

Private Company Services

Establishing a business presence in China*

A guide for private companies

*connectedthinking

PRICEWATERHOUSECOOPERS 



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Investing in China is no less an imperative for private companies than it is for large public companies. China's gradual embrace of market-oriented economic and business principles, its entry into the World Trade Organization (WTO), its growing middle class, its low labor costs—all have propelled it to the forefront of media attention and business planning. Firms of all sizes understand that by ignoring this potentially vast market for their goods and services or by failing to take advantage of the possibility of labor arbitrage, they risk falling behind their competition.

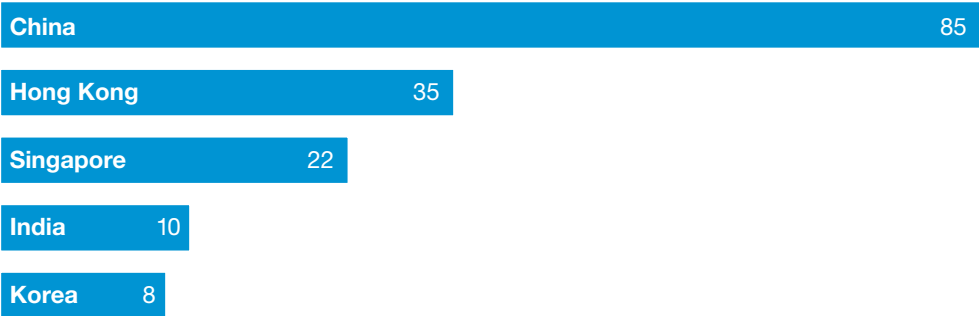
Given the right approach, private companies of various sizes can be extremely successful in China. Despite widespread publicity around the difficulties of operating in China, the risks of China's business environment can be mitigated by working closely with knowledgeable advisors, local partners, and government officials. The need for guidance is especially acute among midsize private companies, which generally lack the resources and the market expectations of large public firms. Public companies often build a presence in China slowly, learning about the market without concern for an immediate payoff. In contrast, a private firm can decide on a strategy, obtain the necessary approvals, commit capital, and ramp up in a matter of months, but the owners also need to see results more quickly than those in firms with deep pockets and risk-averse shareholders.

Well-managed operations in China have the potential to save a U.S. firm significant sums and to help expand its business more quickly. But in such a complex market, a blanket, across-the-board approach to strategy is impossible. Every decision, from the size and type of investment to the level of participation in the market, must be carefully considered and taken with a view toward the firm's particular industry, goals, and resources. And it is here that midsize companies actually enjoy an important advantage over their larger, better-resourced public counterparts. Private firms tend to benefit from faster, more-efficient decision making than large, publicly traded companies do. This is especially true when—as is often the case—the firm's chief

decision maker and its owner are one in the same person. And although they may be formulated more quickly, private firms' strategies are in many cases more carefully thought out than those of large public corporations, since the financial repercussions of any missteps are likely to be felt more acutely.

This paper begins by examining different strategies that may entice companies to enter the Chinese market. It then discusses the most important obstacles faced by these firms and it concludes with practical guidance on strategies for surmounting these challenges.

Estimated Foreign Direct Investment in Asia – 2007



Data estimated and in USD billions.
Source: World Investment Prospects, May 2007, Economist Intelligence Unit

Opportunities: Why establish a presence?

Since the earliest days of China's economic opening, multinational and foreign firms have been dazzled by the prospect of the fabled market of 1.3 billion consumers. This dream has remained very much alive: 62% of companies surveyed by the American Chamber of Commerce in China and the American Chamber of Commerce in Shanghai in 2005 reported that their number-one business goal was to produce goods or services in China for the domestic market.

With the crumbling of regulatory barriers, the challenges of meeting that goal have more to do with business strategy than with legal obstacles. The key questions now are how best to price and market foreign products produced in China and how to segment the Chinese market. As early as 2001—even before it joined the WTO—China began loosening the regulations that required or encouraged foreign-invested firms to export most of their output. And in December 2004 China fulfilled a key WTO commitment by allowing foreigners to (1) own enterprises engaged in local retail and wholesale trade through foreign-invested commercial enterprises, which are now permitted to distribute imported and locally manufactured products, and (2) provide related services such as storage, warehousing, inventory management, and delivery.

