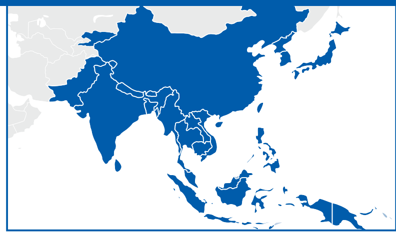

Establishing a Company in China
A guide for overseas investors

Executive summary

Establishing a business in China is not as straightforward as most overseas investors into China initially anticipate and the process comes with its own unique challenges and complexities. Understanding the corporate environment is vital and to do so, investors need a clear understanding of their business model as well as the ever-changing body of governmental regulations.

Multiple government bodies are involved in the process and the overall procedure can take anywhere from two to even as long as nine months depending on the type of entity that needs to be established and proper compliance with the procedural elements being met.

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LehmanBrown International Accountants is a member of MGI Asia with office locations in Beijing, Guangzhou, Hong Kong, Macau, Shanghai, Shenzhen and Tianjin, China. Dickson is a Senior Partner at the firm and also North Asia Circle Leader for MGI in Asia. Dickson has over 24 years China accounting and financial experience and the firm has been a member of MGI Worldwide for 10 years. For more information go to www.lehmanbrown.com

Introduction

This guide gives an overview of the key benefits of setting up a business in China, whether it is setting up a Wholly Foreign Owned Enterprise ("WFOE") or a Joint Venture ("JV").

Understanding the Corporate Environment

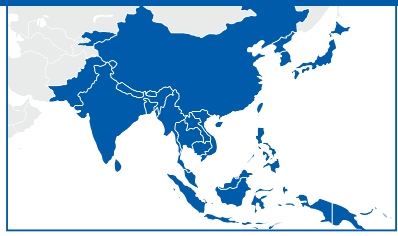
Prior to setting up a Permanent Establishment ("PE"), an investor needs to understand clearly their model for business in China and answer the following key questions, which would include:

- What are the specific business objectives for the Chinese market and is establishing a legal entity the appropriate course of action at the given time?
- What type of legal entity would be the optimal operational vehicle for conducting compliant business practice?
- What will the Business Scope of the company be?
- How will the company be capitalised, financed and structured?
- Who are the target clients / customers and how does the business intend to find and service them?
- What is the level of control that the parent company expects to exercise over their company?
- Will the scope of business require any further governmental pre-approvals?

All of these questions will enable an investor in China to identify the type of entity that they wish to establish, as well as ensuring that the foundations for the company's long-term sustainability in China are set.

Setting up a Wholly Foreign Owned Enterprise ("WFOE")

A WFOE is 100% foreign-owned and provides greater control over the business for a foreign investor in China. Historically due to a WFOE's mandatory adherence



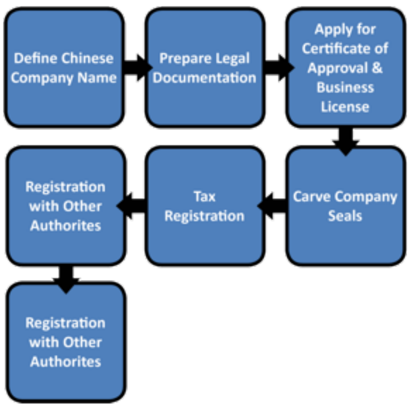
to the Foreign Invested Enterprise Law ("FIE Law") creating an irregular playing field for foreign companies in the PRC, there have been a number of regulatory restrictions placed on WFOEs.

Setting up a WFOE in China takes between 2 to 9 months depending upon the scope of business and consists of many stages and procedures. The 'Registered Capital' is the amount required to cover the company costs for the first one to two years (e.g. salary, rental fees, operational costs, equipment, travel expenses) and run the business until it breaks even.

The advantages of setting up a WFOE in China include the ability to uphold a company's global strategy free from interference, maintain total management control within the limitations of PRC laws, the ability to receive and dispatch RMB to the parent company overseas, increased protection of trademarks and intellectual property, and shareholder liability limited to the original investment. While the cost to establish a WFOE remains relatively high when compared to that of a Domestic Company, a WFOE is still regarded as the most attractive business structure option for investing into China from overseas.

The Process

The steps to setting up a WFOE are to:



Representative Office ("RO")

A Representative Office, or Rep Office ("RO"), is an office established by a company to conduct non-profit practices, such as marketing and other non-transactional operations in a foreign country. Companies in foreign locations use Rep Offices for the use of sourcing of products and perform as a connection between the head offices and rep offices in other countries. This type of office allows a company to show its commitment to the new market while permitting more intense on-the-ground research and is the most common form of foreign entity in China.

Guidelines for Establishing an RO

The advantages of Rep Offices are that they are cost efficient, require no minimum capital investment or business plan, are easy to control, quick to set up, and are relatively inexpensive. The disadvantages of rep offices are that they are limited in the nature of business activities involving consumer and profit-making engagement plus they cannot employ staff directly and they must use an authorised human resources agency in order to hire staff.

Joint Venture ("JV")

A Joint Venture ("JV") is a business arrangement in which two or more parties agree to combine their resources for the purpose of accomplishing a specific task. A Chinese party and a foreign party merge their resources and expertise to reduce the exposure of risks from other businesses and to create new business projects or activities. Joint Ventures are sometimes the only way to register in China if a certain business activity is still controlled by the government or restricted for foreign investors. In certain industries, the Chinese shareholder should hold the majority equity stake.

There are two types of Joint ventures:

1. **Equity Joint Venture ("EJV")**
   Profit and risk sharing in an EJV are proportionate to the equity of each partner in the EJV.
2. **Contractual (Cooperative) Joint Venture ("CJV")**
   A CJV's profits are allocated according to the terms of the co-operative venture contract.

Guidelines for Entering into a JV

The advantages of setting up a JV in China are the existing relationships already in China, existing distribution and sales channels, enhanced ability to enter into industrial sectors that WFOEs are excluded from. The disadvantages can include sharing profits with a Chinese partner, conflicting interests in management and risks with Technology Transfer and Intellectual Property Management.

Conclusion

China continues to open up industries and to make it easier for foreign companies to establish operations in China and to conduct business. This process of opening up and reduction of red tape is a continuum and companies are advised to therefore follow developments and to review where their operations should be located, the type of entities to be used, their scope of business and capital required in their China businesses.