

# M&A Due Diligence in China

## —Institutional Framework, Corporate Practice and Empirical Evidence

Lars Büttner\*, Reinhard Meckl

University of Bayreuth, Bayreuth, Germany

Email: lars.buettner@gmx.de, reinhard.meckl@gmail.com

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### Abstract

Western companies have established rigorous and robust processes to evaluate a target enterprise before its legal acquisition. This should allow the risks to be mitigated by adjusting purchase price or representations & warranties. In China, however, investors experience that conducting such M&A due diligence might be less effective. Based on neo-institutional economics, experience from corporate practice and empirical evidence, our paper explains the limitations of the approach. Our research concludes that following Western best-practice procedures does not necessarily reduce the uncertainty of an investor in China. Likewise, experts in China do not fully recognize typical M&A measures and indicators as informational substitutes (e.g. contractual terms like earn-out-agreements). Due to different cultural and institutional framework conditions, it takes further activities to overcome the asymmetric information between investor and seller.

### Keywords

China, Due Diligence, Information Asymmetry, Mergers & Acquisitions

## 1. Introduction

Despite the ongoing concerns about its economy, China remains an attractive target for foreign direct investments. While joint ventures with local partners or green field activities have been initially the primary choice for achieving market access as well as establishing production facilities, nowadays multinational corporations and medium-sized companies are increasingly investing volumes via mergers & acquisitions (M&A). Moreover, China is experiencing mega deals like the half billion USD acquisition of dairy Yashili by French food giant Danone [1]. This change has mainly been driven by a transforming regulatory frame-

\*Located in Shanghai, China.

work as well as the progressing privatization of small and ailing state-owned enterprises (SOEs) [2]. However, foreign investors still perceive the Chinese economic and legal environment as diffuse and report complex and failed transactions. For instance, in 2012 US-headquartered machinery corporation Caterpillar had to impair USD 580 million after uncovering “*deliberate, multi-year, coordinated accounting misconduct*” [3] in the books of a subsidiary of its acquisition ERA Mining Machinery Ltd. At that time, and like many other multinational firms, Caterpillar trusted in a standardized “*rigorous and robust process*” [3] that should identify risks and weaknesses of a target enterprise before its legal acquisition and allow these to be mitigated by adjusting purchase price or representations & warranties [4] [5].

However, corporate practice as well as an empirical study [6] [7] researched by the professorship of International Management at Bayreuth University (Germany) indicate that the established Western process of conducting M&A due diligence might be less effective in China. Due to different cultural and institutional framework conditions, it takes further measures to reduce the uncertainty of an investor. Thus, the following study is anchored in the research approach and findings of Neo-Institutional Economics and Economics of Information (*i.e.* information asymmetry, etc.). Since the established form of due diligence is designed around Western structures of governing behaviour, it is necessary to contrast them with the pillars of Chinese social norms. In particular, this paper addresses the role of law and social capital in China as it might have an impact on the exchange of information in business transactions. Moreover, it will help the reader understand the weaknesses inherent in the informational procedure of an M&A due diligence.

## 2. Institutional Framework

### 2.1. Investment Uncertainty, Asymmetric Information and Institutions

Many Chinese vendors are still unfamiliar with the methods of conducting M&A as well as its related due diligence process and have little to no knowledge about the structure and procedures of a transaction. Western investors, therefore, frequently experience a lack of understanding or cooperation from their Chinese business partners whenever they ask for relevant information and data about the targeted company [8]. In Western eyes, reviewing financial numbers, documents or contracts is an essential part of the due diligence in order to reduce the information asymmetry between themselves and the vendor as well as to mitigate their uncertainty in terms of the investment. Investment uncertainty results from the investor's imperfect knowledge about the characteristics of the target, which leads to an imbalance of power in the M&A transaction. As a rule, the seller has significantly more information available about the target enterprise and is therefore in a much better position. Should the buyer choose to not abandon a transaction (market failure), information asymmetry could expose

him to the risk of being exploited by the seller (moral hazard). Thus, the buyer should induce the seller to reveal more information in order to reduce the asymmetry and to make his own improved assessment. Alternatively, the investor could demand warranties or lump-sum discounts to the purchase price.

However, even disclosed information might not bring clarity and transparency into the analysis of the investor as data sometimes cannot be verified, is inconsistent or doubtful. For instance, there are Chinese companies who maintain separate accounting books for shareholders, authorities and lenders (*i.e.* banks) to enable them to manipulate the basis for credit rankings, taxes and distribution of dividends [9]. Furthermore, and in regard to family- or state-owned enterprises, the ownership of assets is not always clear [10].

From the perspective of Western investors, these are quite extraordinary conditions. In their home market they are used to being supplied with a wide range of documents and information regarding the target company, which in many cases can even be accessed via virtual data rooms [11]. Moreover, they can trust on external and partially public information that is available from authorities (*i.e.* land register, operating permits, tax statements etc.). In China, such information might not always be reliable as it could be the result of individual and/or improper agreements (*i.e.* corruption) between owners, managers and (responsible) officials. In consequence, the status quo can depend on very specific people and is likely to change after a new owner or management team has taken over control. The informative value of such documents, therefore, is also compromised and a sign of the legal uncertainty in China. In addition, the legal uncertainty negatively influences the confidence in representations and warranties covering—as a substitute for information—unsettled questions during M&A transactions.

This uncertainty remains, even though the country has made huge progress developing its traditional and backward legal framework into a quite modern legal system during the last three decades [12] [13] [14] [15]. The legacy of China's ancient social ethics, as well as its recent, radical political and cultural revolution, still influence and limit the significance and impact of legal regimes and are major factors in its present organizing principles within the Chinese civil society, which is obviously not disintegrating into anarchy or chaos, but being kept together in an alternative way.

But why does written law not have a leading institutional role in China? And what are the alternative institutions within China's society assuring social order and controlling the individual behaviour of its members? How does society enforce a system of formal and informal rules? Since the established M&A due diligence procedures are designed around Western institutional structures governing (social) order and behaviour, it is important to understand the aforementioned topics.

The following glance at the traditional principles of Chinese law as well as at the recent history of its legislation and legal profession can provide answers to these questions. In addition, the ancient scope of action of China's civil society,

which is based on personalized concepts like trust, reputation and reciprocity needs to be taken into further consideration.

Talking about trust in the context of M&A transactions might sound odd. However, academic research (*i.e.* sociology, economics etc.) has already shown that trust can reduce the complexity of decision-making while lacking sufficient information [16]. Acting on the basis of trust is undoubtedly risky. Nevertheless, it is not necessarily irrational, as it requires less information, will save hedging costs and has ex-post proven to be the better economic choice in many cases [17] [18]. The acquisition (2007) of the Italian bank Capitalia by its competitor Unicredit demonstrates that these thoughts are not entirely academic, but also have practical relevance. Unicredit basically waived their right to conduct an M&A due diligence, which caused some irritation amongst financial analysts. Former Unicredit-CEO Alessandro Profumo justified this approach with his trust in the financial markets as Capitalia would be “*stock-listed, audited and regulated*” [19]. Hence, the Chinese concept of trust should also be discussed in this article.

## 2.2. Chinese Concept of Law

### 2.2.1. Traditional Law

China’s ancient history of law shows many traces of penal and administrative, but hardly any distinctive, civil law [14] [20]. The function of creating a civil order was less assigned to written private acts but rather ensured by moral obligations, which also can be found in the doctrines of philosopher Confucius. These traditional Chinese ethics ruled the relationships among people via rites and defined role-specific expectations as well as reciprocal commitments achieving social and public harmony [21]. These rites are not about external, religious customs but an ideal of intrinsic values in terms of moral, manners or social order [22] [23] [24].

