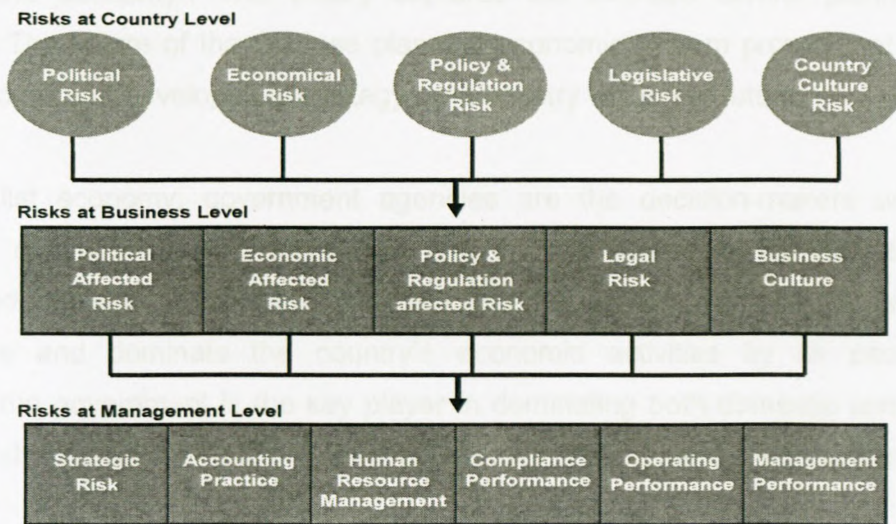


Figure 4.3: Conceptual Model of Risks Associated with Cross-border Mergers and Acquisitions

4.5 Risks at Country Level

Considerable efforts are required by foreign investors to obtain the necessary approval for a merger or acquisition transaction in China. The Chinese government retains control of both the Chinese and foreign companies for such an initiative. An understanding of the government's role, the conditions of the country's economy, the Chinese Communist Party's political stance, the applicable legal framework and approval process, as well as cultural issues, are important aspects, which need to be considered to conduct such transactions successfully in China. Identifying risks associated with these aspects will contribute to a successful due diligence and valuation in order to minimise the potential loss of investment.

4.5.1 The Roles of the Chinese Government

Markets are usually a good way to organise economic activity (Mankiw: 1998:9). In a socialist economy such as China, the economic planning sector is stronger than the free-market economic sector. After 30 years of economic reform to establish a market-oriented economy, China still retains strong economic control. The history of the Chinese economy has proved that the planning economic system did not accommodate the market needs of 'demand and supply' as in the case of a Western economy. "The theory behind central planning was that only the government can organise activities in a way that promoted economic well-being for the country as a whole" (Mankiw, 1998:9).

Mankiw (1998:9), describes government's planning activities on guiding a country's economy as: "...when the government prevents prices from adjusting naturally to supply and demand, it impedes the invisible hand's ability to coordinate the millions of householders and firms that

make up the economy". This theory captures the Chinese central planning economy accurately. The failure of the Chinese planning economic system proved that it can not be used as a long-term development strategy for a country within the future.

In a socialist economy, government agencies are the decision-makers with regard to production, consumption and distribution, and there is little room for individual economic choices and decisions (Dwivedi, 2008:636). The Chinese government is empowered to administrate and dominate the country's economic activities by its people's choice. Therefore, the government is the key player in dominating both domestic and cross-border mergers and acquisitions (Quam Capital & Deacons, 2005:2; and Pukthuanthong & Walker, 2007:724).

With reference to the process of Chinese inbound mergers and acquisitions, Webre (2007:Online), notes that obtaining the required approvals may take considerable effort. Therefore, an understanding of the government's role in the acquisition process is important to conducting the transactions successfully. The role of the Chinese government in the Chinese economy can be summarised as follows:

Authority: Any foreign investment entering into China will be verified by the relevant Chinese authorities for approval (Quam Capital & Deacons, 2005:3; and Baker & McKenzie, 2005:12-15).

Agency: The Chinese government plays an important role as an agency in Chinese merger and acquisition transactions. To address the needs of regional economic development, local governments will search for and invite foreign companies to invest in the regions and recommend domestic (especially state-owned) companies to them to serve as business partners.

Supervisor: The Ministry of Commerce, formerly the Ministry of Foreign Trade Economic Cooperation, is the primary regulator of foreign investment and has general supervision over merger and acquisition transactions (Webre, 2004:Online). The State Development and Reform Commission, the former State Economic System Restructuring Officer, is responsible for both the approval of foreign investment projects and supervision of the state-owned enterprises reconstruction (Webre, 2004:Online).

Owner/ Shareholder: Currently, the state-owned companies (including stock listed) still occupy half of the Chinese economy (Chen & Young, 2009:Online). As the owner and/or shareholder of state-owned companies, the Chinese government has the right to exercise

decision making on cross-border mergers and acquisitions. Foreign investors need to treat this dispensation with some caution (Chen & Young, 2009:Online), as they are dealing with business owners who have the country's interests at heart.

In China, the administrative hierarchy comprises of state – province – municipal city and county townships. Below the state are local governments. In the Chinese economic system, local government agencies play significant roles. They are the representatives of the ruling party and are empowered to implement and supervise the country's regulations, policies, and laws. They are also authorised to promulgate provincial rules that are applied in the provinces. Furthermore, provincial government agencies are also the approval authority of cross-border mergers and acquisitions.

The economic outcome of a local area is a major indicator of the local government officials' capability, and it is regarded as the most important parameter for an official's political career and promotion (Berrell & Wrathall, 2007:58). If a merger or acquisition takes the benefits and interests of the region into consideration, it will increase the possibilities of success. Nevertheless, a local government's over-participating and flexible administration in respect of the control of merger and acquisition transactions may have a negative impact on the economy, as there is a lack of monitoring and restriction of political performance in the governing system.

The Chinese government's involvement with cross-border mergers and acquisitions are not limited to competitive consequences and formalities. Social concerns and interests are also taken into account when approval is called for, which may contribute to difficulties in conducting a deal (Webre, 2007:Online). For instance, to merge with or acquire a well-known brand Chinese target organisation, the discussion may be opened to the public for approval. Difficulty in satisfying approval requirements is a distinctive feature of mergers and acquisitions in China (Webre, 2007:Online).

4.5.2 Political Risk

China as a socialist country, has the typical features of a socialist economy such as central planning and command control, which have ingrained effects on the country's governing principles. Despite the Chinese government's attempts to develop a market-oriented economic system open to the world, those characteristics will still be immutable because they are intrinsic to China's socialist political system. The very substance of the Chinese political system dictates that the Chinese Communist Party is the only reigning party to hold power

over the country. Economic infrastructure determines superstructure. Therefore, strong economic development in China will only intensify the Chinese government's control.
The ruling party's central control is deeply embedded in its political ideology. As an inevitable result of the Chinese economic reform, complexity and preference become issues in China's policy, judicature and legislature, which directly affect their feasibility and practicability. It is evident that the Chinese government will maintain consistently powerful political control with regard to its emerging economic reform. Furthermore, when private and foreign business sectors grow stronger, the conflicts of various interests between businesses and the state may create greater risks.

Chinese economic reforms do not necessarily promote the country's political reform. According to the foundations of China's constitution, the Chinese Communist Party's reign may remain unchanged. However, the Chinese government's administrative reform, which took place in 1998, was to engage with and supply aid to the economic reform. Several departments were reorganised for functional transformation to perform macro planning, policy guidance, laws and supervision enforcement, and organisational coordination with laws and supervisions, as well as services to enterprises and society (Ma *et al.*, 2004:23).

After ten years of political reform, the country's economy has not yet converted to a competitive free market (Gao, Z., 2007:319), and continues to generate political risk to foreign investors conducting business in China. As evidence of command control, Luthans and Doh (2009:314-315), quote an analyst's complaint that, "...a series of recent moves by China authorities – price control, currency restrictions, limits on sales of state-owned companies – seem to reflect a showdown in the nation's effort to shift from a planned to a market economy. Whether such steps are justifiably cautious or simply timid, economists and business executives agree that they are likely to further deter trade and investment in the near future".

The corollary of China's political structure is that risks originate from China's political ideology and weak supervision. The structure of a one-party state follows a logical impasse of political monopoly and authoritarian rule. The Chinese government has accelerated economic development but has ignored the fall of moral standards and the increase in crime in society. When these risk factors gradually emerge, they by implication reflect on the reliability of due diligence, the reputation of Chinese business, and cooperation in respect of integration.

As a rule, government interference in cross-border mergers and acquisitions is a necessary mechanism to prevent harm to the host country's economy and employment. The debate is to what degree and to what extent a government should interfere. On the one hand there is a

strong need for the government to guide inexperienced Chinese businesses to compete in the global market. On the other hand, businesses demand a free market to grow in with less government participation. As the possessor of state-owned enterprise, the government has an obligation to protect the value of state assets and to ensure appreciation in the transfer of ownership via mergers and acquisitions. For this purpose, the government's interference in cross-border mergers and acquisitions has to be broad and comprehensive, which may be risky for foreign investors due to the concerns of the value, cost, conditions, and time involved in the process of purchase.

A further consequence of China's political system is the cumbersome bureaucracy, which is particularly frustrating for foreign investors to deal with. Bureaucratic officials are not uncommon in China. Their personal interests and powerful positions juxtaposed with 'social connections' have added to the complexity of normal administrative services. The complex rules and regulations also provide room for officials to interpret them as they deem fit. Berrell and Wrathall (2007:61), believe that the particular exploitation of personal power, blended with political ideology and economy reality confronts foreign managers on a daily basis by way of the convoluted process of doing business in China. Foreign business regards building such a relationship as a challenge but a required necessity to ensure successful investment in China (Zhu, Mckenna & Sun, 2007:356).

Personal power, which is above the rules and regulations in any economic system, is highly risky. Such a phenomenon infiltrates the business sector and more often than not over-utilised to facilitate officials' individual interests. The accumulative increase of these personal interest activities, leads to the breakdown of the normal economic order and equality bases in the entire society and further exacerbate uncontrollable economic crime. Berrell and Wrathall (2007:58), believe that Chinese officials frequently use economic outcomes as a means for promotion, while political achievement are focused on short-term strategies such as using infrastructure projects to drive GDP growth in a particular precinct. The weakness of supervision in China's current political system has encouraged the viability of politically involved economic crime. The recent exposure of corrupt officials has shown an upward trend involving larger amounts, higher positions and an increasing number of cases, indicating that the problem lies in the highly centralised system of China's political economy.

The host country's political and economic stability is a primary consideration in cross-border mergers and acquisitions. From a macro economic perspective, China's political structure of the ruling party is a positive factor, which allows businesses to gain a long-term stable economic dispensation in China. However, without a political competitor or independent supervision, the ruling party structure has a vulnerability that is harmful to the party's

governing performance. The superiority of a one party state would gradually permeate into the country's economic, judicial and legal systems. Consequently, this would weaken service delivery and encourage corruption and crime, resulting in significant risk to the entire economic system.

4.5.3 Economical risk

Influenced by the 1998 Asian financial crisis, the Chinese market had a large number of bankrupt state-owned enterprises. The common characteristics of these enterprises were overstaffing, low productivity, inanimate products, inefficient management, high debt, heavy social burdens (staff welfare) and huge losses (Zhang, 2006:78). As the owner of these companies, the state had to carry all the associated losses. Compared to the less affected private sector, the government realised that the state-owned companies needed radical operational transformation to resolve their engrained problems. In integration, the government decided to use foreign companies, especially large multinational companies, to restructure state-owned enterprises to improve their performance, and avoid carrying such losses. To support this decision, the government promulgated interim provisions for foreign invested mergers and acquisitions. Consequently, some state-owned companies were selected as available targets offered to foreign investors (Webre, 2004:Online). As a result, Chinese inbound mergers and acquisitions have been formally sanctioned since 2002. With a low price offer and huge marketplace, China quickly became a very attractive market for cross-border mergers and acquisitions.

The rapid increase of foreign investment has changed the Chinese market dramatically. Economic exponents such as inflation, balance-of-payments deficits or surpluses, and growth rate of per capital GDP, are indicators of the risk level of cross-border investment, and reveal a country's economic prospects (Shapiro, 2003:202). Table 4.1 below shows the Chinese economic statistics from 1981 to 2010 clearly reflecting amongst others an upswing in the economy over the period.

Table 4.1: Chinese Economic Statistics (**Source**: National Bureau of Statistics of China, 2011)

Year	Inflation (CPI) %	Deficit (¥ Billion)	GDP (¥ Billion)	Deficit/GDP %
1981	2.4	-3.74	489.16	-0.76
1982	1.9	1.77	532.34	0.33
1983	1.5	4.25	596.27	0.71
1984	2.8	5.81	720.81	0.81
1985	9.3	-0.06	901.60	-0.01
1986	6.5	8.29	1,027.52	0.81
1987	7.3	6.28	1,205.86	0.52
1988	18.8	13.40	1,504.28	0.89

1989	18.0	15.89	1,699.23	0.94
1990	3.1	14.65	1,866.78	0.78
1991	3.4	23.71	2,178.15	1.09
1992	6.4	25.88	2,692.35	0.96
1993	14.7	29.34	3,533.39	0.83
1994	24.1	57.45	4,819.79	1.19
1995	17.1	58.15	6,079.37	0.96
1996	8.3	52.96	7,117.66	0.74
1997	2.8	58.24	7,897.30	0.74
1998	-0.8	92.22	8,440.23	1.09
1999	-1.4	174.36	8,967.71	1.94
2000	0.4	249.13	9,921.46	2.51
2001	0.7	251.65	10,965.52	2.29
2002	-0.8	314.95	12,033.27	2.62
2003	1.2	293.47	13,582.28	2.16
2004	3.9	209.04	15,987.83	1.31
2005	1.8	228.10	18,321.74	1.24
2006	1.5	216.25	21,192.35	1.02
2007	4.8	-50.84	24,952.99	-0.20
2008	5.9	111.43	30,067.00	0.37
2009	5.5	950.00	33,535.30	2.83
2010	3.3	1,050.00	36,200.00	2.90

Inflation challenges a country's fiscal and monetary policies. The data reflected in Table4.1 were reviewed from 1981 to 2010 in order to compare its relative to other economic statistics. During this 30-year period, two periods reflect a double-digit inflation rate 'galloping inflation'. The first period from 1985 to 1989, the average inflation rate for the five years was 11.98 percent. The period from 1992 to 1996 show an average inflation rate of 14.12 percent, while 1994 the highest inflation rate of 24.1 percent was reflected. The inflation rate has been moderate since 1997, but rose again from 2007 when it was 4.8 percent, 5.9 percent in 2008 and 5.5 percent in 2009. The inflation rates published by the Chinese government is a controversial topic. Government statistics have triggered a dispute by economists and businesses on their validity and accuracy. Matter of fact being that the increase in the prices of materials and wages have already driven some companies to consider manufacturing in cheaper Asian countries. As a result, businesses need to be aware of the controversies when using data to analysis the investment environment. Compared with an average of 16.6 percent GDP growth rate of 2007, 2008 and 2009, inflation in China has been kept well under control.

The balance-of-payments deficit in China drawn from available data is under control. The statistical data of China's deficits for the last 30 years as published on the Internet reflect opposing data facts, and it is difficult to confirm the reliability of these figures as they are all published on the official news websites, but not on the central government's websites. The

statistics show that the deficits before 2000 were relatively insignificant compared to the GDP. Although the deficit numbers have increased dramatically from 2008 year on year, 2008 recorded RMB 111 billion, 2009 RMB 950 billion, 2010 RMB 1,050 billion (Ouyang, 2010:Online). It is of importance to note that the weight of these deficits in China's GDPs is all below the 3 percent safety threshold as claimed by the Chinese official announcement. Table 4.1 further reflects that China's GDP growth rate is strong despite the fact that the country's economy was harmed by the 2008 global financial crisis. The sharply increased deficits are due to the government's economic stimulus to boost domestic demand and offset the decreased export. Should the reflected statistics prove to be reliable, the analogy can be drawn that the Chinese market is safe for cross-border mergers and acquisitions compared to that of some Western developed countries.

Ma, Ye and Hong (2011:Online), cite 2010 statistics to argue that the Chinese government published data of deficits do not include the significant provincial debts. The real number may significantly exceed the safety threshold. According to the authors, the provincial government is under intense pressure to repay local debt which arose primarily from over-constructed infrastructures. The significant amount of debt forces local governments to seek opportunities of selling more land to increase revenue in order to settle debts. The revenue obtained by land relinquishment was as high as 65.9 percent of the local government's total revenue during 2010 (Ma *et al*., 2011:Online). This phenomenon explains why the central government has failed to control the continuous price rise of land relinquishment pertaining to China's 'overheated' property market in recent years. Although the Chinese government has not explained or acknowledged the existence of high levels of local government debts, the discussion at the People's Congress about concerns regarding the establishing of a framework for mitigating government debt risk and a risk warning system in May 2011, has proved that it is an urgent call for the resolution of critical risk issues of the Chinese local governments. Because of the huge local government deficits and high property prices, the central government has tightened credit policies for property borrowing from the beginning of 2011, which may slow down the pace of Chinese economic growth.

China has cheap surplus labour in the market, but recruitment can be challenging. In 2006, the total employment in China was 764 million, 119 million of whom were migrant workers (average monthly wage of US$120) and 362 million rural workers, which equates to 481 million unskilled workers (Xiao, 2009:Online). This group of workers do not have stable employment contracts and mainly work in the Eastern, more developed regions at the lowest wages possible. A huge number of workers were unemployed owing to the collapse of manufacturing industry in China's Southern coastal areas, and because of a decline in exports, which was caused by the world financial crisis. These workers have to look for jobs

in inland areas; which leads to a dispensation of worker shortages when manufacturers start to operate again, and further leads to labour cost increases.

The Chinese central government injected a RMB4 trillion stimulus package into the market during 2008 to sustain economic growth. Should the provincial investment plan be added to this amount, the total of the stimulus will reach RMB10 trillion (HSBC Global Research, 2008:2). In spite of the remedial, actions, government deficit remains high and inflation keeps on rising. The main government was tasked during 2011 to increase the national income and lower the inflation rate. Despite the negative issues, China still has a high GDP growth. The high inflation has escalated the cost of labour and materials, which reduces the profit margin of businesses in China. Reciprocally, higher priced products will reduce the domestic and global demand. These uncertainties in the Chinese economic environment need to be taken into consideration for cross-border mergers and acquisitions.

4.5.4 Policy and Regulation Risk

China's economic reform represents a significant milestone for China. Opening up Chinese markets to the world is an important and fundamental policy of China's economic reform, while peace and development are focal points in China's diplomatic policy. For foreign investment, a market-based free trading environment is paramount. To shift a 'planning economy' to a 'market-orientated economy', underpins the previous leader Deng Xiaoping's theory and which has been embraced by the Chinese ruling party as a significant guide to promoting China' economic reform. In terms of his ideological maxim, economic reform must be practiced inline with China's economic conditions. 'Development is the fundamental principle' and is the quintessence of Deng Xiaoping's theory (Chi, 2000:322-324). As a result, the success of the reform has seen China's GDP increase by 9 percent year on year (Chi, 2000:321).

In order to stimulate and support foreign investment, some preferential policies have been introduced, such as the exemption of tariffs and value-added taxes to foreign investors and import facilities for domestically funded projects initiated as from 1 January 1998. To access the Chinese market, foreign investment should be able to introduce advanced technology, encourage hi-tech industries, enhance the research and development of those foreign enterprises stationed in China, promote the system transition of state-owned-enterprises and facilitate the development of the Central and Western regains of China (Chi, 2000:344-346).

Chi (2000:346), is of the opinion that, "...any policies and regulations unfavourable to attracting foreign capital should be readjusted and the legal systems concerning foreign investment should be perfected". Despite having trading preferences, Western investors

remain to have concerns regarding China's foreign investment policies. Berrell and Wrathall (2007:62), emphasise that there is a significant loss of control in strategic areas of Chinese policies and regulations, in particular with the "rise of regionalism and corruption and the enormous growth in power of local officials". As a result, foreign managers in China remain perplexed by the various ways local officials interpret, administer and subsequently enforce the laws and regulations of what is outwardly a uniform legal code (Berrell & Wrathall, 2007:62).

Owing to a lack of constitutional rules, which define the division of authority between different levels in the structure of China's political system, policies in China continually change and are ruled over by officials without control (Lieberthal & Lieberthal, 2004:15, cited by Berrell & Wrathall, 2007:62). This dispensation weakens China's judicial system (Berkman, 1996, cited by Berrell & Wrathall, 2007:62). It implies that the implementation of policies and regulations at the local government level deviates from and does not comply with, the central government's macro control approach. Furst (2002b:134-135), states that in some cases foreign companies find that they have to deal with several political groups, including government representatives, local labour bureaus and union management, which makes the operation of running foreign companies operating in China more challenging than in the West.

Economic policies in the following areas have affected the success of cross-border mergers and acquisitions:

Inflation threatens China's economy. The government's RMB 4 trillion stimulus package budgeted for in 2008 has inflated China's economy. Price control is the Chinese government's primary concern, to be resolved by 2011. The current inflation surge on food prices and housing costs began in 2008, and food prices rose by 23.3 percent in that year (Zheng, 2011:Online). The consumer price announced by the government reached a high of 5.2 percent in March 2011, including labour cost escalations. The interest rate in China has risen five times since October 2010 up to July 2011 in an effort to cure inflation (Zheng, 2011:Online). According to Premier Wen Jiabao in April 2011 (Zheng, 2011:Online), the government uses reserve requirement ratios, interest rates and foreign exchange rates to eliminate the monetary basis for inflation. Apart from the increase in the interest rate and the tightening of monetary lending, the government has also introduced price fixing on foodstuffs such as pork, cooking oil, flour, and grain, and some other basic commodities (Asianews, 2011:Online; Yarong, 2011:Online). Such command control might be able to restrain current inflation, however in the long term it will result in small businesses shutting down and further cause a supply shortages.

Foreign exchange control: The currency market is a highly specialised and complex arena, and specialised knowledge is required to navigate within it. Foreign exchange-associated risks are of concern to participants in Chinese cross-border mergers and acquisitions.

The Chinese foreign exchange authority attempts to control exchange on imports overpricing, exports under-pricing, multinational companies charging expenses to their branches or subsidiaries in China, and foreign controlled companies declaring excessive dividends (Invest in China, 2006:Online). China's foreign exchange control is a partial control system, which in principle controls three dimensions in foreign exchange system namely convertibility on current accounts, certain control on capital items, and supervision and management of foreign exchange activities of financial organisation s (Invest in China, 2006:Online).

The convertibility of the Chinese currency under current accounts according to Investment in China (2006:Online) is presented as:

- "To implement banking settlement of exchange system on foreign exchange revenue of current account.
- To lift limitations on the foreign exchange payment of current accounts.
- To carry out the system of cancellation after verification on the exchange of import and export acceptance and payment.
- To check the authenticity of trade through customs declaration net checking system on import and export".

To manage foreign exchange receipts and disbursements of Chinese capital items, the control thereof is based on the principle of boosting the exchange of Chinese currency and creating conditions to abandon the limitation on the convertibility of current accounts (Invest in China, 2006:Online).

The supervision and management of the foreign exchange policies are aimed at exchange, settlement, and sales of financial organisations. A bank is required to check the authenticity of foreign transactions strictly according to regulations, to avoid the infusion of foreign exchange receipts and disperse disbursements under capital items into the exchange settlement, and to prevent the unlawful transactions from 'kiting' transaction through the channel of exchange, settlement and sale (Invest in China, 2006:Online).

Luthans and Doh (2009:314-315), indicate that the Bank of China recently announced new restrictions on foreign exchange convertible currency transactions flowing out of China. This control approach was officially described as a crackdown on illegal transactions. This move

creates difficulties for both domestic and international companies to transfer money in and out of China effectively (Luthans & Doh, 2009:316). Despite the adoption of such a strict policy, there was still RMB 800 Billion (US$123.6bn) ill-gotten gains smuggled out of China by Chinese corrupt officials from the middle of the 1990s to 2008 (Anderlini, 2011a:Online).

Foreign exchange rate: To encourage exports, the Chinese government has minimised the underlying exchange risk for Chinese business enterprises by adopting a fixed foreign exchange rate policy. Since the 1st of January 1994, China has begun to implement a floating exchange rate system based on market supply and demand as the formal mechanism of integrating Chinese currency with international exchanges. Owing to an upward pressure from the US Dollar during 2005, China changed the exchange rate regime by moving it into a floating exchange rate regime based on market supply and demand in line with a 'basket of currencies', as well as the continued appreciation of RMB by a small margin (Huang & He, 2005:1128). It is a major transformation for the Chinese government to reform the financial system to speed up financing, and especially to on a sustained basis open up the capital market. From a Western perspective, the Chinese currency has been under-valued. Since the 2008 worldwide financial crisis, Western governments have been pressing the Chinese government to appreciate the Chinese currency. In order to protect Chinese exports and foreign investment, and to avoid speculators utilising Chinese currency appreciation to disrupt the foreign exchange market, the government will continue to insist on a moderate policy for exchange rate control. From this perspective, the risk of foreign exchange rate fluctuation in China is not as high as that in the West.

Export is the primary mechanism of China's economic development. The government takes full advantage of cheap labour and materials to encourage foreign companies to manufacture in China. As a result, China has become one of the biggest exporters of consumer goods in the world. Since the 2008 global financial recession, China's exports however have decreased sharply. In order to help exporters to cope, the government has intensified supporting policies to facilitate exports, namely: Adjusted export tax rebate from the second half of 2008, and lowered or cancelled some export tariffs for a number of products and stabilised the exchange rate on Chinese currency to minimise exporters' exchange losses from RMB appreciation (HSBC Global Research, 2008:6). Consequently, exports have recovered and the first quarter statistics of 2011 show that Chinese export growth still remains strong (Zheng, 2011:Online).

Land Use: Land ownership and the right of land use are separated in China. In essence, urban areas are owned by the state, while rural areas and suburbs are owned collectively (Ma *et al.*, 2004:235). The land can be allocated for commercial use, however individuals and

businesses can also claim and purchase the right of land use from the local administration authorities for a certain period (Ma *et al.*, 2004:235). Land users have the right to transfer, let or mortgage the land use rights to other parties (Ma *et al.*, 2004:235). The terms of land use are negotiable according to the purpose for which the land is used. The use of land by many Chinese state-owned companies are based on arrangements with local government. Ma *et al.* (2004:236), point to the fact that if the Chinese partner let premises on land, which is allocated by the government, the leasing transaction is illegal unless the procedure of land use purchase has taken place. As a result, it is necessary for cross-border investors to check the status and terms of land use to avoid unnecessary costs or disruption of the deal. Prior approval for any proposed construction on a land must be obtained in advance.

Security: Stratton (1998:24), suggests that foreign companies do not overstep China's vague boundary between commercial research and alleged criminal activity to obtain business information. State secrets are of great concern and create confusion with foreign businesses, as similar economic and financial information would be considered public in the West (Stratton, 1998:24). State security is broadly defined, and ambiguity can create grey areas between permissible and forbidden activities. In China, the determination of a threat to state security from business activities may depend largely on political preference rather than legal considerations (Stratton, 1998:24). Stratton (1998:24), believes that the flexibility of the Chinese legal system means banks, insurance companies, and other professional service companies, who place a premium on information, are faced with the risk of state security, which is encapsulated in the law. Scrutiny of state security in China has been taken into account for cross-border merger and acquisition approval from March 2011. It is a significant step for China to accomplish legislation on cross-border mergers and acquisitions. Simultaneously, it also provides latitude for the government to tighten foreign investment policy.

Tax risk: Any business in China that has more than 25 percent foreign equity will be eligible to benefit from China's preferential tax policies (Webre, 2007:Online). The current Chinese taxation system was established in 1994 after a large-scale tax reform, in order to engage with the market-oriented economic reform (Jin & Chen, 2006:Online). The system includes 22 tax categories (in this respect see Appendix i), with 14 of them applicable to foreign investment enterprises and foreigners. The applicable taxes include amongst others income tax, value-added tax, consumption tax, business tax, and personal income tax (Ma *et al.*, 2004:232; Jin & Chen, 2006:Online). China has promulgated laws and regulations on governing tax collection and administration to reinforce tax collection and payment.

In China, the fiscal policy promotes taxation in various forms. The central government also authorises power to provincial governments in waiving taxes and reducing duties in their controlled territory to promote local and foreign enterprises (Jayaraman, 2009:60). For instance, local governments have the power to decide whether to raise a levy on 'Slaughter and Banquet Tax', to determine the rate of certain taxes within the scope of the central government promulgated tax rates, and also to enact rules on tax collection and administration (Jin & Chen, 2006:Online).

Local government's flexibility on tax can be used to attract foreign investment as a cost-saving advantage, but it also can be used to wage a price war against foreign enterprises. This political power leads to a disturbing consequence, which is that businesses have to build up and maintain sound relationships with local officials to obtain such benefits. Furthermore, it raises concerns regarding the validity of foreign companies' tax benefits and equality-based free competition between foreign and local companies in the Chinese market.

According to Jin and Chen (2006:Online), owing to concerns in respect of the number and the quality of foreign investment, China's tax authorities have attached more detail to the policy pertaining to foreign investment. The objectives of tax collection and administration of foreign invested enterprises, include according to Jin and Chen (2006:Online) the following:

- "Strengthen tax collection and administration of foreign-source income of Chinese residents (i.e. domestic enterprises and individuals: (1) Establishing an effective supervision mechanism for foreign-source income; (2) establishing and optimizing a tax declaration system for foreign-source income; (3) and carrying out strict foreign-source income tax audits.
- Taking a more centralized and stringent approach towards enforcing the transfer pricing laws to prevent taxpayers from avoiding taxes, establishing rules about research and development cost sharing and capitalisation, etc. to improve the independent innovation capacity of enterprises.
- Revising certain outdated articles contained in tax treaties with other countries to adapt to the new economic environment in China and other countries.
- Studying tax harmonisation and tax competition issues to give an impulse to development of the regional economy, especially the development of China-ASEAN (Association of Southeast Asian Nations) Freedom Trade Region.
- Building an international taxation information exchange system to strengthen China's cooperation in the field of international tax collection and administration with other countries".

Companies with more than 25 percent equity invested by foreigners or foreign companies can be categorised as foreign investment enterprises, and are obliged to comply with China's domestic and foreign taxation laws and policies. China has piloted special economic zones along the coastal areas to promote foreign investment with a much lower tax rate (See Appendix ii), of between 10 -15%, and various subsidies, which are provided by local governments. The economic conditions in coastal areas are quite different from those in the interior of China because of the distinct geographic features of the Chinese economy (Jayaraman, 2009:60). As a result, businesses who wish to establish Chinese markets in different regions need to be aware of the differences, and a full evaluation of investment conditions is needed to avoid unexpected costs.