The liberalization also allowed wholly-foreign-owned enterprises to directly buy from and sell to Chinese firms. Foreign companies had previously been forced to deal only with approved Chinese companies, which acted as middlemen between foreign and Chinese buyers and sellers. As a result, a foreign retailer can now source items in China and then sell in the domestic market items it did not use itself. The impact of this change has been dramatic: in 2005, the Ministry of Commerce approved more than 1,000 foreign-invested retail ventures—and there were about 1,600 in China as of June 2006 (the most recent date for which figures are available).

Despite the liberalization of the rules about selling into the domestic market, many foreign firms continue to focus on exports. Production outsourcing, or the use of China as a manufacturing base for finished products, is based on one simple fact: low labor costs. In 2006, manufacturing labor costs averaged US\$24.48 per hour in the US versus an average of US\$1.41 in China—though, wages differ sharply by sector and location, as do labor quality and the availability of specialized skills. Although wages are rising more quickly in China than in the US, even by 2010 manufacturing labor costs in China are expected to be more than ten times lower than in the US.

Cost considerations are also the driving forces behind basic procurement strategies, as low manufacturing labor costs translate into low costs for parts and components. As the quality of local manufacturing continues to improve, foreign firms are not only increasing the percentage of their overall supplies that come from China; they're also having increasingly complex parts sourced there. In many industries, the entire supply chain is moving to China. Moreover, a procurement strategy can be an excellent first step for a firm new to the Chinese market but interested in keeping the option of setting up local production later.

Challenges: How to overcome them

Reward does not come without risk, but risk can be mitigated by a mixture of the right strategy, planning, and execution. The rewards of China are fairly obvious: low costs, fast growth, a strong manufacturing base, and a large domestic market. The risks are more complex. In addition to the normal business risks accompanying any investment decision, China—like other emerging markets—presents foreign firms with a host of regulatory and cultural issues. Mitigating those risks requires specialized expertise.

Obstacles can be divided into two broad categories: regulatory and cultural. For midsize private companies, the most important regulatory obstacles are foreign exchange and financing restrictions. There are many cultural obstacles, but those most relevant to foreign investors have to do with inconsistent enforcement of regulations.

Regulatory obstacles

Foreign exchange The renminbi (the currency of the People's Republic of China, the basic unit of which is the yuan) has been officially convertible on the current account since 1996; this means that importers and exporters have free access to foreign exchange. Payments by companies (including foreign firms) for imports, labor and services, repayment of interest on foreign debt, and repatriation of profits by foreign businesses in China are subject only to relatively straightforward rules such as audited financial statements, a statutory reserve, and tax clearance. Convertibility on the capital account, however—which covers transactions related to direct investment, international loans, and securities—is expected to be implemented only over the longer term.

The trend in China during the past decade has been toward a gradual liberalization of the forex market. That trend will only accelerate in the coming years as the government gradually opens its financial system and as trade and investment grow. It is well beyond the scope of this paper to examine in detail the myriad policy relaxations that have already occurred, much less to discuss

planned future reforms. For that reason, it is imperative that firms of all sizes doing business in China work with an advisor who is closely monitoring the pace and extent of change in the operating environment.

Foreign-invested enterprises (FIEs) may open foreign-currency bank accounts only with the permission of the State Administration of Foreign Exchange, which grants the enterprise a Foreign-Exchange Registration Certificate. FIEs are required to separate hard-currency bank accounts into capital accounts—for capital injections from foreign investors, foreign currency loan activity, and so on—and current accounts: for foreign exchange used for ordinary operating items. The inconvenience can be significant: when asked about the greatest difficulties for its China business, privately held architectural services firm Kohn Pederson Fox (KPF) cited “moving money in and out of the country.” However, the rules vary by industry, and service firms like KPF often have a more difficult time than firms in other industries do.

Financing Financing an operation can also be a challenge—though here too the trend is toward the gradual expansion of financing opportunities for FIEs. In December 2006, the Regulation on Administration of Foreign-funded Banks came into effect, ending any differences in the treatment of domestic and locally incorporated foreign banks. One of the key areas of business for foreign banks will be to provide financing alternatives for FIEs.