Acme and archetype of all human relations have been the patrilineal and patriarchal ties of the family, which have dominated China’s society since the beginning of time [25]. Hence, the family, and not an individual person, was perceived as the core of China’s society which might explain the emersion and persistence of emotional regimes as well as the lack of formal rules and institutions [25].

Though traditional social order was guaranteed by informal norms and morals, formal and judicial institutions have not been completely foreign to Chinese society. One example of this being the prominent philosophical school of Legalism which disagreed with assumed pre-dispositioned human virtue and therefore preferred to maintain social order by rule of law [26] [27]. However, its impact on Chinese culture was not nearly as sustainable as the archaic social ethics of the Confucian kind [22] [25].

### 2.2.2. Modern Law

More than one hundred years ago, Western civil law once more ignited a strong

desire to establish a similar legal system as well as transparent practice in China [28]. At the beginning of the last century the Qing Dynasty even started to reform its commercial and civil law following in the wake of European and German examples [29]. With the collapse of the empire (1911) as well as the civil war that followed, however, all these efforts vanished and an era of political uncertainty and instability began [15].

After the communist party seized power in 1949, Mao Zedong initially replaced all republican law [14] [30] while during the course of the Cultural Revolution all legislation and even the Ministry of Justice were suspended. At that time, many lawyers and judges were sent to the countryside for re-education. De facto, all legal professions had been erased by 1978 [31].

The death of Mao Zedong (1976) and, what is more, the economic reforms of Deng Xiaoping (1978) eventually marked the turning point of this “*era without rights*” [15]. The opening of the country required stable and reliable (legal) framework conditions to attract foreign investors [12]. Unfortunately, the efforts ended in many preliminary, partially contradicting, approaches that have only been interpretable by executive order of subordinated authorities [14].

Likewise, the training of the legal profession, revived very quickly after 1978, and the number of juristic faculties developed from two to 500 within 30 years [32]. Thus, the number of judges at the People’s Courts in possession of a formal legal education increased significantly. However, there are still judges practising the office without having a formal degree [13] [33].

## **2.3. Chinese Forms of Social Capital**

### **2.3.1. Guanxi Networks**

Due to the inadequate, less than effective legal system as well as the drastic political and economic changes, ancient values and traditional moral norms are experiencing a renaissance in China. A term that is frequently linked to these norms is the concept of Guanxi. Guanxi, which should not be confused with its folkloristic description as ‘useful contacts’ and as seen in popular business magazines [34], maintains order in Chinese business and society assuring stability and reliability as well as reducing complexity in human interactions. Western cultures often mistake guanxi networks as a mere complementary approach to social manners and generally accepted behaviour. In China, however, such guanxi networks have been the foundations of its civil society for hundreds of years and are now reviving while moral norms are generally eroding.

Guanxi is a form of Chinese social capital that defines the structure of relationships among members of a group of joint provenance (e.g. family, village), shared experience (education, studies etc.) or social togetherness (e.g. members of the political party) [35] [36]. The social concepts of reputation, trust and reciprocity thereby function as cohesive forces holding the network closely together, while separating it from the outside world at the same time [37]. In terms of guanxi networks, personal relationships are embedded in an ethical scope of

action that manages and defines expectations among human beings and assures reliability in their transactions.

In China, it is not uncommon to cultivate existing ties or to establish new contacts by presenting gifts and giving favours. By accepting such courtesy, the acceptor affirms the continuity of the relationship and “*commits to returning the favour at an undesignated time and in an unspecified way in a form of an abstract obligation*” [35]. If he does not honour his obligations, losing face among his peers, experiencing retaliation or being excluded from the network are imminent. De facto, guanxi networks create a socially accepted, if not morally necessary privilege of group members as well as a behaviour-related grading of social contacts that are perceived as corrupt in the context of impersonal and law-based concepts of social order [35].

From the perspective of Transaction Cost Economics, establishing long-term guanxi requires high fixed costs in the form of the invested social capital. On the contrary, inherent expectations, as well as enforcing measures, result in lower variable costs when using guanxi networks: a fact which makes frequent applications quite beneficial [35] [37]. Nevertheless, using legal regimes causes hardly any fixed costs to an individual, although variable costs only remain on a stable and low level if the system is able to enforce agreements and can effectively sanction breach of law. Due to the weak characteristics of Chinese law, the amount of variable costs is very uncertain and frequent transactions are therefore less attractive [37].

### 2.3.2. Concept of Trust

The World Values Study, a global research project and the “*largest non-commercial, cross-national, time series investigation of human beliefs and values ever executed*” [38] which has been conducted in almost 100 countries, came to the conclusion that China displays a high level of context in terms of trust [38]. In contrast, other sociological studies indicate that differentiation is necessary in order to fully comprehend. Trust, which results from personal experiences by dealing with third parties (generalized trust) [18], is not very developed among Chinese people. In fact, trust in China is rather a matter of differentiation and particularity bound to familiar people (personalized trust) [39].

Academic papers frequently explain this attribute by referring to the traditional and fundamental values of Confucian nature, that define ethical behaviour merely in the context of specific interpersonal relations and that are foreign to a universal morality [21]. Because trust is also a concept of morality [40], this conditional ethic prevalent in China is transferred to the parameters of trust, thus limiting its scope of application [6] [41]. Exclusivity and diversity of social obligations in the context of familial or amicable relations as well as personal networks likewise result in a differentiation of mutual trust.

China’s pioneering sociologist and anthropologist Fei Xiaotong traces the origin of Chinese trust back to the traditional and agricultural structures of its primal societies that lived in relatively isolated, scarcely mutational and rather im-

mobile village collectives [42]. Members of these communities depended on each other and had fixed roles linked by interpersonal obligations. Being oneself was defined by being embedded in structures as well as by relations with fellow men while social order was enforced by expectations, morals and manners [42].

It is obvious, that the China of today can hardly be described by such sociological surveying of archaic villages and clans that bore the above-mentioned ethical codes and a differentiated, particular trust. Countless migrant workers have already left their villages and families in order to live with millions of other Chinese door-to-door in anonymous high-rise buildings located in mega-cities like Shanghai or Beijing. Likewise, Chinese society is experiencing a rapid social change which has been caused by political unrest and the transformation of its planned socialist economy. Modern China offers its people a broader individual scope and new economic freedom while collectivistic structures like village communities or SOEs are regressing. Nonetheless, anonymization of its society as well as the market-oriented economy require new rules of social interaction and different institutions, which are not yet fully developed, in order to sustain a feeling of stability and safety. Likewise, traditional values are losing their impact on social order causing an increase in opportunism and distrust.

### 3. Regulatory Framework

Despite the limited institutional effectiveness of its legislation, China is not a law-free zone and, indeed, its legal system has been extensively reformed during the recent years. Thus, this article will also examine the regulatory framework of M&A transactions and research into which legal challenges influence the acquisition of a target company as well as require being addressed within a due diligence procedure.

Although the government is pulling out of many industries by promoting the sale of state-owned enterprises to private investors, M&A-transactions are still exposed to severe legal and administrative barriers [43]. Herewith, the government wants to control an ongoing public controversy about the “*dissipation of state property*” [14]. Next to company law and the law of securities, the acts and provisions that are most significant to foreign invested transactions—and can be extended by additional regulations from the provinces and municipalities—include the *Catalogue for the Guidance of Foreign Investment Industry*.

