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Cultural Literacy and Sound Due Diligence: Two Imperatives for Business Success in China

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Cultural Literacy and Sound Due Diligence: Two Imperatives for Business Success in China

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Abstract: Doing business in China can be very complex and costly. However, businesses can reduce their risk by being patient, and improving their cultural literacy and the quality of their due diligence. Understanding China's culture and its ethical and legal system is a necessity for those businesses considering establishing operations in China. Partner selection has received very little attention even though it is one of the major causes of alliance failure. This paper focuses on the importance of these issues and explains why businesses should exercise due care when deciding to invest directly in China.

An in depth understanding of Chinese culture is essential to conducting business successfully in China. A review of the literature covering Sino - foreign business failures points to cultural illiteracy as the major cause of failure. The omission of cross-cultural analysis during the due diligence phase or the superficial manner in which it is conducted creates conditions that undermine the viability of an alliance. Culture influences the way we behave, think, and act; it influences our expectation and values by assigning priorities to what we consider to be most important (Morosini 1998).

The root of Chinese culture can be found in the teachings of Confucian and Tao philosophies. Both philosophies are deeply embedded in Chinese culture and they continue to be very influential in current Chinese business practices. Confucian teachers in the imperial court of China provided guidance and teachings to the elites; Lao Tzu philosophers in the villages and hamlets provided moral and social guidance to the common people through the teaching of Tao Te Ching (Haley, Haley, & Tan 2004; Menzies 2003).

THE FOUNDATION OF CHINESE PHILOSOPHY

The Lun Yu, or Analects as we know it in English, is a collection of Confucian sayings that provide specific guidance for each situation that a person may encounter in their daily activities. The Tao Te Ching, which literally means "the way" of virtuous behaviors, has come to represent the path to living a virtuous and spiritual life (Haley, Haley & Tan 2004). Both the Analects and the Tao Te Ching provide the moral, social, and legal philosophies that guide current business and social practices in China. Because the Analects and Tao Te Ching provide prescriptive norms of behaviors, Chinese moral and ethics are considered to be contextual and situation - specific (2004). Understanding Chinese contextual ethics is very important for engineering sound business relationships, especially if we are going to keep relational and ethical disputes to a minimum.

THE STRUCTURE OF CHINESE SOCIETY

The structure of Chinese society is considered to be egocentric and relationally bipolar. Relations are cultivated and grown through a web of linkages that connect families, clans, lineages, localities, provinces and countries. Relationship, according to Chinese social philosophy, is restricted to individuals; it cannot exist between individuals and abstract entities such institutions or even the state (Haley, Haley & Tan 2004). Similarly, loyalty can only exist between individuals and it is not transferable to institutions or even to another associate within the same organization. A Multinational corporation (MNCs) business policy that promotes transfer of employees frequently could inadvertently undermine or terminate existing relationships thereby weakening the business guanxi.

THE CONTEXTUAL LIMITS OF CHINESE ETHICAL PHILOSOPHY

The contextual nature of the Chinese ethical system was established by Confucianism and is limited to five unequal bipolar relationships consisting of ruler/minister; father/son; husband/wife; elder son/younger son; and friends (Haley, Haley & Tan 2004). Neo Taoist reduced the number of bipolar relationship to three (father/son, older brother/younger brother, husband/wife). Two things emerged from this redefinition: no ethical relationship exists beyond the family and stronger ethical duties are expected from the weaker (son, younger brother, and wife) towards the stronger (father, elder son, and husband) bipolar relationship. No ethical duties are expected beyond the familial context other than to maintain social harmony (2004).

The inability to fully understand the significance of the limitation of Chinese ethical responsibility has been the source of many conflicts between Chinese and Western business partners (Delios & Singh 2005; Nixon 2005). For example, after a decade of market research, McDonalds Corporation opened its first restaurant two blocks away from Tiananmen Square, a location considered by many to be a prime location in the center of Beijing. Within two years, sales had surpassed all expectations and McDonalds was very pleased with its selection of this choice location. Then the city government notified McDonalds that it had to move to make way for a commercial and residential development project. With 18 years remaining on its lease, McDonalds decided to take the Beijing City government to court to enforce the lease. The court refused to enforce the lease. McDonalds was forced to vacate the location to make way for Hong Kong's developer, Li Ka-shing (Hill 2007).

