

# *Opportunities to improve financial reporting and internal controls in China*

## CAS and C-SOX

May 2011

### **At a glance**

How China is enhancing the quality of financial reporting and internal controls with CAS and C-SOX

Key considerations for automotive MNCs who are doing business in China

Managing these changes in the regulatory framework will take a coordinated and collaborative effort for all involved

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## Introduction

*As China's stature in the global economic arena rises, the government recognizes the need to strengthen China's financial reporting and align with global standards. China's regulatory bodies are diligently working to create an environment of quality in the application of accounting and internal controls over financial reporting. And with the speed and magnitude of the automotive industry growth in China, this is an important step forward for all companies involved. In fact, many Chinese companies are training their talent, upgrading systems and enhancing the governance structures to tackle these regulations. The challenge may appear daunting to the Chinese companies, where many MNCs have the experience and institutional expertise in these key areas to leverage. So, is this an opportunity to share and collaborate? Or will these changes test the relationships of the MNCs and Chinese partner?*

Over the past three decades, the Chinese automotive industry has attracted significant global and local investments—seeking to tap into what is now the largest and fastest growing automotive market as well as the second largest economy in the world. For multinational companies, or MNCs, as the level of these investments and the relative materiality of these operations have grown, so has the importance of the financial reporting at, and internal controls over these operations. In recent years, China has taken two significant steps towards enhancing the quality of financial reporting and internal controls:

- **Chinese Accounting Standards (CAS)**—with significant changes from 'old PRC GAAP' and intended to provide greater convergence with IFRS
- **Basic Standard for Enterprise Internal Control (C-SOX)**—with requirements for management assessment of internal controls, and an opinion on the effectiveness of the company's internal controls

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*According to Autofacts, China will produce 28 million units by 2020.*

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## Impact on MNCs

- **The regulations are principle based.** However, the Ministry of Finance (MOF) provides some interpretation in specific circumstances. Overall the regulations are intended to allow some flexibility in interpretation, application and implementation so as to: 1) minimize the burden of compliance, and 2) accommodate the variations in stages of development, local operating and regulatory environments, along with other considerations. For CAS, an additional related matter is the need to consider differences in the timing of implementation among different jurisdictions.
- **The existing financial accounting and internal control processes and related resources need to be assessed** so as to determine whether they are capable of addressing and reconciling the noted variations. For operations which are more reliant on local finance staff for interpretation, implementation, and on-going compliance, a specific assessment may be required to determine whether additional training and/or development are necessary.
- **The fragmented nature of the Chinese automotive industry and its different forms of joint business relationships, or JBRs, adds another potential layer of complexity** in the implementation of the new regulations and emphasizes the need for cooperation with Chinese partners. This is especially critical where the MNCs have limited or little influence, such as joint ventures, affiliates or other non-controlling interests.
- It is also important to recognize that these actions taken by the Chinese government are **not intended to provide immediate and complete alignment with their equivalent global standards.** Rather, they should be viewed as steps by the Chinese government to gradually establish a high quality financial management infrastructure that can support its rapidly growing economy—with consideration of its own unique set of circumstances.

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## Opportunity for collaboration and improvement

Notwithstanding the above, **for MNCs with a collaborative mindset and a sound understanding of the regulations and the operating environment in China, these two regulations can provide an excellent opportunity to make significant improvements in the financial reporting and internal controls over their Chinese affiliated operations.**

The following pages provide an overview of the new rules and how these compare with the framework they are intended to replace, including the timetable for implementation. In addition, we have provided our viewpoint on the challenges, considerations and opportunities for automotive companies.

## CAS—Joining the global move to IFRS

### What is the new regulation?

CAS consists of one basic standard and 38 specific standards. It differs significantly from historically generally accepted accounting principles in the PRC, or old PRC GAAP (see table

below for some of the key differences), but is in many respects converged to IFRS as issued by the IASB. However, there could be significant differences depending on the accounting policy choices made by an entity.