Since 1995, the Chinese government has been regulating, restricting or prohibiting foreign investment in specific industries by applying this catalogue. In many cases, foreign investors can enter restricted industries only in cooperation with a local joint-venture partner as well as in the form of a minority shareholding. In industries that affect national security, are of strategic or environmental relevance (e.g. manufacturing firearms and ammunition or operating grids) the government completely prohibits foreign investment. As the acquisition of a target company and even running a business in such prohibited sectors involve the application of the catalogue, the consequences and limitations of foreign in-

vestment need to be examined prior to the legal transaction. On the other hand, foreign investment in industries that are encouraged by the government might be incentivized by simplified authorization procedures or tax benefits.

If it concerns Chinese targets of key industries or well-known trademarks, foreign investment transactions are also subject to the reporting and approval processes of the *Provisions on Mergers & Acquisitions of Domestic Enterprises by Foreign Investors* [43]. Moreover, there are further specific M&A regulations, which experience frequent changes and are therefore quite elusive. Experts perceive China's competition and antitrust law to be just as difficult, as it provides the government authorities with wide discretion and scope for intervention when approving mergers and acquisitions [43]. To sum up, the laws and regulations that are relevant for M&A transactions in China are a complex and less-than-transparent framework for foreign buyers which hardly contribute to reducing their uncertainty while making an investment decision.

#### 4. M&A Stages

The analysis of the different transactional stages while conducting M&A in China is similarly complex. Although the scheme of an acquisition in China can basically be described by the Western concept of “*analysis, transaction and integration*” [44], socio-economic factors impact each sub-process noticeably in terms of content and duration [45]. Screening China's highly fragmented industries, for instance, is a challenging task while looking for a potential acquisition-target even though this fragmentation offers the opportunity of taking a leading position as a result of market consolidation and successful integration.

Moreover, there are quite different types of Chinese enterprises and management styles. Of special note is the decision-making process within state-owned enterprises or family-run businesses. More than a few state-owned enterprises, most of which are ailing and merely operating locally, are managed by cadre, who made their careers thanks to personal and political networks but not so much due to professional education and expertise. Consequently, individual relationships and an exceptionally large number of informal rules hinder internal flows of information and cloud the decision-making process: a factor which contributes greatly to the backwardness of corporate know-how as well as the applied manufacturing technologies. Similarly, quite a few traditional family-businesses do not demonstrate much evidence of being operated by formalized structures and procedures while their key executives are severely lacking in professional qualifications. In fact, a lot of these private enterprises are managed by a paternalistic authoritarian leadership style with a high involvement of family members, which also limits transparency and decision-making to an exclusive circle of people.

Once a target company has been identified and approached, it is quite common even in China that investor and vendor show their sincerity by signing a “Letter of Intent” [46] (in the transition between the phases of screening and

transaction) if a large transaction is being considered. However, the level of commitment and exclusivity of contract negotiations are still limited and Chinese vendors still reserve their right to approach other potential buyers [47] as well as re-negotiating basic points that they have already agreed on [9]. Hence, it is not surprising that about three quarters of M&A-transactions, even after signing a LoI, will not be completed ([48] quoted in 6). While entering the transaction-phase, a potential buyer usually starts screening for relevant information in order to form a valid picture of the target as well as to reduce the uncertainty of his investment. Thus, the investor has initiated the actual process of due diligence, which is considered to be the most complex task while acquiring targets in China and requires more resources compared with similar transactions in the Western hemisphere [45]. According to experts, conducting due diligence that takes about one to eight weeks in Europe, might take from three to twelve weeks in China ([48] quoted in 6). However, the lack of M&A experience of Chinese managers and businesspeople is not the sole reason that it requires more time [49]. In fact, according to the experience of (foreign) investors, some Chinese vendors are less willing to disclose information about the target company and purposely maintain the insufficient transparency [45] [50]. Poor data quality adds another layer of complexity to these unfavourable preconditions as commercial facts and business transactions are not necessarily and completely documented or consistently filed. Moreover, data has been manipulated to match it to a specific purpose like the interest of shareholders, lenders or tax authorities [51]. Furthermore, the legal position concerning property and (operating) permits might be doubtful and its utilization is bound solely to individual relationships. As long as the network can be maintained, access and disposal rights remain stable. Such tacit agreements, however, might be lost as a result of the change of corporate control. This is a phenomenon frequently experienced in connection with SOEs and family-run businesses. In such cases, the ownership structure of assets and licenses was not always transparent and it was difficult to ascertain whether they legally belonged to the target company [10]. Hence, an investor cannot fully rely on the information that he has obtained from the vendor and/or target company but might need to critically question the data as well as spend further resources validating the status quo [47] [52].

In addition, there are numerous due diligence related topics that arise from their context with company size, industry or individual objectives of the investors etc. Below, a following subchapter will review some of those aspects frequently observed during due diligence in China.

Depending on investment volume, industry and/or nature of the Chinese target, the transaction might also be subject to a regulatory announcement, or further, local as well as national authorization. While, in principle, the interest of authorities in the information about investment and cooperation is not unusual, the degree of intervention by the Chinese authorities is much more intense when compared to their Western counterparts. Thus, a study conducted by the US

American Chamber of Commerce concluded, that “*obtaining government approvals*” is a key M&A challenge to almost one third of all polled companies, while 8% even identified it as their greatest obstacle to transactions in China [53].

## 5. Functional Aspects of M&A Due Diligence

### 5.1. Financial Due Diligence

#### 5.1.1. Accounting and Business Evaluation

Assessing the profitability and financial status of a target company as well as concluding the basis for its business evaluation require reliable accounting figures. However, even today many Chinese companies do not provide solid and trustworthy financial statements although the country has made huge efforts and significant progress converging its accounting regulations to international standards. Just three decades ago, Chinese accounting merely focused on the requirements of a socialist planned economy (*i.e.* documentation of business transactions, recording of assets etc.) [54] and there was no need for double-entry bookkeeping. With the political changes in the nineties, the country also amended its accounting regulations: however, a clear concept was still lacking [55]. While joining the World Trade Organization (WTO) in 2001, China aligned the adaptation of its regulations to International Financial Reporting Standards (IFRS) which eventually resulted in the “*Accounting Standards for Business Enterprises*” (2006). Yet, its domestic economy has neither fully implemented the new standards nor managed to train and qualify sufficient accounting clerks and auditors ([48] quoted in 6), which is particularly noticeable outside the booming regions and top tier cities like Beijing and Shanghai [56].

Poor quality accounting will also negatively impact the business evaluation of a target company and thus distort fixing the spread of a potential purchase price, which in Anglo-American corporate practice is mainly calculated by discounting future cash-flow on the basis of average weighted cost of capital (Discounted Cash Flow method). A common understanding of such business evaluation methods as experienced in the Western business world can facilitate negotiations, as it determines the scope and quality of relevant input data and defines the information required to assess the business. However, in China no commonly accepted method has been established and many small to medium-sized businesses completely lack the skills and know-how needed to calculate (the spread of) a potential purchase price. If any, there seems to be rather a preference for methods that are regarded as obsolete in Western practice (alignment of net asset value, liquidation value or replacement value) [50] [57] which will lead to diverging assessments of the purchase price and make it difficult to find a consensus between buyer and seller.