Four points are worth noting from this example:

1. McDonalds' relationship (guanxiwan) with the city of Beijing was weaker than Hong Kong's developer Li Ka-shing. The city of Beijing reasoned that more could be obtained by cultivating a reciprocal relationship with Li Ka-shing, Asia's richest man.
2. Taking the Beijing city to court disturbed the social harmony and may have destroyed whatever relationship it may have had with the Beijing city government.
3. The legal system in China is very weak, compared to two thousands years of cultural practices guided by contextual ethics of Confucian teachings.
4. To be successful in China, businesses must adapt their strategy to be responsive and supportive of the wishes of the relevant level of government.

FOUNDATION OF CHINESE LEGAL PHILOSOPHY

Understanding the Chinese legal system is imperative for any business contemplating commercial activities in China. Failure to understand the structure of the Chinese legal system and its limitations on guaranteeing individual and private rights is a major source of conflict with international partners. China's legal system is a social mechanism designed for control purposes and not for protecting the rights of its citizens (Haley, Haley & Tan 2004).

This customary system rooted in Confucian philosophy does not acknowledge or guarantee imperial subjects any individuals' rights; it only recognizes duties owed to the emperor. To ensure that emperors were able to impose their will as they saw fit, subjects were never guaranteed constitutional rights by the imperial courts. The important point here is that the legal system in China was never used to seek remedy for the violation of "rights"; rights reside with the authorities and not its citizens. The Chinese have written five constitutions to bring an end to public law, but they have not been able to overcome its influence.

Intellectual property rights is a major source of contention between Chinese and Western owned businesses. Historically, only the state of the emperor held intellectual property rights. The teachings of Tao however, encourage the diffusion of innovation through copying, recognizing this act as way of honoring the producer. This is a major reason why Chinese businesses do not consider violation of intellectual rights as an ethical issue. Moreover, as stated previously, if there is no relationship, then there is no ethical duty.

Take for example Apex Digital, a large manufacturer of DVDs based in Zhejiang province. After two years of futile attempts to negotiate royalty payments, Sony filed a lawsuit in the U.S against Apex Digital. Shortly thereafter, the suit was dropped when Apex agreed to pay royalty fees to Sony, Philips, and Pioneer. A spokesman for China Electronic Video and Auditory Industry Research institute claimed it was a big misunderstanding, and the Chinese were not cheating foreigners, but were simply confused. "All of us believed that you pay tuition when you learn the technology." Since the Chinese had not learned the technology, they should not have to pay (Haley, Haley & Tan 2004).

Additionally, China's patent law system not only recognizes a first to file rather than a first to invent, it requires that foreigners filing patents in China must do so through a government approved Chinese agency. Enforcement is a major problem with patent protection especially when the dispute involves state owned enterprise. Litigation is viewed as failure, since it disrupts the social harmony. Consequently, litigation is highly discouraged. The government encourages the disputing parties to consider compromise and negotiation to resolve the dispute. This of course does not sit well with companies from "rights" based societies (Haley, Haley & Tan 2004).

Native Chinese use social pressure and not the coercive force of constitutionally guaranteed rights to discourage unwanted behavior. The family is charged with enforcing socially acceptable norms of behavior. If the family fails to correct miscreant behavior, then their right to correct and supervise the offending individual will pass to their neighbors. If the neighbors fail, this right will pass to the village and all the way up to the state, if necessary (Haley, Haley & Tan 2004; Chua 2004).

NETWORK- BASED ECONOMY

In China, the marginal cost of acquiring information needed to assess the business risk of a transaction is costly; consequently, personal relationship is used as a substitute. To reduce the risk of adverse selection, Chinese limit business transactions to people they know (Haley, Haley & Tan 2004). Building a relationship prior to conducting business transactions is the preferred route.

When the party to a business transaction fails to comply, the aggrieved party would resort to social pressure as a mechanism to enforce compliance. Social pressure would be applied to the social network of the offending party and they in turn would apply pressure to the offender. The threat of being treated as an outcast and bringing shame and loss of face on the family and social network is a more effective deterrent than being threatened with judicial prosecution in the legal system. In most cases, the legal system is slow to respond, and even when it does, the cost imposed on the offending party is so small that it fails to act as a deterrent. Procter & Gamble cancelled contracts with two of its largest packaging suppliers in China, Dalian Dafu Plastic and Color Printing and Zhongshan Dafu Plastic Packaging, for supplying counterfeiters with its labeled packaging materials. Like many other Western companies in China, Procter & Gamble has not received adequate redress from the legal system to stop counterfeiters (Haley, Haley & Tan 2004).