4.5.5 Legislative Risk

"Scholars have observed that lawmaking in China is decentralized and fragmented, with government ministries holding enormous influence over the interpretation and implementation of laws" (Lubman, 1999; Tanner, 1999, cited by Gao, 2007:310). Fundamentally, China is a bureaucratic administrative country (Cheng & Rosett, 2003:16), with inherent complexity, abuse of power and regulations that are extremely susceptible to confusion, inefficiency, and bureaucracy. Since the various government agencies regularly issue new rules, regulations are in a constant flux, which creates difficulties for businesses to navigate (Gao, 2007:311).

The Chinese economic system is the product of its political ideology, with the political powers deciding its legislative forms. Ringe (2005:731), states that, "...ideology shapes preferences and outcomes, but maintains that the impact of ideology is mediated by the degree to which strategic legislative actors successfully link ideology to specific policy proposals through the provision of focal points". China's legislative system is established in a socialist society, and it is distinctly aligned with socialist principles and the preferences of the ruling party. The ideological influence of Chinese political preference shapes the process of deliberation of focal points (Ringe, 2005:731), for example foreign investment.

"On 1 July 1979, the *'Regulation of People's Republic on Joint Venture with Chinese and Foreign Investment'* was ratified by the second session of the Fifth National People's Congress, which was the first legal document approved at a national level after the policy of reform and opening was enforced" (Chi, 2000:343). Thereafter, laws and regulations pertaining to foreign investment were established in succession, which include enterprise establishment, utilisation of land, utilisation of labour force, import and export, conference norms, and taxation. Chi (2000:343), believes that the forms of laws and regulations of

foreign enterprises are based on that of the Chinese domestic enterprises. Table 4.1 below contains a summary of applicable laws and regulations to China's cross-border mergers and acquisitions (Rui, 2007:33).

Table 4.2: Summary of Chinese Laws and Regulations Applying to Mergers and Acquisitions (**Source:** Rui, 2007:33)

Name of the law	Effective Date
Several Provisions on Changes in Equity Interests of Investors In Foreign-Invested Enterprises	28 May 1997
Interim Provisions on Domestic Investment by Foreign-Invested Enterprises	01 September 2000
Regulations on Mergers and Divisions of Foreign-Invested Enterprises	22 November 2001
Notice on The Relevant Issues Concerning the Transfer of State-Owned Shares and Corporate Shares of Listed Companies to Foreign Investors	01 November 2002
Administrative Measures on The Acquisition of Listed Companies	01 December 2002
Provisional Measures on the Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors	01 December 2002
Provisional Regulations on the Utilization of Foreign Investment to Reorganize State-Owned Enterprises	01 January 2003
Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors	12 April 2003
Establishment of Companies with an Investment Nature by Foreign Investors Provisions	17 November 2004
Strengthening Foreign Exchange Control in Foreign Acquisitions	24 January 2005
Circular of the SAFE on Relevant Issues Concerning Foreign Exchange Administration of Financing and Return Investment Undertaken by Domestic Residents through Overseas Special-Purpose Vehicles	01 November 2005
Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises	05 August 2006

(SAFE: State Administration for Foreign Exchange)

Clarke (2003:113, cited by Gao, 2007:309), states that, "...simply describing the Chinese legal system in a way that makes sense of the observation is much, much harder than evaluating it, because . . . one must imagine several models and try them all out to see what kind of understanding they yield". To present a comprehensive insightful view and meaningful suggestions on regulations of Chinese cross-border mergers and acquisitions is an arduous objective. It is not only because of the anfractuous nature of the entire legal system, but also the vague and broad range of definitions of legislative articles. To attain clarity, requires detailed explanations. Contrary to this however, different authorities provide different interpretations based on their engaged political context, and some can be opposed

to each other (Gao, 2007:317). This is currently an insurmountable barrier in China's legal system due to the complex political environment. Consequently, the power of officials may be greater than that of the laws. The risk to businesses is that the outcome of legal compliance is uncertain owing to regulations that may easily be manipulated to suit specific outcomes.

Cross-border mergers and acquisitions of China's listed companies have experienced long and arduous 'journeys' to attain legality. In 1995 the Chinese government prohibited foreign investment circulating into the Chinese A-share market (Chinese domestic stock exchange) (Huang & He, 2005:1129). During that time, most of the companies listed in the A-share market were state-owned enterprises. The stock exchange regulations did not apply to foreign investment transactions. Prohibition was initiated due to foreign shares having already used regulation loopholes to enter into the A-share market. As the process matured by 2002, China's Securities Regulatory Commission, the Ministry of Finance and the State Economic and Trade Commission promulgated a law referencing the *Relevant Issues Concerning Transfer of State Shares and Legal Person Shares to Foreign Investors*. As a result, foreign investment mergers with and acquires of Chinese stock exchange-listed companies was permitted subject to terms and conditions (Huang & He, 2005:1130).

The current standardised regulatory framework of cross-border mergers and acquisitions is encapsulated in the amendment to the *Provisions on the Acquisition of Domestic Enterprises for Foreign Investors* (2006). It was jointly issued by the Ministry of Commerce, the State-owned Assets Supervision and Administration Commission and four other government agencies. The regulations provide primary guidance on the acquisition of Chinese domestic equity or assets by foreign investors. The regulations stipulate and simplify the approval procedure, and emphasise compliance of China's industrial policies of foreign investment. An acquisition cannot be used to circumvent licensing or industry sector restrictions (Webre, 2007:Online). Simultaneously, the range of permitted target organisations in the Chinese business context is vastly expanded, such as domestic enterprises, foreign invested enterprises, state-owned enterprises and listed companies. It is of importance to note that distinct regulations are applied to these entities as the permissions and restrictions on legal behaviours of each type of entities, are different.

Lack of integration and consistency is an issue in China's laws and regulations. Some regulations on cross-border mergers and acquisitions are rather unclear, which is demonstrated in the following examples:

- Too many regulations issued by different ministries, some even conflicting. For example, to determine the price valuation of a target organisation, different choices can be made on

the basis of: state assets valuation regulation, international institutions' acknowledged valuation, and tender offers.

- The performance levels of some authorities are low, results are poor, and some regulations may not be accepted by other authorities. As a result, this increases the cost of conducting normal business activities.
- The current regulations are embedded in a wide range of requests for detailed explanations, which creates difficulties in practice. Owing to different government agencies playing different roles, the lack of explanations, complexity and regulation contravention, confuse both business and the practitioner.

Jurisdictional system risks: Since China's accession to the WTO and the demand from foreign investors for transparency and rule of law, China has increasingly recognised overseas arbitration awards and rulings (Hoenig, 2006:Online). However, few judges in China understand and have significant experience in handling commercial disputes. Many of them succumb to pressure from government, which is of great concern for the justice and righteousness of Chinese judicial practice (Hoenig, 2006:Online). The author further states that even after receiving a favourable ruling, some companies have reported enforcement problems, for instance companies often find that authorities fail to implement judgements in bankruptcy rulings (Hoenig, 2006:Online).

Law enforcement risks: Law enforcement in China remains a problem as informal codes are largely based on personal 'connections' and relationships (Stratton, 1998:24). The lax law enforcement is especially troubling for foreign investors in remote regions of China, where local officials' power may go unchecked (Stratton, 1998:24). Large corporations tend to get a higher level government to intervene and help to resolve cases. Stratton (1998:24), claims that a Chinese partner's 'connections' or hidden agendas can create havoc with the most carefully formulated business plan.

The loosely defined legal system creates risks through various loopholes in the law (Jayaraman, 2009:56). These loopholes may be used by Chinese companies or introduced to foreign businesses, which could result in costly legal claims between foreign and Chinese parties (Stratton, 1998:24).

Corruption is commonly acknowledged by foreign companies as one of the most prominent features of the Chinese business environment. Despite the Chinese government having draconian anti-corruption enforcement, the Chinese legal environment still cannot offer adequate dispute resolution mechanisms to the public, but tends to 'breed' corruption

(Stratton, 1998:24). This indicates the central government's inability to control the situation (Stratton, 1998:24), and indicates the degree to which the problem is engrained in the regime.

Intellectual property risks: Foreign companies face significant risks in respect of intellectual property in China (Berrell & Wrathall, 2007:59; and Jayaraman, 2009:56). According to Jayaraman (2009:56), China is the world's largest producer of counterfeit products. Intellectual property threatens both local and Western businesses. From a Chinese business perspective, many Chinese companies do not value intellectual property as a foreign target would do (Schaub, 2010:Online). However, this demonstrates that Chinese companies have a much less rigorous approach to intellectual property protection. It is not uncommon for a Chinese company to sell technology over which it has no proprietary rights; therefore, trademarks and patent registrations must be cross-checked with official records (Schaub, 2010:Online). Within China's competitive markets, the Chinese government's weak achievement on intellectual property rights' protection has become a threat to businesses, especially international companies (Luthans & Doh, 2009:63).

From a foreign investor perspective, rampant counterfeit products have had a major negative impact on businesses. To confront such illegal behaviour without support from the Chinese government, society, laws and businesses, means that protection cannot be guaranteed. The attitude towards and punitive actions in respect of the breach of intellectual property rights by Chinese local government remain vague (Jayaraman, 2009:56). It is even more difficult to protect intellectual property in the context of information and communication technologies, which are rapidly developing and expanding (Levinson, 1997, cited by Berrell & Wrathall, 2007:63). Berrell and Wrathall (2007:63), argue that the magnitude of the current problem in respect of intellectual property in China is partially due to the intangible nature of intellectual property rights, and the inherent difficulties associated with detecting transgressions.

This argument ignores the fact that China has intellectual property laws, adopted from the West. In reality, requests to local government to set up law enforcement in respect of intellectual property will be more difficult than detecting transgressions. As a result of China's intellectual property administration, counterfeit products have actually boosted local economies, and lax law enforcement has spawned a significant number of small businesses, which culminates in the obvious analogy that counterfeit products contribute to the local government's GDP increase. If the ideology of increasing GDP growth has directed local government's attitude to and actions on protecting intellectual property rights, the road towards protecting intellectual property rights in China will be arduous.

Labour laws and trade unions: The Labour Bureau is responsible for enacting the labour laws and monitoring law enforcement. Local Labour Bureaus collect employees' basic information and open an account for each individual as a record. Labour law enforcement is flexible in China. However, law enforcement is naturally stricter for foreign businesses, to protect local employees' rights. From an employment perspective, it is always necessary for foreign companies to consult the local Labour Bureau for major hiring and dismissals, as there are always additional rules and requirements beyond the laws applicable at national level (Furst, 2002a:152). For example, in an area where foreign investment is highly encouraged, the local Labour Bureau may interpret the labour law in a manner conducive to trade. In contrast, a local Labour Bureau may be neutral or against foreign investment (Furst, 2002a:152). Foreign companies are required to submit resumes of their foreign employees to the local Labour Bureau for assessment in determining whether there are no local personnel available to compete for the same post before issuing a work permit (Furst, 2002a:151).

There is only one trade union that is recognised by the Chinese government, namely the All China Federation of Trade Unions (Cooke, 2011:314). "…The basic function and duty of the trade union is to safeguard the legal rights and interests of employees. While upholding the overall rights and interests of the whole nation, the trade union shall represent and safeguard the rights and interests of employees" (Article 6, from the Trade Union rules cited by Cooke, 2011:315). Martin (cited by Cooke, 2011:135), states that the Chinese trade union is the instrument of the state whose primary responsibility is to the state, and the interests of the state are not necessarily aligned with those of the workers. The trade union's main functions currently are to organise social events, take care of workers' welfare, help management implement operational decisions, organise skills training, raise employee morale and coordinate relations between companies and workers (Furst, 2002a:152; and Cooke, 2011:315). "Union officials generally lack resources and power, skills and legal knowledge to fulfil their collective bargaining role and to defend their members' rights" (Cooke, 2011:316). The extent to which unions fulfil their duties varies from company to company. The Union has more power of influence in state-owned companies than in private companies. As a rule, the union resolves disputes and conflicts of employees of Chinese state-owned companies. In private companies, the union merely participate in labour matters such as company affairs, labour disputes, restructuring and downsizing (Furst, 2002a:152).

Anti-monopoly law: The Anti-monopoly law in China was promulgated on 1 August 2008, and filled an important void in Chinese legislation (Chen, 2008:63). It is aimed to guard against and restrain monopolistic conduct, protect fair market competition, enhance economic efficiency, maintain consumer and public interests, and promote the healthy development of a socialist market economy (Lehman, Lee & Xu, 2007:Online). It is employed

to conduct anti-monopolistic trends in businesses, and applies to both domestic and foreign companies in China. The Chinese government's jurisdiction includes China and beyond the territory of China, where it eliminates or restricts unfair competition with the Chinese domestic market, including the use and abuse of intellectual property rights (Lehman *et al.*, 2007:Online).

The law targets three general categories of prohibited behaviour, namely 'monopoly agreements; abuse of dominant market position; and regulation of mergers and acquisitions or business concentrations'. It also has special provisions for government or 'administrative' monopolies.

An anti-monopoly examination is compulsory prior to the application process for Chinese cross-border mergers and acquisitions. Companies must notify the Chinese Ministry of Commerce of the contractual agreement when one of the following stipulated 'concentration' thresholds, has been reached:

- The aggregate global turnover from the previous financial year of the participators exceeds RMB10 billion, and at least two of those participators have a turnover exceeding RMB400 million each in China, or
- The aggregate turnover in China from the previous financial year of the participators exceeds RMB2 billion, and at least two of those participators have a turnover exceeding RMB400 million each in China (Bachrack, Huang & Modrall, 2009:Online).

The Chinese Anti-monopoly Law is the first version in the country's history, and still needs to be modified and adjusted from 'practice to completeness' (Blodgett, Hunter & Hayden, 2009:210). In terms of the Chinese government's uncertain law enforcement performance, it is risky for foreign investors who have merger and acquisition synergies to exceed the monopoly thresholds according to the Chinese anti-monopoly law in future.

According to Rao (2008:110), in the Chinese market, foreign investors have controlled the top 5 companies in almost all Chinese government authorised industries since 2007. Furthermore, out of 28 Chinese dominant industries, 21 are controlled by foreign investors. Currently nine of the top 10 global heavy machinery manufacturers already have Chinese partners (Rao, 2008:112). In the automobile industry, almost all Chinese brands have foreign interests, namely GM, Ford, Toyota, Peugot Société Anonyme, and BMW, controlling 95 percent of the Chinese automobile market and holding all the advanced technologies (Rao, 2008:112).

This strong upward trend has alerted the Chinese government to strengthen the security of the national economy with regard to foreign capital control. Rao (2008:112), predicts that 60 percent trade dependency, 40 percent fundamental energy resources dependency, less than 4 percent autonomous intellectual property, and a high percentage of foreign control of Chinese core industries, will result in a serious industrial security threat to China in the future. Furthermore, the author states the features of the Chinese inbound cross-border mergers and acquisitions as foreign investors mainly target Chinese companies, which have the potential for monopoly advantages in technology, regional markets, resources and privileges in that industry; and require a majority control of the investment, and a more than 15 percent return rate (Rao, 2008:112, 125).

It is evident that foreign businesses have much room to grow stronger in China's expansive markets, and some of them may possibly reach monopoly status. Despite the Chinese government's assertion that scrutiny on cross-border mergers and acquisitions will be tightened, the government's actual action on this matter is unknown. Whether or not the Chinese government will take action in respect of Chinese businesses' complaints against foreign giants, is also unknown.

National security review: The Chinese State Council issued a circular on the Establishment of Security Review System Regarding Inbound Mergers and Acquisitions by Foreign Investors, effective from the 5th March 2011 (Invest in China, 2011:Online). The security review applies to foreign invested mergers and acquisitions and shareholding modification of foreign invested enterprises wishing to obtain a shareholding control position in enterprises, which involve military related enterprises, major agricultural products, material energy and resources, fundamental infrastructures, important transportation services, key technologies, and important equipment manufacturers (Invest in China, 2011:Online). The security review needs to be applied and processed by the Chinese Ministry of Commerce for approval.

The security review aims to address four effects on the national security, including effects on productivity, domestic service affordability and related equipment and facilities on national defence; effects on national economic stability; effects on basic living conditions of society; and effects on key national technology research and design development (Invest in China, 2011:Online).

The purpose of the security review is not to increase the threshold of cross-border mergers and acquisitions, but rather to integrate the legislation of Chinese laws and regulations on foreign investment. The scope of the security review is broad, which allows government officials to decide which deal needs to be reviewed. This situation is potentially open to

corruption. The circular also has broad review contents. As a result, the review will rely heavily on the reviewer's own judgement and interpretation of the effects on national security. These ambiguities and broad definitions create difficulties for foreign investors wishing to comply with the regulations and to control the situation.

Rui (2007:15), states that the ambiguity of Chinese laws and regulations is caused by the multiple roles of the regulators and their conflicting interests. The lack of experience of the regulators has led to both under and over regulating laws in China. In addition, the regulators also lack practical experience in the field and reciprocally the market responds negatively. As a consequence, "...many laws are out-of-date, at odds with reality and current practices, and in need of amendment" (Peerendoom, 2002:13, cited by Gao, 2007:319). The risks associated with Chinese regulations echo the experimental nature of China's ongoing economic and legal reform (Lichtenstein, 2003, cited by Gao, 2007:319). Berrell and Wrathall (2007:62), claim that there is an urgent call to create a transparent and efficient legal environment in the current Chinese legal system to foster foreign investment. Risks in the Chinese legal system are difficult to resolve unless the Chinese government is willing to embark on significant political changes and tighten law enforcement.

As a major player in global trade, China is obliged to integrate international standards into its regulations, which are compliant with cross-border mergers and acquisitions. However, the 'roots' of risk at country level are embedded in the Chinese political, economic, and legal systems, culminating in risks, which cannot be changed simply by adopting international standards. Berrell and Wrathall (2007:63), believe that the legislative issues in China are complicated by Chinese society and cultural architecture. However, in China's fast expanding and inflated economy, imperatives and pragmatism have driven the Chinese people's attitudes, values, sentiments and ethics constantly towards power and self interests (Berrel & Wrathall, 2007:62). To find a suitable way to resolve China's own problems, transformation needs to be promoted by the government. It is critical for the Chinese government to build a governing foundation upon sound standards, values, ethics and attitudes to establish an enhanced system. However, selfish interest causes conflict in government departments and society imply that transformation will be a tough and time-consuming task (Berrel & Wrathall, 2007:62).

4.5.6 Chinese Culture Risk

The success of the Chinese economy may be attributed to the Chinese economic reform and development policies, as well as the Chinese culture. The distinctive Chinese culture and strong mindset make for a unique 'Chinese way' of doing business. Culture difference becomes an important consideration for foreign investors to invest in China. Yan

(2006:Online), believes that a report published by the Economist Intelligence Unit in Hong Kong points to the fact that the high failure rate of merger and acquisition activities are due to a misunderstanding of the business environment in China, and the cultural conflict between different firms. The author further cited a warning from Morgan Stanley, that companies who wish to have a successful merger or acquisition in China, should "open their eyes and grasp as much information as they can and be well prepared for the culture difference" (Yan, 2006:Online).

China has a long-standing history. To the West however, Chinese social and business activities are not only different, but also complex. The diversity of Chinese culture is formed by a multitude of factors, such as expansive territory, various landforms, many different religions, multi-ethnicity, 2500 years of feudalistic reign and various ideologies. The factors that affect the Chinese people's morals, values and behaviour are a mixture of philosophical ideologies, which were used to serve the feudalistic reign (Cheng, 2000:71-79).

China has various religions such as Buddhism, Taoism, Islam, Christianity and many others in small minority ethnic groups (Cheng, 2000:86). Buddhism has affected most of the Chinese people's beliefs for thousands of years, and it has been accepted by the West that Chinese culture is fundamentally influenced by it. In addition, the ancient Chinese philosophies formulated some 2500 years ago, are the soul of Chinese culture (Cheng, 2000:112). The typical representatives of the culture are Confucianism, Taoism and Mohism. In philosophical ideology, the Chinese people's values and practices are profoundly influenced by these philosophical concepts (Cheng, 2000:112). From a Chinese perspective, Confucianism affects the Chinese peoples' personal values and practices the most, and is prevalent even today (Cheng, 2000:71). Confucianism is represented by the philosophers Confucius and Mencius, whose doctrines have a strong focus on socio-political governance, and how people should comply with that governance (Cheng, 2000:72; and Wright, Berrell & Gloet, 2008:798). The concepts of Taoism are more focused on dialectical thinking and the individual's spiritual cognition (Cheng, 2000:71-75). Some of these concepts have proved valuable, even in today's practices.

As part of the Chinese culture, people's beliefs in these philosophical ideologies have changed gradually over time. The current cultural features are twofold, namely materialism and individualism, which penetrate Chinese culture deeply, and have left a distinct mark on the beliefs and values of the Chinese mindset (Gao, 2007:310). For instance, taking advantage of grey areas and loopholes in the laws and regulations has become embedded and considered a common phenomenon, particularly in the political and commercial sectors. Those able to discover at grey areas and loopholes are regarded as capable of promotion.

This results in that some traditional moral values such as loyalty, honour, compassion, integrity, helpfulness, humility and charity are disappearing.

Owing to the focus of this study, the detailed aspects of these ideologies on the Chinese culture fall beyond the scope of the research. However, for the purpose of completeness, the following aspects are drawn from Luthans and Doh (2009:141):

- High power – distance: Hierarchy of management rank is strictly classified. Lower positions serve the higher positions with less respect.
- Uncertainty – avoidance: Clarity and order are needed; people work hard in stable careers and abhor defiance.
- Particularism: Gives greater attention to the obligations of relationships and unique situations.
- Collectivism: Places the emphasis on shared benefits and judges individuals by what they put in.
- Neutral culture: Spawns business relationships which are focused on objects.
- Specific behaviour: Places contracts before personal concerns.
- Ascription-orientation attitudes: Awards status according to birth, kinship, gender, age, connection, school, etc.
- Conservative ideology: Lack of venture and innovation.
- Family-based: Lack of contribution to the society.
- Self-importance, as opposed to democracy.

Cultural differences in business challenge the integration of cross-border mergers and acquisitions. The following aspects are the primary risks associated with Chinese business culture, which serve as the parameter for businesses to avoid unnecessary misunderstanding and wrong decision making.

Social Connections: In the process of mergers and acquisitions, foreign companies have to deal with many different government authorities and officials, and without having internal personal connections, negotiations can be much more difficult than anticipated (Luthans & Doh, 2009:141). The attention of the reader is drawn to the fact that the terms 'social connection' and 'connection' will be used interchangeably in this thesis. For the purpose of clarity of interpretation, the terms 'social connections' and 'connections' refer to, "…a body, or circle of persons connected together, or with whom one is connected by political, religious or commercial ties" (Oxford Dictionary 1962:372), while the Collins Dictionary (2007:358) refers to the term 'connection' as 'acquaintances', especially who is influential or has prestige. In this thesis 'social connections' and 'connections' will refer to 'acquaintances' or friends of a group of people or a person in an organisation who could facilitate by using their influence or

prestige, the outcome of a particular aspect pertaining to a cross-border merger or acquisition. As an important feature of Chinese culture, using 'connections' to do business has become the rule rather than the exception and permeates all areas of business in China, for example in marketing, recruitment, financing, outstanding payment, tender bidding, product accreditation, and law suits (Luthans & Doh, 2009:142, and Solomon & Schell, 2009:113-117, 125-127). Originally, Chinese connections served as an effort to avoid distrust. In current Chinese business dealings, it has become an important and necessary tool of access, which invariably leads to power abuse. When such abuse turns to a common acceptable social scenario, it leads to a vicious circle of abuse in society. In the Chinese culture, the ideology of relying on connections, is that connections can solve problems, but connection abuse also has many problematic concomitants, such as illegal businesses, hidden 'tricks', a breeding ground for fraud, bribery, corruption, nepotism and other unethical behaviours (Hoenig, 2006:Online). As a result but also a cause, in an incomplete and lax legal context such as China, connection abuse is strengthened by power abuse and further forms of powerful interest groups to facilitate and satisfy individuals' interests and benefits. This is also the cause of the phenomenon that the individual's power is greater than the power of the law. The fact is that power abuse creates stumbling blocks for doing business through normal channels, and connections may seem to be the only solution. This has been the experience of many foreign companies in China.

Axiology: Chinese people's values are traditionally of a high standard. However, this has also changed gradually since the start of the economic transition. Currently, an increasing demand for financial and material well-being has become a top priority for employees, which disrupts employment performance in foreign companies (Luthans & Doh, 2009:143). In today's Chinese society, impressive appearance becomes an important measurement to judge a person's ability to deal with individuals and businesses. More and more Chinese people believe that wearing exclusive clothing brands, operating from luxury offices, and using expensive vehicles represent success and can disguise disregard and ignorance. This trend is demonstrated by the fact that China was the biggest luxury goods consumer country in 2010. Luxury gifts are also used to maintain connections and to gain an important relationship. Controversially, many examples of fraud have warned businesses that impressive appearances can mislead the judgement of a business. To avoid such misleading notions and to perform due diligence for the real value of assets and equity of a target organisation, a proper examination of assets and liabilities, operation functionality, and business performance is essential. Judgement based on the appearance of a company, may lead to poor decision making.

Communication: It is well documented that failure in mergers and acquisitions arise from ineffective communication (Gadiesh *et al.*, 2001, cited by Hoang & Lapumnuaypon, 2008:61-62). The essential aspect of communication is to ensure that information can be transferred and exchanged correctly and appropriately to the key shareholders and decision-makers. Communication is particularly important in cross-border mergers and acquisitions, where many conflicts are caused by misunderstanding and miscommunication. The preferred communication style in the Chinese culture is indirect information transmission, which is especially used in businesses (Trimarchi & Liesch, 2006:1211). For example, the rejection of a partner's suggestion may be presented in such an ambiguous way to actually support the suggestion. More often than not, this means communication can be difficult even for Chinese to understand, which is contra to custom in the West (Trimarchi & Liesch, 2006:1213). Regarding the loss of integrity demonstrated to their Chinese counterparts, foreign managers' behaviour of showing anger, grief or aggression is considered weak or unacceptable communication behaviour (Jayaraman, 2009:57). In addition Luthans and Doh (2009:142), believe that Chinese people are much less animated than their Western counterparts; they avoid open displays of affection, and would not for example, slap each other on the back. In the process of cross-border mergers and acquisitions, communication in integration is directly related to the success or failure of the project. Both Chinese and foreign companies often fail to interpret and present their expertise via communication in a way that their counterparts will understand.

Transparency: Lack of transparency in China is partly due to connection abuse. In order to maintain small groups' interests and maximise benefits, material information normally is held confidentially within that group. In Chinese business, information such as financial reports, human resources, credit records, legal matters, and subcontractor lists are regarded as business secrets. Lack of transparency has become a concern of foreign investors on the extent and reliability of information received in due diligence performance. Fox (2008:Online) and Hoenig (2006:Online), believe the risk to the investing company is that the information made available for mergers and acquisitions is often exaggerated or false. Hexter and Woetzel (2007:105), support the opinion that the source of information in China is a holistic problem for international companies. Lack of transparency also conceals the real business problems, especially in complex affiliated business relationships. These affiliated relationships may involve owners, subsidiaries, owners' life partners and relatives, top managers, officials, and official's relatives. These relationships have formed a strong interest group, in which the members are inextricably bound together in holding information and operating within their own rules. Therefore, it is difficult for outsiders to break into this network to gather material information. Having affiliated companies with normal business

transactions is incontestable; however, if the required information exposure is absent, it very likely involves a hidden agenda.

Negotiation: Zhu *et al.* (2007:354), maintain that the behaviour of Chinese negotiators are difficult and unintelligible compared with that of Western negotiators. "Negotiating with Chinese can be very challenging and [they] are frequently recognised to be some of the toughest negotiators in the world" (Zhu *et al.*, 2007:354). Negotiation in the Chinese culture is a tactical skill that often involves intermediaries and connections to build trust; these bring conflict during the negotiation process (Jayaraman, 2009:57). A fundamental aspect of these negotiations is that both parties are able maintain face value during the negotiations. Westerners often miss this important point and are confused by the Chinese indirect way of communication in negotiations. For example, 'think about it' would as a rule mean 'consider', however from a Chinese negotiator perspective it could also mean 'no'; while 'maybe' could also mean 'no'. Unclear strategies and motives often confuse Chinese company's negotiations. Other factors such as different styles of communication, different decision-making procedures, closed mindedness, and shrewd and tenacious behaviour, will also exacerbate risks in negotiations between Chinese and Westerners (Zhu *et al.*, 2007:356; and Jayaraman, 2009:57).

The above-mentioned culture risks are accepted in Chinese business, and are common risks for foreign investors. Chinese people's values, intellectual processes, and social influences such as transparency and personal motives, are embedded in procedures of communication and negotiation, which can lead to misunderstanding and confusion for Westerners. Respect and loyalty are the cornerstones of traditional Chinese harmonious society (Creel, 1949; Nivison & Wright, 1959; Wright, 1960; and Chinnery, 1996, cited by Berrell & Wrathall, 2007:63), and have been an integral part of social etiquette for thousands of years. However, these characteristics also contribute to the aforementioned risks in Chinese businesses. As a result, compliance with laws and regulations is significantly reduced. Morality becomes a means of maintaining the social order – the prevailing moral and social codes, negotiation, mediation and compromise serves as ideal solutions for laws and regulations (Chen, 1993, cited by Berrell & Wrathall, 2007:63). Since foreign companies become part of the Chinese business environment, following the Chinese code might be the solution to operating in China. However, this means that the violation of laws and regulations in China will be encouraged by foreign investors. As a result, these risks in the Chinese business environment will be aggravated and further create increased conflict between the Chinese government and society, thus threatening the entire business environment.

4.6 Risks at Business Level

When Western countries started to experience rapid growth after the Second World War, China closed its doors to the outside world and focussed on building a new country with the inauguration of the Communist Party in 1949. With strong socialist principles and policies, commercial trade was restricted, and private factories, stores and land were confiscated from individuals and owned and controlled by the government (Pan & Wei, 1997:399). The Chinese economy was extremely poor at that time. From 1949, when the People's Republic of China was established, until the economic reform in 1978, private trade in China was restrained (Pan & Wei, 1997:399). Collective working and sharing were the main economic activities (Pan & Wei, 1997:399). As a result of the socialist economic development, China had almost a full century of economic retardation in comparison with America (Xie, 2005:Online). Poverty, the stagnant economy and huge economic disparities forced the ruling party to seek solutions for the country and the Party's future (Wu, 2009:Online). Transformation started in 1978, while both private trade and foreign investment in China were formally permitted and encouraged by many newly introduced policies (Wu, 2009:Online). After a long period of minimal productivity and material deficiency, the Chinese markets, with a population in excess of one billion, were suddenly boosted by a surge in demand and supply (Wu, 2009:Online). This phenomenon has accelerated China's economy development over the last 30 years, to extend its borders in unprecedented proportions.