Apart from this, Western investors might already experience difficulties in evaluating the target business by themselves, as budget figures are quite often lacking in completeness and reliability or appear doubtful for other reasons. Moreover, it is difficult to anticipate the dynamic of Chinese markets and trans-

late this into financial planning (see Commercial Due Diligence, chapter 5.4). Although Chinese legislation demands the mandatory involvement of an asset appraisal institution, this will not necessarily help in determining a sound enterprise value/purchase price as most of them are neither qualified, nor work independently and in a transparent way.

### 5.1.2. Management Accounting and Internal Control

Most Western enterprises have established systems and procedures, perhaps even an independent department to provide timely information and variance analysis as well as to evaluate potential countermeasures as a response to forecasted deviations. The sheer existence of such procedures already indicates the importance of ensuring economic rationality within management decisions as demanded by Weber & Schäffer [58]. If such collected and analysed information is disclosed during the M&A-transaction (e.g. in a data room), the potential investor might be able to draw further conclusions about specific objectives and measures of the target company.

While conducting due diligence in China, there are slim chances of finding such procedures and information due to the fact management accounting & control are still of less cultural significance within Chinese corporate practice and related training opportunities are rare. For instance, Shanghai based Tongji University has the only professor's chair for teaching management accounting & control in China [59], while Knauer, Nuss & Wömpener have counted 72 professorships alone in Germany [60] although the Central-European country only has about 6% of the population of China. Wang Xuhui, being that sole holder of above-mentioned professor's chair, assumes that the concept of management control cannot be fully adapted in China, as there is "*less cultural want for accuracy and exactness but higher tolerance for deviations and indirect approaches of solving problems*" [61]. Likewise, Schäffer & Wu trust that the emphasis on rationality, efficiency and transparency which is immanent to the Western concept of management accounting & control conflicts with Chinese traditional values such as collectivism and social harmony [62]. Moreover, there are further historic reasons that management accounting & control are barely perceived as an informational instrument to control business, but rather to check and supervise [59] [63]. The roots of this understanding date back to the times of the planned economy, when production, distribution and consumption were centrally managed and planned while enterprises simply focused on meeting their given targets set by the state. The term *management control* here may be defined as purely a monitoring of implementation [64].

In addition, the legacy of the planned economy also limits the efficiency of Internal Control Systems (ICS), which are supposed to be an essential part of corporate risk management. An ICS reflects all technical and organizational measures safeguarding the assets of a company by detecting and preventing fraud, error and other irregularities as well as minimizing operational risks and assuring effectiveness and efficiency of operations [65] [66] [67] [68]. In China,

such control-related procedures and methods are less developed, which mainly results from the early socialist economic system. As maximizing profits and improving efficiency was not of utmost importance to the communist society, plus the fact that the division of labour in a state consisting of workers and peasants was quite low, there was simply no particular need for elaborate control mechanisms [69]. In the meantime, the Chinese legislator has introduced the “Basic Standards for Enterprises Internal Control” in order to bring (stock-listed) enterprises much closer to the best practice of corporate governance [70]. However, recent academic research casts doubt on whether there is a significant correlation between the new regulation and the reliability of financial statements of stock-listed companies [71]. Therefore, the impact of the new amendment remains uncertain.

## 5.2. IT Due Diligence

IT-based Economic Resource Planning (ERP) systems are a technical tool facilitating information flow across business functions and implementing internal control. According to KONRADIN, for example, approximately nine out of ten German companies with more than 50 employees are running an ERP system [72]. On the other hand, such software-based solutions are less widespread in China and manual processes as well as partial solutions of local origin are still quite common. A case in point is the software KINGDEE, which according to Western standards might not be considered as a fully-fledged ERP system, focusing as it does on financial management. An IT due diligence has to clarify whether such existing local applications meet the requirements of the investor while, in addition, specifying the costs for inevitable improvements.

It is self-evident that conducting IT due diligence is not exclusively limited to ERP systems, but should be expanded to cover the entire technical resources and organization required for archiving, processing and transmitting data [73]. In China, an investor might place a special focus on software solutions owing to the fact that a legal purchase of a computer program cannot necessarily be assumed. According to BLOOMBERG, even well-known state-owned enterprises like CHINA POST run software applications without having obtained proper licenses [74].

## 5.3. Tax Due Diligence

China’s taxation system has been repeatedly amended and adapted to international standards during the recent years.

Theoretically, legislation is exclusively subject to China’s National People’s Congress [14], however practically, China’s State Council prepares all laws [75]. Moreover, the State Council can—alongside the State Ministry of Finance as well as the State Administration of Taxation—issue administrative directives that primarily serve to interpret the existing acts [76]. Likewise, local governments (provinces and municipalities etc.) can issue implementing directives provided

such regulations do not conflict with provisions from higher bodies [77]. Due to its abstract nature, Chinese tax legislation basically becomes comprehensible and applicable with these directives only. However, ambiguous tax legislation, numerous decrees as well as the varying competence of local tax authorities enacting directives, is nourishing an arbitrary and inconsistent interpretation of tax laws and promotes—paired with the existing high level of corruption—informal agreements between companies and public officials evading taxes. However, investors should not place any trust in these granted tax privileges being either compliant or enduring post-acquisition.

#### 5.4. Commercial Due Diligence

Risks and chances that are inherent to a business model can only be determined in the context of the market and competition of a (Chinese) target as well as its specific product and service portfolio [78]. However, there are basically two and evident reasons why Western companies invest in China. On one hand, they target China as a fast-growing sales market for distributing their own output or, on the other hand, intend to manufacture goods while keeping costs low.

Focusing on the People's Republic of China as a sales market for consumer goods, it is becoming obvious that its 1.3 billion inhabitants cannot be considered a homogenous target group. The sheer size of the country already results in clear local differences in consumer trends, which might be amplified by disparities in the domestic income between the developed and prosperous coastal cities like Shanghai or Shenzhen and the poorer West.

Moreover, there is a material difference in consumer behaviour across age groups and generations as they have been influenced by extremely diverse political and social streams like the Cultural Revolution under Mao Zedong or the economic reforms under Deng Xiaoping, that eventually led to the opening of the country. Thus, elder Chinese are also supposed to consider collectivistic aspects while making purchase decisions, instead of fully prioritizing individual needs [79]. As a result of the One-Child Policy (1979-2015), extended families suddenly focused on the only remaining son (or daughter) and heir and spoiled them as a “*little emperor*” [12] [79]. In contrast, the younger and adolescent generation is consuming in a more self-centred way while aspiring for individual fulfilment and self-expression. Thus, this age group can be characterized by increasing brand awareness. In spite of this, it seems that, for them, there is no distinct brand loyalty and local champions are playing as much of a role as international products do.

It requires authentic socio-demographic data to segregate and form an opinion about customer groups. And yet China does not make full use of established tools and instruments of market research, but relies, according to Zinzius, on other sources that mainly provide information only vaguely appropriate and requires further interpretation [12]. Thus, making business forecasts about potential consumer groups is quite an endeavour in China. Moreover, sub-segments

are characterized by sudden and quick changes and fluctuating preferences, which are difficult to predict. The regional expansion of US-American headquartered coffee-chain Starbucks, which to date runs 2600 coffee houses in more than 120 Chinese cities [80], can be considered as a prime example. Competitors like Costa Coffee, The Coffee Bean and The Tea Leaf or Pacific Coffee followed quickly, entering into a “*coffee war, brewing in China*” [81]. In contrast and up until the turn of the millennium, Chinese people had been assumed to be tea drinkers, who even celebrated its consumption ceremonially. This case represents the dynamics of the social and cultural environment requiring a high adaptability of existing business concepts [6].