Pepsi offers another example of the how things can go awry in a partnership, and how difficult it could be to receive compensation for damages from the partner. Pepsi was one of the first companies to enter China in a joint venture with a Chinese government supplied partner, Sichuan Administration of Radio, Film and Television Department. This was a provincial state owned enterprise (SARFTD). Pepsi

took its partner before the international arbitration panel in Holland, alleging that SARFTD breached failed to provide financial statements of the joint venture, prevented Pepsi's auditors from conducting an audit, and that the Sichuan government transferred ownership from SARFTD to a new partner, Sichuan Yunlu, without Pepsi's prior permission. SARFTD countered that Pepsi acted unilateral by raising the price of soft drink, and that Pepsi's auditors behaved unprofessionally (Haley, Haley & Tan 2004). Unfortunately, even when international arbitrators rule in favor of Western partners, compensation is a low priority, and they often face harassment from government agencies as is the case with Pepsi (2004.).

STRUCTURE OF CHINA'S GOVERNMENT

The Communist party occupies the apex position within the structure of the Chinese government. The wishes of the party are carried out through the elected representatives and the powerful Central Committees in the National People's Congress (NPC). As depicted in Figure 1, all levels of power within China are under the leadership of the Chinese Communist Party (CCP) (Vanhonacker 2004; Delios & Singh 2005; Keister 2000).

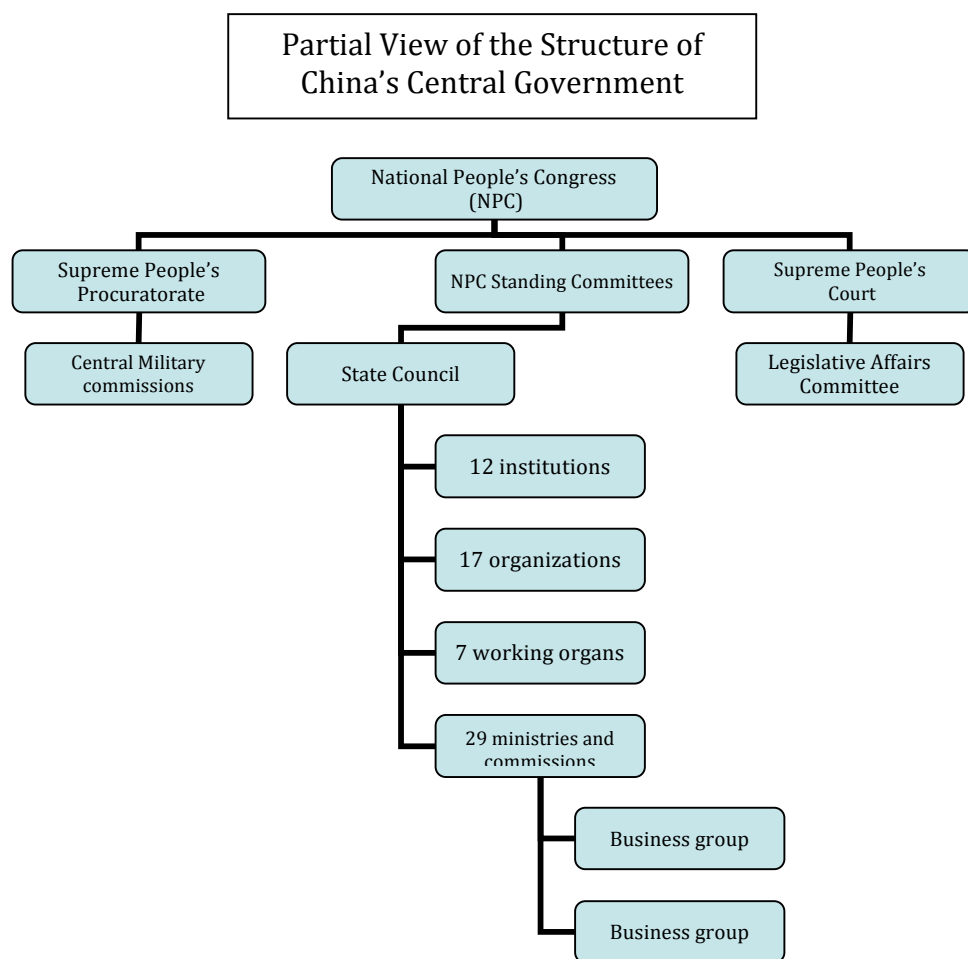
Of special interest to this paper, is the location of the powerful State Council and the ministries, commissions, institutions, administrations, and bureaus that fall under its jurisdiction, including the business groups. China's constitution empowers the State Council to implement the constitution, laws, and decisions made by the representatives and standing committees of the National People's Congress. Industrial reform has led to the emergence of business groups that are playing a crucial role in China's strategy to attract international investment to finance its economic development.