Most FIEs currently finance themselves with funds from their initial capitalization (and any subsequent capital injections) and reinvested profits. They must satisfy several criteria in order to borrow locally, and they face competition from state-owned enterprises, which have priority access to credit. The ability to obtain local financing depends on the nature of the operation, on whether it generates local-currency or export revenues, and on how the financing is used. Domestic-trade financing and working capital lines can often be obtained by pledging real estate, including land usage rights. Offshore-trade financing from Hong Kong banks is also feasible, if properly structured.

Cultural obstacles

From the viewpoint of an investor seeking to mitigate risk, the most important cultural difference between China and the West may be China's lack of a rule-of-law tradition. Under the norms of traditional Chinese culture, personal connections are paramount; morality and justice trump regulations; and local officials have wide decision-making discretion. Foreign companies can use this tradition to their advantage by spending time developing personal relationships with local managers and offices. However, the negative aspects of the tradition are inconsistent interpretation of laws and regulations and substantial uncertainty among investors who are used to the West's strong court systems backed by many years of accumulated precedents.

Although rule of law may not be part of China's past, there are two reasons to believe it will be part of China's future. First, many scholars argue that a system of formal laws is required in a society that—like China's—is growing, is pluralistic, and is becoming increasingly integrated into the world economy. It is not just foreign investors who need protection from capricious legal interpretations; Chinese companies, too, will benefit from the relative certainty of a consistent, rule-based order throughout the country.

Second, the shortcomings of China's legal system are widely acknowledged within China, and the central government is making efforts to rectify them. For instance, the Unified Enterprise Income Tax Law—enacted in March 2007 and taking effect January 1, 2008—is intended to standardize the tax treatment of domestic firms and FIEs and bring more clarity, transparency, and fairness to the system.



Intellectual property (IP) protection Probably the most widely publicized obstacle to setting up operations in China is the difference in attitudes toward intellectual property. The Chinese government has signed treaties, passed legislation, and created special courts to safeguard IP rights. Nevertheless, reverse engineering, counterfeiting, theft, and other forms of IP misappropriation remain widespread. A deep-rooted social tenet is that shared property takes precedence over property owned by individuals or companies, and the decisions of Chinese courts and law enforcement entities often result in outcomes adverse to the rights of foreign IP owners. This is a problem not just in China: the dynamics of globalization, including countries with low cost production facilities and weak enforcement mechanisms, pose risks to IP even for companies investing in countries outside China.

But forewarned is forearmed. Many FIEs have found ways to work within China's high-risk IP environment. The key lies in taking a more holistic value-management approach to IP protection—one rooted in proactive strategic and operational decisions rather than a purely legal (and often reactive) approach.

Engage with the legal system while reducing dependence on it. Although conventional legal methods of protecting IP may not always be effective, copyrights, trademarks, and patents should still be registered. At the same time, it is important to recognize that the legal system is only a starting point. The most effective methods of guarding intangibles have little to do with the law.

Focus on where IP value is created. Some companies avoid manufacturing innovative, high-margin products in China, focusing instead on mature, commodity-type products with lower margins. Another example might be choosing to develop products in countries with better IP protection and then bringing the products to China, thereby keeping the technical details (for instance, source code) hidden. Still other products may be developed,

manufactured, and distributed in China as long as the IP value lies in the accompanying services or brand attributes rather than the products themselves.

Be prepared to use pricing and versioning aggressively. Global product launches can help foreign companies get a head start on local manufacturers that may create derivative products. Versioning can keep foreign firms a step ahead of local competitors. And, as elsewhere in the world, aggressive pricing can prevent less capable manufacturers from keeping pace.

Go beyond standard security precautions. On the operational side, security measures are just a starting point. Background checks, noncompete agreements, strict screening of job candidates, and education programs aimed at raising the visibility of IP protection may ultimately be more effective. Foreign companies can also audit business partners to ensure compliance with business terms. Finally, companies can adopt such common (but often ignored) management techniques as assigning specific responsibility for IP protection, monitoring performance, measuring results, and establishing incentives.