When China opened its doors to trade with the world, there were serious issues that urgently needed attention in the likes of: low GDP; low agricultural production; low levels of productivity and industrialisation; and a large population, the latter of whom were uneducated or with low levels of education. China faced a decided lack of a framework, principles and relevant examples upon which to build its economy (Pan & Wei, 1997:3).

Against the above background, China still struggled with the performance of cross-border mergers and acquisitions, although China's economic reform has achieved significant success. These limitations at business and management levels are derived from Chinese history and culture, and therefore cannot be avoided. In fact, the current economic outcomes in China represents an accumulation of basic supply and demand in a large population with low production and poor infrastructure. As a result, the Chinese economy has the distinct features of intensive and cheap labour, cheap materials, low technology, resource waste and environmental pollution. To improve the level of industrialisation and technology, education need to be improved, which China has attempted to do. However, improving education is a long-term strategy, and transforming knowledge into industry, commerce, agriculture and technology needs sufficient time for training and practice. In China's 30 years of

development, despite big cities having adopted a modern Westernised image, and large manufacturers having imported top quality machinery, Chinese thinking and management are still inadequate. This scenario results in business conflicts when Chinese businesses integrate with top managerial levels in Western businesses. In evidence of this statement, the integration failure rate in Chinese cross-border mergers and acquisitions is high (Ho & Koh, 2007:5). Therefore, due diligence at a Chinese business level is of importance in attaining successful synergy. The following factors are perceived as being 'at risk' at business level namely accounting, currency, human resources, legal and culture, and is elaborated upon in detail below to emphasis their importance to cross-border mergers and acquisitions.

4.6.1 Accounting Risk

Rui (2007:21), believes that accounting in China is not only a matter of a lack of standards, but also credit ratings, which are impaired by weak legal performance. Accounting standards, as the most important measuring mechanism of business performance in China, still have a long way to go to meet global international accounting standards. Peng (2006:27), cited by Ho & Koh (2007:5), states that Chinese state-owned enterprises (not limited to state-owned enterprises only) often maintain three sets of accounting records, namely one set which exaggerates performance to present to administrative superiors; one set which under reports performance for tax purposes; and a third set, which is accurate, and which is for internal management use only. Consequently, companies normally lack accounting reports and management information services (Gtnews, 2006a:Online). The situation in smaller state-owned companies and private companies is even more severe, as the requirements for accounting statements are lower. As a result, they have even less transparency and poorer quality financial information. Ho and Koh (2007:5), believe China's publicly held accounting records are often unavailable and even if made available, are unreliable.

In China, cash is the most favoured form of payment compared to credit and debit cards. There are other available forms of payment in the Chinese payment system, namely, promissory notes, bank-accepted drafts and commercial-accepted drafts. However, 80 percent of payments are executed via telegraphic transfer and the rest are executed using cash (Gtnews, 2006a:Online). This means Chinese companies demand cash payment rather than credit; both telegraphic transfer and cash payments require sufficient working capital, which results in a cash liquidity burden on debtors. Cheques are common in a Western cash payment market but are not widely used in China, owing to their having a 10-day validity limit and being subject to fraud (Gtnews, 2006a:Online).

In China's highly competitive market, low cost, low prices, fast-changing products and better services are essential for survival. From a financial perspective Wegner (2005:Online), points out that because Western buyers prefer to use open account terms more than a Letter of Credit due to the undesirable limitation on free cash flow and bank fees, Chinese companies are persuaded to use open account terms. However, having due concern for the risk of non-payment and financing implications involved with open accounts, Chinese companies still prefer the use of A Letter of Credit.

Listed companies in China have a duty to report any major financial transaction to the China Securities Regulatory Commission and are audited by international auditing firms (Gtnews, 2006a:Online). Accounting issues listed below appear more in China's state-owned enterprises and private companies than in listed companies (Gtnews, 2006a:Online).

- The accounting data of the dealers are not very reliable.
- Difficulty in obtaining reliable financial data on companies.
- The balance sheet reflect hidden agendas, such as off-balance sheet items and 'dressing up' unpaid loans.
- Significant variance from province to province in accounting standards enforcement.

Hidden issues in asset ownership transfer in state-owned enterprises also confront acquiring companies (Zhang, 2009:435). Examples of such issues are elaborated upon below gleaned from Zhang (2009:435)

- The ambiguous property rights between the target organisation and target's parent organisation, which existed before the merger or acquisition create dissension when the new management takes over the legal obligation in practice.
- The ambiguous property rights between the target organisation and its subsidiaries. The asset transfer between subsidiaries is normally under the instruction of the parent organisation and is not concluded through a legal procedure for tax- and cost- saving purposes. As a result, it is very likely that the owner and the user of assets are different entities.
- Indistinct relationships pertaining to assets, liabilities, outstanding tax, labour issues, and rights and obligations within the target company. For instance, a reformed target organisation may still have state-owned assets that are not transferred and excluded in terms of accepted accounting practices, leading to associated exempted taxes, which are not claimed.
- Assets are registered under the employee's individual name or another company's name, however the actual owner is the target organisation. This issue occurs due to an asset not being transferred on time after the agreement was reached.
- Pending lawsuit between the target organisation and a third party.

Accounting firms are mainly used for preparing audit statements for tax purposes in large state-owned and private enterprises. The role of the accounting manager is that of accounting data collection and compiling accounting reports. As a rule, accounting managers report to general managers and lack power in decision-making. Norton and Chao (2001:Online), are of the opinion that, "...corporate accounting is frequently lax by foreign standards in China... particularly state-owned companies are accustomed to rigid secrecy policies and may be uncooperative in disclosing their records". The major challenge in due diligence is the lack of proper documentation and the target organisations' reluctance to provide material information.

Western companies manage credit risk by analysing collected information from credit records. China has not established an efficient credit management system (credit information database) to reduce credit risk. The fundamental challenges facing companies in China are the lack of an available credit information database and unreliable credit records (Gtnews, 2006b:Online). The solution to managing credit risk in China is to build an interactional trust relationship with debtors. This type of relationship in business is an intangible asset that affects business globally. The relationship is established through various avenues. It can be through a long period of business interaction, established by influential government officials, or guaranteed by other companies who have already built a good relationship with a particular organisation.

In general, accounts payable is high in Chinese businesses and credit can be sustained for a long period. Credit periods can span three to six months or even one year, depending on the negotiation. Chinese companies use the account of inventory to adjust sales in order to minimise tax, so it is very challenging to decrease credit terms in China. As a result, many of the figures of the inventory and the sales in financial statements does not reflect actual figures (Gtnews, 2006a:Online). Furthermore, there is a significant risk when companies offer a 60 to 90 days credit term and thereafter receive a 100 percent bank guaranteed draft, which is due in six months (the maximum draft credit period for Chinese banks), which can hike up the credit period to nine months. As a result, the interest charged on credit drafts is normally lower than loan notes, culminating in this approach of paying for credit, which is popular in China, and creates a huge risk for cash flow management. Gtnews (2006b:Online), expressed the opinion that in the case of an unpaid debt, companies have very little legal power to reclaim the debt. Foreign companies, who wish to approach a Chinese court, need to take a fairly conservative approach, because recourse through the court to recover bad debt is ultimately convoluted and difficult (Gtnews, 2006b:Online).

In China amongst others, intangible assets include the following: Trademarks, patents, proprietary technology, copyright, concession, computer software and network technology, domain names, preferential contracts, commercial secrets, labour assembly, commodity credit, supplying networks, property access, and leasehold (Gu, 2010:268). According to Clause 24 of the Chinese Company Law, intangible assets are stipulated for industrial intellectual property rights, which include trademarks and patents, non-proprietary technology and property access (Gu, 2010:268). The number of industry property rights and non-proprietary technology cannot exceed 20 percent of a company's registered capital as investment capital. In the practice of cross-border mergers and acquisitions, many Chinese well-known trademarks have been lost without having intangible assets being valuated (Gu, 2010:268).

4.6.2 Currency Risk

Foreign exchange transactions are considered to be amongst others some of the primary considerations when merging or acquiring a cross-border enterprise. Baker and McKenzie (2005:23), contend that this is of particular importance, as the Chinese government imposes significant control on foreign exchange transactions. During the planning economic system period, China adopted a highly centralised currency policy. Although the policy has been changed significantly in the market-orientated economic system from a fixed exchange rate to a relatively flexible exchange rate, the extent of a floating currency is insignificant.

The surging increase of foreign investment affects the demand for the Chinese currency (RMB/Yuan), which challenges the Chinese government's exchange rate policy. To reduce speculation on the Chinese currency, the People's Bank of China has since 21 July 2005 floated the currency in a 'tight band' against a basket of foreign currencies. Notwithstanding, the fact that foreign investors deem the Chinese currency not yet freely convertible in the international foreign exchange market (Baker & McKenzie, 2005:23). It is difficult to convert investments back to hard currency once the money has been converted to RMB and registered in the acquired company's capital account (Norton & Chao, 2001:Online). Despite this, the Chinese government's stable exchange rate policy has mitigated the risks materially for businesses. As a result, it is unnecessary to hedge foreign exchange risks when the foreign exchange rate is stable. Since the Chinese currency has appreciated moderately, businesses need to manage the associated risks from a long term perspective. A survey done by Li and Ma (2007:26-27), found that the number of Chinese companies hedging foreign exchange rate risks is low, and it is unclear what assessment methods are used to determine foreign exchange risk exposure.

4.6.3 Human Resource Risk

Human resources is another important factor in process of integration required for a merger or acquisition, calling for the requirement for a due diligence to include the identification of how businesses conduct such issues. Furst (2002a:143), contends that labour policies and regulations in China are constantly changing, and hiring staff in China needs to comply with both national and local labour regulations in line with local and foreign employment requirements and dictates. Businesses also need to be aware of the associated risks and cost (Furst, 2002a:143). Thorough due diligence and pre-assessment of the cost of human resources in China, is an important step for mergers and acquisitions valuation.

The challenge of managing human resources in China is that 'connections' play various roles, which complicates the employees' work environment. For example, having the right 'connections' is critical for landing a decent job, and often more important than having the necessary skills and training (Fox, 2008:Online). Chinese employees are generally self motivated, however in China's competitive environment, people often depend more on (and prefer to use) 'connections' to get jobs, especially government posts. This often lead to employees filling positions for which they are unsuitable or incompetent, especially in state-owned enterprises. When a merger or acquisition takes place, maintaining key talented employees and terminating inefficiencies to achieve cost savings, become a challenge. It is recommended to do a thorough investigation before making rash decisions, as some employees who lack technical skills and abilities may have strong political 'connections', and dismissing them may prove problematic going forward.

Chen (2007:Online), an HR manager employed by a foreign company, lists a few traits of Chinese people in the workplace:

- **Personal loyalty:** Chinese devote a significant amount of time to internal strife among departments or among small cliques and individuals.
- **Disregard for rules and regulations:** The mindset is that connection places one above laws and regulations.
- **Evading responsibility:** Chinese workers including top managers evade responsibilities and often shift their responsibilities to subordinates.
- **Lack of sincerity:** Reluctant to speak freely in a meeting but criticise privately afterwards.
- **Jealous of colleague's rewards:** A rewarded colleague can be targeted by means of refusing to assist him/her and intentionally setting up barriers.
- **Contempt:** Widespread contempt for others is a common phenomenon.

Payroll costs include salaries, allowances, bonuses and other benefits. Salaries increase annually in China. Salary costs are generally higher in an international corporation. If a

retrenchment or dismissal needs to take place, the fees need to be identified and clarified before the deal is finalised, which is normally negotiable with the target organisation and the local government (Furst, 2002a:144). Valuation and negotiation are important steps in avoiding unexpected costs for future operations. As the Chinese employees of the target organisation expect higher salaries from foreign investors, ignorance concerning increases can trigger a troubled partnership and employee strikes, and adversely impact on the business strategy implementation, in particular in Chinese state-owned enterprises.

Chinese 'cheap' labour is shaped by large-scale migrations from rural areas to cities and from small cities to big cities. For security and administrative control purposes, the Chinese government sets up strict administrative rules particularly for migrations in terms of a system known as 'hukou'. The term of 'hukou' refers to the origin of a particular person. With regard to migrants, the consequences of these rules include: Extra costs for residing in a new location, fewer rights of property purchase, extra temporary residence administration fees, and fewer opportunities for future generation education. These hurdles create significant difficulties for qualified and skilled employees to relocate into other areas, especially for those who have attained the desired 'hukou' location status (Furst, 2002a:148). As a result, foreign companies have to provide attractive salaries and allowances to recruit the most suitably qualified staff.

In recruiting top managers Furst (2002b:136-137), points out that finding the best employee to fill key management and technical positions is challenging for foreign companies. Furst further suggests that people of different cultures and linguistic backgrounds are often the best choice to fill such positions. However, employing such individuals involve a great deal of operational responsibility. From a human resource management perspective, there are also many human resource practices that unwittingly increase a company's risk of fraud and corruption, such as matrix management, downsizing, and expatriate management rotation (Furst, 2002c:178).

Few Chinese companies can comply totally with labour laws and associated obligations. One reason for this is that employees prefer to use their 'connections' to solve problems as opposed to using the law to protect their legal rights. Employees are aware that their companies will have their own connections in the Labour Bureau and therefore the chance of winning a legal claim against the company is slim. As a result of powerful connections, labour issues may surprise many foreign companies.

"One due diligence report found that 220 of a target (organisation)'s 350 workers were classified as disabled, which enabled the company to take advantage of the value added tax

exemption for certain enterprises employing disabled people of more than 50% of their staff. However, none of the employees actually performed work for the company; rather the company's workers were found to be employed by a third party" (Schaub, 2010:Online). Cases like this indicates that proper and solid due diligence is vital for cross-border mergers and acquisitions.

4.6.4 Legal Risk

Legal risk at business level refers to risks embedded in Chinese business. Regarding legal risk, more attention is usually being directed to risk at the country level; however to perform proper due diligence, risks at business level are more critical.

In general, listed companies have better legal compliance than unlisted companies in China. However, embezzlement and misappropriation of public funds are prevalent problems in listed companies (Yiming, 2011:Online). It is especially common to transfer money to affiliated enterprises by internal transactions. Other examples include the illicit distribution of profits and reserves, market abuse such as monopolising the market, misusing information to mislead the market, and price fixing (Yiming, 2011:Online). False financial statements and 'juggling' of financial figures are other examples of fraudulent activities.

Luo (2006:Online), lists three features of Chinese financial crime, namely

- IT, high-tech and financial instruments are used for financial crime.
- Bribing officials to obtain illegal profits and escape from the crime charges.
- Becoming more sophisticated and globalised.

There are strict laws in China against financial crime, which includes two new laws namely 'anti-corruption' and 'anti-money laundering' laws. Owing to Chinese businesses being able to build a wide net of connections in all areas, financial crime becomes an increasing problem in China. Aligned with this is the 'secret code' of Chinese business and society and 'loose' law enforcement. Simultaneously, the possibility of a costly legal dispute arising between foreign and Chinese businesses remains a significant risk for investors (Stratton, 1998:26). Many foreign and Chinese business partnerships established in the 1999s ended in costly separation (Stratton, 1998:26). Many Chinese business behaviours are perceived as risky to Western business, such as intellectual property. Chinese markets are competitive, which compels businesses to move fast to market new products on a sustained basis, as well as to obtain and retain customers.

Luthans and Doh (2009:63), state that research has shown that piracy, counterfeiting and industrial spying still threaten business operations in China. The authors also found that the Chinese government does not have clear legal definitions for these activities (Luthans & Doh, 2009:63). Furthermore, industrial spying has increased over the years, increasing risks to international companies, as Chinese partners break business agreements and walk away with patents and capital, or simply start a new operation that competes directly with the original venture (Luthans & Doh, 2009:63). Berrell and Wrathall (2007:59,) believe that intellectual property violations are caused by Chinese managers who are more influenced by Chinese national culture rather by than the rule of law. Such attitudes also result in the undervaluation of Chinese businesses, as the value of intellectual property is largely not taken into account.

4.6.5 Business Culture Risk

Unlike financial performance, cultural risk at business level is not easy to measure. With the diverse nature of Chinese society and economy, Chinese culture differs from region to region. Each region follows its own level of business structure, leadership and management capacity. From a development perspective, doing business in Eastern China is less risky than in the West, and the South is less risky than the North. Cross-culture management demands harmonious cooperation between acquiring and acquired companies, and integration within Chinese business culture, is perceived as difficult by Western businesses.

Hierarchical and egalitarian behaviours are two typical features in Chinese business culture. Attitudes toward hierarchy and egalitarianism have a pervasive influence on the sense of empowerment and autonomy, leadership, decision making and teamwork within the business environment (Solomon & Schell, 2009:82). In terms of internal company management, hierarchy is a sense of power and benefits higher management levels, while egalitarianism is a sense of value and recognition at the same management level. In terms of external company management dealing with government officials, is also subject to this code. For instance, if a company sends employees or low level managers to receive a government examination committee, the company will be considered as less suitable or incompetent with regard to government work opportunities. In contrast, if they are received by high level managers, they will be satisfied and the examination may be passed easily. Egalitarianism is demanded in internal business, which may cause conflict in employees and management if not performed well. Foreign managers may not be aware of the sensitivities involved within such working environments, and this will result in conflict between top managers. This in turn may lead to the failure of their objectives, and often delay the pace of integration.

Few directors or top level managers are able to communicate in a second language in China, which makes translators indispensable. The understanding and knowledge of the translators pertaining to business and culture issues, may directly impact upon the results of mergers and acquisitions (Christozov, Chukova & Mateev, 2006:148).

Chinese business culture focuses on networking, harmony and seniority. Personal judgement and aspiration frequently drive individual behaviour. Wright *et al.* (2008:803) found that self-achievement generates more excitement than team achievement in Chinese businesses. Chinese workplace behaviour is more complicated than simply acting according to practical judgement (Wright *et al.*, 2008:803).

Compromise is another trait common to the Chinese business culture, which is widely used in business operations, management, and negotiation. The concept of Chinese compromise in business represents the balancing the interests of potentially discordant elements from holistic approaches, to a forward moving unity (Chen, 2002:179). In practice, the concept can be applied at both personal and business levels. Chinese compromise has its advantages in dealing with paradoxes, but it differs from the Western method of breaking the whole into parts, which can easily create divergences during integration and cooperation (Chen, 2002:179).

Chinese companies are accustomed to rigid secrecy policies and are uncooperative in disclosing business information, which creates difficulties with regard to due diligence. The above perceived risks in Chinese businesses are ubiquitous, any default or ignorance in these categories can result in conflict in integration. To avoid such uncertainties, foreign businesses have endeavoured to arrange comprehensive representation and secure warranties and indemnities for breach from Chinese partners, but find such practices extremely challenging (Norton & Chao, 2001:Online). From many failed cases, Chinese businesses have learned from Western businesses to negotiate terms and conditions in order to avoid the risk of breach. In conclusion, risks at Chinese businesses level are the result of management performance, particularly as practiced in China's business environment.

4.7 Risks at Management Level

Foreign investment does not only provide Chinese businesses with financial support, but also management practice at higher levels. Improving management and leadership performance is one of the main objectives of the Chinese government with the strategy of attracting foreign investors (Long, 2005:319). Before 2000, these objectives were simplified and led

Chinese businesses to the point of idolising foreign investment. In order to obtain foreign investment, Chinese businesses and local government would consent to various rigorous investment terms and conditions from foreign investors. However, many inexperienced Chinese businesses entered into the agreement hastily for financial and labour benefits, without considering business protection and control rights. Owing to Chinese management's negligence and low level cooperation, collaboration with foreign investors did not always promote Chinese brands and products as was intended. As evidence, many well-known Chinese brands have disappeared on Chinese markets after mergers or acquisitions involving such brands (Gao, L., 2007:Online). Chinese businesses were targeted as a marketing channel mainly for foreign companies to access Chinese markets. Consequently, many failed Chinese businesses had to sell shares to their foreign partners at low prices after a few years of failed cooperation attempts. These were hard earned lessons for Chinese businesses, however because of the concealment of these lessons by the government, many Chinese businesses subsequently followed the same route with unnecessary loss. Since that time, Chinese business's acumen of conducting cross-border mergers and acquisitions has improved gradually.

Notwithstanding, integration of cross-border mergers and acquisitions needs a high degree of management performance. As previously elaborated upon, the risks embraced in the above listed categories reflect the management levels of native Chinese managers. Their management skills are continually restricted by the following business conditions.

- Their 'connection' plays too many roles in management performance. Chinese businesses are accustomed to operating behind closed doors, beyond the justice system, investors, and potential partners (Hoenig, 2006:Online).
- Reluctance of engaging fully with legal entities, and avoidance of direct confrontation resorting to formal law enforcement as an action of last resort (Berrell & Wrathall, 2007:64).
- Speculation permeated in business concepts and performance.

Risks associated with Chinese business management are perceived as a lack of transparency and consistency because of enigmatic communication. The fact is that covert business transactions between specific top individuals of businesses, such as founders, CEOs, or leaders, and their political connections are at the heart of Chinese business management risks, foreign businesses have to adopt the local management system if they wish to operate successfully in China.

Business offences such as embezzlement and misappropriation of public funds, illicit distribution of profits and reserves, market abuse, false corporate communications, illusive

financial statements, 'juggling' of financial figures, fraud, corruption, etc., have become common scenarios in China (Yiming, 2011:Online). The dispensation, fostering such scenarios, is the government's governing system and its weakness in supervision and law enforcement. As a result, the number and amounts involved in such kind of offences are increasing year on year despite the fact that the government has intensified the extent of offence examination. One of the reasons that further exacerbates these offences is the point that the punishment for both companies and individuals is inadequate compared to the profits from and benefits of illegal activities, which have consequently promoted such business offences. Management are most often responsible for such business offences.

By utilising the weaknesses of government's domination, management has performed varied actions to maximise individual profits in businesses including the financial markets (Yiming, 20011:Online). Businesses, which are *au fait* in looking for and using loopholes, weaknesses and grey areas of policies, laws and regulations to guide business management and performance, are more likely to succeed. Inspired by such a business environment, Chinese traditional standards, values, and morality in business management have disintegrated in China's exponential fast economic growth. It has become a standard trend and indeed a 'value', as executives of this nature are praised, preferred and welcomed as capable in managerial positions in China. As long as such management ideology becomes a symbol of success, it will increasingly infiltrate business, and challenge the government dominating systems. This explains the reason why foreign companies perceive it as difficult to cope with managerial conflicts during integration. Notwithstanding, when Chinese businesses operate in a global environment, this type of ideology will direct management performance in the same way, and continuously challenge the host country's domination of systems.

Chinese business management represents the 'art' of dealing with the confluence of diverse complex relationships between officials, government authorities, and various connections. The Chinese political system has created an extremely complex environment for businesses. Therefore, businesses are not only the victims of governance, but also the advocators of complexity. Against this ideology, Western management principles do not perform well in the Chinese business environment. With management performance features like this, it is necessary for investors to review the target organisation's management polices and procedures, and follows up on its performance records to gain insight into a business valuation.

4.8 Conclusion

The exponential growth of China's economy over the last 30 years has significantly promoted the mergers and acquisitions market. The recent transactions have shown a trend towards an increased number of deals, larger size of acquiring companies, and diversified tactics. Simultaneously, the conflicts between Chinese and Western companies have proved the existence of cooperation risks.

Foreign investors have opportunities to acquire assets and/or shares in Chinese state-owned enterprises, domestic firms, and listed companies. The complexity and the lack of a unified code on mergers and acquisitions in China is due to a plethora of complex rules, burdensome procedures and defective regulations in China's legal and political system.

With regard to competing in global markets, the Chinese government and businesses are still in its infancy stage, and both suffer from a lack of experience in cross-border mergers and acquisitions. Chinese state-owned businesses have retained evidence from its planning economic system, and their weaknesses indicate that government support is required. As a result, the Chinese government's participation in the global markets will be unavoidable in protecting the country's interests and in supporting Chinese businesses dealing with such complex transactions.

The issues raised in this chapter provided instructive guidance to both Chinese and foreign companies on determining risk factors and their causes in order to improve actual cooperative performance.

Synopsis: Chapter Five

Risks by implication have causalities. Risks associated with Chinese cross-border mergers and acquisitions have shown that there are clear tangent planes between risks of Chinese business, management and government. To approach the research objective of determining what risks associated with Chinese business are affected by the Chinese government's domination, the researcher conducted an in-depth case study to determine the concepts underpinning these complex activities. To approach the objective of mitigating the identified risks, the research focuses on identifying risk factors in general, and provides solutions to businesses associated with Chinese cross-border mergers and acquisitions.

This research is presented as a multiple case study, by adhering to the methods associated with the concept. In the case study, methodological triangulation was used for the purpose of data collection to achieve the research objectives.

The research results of a single case study are deduced from the particular conditions and circumstances of the particular case, however cannot address the objective of mitigating risks for other businesses. To mitigate this concern, thirty-four cases of Chinese inbound mergers and acquisitions were studied by using both quantitative and qualitative data collection methodologies. The qualitative data were collected via interviews; while the quantitative data was gleaned from studying secondary cases using multiple sources.

CHAPTER FIVE: RESEARCH METHODOLOGY AND DESIGN

5.1 Introduction

The research in this chapter aims to collect evidence from multiple case studies to achieve the objective of adding academic value to the field of research. The research design of this case study is complex, as there were many overlaps in using the various research methods and approaches. In considering the research context and applicable research methods, the study employed methodological triangulation for the purpose of data collection. The research design of this study is graphically depicted in Figure 5.1 below:

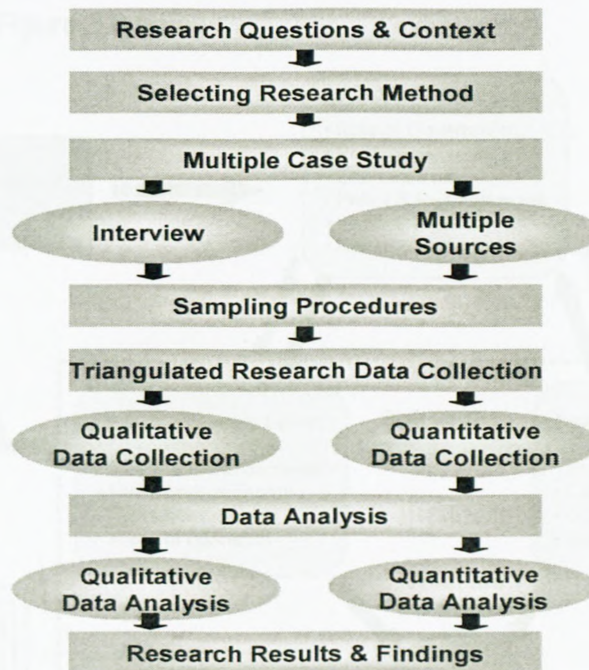


Figure 5.1: Research Design

The research design as graphically depicted in Figure 5.1 consists of the following key elements:

- Understand the research question within the research context.
- Select the most suitable research method and data collection methodologies for the study.
- Determine the sample.
- Collect qualitative and quantitative data.
- Analyse data.
- Present the research results from both qualitative and quantitative analysis.
- Document research findings.

The value of adopting methodological triangulation has been highlighted by many scholars such as Yin (1994), and Creswell and Plano Clark (2011). The research also used the research findings to further develop the established framework of risks associated with

mergers and acquisitions, introduced in Chapters 3 and 4 of this research study. The research findings are regarded as evidence to prove the validity of the various concepts and issues raised.

5.2 Research Question and Context

The research question of this study is to determine what risks associated with post- cross-border mergers and acquisitions are affected by the Chinese government domination in a Chinese business context. The question indicates the research field and associated scope thereof. Based on the concepts of the established framework, the research scope is graphically depicted in Figure 5.2 below:

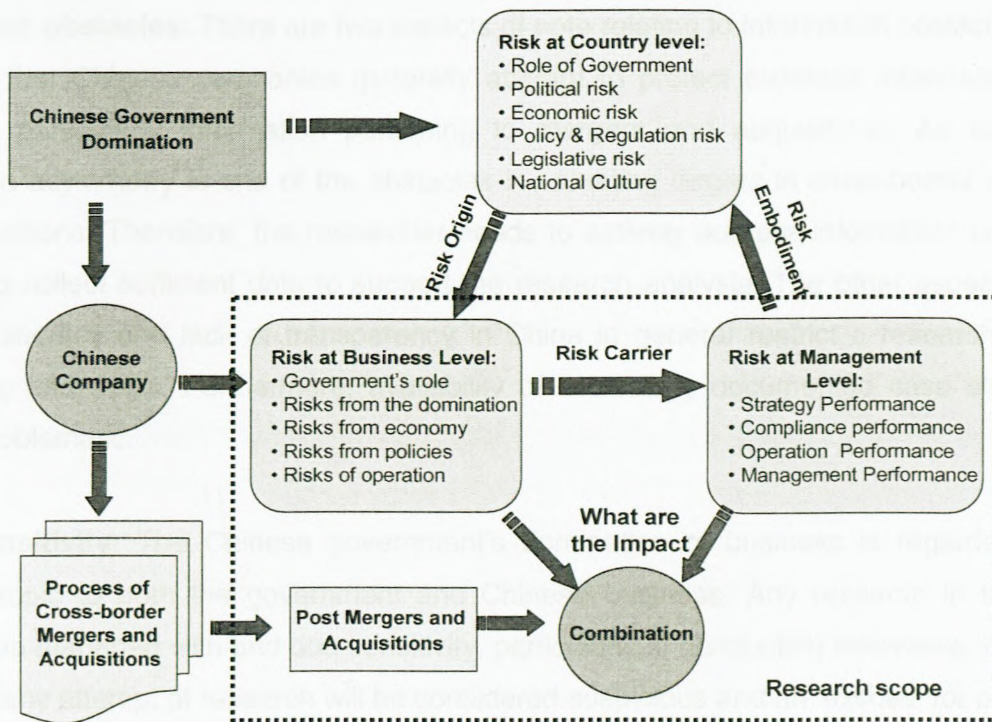


Figure 5.2: Research Scope

The research scope is to identify risks in the integration at two levels, namely at a Chinese business and management levels. There are some elements related to risks at each level, which need to be determined by the research. At business level, there is the need to determine a) what is the Chinese government's role in business activities? b) What risks are the effects of government policies with regard to business? c) What risks pertain to Chinese business performance? Since the research is conducted from a Chinese perspective, the research is focused on Chinese business only.

Figure 5.2 applies the conceptual framework, which served the search in the previous chapters. The framework is proposed to show the correlation between the three risk

dimensions and how they can affect one another. More specific, the research aims to identify risks associated with business and management levels to determine which risks are impacted upon by government domination at country level. In Figure 5.2, the 'risk at business level' and 'risk at management level' are the elements that correlate with the 'risk at country level'.

