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Invest and operate in Canada

What Chinese state-owned enterprises need to know

There is little doubt that Canada has become a prime investment location for Chinese state-owned enterprises (SOEs) in recent years – and for good reason. China's five-year plan for 2011-2015 encourages overseas expansion and cooperation to secure access to resources, acquire technology and improve management capabilities.[1] Canada offers all this and more. In addition to being rich in energy and natural resources, Canada provides advanced technology in new material, new energy and high-tech.[2]

Invest in Canada and the future

Lin Ning, deputy director-general of the economic information department of the China Council for the Promotion of International Trade, indicated that China's investments in Canada will continue to grow rapidly since both economies share strong complements in their economic structures[3].

Thanks to these advantages, Canada has attracted significant foreign direct investments from Chinese SOEs. In 2011, China's investments in Canada surpassed $20 billion, mainly in the fields of energy, mineral resources, agriculture, high-tech and biopharmacy[4].

Yet, despite these significant transactional activities, many of China's past overseas investments have experienced considerable losses – many of which were caused by weak risk prevention measures, poor contract negotiation and a lack of accountability when projects fail.[5] As a result, the Chinese government has taken steps to prevent future loss, improve performance and reduce risk. As of July 1, 2011, overseas investments held by SOEs must now be registered, monitored, audited and reviewed by China's State-owned Assets Supervision and Administration Commission (SASAC). In particular, the regulatory agency expects SOEs to strengthen their transactional oversight by enhancing their understanding of local regulations and requirements and improving due diligence when making foreign investment decisions.

This is no easy task for China's SOEs, whether you are already established within Canada or are considering operating here. To invest successfully in Canada, your organization needs to do more than identify optimal investment opportunities. You must also adhere to a wide range of Canadian and Chinese reporting requirements, adopt appropriate accounting standards for financial reporting, comply with complex international tax rules and streamline both your mergers and acquisitions (M&A) process and your post-merger integration process to realize full value from your investments. And these requirements will vary depending on your investment and operational phase, which ranges from inception to business development to ongoing operations.

Business inception

Before investing in Canada, your organization first needs to establish a local office, branch or subsidiary in the country and ensure it complies with all relevant Canadian laws and business requirements. This includes obtaining a business number and registering for a sales tax number, as well as filing income tax returns on an annual basis. You will also have to develop corporate mandates, charters and policies.

Additionally, your branch office should be prepared to comply with requirements for financial statement audits as well as compliance audits imposed by SASAC, parent entity or Canadian regulators. This will require the adoption of appropriate accounting standards for financial reporting.

Business development

Once a branch office is established the following steps may be taken to investigate and pursue business opportunities in Canada:

Identify opportunities:

- **Screen** the target to identify potential investment opportunities
- **Use** performance metrics to benchmark your target with comparable companies
- **Formulate** an investment strategy that meets the mandates and objectives of your organization
- **Assess** the viability of the investment opportunity and estimate the rate of return of the identified target

Conduct due diligence:

- **Examine** the target to assess its financial, legal, labour, tax and IT performance, and to assess both its control environment and market or commercial viability
- **Evaluate** financing alternatives, including local financing (debt financing or equity), partnering with other interested parties, financing from the parent entity and government subsidies
- **Assess** business risk
- **Identify** and evaluate applicable Canadian laws and regulations (e.g. securities regulations, tax laws and Aboriginal laws)
- **Review** the regulatory reporting requirements that would be triggered by the transaction

Negotiate the deal:
- **Develop** contract provisions based on your due diligence (such as indemnity provisions)
- **Consider** any accounting consequences that could result from terms and conditions in the draft purchase and sale agreement
- **Identify** opportunities that could affect pricing strategies, including consideration of potential accounting implications and requirements for accounting policy conversions and convergence
- **Evaluate** the tax consequences and regulatory reporting requirements triggered by the transaction

Execute the deal:
- **Prepare** all reports required for your parent entity, as well as for the Canadian and Chinese regulatory bodies
- **Value** the acquired assets and liabilities for financial reporting purposes
- **Conduct** working capital audits, inventory counts and opening balance sheet audits
- **Apply** purchase accounting for financial reporting purposes, which requires coordination with your auditors, valuation specialists, tax advisors, investment bankers and other external advisors
- **Ensure** you remain in compliance with all tax reporting rules

Integrate operations:
- **Carry** out post-merger integration activities to ensure your systems, people and accounting policies inter-operate successfully following your merger or acquisition
- **Design** and implement internal controls over financial reporting and operational processes of the combined company
- **Develop** and execute tax planning strategies
- **Design** and establish the organization structure that is optimal for integration of operations

Ongoing operations

Your organization is held accountable for annual budget targets and spending as well as the financial results of your investments. In fact, under new SASAC rules, the heads of SOEs will be investigated if their overseas investments incur losses. The Chinese central government also plans to closely monitor SOE budgets and spending.[6] As such, you will need to manage and monitor operations, costs and financial risks once you invest in a Canadian business. This includes:

- **Maintaining** internal controls over financial reporting and operational processes
- **Adopting** a robust risk management and compliance program related to corporate governance, local and SASAC reporting, and tax compliance
- **Managing** costs and applying appropriate accounting standards
- **Complying** with tax regulations and taking approved steps to minimize tax
- **Evaluating** your investment performance on an ongoing basis
- **Ensuring** the ongoing operations and/or financial audits are conducted in accordance with applicable local and international compliance requirements

Partner to succeed

Until recently, many Chinese SOEs have chosen to enter the Canadian market without the help of external advisors. However, mounting financial losses from certain overseas transactions mandate a new approach to expansion. To succeed in Canada – and indeed, internationally – SOEs will increasingly require guidance to establish a solid operating foundation.

The key lies to working with professionals who can support your organization through all phases of its operation – from inception, to M&A, to post-merger integration and beyond. That's where Deloitte Canada comes in. Our eminence in the Canadian marketplace and our close connection with Deloitte China will give us the expertise to assist you with:

- **Understanding** Canadian commercial practices and industry best practices to ensure you properly negotiate and structure your contracts and protect your operations from risk
- **Educating** your board and management about the Canadian market and culture
- **Streamlining** your M&A process, from due diligence and valuation through to post-merger integration
- **Complying** with all relevant Chinese and Canadian regulations and tax rules
- **Meeting** local and international reporting requirements
- **Assessing** your business risks, and develop appropriate internal controls, to avoid unexpected loss

Determining the best investments, understanding the rules and regulations, and ensuring business success in Canada can be overwhelming and challenging. But we can help. Working closely with Deloitte China, we can provide you with a team of professionals who speak your language, understand the concerns of your various stakeholders and possess an in-depth knowledge of Canadian businesses and industries. This means we can assist you each step of the way – to help you achieve business success.

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Endnotes

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