Formulating an IP protection strategy is crucial for foreign firms contemplating a presence in China. Although the need to obtain legal advice should not be discounted, advisors with on-the-ground experience and broad understanding of the business issues should also be enlisted to help businesses retain control over IP.



One private company that has developed a successful strategy for its China-based operations is Galleria. Established in the US in 1982 as a home decoration and home accessory importer and wholesaler, Galleria has procurement operations in Hong Kong and Shenzhen and a manufacturing operation in Qingdao. The driving forces behind this international expansion were China's low labor costs and its competitive product pricing. Galleria's US competitors were already sourcing products from China, and Galleria would not have been able to compete had it not followed the trend.

Cheri Fu, one of Galleria's cofounders, described the company's experience in China as "very challenging but very rewarding." She notes that local government officials can be critical to the success of a foreign-invested enterprise (FIE). In her experience, an FIE can choose the broader region (e.g., the province) it wants to establish a presence in and then can contact the government office in charge of foreign investments for that region. The office presents available locations within the province, and the FIE can then select a location depending on its needs—for example, for raw materials or for skilled labor.

Sometimes the choice can even come down to which government official a company feels most comfortable working with, since "different officials have different mindsets when they manage their relationships with investors," says Ms. Fu. Even if a location looks promising for other reasons, an FIE may decide against it if it isn't confident about the local official. This is because local officials play an important role in an FIE's operations far beyond the initial setup stage.

According to Ms. Fu: "They [local officials] can help manage relationships with local employees and with other government departments—environmental, fire, etc.—and help communicate with other officials ... [They] can lead you down the right path" and generally facilitate a better understanding of the culture and the system.

That does not mean, however, that a foreign firm can sit back and let the local government do all the work. "You don't want to be the business that depends on the local government to teach you how to run or control your business," observes Ms. Fu.

The best way to maintain good relations with Chinese government officials is to work with them. Although some Chinese laws can be burdensome and compliance expensive, a company that diligently follows all the rules will be in better standing with the government.

As for charges that some regulations are unfair, Ms. Fu believes that to be an oversimplification. In her view, it's not so much that regulations are unjust or deliberately restrictive; it is that the economy is growing so fast that the regulatory regime cannot keep pace, and so it frequently does not reflect current business operating conditions.

The solution? "Work within the system," says Ms. Fu. And use an advisor with on-the-ground experience in establishing China operations.

Every foreign firm establishing a China presence needs to develop a strategy that leverages its core strengths while enabling it to adapt to the Chinese business environment. With its double-digit gross domestic product growth and one of the highest savings rates in the world, many firms consider establishing a presence in China mandatory. But simply duplicating the strategy used in the home country, without taking into account China's unique business environment, is a recipe for failure.

The key to developing a successful China strategy lies in recognizing and leveraging a company's core competencies. Those competencies may not be the same as they are in the home country. For instance, IKEA enables customers to save money by assembling furniture at home. Many of its customers enjoy small do-it-yourself projects. But in China, where manual labor is cheap, there is no do-it-yourself tradition. Home assembly may even carry a stigma for IKEA's aspirational middle-class consumers. IKEA's Chinese venture solved this problem by offering inexpensive assembly services to its Chinese customers. These services are not unique to China, but Chinese consumers use them at a much higher rate than do consumers other countries.¹

Customer segmentation is also important. IKEA started out in 1998 by pricing its products too high—even for the young professional couples it was targeting. The company soon lowered its prices, which are now considered mid-range (at least in the coastal areas). The income of the typical IKEA customer is about three times the national average, though that average is atypical of the areas around Shanghai, Beijing, Guangzhou, and Chengdu, where IKEA's stores are located.

¹ Paula M. Miller, "IKEA with Chinese Characteristics – The Swedish furniture retail giant is bringing its unique style—and sales model—to China," *The China Business Review* online, July/August 2004, accessed April 2007.

Among China's highest-income consumers, price is less important than the product's brand characteristics. In fact, the most expensive foreign products sell at higher prices in China than at home. Consumer products companies with strong brands may start by targeting affluent customers in the coastal areas and charging relatively high prices, emphasizing profitability over market share. Unfortunately for US companies, US products are not generally seen as high quality, so some expensive US products are labeled as European.