Research methodology adoption is complex in that actual business circumstances. There are other factors that can affect the practicability, reliability and validity of the adoption of a particular research method, such as the context of the research field, sampling and access to data collection. Aspects, which impact on the research process, are expanded upon below:

Information obstacles: There are two aspects of note relating to information obstacles. One aspect is that Chinese companies generally attempt to protect business information from outsiders, particularly information pertaining to mergers and acquisitions. As evidence, information asymmetry is one of the obstacles in valuating targets in cross-border mergers and acquisitions. Therefore, the researcher needs to actively address information obstacles in order to collect sufficient data to support the research analysis. The other aspect is that business secrecy and lack of transparency in China in general restrict a researcher from conducting interviews. Furthermore, availability of secondary documented case studies is equally problematic.

Topic sensitivity: The Chinese government's domination of business is regarded as a sensitive topic to both the government and Chinese business. Any research in this field needs to be managed with and due sensitivity, particularly in conducting interviews. It is very likely that any attempt at research will be considered suspicious and an 'excuse' for obtaining confidential information for competitors. Despite the assertion that interviews would be highly confidentiality, outsiders doing research in business are not trusted in China.

Results significance: Studies on individual cases can provide substantial insight into risks associated with mergers and acquisitions. However, a limited number of cases cannot provide enough evidence to further develop and establish a conceptual framework. Providing solutions to risks associated with Chinese cross-border mergers and acquisitions also requires sufficient evidence from the research in order to determine their mitigation appropriateness. Therefore, to achieve reliable and valid research results, the study would need a large number of cases.

In choosing an applicable research method for this research, the researcher considered the abovementioned factors. Above all, a thorough understanding of research methods and approaches is essential for selecting an appropriate research method.

5.3 Research Methods and Approaches

The results from research depend on the research method adopted (Brace, 2004:43). Good research is a generic reasoning approach that is more or less divorced from specific tools and techniques (Emory, 1980:viii). Selecting a research method must take a comprehensive account of available research methods, the research topic, objectives, and context (or conditions) of the research.

5.3.1 Research Methods

Research methods are generally classified as the paradigms of empirical research and theoretical research:

Empirical research (also referred to as positivistic research or quantitative research): Empirical research is a research paradigm that combines a deductive approach with precise measurement of quantitative data (Neuman, 2000:516, cited by Struwig & Stead, 2001:5). It seeks to explain causal relationships between variables and needs a highly structured approach to facilitate replication (Saunders, Lewis & Thornhill, 1997:71)

Theoretical research (also referred to as phenomenological research or qualitative research): Theoretical research is a research paradigm that refers to an inductive approach. It is based on how people experience social phenomena within the associated context; and it seeks to expose different views of phenomena by the small scale of the sample (Saunders *et al.*, 1997:72).

Typically, empirical research is adopted in business and management, and it requires extensive interaction with people, while theoretical research requires intensive textual investigation (Saunders *et al.*, 1997:71-73; Struwig & Stead, 2001:5-15). Empirical and theoretical research methods refer to quantitative and qualitative data, which are subject to reciprocal data collection and data analysis approaches. In research, empirical and theoretical methods can complement each other for different objectives, yet need not be entirely isolated from a research focus perspective (Johnson & Harris, 2002:101). These two methods have distinctive characteristics, according to Struwig and Stead (2001:4-19), Hennink, Hutter and Bailey (2011:16), and Cooper and Schindler (2008:165). These characteristics are summarised in a comparative analysis, shown in the Table 5.1 below.

Table 5.1: Comparison of Quantitative and Qualitative Research Strategies (Summary)

Research Focus	**Quantitative** (Positivistic) (Empirical Research)	**Qualitative** (Phenomenological) (Theoretical Research)
General framework	• Seek to examine hypotheses about phenomena	• Seek to explore phenomena
	• Instruments use more rigid style of eliciting and categorising responses to questions	• Instruments use more flexible, iterative style of eliciting and categorising responses to questions
Objectives	• To examine variables	• To describe variables
	• To establish causal relationship	• To describe and interpret relationship
	• To determine the characteristics of a population	• To describe participants' and researcher's perspective
	• To generalise results	• To open mind
	• To test theory	• To build theory
Question format	• Closed	• Open-ended
Data format	• Large sample size	• Small sample size
	• Numerical	• Textual
	• Probability	• Non-probability
	• Interpretive	• Statistical
Research design	• Research design is stable from beginning to end	• Research design is flexible
	• Participant responses do not influence or determine research questions asked	• Participant responds openly to research questions asked
	• Research design is subject to statistical assumptions and conditions	• Research design is interactive

Table 5.1 reflects general perspectives of distinguishing empirical and theoretical research methods. The disadvantages of using empirical methods include, inflexible with respect to data collection, poor in understanding social processes, and often does not discover the meanings people attach to social phenomena (Saunders *et al.*, 1997:74). The disadvantages of using theoretical methods include, time consuming in data collection, difficulties in data analysis, and less credibility due to unskilled researchers (Saunders *et al.*, 1997:74).

5.3.2 Data Collection Methodologies

It is important for researchers to follow the correct approach when collecting research data. Data collection is a systematic procedure of accomplishing research tasks with complex and/ or scientific techniques. Table 5.2 lists the various data collection methodologies when

collecting quantitative and qualitative research data (adapted from Struwig & Stead, 2001:86-102; Cooper & Schindler, 2008:169-187).

Table 5.2: Methodologies of Quantitative and Qualitative Data Collection (Summary)

Quantitative research approaches	Qualitative research approaches
Experiments	Experiments
Surveys	Surveys
Interviews:	Interviews:
Standardised interview	Standardised interview
Semi-standardised interview	Semi-standardised interview
Un-standardised interview	Un-standardised interview
Focus groups	Focus groups
Observation	Observation
Questionnaires	
Case study	Case study
	Action research
Mixed methodologies	Mixed methodologies

5.4 Case Study

A case study is but one of several ways of doing social scientific research in that "... it investigates a contemporary phenomenon within its real-life context" (Yin, 1994:1). Thomas (2004:21), describes a case study as, "... seeking to gain a rich and complex understanding through examining a single instance of some broader class of phenomena".

A case study can comprise both single and multiple case studies (Yin, 1994:14). A single case study refers to a research study that is designed for a single experiment and/or many of the same conditions that justify a single experiment (Yin, 1994:38). A multiple case study refers to more than one experiment (Yin, 1994:38). A multiple case study (as in the instance of this research study), "...relies on multiple sources of evidence, with data needing to converge in a triangulating fashion, and benefits from the prior development of theoretical propositions to guide data collection and analysis" (Yin, 1994:13). A case study can identify more risk variables than any other research methodology. Multiple sources of evidence are heavily relied upon in conducting case study research (Yin, 1994:34), and prior developed theoretical propositions can be used to guide the data collection and associated analysis (Yin, 1994:13).

A case study often involves a wide range of data collection methodologies, such as interviews, questionnaires, observation, and the analysis of documentary records (Thomas,

2004:21). The advantage of a case study is that data collection and analyses can be based on the triangulation of quantitative and qualitative research paradigms (Yin, 1994:14; Thomas, 2004:21). Adopting data triangulation to improve confidence in reliability of data and findings is becoming increasingly popular in research (Thomas, 2004:23).

Webb *et al.* (1966), cited by Thomas (2004:23); Saunders *et al.* (1997:80) and Creswell and Plano Clark (2011:2-5), state that using both quantitative and qualitative research paradigms for obtaining data is commonly termed as 'mixed methodologies'. Denzin (1978:291) cited by Thomas (2004:23), explains the concept of 'mixed methodologies' as the 'combination of methodologies in the study of the same phenomenon'.

According to Denzin (1978), cited by Thomas (2004:23), and Yin (1994:92), mixed methodologies use multiple but independent measures, of which four categories can be recognised:

- **Triangulation of theories**: Involves borrowing models from one discipline and using them to explain in another discipline.
- **Triangulation of data**: Refers to research where data are collected over different times, in different places or from different sources.
- **Triangulation by investigators**: Multiple observers or investigators collect data on the same situation, and the results are then compared.
- **Methodological triangulation**: Refers to research where both quantitative and qualitative research paradigms are used for obtaining data.

In terms of to the research objectives, this research study falls within the ambit of methodological triangulation, which provides strengths that offset the weaknesses of both quantitative and qualitative research, and generates more evidence for solving research problems (Creswell & Plano Clark, 2011:12). Methodological triangulation is a consolidation of inductive and deductive thinking (Creswell & Plano Clark, 2011:12); it culminates in diverse data collection methodologies, which can be juxtaposed for example, questionnaires, interviews, surveys and field studies (Yin, 1994:93).

The following principles of a multiple case study as illustrated by Yin provide conceptual guidance to this study.

Principle 1 □ use multiple sources of evidence: A major strength of a triangulation case study is the opportunity to use diverse sources of evidence for data collection necessary to exceed the limitations of other research strategies (Yin, 1994:91). Any sources of evidence from documentation, archival records, interviews, direct observation, participant observation

and physical artefacts, can and have been the sole basis for case studies (Yin, 1994:90). Using multiple sources of evidence also allows a researcher to address a broad range of historical, attitudinal, and behavioural issues in order to develop 'converging lines of inquiry' (Yin, 1994:92). As a result, research conclusions and findings from triangulated data collection will be more convincing and accurate (Yin, 1994:92).

Triangulation can also address the potential problems of construct validity because the multiple sources of evidence essentially provide multiple measures of the same phenomenon (Yin, 1994:92). The challenges of using multiple sources of data are that the collection of data involves more expense and greater technical skills for implementing the full variety of data collection techniques (Yin, 1994:94).

Principle 2 □ create a case study database: A large amount of evidence can be collected through multiple sources. As a result, a database needs to be created for storing evidence. For instance, the database collection pertaining to documentation can be classified in two ways, namely the data or evidentiary base; and secondly, the report of the investigator, whether in the form of article, report, or book (Yin, 1994:94). Researchers need to be aware of the commitment of collecting multiple sources of data, as every case study should develop a presentable, formal database so that the readers can review the evidence directly to increase the reliability of the study (Yin, 1994:95). An existing database does not preclude the need to present sufficient evidence within the case study report itself. Reciprocally, every report should still contain enough data so that the reader can draw independent conclusions about the studied case (Yin, 1994:95). Yin (1994:95) introduces four forms of database for the validity of evidence, namely notes, documents, tabular materials, and narratives.

Principle 3 □ maintain a chain of evidence: The intention of collecting data from multiple sources is that they will be used as evidence for research. As a result, a case study should have a logical link between evidence and conclusions. From the initial research question to ultimate case study conclusions, an external observer should be able to follow the derivation of evidence and to trace the steps in either direction, from research questions to research conclusion and from conclusion back to initial research questions (Yin, 1994:99). As a result, a database should contain the actual evidence and determine the circumstances under which the evidence was collected (Yin, 1994:99).

In order to present a clear perspective to the reader on the adoption of methodological triangulation for this multiple case study, Figure 5.3 below graphically outlines the strategy.

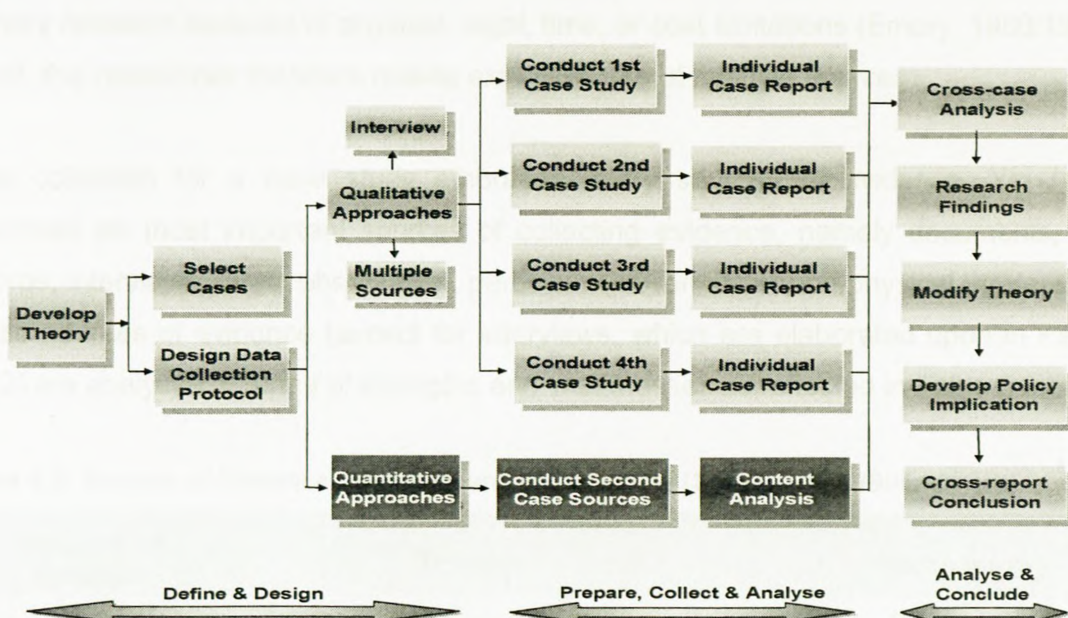


Figure 5.3: Multiple Cases Strategy

Figure 5.3 reflects that both qualitative and quantitative research paradigms are utilised for data collection. Within the qualitative research paradigm, four cases are studied through interviews, and multiple sources are collected as supporting evidence. Within the quantitative research paradigm, a large number of secondary cases are studied via multiple sources of evidence. In turn, a qualitative content analysis of each individual case is executed as the first analysis, and a quantitative analysis cross-case analysis is used as secondary analysis. Research findings are based on the cross-case analysis.

5.4.1 Sources of Data

This research has made extensive use of multiple sources of data. Mergers and acquisitions are in a typical research environment whereby a researcher can study previously reported cases when they have met the criteria of 'value in use'. The wide use of multiple sources in this research study is twofold. The first is the use of multiple sources for data collection, whereby the interview as a direct approach served as one of many sources for collecting evidence. Other forms of sources are considered as indirect approaches. The second refers to the sufficiency and significance of evidence, whereby collecting data from a large population through multiple sources can increase the validity and reliability of the results.

Emory (1980:193), suggests that secondary data sources may be used as the sole source of evidence for a research study. Secondary data can usually be obtained more quickly and cheaply compared with primary data collection, which can be costly and time-consuming and therefore impracticable in many instances (Emory, 1980:192). Furthermore, if the gathering of primary information becomes unworkable, collecting of secondary data sources is vital (Emory, 1980:192). In fact, in many research situations, it is impracticable for one to conduct

primary research because of physical, legal, time, or cost limitations (Emory, 1980:193). As a result, this researcher therefore makes extensive use of multiple sources.

Data collection for a case study embraces many sources of evidence. Yin (1994:78) described six most important sources of collecting evidence, namely documents, archival records, interviews, direct observation, participant-observation, and physical artefacts. Of the based sources of evidence (except for interviews, which are elaborated upon in Paragraph 5.4.2) are analysed in terms of strengths and weaknesses as reflected in Table 5.3 below.

Table 5.3: Sources of Evidence: Strengths and Weaknesses (**Source**: Yin, 1994:80)

Sources of evidence	Strength	Weaknesses
Documentation	➢ Stable – can be reviewed repeatedly ➢ Unobtrusive – not created as a result of the case study ➢ Exact – contains exact name, references, and details of an event ➢ Broad coverage – long span of time, many events, and many settings	➢ Retrievability – can be low ➢ Biased selectivity, if collection is incomplete ➢ Reporting bias – reflects (unknown) bias of author ➢ Access – may be deliberately blocked
Archival Records	➢ (Same as above for documentation) ➢ Precise and quantitative	➢ (Same as above for documentation) ➢ Accessibility due to privacy reasons
Direct-Observation	➢ Reality – covers events in real time ➢ Contextual – covers context of event	➢ Time-consuming ➢ Selectivity – event may proceed differently because it is being observed ➢ Cost – hours needed by human observers
Participant-Observation	➢ (Same as above for direct observation) ➢ Insightful into interpersonal behaviour and motives	➢ (Same as above for direct observation) ➢ Bias due to investigator's manipulation of events
Physical Artefacts	➢ Insightful into cultural features ➢ Insightful into technical operations	➢ Selectivity ➢ Availability

Apart from the above-listed sources of evidence, other forms such as films, photographs, and videotapes; projective techniques and psychological testing (proxemics; kinesics; 'street' ethnography; and life histories) are all adoptable sources (Marshall & Rossman, 1989, cited by Yin, 1994:79).

5.4.2 Interviews

Interviews can spontaneously yield additional and vital information (Johnson & Harris 2002:102), making the interview one of the most important sources of data collection for a case study (Yin, 1994:84).

There are numerous advantages to an interview approach, namely in that respondents can query the meaning of questions; they can be encouraged to provide deeper responses to open questions; the researcher can inspire respondents into deep conversations; more complex questions can be asked; questions are directly focused on the topic; and research is more insightful from perceived casual inferences (Yin, 1994:80; and Brace, 2004:25). A balanced perspective on interviews, also highlights certain disadvantages of interviews (Yin, 1994:80; and Brace, 2004:25), which are expanded upon below:

From an interviewer's perspective:

- Self-presentation bias – as meanings are dependent on the researcher's understanding.
- Selection bias – as data collection relies on the researcher's own opinions.
- Important information may be missed.

From an interviewee's perspective:

- Poorly constructed questions causes bias.
- Response bias.
- Poor recall caused inaccuracies.
- Answers modelled to what the interviewer wants to hear.

Avoiding the above listed issues are core to any research method adoption (Brace, 2004:25). The researcher needs to be aware of the existence, and the strengths and weaknesses of each selected research approach, and should take action when it is deemed to be appropriate.

Regarding interviews conducted in this study, there are further issues that need to be noted.

Interviewee: The candidates for the interviews were participants in Chinese inbound mergers and acquisitions from Chinese businesses. The potential candidates were directors, top managers, and the majority shareholders who have engaged in the deal. The selection of candidates was not limited to certain numbers per case in this study, but at least one candidate in one case (depending on availability) was nominated to be interviewed. In principle, the more interviews conducted, the richer the data generated. However, a serious drawback with mergers and acquisitions was that a limited number of interviewees were

willing to share information for a research project, because of the impact of information exposure on businesses and the relevant partnership.

Confidentiality: Was a major concern in conducting interviews. Leedy and Ormrod (2005:185), point out that if respondents are assured that their responses are confidential, they will be more truthful in a personal interview than they would otherwise be. In research of this nature, confidentiality may be even more sensitive as it might affect business reputation, partner relationships, management performance, and business strategies. Much internal information is regarded as business secrets, and is strongly protected from exposure. Despite the researcher presenting a letter in order to ensure the confidential nature of the interviews, it did not change the fact that businesses absolutely refused to avail themselves for research interviews.

5.5 Sampling Procedure

The total set of interested source elements in research is termed the 'population', which can comprise individual people, groups, organisations, industries, documents, processes, events and even time periods (Thomas, 2004:105). Defining the research population is an important prerequisite to establish a spectrum of samples. According to the research circumstances, there are many sampling techniques to choose from for an appropriate population (Thomas, 2004:105). The considerable threat to the research results is the validity of sampling approaches in both quantitative and qualitative researches (Struwig & Stead, 2001:136-145). However, in a multiple case study, increasing the range of types of businesses investigated may mitigate the drawbacks commonly associated with a single case study (Bryman, 1989:172).

5.5.1 Unit Selection

The population selected for this research study needed to meet specific requirements, such as: Being involved in Chinese inbound merger or acquisition; which occurred in the territory of mainland China; the acquiring companies should have been Western based; the acquired companies should have been original Chinese businesses; and the merger or acquisition need to be at/or after the stage of integration. The research relied on two primary sources for the unit selection, namely the *2008 China Mergers and Acquisitions Yearbook* (Zhang *et al.*, 2008); the other one an article entitled 'The situation of Chinese enterprise that are acquired and controlled by foreign investors' (Gao, L., 2007:Online). The yearbook and article list some influential and/or controversial cases of Chinese inbound mergers and acquisitions, which were regarded as reliable sources for this study. This particular selection due to the

fact that the authors of the book are senior researchers and executors of Chinese global mergers and acquisitions, while Gao the author of the article, is a senior researcher of the Macroeconomic Academy of China's State Development and Reform Commission. From the resource perspectives, the research adopted mixed sampling techniques, namely convenience sampling, and purposeful sampling. Since many referred cases do not have detailed material for analysis, the unit selection was based on the researcher's personal judgement according to information availability.

For the qualitative sampling process, the selected respondents were from the Jiangsu province. The reason for choosing this province, was that it has active foreign investment activities (38,594 foreign invested businesses were registered up to 2009 in the province), which provides more scope for interviews. Furthermore, businesses in that province are more centralised, which could facilitate unit selection and reduce the cost of conducting interviews. The researcher was concerned about the willingness of interviewees to participate in the survey, as directors, CEOs and general managers are wary regarding interviews in this kind of research. To facilitate this process, the researcher had a 'connection' who worked for the Nantong Development and Reform Commission (one of the mergers and acquisitions approval agencies). The 'connection' promised to find top managers for interviews, and guaranteed that there would be more than five deals in the city of Nantong involved with the world's top 500 companies, which could address the researcher's requirements.

5.5.2 The Size of the Units

Struwig and Stead (2001:119), state that in theory the larger size of sample will have a greater likelihood of precision or reliability. The reported number of cross-border mergers and acquisitions in China is significant, namely 944 foreign invested mergers and acquisitions in 2008 alone. However, compared with the publicly announced number, the uncovered cases with rich information were very limited. Of the total of cases, only 147 rendered reliable data of which only 34 proved to be viable in terms of data analyses.

5.6 Data Collection

Qualitative data collection, where data were collected via interviews. Quantitative data collection, where data were collected from secondary cases were employed for the purpose of data collection.

The evidence collected from both qualitative and quantitative approaches were regarded as not only appropriate, but also sufficient to facilitate data analysis. The research question of this study is: 'What risks associated with post- cross-border mergers and acquisitions are affected by Chinese government domination?' The structured questions posed during the interviews were considered to be in line with the established conceptual framework of risks associated with mergers and acquisitions in a Chinese business context. Figure 5.4 is a graphical depiction of the research question model.

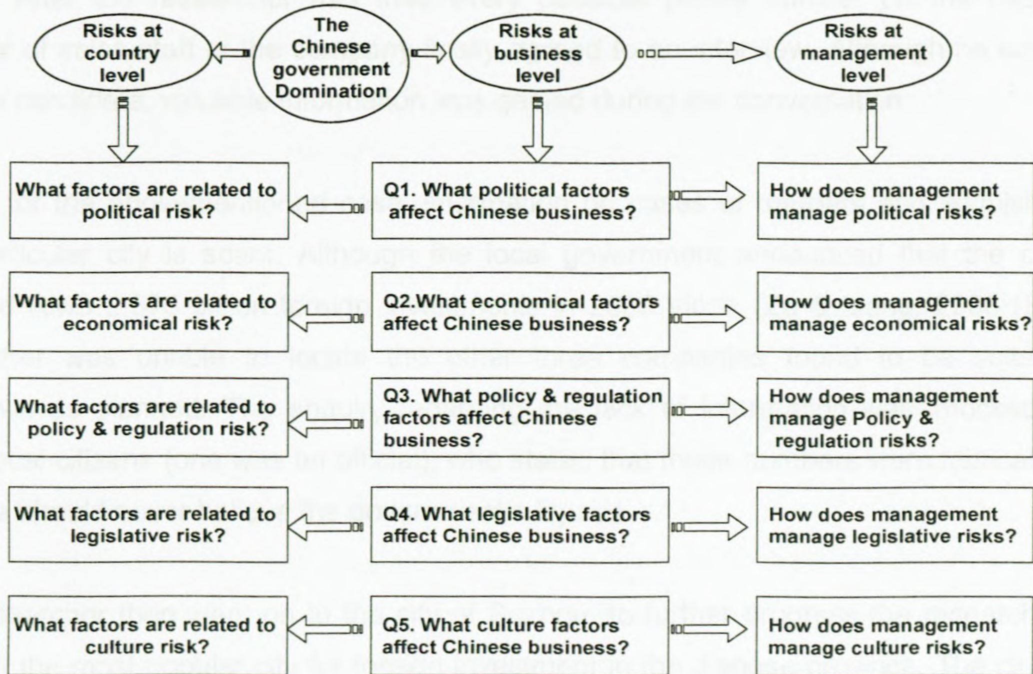


Figure 5.4: Research Question Model

The attention of the reader is drawn to the fact that the Research Question Model is reflective of the three risk levels of country, business and management.

5.6.1 Qualitative Data Collection

A qualitative research approach as a rule is applied to explore new phenomena within a real world context. Interviews as a method used for an intensive investigation into an individual's opinions on a specific subject (Davis, 2005:312), can as a result provide rich insights into risks associated with mergers and acquisitions.

There were four cases selected for qualitative data collection in Nantong, with expected assistance from the 'connection' of this author. However, after arrival in Nantong in March 2010, the researcher found that the connection had left the department, which had not been mentioned in previous discussions and emails. The researcher then contacted the company Nobel Grain & Protein Co., Ltd (Nobel) directly to secure interviews. In the attempt to secure

the interviews, the researcher discovered that the telephone numbers of the target company, Nantong Baogang Oil & Fat Development Co., Ltd (Nantong Baogang), had been cancelled. Furthermore, the telephone numbers of the merged company Nobel were not available, and there were no other contact details available for the directors and top managers of both companies on the website. This situation is unique for China, as there would as a rule a plethora of data available for an important merger such as between Nobel and Natong Baogang. In addition, access to the company was refused since no invitation had been issued. After the researcher had tried every possible phone number on the Internet, a member of sales staff of the company finally agreed to an interview. Although he was not a suitable candidate, valuable information was gained during the conversation.

Except for the abovementioned case, information on cases of mergers and acquisitions in that particular city is scant. Although the local government announced that the city had received RMB 2.575 billion foreign investments in 2006 alone (Zu & Liang, 2008:186), the researcher was unable to locate the other three companies found to be suitable for interviews as planned. The enquiry regarding the lack of information was 'mocked' at by some local citizens (one was an official), who stated that these numbers were fabricated and that one should never believe the government's figures.

The researcher then went on to the city of Suzhou, to further progress the research study, which is the most popular city for foreign investment in the Jiangsu province. The city is two hours' driving distance from Nantong and one hour from Shanghai. In Suzhou, the researcher visited Suzhou Philips, the international manufacturer from the Netherlands, who had a joint venture with China's TV manufacturer Kongque Group in 1994. Philips merged with the Chinese partner in August 2002. Here the researcher experienced exactly the same situational dispensation as in Nantong. An attempt at making an appointment with the company's general manager also failed. When the researcher enquired telephonically about the merged company Kongque Group from the General Manager's office, the answer was that they knew nothing concerning the deal. The respondent also showed unwillingness in respect of recommending anybody who might be able to provide information about the deal.

The researcher was confronted with similar experiences in an attempt to solicit interviews at the other two companies, namely Minsheng pharmaceutical manufacturer, acquired by the French pharmaceutical giant Sanofi-Aventis; and Zhejiang Supor electrical home appliance manufacturer, acquired by French company SEB. The researcher managed to make contact with the secretaries of both companies' general managers via email. Instead of refusing directly, both companies asked for a list of questions about the proposed interview. The response from the company Minsheng, was that the previous cooperation was complete, the

negotiation for further cooperation was in progress, and thus no information could be provided at this stage. The response from Zhejiang Supor, was blunt and straight to the point in that the manager was not interested in the questions. Extensive efforts to find more cases for interviews returned no results.

From a primary data collection perspective, the interviews failed. From the real word experience of the researcher in China, the analogy can be drawn that it is very likely that research in this field will fail if the researcher is an outsider, because of confidentiality and the impact of information exposure. From a sampling perspective, the selection of the research region followed the research process. According to the available information from Chinese central and local governments, Nangtong should be included in the areas, which have active inbound mergers and acquisitions. Therefore, the merger and acquisition cases that occurred in that city should be relevant to interview selection. However, lack of information transparency and accountability to the public, misled the researcher, and by implication blocked the interviews. Another factor is the use of a connection. It is difficult to judge the degree to which this may, or may not have influenced the outcome of setting up interviews. Using a connection is an important aspect of Chinese philosophy when managing issues like this; however the risk of unreliable and/or fraudulent connections is also embedded in the process. It is possible and highly likely that the same fate was experienced by some foreign companies that wished to gain access to Chinese markets in this way, which is a further risk to be mitigated in terms of mergers and acquisitions in China.

5.6.2 Quantitative Data Collection

The secondary cases were designed for quantitative research data collection, and followed the same structure of the questions of the primary study. Quantitative data collection works with large, representative samples and uses structured data collection to obtain a general conclusion to the phenomena (Struwig & Stead, 2001:4; Johnson & Harris 2002:101; Thomas, 2004:22; Leedy & Ormrod, 2005:183). As a result, the study of secondary cases has a material contribution to the validity and significance of the research results. The importance of this type of research approach is that the study is replicable by different organisations in the same investigation area, and the same research results should be obtained (Johnson & Harris, 2002:101).