### 5.5. Integrity Due Diligence

Numerous scandals and bribery affairs have cast a shadow on the business ethics of China’s private and public sector and also involved foreign subsidiaries and managers, as in the case of British pharmaceutical group GlaxoSmithKline or the local distribution division of German car-makers AUDI and VW. Meanwhile President Xi Jinping has already announced he is taking on the fight against corruption, which he compared to “*worms breeding in decaying matter*” [82]. Nevertheless, evidence, like the research of the non-governmental organization Transparency International (TI), still paints a different picture. Based on TI’s corruption perception index measuring bribery in the public sector, China shares with Belarus, Brazil, India a disreputable 79<sup>th</sup> place out of 168 countries and territories [83]. Hence, corruption is here one of the key factors for Corporate Crime—including misdemeanours like illegal price-fixing, tax fraud and purposely delayed filing of insolvency—committed by employees and mainly benefitting the company.

Yet there is another aspect of Corporate Crime resulting from employer’s greed referred to as Corporate Violence [84]. Corporate Violence does not necessarily mean that an organization deliberately intends to harm the life or the health of its stakeholders, but obviously hazards such consequences by suspending standards, routines and control mechanisms as well as by exposing people to harmful conditions due to running business negligently [85].

In the case of China, such kinds of White-Collar-Crimes are mainly driven by profound social changes resulting from the transition of a socialist planned into a market oriented economy. While there was an ancient image of a reputable and socially responsible “*Confucian Trader*”, ethical and moral standards mainly started eroding after 1949 and during the Cultural Revolution. China’s intrinsic, social conscientiousness had been increasingly replaced by a state-organized and indoctrinated polity [86]. With the political reforms and opening up of the country, “*getting rich was glorious*” (*Deng Xiaoping*): traditional virtues and norms eventually dissolved and moral considerations have been superseded by self-interest.

The scandal of Chinese dairy Sanlu in the year of 2008 can be taken as an extremely sad example for such a loss of morals, resulting in the death of 6 infants and causing sickness in about 300,000 small children as the company added the

chemical adhesive Melamin to their milk in order to artificially increase its protein levels. In addition, the New-Zealand headquartered Fonterra Group was severely impacted by the affair as they had acquired 43% of Sanlu in 2005 and now faced collateral damage to their reputation as well as experiencing the impairment of their investment.

Beyond these financial losses as well as damages to the company's reputation, there are further risks that need to be considered regarding a potentially non-compliant target as the investor could be held legally liable if the misconduct continues after the acquisition [87]. Some legal regimes prosecute related criminal offenses even if they have been committed outside of their own territory. In terms of corruption, the US-American Foreign Corrupt Practices Act as well as the UK Bribery Act, which sanction the corruption of foreign officials, can be considered as a prominent example [88]. In some cases, the UK Bribery Act can even prosecute local subsidiaries of a foreign commercial organization bribing an official in a third country.

To protect the investor's interest against the aforementioned threats, corporate practice has developed standards over the recent years which are today known as integrity, compliance, reputational or fraud due diligence. Integrity due diligence is mainly a kind of systems audit assessing the overall mechanisms of Corporate Control (*i.e.* internal control system, corporate compliance, risk management system) which could serve as preventive measures detecting and removing such criminal behaviour. Moreover, integrity due diligence means analysing specific, actual business conducts, industries or procedures that could serve as a red flag. In terms of corruption and bribery, significant expenses for consultants and agents could be an indication for disguising the real reason for a payment. However, it is quite common to rely on such service providers in China and does not necessarily mean anything illegal. In a similar fashion, a close look at entertainment, travel as well as sales expenses might be of interest as it is still possible to purchase (counterfeit) tax receipts for about 5% to 7% of the nominal value. Thus, the remaining cash could have been turned into money used for bribery (the so-called *Slush Fund*). Some HR due diligence in China even brought to light invented employees or real people who are not serving the company and who have been put on the pay-roll to misuse the fictitious personnel expenses in order to 'launder' the money. Furthermore, the industrial sector might indicate the level of exposure to a corruptive environment of a target company. According to Grime und Guo [89], especially State-Owned-Enterprises, state-controlled businesses in the field of energy, oil, petrochemicals, telecommunication, transport, automotive, construction, financial services and health-care are associated to a high risk of corruption.

## 5.6. Operational and Technological Due Diligence

According to Western empirical studies, production as a value-added process is mainly out of scope while conducting due diligence [90] [91]. In the case of M&A

in China, this approach should be wholeheartedly reconsidered as a significant number of local companies still run businesses with outdated machines and production methods that require a higher expenditure of human labour. Due to the significantly increasing wage levels, especially in Chinese top tier cities, such labour-intensive manufacturing methods are becoming less cost-effective.

Not only, however, does assessing production cover more aspects than the material-related output, it also includes the organization of business processes as well as general management (production in its broadest sense). Western investors quite often experience that the organization and the course of business processes of Chinese targets significantly differ from their own expectations in terms of design and efficiency. The different set-up in China can either be explained by traditional, mostly Confucian values (e.g. collectivism, saving face, concept of hierarchy, relevance of seniority, meaning of personal and less abstract relations) [92] or by a more recent political ideology that intends to satisfy the needs of a planned economy rather than managerial economics. Thus, a post-merger re-organization does not necessarily improve the situation. Under the prevailing circumstances and due to the socio-cultural conditions, organization and operational sequences have already been optimized to a large extent.

### 5.7. Environmental Due Diligence

China's rapid growing economy has been spurred on during the last decades at the expense of the natural environment and, consequently, the quality of its air, water and soil has deteriorated [93]. Today, more than every second city in China is suffering from severe air-pollution [94] such as particulates, sulphur dioxides and global warming gases, which in addition also lead to acid rain and pollution of agricultural land [95]. According to its environmental protection agency, almost 20% of China's agricultural land is contaminated [96]. Moreover, one fourth of China's population does not have access to clean drinking water [93]; additionally more than 60% of its rivers, lakes and reservoirs are presumed to be significantly polluted [97] [98].

In the meantime, the Chinese are no longer taking the destructive exploitation of Mother Nature lying down but are increasingly displaying fear and anger [99]. Hence, the Chinese government tightened the framework conditions as well as corporate liability by enforcing a new environmental protection law in 2014. In fact, China had a "*long lasting and institutionalized environmental policy*" [93] as well as "*incorporated a national obligation protecting the environment already in its constitution*" [93]. However, the implementation of the progressive environmental regulations was partially slowed down by public authorities suffering from a lack in capacities and/or qualified personnel. In some cases, the officials even deliberately neglected the pursuit of the new regulations in resident companies when they conflicted with specific minority business interests, choosing instead to focus on taxes and other dues; in some cases the authorities put pressure on their environmental counterparts to follow their chosen priority

[100] [101]. Some companies took advantage of this situation and tried to influence personally and/or bribe public officials to make them overlook any non-compliance.

This conflict of interest might bear considerable consequences for an investor as he cannot assume that a target per se complies with environmental norms and regulation. Due to a widespread willingness favouring economic success over ecological requirements, it shouldn't be surprising if cases of misconduct and lack of conformity can be identified. For the time being, it was possible to cover most wrongdoing by making use of influential networks or bribing officials. However today, public opinion is increasingly applying pressure on politicians and officials to act against such violations. Besides, Western investors might not have access to these networks protecting an improper operation or they might be unable to maintain the circumstances due to a scope of action that is limited by their own corporate compliance as well as the law of their native countries. An investor should also bear in mind, that even though China does not always enforce the law, it has implemented sufficient regulations to punish misconduct appropriately.