Middle-class Chinese consumers are more price sensitive. Some companies may choose to neglect margins in order to expand aggressively, build market share, and drive out competitors. Of course, pricing products cheaply also requires sourcing from low-cost locations.

What are the best ways for foreign firms to actually get a foot on the ground? The possible forms of entry into the market can be divided roughly into two categories: direct and indirect.

Direct

Of the direct-entry methods, the wholly-foreign-owned enterprise (WFOE) is the most popular choice because it requires little need for a local partner. A WFOE is funded entirely with foreign investment and has sole responsibility for profits and losses. It must register as a legal person, giving it, among other things, the right to sue other entities or persons in a Chinese court.

Other options include the following:

An equity joint venture (EJV) is typically used for long-term projects and must register as a legal person. It is a limited-liability company, with liabilities limited by the investments. Both the foreign and the Chinese investors contribute capital, obtaining equity and subsequently receiving redistributed profits accordingly. The minimum share that a foreign investor can hold is 25%.

A cooperative joint venture (CJV) is often used for shorter-term projects or for build-operate-transfer investments. It can register as a legal person with limited liability but does not have to. If the company does register as a legal person, the foreign investor must contribute at least 25% of the registered capital. Typically, the foreign investor provides funding and technology, and the Chinese partner provides land, labor, natural resources, and power and water facilities. Profits need not be redistributed according to the investors' respective contributions, thereby giving both parties significant flexibility in negotiating contracts.

Finally, the foreign-invested company limited by shares, also known as a foreign-invested joint-stock company, forms a subclass of joint-stock companies. It requires registered capital of at least Rmb30m and at least five promoters, half of whom must be domestic. Joint-stock companies are similar to Western-style public-shareholding companies.



As the Chinese government strives to consolidate industries to create large, competitive firms, foreign firms also have the option of entering the market by acquiring a local company. Both equity acquisitions (where foreign investors buy existing shares of a Chinese enterprise or subscribe to new shares issued by a Chinese enterprise) and asset acquisitions (where foreign investors buy the assets of a Chinese enterprise) are permitted. In practice, however, foreign firms rarely avail themselves of this option. The Merger and Acquisition Guild of the All-China Federation of Industry and Commerce said in January 2007 that mergers among Chinese enterprises were growing faster than those involving foreign companies. Quoting statistics from Dealogic, the organization noted that there were 1,270 mergers between Chinese companies in the first 11 months of 2006, with a transaction value of US\$56.8 billion.

Indirect

The indirect approach, meanwhile, generally takes one of just two forms. Foreign companies with patents, trademarks, or other intellectual property are free to enter into *licensing agreements* with local companies. Licensing, used mainly for technology or trademark-related products, has the advantage of limiting a foreign company's exposure, since the company need not set up an office or a joint venture. However, a licensor has less control over how its product is priced, marketed, and distributed. Furthermore, in practice, uncertainty over China's protection of intellectual property and shifting Chinese priorities and policies can undermine deals with Chinese enterprises.

Alternately, a foreign firm may set up a Chinese *branch or representative office*. A branch remains part of the parent company and is therefore not entitled to the rights and protections accorded to Chinese legal entities, however. It also must appoint a Chinese legal representative. A representative office—despite strict limits on the permitted scope of services—has been the most common vehicle for foreign services companies like banks and consultancies establishing a presence in the country. It allows a foreign investor to enter the Chinese market with little initial investment, but the investor is prohibited from direct profit.

The importance of working with a trusted local partner cannot be overestimated. This kind of co-operation is what made it possible, for example, for KPF to enter the Chinese market despite the fact that the local services market is still tightly restricted and the fact that foreign services firms have generally had more difficulty in China than other types of companies have. Once on the ground, this midsize company with relatively limited international experience attributed its success in China largely to its choice of a local mentor and to its use of a local firm to execute back-end work.

Foreign Direct Investment

Although foreign direct investment (FDI) into China fell 4% year-on-year in 2006, to US\$69.47 billion, China remains the most important investment destination in Asia. The Economist Intelligence Unit forecasts that China will be the world's third-largest destination for FDI, behind only the US and the UK, over the 2006-2010 period.