The data of 34 selected cases of mergers and acquisitions in China were researched from the sources previously alluded to. The researcher collected additional evidence for these cases from other sources, such as books, journals, articles, news, magazines, dialogues and from Internet blogs. The secondary cases are listed in Table 5.4 below:

Table 5.4: The List of Companies Representing the Secondary Research Cases

	Date	Acquired Chinese Company	Types	Acquiring company	Country	Industry	Status
1	2004	Anhui Hefei transformer Manufacturer	S	Asea Brown Boveri (ABB)	Sweden	Manufacture of Transformer	WF
2	2007	China Oriental Group Company Limited.	L	Arcelor - Mittal Steel	USA	Iron & Steel Industry	CC
3	2000	Dalian Electric Motors Manufacturer	S	Western Electric	Singapore	Machinery Equipment	FC
4	2006	Delixi Electric Ltd	P	Sehneider	France	Low-tension Electronic Equipment	FC
5	2000	Double Coin Holdings Ltd	S	Michelin	France	Tyre	WF
6	2006	Five Star Appliance Co., Ltd	P	Best Buy	USA	Electrical Home Appliance	WF
7	2006	Fujian Sedrin Brewery	S	InBev	Belgium	Brewaging	WF
8	2006	Guangdong Development Bank	S	Citygroup Corporate	USA	Banking	FC
9	2005	Harbin No1.Tool Manufacturing Co., Ltd	S	Greason	USA	Cutter Machinery	FC
10	1999	Hongxin Electric Iron Manufacturer	S	SEB	France	Electrical Home Appliance	WF
11	2005	Hunan Valin Iron and Steel Group Co., Ltd	L	Mittal Steel	India	Iron & Steel Industry	FC
12	2005	Jiamusi Coal Mining Machinery Co., Ltd	S	International Mining Machinery Holding Ltd	USA	Mining Machinery	WF
13	2004	Jiamusi Combine Harvester Co., Ltd	S	John Deere	USA	Agriculture Machinery Equipment	WF
14	2005	Jinxi Chemical Machinery (Group) Co., Ltd	S	Siemens	Germany	Chemical Equipment Plant	FC
15	2005	Jixi Coal Mining Machinery Co., Ltd	S	International Mining Machinery Ltd	USA	Mining Machinery	WF
16	2002	Kongque Electrical Products Manufacturer	S	Philips	Netherlands	Electrical Home Appliance	FC
17	2003	Mininurse	P	L'Oreal Paris	France	Cosmetic	WF
18	2003	Nanfu Battery Co., Ltd	S	Gillette	USA	Electrical Home Appliance	FC
19	2007	Nantong Baogang Oil & Fat Development Co., Ltd	P	Nobel Grain & Protein Co., Ltd	Singapore	Food & Beverage	WF
20	2000	Robest	P	Danone	France	Food & Beverage	FC
21	2003	Sanxiao Group	P	Colgate	USA	Consumer Goods	WF
22	1996	Seagull Group Pty, Ltd	S	Henkel	Germany	Consumer Goods	WC
23	2005	Shandong Sem Machinery Co., Ltd	S	Caterpillar	USA	Heavy Machinery	WF
24	2003	Shenyang Rock Drill Manufacturer	S	Atlas	Sweden	Machinery Equipment	WF
25	2004	Shenzhen Development Bank	L	New-bridge Capital Group	USA	Banking	FC
26	1998	Shenzhen Seg Co., Ltd	L	Samsung	Korea	Television kinescope tube	FC
27	2006	Shuanghui Group	L	Rotary Vortex Limited	USA	Food & Beverage	WF
28	2007	Sichuan Shuangma Cement Co., Ltd	L	Lafarge	France	Cement Plant	FC

29	2001	The second Dalian Electric Motors Manufacturer	S	Brook Crompton	Britain	Machinery Equipment	WF
30	1996	Wahaha Group	P	Danone	France	Food & Beverage	WC
31	2004	Weifu High-Technology Group Co., Ltd	S	Bosch	Germany	Chemical Equipment Plant	FC
32	2001	Xibei Bearing Co., Ltd	S	FAG	Germany	Bearing	WF
33	2000	Yangtze Refrigerator Manufacturer	S	Bosch-Siemens Home Appliances	Germany	Electrical Home Appliance	WF
34	2006	Zhejiang Supor Cookware	L	SEB Home Appliance Maker	France	Electrical Home Appliance	FC

Notes:
S = State-owned Company
P = Private Company
L = Listed Company
WF = Wholly Foreign-owned Company
CC = Chinese-controlled Company
FC = Foreign-controlled Company
WC = Wholly Chinese-owned Company

Due to the large amounts of evidence sourced from the Internet, there may be some academic debate on the use of the Internet for the research, as the reliability and validity of the selected information are completely reliant on the (Internet) researcher's personal judgement. In this study, except for journal articles, evidence from government (including local government) websites was the priority, and well-known individuals' blogs were also found reliable.

5.7 Data Analysis

Data analysis is largely dependent on a researcher's own style of ideas, along with sufficient evidence and careful consideration of alternative interpretation (Yin, 1994:103). Bryman (1989:178), notes that when large numbers of cases are involved in a multiple case study, some of the 'distinctiveness' gets lost. This statement indicates that the analysis of a multiple case study is more complex than other research approaches, and high-level analysis skills are required. The critical step in the analysis process is to quantify qualitative variables.

5.7.1 The Process of Data Analysis

One approach often used for the execution of a successful multiple case study analysis, is statistical analysis (by coding events into numerical form) (Yin, 1994:103). Miles and Huberman (1984, cited by Yin, 1994:103) suggest the techniques of statistical data analysis of qualitative research as:

- Assigning information to different arrays.
- Formulating a matrix of categories and placing the evidence within such categories.
- Creating data displays – flowcharts and other devices – for examining the data.
- Tabulating the frequency of different events.

- Examining the complexity of such tabulations and their relationships by calculating second-order numbers such as means and variances.
- Assigning information in chronological order or using some other temporal scheme.

Considering the abovementioned techniques with the aim of data analysis of this research study, the researcher adopted Yin's (1994:103) concept of using a pre-determined theoretical framework to structure the analysis of the qualitative data, and combined this with Huberman's coding procedure. Against this background the researcher used the following steps to approach the data analysis:

- Step one was to tabulate the pre-determined key risk areas on a spreadsheet. The risk areas were aligned with the five risk categories, which are political, economical, legal and regulative, legislative and cultural risks. The demographic background of each case (if available), was also presented on the spreadsheet such as the date of the deal, industry, the country of the acquiring company, amount, type of business, and the percentage of shareholdings. Some demographic factors were used for relationship analysis.
- Step two was to identify the independent risk variables. This step transposed in using content analysis to identify risk variables, and enter the material information into the related risk categories for each case on the spreadsheet, with the references serving as notes.
- Step three was to code variables whereby the identified variables were classified from each risk category, and tabulated onto different spreadsheets and coded in numbers, in order to quantify the frequency of risk variables.
- Step four was to check the variables from the original documents to ensure valuable variables are not missing or re-coded.
- Step five was to compute the number of each variable for statistic measurements.

The process of data analysis of this research was to use qualitative approaches to identify risk factors, and then use quantitative approaches to analyse and determine the extent of these risk variables. Techniques used in the process of data analysis are elaborated upon below.

5.7.2 The Approaches of Analysis

Content Analysis: Content analysis was applied to the interviews and the secondary cases in order to identify the risk factors that are introduced by the Chinese government's domination. Berelson (1954:489), cited by Thomas (2004:218), states that content analysis is, "a research technique for the objective, systematic, and quantitative description of the

manifest content of communication". The interviews and cases were analysed and interpreted to convey an understanding of the meaning of the texts.

Statistical Analysis: The aim of statistical analysis is to enable the constructed data to be addressed in relation to the overall objectives of the study, and broadly include summarisation and identification of relationships (Thomas, 2004:205). The author further determined that the summarisation of quantitative data is an important outcome of the research, and a prelude to further analysis (Thomas, 2004:206). Frequency analysis is one of the broad methods of organising and summarising statistical data; this study has mainly used this approach to present the results. Pie and bar charts were used for demographic analysis.

Descriptive Approach: Essentially, a descriptive approach only describes the situation in its original state during the investigation. Without any modification of the truth, the trend of descriptive approach is towards determining the cause and relationships between variables (Struwig & Stead, 2001:8). This study used a descriptive approach to present the situational foots of the studied cases, as well the research results; and to explore the correlation among different variables.

Interpretive Approach: Interpretive approach is also referred to as an explanatory approach. It explains a phenomenon in order to stipulate a set of causal links within it, and from which related research questions are answered (Yin, 1994:110).

There is a complete overlap between descriptive and interpretive approaches in this research. Based on the collected data, the research achieved the research objectives by using the above steps.

5.8 Research Ethics

Research ethics provide an important philosophical guide to researchers' conduct during research processes. "From the beginning of defining one's ontological positioning to the end of justifying of the epistemological positioning, a basic motivation for research is the desire for new and better insights – for new knowledge" (Korac-Kakabadse, Kakabadse & Kouzmin, 2002:20-21).

According to the ethics disciplines listed by Struwig and Stead (2001:66), this research study conforms to the following research ethics:

- Recorded the respondent's actual thoughts and behaviour, ensuring the research data and results are a true reflection of an individual's presented evidence.

- Avoided the research being influenced by the researcher's views of the social world, and the researcher's personal bias.
- The collection of secondary data was referenced to ensure the validity of the data, and to provide evidence for other researchers to track the original description.
- Plagiarism was avoided in collecting both primary and secondary data of this research.

Adherence to the above guarantees that this research study was conducted in strict compliance with research requirements, which ensured that research results are true, reliable and valid.

5.9 Conclusion

In this Chapter, literature was reviewed in respect of research methods for a case study, and comprises the research design of, procedures for and approaches to conducting this research study.

The design of the research in addition highlighted aspects pertaining to the unsuccessful primary data collection process. According to the research scope, the adoption of methodological triangulation and the detailed approach to data collection and data analysis are clarified. Research context is an important consideration in achieving research objectives from the adopted research methodologies.

The chapter is represented as a systemic integration of research methods and approaches with the concerns of the research objectives and actual research context to enhance the validity and reliability of the research results highlighted.

Synopsis: Chapter Six

This chapter presents the research results from 34 studied cases. All but one case was researched through primary data collection, while the other cases were studied through secondary sources.

The research analysis is representative of a juxtaposition of quantitative and qualitative research methodologies. As a result, the research results and findings are also 'mixed' in order to determine, interpret, and describe the quantified qualitative risk factors within context. To highlight the relationships in these identified risk factors and focus the research results, a discussion regarding conceptual framework is also provided. These research results and findings are structured in terms of predetermined categories, which are classified by the focus of research the conceptual framework and the research questions.

The research results were drawn from cases with the focus of identifying which risks associated with Chinese cross-border mergers and acquisitions are affected by government domination. In terms of research results, the conceptual framework of risks associated with Chinese cross-border mergers and acquisitions is modified.

The research achieved its research objectives; the results from risks associated with Chinese inbound mergers and acquisitions in the integration process address the research questions, and indicate their significance to practice in the real world. The recommendations in order to advise on mitigating risks associated with mergers and acquisitions within a Chinese business context presented as a conceptual model of risks in Chinese business for cross-border mergers and acquisitions are also presented in this chapter, which is aimed to contribute to the academic body of knowledge of managing both Chinese inbound and outbound mergers and acquisitions.

CHAPTER SIX: RESEARCH RESULTS, FINDINGS, MODEL CONCEPTUALISATION AND RECOMMENDATIONS

6.1 Introduction

This chapter comprises the research results, findings, and recommendations to mitigate the research problem. Of the four proposed companies selected for interviews, the research only obtained material information from one company as reported on in the previous chapter. Although the primary data collection from the interview was unsuccessful, some valuable information was gleaned during the process, which facilitated the process of risk identification. The report of the primary data collection is presented in this chapter and analysed along with the other cases. The contexts and conditions of mergers and acquisitions differ from case to case. As a result, the risk factors from the 34 secondary cases relating mergers and acquisitions were identified, analysed and quantified to determine the extent of their risk profiles. The identified risk factors are categorised according to the risk areas of the conceptual framework, which were introduced in Chapter Three and Four. These risk categories also map to the same categories of research questions posed in Chapter Five. Owing to the number and content of the studied cases, it was problematic to reflect all the details for each case. However, the most significant details as it relates to risks associated with mergers and acquisitions are highlighted.

6.2 Research Report on Primary Data Collection

Case studies relating to cross-border mergers and acquisitions can provide in depth insight into strategies, execution and risk management practices. The researcher conducted an interview with one of the initially planned four companies. Although the interview did not answer the proposed questions, the process of data collection is of significance to the research questions. Therefore, the results of the primary data collection are from this case.

Nantong Baogang Oil & Fat Development Co., Limited (hereafter referred to as Nantong Baogang) was one of the biggest Chinese cooking oil manufacturers, and the third largest protein giant in Asia. The company was also the biggest private company in Nantong city in early 2000, ranked as one of China's top 500 private companies, and was awarded the best brand in China in 2005. This private company commenced operations in October 1999 with 32.39 million Yuan registered capital and 500 million Yuan fixed assets. In the second half of 2005, the company was sued for a total of 190 million Yuan for fraudulent transactions by two of its biggest suppliers. Nantong Baogang took contracted materials from the Nantong port without the suppliers' permission and reciprocal payment. Some of the materials have been processed to final products and sold when the suppliers discovered the fraud. Owing to

the severity of the case, the Nantong local government appointed a supervisory group immediately after the incident was discovered. The group included the Nantong municipal government, the Chongchuan precinct government, the Nantong Economic and Trade Commission, and the People's Bank of China. When the investigation began, the owner and general manager (father and son) of the company, absconded.

The company's initial registered capital in 1999 was 2.6 million Yuan. The accumulated loans reached 7.65 billion up until 2005, of which 1.05 billion represented unpaid mature debts. The total of the mature debts was 1.4 billion Yuan in September 2005. As a result of over-expansion, the company had a serious cash flow problem to maintain financial solvency. The fraud also trigged panic amongst other creditors who requested payback on outstanding invoices. The banks formed the majority creditors, as 800 million Yuan of unpaid loans had been borrowed from 12 banks. Having made a huge tax contribution to the local economy, the company was well supported by the local government with different types of arrangements with regards to loans, including guarantees from a big state-owned company. The company also received preferential policies for operations such as permission to locate to the Nantong port, where companies were not allowed to build any factories according to the local municipal policies. In October 2005, the company was considered to be in liquidation.

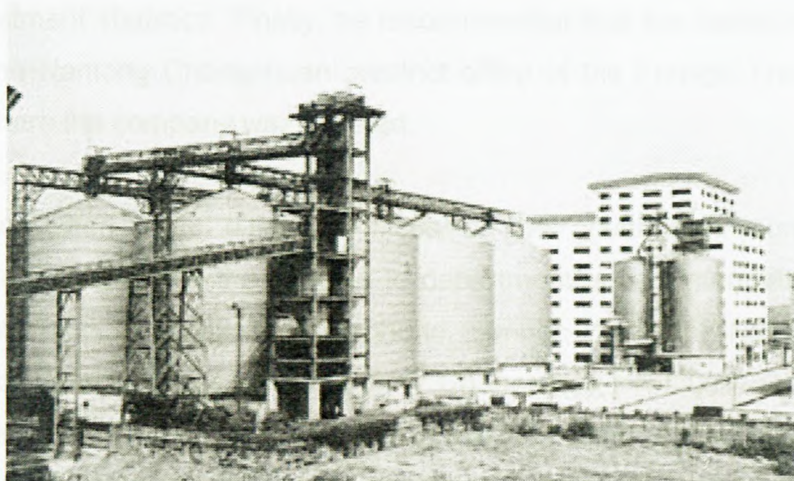


Figure 6.1: Nantong Baogang Oil & Fat Development Co., Ltd

This incident had an enormous impact on the economy of Nantong, as the government wished to establish the city as the top private ownership economic city in the Jiangsu Province, and also to raise the image and economic strength of the city. Nantong Baogang was depicted as a successful example of achieving this political aim; however, its collapse destroyed this objective.

In April 2007, the local government approved a merger between Nantong Baogang and the Nobel Group at a contracted price totalling US$49.8 million. The acquiring company was a Singapore-listed multinational corporation.. The Nantong government was the mediator in spearheading the deal to satisfy the debtors of Nantong Baogang and to rebuild the confidence of the local economy. The attractiveness of Nantong Baogang to the Noble Group was the fact that the company was situated at a port on the Yangtze Rive - China's longest inland river; the 300 000 ton shipping capacity of the harbour; as well as excellent transport facilities and proximity to Shanghai.

Since telephone calls to both the Noble Group and Nantong Baogang were unsuccessful, the researcher decided to visit the local government of Nantong in person to map the procedures and process of the deal and officials' perceptions of the status quo.

The Nantong Bureau of Foreign Trade and Economy is one of the authorities responsible for foreign investment approval. The researcher was introduced to the top official of the department regarding the purpose of the research. However, the top official denied any knowledge of the deal between Nantong Baogang and the Noble Group. After the question whether all the foreign investment in the city had to be approved by this department, oppose to a direct answer the official made the observation that they were actually only responsible for foreign investment statistics. Finally, he recommended that the details required could be sourced from the Nantong Chongchuan precinct office of the Foreign Trade and Economy Cooperation, where the company was situated.

The researcher visited three different offices at the government bureau of Nantong Chongchuan precinct to locate the referred to department, as no information pointed to the existence of the office, its location or telephone number. When the Nantong Chongchuan precinct office of Foreign Trade and Economy Cooperation eventually was located by the researcher, the department was in the process of being consolidated with another department, and no one was in charge at the time. Further information was provided to contact an officer of the Chongchuan precinct government administration. He mentioned that the workers of Nantong Noble have had a strike in 2009, which caused serious trouble for the local government. Strikes are not a common and are not an encouraged activity in China. Such actions were regarded as devaluing the city's image and disturbing the political achievements of the local government. It could further impede the officials' political promotion. As a result, all the information related to the strike was suppressed, and nothing could be found following on Internet research or search of the local. The reasons for and the result of the strike were unknown.

The researcher then visited the Economic and Trade Commission of Nantong, another authority for foreign investment in that region. After the researcher's introduction, the head official reviewed the researcher's recommendation letter, and remarked: "Lucky you come from South Africa, if you were from any other country, we would have suspected you of spying!" The researcher enquired about figures pertaining to mergers and acquisitions in the city. The officer informed the researcher that except for wholly foreign-owned companies and joint ventures, there were no records of mergers or acquisitions with foreign companies in his governing system. This response was very confusing as the government issued news and statistical data maintaining that the number of foreign invested mergers and acquisitions took place in the city. However, the actual governmental records of mergers and acquisitions did not exist according to the government official. This raised the question of where the information about the mergers and acquisitions had come from and if it was trustworthy? Or was the official lying to the researcher? After the researcher mentioned the merger of Nantong Bangong, the official became suspicious and asked how the researcher knew of the company, and why that company specifically was chosen to serve as object of her research. Consequently, the researcher did not obtain any information about the deal, and the official also denied knowing any details thereof.

Through the Internet, the researcher found a cell phone number of a sales representative and made an appointment with the representative. A meeting was scheduled at the 'Four Seasons', a five-star hotel in the city. After a few questions about the company from the researcher, the sales representative became very suspicious, and questioned the researcher's real status and purpose for the meeting. He refused to answer any more questions about the company, although the researcher explained that it was necessary to know more about the company. The researcher showed him the recommendation letter from the university, and explained the purpose of the research. Surprisingly, the representative commented that it did not matter who the researcher was, nobody had succeeded in conducting interviews or obtaining information in any way of this deal. This was a strong indication that some abnormal hold was on the people of the company, as well as the government as to not divulge any information about the deal. The information was completely suppressed by local government, and nobody, including workers, were allowed to leak any information to the media.

The sales representative eventually asked for details of the interview questions, but refused to respond to any question. Before his departure, he told the researcher that there was some information about the company on a website in Hong Kong, which might be helpful, as related information was all blocked or cancelled from the websites of mainland China. By following his suggestion, an incident report about Nantong Noble Grain & Protein Co., Ltd

was found on Ifeng.com, written by Zhou Yu, which provided material information on this case and their reciprocal refused to be interviewed.

6.3 Research Results from Secondary Data Collection

The outcome of 34 studied cases is a convergent aggregation of multiple independent risk variables. Each case has a pattern of various independent risk factors that respond to the failure of the integrations. The objective of this study is to identify risk factors and determine their validity to the established framework. Therefore, the analysis of these independent variables is focused on those factors which resulted in unsuccessful integration. The determination of successful or unsuccessful integration is based on the outcome of whether the shareholders' value had been increased and/or synergies had been achieved to both acquiring and acquired companies.

The analysis followed two steps. Step one was to identify independent risk variables and deploying them to risk categories for each case. Step two was to determine the magnitude of each independent variable and its contribution to the failure.

Regarding the research-focused categories, there was a lack of information in many studied cases owing to the limitations of secondary sources. The reasons for this were that the researcher's interests differ from those of the writers, and/or there were restrictions on information exposure to the public. However, the private companies among the studied cases offered more detail than the other sectors. A comprehensive list of companies representing the secondary research cases and their associated applications, refer Table 5.4 Chapter 5.

6.3.1 Research Demography

Types of Chinese companies: The total of studied cases was 34, of which 7 were Chinese private companies representing 21 percent of the total; 7 were Chinese stock listed companies representing 21 percent of the total; and 20 were state-owned companies representing 58 percent of the total. The distribution is reflected in Figure 6.2 below.

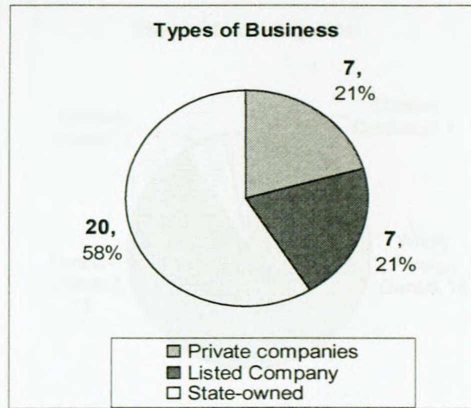


Figure 6.2: Distribution of Types of Chinese Businesses

The countries representing the acquiring companies: The USA was the investing country involved in 12 cases representing 34 percent of the total; 8 cases were invested in by French companies representing 24 percent of the total; 5 cases were invested in by German companies representing 15 percent of the total; both Singaporean and Swedish companies invested in 2 cases respectively each country has 6 percent of the total. The distribution is reflected in Figure 6.3 below.

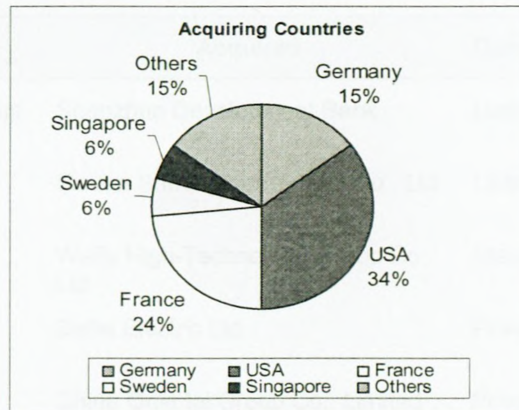


Figure 6.3: Countries Representing the Acquiring Companies

The results of integration: In 18 of the studied cases, the Chinese companies were merged by foreign partners, with the combinations shifting to wholly foreign-owned enterprises, while 13 cases were foreign-controlled acquisitions. Two cases became wholly Chinese owned: One was purchased due to the extended period loss in the integration, and the other was purchased due to sustained law suits. Only one case was controlled by a Chinese company, however had concluded an agreement in the initial contract for selling their controlling shares. Figure 6.4 is reflective of this dispensation.

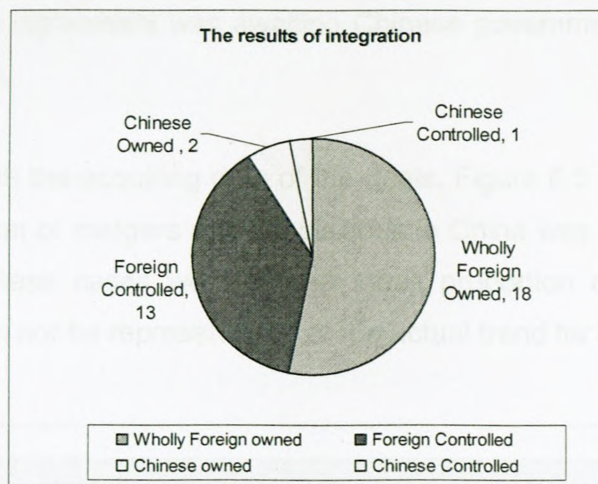


Figure 6.4: Results of Integration

Regarding the results of integration, the total number of successful cases was 13 (listed in Table 6.1 for ease of reference), which represented 38 percent of the 34 studied cases. More specific, 62 percent of integrations were unsuccessful.

Table 6.1: Successful Cases

Date	Acquiring	Acquired	Company types	M/A
2006	New-bridge Capital Croup	Shenzhen Development Bank	Listed company	Acquisition (Foreign Control)
2007	Lafarge	Sicuan Shuangma Cement Co., Ltd	Listed company	Acquisition (Foreign Control)
2004	Bosch	Weifu High-Technology Group Co., Ltd	State-owned	Cooperation (Foreign control)
2006	Sehneider	Delixi Electric Ltd	Private company	Acquisition (Foreign Control)
2007	Arcelor – Mittal Steel	China Oriental Group Co., Limited.	Private listed company	Acquisition (Chinese control)
2006	SEb Home Appliance Maker	Zhejiang Supor Cookware	Privatel listed company	Acquisition (Foreign Control)
2006	Best Buy	Five Star Appliance Co., Ltd	Private company	Merger
2003	Colgate	Sanxiao Group	Private company	Merger
2006	InBev	Fujian Sedrin Brewery Co., Ltd	State-owned	Merger
2005	International Mining Machinery Ltd	Jixi Coal Machinery Co., Ltd	State-owned	Merger
2005	International Mining Machinery Ltd	Jiamusi Coal machinery Co., Ltd	State-owned	Merger
2005	Caterpillar	Shandong Sem Machinery Co., Ltd	State-owned	Merger
2006	Rotary Vortex Limited	Shuanghui Group	Listed company	Merger

Regarding the status of control in the integration, Table 6.1 reflects that only one case was controlled by a Chinese company. The Chinese company China Oriental Group has made a further agreement on selling more shares to the foreign investor, Arcelor – Mittal Steel for

controlling status. This agreement was awaiting Chinese government's approval at the time of compiling this thesis.

Trends: Compared with the acquiring date of the deals, Figure 6.5 shows that 2003 was the year in which integration of mergers and acquisitions in China was at a low point in terms of the studied cases. These cases were only a small proportion of the actual deals, and therefore this trend can not be representative of the actual trend for mergers and acquisitions in China.

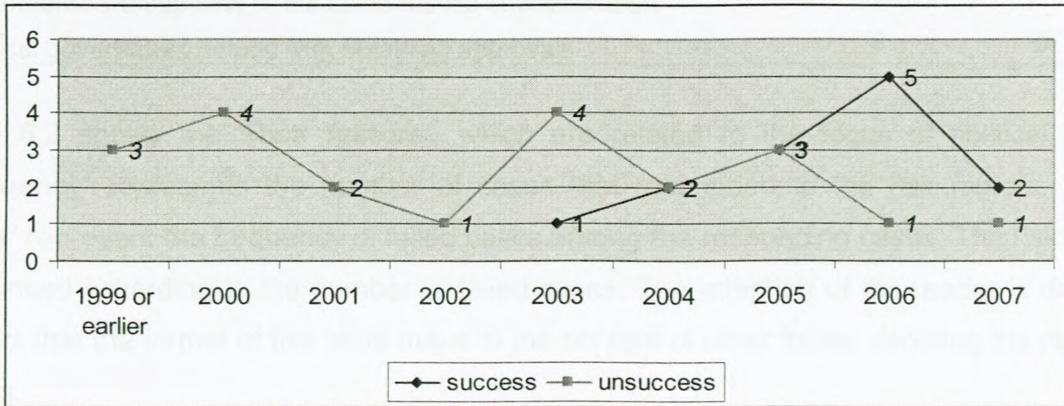


Figure 6.5: Trend of the Deal

There were 10 cases that occurred before 2003, but none of the Chinese companies succeeded. After 2003, the number of unsuccessful cases started to drop, and the number of successful cases started to rise. The year 2005 reflects a transformation in the studied cases as the number of successful cases was greater than the number of unsuccessful cases.

6.3.2 Research Results Pertaining to Political Risks

The research results attained for ease of reference are presented in terms of the identified risk categories, and map to the research questions posed. Research Question 1 reads: "What political factors affect Chinese business in cross-border mergers and acquisitions?"

Responding to this question, 11 out of 34 cases did not have sufficient information to answer the question. Among these, 7 were private companies, 2 were private listed companies and 2 were state-owned companies. This situation may imply that private companies were less likely to be affected by political factors. There were 16 failed cases among the 23 responding cases. Of these cases, 8 independent risk factors associated with political issues were identified, as shown in Table 6.2 below.

Table 6.2: Research Results Pertaining to Political Risks

Risk factors (23 responding cases, 11 cases were missing information)	**Frequency**	**Failed Cases**
Perusing political motivation on the use of foreign investment	20	14
Executing the requirement of state-owned enterprise reform policy	17	13
Motivated by increasing local GDP	19	12
The government arranged the deal	17	12
The government participated in the negotiation	16	11
Split-off unemployed workers and debts to Chinese parent company	9	9
Government's perceptions of the failed results of cooperation	7	7
The local government helped with obtaining approvals	8	5

Table 6.2 shows the **'Risk factors',** which are related to the focus of political issues. '**Frequency**' represents the number of cases that responded to the risk factors. **'Failed cases'** represent the frequency of failed cases among the responding cases. The risk factors are ranked according to the number of failed cases. The attention of the reader is drawn to the fact that the format of this table maps to the content of other tables denoting the research results.

From the risk factors listed in Table 6.2, the following risks were determined.

- **Risks on governing principle**

The top three risk factors reflected in Table 6.2 were also the drivers of the Chinese businesses engaging in cross-border mergers and acquisitions. However, they had affected many Chinese companies failing to determine synergies of the deals, as these political missions were the priority to synergies, while business strategies were less important.

The central government's policy of encouraging foreign investment is positive in resolving actual problems of struggling state-owned companies. During policy implementation, the central government also realised that local governments are the core operators and will play important roles in the process. To support policy implementation, the central government gave the task of absorbing foreign investment to local government, but also rewards political promotion to the best performers. This governing principle explains the reason that local government feared losing foreign investors, especially top global investors. There were three cases in which Chinese companies yielded to the threats of foreign investors, who claimed that they would not invest in the regions if their terms and conditions could not be met. The principle also explains why foreign investors prefer to obtain investment conditions by approaching local governments, as they can place pressure on target companies to meet their demands.

The German company FAG, acquiring Xibei (South North) Bearing Co., Ltd (case no. 32), was a typical example of presenting the role of local governments in the deal. During 2001, FAG bridged the contract for failing to transfer the contractual amount to the Chinese company because of its own financial issues. Owing to this, the Chinese company wished to terminate the deal. After consulting with the local government for permission, the Chinese company was instructed to continue with the cooperation. The government's reason was that the cooperation could contribute significantly to the amount of foreign investment utilisation in that region. Therefore, the Chinese company obeyed the instruction in order to meet the local government's political goal. The integration in the following two years was a disaster, as the two parties had various disagreements and issues. The cooperation incurred a 120 million Yuan loss in 2002 and a 140 million Yuan loss in 2003. At the end of 2003, the Chinese company wished to buy back the shares from the foreign investor in order to minimise further losses. However, the local government decided to sell the 49 percent Chinese shares to the foreign partner to keep foreign investment in the region. The 28.5 million Yuan offer was the Chinese company's 1.5 year turnover before the deal was struck. When a 'bull market' resulted after 2005, the Chinese company had already been sold. The Chinese company also lost the opportunity of rebuilding, as it had given up the right of producing the same products in the market in the initial contract. Since then the business has shifted to a wholly foreign-owned company, where there has been a rapid increase in profits.

The government's political pursuit of attracting foreign investment can also be evaluated from Nobel Grain & Protein acquiring Nantong Baogang (case no. 19). As reported previously, since the Chinese company Nantong Baogang was experiencing financial collapse, the local government sought a foreign investor to take over the company, despite there being strong domestic companies interested in the purchase. The government completed the merger within four months after the Nantong Intermediate Court announced the company's liquidation. In this respect, the local government had to arrange the deal for the company because the owner had been arrested and the company had many benefits from the local government's preferential policies. From a local government's perspective, the sooner the government could solve the problems, the less negative the impact would be on the government itself.

A further example of local government's foreign investment pursuance was Mittal Steel acquiring Hunan Valin Iron and Steel Group (case no. 11). The central government's policy of restricting foreign investor's purchasing of controlling shares in a Chinese company in the steel and iron industry was in effect at the time when Mittal started to negotiate the acquisition. Despite being aware of the new policy, the Hunan provincial government still approved the deal in order to obtain foreign investment.