### **5.8. Real Estate Due Diligence**

In terms of real estate, legal aspects matter in particular while conducting due diligence in China. Despite comprehensive legal amendments, as well as the introduction of a property law in 2007, land cannot be acquired by individuals or organizations. According to Article 10 of the Chinese constitution, all land belongs to the state as well as to the collectives. Since the late 80s, it has still been possible to acquire land use rights that are equivalent to ownership [102] [103]. Depending on the type of use, ownership rights are granted for a period between 40 (commercial) and 70 years (residential) [104]. In addition to this, it is possible to acquire an estate in severalty for a building and divisions of such, for example, flats, office premises or other business premises. A main concern of investors is the impact on their ownership once the property rights have expired. At least for residentially-used property the answer to this question is less uncertain as Chinese law eventually stipulated an automatic extension resulting in—in the eyes of most legal experts—de facto an unlimited ownership [105]. However, the future consequences for any other category of usage remain unclear.

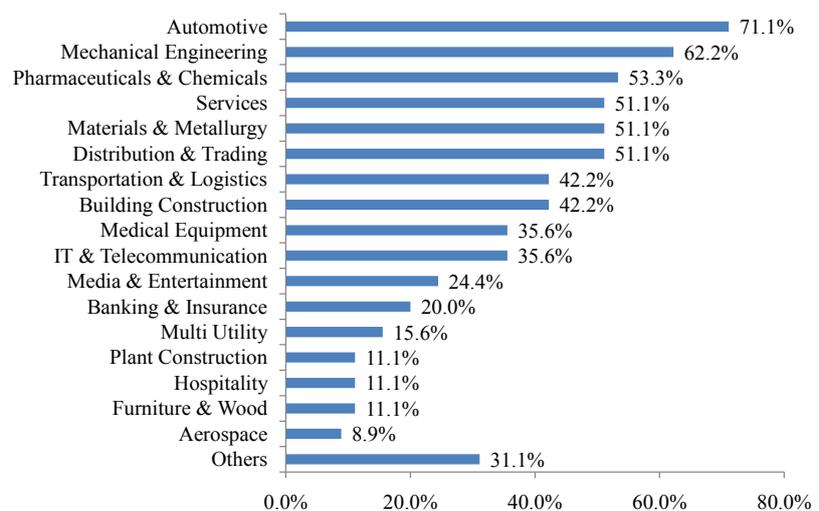
Another focus related to real estate, should be placed on technical aspects. During the 90s, training and education of professional construction workers could not keep up with the building boom and an increasingly high number of unskilled labours have been employed, which left a noticeable impact on the quality of homes and commercial buildings. Moreover, booming construction, governmental influence on infrastructure projects as well as the public monopoly of granting land-use rights nourished corruption, which in turn led to low-grade real estate, as bribes had to be financed by using inferior building material [106]. Thus, it is not surprising that a scientific survey among real estate experts

concludes a lower quality and shorter useful life of Chinese buildings compared to Western standards [107]. In 2009, Shanghai's housing complex Lotus Riverside provided an extreme example of this disparity in construction quality when one of its new high-rise buildings suddenly tilted over shortly before its completion, killing one worker.

## 6. Empirical Study

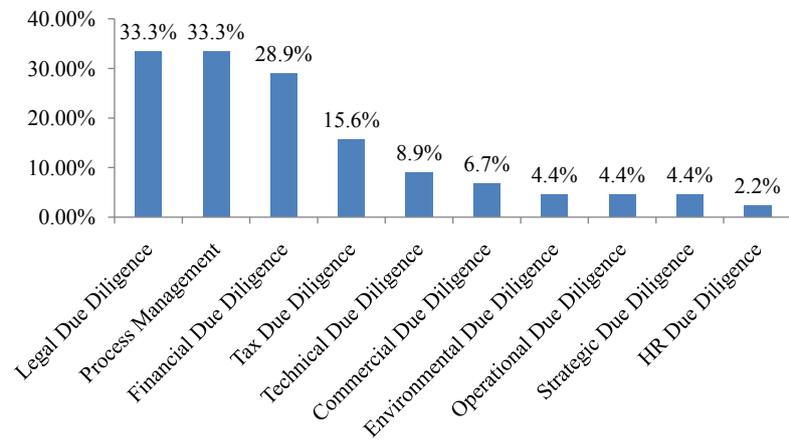
To validate the statements and assumptions of this article, which are barely documented in any other scientific papers, the Professorship of International Management at Bayreuth-University has conducted an empirical survey and contacted 323 M&A professionals operating in China. Thereof, 46 professionals positively responded to the survey by answering a questionnaire reflecting a return rate of 14.2%. Most participants of the study are versed experts within their discipline and have on average a track record of 36 due diligence cases in China. Most experts (see **Figure 1** & **Figure 2**) conducted due diligence in the automotive sector (71.1%), in businesses related to mechanical engineering (62.6%) as well as in the chemical and pharmaceutical industry (53.3%). On average, one out of ten experts (11.1%) gained their knowledge as an employee of the investor, while the majority (88.9%) conducted due diligence as an external consultant (*i.e.* auditor, tax or management consultant, lawyer etc.).

The study concludes that due diligence in China is (significantly) more complex compared to similar transactions in Europe or the United States [108] as an overwhelming majority of the participants confirmed such assumption (95.6%). Most of the experts attribute the causes of the difficult framework conditions to be due to the Chinese investors being unfamiliar with processes and procedures related to acquiring a company (84.4%) as well as to their being unwilling to disclose information (73.3%). Moreover, disclosed information is in many cases



Source: [6]

**Figure 1.** Due diligence experience of respondents by industry.



Source: [6]

**Figure 2.** Experience of respondents by due diligence area.

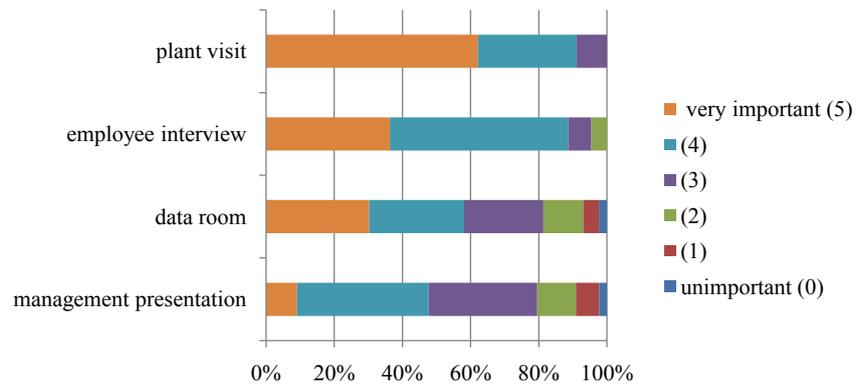
faulty or inconsistent (73.3%).

A vendor is supposed to be self-interested in providing the buyer with information about the target company to enable the latter to reduce their uncertainty about the investment, complete the transaction and offer a fair purchase price. Interestingly, Chinese vendors are rather hesitant to supply relevant information. According to the study, about two thirds of the participants did not experience any proactive supply of data from the vendor. Likewise, a vendor due diligence is not very common (62.2%) or even non-existent (22.2%) in China, though it is supposed to strengthen the seller's position controlling the process of exchanging information [6] [109].

In contrast, the level of motivation from the investor's perspective barely differs to that of an M&A transaction in Germany. Most participants of the study intend to identify risks related to the target (95.6%), to make themselves familiar with the target (73.3%) as well as to determine the input data that might be relevant for assessing the target in order to conclude an enterprise value and/or purchase price (73.3%). In addition, more than half of the experts in China (53.3%) want to identify synergies between the investor's existing portfolio and the target company.