China welcomes FDI and is bound under World Trade Organization rules to open its industries further to foreign businesses. At the same time, it does not want important or "strategic" sectors of its economy to come under foreign control. Because of this, the approval system essentially divides China's economy, for foreign-investment purposes, into four parts:

- Prohibited
- Restricted
- Permitted
- Encouraged

This system, governed by the Foreign Investment Catalogue, assumes that approval for domestic projects will be granted automatically as long as such projects do not require government financing and as long as they fall into the permitted and encouraged categories. The catalogue allows for some flexibility since companies in the permitted category are considered to be encouraged if they export 100% of their output. Similarly, enterprises in the restricted category may be upgraded to permitted if their exports account for at least 70% of their output.

Wholly-foreign-owned enterprises (WFOEs)

- A prospective foreign investor must submit a report to the local authorities on the planned project, including its size, purpose, products, technology, and land-use requirements. The local authorities normally reply within 30 days.
- If the project exceeds an investment value threshold (now usually US\$100 million) or is in an industry in which investment is restricted or considered sensitive, the foreign investor must subsequently submit the local authorities' reply and a new application and feasibility study for approval to the Ministry of Commerce (MOFCOM). The application must include the articles of association, certificate of incorporation, letter of creditworthiness issued by the investor's bank, and the identity of the legal representative of the investor. MOFCOM normally replies within three months.
- After approval, the foreign investor must register with the State Administration of Industry and Commerce within one month to obtain a business license.
- WFOEs, like joint ventures, must file an environmental-impact assessment, followed by an application for land-use and construction permits.

Equity joint ventures (EJVs) and co-operative joint ventures (CJVs)

- The Chinese party submits a project proposal, preliminary feasibility study and letter of intent indicating the foreign company's interest in the project to the Chinese agency in charge of approval.
- Following approval from the Chinese agency, the two JV partners prepare a joint feasibility study.
- They submit an application, a joint feasibility study, the JV contract, and articles of association for approval. Other documents may be submitted, including contracts on technology transfer and trademark licenses.
- For EJVs, authorities must make an approval decision within three months of receipt of the documents; for CJVs, the period is 45 days. Note that the letter of the law is not always followed in the case of approvals, and actual decisions can take longer.
- Both EJVs and CJVs must file an environmental-impact assessment to the local authorities.
- Following the filing of an environmental-impact assessment, the joint venture should apply for land use and construction permits.

Representative offices

- Foreign investors must first seek agreement with a Chinese company that can act as its sponsor.
- An application must be submitted to a local approval authority. A reply is normally given within one month after formal application.

Conclusion

Although the difficulties of doing business in China are many, they can be mitigated with proper planning. The most important observation is that for private firms as well as large public multinationals, there is no one sure route to success in the Chinese market. Midsize firms in particular should analyze their reasons for entering the market and assess carefully whether the benefits will outweigh the costs and difficulties. In the case of a procurement-only operation, for example, the larger the scale of operations, the greater the cost benefit gained by sourcing from China. Smaller firms may also be able to achieve economies of scale, however, and need to carefully assess the economics of their planned operations.

A company's strategy must be tailored specifically to suit its product or service, resources, and goals, as well as the reality of the operating environment. In this respect, midsize companies may in fact have an advantage over larger firms with more resources and international experience. Many of the latter have been tempted to simply modify the business model used in another foreign market and apply it in China—often with disastrous results. A midsize firm with no prior international experience, however, will be forced to formulate a China strategy from scratch. Midsize firms, often unburdened by the confidence that comes from success in other foreign markets, may be more likely to carefully consider how to adapt their home-country strategy and develop the best market penetration plan. They may also be more open to seeking out advice from experienced and trusted advisors who understand both their business and China's business environment.

Although they may benefit from their inherent flexibility, midsize firms must still face the many hurdles of establishing a China presence, including regulatory challenges and cultural and business environment factors. Finding and maintaining knowledgeable local contacts may determine the ultimate success or failure of a business. Whether formal (as in a joint-venture contract) or informal, establishing this local link requires patience and good judgment.