Another two cases with successful results also reflected the Chinese government's domination of the deal: International Mining Machinery Ltd acquiring both Jiamusi Combine Harvester (case no. 12) and Jixi Coal Mining Machinery (case no.15). Both transactions were conducted in terms of local government instructions and directives.

The Chinese central government strategises on long-term economic development. Foreign investment, including cross-border mergers and acquisitions, is strongly recommended to drive the country's economic growth. It is also the government's objective to reduce the number of struggling state-owned enterprises by restructuring state-owned equities with foreign investors. In principle, this approach can mitigate the government's financial and social burdens effectively. When this political and economic task was imposed on the Chinese local governments, they believed it would be difficult to rely on companies with poor performance to find suitable foreign investors without the government's assistance. As a result, local governments replaced the role of business to conduct deals with foreign investors.

With pressure from the Chinese central government, local governments have to focus on short-term strategies to increase the amount of foreign investment and regional GDP in order to gain greater political performance. Therefore, local governments intensified their domination of businesses for their own political achievement. The task of absorbing foreign investment also triggered a campaign amongst provinces by providing increasingly attractive investment conditions to foreign investors. Because of the political issues involved, very few cases have evinced the mistakes that local government and Chinese companies have made. These would serve as good examples for other businesses to learn from, and consequently avoid failure in their cooperation. In fact, failures are denied by the local governments, as seven Chinese company losses were regarded as successful transactions, because of the foreign investment contribution to the region.

➢ **Risks from government's perceptions of the result of a deal**

Cross-border mergers and acquisitions pursue to gain maximum value via synergy achievement for both parties. According to the results of the studied cases, there was a distinct difference in perception between the government and businesses regarding the outcome of cross-border mergers and acquisitions. These perceptions led to risky government decisions on the arrangements, negotiations and approvals of cross-border mergers and acquisitions.

There were 7 out of 13 cases, which were perceived successful by local governments, yet in reality failed. All these companies had state-owned backgrounds. In the case of John Deere

acquiring Jiamusi Combine Harvester Co., Ltd (case no. 13), the local government perceived the deal as a successful example of attracting foreign investment, despite the Chinese company having lost their skilled employees and the entire business. The integrated company did not pay any tax between 1997 and 2004, and left a 300 million Yuan debt to the government to write off. The Chinese company had a 95 percent market share in China in the combined harvester manufacturing industry before 1997. The company was heavily in debt and suffered huge losses due to inefficient operations and industrial downturn. The ratio of assets and liabilities reached 130 percent at the time. John Deere invested in the company under these conditions however the acquisition did not save the Chinese company, as it sold the shareholding to and became a subsidiary of John Deere in 2004. A famous Chinese leading company in the harvester manufacturing industry shifted to a wholly foreign-owned company. The inferior assets, which were split off from the cooperation later formed another company which has been growing fast with competitive products in the market.

The government's explanations about the success of this deal were as follows: 1. Levels of technology and equipment of the Chinese company were inappropriate to continue with the operation, therefore integrating with a foreign competitor was the only solution. 2. The company had incurred huge debt and losses, which were impossible to finance from either the banks or other financial institutions. 3. Although some employees were retrenched, most of the employees in the company remained in their jobs. 4. Most importantly, the cooperation boosted the local businesses in the supply chain, which led to the growth of local GDP. 5. The deal could also optimise the investment environment for other foreign investors. Overall, the ownership of the Chinese company was of little concern to the government. From a local government perspective, the judgemental criteria on the failure of a cross-border transaction is not based on the loss of a Chinese business, but whether it can contribute to tax revenue, increase employment, and drive the growth of upstream and downstream businesses in the supply chain in that region.

With these perceptions, local governments were motivated to increase the number of cross-border mergers and acquisitions in order to complete their political task. Other examples are the cases of International Mining Machinery Ltd acquiring both Jiamusi Coal Mining Machinery Co., Ltd (case no. 12) and Jixi Coal Mining Machinery Co., Ltd (case no. 15). The two companies were both the leading manufacturers in the mining machinery industry, and situated in the same region. Despite both companies making profits and with potential in the growing market, the local government still decided to deny their financing applications for expansion in order to compel them to consider cooperating with foreign investors. The local government perceived that if these two state-owned companies did not restructure with foreign investors, they would still be only two big state-owned companies with low-level

products and management, no matter how much money would be invested in them. Ultimately, these two companies were merged with an American company in line with the dictates of the local government.

These types of government perceptions of cross-border mergers and acquisitions was also evident in the cases of: Asea Brown Boveri acquiring Anhui Hefei Transformer Manufacturer (case no.1); Mittal Steel acquiring Hunan Valin Iron and Steel Group Co., Ltd (case no.11); Gillette acquiring Nanfu Battery Co., Ltd (case no.18); Nobel Grain & Protein Co., Ltd acquiring Nantong Baogang Oil & Fat Development Co. (case no.19); and Bosch-Siemens Home Appliances acquiring Yangtze Refrigerator Manufacturer (case no.33).

Many state-owned companies were left with serious financial, social and administration burdens to the local governments in the 1980s and 1990s, which were the main drivers of state-owned enterprise reform. In order to convert these distressed state-owned companies into profitable and manageable entities through equity reconstruction, local governments were more willing to compromise on all kinds of investment conditions with foreign investors. These included tax reduction and/or exemption, relinquishment of controlling rights, previous loss takeover, debts cancellation, and employee retrenchment. The privileges that foreign companies obtained from local governments exceeded those of Chinese private companies. With such support, foreign companies developed rapidly in the Chinese market in the past ten years.

However, these perceptions have failed Chinese businesses as proved by the results of the studied cases as no synergy was achieved and no value was added to the individual Chinese companies. Compared to the strong growth of foreign competitors, the Chinese domestic businesses remain weak. The argument being that with such privileges, local companies could also develop as the Chinese market goods are in such a high demand. In evidence, private businesses have grown rapidly since the start of the 1978 Chinese economic reform. Failed Chinese companies have missed the best period of development in recent years by relying on foreign investors. When that period of market prosperity has passed, to rebuild these failed Chinese businesses to produce competitive products and/or services, will be more costly and difficult.

6.3.3 Research Results Pertaining to Economic Risks

Research Question 2 reads:"What economic factors affect Chinese business in cross-border mergers and acquisitions?"

The total number of cases that responded to this question was 22, and 12 cases had missing information. The identified risk factors are shown in Table 6.3 below.

Table 6.3: Economic Risk Factors

Risk factors (22 responding cases, 12 cases were missing information)	**Frequency**	**Failed Cases**
Industrial recession	7	6
Pressure from domestic competitors	9	4
Chinese business's heavy burden on staff welfare	4	4
Pressure from strong foreign competitors	7	3
The Chinese market recession	3	2
Countrywide triangular debts	2	2
The increased cost of material	2	1

Chinese markets have been gradually opened to international business, and the stable economic environment is favourable to business development. The 1998 financial recession in Asia affected Chinese businesses adversely, especially equipment manufacturers. That period was regarded as China's industrial recession since China's economic reform. The countrywide growth downturn was regarded as a 'market recession'.

Seven of the companies, which served as cases for this research, was subjected to the 'industrial recession', which was the main cause of failure in this category. Of these, only one private company succeeded from the merger, while one private company and five state-owned companies failed. State-owned companies involved are cases no. 1, 3, 13, 26, and 29. Since L'Oreal Paris merged with Mininurse (case no.17) in 2003, sales of the Chinese brand have fallen significantly due to the acquirer's marketing strategy and the disparity between the management of the two companies. Mininurse was the third largest cosmetic brand in the Chinese market in 2003. Two years after the integration, their products could rarely be found in the market.

In Table 6.3, the highest frequency of risk factors was 'pressure from domestic competitors', which indicates the motive for cross-border mergers and acquisitions. Of the nine studied cases, four had failed. Two were state-owned companies, and two were private companies. Chinese cross-border mergers and acquisitions were also motivated by 'pressure from strong foreign competitors'. Regarding this risk, four companies succeeded in the integration, while three failed. Mininurse was the company who merged due to pressures from both domestic and foreign competitors.

The heavy burden on staff welfare was a major issue for Chinese state-owned companies, which caused four cases to fail, namely cases no. 3, 9, 13, and 29. Yet another risk factor is debt. State-owned companies Dalian Electric Motors Manufacturer (case no. 3) and The Second Dalian Electric Motors Manufacturer (case no. 29) had operational difficulties, which were caused by countrywide triangular debts. The results show that businesses were unlikely to recover from these two risk factors, since none of the businesses in the studied cases succeeded from foreign investment. The heavy burden of staff welfare is the result of China's planning economic system, which has been changed since the Chinese state-owned enterprise reform policy took effect. More specific, the risk in respect of this matter has now significantly been reduce, however the countrywide triangular debt is still hampering business operations.

From a holistic perspective, economic risks have a lesser impact if compared to other risks, as the government has been dedicated to creating an attractive business environment from a policy-making perspective.

6.3.4 Research Results Pertaining to Policy and Regulation Risks

Research Question 3 reads: "What policy and regulation factors affect Chinese business in cross-border mergers and acquisitions?"

Policies are the Chinese government's governing directives, and in the studied cases they served as the drivers of the Chinese cross-border mergers and acquisitions. Risks were generated from the conflicts between policy implementation and business strategy.

Table 6.4: Risk Factors Associated with Policy & Regulation

Risk factors (23 responding cases, 11 cases were missing information)	Frequency	Failed Cases
Foreign investment policy	15	12
State-owned enterprise reform policy	10	5
Industrial policy	7	4
Labour policy of retrenchment	4	3
Non-tradable shares reform	2	1

As Table 6.4 reflects, 15 Chinese companies engaged in cross-border mergers and acquisitions were encouraged by China's foreign investment policy, and ten companies were encouraged by state-owned enterprise reform policy. In terms of the execution of these policies, the number of involved cases and the failure rates were both high. From a risk factor of foreign investment policy perspective, there were 12 failures among 15 studied cases,

which led to an 80 percent failure rate. Of the ten cases, which engaged in the state-owned enterprise reform policy, five failed. This high failure rate focuses attention on the risks of policy implementation and policy practicability.

➢ **Risks of policy implementation**

The aims of the Chinese foreign investment policy include access to advanced technology and increasing management levels for Chinese companies. The policy is a positive paradigm of the Chinese government's domination, which allows international businesses to trade in China with Chinese businesses. The studied cases show that the policy of foreign investment utilisation needs to be implemented within the context of a merger or acquisition. The issue is that the broad definitions and ambiguous terms of the policies leave scope for abuse during implementation, which may go against the government's will and/or the Chinese law.

In the case of Greason acquiring Harbin No1.Tool Manufacturing Corporation Ltd (case no. 9), the government restricted the deadline for the state-owned enterprise reform completion, which was before 2006. The Chinese company had more than 50 years' history, and was one of the four most competitive companies in the industry in China holding a 36 percent market share. To fulfil the government's policy, the top manager of the company spent several years focusing on finding a suitable foreign partner. However, the company had been at a sustained loss for many years, and it was difficult to find a competitive investment partner according to its financial and operational situations. In 2005, when the negotiation between the company and Greason, the world's biggest gear manufacturer was in a deadlock, the local government pressurised the top manager to accept the terms required by the foreign investor. In return, the local government promised Greason that the government would take over the Chinese company's debts, retrench employees, and reduce other relevant social burdens. The local government believed that the Chinese company would benefit from invested capital, advanced equipment and technology, and the salaries of the workers would also be increased. As a result, the local government advised the company that they "do not have to control the acquisition". Despite the entire management team being against the deal, Greason acquired the control rights of the company's most valuable assets. After the foreign capital had been invested, the company was still operating at a loss. The equipment that the government wanted was purchased; however, the Chinese workers were only taught to operate only certain aspects of the machinery, and the technological know how that the Chinese company required, remained in foreign hands.

➢ **Risks associated with policy practicability**

Weifu High-Technology Group (case no. 31), was a profitable and competitive Chinese company. It lost control of its own technology and productivity during an acquisition, owing to

pressure by the Chinese government to achieve the set exhaust emission criteria. This company had the most competitive productivity history in the industry in China with eight leading products in the country. However, to meet the government's criteria timously, it was impossible to rely on the company's own capacity. Cooperating with a foreign company (Bosch) to upgrade its technology was considered the best solution. For this reason, the Chinese company had to agree with the foreign investor relating to the following: (1) The Chinese company would have only 33 percent shares in the cooperation; (2) only produce the products under grade II of the diesel injection system; (3) the engineers and skilled workers of the parent company would all move over to the combined company.

These three terms signified that the Chinese company would abandon the rights of equity control, upgrade productivity and human capital control of its business, and yield to the control of the foreign investor, Bosch. The integrated organisation was a highly competitive manufacturer in China and worldwide, however the Chinese company did not obtain the upgraded technology. The marketing, operating and production of the company were all controlled by Bosch. After three years of integration, the cooperation started to make significant profits, and both partners were content with the dispensation. The pressure from the government policy was perceived as one of the main reasons that the Chinese company decided to integrate with the foreign investor. It may be said that the government's requirement for exhaust emission criteria were too high for the company to achieve satisfactory results. If the company had the capability, it would have been able to upgrade the equipment and technology independently. As a leading company in China, Weifu High-Technology would be able to meet the policy requirements.

Despite these achievements, questions are raised with respect to this industrial policy. If a top company in the industry could not achieve the government's requirements, the question is open if other companies could succeed in China, which are subjected to the same requirements within a limited time frame? If the criteria are aimed in meeting international standards, then this deal culminated in China losing a profitable domestic leading company. The fact is that the technology Bosch had that could address the Chinese government's criteria, has not been achieved by any other Chinese company. Regarding the acquisition, the foreign investor successfully eliminated the biggest Chinese competitor in the Chinese market with an intensified competitive capacity. Being such a strong competitor in China, would threaten other Chinese domestic businesses in the industry. This phenomenon raises the issue of practicability of the Chinese government's policy. It is possible that the requirements were too high and above the average level of achievement. To mitigate the bottleneck of inadequate technology, a top Chinese company such as Weifu should be encouraged to technology innovation by the government. Instead, the policy stimulated the

company to succumb to its competitor. By adhering to this kind of cooperation, the Chinese company had lost the ability of developing technology and improving productivity.

Another case related to industry policy was case no.11, Mittal Steel acquiring Hunan Valin Iron and Steel Group. This case has been briefly introduced in Question 1. Mittal's initial intention was to purchase the controlling shares of Hunan Valin. Cooperating with the world's biggest steel company, the Chinese company strategised synergies included (1). To reduce the cost of imported raw material; (2) to share the sales net of Mittal; (3) to utilise convenient transportation service from Mittal; (4) to cooperate with respect to technology, research and development. In this deal, Mittal expected a 15 percent annual return rate from Hunan Valin. However, since the Chinese government restricted foreign company's control rights on investment in the steel and iron industry in 2005, the deal was approved as Mittal had a one percent share less than the biggest shareholder Hunan Valin, at 36.673 percent shares of the total. Because Mittal only obtained the position of second shareholder, none of the proposed synergies in the contract had been fulfilled or achieved. The acquisition went ahead in 2010 at a loss of cooperation incurred an 857 million Yuan, resulting in a net profit rate of -7.29%.

Including the cases mentioned in the political risks, the Chinese local governments' merger and acquisition decisions were based on the interests of the number of the deals made, and regional GDP. The interests of the Chinese companies from a long-term development perspective were of less concern, and not evaluated. The Chinese central government's policies encouraged inexperienced local governments and Chinese businesses to perform cross-border mergers and acquisitions with sophisticated multi-national corporations in order to benefit the Chinese economy as a whole. However, both the Chinese central and local governments were not fully aware of the risks associated with the activities, as well as risks involved in policy implementation as the consequences of industry policy may only emerge after many years of integration.

6.3.5 Research Results Pertaining to Legal Risks

Research Question 4 reads:"What legislative factors affect Chinese business in cross-border mergers and acquisitions?"

There were not many legal issues which have been disclosed to the public. The identified risk factors are shown in Table 6.5 below.

Table 6.5: Risk Factors of Legal Issues

Risk factors (12 responding cases, 22 cases were missing information)	Frequency	Failed Cases
Chinese company broke the contract of Company Law	2	2
Chinese government hiding illegitimate business activities	2	2
Foreign partner breached the contract	2	1
Partnership involved lawsuits	2	1
National security scrutiny	1	1
Government officials involved in unlawful business activities	1	1
Intellectual property legal matters	1	1
Did not claim legal rights via lawful means	1	1

- **Lawsuits**

There were two companies that was subjected to the impact of lawsuits in the studied cases: Danone acquiring Wahaha Group (case no. 30), and Newbridge Capital Group acquiring Shenzhen Development Bank (case no. 25). The first was China's most controversial and influential case brought to the attention of the public. The lawsuits in the latter case were concluded by an acquisition agreement, which satisfied both parties.

The lawsuits between Danone and Wahaha Group were caused by the Wahaha brand. The cooperation between Wahaha and Danone began with the Wahaha joint venture, where Wahaha had 49 percent and Jinjia joint venture had 51 percent shares. Danone and Peregrine both held 50 percent shares of the Jinjia joint venture. In terms of this dispensation, Wahaha Group was the controlling shareholder in the joint venture. However, the Wahaha Group did not secure its 49 percent shareholding control rights in the contract with the Jinjia joint venture. This initial contract essentially laid the groundwork for later lawsuits. Peregrine later sold all the shares to Danone in the Jinjia joint venture, which made Danone the controlling shareholder of the Wahaha joint venture. The trademark of Wahaha was to be used in the joint venture only according to the contract. However, the use of the trademark in the joint venture was not approved by the government, result in the contract not being totaly protected under Chinese law. In addition, the assets in the joint venture were only part of the Wahaha Group's total assets, and the brand was still used in its non-joint venture subsidiaries. Due to the Wahaha group's loss of the controlling rights in the joint venture, and the two partners' different marketing strategies, the owner of Wahaha Group developed more non-joint venture subsidiaries by using the same brand. After Danone's offer of acquiring 51 percent controlling shares of Wahaha Group's non-joint venture assets in 2007 was refused, the conflict between the two companies worsened. This triggered ongoing lawsuits between Danone and Wahaha from 2007 in China and worldwide. The lawsuits ended in 2009, with Danone selling all the shareholdings to the Wahaha Group.

The lawsuits between Newbridge Capital Group and Shenzhen Development Bank were caused by the acquisition negotiation before the final agreement was concluded. In 2002, the two companies approached each other, and both were satisfied with the synergy strategies. Because of three divergences, the negotiation went into a deadlock. One divergence was the purchase price; the second was the allocation of shares; and the third was the split off of Shenzheng Investment Management Co., Ltd. In February 2003, Newbridge Capital applied for arbitrage to the International Court of the Arbitration of International Chamber of Commerce for the following reasons:

- Shenzhen Development Bank had approached another investor, which breached the agreement with Newbridge.
- Newbridge was forced to pay a higher price by the bid of a third party.
- Incorrectly allotted shares, which broke the agreement and resulted in fewer available shares for Newbridge's purchase.

Accordingly, Newbridge demanded five million US dollars compensation. Because of this action, Shenzhen Development Bank sued Newbridge in November 2003 for disturbing normal operations, and sued for compensation worth billions of US dollars. In February 2004, the two companies started their negotiation again, and soon reached an agreement. Newbridge purchased 17.89 percent shares of Shenzhen Development Bank. In December 2004, Newbridge became the biggest shareholder of Shenzhen Development Bank. This deal was the first example of a foreign investor's acquiring a Chinese commercial bank. The integration was reported as being successful according to media reports.

The lawsuits in the first case received enormous support from both Chinese businesses and consumers. Since Danone had also acquired other brands in the food and beverage industry in China, this case had a negative impact on its operation in the Chinese market. The two cases demonstrated the risk involved in agreements and contracts related to Chinese mergers and acquisitions.

- **The government's involvement in legal procedure**

National security was at stake in the case of SEB acquiring Zhejiang Supor Cookware (case no. 34). Zhejiang Supor was a listed Chinese private company, which agreed to sell its controlling shares to SEB. In order to pass the government's security scrutiny, the owner of Supor bribed the government's top official in the Ministry of Commerce for the anti-monopoly approval. The anti-monopoly scrutiny was initiated by Zhejiang Supor's domestic competitors, as the acquisition would intensify Supor's competitive capacity and further threaten their market shares. SEB preferred Zhejiang Supor's leading manufacturing position in China in the electrical home appliance market and Zhejiang Supor aspired to SEB's infrared

technology and international achievements. The negotiation between the two companies was completed, and an agreement was reached. However, a strong demand of anti-monopoly scrutiny from domestic competitors placed huge pressure on government approval. Zhejiang Supor successfully reached the top official through a law firm, and according to his sanction the case was approved in April 2007 without a convincing scrutiny procedure being followed. Despite the acquisition having achieved a 14 percent net profit increase rate annually since 2007; however the bribery was exposed in August 2008, the Chinese owner and official involved in the case faced legal action. Since the official was facing litigation, Zhejiang Supor started to sell more shares to SEB, and as of February 2011, SEB held 71.31 percent shares in Zhejing Supor.

The government's involvement in legal matters also appeared in the case of Nobel Grain acquiring Nantong Baogang (case no. 19). As previously discussed, the local government interfered in the investigation of the unlawful products (namely the cooking oil made from mouldy soybeans), and the associated light fine imposed. During the entire case, Nobel Grain was protected by the local government – even up to blocking any media coverage of the incident.

➢ **Risks of legal right claim**

It is an accepted fact, not only of the cases studied in this research, that Chinese companies were reluctant to use legal means to protect their rights. This reluctance may be caused by their complicated relationships with government. As a prime example, during the integration of the case of Xibei Bearing (case no. 33), the Chinese company found that the foreign partner broke the contract on the following issues: (1) Importation of new equipment, (2) upgrade to new technology, (3) employment retrenchment, and (4) amount of invested capital. Despite these transgressions, the company did not use the law to claim their rights. This was because Xibei Bearing was under pressure by the local government's political agenda to keep foreign investors in that region.

Another example was the case Mittal Steel acquiring Hunan Valin Iron and Steel Group (case no. 11). Despite the agreement of foreign control being made by both parties, which was well supported by the local government, Mittal Steel failed to obtain Chinese central government approval for the controlling shares of Valin, because of the Chinese steel industry policy. As mentioned previously, Mittal's intention was to obtain the position of biggest shareholder. Having been the secondary shareholder, Mittal did not fulfil its obligations according to the agreement. The acquisition suffered a continuing loss, which reached 2.6 billion Yuan in 2010, mainly due to increased costs. Valin also claimed that Mittal had not transfer the technology to the new product line since acquiring the

shareholdings in 2005, and also had not supplied ironstone as agreed in their contract. The main reason for the loss incurred by the Chinese company was that there were no clauses in the contract to restrict Mittal's non-performance.

6.3.6 Research Results Pertaining to Business Risks

The risks in business culminated as a result of risks in business strategy, operating, and human resource issues.

Business strategy

Business strategy is one of the most important considerations when engaging in cross-border mergers and/or acquisitions. The identified risk factors are shown in Table 6.6.

Table 6.6: Research Results of Business Strategic Issues

Risk factors (34 responding cases)	Frequency	Failed Cases
Strategised on using foreign investors to upgrade business level	28	18
Business development strategy divergence	18	17
Unclear strategies on the operation of cooperation	22	16
Strategy on using Chinese market to exchange foreign technology	16	13
Conflicts caused by strategic divergence	14	11
Strategy on avoiding continued losses	9	8
Marketing strategy divergence	6	6
Business control divergence	4	4
Restriction on Chinese products/or sale	4	4

As evidence of the high failure rate, Table 6.6 shows that strategic risk was the major risk in Chinese cross-border mergers and acquisitions. Strategic divergence and/or strategic conflicts occurred frequently, because the strategies of engaging in Chinese cross-border mergers and acquisitions were not well planned and not clearly understood by either party. Owing to a poor understanding of strategies, Chinese companies did not benefit from cross-border cooperation, as expected by the government and businesses.

Obtaining foreign technology and increasing business management levels were the two major strategies that attracted Chinese business to engage in cross-border mergers and acquisitions. From the high number of failed cases, it can be said that these strategies were unsuccessful for Chinese businesses. Of the 13 failed Chinese companies, none effected any technology upgrades. Concerning the issues of technology and loss, nine unsuccessful Chinese companies (26 percent of total cases) were of the opinion that the foreign partners intended to make a loss, merely to obtain the controlling share in the cooperation.

From a competitive strategy perspective, some foreign investors restricted the production of Chinese brands after acquisition. Chinese companies agreed to manufacture certain products under the terms and conditions of foreign investors, because of their concerns about obtaining foreign capital, leaning new technologies and improving management skills from their foreign partners. However, the results show that this type of strategies contributed to a high failure rate in Chinese companies, as four state-owned companies, which concluded such an agreement have all failed. The failed integrations reminded these Chinese companies that their foreign partners were strategising to expand their own brands through Chinese companies' distribution channels and enter into the Chinese market. Indeed, the loss is foreseeable if a Chinese business has a strong brand in the market (this is the advantage of acquiring) and has agreed to devalue the brand when engaging in cross-border mergers and acquisitions.

Business strategies in cross-border mergers and acquisitions need to be determined and agreed upon both parties, in order to achieve joint synergies. However, that was not the case in many studied instances. The identified strategies and results are shown in Table 6.7 below:

Table 6.7: Chinese Business's Strategies and Results

Strategy	**The results of these strategies:**
• Upgrade management skill levels	• Divergences in management
• Adopt foreign partner's technology	• Did not receive expected technology • Lost own technology
• Reconstruct the state-owned equity	• Company become wholly foreign owned
• Avoid continued loss	• Lost assets • Lost capital
• Grow business	• Lost control of business • Lost own brand • Lost market • Lost skilled employees

From the studied cases, there were two issues that emerged with respect to strategic alliances. One was a lack of understanding of the cooperation strategy; and the other was the lack of determining the practicability of the strategy.

➢ **Lack of understanding of cooperation strategy**

Most Chinese companies were particularly interested in obtaining advanced technologies through mergers and acquisitions, as 17 studied companies had strategised around this erroneous aspect. Should the view be adopted that, technology is the 'soul of business

development'; it by implication would under aspects pertaining to intelligence, techniques, knowledge, time, and substantive cost., which is why protecting the legal rights of technologies is of considerable importance. Therefore, the benefits of technology in mergers and acquisitions are mainly based on the conditions of the strategic alliance.

A common issue evident in all of the studied cases is the fact that the Chinese government and businesses did not realise the importance of technology to foreign partners, which resulted in enormous misunderstanding of strategies. Some companies simply assumed that once the two companies have a partner relationship, they would be able to learn and share technology from the involved products, equipment, and/or projects. Such oversight was demonstrated in an interview, which was held by a Chinese government TV station. The interviewee was the general manager of Xibei Bearing Co. (case no. 32), which was acquired by the German company FAG. The interview was held six years after the deal was concluded. The general manager acknowledged that he did not know what the foreign investor's strategies were. It was also found that the manager had signed the contract without having read it through, despite its having been drawn up by the foreign partner, and translated into Chinese. Since a great deal of conflict occurred in the integration, the manager started to read the contract page by page, and realised what he had signed off on, he had virtually no control over or had any management rights in the acquisition, with 49 percent shareholding in the company. This major oversight caused the lost of control of the entire Chinese business. This Chinese company strategised on using its marketing channel, a well-known Chinese brand, and the special access permit of supplying the railway industry to exchange the technology of FAG. However, except for knowing that FAG wanted access to China's railway industry, he did not know whether the foreign partner had agreed to such a strategic alliance. As the top manager, he assumed that sharing everything was part and parcel of a partnership.

- **Determining the practicability of the strategy**

In the 16 cases where Chinese companies strategised on obtaining technology, and where 13 failed, they were guided by government's policy of obtaining technology through mergers and acquisitions. Businesses believed that this strategy was achievable with government support, including those that were having financial and operational difficulties, Chinese business strategies were to obtain both foreign capital and advanced technology. How to plan business strategic alliances with actual business situations without losing the business in a cross-border partnership, was not fully understood and of concern. Furthermore, it was not clarified in the contract as a formal agreement for implementation and did not include punishment of breach for the involved parties. None of the studied cases had mentioned restrictions on breach of contract from a Chinese business perspective. It is not only a

strategic but also a legislative weakness of Chinese business contract negotiations. Most importantly, it created substantial risk to Chinese cross-border mergers and acquisitions, particular to Chinese businesses.

Strategy alliance of mergers and acquisitions needs to be assessed for practicability and viability. From a synergy perspective, the Chinese government encourages a strategy of obtaining technology through foreign investment, however not executable from a practicability perspective for the following reasons:

- Chinese businesses were in inferior positions in the cooperation agreement due to their urgent need for capital, management skills, and upgraded products and technology.
- Most of the Chinese businesses involved were running at a loss, and it would be difficult for them to gain trust for having a controlling position from much higher level foreign partners.
- Foreign investors would insist on a controlling position in the acquisition, or otherwise request critical investment conditions, to ensure the enormous investments would not be lost and could add value to their shareholders.
- Foreign partners would require a controlling position to secure and protect their intellectual property rights, whereby their usage and transfer in a partnership would be exercised with extreme caution.
- In the situation of management control in the partnership, if the Chinese business did not know how to negotiate and regulate their controlling power and rights in the contract, and it was very likely to lose the entire business as a result.

Once Chinese businesses have made concessions in order to achieve certain business strategies failed to execute them, the partnership would experience serious conflict. On the other hand, if foreign investors do not understand the Chinese businesses' strategies, or meet their expectations, it would also be very unlikely that the two parties could maintain a harmonious and friendly partnership. Once that gap has appeared in the partnership, loss and severance become unavoidable.

Operating Risks

The information on operating issues was limited, and the researcher as a result present in this part limited information.

As shown in Table 6.8 below, there were four cases involved in accounting fraud, and three in tax fraud. The cases involved in accounting fraud were: Fujian Sedrin Brewery (case no. 7), Nantong Baogang (Case no. 19), Yangtze Refrigerator (case no. 33), and Zhejiang Supor (case no. 34).

Table 6.8: Research Results Pertaining to Operating Issues

Risk factors on Chinese business (27 responding cases, 7 cases were missing information)	Frequency	Failed Cases
High debt	8	7
Operation problems caused by poor cash flows	5	4
Record of taxation fraud	3	3
Believed the foreign partner transferred money out of China	3	3
Have a record of accounting fraud	4	2
Chinese business have high account receivable	2	2

Fujian Sedrin Brewery (case no. 7), was found guilty on declaring income, and paid 5.26 million Yuan tax and penalty for tax evasion in 1996. The fraud occurred again in 1999 involving 39.55 million Yuan inflated income, and the company paid 5.87 million tax supplements and penalties. In 2003, the company was again found guilty of unlawful conduct to the amount of 825 million Yuan. Of this amount, 496 million was undisclosed income. This amounted to tax evasion of 220 million Yuan. The company also used the employees' names to open 26 bank accounts. In short, efficient cash management in the company was questionable.