CHINA'S INDUSTRIAL REFORMS

Between 1979 and 2000, China has undergone 17 different reforms, each one inching China grudgingly closer to a market economy. China's initial decision to embrace economic reform was not so much driven by a change in ideological perspective; instead, change was being driven by necessity. China's economic system had become so inefficient and bureaucratic that as far back as 1964, party leaders were hinting of the need to modernize the economy (Keister 2000; Haley, Haley, & Tan 2004). One report claims that in 1978, industrial fixed assets were nine times greater than they had been in 1957, but industrial output only increased six times (2000).

The first experimental industrial reform took place in Sichuan province where managers were given greater discretion over the management and operations of their factories. Managers participating in this experiment reported nearly five times the level of profits reported by non-participating factories (Keister 2000). In 1978, the central government decided to extend the experiment to the Southern and coastal regions of China. Managers were given greater responsibility and incentives for increasing productivity and efficiency within their factories. As an added incentive, managers were permitted to keep a portion of the profits earned in a financial arrangement similar to franchising.

The Chinese government studied the Japanese Keiretsu and the Korean Chaebols and decided to model their development strategy after the Japanese and Korean business groups. The state has provided the SOEs with protection from foreign competition and has openly engaged in practices designed to give Chinese partners an advantage over its foreign partner that most often supplies the capital and technology.

FIGURE 1 PARTIAL VIEW OF THE STRUCTURE OF CHINA'S CENTRAL GOVERNMENT

Source: Vanhonacker 2004

Qualcomm offers an interesting case in its saga to make its CDMA technology the standard in China. CDMA is one of the three main technologies used in digital wireless phones, and its main advantage is that it utilizes the radio spectrum more efficiently than competing technologies. Qualcomm has more than 800 patents covering CDMA technology.

In 1994, Qualcomm decided that it would make CDMA available to the Chinese Army who was interested in developing a secure communication system. The Chinese Army command announced that they would develop a digital wireless system for the Army and that they would come to dominate the emerging mobile phone market shortly thereafter. This announcement caught China's ministry of Posts and Telecommunication off guard especially since they, too, were contemplating forming their own SOE digital wireless phone system. The ministry of Posts and Telecommunication agreed to form a 50/50 joint venture with the Chinese Army, and issued a license to operate in four cities. In the meantime, the minister of Posts and Telecommunication instructed his own two SOEs to speed up development and roll

out ahead of schedule, while it froze issuing additional licenses to the Army, thus eliminating the Army as a competitor. Qualcomm got squeezed between two powerful institutions and would see its efforts stymied. The Premier, Zu Rongji promised that China would adopt CDMA technology if the U.S were to approve China's entry into WTO. China refused to pay Qualcomm's usual royalty rate and insisted that they be lowered. Qualcomm relented, and an agreement was announced. The day after the U.S senate approved China's entry into the WTO, China's SOE announced that the deal was cancelled. Aware of the importance of global scale, Qualcomm eventually signed a deal well below its normal royalty rate (Hill 2007).

CONCLUSION

The cases and examples cited illustrate the difficulties foreign companies face when dealing with the many competing interests in China. Understanding the structure of Chinese society, the philosophies that have shaped ethical behavior over thousands of years, and the limitations of the legal system could improve the due diligence process, leading to the selection of more compatible partners. Aligning with the wrong partner can be very costly and difficult to undo. Western businesses interested in forging alliances with Chinese counterparts are well advised to invest in assessing the nature and quality of their uprightness in their business network. Chinese business groups can mask the entity that is pulling the levers behind the scene.

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