CHINA'S INTESTINAL FORTITUDE MAY SOON BE TESTED

It was announced in Beijing, the capital city of the People's Republic of China (PRC), on Wednesday, that Premier Zhu Rong Ji and European Union (EU) Trade Commissioner, Mr Pascal Lamy, had held '*substantive*' talks on certain trade issues, issues which had been of some concern to EU members: Those are the members who form part of the illustrious World Trade Organisation (WTO).

The EU and such tricky matters are the last hurdles that Beijing has to jump in order to achieve the international Holy Grail: A seat in the WTO.

These issues are thorns in the side of the PRC and its avowed intentions to try to persuade the WTO to admit it as a full member of this international trading club -- after 14 years of trying.

Two-way trade between the EU and the PRC is known to be valued at more than $HK500 billion, annually.

Not an inconsiderable sum of money, one may be tempted to comment, and that is the reason that the PRC's admission to WTO is very important to the expansion of the economy of the world's most populous country.

The EU would like the PRC Government to agree to relax limits on foreign ownership of domestic insurance companies and telecommunication companies, among other things.

Without obtaining the EU's approval and support, the PRC Government is unlikely ever to be able to obtain that which it covets.

In addition to opening up its economy to a position that is considered a flat and level trading field to all members of the WTO, the entry of the People's Republic of China as a full member of the WTO could well have wide-ranging ramifications for many companies, listed on The Stock Exchange of Hongkong Ltd, and, especially, for prospective entries to the rolls of The Stock Exchange.

For one thing, the PRC's preferential tax holidays, afforded to its *'favourite sons',* will cease in short order – because the WTO will not permit the tax holidays to continue since such concessions would be contrary to the precepts, held sacred by the WTO: All member of the WTO must be afforded equal treatment.

When SIIC Medical Science and Technology (Group) Ltd went public on The Growth Enterprise Market of The Stock Exchange of Hongkong Ltd on November 23, 1999, Page 27 of the New Issue Prospectus stated, inter alia:

> *'In 1998, CTQ* (one of the Group companies) *should have been subjected to an income tax rate of 26.4%. However, pursuant to an approval received from local tax authorities on 16th September, 1998, CTQ was classified as one of the approved ... Accordingly, CTQ is entitled to a preferential PRC income tax rate of 12% until the year ending 31st December 2000. Such entitlement will be reviewed by relevant PRC authorities each year. As for Shanghai Jahwa* (another Group company*), it is entitled to a 50% relief from PRC income tax at the applicable rate of 27% which will end in year 2000. The expiry of the preferential tax treatment and the failure to renew such status or obtain similar treatment will increase the future tax expenditure of the Group which in turn will negatively impact on the profitability of the Group.'*

In view of the fact that the PRC Government is on the threshold of being a full member of the WTO, it is logical to assume that SIIC Medical Science and Technology is about to suffer a reversal of profits' fortunes.

This is on the assumption, of course, that that which was written in the November 1999 Prospectus of the Company is accurate in all respects.

This little tax holiday, as TARGET commented at the time, permitted SIIC Medical Science and Technology to obtain a profit in 1998 that, if the preferential tax consideration had not been afforded, would have resulted in either a dramatically reduced profit … or even a loss situation.

When Hudson Holdings Ltd sought a listing on The Stock Exchange of Hongkong Ltd, also on November 23, 1999, on Page 76 of that Company's Prospectus, it was stated:

> *'WHRED* (Wuhan Huaxin Real-Estate Development Company Ltd, a Sino-foreign equity joint venture established in the PRC, which is owned as to 51% and 49% by the Group and Wuhan Department Store Group Company Ltd)*, an indirectly non-wholly owned subsidiary of the Company, and* WPM (Wuhan Plaza Management Company Ltd, a Sino-foreign equity joint venture established in the PRC which is owned as to 49% and 51% by the Group and Wuhan Department Store Group Company Ltd)*, a jointly controlled entity of the Group, were exempted from income tax for the first profitable year of operations in 1993 and 1997, respectively, and were entitled to a 50% relief from income tax for the next two years in the PRC based on the statutory financial statements prepared in accordance with accounting principles generally accepted in the PRC.'*

Again, without the above-mentioned tax concessions, Hudson Holdings would not have been able to record the profits, stated in the Prospectu.