According to the Nantong Intermediate Court, Nantong Baogang was charged for three illegal transgressions. One pertained to artificially registered capital of 94.78 million Yuan, which was three times more than the actual amount earned between May 2002 and December 2004. The second charge relating to the wrongfully reporting of 92.68 million Yuan paid in default. The third charge related to contract fraud, as the company obtained 306 million Yan loans from banks through deceit in the use of financing, false reports on operating conditions, iterative mortgage and pledge, counterfeit financial seals (seals of companies and/or individuals are mandatory on Chinese documents), and hidden capital. Accounting fraud perpetrated by the company include unrecorded income and assets, and hidden debts and equity. The suspected amount was 60 million Yuan.

It was noted that these issues were not found through the process of auditing during the trading periods. Nantong Bangong had 1.4 billion Yuan debts in which 57 percent were from banks. Because the company provided fraudulent financial reports, 12 banks were misled into lending. The negligence of banks resulted in a 25 percent loss in loans because of the resultant insolvency. There was one bank that successfully avoided the loss, as it had conducted fieldwork for the company one year before its bankruptcy, and had found some risky issues, such as fraudulent stocks, management chaos, and undisclosure of poor operating conditions. In terms of these undisclosures, the bank issued warnings to the company, stopped lending, and recouped the loan successfully. However, this information

was not shared with the other 12 banks, which had ignored the process of conducting due diligence of the company.

The accounting fraud in Yangtze Refrigerator (case no. 33), had no detailed information. Zhejiang Supor (case no. 34) was found to have 128 million Yuan undisclosed affiliated transactions in the annual financial reports for three years since being listed on the stock exchange, which misled the investors. Another instance involving fraud was using the government subsidy to increase earnings, with the received amount reaching 26.27 million Yuan in 2003.

Of the four cases, only Nantong Baogang was charged by a Chinese court. Fujian Sedrin was fined for the transgressions, while the remaining two companies are unknown. The instance of Nantong Baogang was shielded by the local government, as the company contributed a significant amount of tax revenue to the region. Despite being over extended, the company could still receive support from the local government in obtaining loans from more than 12 banks, as they were subject to local government domination. Although Fujian Sedrin was penalised for the fraud, the amount involved in transgressions showed a significant increase, which means that the penalties did not deter the company's repeated infractions of the law.

Accounting fraud has been raised as a serious and common problem in Chinese business, which has been of major concern for foreign investors. Fraud is often not taken to court, despite the presence of laws against it. Financial penalties are the most commonly used form of punishment. However, the studied cases indicate that the punishment of fraud is too lenient as the benefits derived from fraud are much greater than the costs involved, which have encouraged fraudulent behaviour. In this instance, the analogy can be drawn that the Chinese government has failed to deter this type of illegal action through the law, which has resulted in increased occurrence thereof.

There were some common factors in the studied cases that reflect on operational problems within Chinese companies, such as cash flow problems, which result in high debts and account receivables. Regarding the strategy of being financially rescued by foreign investment, of the studied cases one company with high debts succeeded, while the other seven companies all failed. Four out of five companies that had cash flow problems also failed. Due to substantial losses in integration, nine out of 21 failed Chinese companies had to sell all their shareholding to their foreign partners.

Human Resource Issues

There were 17 cases that contained information about labour risks, which are summarised in Table 6.9 below.

Table 6.9: Research Results Pertaining to Labour Issues

Risk factors (17 responding cases, 17 cases were missing information)	Frequency	Failed Cases
Retrenched workers	11	9
Employees were unsatisfied with their salaries	6	5
Chinese top level managers were changed	6	4
Original leader or top managers resigned	4	4
Labour burden left to the Chinese parent company	4	4
Top managers having conflicts with partners	4	4
Worker strike	4	3
Chinese HR manager did not know the strategy of the deal	2	2
Conflict caused by a lack of promotion of native managers	1	1

From the evidence gleaned from the researched companies, merged and/or acquired companies involving the above-listed issues were more likely to fail. In Table 6.9, the top risk factor was employee retrenchment, where nine out of 11 companies failed during the process of integration. Five out of six companies failed where employees were dissatisfied with their salaries, and of the six companies where top managers were changed, four failed. In four cases where employees went on strike, three failed. Over and above the aforementioned, no case succeeded at all under the remaining factors.

- **Lack of coordination on strategic changes**

Human resource issues in the studied cases primarily related to two aspects, namely workers, and the other, managers.

In nine failed cases, seven had retrenchments because of the integration, and three cases had workers dissatisfied with their salaries and welfares benefits. The other two cases had retrenchments during the integration, which contributed significantly to the failure of acquisition. These two cases were Danone acquiring Robest (case no.20), and Bosch-Siemens acquiring Yangze (case no.33).

Robest was a strong branded private company, one of the top ten drinking water and milk producers in China during 1990s. Danone acquired 92 percent shares of Robest's in 2000, however the acquisition had difficulties since the advent of the acquisition, owing to Danone's strategic changes in marketing and sales. In 2005, losses relating to the acquisition reached

157 million Yuan. Danone started retrenchment in 2006, and 30 percent of sales representatives and 40 percent of workers were retrenched, while in some areas the retrenchment reached 60 percent. Along with the retrenchment, employee's salaries were also cut. This widened the gap between the managers and the employees, and furthermore triggered serious conflicts within the company. This was not the first time Danone had retrenched Robest's employees. There were only 20 percent of Robest employees left, and Robest's employees perceived that they were discriminated against by Danone's employees. As a result, the productivity of the combination declined rapidly, the brand was seriously devalued, and lost its popularity in the Chinese market. Danone started to sell certain of its factories all over China to offset the loss. By 2010, Danone had stopped using the brand 'Robest' as its usufruct had expired.

A similar situation occurred in the case of Bosch-Siemens acquiring Yangze (Case no.33). The acquisition was problematic from the time Bosch purchased 70 percent shares of Yangze. Owing to serious conflict between the two companies, the top managers of Bosch were changed frequently, however this did not exclude the acquisition from running at a loss. The former workers of Yangze believed that the strategies of Bosch were inappropriate and all the problems Bosch had experienced, managing the employees of Yangze was the toughest challenge of the integration. Because of the continued financial losses, Bosch initiated retrenchment, which triggered an employee strike. The foreign managers requested assistance from the German embassy, and eventually the Chinese local government resolved the strike.

Retrenchments before the acquisition were caused by over-staffing in state-owned companies particularly, which was the outcome of the planning economic system. It was the Chinese companies' opportunity to solve this problem through mergers and acquisitions in order to attain operational efficiency. However, despite aid from local governments, there were six cases, which failed where retrenchment took place. This indicates that the failure of integration was due to poor management skills and negligence. Retrenchment during the integration was a sign of a problematic cooperation, as had occurred within Robest and Yangze. These two cases had some common issues, such as strong brands in the market, serious management conflicts, and frequent top manager changes. The failure of the two cases was in fact caused by strategic divergence. Both Chinese companies targeted low-income markets with extremely successful records. The foreign partners attempted to change the marketing model without proper communication and consultation with the Chinese managers, the latter who opposed the strategic changes. Furthermore, the feasibility of the strategic changes were not determined, resulting in the fact that management could not influence the Chinese teams. The outcomes of the two cases proved that Chinese brands

are highly related to the quality and features of their products in its market. Strategic change in an unknown foreign market should address this consideration. The Chinese way of product distribution in these two companies was suited to their target markets, irrespective of the fact that the foreign companies completely disagreed with the governing principles. Overall, strategic changes were the major causes of the conflict between the partners in these two cases. From a foreign investor perspective, the Chinese managers had to be changed in order to promote and implement the strategic transformation.

➢ **Lack of human resource management skills**

Four cases was the subject of industrial strikes because of cross-border cooperation. This demonstrates the lack of human resources management skills prevalent in Chinese businesses. With the exception of an unknown cause of the industrial strike in the case of Nantong Baogang (case no.19), the other three Lafarge acquiring Sichuan Shuangma Cement (Case no. 28), FAG acquiring Xibei Bearing (case no. 32), and Bosch-Siemens acquiring Yangze (case no. 33) were all due to retrenchments.

Sichuan Shuangma Cement was a large Chinese state-owned stock-exchange listed company. In order to meet Lafarge's investment requirement, the company started retrenchment with a small remuneration package, which caused the employees to call for an industrial strike. In state-owned companies, the benefits of employee welfare depend on the actual working period, while retrenchment meant the employment period would be interrupted, thus a higher compensation was expected. The workers complained about the low wages they had earned, which were far below the industrial average, and the associated low retrenchment package received. They also criticised the Chinese management's unacceptable attitudes and unfair treatment. Workers were of the opinion that their voices had never been heard and were generally ignored, and that the managers had no respect for them. Despite the company operating at a big loss and workers having shares in the company, top managers were still receiving much higher salaries, and were abusing the employees' housing fund to build luxury houses for themselves. The workers demanded a salary increase and fair treatment. To ensure the acquisition was not interrupted, some strikers were locked up in the company's offices by the managers, and police were in force to calm down the protestors. The industrial strike happened in 2007, and the news of the 3,000 worker industrial strike was well concealed and did not leak to the public. The deal was finalised in the same year with the support of Chinese management, as well as the support from the local government and the State-owned Assets Supervision and Administration Commission.

Human resource managers play an important role in supporting a potential successful merger integration. However, this was ignored by all of the Chinese companies. As an example, the human resource manager of Robest did not know what Danone's strategies in the acquisition were. The same situation occurred at Xibei Bearing. These cases demonstrate the lack of human resource management skills in these Chinese companies, which greatly contributed to the failure of the integration. The level of employee dissatisfaction in the failed cases was also high. Controversially, China does not have minimum wages in industries to protect worker interests, resulting in different salary levels being applied in the same industry. In dealing with employment issues, government generally gives priority to business growth, which has encouraged businesses to take undue advantage of workers. Because of the huge population base, less skilled workers are often managed in a cavalier fashion. This situation has started to change since the labour shortage after the 2008 financial crisis, which not only challenged Chinese companies with respect to on increase of labour costs, but also the management skills of human resources.

6.3.7 Research Results Pertaining to Cultural Risks

Research Question 5 reads:" What cultural factors affect Chinese business in Cross-border mergers and acquisitions?"

Cultural diversity in cross-border mergers and acquisitions is regarded as a high-risk area during a merger or/and acquisition. However, from a Chinese perspective, cultural diversity was not one of the major concerns in most of the studied cases. This may be due to Chinese companies generally welcoming foreign investors and accepting different cultures. Although there were five cases mentioned in respect of cultural differences, only a few risk factors were identified.

Risks associated with cultural issues were summarised from ten cases, of which nine cases were unsuccessful. Also in this instance, the lack of detailed information pertaining to cultural risk curbed the ability of the researcher to elaborate on the issues in detail. Risk factors pertaining to cultural issues are reflected in Table 6.10.

Table 6.10: Risk Factors Pertaining to Culture Issues

Risk factors (10 responding cases, 24 cases were missing information)	**Frequency**	**Failed Cases**
Lack of harmony between shareholders	8	7
Lack of harmony during the cooperation	8	7
Cultural difference caused long integration period	8	7
Different management styles caused cultural conflict	6	6

Distrust in partnerships	5	5
Foreign partners did not understand Chinese business	5	5
Difficulty in making foreign partners understand Chinese business	5	4
Difficult integration owing to cultural difference	5	4

The concept of "foreign partners not understanding Chinese business", can be regarded as the most important factor relating to culture. This perception results in distrust in the partnership and management conflicts, which further leads to the failure of integration in that the 'Chinese way' of doing business is different from that of the West. With this background, the perception in cross-border cooperation, a Chinese partner is very likely to be biased towards the Western way of managing business. Due to the fact that these foreign companies were all successful multinationals, Western management skills may be just what the Chinese managers expect to learn from. However, five Chinese partners who had this perception during the integrations all failed.

In fact, these failed Chinese businesses were not even aware of cultural risks, as they perceived cultural differences to be due to a lack of harmony between shareholders, lack of harmony in cooperation, different management styles, distrust in partnerships, and the lack of understanding of their businesses. The research results also show that mitigating cultural risks in Chinese cross-border mergers and acquisitions were not regarded as a consideration in achieving successful integration. In practice, the conflicts caused by strategic and managerial divergences were often regarded as cultural risks. For instance, in the cases of Bosch acquiring Yangze (case no. 33) and Danone acquiring Robest (case no. 20), Chinese managers deemed the conflict during integration process to be caused by cultural difference. They did not realise that these so called 'cultural conflicts', were the result of strategic and managerial divergence. Both companies were urged to cooperate with foreign investors, however, because they did not have clear strategies or an understanding of the synergic strategies, they believed that 'their way' of operation was best, thus refusing to accept other opinions.

This misunderstanding of cultural risks by Chinese business could mislead their decision making capability during integration. Five Star Appliance merged with Bestbuy using a two step approach in terms of the agreement. In step one, Bestbuy acquired 75 percent shares of Five Star in 2006; while in step two, acquired the remaining 25 percent shares not later than February 2009 at the same purchase price as the 75 percent shares. As the third largest retailer in the home appliance market in China, Five Star expected to surpass the other two Chinese competitors through the merger. However, after three years of joint cooperation, Five Star did not grow as fast as its competitors. Against this expectation, gaps between the

two competitors and Five Star grew. Despite Five Star and Bestbuy having had various conflicts within operations and marketing, the cooperation was still successful. The net profit of the company was 100 million Yuan in 2005, and it reached 400 million Yuan in 2008. Since the prices of the deal were fixed in the contract, this result disappointed the managers of Five Star, who felt that they had erred with determining a fiscal selling price. The conflict between the two companies emerged from two strategic divergences. One was the operating strategy, whereby Five Star strategised on quick market occupancy by opening more new shops countrywide; and Bestbuy strategised on integrating supply chain resources. Marketing strategy also played a part: Five Star targeted smaller cities from which they could receive benefit from the government's subsidy for operating in rural areas, and Bestbuy targeted expensive stores in big cities. The two companies used both brands in different markets respectively, and developed in their separate ways. Owing to strategic divergences, the growth of Five Star was constrained. This intensified the conflict between the two companies, especially when Five Stars' two competitors were growing even faster than it was and gaining more market share. The result proved that Five Star generated huge profits for Bestbuy, while Bestbuy's shops in the big cities incurred losses and closed in 2011. A few years after the merger, Five Star was no longer a competitive entity in the market.

Similar partnership conflicts also occurred in the cases of Danone acquiring Wahaha (case no. 30), and Citygroup Corporate acquiring Guang Dong Development Bank (Case no. 8). These strong branded Chinese businesses had their unique way of development. Chinese business culture has changed significantly since the upswing of economic development in China. Chinese perceived cultural risks focused on various conflicts, which were actually caused by strategic divergence.

6.3.8 Research Results Pertaining to the Management of Risks

Management capacity is key to managing risks associated with cross-border mergers and acquisitions. The identified risks in Chinese management performance are shown in Table 6.11.

Table 6.11: Research Results of Management Issues

Risk factors (24 responding cases, 10 cases were missing information)	Frequency	Failed Cases
Chinese productivity were reduced	17	16
Chinese brand was under-developed	16	15
Did not increase Chinese shareholders' value	15	15
Managers lack strategic forecasting and planning	10	9
Management are dissatisfied with foreign partner	10	9

Poor integration performance	10	9
Lacked awareness of shareholding control	7	7
Management negligence caused the loss of business control	7	6
Did not protect the shareholding rights	7	6
Poor management performance	7	6
Board conflicts in cooperation	6	5
Accepted foreign investor's terms & conditions by non-investment threat	3	2
Lacked capacity of managing cash flow in expansion	2	2

The listed risk factors such as reduced productivity, under-developed brands, and devalued shareholding were critical elements in the losses incurred by Chinese businesses. These losses could have been attributed to poor strategic planning of the cooperation, lack of awareness of shareholding control, and poor management performance. The direct impact on the cooperation was discontent with the partnership and board conflict, which created great risk to the integration.

Except for the two cases in the banking industry, none of the other 32 cases mentioned the issue of due diligence of the foreign partners. Poor quality evaluation is another issue that increased the losses in Chinese companies, especially those state-owned companies, which executed their deals before 2003. These Chinese businesses split off the best assets to foreign investors, and left high debts and employment burdens to the unproductive parent companies, which resulted in their market share being completely destroyed.

➢ **Poor coordination of senior manager**

Reconstruction can create stress for employees, and in mitigation, the management team needs to have a structured plan to assist acquired employees to cope with the changes, and understand the strategies of the deal. How a top manager cooperates with foreign partners and employees is critical to the success of the merger or acquisition integration. In the studied cases, resistance from top managers of the Chinese partners often impacted adversely on the integration progress. This usually points to the misunderstanding of strategies, however the lack of coordination in terms of strategic transformation, was the primary cause of failure of the merger or acquisition.

Robest had successful operations in China before the merger. The original managers strongly believed that their operation model was the best, which made them unwilling to implement Danone's strategic changes. Danone's opinion was that the former managers of Robest only paid attention to operations, but lacked strategic thinking. Five senior managers resigned simultaneously in 2001 due to strategic divergences, and all types of management

conflicts resulted. Robest's middle-level managers perceived that their suggestions for and participation in operations were not considered or respected. As a result, they did not coordinate with the new foreign management team. Since Danone retrenched senior managers of Robest and recruited new managers and employees, the employees of Robest felt discriminated against at work. This exacerbated the conflict between these employees and Danone. Managing these employees became extremely difficult. Ultimately, Danone was forced to change more than 70 percent of Robest's employees, whom they needed the most at the start of the integration.

Apart from Robest, the management conflict in Yangze (Case no. 33) pointed to Chinese manager dissatisfaction with unequal salaries compared with those of foreign managers, and unfair promotion in important management positions in the acquisition. This disposition was in particular evident at board level resulting in all suggestions from the opposite party were discounted at board meetings, where Bosch was holding 70 percent controlling shares. The top manager's dissatisfaction triggered negativity among all other Chinese managers and workers. In addition, the foreign partner changed the strategy on marketing, which caused customer loss and productivity declining. This made the Chinese managers believe that their suggestions were correct and they were indispensable to the success of the acquisition. An analyst described the Chinese top managers of Robest as pretentious and arrogant. They also disregarded the German managers' inexperience in dealing with the local government.

A similar situation occurred in the case of Citygroup Corporate acquiring Guangdong Development Bank (case no. 8), in which management conflict were caused by the resentment of un-promoted Chinese managers and the change of senior managers. In the Chinese company's opinion, some important posts required an understanding and knowledge of Chinese policy and markets, calling for the requirement that these positions to be allocated to Chinese speakers. They also disliked Citygroup wanting to change everything to their way of operating. Therefore, they had to align with other majority shareholders to confront the changes, which led to complicit at board level. This led to Citygroup considering in selling their shares held in Guangdong Development Bank.

➢ **Weakness of contracting**

Contractual agreements are formal legal documents signed by involved parties transferring clear clarified legal rights and obligations of parties involving into a cross-border merger or acquisition. They are the most important legal documents for protecting a company's rights in a partnership. However, the weakness in contracting caused the Chinese businesses to be placed in a passive position in the partnership, and consequently caused many Chinese companies to fail.

In the case of Xibei Bearing Co. (case no. 33), the Chinese company had 49 percent shares in the merger. However, in their agreed contract, the Chinese company did not have the power of participation in any business activities, including financial management and business operation. The company lost control of the business because of the general manager's disregard of the importance of the contract. An interview, which was conducted by a Chinese government TV station with the general manager, discovered the following issues about the contract. The company:

- Had signed the contract without having read it (the contract was prepared by the foreign investors and translated into Chinese).
- did not know the terms and conditions of the contract.;
- did not claim any legal rights; and
- did not know what the foreign partner's legal rights were.

As the deal was arranged by the local government, the company lost the ability to protect itself in the cross-border cooperation under the government's supervision. This weakness of Chinese business demonstrated that there was a significant gap between the Chinese business and foreign investors when negotiating cross-border mergers and acquisitions. Furthermore, pointing to the aspect relating to management, the manager could not even fulfil the basic obligation to protect the assets of the company. The analogy can be draw that the government's control of business weakened the company's management capability.

In another case, the unintelligible terms and conditions in the contract destroyed the company. Shenyang Rock Drill Manufacturer (case no. 24) was the top company in the pneumatic rock drill industry, and was ranked as one of China's national industrial mainstays, which was supported by the government. According to the Chinese government's policy of state-owned equity reconstruction, the company started to look for foreign investors since 1999 and concluded a deal with the Swedish company Atlas, the world's largest rock drill manufacturer, in 2003. The Chinese company agreed to sell its brand, market, and main equipment to Atlas for 15 million Yuan cash, and use other valuable assets, fixed assets and current assets valued at 45 million Yuan, to establish a new corporation with Atlas. The Chinese company owned 75 percent shares, while Atlas owned 25 percent shares of the corporation. The Chinese company had four directors and Atlas had three on the board of directors of seven. According to the contract, all the decisions related to operations, sales, products, employment, branding, share changes, and profit distribution, had to be passed through the board. However, the contract restricted the Chinese company from producing products other than those supplied to Atlas. These terms indicate that the foreign company used 25 percent shares of the cooperation to control the entire Chinese company. The combination made a 2 million Yuan loss in 2003 and a 0.17 million Yuan profit in 2004. With

this unexpected result, the Chinese company offered 57.7 million Yuan sale of all its 75 percent shares to the public in August 2007. In August 2011, Atlas bought all the shares and completed this merger. Atlas by implication used the Chinese company's brand, market, and equipment to continue with the same production, and without upgrading any equipment, technology, or new products, Atlas made an estimated profit of 20 million Yuan in 2005 alone.

In the case of Danone acquiring Wahaha Group, various lawsuits occurred all over the world between the two parties, which was caused by a contract bridging. Wahaha lost the controlling right because the controlling shareholding were unsecured, which trigged the battle between the two partners on brand utilisation. The worldwide lawsuits started in 2007 and ended in 2009 with the Chinese company purchasing the shares back from Danone. In this incidence, both parties were deeply immersed in contract dispensation, and although the operation was profitable, the integration of the merger itself failed.

Other cases in which businesses lost due to contracting negligence are: Western Electric acquiring Dalian Electric Motors Manufacturer (case no. 3); Michelin acquiring Double Coin Holdings Ltd (case no. 5); SEB acquiring Hongxin Electric Iron Manufacturer (case no. 10); Mittal Steel acquiring Hunan Valin Iron and Steel Group (case no. 11); Henkel acquiring Seagull Group (case no. 22); Brook Crompton acquiring The Second Dalian Electric Motors Manufacturer (case no. 29). In order to obtain foreign investment, these Chinese companies had made huge concessions to foreign investors either willingly or unwillingly. These cases show that Chinese management lacked knowledge and managerial capability in cooperative contracts, which caused the failure of mergers and acquisitions. These cases are also indicative of the fact that Chinese managers were not aware of the enormous risks associated with cross-border mergers and acquisitions.

➢ **Weakness in protecting shareholding**

Owing to the weakness of contract content, Chinese business shareholding as a rule were unprotected in most of the studied cases, which resulted in dilution and loss of capital. There were six cases that had similar unsuccessful experiences in cross-border cooperation, which the Chinese companies perceived the cooperation to be unacceptable as they lost their companies. They strongly believed that the foreign partners purposely engineered losses, and then requested more capital investment for expansion. Since the Chinese company did not have the capacity to raise funds to follow up the expansion, their shares were subsequently purchased by the partners.

The above dispensation was evident in the cases of Western Electric acquiring Dalian Electric Motors Manufacturer (case no. 3); SEB acquiring Hongxin Electric Iron Manufacturer

(case no. 10); John Deere acquiring Jiamusi Combine Harvester (case no. 13); Atlas acquiring Shenyang Rock Drill Manufacturer (case no. 24); Brook Crompton acquiring The second Dalian Electric Motors Manufacturer (case no. 29); and FAG acquiring Xibei Bearing (case no. 32). All the Chinese companies in these cases were state-owned.

The lack of the ability in protecting shareholder rights is one of the most significant risks for Chinese businesses when engaging in cross-border mergers and acquisitions. Businesses with this type of inability will invariably be eliminated from a free competitive market. However, under the Chinese government's protection, these businesses did not realise the risk involved in the transactions. From a management perspective, these Chinese businesses were too weak to compete with international corporations.

➢ **Lack of management skills**

Except for the above risks associated with Chinese business, the following issues relating to management skills also contributed to the failure of Chinese inbound mergers and acquisitions:

- Family-based businesses with members in management positions hampered decision-making (case no. 4 Sehneider acquiring Delixi Electric; case no. 21 Colgate acquiring Sanxiao)
- Shareholder conflicts culminated in shareholding transfer (case no. 2 Arcelor–Mittal steel acquiring China Oriental Group)
- Lack of awareness of cash flow problems (case no. 11 Mittal Steel acquiring Hunan Valin Iron and Steel Group)
- Lack of appropriate valuation of the business in which the shares were sold cheaply (15 cases were noted)
- Malpractice pertaining to intellectual property (in 12 cases Chinese brands disappeared from the market)

Chinese business management skills have improved since the country's economic reform. State-owned companies were forced to be more independent in competing with other forms of economic entities in the market, including foreign and private companies. However, the results show that Chinese state-owned companies were still shielded by the government. Including private companies, the management capacity of Chinese businesses have not improved to a level in which they can compete with international conglomerates.

An aspect which could be determined through the research due to a lack of evidence, is the government's strategy of improving Chinese businesses' management levels. However two factors were evident. One was that foreign businesses preferred to deploy top managers by

using either local or expatriate Chinese in the merger or acquisition, in order to cope with Chinese methods of operating in China. In this way, the Western management style and methods could be selectively introduced to Chinese businesses. The other was that Chinese businesses lost their controlling position in the merger or acquisition, and their participation in business management and operation was limited. As a result, it was difficult to determine the degree in which their management skills acumen improvement. In general, Chinese businesses can learn the Western way of management through cooperation and training. The problem being that they invariably confront or deny the Western way of management, continue with 'their way' of management at the current level.

6.4 Model Conceptualisation and Recommendations

From 1994 up to 2005, cross-border mergers and acquisitions experienced a 'friendly welcome' phase in China. It served as a learning period for Chinese businesses to cooperate with Western businesses and experience their different business cultures. During this period, a considerable number of state-owned companies were the subject of cross-border mergers and acquisitions according to the government's policy. However, the research results show that the number of failed cases was significant. In most of the cases, the acquiring companies successfully achieved market access, developed brands and productivities, and added value to their shareholders. The targeted Chinese companies however lost their businesses, markets, brands, and productivity. After 2005, China started to conduct more rational mergers and acquisitions, which indicates a degree of risk management improvement by Chinese businesses when subjected to a merger or acquisition.

The research identified that the drivers of these Chinese cross-border mergers and acquisitions were not based on the strategies of business development and actual business capacity. They were rather deemed as the pursuance of the government's policies. These drivers can be summarised as follows:

- Upgrade of business management levels (28 cases).
- Government's policy implementation (23 cases).
- Political performance pursuance (20 cases).
- Increasing local GDP (19 cases).
- Poor business performance (16 cases).
- Upgrade to new technology (16 cases).
- Increasing business compatibility (14 cases).

With the exception of private businesses that regarded increasing business compatibility as of primary concern, most of the cases were driven by political issues, such as policy

implementation, political performance, and local GDP increase requirements. In respect of the government's objectives, the number of the deals made was the primary achievement, although most of the ownership was shifted from Chinese business to foreign investors. The upgrade of business management skills was the main driver for the government and businesses. This indicates that Chinese businesses acknowledge their weakness in business management, and they are expected to learn from the West through cross-border mergers and acquisitions. Regarding the Chinese companies' poor business performance and high demands in upgrading management levels and technology, it was clear that Chinese businesses were in an inferior position in the partnership of cross-border mergers and acquisitions. This culminates in that Chinese businesses have to pay a higher price to obtain rewards from cross-border partnerships.

The Chinese market was restricted to foreign businesses before the economic reform, resulting in market access being regarded and used as an exchange for Chinese companies to obtain technology, management skills, and better business performance from foreign investors. However, without proper evaluation and planning, engaging in cross-border mergers and acquisitions is risky to Chinese businesses. From a Chinese business perspective, the results of the merger and acquisition integration are shown in Table 6.12 below.

Table 6.12: Results of the Integrations

General Results (34 studied cases)	Frequency	Percent of Total
Integration was successful (synergy achieved)	**13**	**38**
- The Chinese company turned from a loss to a profit	4	11
Integration was unsuccessful (synergy unachieved)	**21**	**62**
- A profitable Chinese business turned to a loss	8	23
- The Chinese brand disappeared from the market	12	34
- The Chinese company lost its own technology	16	46
- The Chinese company lost shares in the market	16	46

There were 13 cases which approached synergies successfully for both acquiring and acquired companies, which is 38 percent of the total. More specific, the failure rate of the studied cases was 62 percent. The 21 failed cases out of a total of 34 points to the fact that political arrangements deviate from business concepts in practice, where the government had replaced the role of business in dealing with cross-border mergers and acquisitions. The results also show that none of the successful mergers were controlled by a Chinese company. These losses in Chinese companies were presented as decreased shareholder value, reduced productivity, unexpectedly lost control rights, brand cessation and financial

loss. Losses to Chinese businesses were severe, which point to the lack of management capability of both Chinese business and government.

Foreign investments have played an important role in the Chinese economy, in that from one perspective China has benefited from utilising foreign investment: More tax income is received; more people are recruited; the inbound foreign capital has boosted the entire Chinese market; and China is becoming a modern industrialised country, which drives more domestic businesses to grow in the supply chain. However, from a long-term native productivity perspective, top Chinese companies have become the subsidiaries of international giants. Regarding the failure of technology upgrade, reliance on obtaining technology from foreign investors made these Chinese companies miss the opportunity to improve their own technology. These companies cannot even compete with smaller sized Chinese domestic companies, without support from their international partners.

The high failure rate of Chinese in-bound mergers and acquisitions indicates that the levels of the Chinese government's domination, business operation and management performance are still low, thereby creating risks to Chinese cross-border mergers and acquisitions.

As a result of the research results gleaned from the 34 studied cases, the established conceptual framework, which is presented in Chapter Four and Five, can be further developed in a model for Chinese cross-border mergers and acquisitions, graphically depicted in Figure 6.6.