These results match a survey among German investors conducted in 2002 by Berens and Strauch [90]. However, the relevance of information sources between both studies does differ. The study at hand indicates a higher preference for visits to the factory floor, which matter significantly to 62.2% of the participants (see **Figure 3**). The factory tours are followed by the interviews with employees, which are of great importance for about 40% of the polled experts. This number is in line with the survey of Berens and Strauch although such interviews are the most preferred information source for German investors [90].

The experts in China also expressed their interest in management presentations, but they play less of a role compared with plant visits, employee interviews and data rooms. Hence, these findings reflect the poor communication policy



Source: [6]

**Figure 3.** Importance of information sources.

and lack of willingness to provide information of Chinese vendors resulting in the necessity for investors to find alternative sources of information. Although data rooms are an appreciated source of information among investors in China, they cannot be relied upon. Firstly, data rooms are not frequently offered by Chinese vendors. Secondly, data rooms might not be a very reliable source because of their more legally-based content (audited financial accounts, approvals and permissions from public authorities, contracts etc.). Due to weak law enforcement as well as a significant number of Chinese government officials prone to corruption, such permissions and documents do not necessarily have a high informational value in China. While touring factories and offices, the buyer can get a direct and relatively undistorted impression of machines, manufacturing sites and production processes.

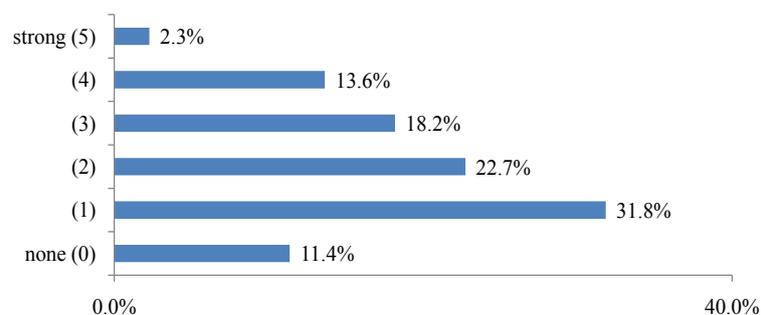
Just as in any international M&A transaction, an investor in China might not be (fully) satisfied with responses from the target or vendor due to a lack of information or doubts about provided data. Thus, this study investigated how buyers as well as their advisors deal with such conditions. The survey revealed that 75% cover the gap by making assumptions and/or developing scenarios. For about one third (29.6%), unanswered questions can develop into a deal-breaker and completely prevent them from executing the transaction. Nevertheless, 11.4% have been willing to ignore the uncertainty. Though most experts expressed their readiness to compensate the informational gap by other means (*i.e.* scenarios and assumptions etc.), they believe that around one third (30.3%) of all initiated M&A transactions in China will not be finalized due to a lack of information.

As in any kind of exchange process as part of an M&A transaction, guarantees & warranties can serve as an informational substitute and essential signal indicating the quality of a good, product or service to be exchanged. The provider of a warranty commits to the quality of his goods or services meeting minimum standards as well as accepting *ex ante* being sanctioned (*i.e.* in forms of rescission of the agreement and transaction, rework, discount etc.) in case of failing to comply with this promise [110]. As a result of the vendor's covenants, the poten-

tial buyer can draw conclusions with regard to the qualities of the goods or services without ever having seen or examined their precise characteristic values. Thus, representations and warranties are also considered to be the centrepiece of an M&A related contract design [111] avoiding lump-sum discounts resulting from a remaining asymmetry of information by transferring risks back to the vendor [112] [113].

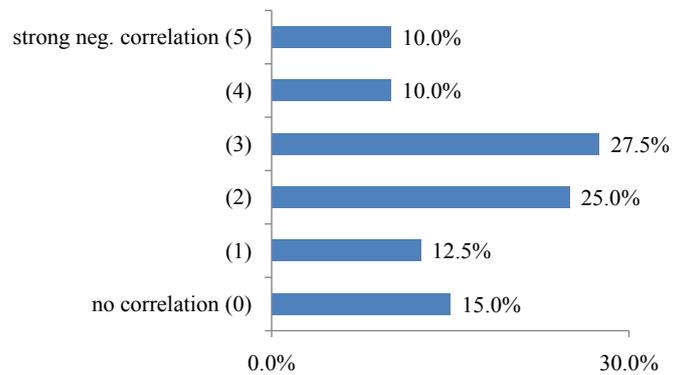
In terms of share purchase agreements, one normally differentiates between asset-related guarantees as well as performance-based price adjustment clauses that are also known as earn-out agreements [114]. In terms of M&A transactions in China, we could not yet determine any clear preference for any of these practices. Less than two thirds (65.9%) of all polled experts do not fully recognize representations and warranties as an informational substitute (see **Figure 4**). Hence, a hard and fast rule of a (negative) correlation between the degree of a due diligence as well as the extent of warranties—in contrast to academic findings for Western transactions [114] [115]—cannot be presumed (see **Figure 5**). Our results indicate a slightly higher preference for earn-out agreements but still vary in a diffuse way across all scale values without showing a clear conclusion (see **Figure 6**). This can be explained by the lien as regulated by Chinese law limiting the right to retain to a period of 3 - 6 months, or in case of governmental approval, to 12 months maximum [14] [75] [116]. As many target-related deficiencies and risks cannot be identified in such a short time frame, such clauses remain largely ineffectual and, thus, could not significantly contribute to reducing the uncertainty of an investor [51].

The personalization of the markets by social institutions, like trust and reputation, can be seen as another stabilizing mechanism. Due to its nature and market size, players seldom encounter exactly the same party once again in the field of M&A, maybe with the exception of very large corporations and private equity firms. Thus, in most cases, the reputation of a seller would need to be judged—if possible—from its operational core business activities. Hence, it is less of a surprise that we found almost two thirds of our respondents did not consider the reputation of a seller as a considerable informational substitute, reducing their investment related uncertainty (see **Figure 7**).



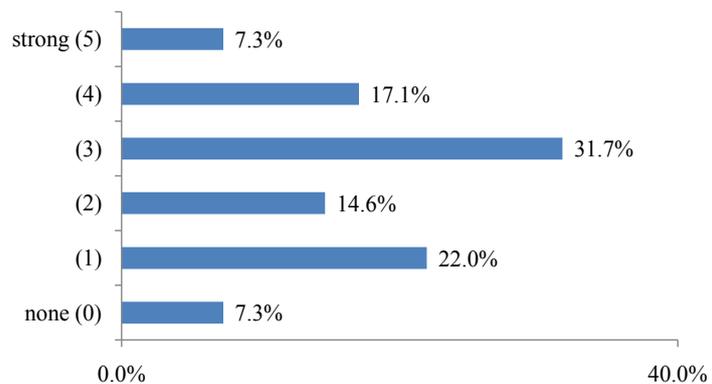
Source: [6]