In fact, serious questions could well be raised about this company's reported profits for, although they are unquestionably correct and are prepared in accordance with The Companies Ordinance, Chapter 32 of the Laws of The Hongkong Special Administrative Region of the People's Republic of China, the quality of the earnings are such as to throw up all manner of questions: One has to assume that the auditors of this company not only sighted documentation, concerning the calculations of the profits of Hudson Holdings, but, also, reconfirmed the existence of those profits.

The Government of the PRC, in order to attract what it terms, Sino-foreign equity joint ventures, lured international entrepreneurs to its shores with promises of tax holidays for periods, ranging from 2 years to 5 years, depending on the financial strength of the foreigners, involved in the negotiations with various petty PRC Government officials.

The result of this successful strategy was to have quite a number of companies, owned partially by foreign entities, establish large manufacturing facilities in the PRC.

This, in turn, resulted in employment for tens of thousands of Chinese workers in these enterprises.

In addition to special concessions, offered by the PRC's State Bureau of Taxation, individual provinces of the PRC, and even towns, have been free to offer prospective investors all kinds of concessions, from Provincial Tax Concessions to indirect local subsidisation for prospective enterprises, via various means, none of which included, however, cash subsidisation.

In a recent TARGET analysis of a New Issue, admitted to the rolls of The Stock Exchange of Hongkong Ltd, Ching Hing (Holdings) Ltd, it was stated that the Founder of the fabric dyeing, printing and finishing company, Mr Yiu Ching On, in September 1997 (just after Asia was embroiled in a financial crisis), acquired *'the remaining 30% equity interest in Zhongshan Ching Hing* (Weaving Factory Ltd) *from ZCNTIC* (Zhongshan City Nantou Town Industry Corporation) *… for … HK$22.09 million …'.* (Page 35 of the Prospectus of Ching Hing)

One does not need to be a very clever chap to realise what must have happened when Chairman Yiu Ching On decided to tap the labour pool in Nantou Town, Zhongshan City, back in May 1992.

With ZCNTIC, agreeing to take up a 30-percent stake in this enterprise, and with about 620 people from the area about to get employment, all kinds of goodies must have been afforded to Chairman Yiu Ching On.

One wonders whether or not ZCNTIC ever put up a penny in cash for its 30-percent stake in Zhongshan Ching Hing Weaving Factory Ltd.

But it would not have mattered since the notional value of its stake, back in 1992, could have been satisfied by all manner of means.

But, when the need was apparent and the Nantou Town needed money, Chairman Yiu Ching On was, literally, *'Johnny-on-the-spot'* with cash, all $HK22.09 million of it.

One may expect that such official deals (a TARGET assumption) would cease the moment that the PRC joined the WTO since the WTO maintains that what is sauce for the goose must, also, be sauce for the gander.

While matters, relating to PRC tax concessions, may be dealt with in short order, including the coming to terms with certain Sino-foreign equity joint ventures, what is a much more thorny question is how to deal with those *'other'* deals.

It is well known that, in order to achieve rapid success in the PRC, it is necessary to have buckets and buckets of a special *'grease',* which may be used to oil petty government machinery, especially the machinery, located in little towns in out-of-the-way provinces where the Beijing Government is too far away to know … and to intercede if needs be.

For a company, seeking a listing on The Stock Exchange of Hongkong Ltd, be it on the Main Board or The Growth Enterprise Market, it will have to come clean with its dealings in the PRC, if that is where it has been doing business.

Scrutinisation of accounts by internationally accepted and respected accounting firms (sometimes difficult to find, these days) will mean that strict observance to international accounting standards will have to be the accepted norm.

Easier said than done.

Not too long ago, it was discovered that certain partners and members of audit teams in PWC – PriceWaterhouseCoopers, one of the 5, largest accounting firms in the world – were found wanting when the US Securities Exchange Commission discovered that they were holding equity stakes in the publicly listed companies in which they were supposed to be impartial and objective observers, verifying, among other things, that the accounts of the companies represented a true and fair view of the state of the companies as at balance sheet date.

Now, in the PRC, such niceties rarely are considered to be important, and it is as common as mud to have *'independent'* accountancy reporting firms, holding stakes in the enterprises that they are auditing.

But these accounting firms may, soon, have to consider changing their ways (if that is possible) since the PRC wants to become a respected member of the most important trade club in the world: The WTO.

The changing face of reporting in the PRC is going to be a tough nut for many a PRC official to swallow, but that will be the price that Beijing has to pay in order to sit down, next to other WTO members.

One wonders whether or not the PRC has the intestinal fortitude for such a change in policy.

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