The returns on financial investments are proportional to their risk; in the nonfinancial world, output is often dependent on the intellectual and emotional resources expended. Nowhere are these two principles intertwined more closely than in China, where foreign businesses are offered potentially wondrous opportunities for cost savings and business expansion. More so than large firms that are better able to absorb losses, midsize companies must develop a China strategy underpinned by strategic planning and sound judgment in order to reap the rewards of the market.

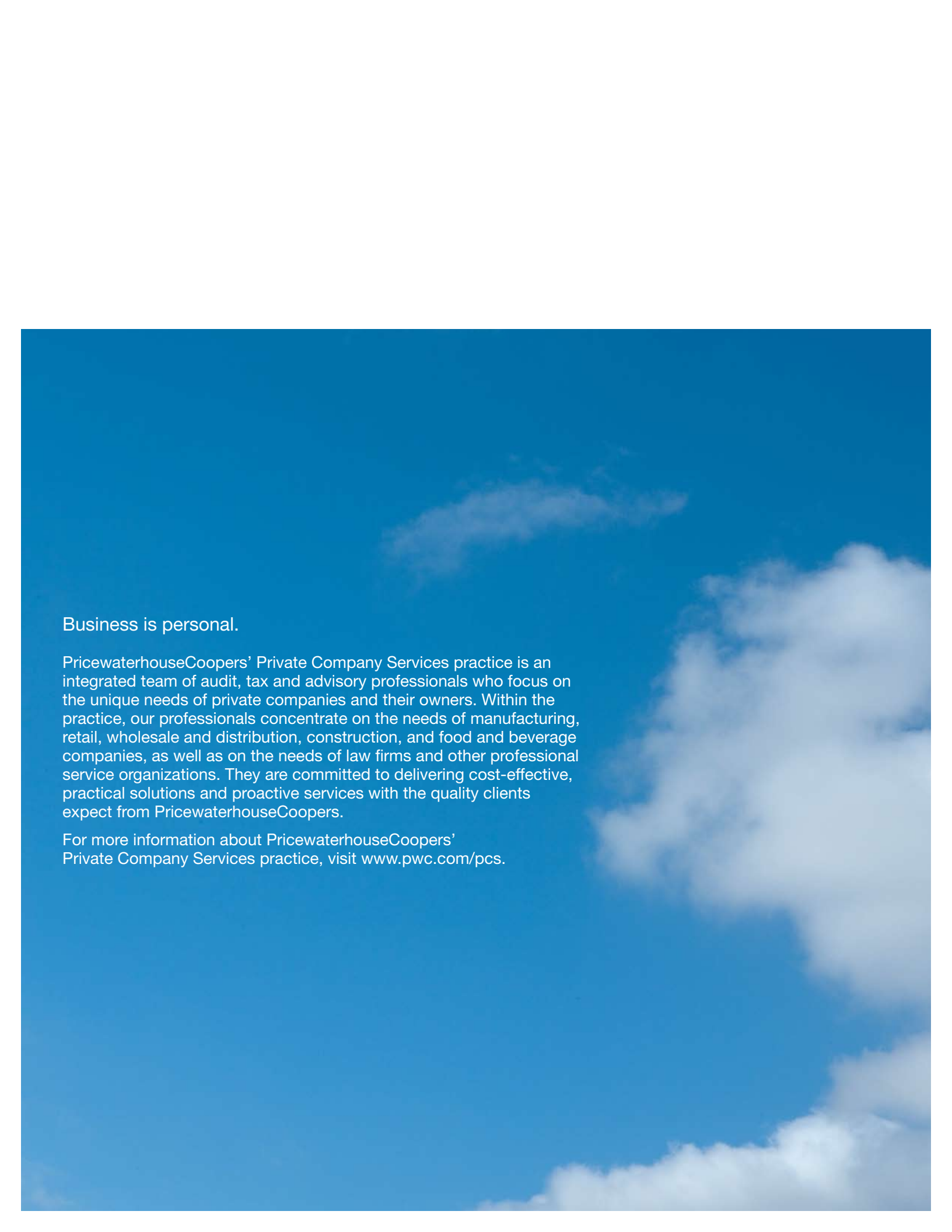
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