**Figure 4.** Recognition of representations & warranties as informational substitute.



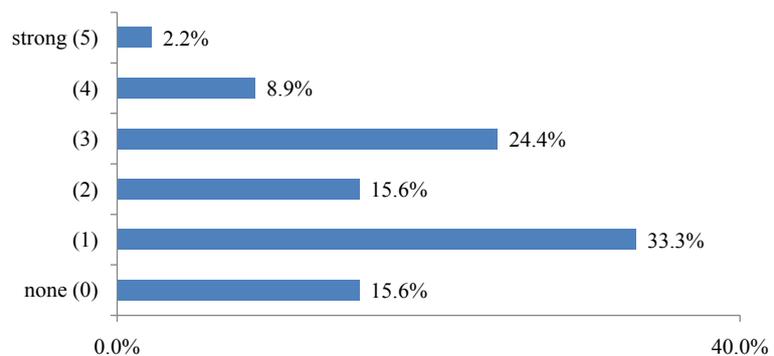
Source: [6]

**Figure 5.** Negative correlation between degree of due diligence and extent of warranties.



Source: [6]

**Figure 6.** Recognition of earn-out agreements as informational substitute.



Source: [6]

**Figure 7.** Recognition of seller's reputation as informational substitute.

On the contrary, it is common corporate practice for a player entering into cooperation with a business partner to waive, at least partially, any hedging strategy [117]. In such cases, market players either trust in the competency and good will of their opponents still performing in their interest (interpersonal trust) [118] or they act on the assumption that the inherent market order will sanction any opportunistic behaviour (generalized trust). The results of our em-

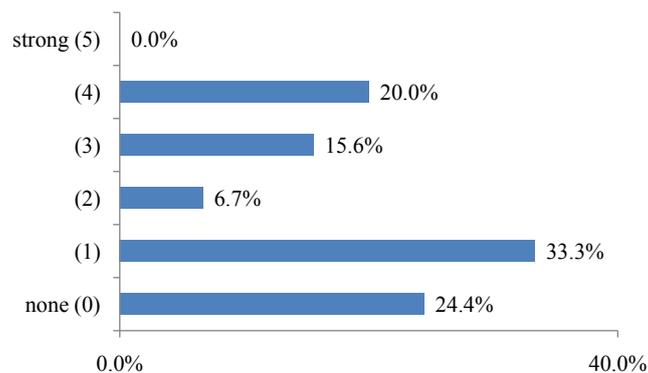
pirical study conclude that more than half (57.8%) of all experts do not believe building trust with the seller to be a valid option when dealing with asymmetric information and uncertainty in terms of an investment. Surprisingly, 20% in contrast attribute a major role to trust in their considerations (see **Figure 8**). We eventually discovered the explanation for these inconsistent findings during our interviews of experts. Mainly experts that understood the term in a sense of interpersonal trust valued the concept as an informational substitute. However, it should be mentioned that interpersonal trust and guanxi can hardly be established within a short timeframe as given in a common M&A transaction. Respondents that made associations with generalized trust were more likely to disregard the idea of being an informational substitute and reducing their state of uncertainty.

## 7. Summary and Prospects

The established Western process of conducting M&A due diligence is less effective in China and does not significantly contribute to reducing the uncertainty of a buyer. Neither comprehensive formal procedures nor engaging costly experts can fully prevent investors from identifying risks and shortcomings of the target only after the legal acquisition, which mostly likely also leads ex-post to an adjusted and lower subjective target evaluation.

The investor has seemingly successfully overcome the asymmetric information between himself and the seller by conducting due diligence. In reality, the investor was not able to inform himself in a sufficient manner, was unable to analyse the provided information completely or has received false as well as purposely manipulated information. This lack of information to make a sound business decision needs to be seen as a failure of the Western due diligence concept as it ignores institutional disparities on international markets.

Mergers & Acquisitions are still a quite young phenomenon in China, and therefore many local shareholders as well as managers are still not used to the procedures and methods. The rapid development and implementation of a regulatory framework, moreover, raised more questions than answers to this



Source: [6]

**Figure 8.** Recognition of trust as informational substitute.

complex topic. Likewise, China's historic legacy as well as the recent socialist planned economy have left their marks on fiscal, financial or organizational aspects of business administration. Applying the Western concept of due diligence, it still might be possible to detect these differences with increased effort and higher transactional costs. The genuine weak spot while conducting M&A transactions in China is the basic set-up of a (Western) due diligence as it assumes markets of comparable institutional patterns. However, assuming equal systems of social order is not constructive. The Western instruments and tools of due diligence are developed from a legalistic order that governs people in their social and business related interactions as well as sanctions them in the case of non-compliance. Thus, permits and licenses, tax statements or (purchase) contracts are less critically scrutinized while conducting due diligence in the Western world and are seen as a primary source of information. In Germany or the USA, this faith in documents might lead to proper results, create informational value and reduce the investor's uncertainty. However, the People's Republic of China cannot be fully characterized by abstract universal norms. The rules of the game that the Chinese society has given itself rather result from traditional expectations developed for concrete interpersonal relationships. Today, these ordering principles and values, which have been founded on the ethics and morals of village communities, experience their limits of resilience due to a rapidly growing and increasingly anonymous society as well as a more complex and disruptive environment. While China's political leadership has responded to these economic and social challenges by passing a comprehensive legal system within just a few decades, the meaning has not completely reached the hearts and minds of its people. Obviously, measures mitigating risks that have been identified in a due diligence process can hardly be transferred in such a context which refers to representations and warranties, as they are less enforceable in China.

The Chinese comprehension of concepts like trust and reciprocity manifests itself considerably more gradually and exclusively compared with other cultures and nations. As most M&A transactions are conducted between strangers, the degree of socially normed behaviour, as well as the expectations, are limited, a fact which facilitates opportunism at least. At the same time, the privilege of networks breeds a perversion of justice and corruption.

To summarize, China exhibits hardly any institutional characteristics that build the structure and playing field of a concept that in corporate practice and academia is known as "M&A due diligence". In fact, China's institutional framework ensuring social order is almost diametrically opposed to Western societies and fairly reflected in this informational process. Our empirical survey confirms these observations. M&A experts consider conducting due diligence in China as a very challenging endeavour, which on one hand is due to a lack of M&A experience of Chinese vendors. On the other hand, Chinese vendors are also assumed to be less willing to disclose information and provide target-related

data. Thus, most experts prefer factory tours to inspections of data rooms. Moreover, representations and warranties covering remaining uncertainties are of less relevance compared to the Western hemisphere. Likewise, neither (generalized) trust nor the reputation of the vendor reduces the uncertainty of an investor.

The logical consequence is that the conducting of due diligence in China has to abandon the idea of universal technical principles ensuring social order, but rather acknowledge different predominant institutions, such as particular bonds of trust and guanxi networks, that are the main pillars to its society and economy. This does not mean that elements of traditional Western due diligence are to be considered uncalled for in China, as the country has experienced drastic economic, political and social changes during the last decades. These changes have not been without impact on China's ancient norms and moral reasoning. After all, the People's Republic of China has established a comprehensive integrated legal system within a short time span.

Unfortunately, there is still no panacea to cure all above-described and M&A related problems in sight and perhaps Western investors will continuously fail to reach a satisfying level of information while conducting due diligence in China and will need to include, lump-sum and risk-related purchase-price discounts in their offers. Though this approach cannot be considered as a tailor-made concept, it is at least a clear instruction. Possibly, the right time for Western investors has not come yet and they should wait for further social and political transformation before dealing with M&A in China. Alternatively, they could attempt establishing guanxi structures to reduce their uncertainty about the performance of business partners. However, the time span from identifying targets to entering M&A related negotiations to finally closing a deal is likely to be too short for establishing a viable relationship. Hence, investors would have to socialize and build strong networks in a proactive and exploratory manner without foreseeing which companies will become M&A-targets in the (near) future. As a result, many questions remain unanswered and, admittedly, the Western concept of conducting due diligence will not be able to answer them.

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