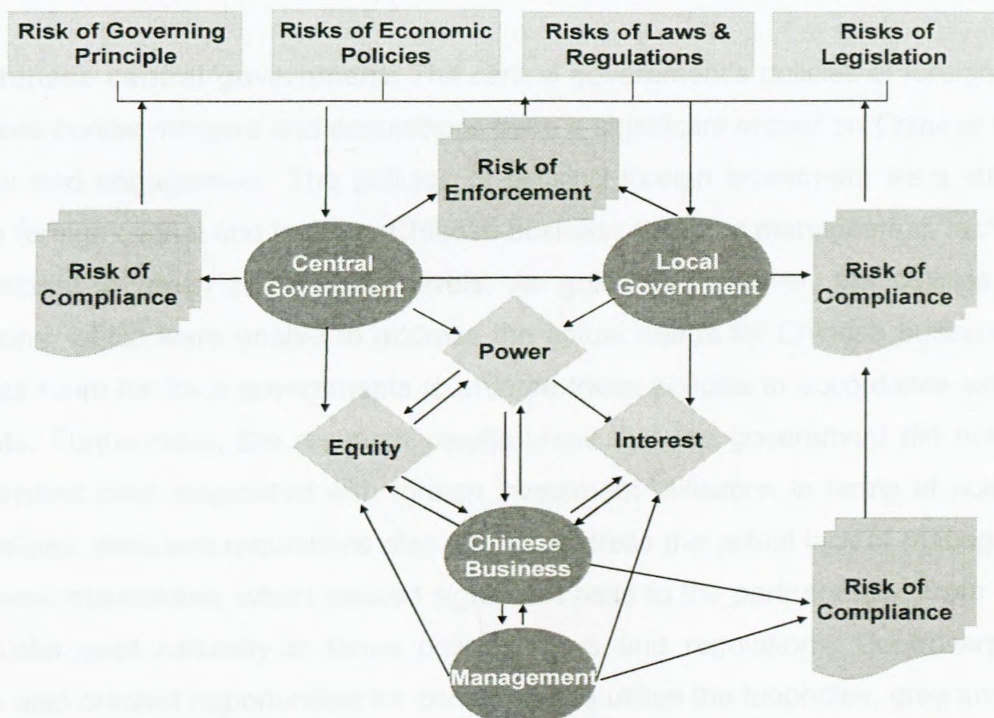


Figure 6.6: Conceptual Model of Risks in Chinese Business for Cross-border Mergers and Acquisitions

The model graphicately depicted in Figure 6.6 is structured based on four fundamental elements, namely:

- **Fundamental of risk factors:** Risk factors are presented as risks of governing principle, economic policies, laws and regulations, and legislation.
- **Fundamental of risk carriers**: Risk carriers represent the parties that are involved in the process of mergers and acquisitions, which include the Chinese central government, local government, business and management. These four carriers are stratified according to their power of control.
- **Fundamental of conflict**: Power, equity and interest are intervolved in risk carriers, and are the risk 'wedges' in the process of cross-border mergers and acquisitions.
- **Fundamental of execution:** Execution comprises compliance and enforcement, which interact as causal relationships in the risk factors. Risks are formed by the government authorities' enforcement performance and the carriers' compliance performance.

The model is focused on risk causalities. The four risk factors are regarded as 'explicit' risk areas, while the elements of conflict and execution are regarded as 'inexplicit' risk areas that explain risk origin. The research results show that there were two major facts that generated risks associated with Chinese cross-border mergers and acquisitions, namely the poor implementation of the government's policies, and the other was the weaknesses identified within Chinese businesses. A detailed explanatory analysis underpinning the conceptual model of risk in Chinese business for cross-border mergers and acquisitions (refer Figure 6.6) are provided below:

The Chinese central government: The central government's policies of foreign investment and cross-border mergers and acquisitions have a significant impact on Chinese businesses' motives and engagement. The policies of utilising foreign investment were strategised to absorb foreign capital and improve Chinese business levels of management, technology and compatibility to reach international levels. As guidance however, the policies had broad definitions, which were unable to address the actual needs for Chinese businesses. It also provides room for local governments to enforce these policies in accordance with their own interests. Furthermore, the research results show that the government did not thoroughly comprehend risks associated with foreign investment utilisation in terms of policy dictates. The policies, laws and regulations also did not address the actual lack of management skills in Chinese businesses, which caused significant risks to the partnerships. From this point of view, risks exist naturally in these policies, laws and regulations. Controversially, these factors also created opportunities for companies to utilise the loopholes, grey areas, and the flexible legal enforcement performance to operate businesses. The highly promoted policy of obtaining technology through foreign investors lacked feasibility in Chinese businesses. The

lack of evaluation and feasible procedures of planning, organising and implementing, created risks in the process of cross-border mergers and acquisitions for both Chinese and foreign businesses.

Local government: To implement the central government's policies, local governments and businesses were both promoted. As such, the local governments' political tasks and performance imply that they have extensive interest in participating in cross-border mergers and acquisitions. Chinese businesses were rendered incompetent under the pressure of local political agendas and poor management skills. As a result, these businesses had to offer huge concessions in the negotiation; the losses incurred by some Chinese businesses were for beyond recovery. The fact is that the politically arranged deals had ignored the huge gaps in productivity and management capacity between Western and Chinese businesses, there were few shared values in the cooperation from a Western investor's perspective. These failed cases proved that these Chinese businesses were the victims of the local governments' own political agendas.

Chinese business: The research results show that the government's domination impacted heavily on Chinese businesses. The broad range of government domination in businesses is not only because the government has ownership in businesses, but also because of Chinese business vulnerability in competing with international businesses both financially and technically. Conversely, in a Chinese business context, businesses intend to work closely with governments in order to benefit from their domination. Under the governments' domination, Chinese business capability of managing business independently and creatively has been weakened. As evidence, risks associated with essential business activities, such as strategising and contracting, counted as some of the major causes of failure in Chinese cross-border mergers and acquisitions.

Management: Management styles are formed by the overall Chinese business environment. Risks occurred in business are the direct result of its management performance. The identified risks in Chinese management include strategising, contracting, communication, human resources management, shareholding protection, coordination, operation, legal compliance, and management skills. These risks in management also reflect the risks of government administration, policies, laws and regulations, and legislation. It is the nature of business to maximise profitability by utilising the environmental conditions. As a result, the way a business operates is very dependent on the trading environment.

China has a complex political relationship between the central government, local governments, businesses and management. These relationships suffer from internal

conflicts, which are in turn triggered by power-grabbing politicians and managers operating out of 'own' interests.

Power: The local governments were the main impetus in policy implementation and domination of business. China's vast territory determines the important role of provinces in the administration. The provincial governments are not only empowered to implement and supervise the country's regulations, policies, and laws, but also to develop the local economy. They are also empowered to stipulate provincial rules, which are applicable in the provinces only. Their decisions are based on the benefit to local governments and politicians' political and economic interests. Because of the local governments' power in defining local rules, offering preferential tax rates, land use approval etc., foreign investors preferred to deal with local governments, in order to obtain investment privileges and approvals. Symbiotically, the local governments were satisfied with foreign investors' approaches, as they also addressed their political and personal needs. In so doing, the cooperation between businesses was shifted to the cooperation between local governments and foreign investors.

Equity: Since the Chinese government has equity in businesses, they by implication interfere in business activities. In some businesses, partial equities are already transferred to managers, employees and other invested companies and/or institutions through China's state-owned equity reform. As a result, the government's decision on selling state-owned shares to foreign investors may be against the interests of other shareholders. Of these shareholders, managers have the position and ability to manage businesses, and may claim the terms and conditions as shareholders. However, top managers in state-owned companies are appointed by central government (if the company is owned directly by the central government), or local government (if the company is owned by the local government). These decision makers' roles, attitudes and interests in the deal become vital in cross-border mergers and acquisitions. In contrast, managers in an appointed management position, without equity being held in the businesses, are more likely to stand to the side of the governments, to gain career advancement.

Interests: A merger or acquisition in China invariably is an interaction and balance of the interests of the central government, local governments, businesses and management with political powers and equity rights. The central government's interests are business development (especially state-owned businesses with losses), GDP increase, tax income, and employment. The local governments' interests are coincident with central government's interests, however, they have 'missions' to accomplishing in terms of state-owned enterprise reform, and attracting foreign investment in a region. These 'missions' are considered to be major exponents in political gain. As a result, local governments' interests are transferred

from dominating Chinese businesses to attracting foreign investors and facilitating the deals to success. This often has conflicts with central government's power of industrial and approval control, and the interests of businesses and management. On the other hand, managers may hold a large number of shares and equity in businesses from China's state-owned enterprise reform, making their interests in the deal are obvious. It is of importance to note the interests of non shareholding managers; when they have opportunities to own equity through foreign investment formed reconstruction, as their decision on the deal will be influenced as a result.

Risk of enforcement and compliance: There are two further important risks in the Chinese economic system that need to be taken into account. These two issues are the risks of enforcement and compliance. Regarding the **compliance** with policies, laws and regulations, the central government, local governments, businesses and management are all compliers, and at the same time, risk carriers. The central government is the administrator of policies, laws, and regulations. Risks pertaining to **enforcement** are presented as flexible performance by central and local governments and their agencies, which are major threats to the Chinese business environment, as manpower becomes greater than the law. In reality, this reduces the influence of laws and regulations, deteriorates the flexibility of law enforcement, disorders the free competition market, and escalates the exchange between power and individual benefits. China's enforcement risks have consequently created a problematic business environment for legal compliance while utilising the possible power influence to maximise personal interests. This will further damage China's orderly economic system and hinder the underway economic development. In addition, compliance and enforcement risks are very likely to trigger other risks associated with Chinese mergers and acquisitions. Despite information blockage, few cases still disclose the risks of law enforcement and legal compliance, such as a breach of company law, fraud, corruption and bribery.

This conceptual model graphically deplicted in Figur 6.6 provides overall risk correlations involved in Chinese cross-border mergers and acquisitions. The identified risk factors need to be assessed in these causal relationships, in order to gain a comprehensive understanding of the effects of these risks. Cross-border mergers and acquisitions are a growing industry in China. Risks, such as due diligence and valuation, have already been acknowledged and have been attributed more attention to in both Chinese in-bound and out-bound mergers and acquisitions. Identifying risks associated with Chinese cross-border mergers and acquisitions is a continuing and challenging process, particularly in a fast-moving and changing business environment. Mitigating risks associated with these activities are paramount.

The research in this thesis reflect that the risks identified in the process of integrations of a merger or acquisition are mainly caused as a result of parties being unaware of the risk associated within Chinese business. Simultaneously, foreign investors also show passive management performance in coping with their Chinese partners in China. This is due to the uncoordinated nature of Chinese business, as the consequence of the Chinese government's domination of and participation in mergers and acquisitions.

The research results furthermore reflect that strategic risk is considered the root cause of other risks in the integration process. This is attributed to the fact that strategic divergences trigger conflicts in operation, marketing and management of the merger or acquisition of many, fail deals. Therefore, mitigating risks in the integration cannot be isolated from the pre-merger and acquisition process. Risks need to be managed and/or avoided before the deal is closed. Regarding the concern of uneven business levels between the acquiring and target businesses, measuring compatibility of cross-border strategic alliances is a priority in risk mitigation for both Chinese inbound and outbound mergers and acquisitions. The integration compatibility measurement within a Chinese business context needs to consider four key areas, which are graphically depicted in Figure 6.7 below.

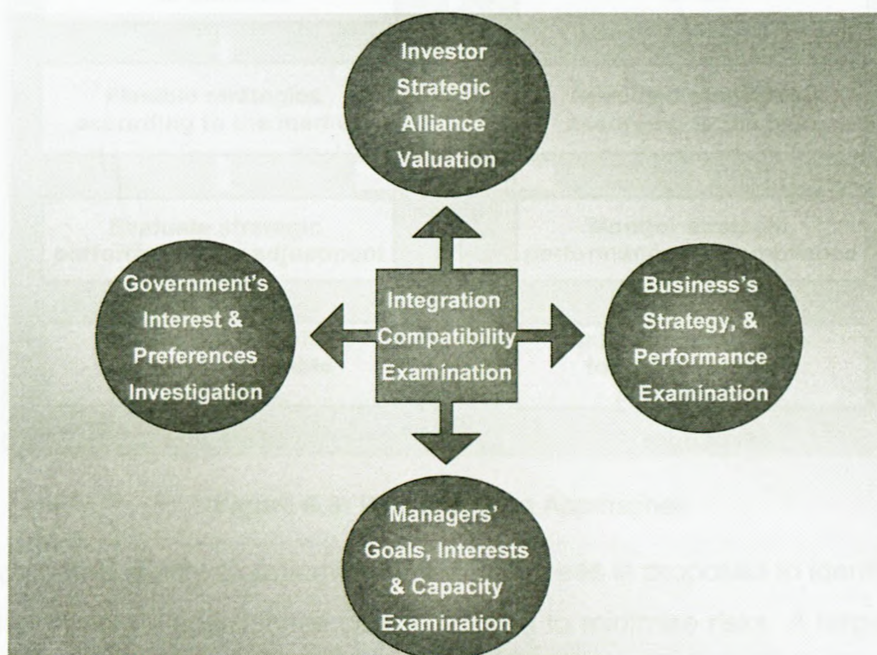


Figure 6.7: Integration Compatibility Measurements

These four key areas (elaborated upon below), need to be managed in the process of pre-mergers and acquisitions in order to prevent or reduce risks in the integration process.

- Valuation of the feasibility of strategic alliance from the strategies of both acquiring and targeting companies to ensure the synergy of the alliance is achievable.

- Investigation of the interests and preferences, particularly the political pursuance of the Chinese government on the deal, including local governments. This will facilitate obtaining government approvals, negotiation and integration of the deal.
- Examination of the goals, interests and capacity of the managers of the target organisation regarding the deal, as these managers are the key players/stakeholders in creating and managing risks.
- Examination of the strategies and business performances in the history of the target company, as these represent their capability in a strategic collaboration going forward.

These four risk areas can be regarded as an integral part of due diligence, but measured for integration compatibility purposes. Strategic divergence creates severe conflict in mergers or acquisitions; and it is important to address it before the final agreement is reached. According to the results of the examination in the process of pre- mergers and acquisitions, risks can be managed by two approaches graphically depicted in Figure 6.8 shown.

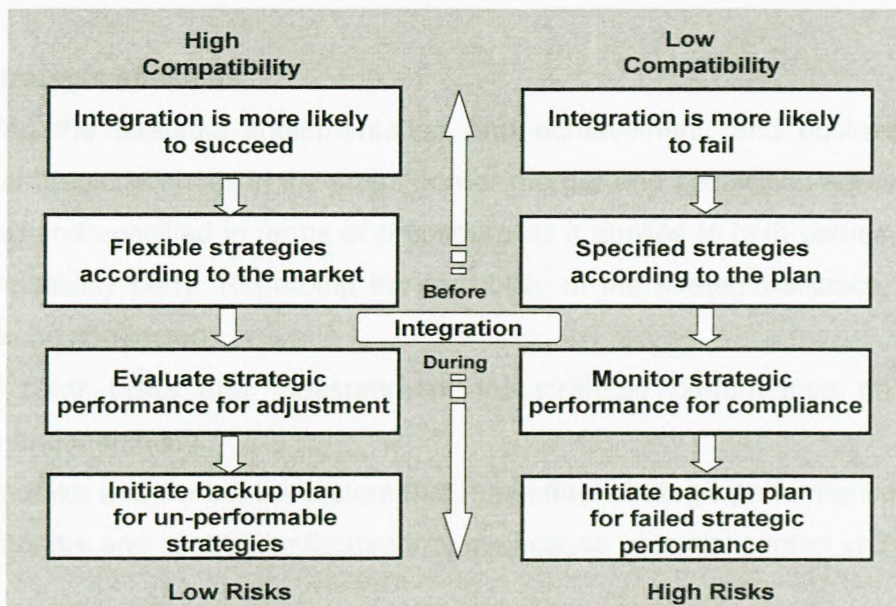


Figure 6.8: Risk Mitigation Approaches

The integration compatibility examination of the four areas is proposed to identify risks and to determine what strategic approaches can be applied to minimise risks. A target organisation with high compatibility will have low risks for integration; therefore the integration is more likely to succeed. Strategic alliances with this type of company should be engaged in flexible and competitive strategic planning according to the forecast of market performance and operating conditions for the integration. Therefore, the strategic performance of a merger or acquisition needs to be evaluated regularly and frequently during the integration, in order to adjust the strategies according to the results and actual conditions for best synergy

achievement. Most importantly, companies need to formulate backup plans regarding un-performable strategies and unforeseen issues.

In contrast, a target organisation with low compatibility will have high risks for integration, and the future cooperation is more likely to fail. To ensure the proposed strategies are implemented properly, rigid and specified terms and conditions must be documented formally. This is because low competitive companies have poor business coordination performance and lack compliancy regarding strategic implementation in the integration. As such, monitoring strategy implementation becomes the focus of the merger or acquisition during the integration. Backups to this type of strategic partnership are even more important, as the merger or acquisition is less flexible to confront conditional changes and unforeseen issues.

To mitigate risks associated within a Chinese business context, and intensify strategic compatibility for the integration of cross-border mergers and acquisitions, the following elements need to be considered in terms of the four risk areas.

Business strategic alliances

In considering the strategic implementation and achievement, and business rights and obligations, strategic alliances in the cross-border merger and acquisition agreement need to be elaborated and specified in terms of procedure as it applies to both parties, especially to the low compatibility party. Regarding the feasibility of the strategic alliance, the following steps need to be conducted:

- Establish clear tasks and measurement for strategic performance on productivity, operation and marketing.
- Identify, monitor and control the factors that may affect strategic performance.
- Identify, monitor and control the factors that may cause potential conflict in the partnership.

Government's interest in the deal

In terms of the Chinese government's extensive domination of mergers and acquisitions and its flexible governing performance, the following factors need to be determined in order to understand the degree of the government's participation in the negotiation and business operation.

- Determine the government's interests and preferences on the deal.
- Determine the government's role and extent in terms of dominating business operation.
- Determine and focus on the government's policy orientation and direction regarding economic policy, industry policy applied, taxation, and import and export.
- Determine how to avoid being the victim of trade friction between China and other trading countries.

It is important for business to understand the Chinese government's political priorities, policy orientation, and decision-making process in China and beyond. As a result, it is necessary to have frequent interaction with the Chinese government, especially local governments, because they can provide accurate prior information. Businesses would then be able to avoid and/or mitigate political and economic risks effectively at an early stage.

Managers' aims, interests, and preferences on the deal

Top managers manage risks for business, but they also can create serious problems in a partnership if not satisfied with the terms and conditions. Knowing what they expect from the deal and management capacity can reduce conflict significantly. This can be done through the determination of:

- Expected roles in the integration now and in the future.
- Expectation in respect of promotion.
- Benefits received in the past and expected in the future.
- Leadership and ethics.
- Management skills.
- Communication skills.
- Attitude towards management style and culture diversity.

Business performance

The determination of the target's business performance must rely on solid field examination. These include management, accounting, legal performance and human resource management. There are considerations under each performance elements, which can be initially used for risk identification and risk management. However, if there are pre-determined threats to strategic alliance, the rigid and specified implementation statements need to be formalised in the legal agreement to avoid poor business performance.

The following list (see Table 6.13) should be considered to be an integral part of a due diligence checklist; however the measurement criteria highlights the risk mitigation actions for the identified risks in a cross-border integration. Because these factors will affect strategic performance during the integration, they need to be measured for business compatibility.

Table 6.13: List of Measuring Business Performance

Performance	Measurement Criteria
Management performance	➢ Capability of transforming and restructuring the organisation ➢ Commitment to business strategies ➢ Management transparency including the extent of information sharing and communication

	➢ Creditability ➢ Skills of protecting shareholders' rights through the route of legal documentation ➢ Risk management structure and policies ➢ Intellectual property protection ➢ Customer relationship ➢ Efficiency of solving problems and conflicts
Accounting performance	➢ Tests on the cost of products, and compared that with the average cost in the previous years and that of similar companies in the industry ➢ Tests on products' selling price consistency ➢ Authenticity of material expenditure ➢ Authenticity of ownership and prices of plants, equipment and fixed assets ➢ Authenticity and prices of transactions with affiliated companies and subsidiaries ➢ Authenticity of transactions with major clients and customs ➢ Track on tax payments from the related state authorities ➢ Authenticity and transactions according to legal agreements
Legal performance	➢ Business intellectual property protection ➢ Anti-monopoly law application (if applicable) ➢ Environment law application ➢ Labour law application ➢ Lawsuits analysis ➢ Other laws and regulation compliance
Human Resource management performance	➢ Evaluate salary system ➢ Check the working environment and conditions ➢ Understanding, respect, compromise, and coordination of business transformation ➢ Determine key people in stabilising the company's productivity, marketing, sales and services ➢ Tactics of keeping talent ➢ Training of both managers and employees. ➢ Employment performance ➢ Communication skills ➢ Employees' regulation compliance and performance

Western businesses have successful business models of production, operation, marketing and risk management. The application of these models in the Chinese market, however, needs to be evaluated in order to engage with the different features of the Chinese market, products and management. This is because China has enormous multiple markets, which are largely affected by the Chinese government's policy orientations. In addition, the

weaknesses of Chinese businesses and management cannot be addressed immediately through cross-border cooperation; therefore, they will continually affect the performance of a merger or acquisitions.

6.5 Conclusion

In this chapter the results of 34 case studies were presented. By adopting the research method of methodological triangulation, risks associated with Chinese inbound mergers and acquisitions that were influenced and impacted upon by the Chinese government were identified.

The presentation of the results aligns with the conceptual framework, in order to address the risk identification from a Chinese government's domination perspective. These identified risks pertaining to Chinese cross-border mergers and acquisitions all fall within the ambit of governing, economic polices, laws and regulations, business, and management. The results show that in a complex business context, the Chinese government is not only a policy administrator in Chinese cross-border mergers and acquisitions, it also initiates, participates in, and decides the activities pertaining to its political system and strategies. The government's participation has significantly affected the results of the cross-border merger and acquisition deals of Chinese businesses. Risks culminated not only as a result of the Chinese government's intervention, but also due to the Chinese local governments' extensive domination of the deals and various political interests involved. At the same time, Chinese businesses' low management skills in comparison with those of international investors contributed the most to the failure of Chinese mergers and acquisitions.

The research also developed a conceptual framework and associated recommendations from the research results. The involvement of equity, interest, and power within the decision-making parties of the central government, local government, businesses and management has complicated the Chinese business environment. In these interwoven, and sometimes juxtaposed relationships, the performance of government's enforcement and businesses' compliance reflects the risks of implementation in the areas of governing principle, economic polices, laws and regulations.

The identified risks culminate from the risk assessment parameters to both Chinese inbound and outbound mergers and acquisitions. Consequently, the study facilitates an improvement of the possibilities of success of cross-border mergers and acquisitions from a Chinese business context if the identified risks can be addressed. For both foreign and Chinese businesses, risk identification and mitigation are ultimately subjected to synergy achievement

and value creation to shareholders. Regarding cross-border mergers and acquisitions, these identified risks need to be managed in a coordinated and structured way, in terms of reconciliation and unification with the economic and political requirements imposed by the Chinese government. The significance of the research results manifests in that it highlights the risks, which may challenge a host country's policy, laws, regulations and enforcement from the perspective in which Chinese companies operate business, and deal with business issues relating to outbound mergers and acquisitions.

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Appendices

i. Current Tax Categories (source: Jin & Chen, 2006)

Tax categories	Tax payer	Tax scope	Tax rate
Value-added tax	Levied on enterprises and individuals that sell and import commodities, and provides of processing repair, and assembling services	Income from sales and imports of commodities, and processing repair, and assembling services.	1.The basic VAT rate is 17%. 2.Public goods, papers and magazines and agricultural production means: 13% 3. Small-scale manufacturing: 6% 4. Small-scale commercial: 4%
Consumption	Levied on enterprises, unities, and individuals engaged in production and importation of taxable consumption products.	Sales revenue of 11 products including cigarettes, wine and alcohol, cosmetics, oil, diesel oil, and automobiles.	The tax rate is 3 - 45%. Also fixed tariffs, such as RMB0.1/L for diesel.
Business tax	Those who are engaged in taxable labour services, the transfer of intangible assets and the sale of real assets.	1. The income from services industry such as transportation, construction, financing, telecommunication, entertainment and services. 2. The income from the transfer of intangible assets and selling assets.	1. Maximum tax rate for entertainment is 20%. 2. Tax rate for finance and insurance industry is 5%. 3. Tax rate for services, transferring intangible assets and selling real estate is 5% 4. Tax rate for transportation, construction, and telecommunication is 3%.
Customs duties	Duty is levied on those who import and export goods, or the owner of the goods being imported or exported.	Based on the price and quantity of imported and exported goods.	The duty rate for most favoured countries is 0 - 65%, and for most other countries is between 0 - 270%.
Corporate income tax	Levied on domestic financially independent enterprises and organisations.	Based on taxable revenue.	1. The general tax rate is 33%. 2. If the taxable revenue is below RMB 100,000, the tax rate is 27%. 3. If taxable revenue is below RMB30,000, the tax rate is 18%.
Foreign-invested enterprises & foreign enterprise income Tax	Levied on foreign-invested enterprises and foreign enterprises.	Based on taxable revenue.	1. The general tax rate is 33%. 2. In special economic zones, the tax rate is 15%. 3. The pre-paid tax rate is 10%.
Individual income tax	Levied on individuals whose income comes from China.	Based on monthly income after certain deductions.	1. The tax rate of wages income is 5 - 45%. 2. The tax rate of small-scale business is 5 - 35%. 3. Tax rate of other income is 20%.
Resources tax	Levied on individuals and organisations that are exploring taxable mineral resources, or producing	Based on the amounts of 7 taxable mineral resources.	The tax rate is RMB 0.3-60 per ton for different phases of exploration.

	salt.		
Urban land-use tax	Using land in cities, countries, towns, and mining areas.	Area of occupied land.	RMB 0.2 - 10/year/sq.m. As determined by provincial governments.
House property tax	Domestic house property owners and users.	The value and rent of original house property minus 10 - 30% of the value of the original house property.	1.2% for original value of house property, and 12% for rental.
Urban real estate tax	Foreign-funded enterprises and individuals who own or use real estate in cities.	Real estate value or rent.	1.2% for original value of house property, and 18% for rent.
Urban maintenance & construction tax	Domestic units and individuals that pay VAT, consumption tax, and business tax.	The value of VAT, consumption tax and business tax paid.	7% for urban payers, 5% for country and township payers, 1% for others.
Arable land occupation tax	Units and individuals who build house on or others engaged in non-agricultural business or arable land.	Real area of occupied arable land.	RMB1.0/year/sq.m. as determined by provincial government.
VAT on land	Units and individuals who transfer real estate through sale and other means.	Value added through transfer of real estate.	30 - 60%, determined according to the value that has been added.
Purchasing vehicles tax	Units and individuals who purchase vehicles.	Taxable prices of vehicles.	10% of purchased price.
Vehicles and vessel usage tax	Domestic units and individuals who own and use vehicles and vessel.	Calculated per ton or per vehicle.	RMB 1.2 - 320 per year, per vehicle or per ton, as decided by provincial governments.
Vehicles and vessel usage plate tax	Foreign-invested enterprises and individuals who own and use vehicles and vessels.	Calculated by per ton or per vehicle for vehicles, ton for vessel.	RMB 1.2 - 320 per year, or per vehicle, or per ton, as decided by provincial government.
Tax on ship tonnage	Foreign ship, or domestic ship leased by foreigners.	Registered tonnage of the ship.	RMB 0.45 - 9.3/ ton.
Stamp tax	Units or individuals who endorse or receive accounting vouchers.	The amount of purchasing value, revenue, loan, or capital.	Ordinary items: 0.003%, 0.005%, 0.03%, 0.05% or 0.1% per transaction. RMB 5 per book.
Deed tax	Those who transfer or receive land use rights or residential property.	Transactions price of transferred land use rights or residential property.	3 - 5% ad determined by provincial government.
Slaughter tax	Units and individuals who slaughter table livestock.	Taxable price or head count of livestock slaughtered.	As determined by local authorities.
Banquet tax	Units and individuals who give banquets	All expenses for the banquet.	15 - 20% as determined by provincial government.

ii. Excerpts of preferential treatment to Foreign-invested enterprises regarding income tax (Ma *et al.*, 2004:234)

	Policy Content	Nationwide Stipulations	Special Economic Zones	Stat-level development zones				Open cities and regions (including coastal, inland, border areas) and provincial economic development zones
				Economic and technological development zones	High-tech industrial development zones	Bonded areas	Border economic cooperation zones	
Rate of enterprise income tax	Production enterprises	30%	15%	15%	15%	5%	15%	24%
	Non-production enterprise	30%	15%	30%	30%	30%	30%	30
	Knowledge-intensive and technical intensive projects, projects with foreign investment exceeding 30 million US dollars which need a long period of time for recovery	30%	15%	15%	15%	15%	*(15%)	15%
	Export product enterprise whose annual export turnover tops 70% of the gross output value after the expiration of the period for tax exemption and reduction	15%	10%	10%	10%	10%	12%	12%
	Banking firms with foreign-invested operational funds exceeding 10 million US dollars and operation period exceeding 10 years	30%	15%	15% as specially approved by the State Council				
	Energy, communication, port projects or projects specially approved and encouraged by the state	15%						

	*Note: ( ) figure inside refers to figure based on policy consulting and following opening areas	
Duration for enterprise income tax exemption and reduction (operation period exceeding 10 years, counting stars from the profit-making year)	Production enterprises and confirmed high-tech enterprises and technical re-research canters	Exemption for the 1-2 years, half-exemption for the 3-5 years;
	Newly started enterprise engaging in communication, power, water conservancy, post, radio, television in central and western areas	Exemption for the 1-2 years, half-exemption for the 3-5 years;
	Non-production enterprises	(In special economic zones, service-based enterprises with foreign investment exceeding 5 million US dollars and operation period exceeding 10 years; in special economic zones and other regions specially approved by the State Council, banking firms with foreign investment exceeding 10 million US dollars and operation period exceeding 10 years) exemption for the 1-2 years, half exemption for the 3-5 years;
	Technically advanced enterprises	After the expiration of the period for tax exemption and reduction, enterprises remain to be technically advanced shall be allowed a half reduced rate of income tax for another 3 years;
	The central and western regions	Foreign-invested enterprises encouraged by the state shall be allowed an income tax rate of 15% for another 3 years after expiration of the period for tax exemption and reduction in accordance with current stipulations;
	Enterprises engaging in port and wharf construction with operation period exceeding 10 years	Exemption from income tax for the 1-5 years, half-exemption for the 6-10 years;
	Enterprise engaging in farming, forestry, animal husbandry and enterprises in underdeveloped border areas	After expiration of the period for tax exemption and reduction in accordance with provisions, enterprise income tax shall be allowed a reduction of 15-30 percent for another 10 years subject to approval by the government department in charge; income from special farming products produced to protect ecological environment in the central and western regions shall be exempted from special farming products tax for 10 years;
Tax refund for re-investment		Foreign investors who reinvest with assets or profits earned in the original enterprises or other foreign-invested enterprises newly launched with foreign investment exceeding 25 percent for the total capital and operation period not less than 5 years shall be refunded 40 percent of the tax payment for reinvestment after approval by the tax authorities;
		Tax payment for reinvestment in export-oriented enterprises or technical advanced enterprises shall be refunded in full.

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