	CAS	Old PRC GAAP
Business combinations	<ul style="list-style-type: none"> <li>• A business combination involving enterprises under common control is accounted for using a method of accounting similar to the pooling of interests method</li> <li>• A business combination involving enterprises not under common control is accounted for using the acquisition method</li> <li>• Goodwill will not be amortised, but shall be tested for impairment at least at the end of each year</li> </ul>	<ul style="list-style-type: none"> <li>• Acquisition of, or merger with other enterprises is accounted for using a method similar to the purchase method</li> <li>• Equity investment difference or goodwill shall be amortized</li> </ul>
Consolidated financial statements	<ul style="list-style-type: none"> <li>• Identification of a subsidiary: whether control exists or not</li> <li>• A parent should prepare consolidated financial statements, with no exception</li> <li>• The proportionate consolidation method is not permitted for joint ventures</li> </ul>	<ul style="list-style-type: none"> <li>• Identification of a subsidiary: holding more than 50% of interests of the investee or holding less of 50%, but in substance having control over the investee</li> <li>• Only four types of enterprise groups are required to prepare consolidated financial statements, and FIE group is exempted from preparing consolidated financial statements in most cases</li> <li>• Proportionate consolidation method is required for joint ventures</li> </ul>
Property, plant and equipment	<ul style="list-style-type: none"> <li>• Deferring payment for the purchase price of a fixed asset beyond normal credit terms: the cost of the fixed asset shall be determined based on the present value of the purchase price</li> <li>• Decommissioning costs: included at its present value as part of the cost of the fixed asset</li> <li>• Fixed assets held for sale: the estimated net residual value of a fixed asset held for sale shall be adjusted to reflect the fair value less costs to sell</li> <li>• An enterprise shall review the useful lives, the estimated net residual values and the depreciation methods of fixed assets at least at each year-end</li> </ul>	<ul style="list-style-type: none"> <li>• Deferring payment for the purchase price of a fixed asset beyond normal credit terms: not addressed</li> <li>• Decommissioning costs: not included as part of the cost of fixed asset, but will be taken into account in estimating the net residual value of the asset</li> <li>• Fixed assets held for sale: not addressed</li> <li>• An enterprise shall periodically review the useful lives and the depreciation methods of the fixed assets</li> </ul>

	CAS	Old PRC GAAP
Impairment of long-lived assets	<ul style="list-style-type: none"> <li>The internal and external indications that an asset may be impaired are described and illustrated, and the quantitative criteria for identifying indications are removed</li> <li>The recoverable amount of an asset is the higher of its fair value less costs to sell and the present value of the future cash flows expected to be derived from the asset</li> <li>The projections of cash flows based on the financial budgets or forecasts provided by management are specified to cover a maximum period of five years unless a longer period can be justified</li> <li>Provision for impairment losses cannot be reversed once recognized</li> </ul>	<ul style="list-style-type: none"> <li>The quantitative criteria for identifying indications of impairment are prescribed, for example, the market price continues to be lower than the carrying amount of long-term investment for two consecutive years; and the construction work of a construction in progress has been suspended and is not expected to recommence within the next three years, etc</li> <li>The recoverable amount is the higher of an asset's net selling price and the present value of estimated future cash flows</li> <li>The maximum time period that projections of cash flows based on the budgets/ forecasts provided by management are permitted to cover is not addressed</li> <li>Provision for impairment losses can be reversed</li> </ul>
Research and development expenses	<ul style="list-style-type: none"> <li>Expenditure on the research phase shall be recognized in profit or loss when incurred</li> <li>Expenditure on the development phase can be capitalized if it meets certain specific criteria</li> </ul>	<ul style="list-style-type: none"> <li>Research and development expenditure shall be recognized as expenses when incurred</li> </ul>

For accounting specific to the automotive sector, there are also areas which can be considered in the CAS implementation process which are not driven by changes from CAS accounting rules, but developments in areas such as data quality, changes in operational practices, and/or changes in other regulations or taxes. Two areas that fall within this description for many automotive manufacturers are estimates for warranty and tooling expenses.

- Warranty expense estimates involve the collection and analysis of several data points to help develop management's best estimate. The estimation methodology considers historical claims and current consumer/market practices for addressing warranty matters. Over the past few years, the data collection process has improved thus *enhancing* the warranty model for financial reporting.

- Tooling expenses is another area where the change in the accounting has not had a significant impact; however, the information technology improvements at the Chinese operations might provide an improved view of usage patterns, thereby requiring an update of models that were established when the business was still in its infancy.

### **How does it apply to Chinese entities?**

When CAS was first issued in 2006, it was only required to be applied by all listed companies. Until 2008, unlisted companies were not required to follow CAS in their local statutory filings. Gradually, selected regulatory authorities began to mandate the adoption of CAS, extending that to most state-owned enterprises, some foreign-owned entities in regulated financial services sectors, and other companies located in particular provinces and municipalities.

Different jurisdictions in China have different timing and scope as mentioned above for the adoption of CAS. Thus, a subsidiary in one location might need to apply CAS while another may not. Due to the differences in the application of CAS there could be potential differences for consolidation purposes in financial reporting

outside of China. An inventory of the regulatory reporting requirements by jurisdiction, and the implementation timetable is a prudent exercise at all enterprises. It is important for management to identify any differences, assess the magnitude of the impact and standardize policies where appropriate to reduce differences.

### **What is the implementation timetable?**

To date, the MOF has not issued a specific timetable for the adoption of CAS throughout China. Each jurisdiction has established its own implementation timeline. For example, Shanghai issued a notice requiring unlisted companies located there and meeting certain industry and size criteria to adopt CAS as from January 1, 2011, (i.e., required for annual financial statements for fiscal years ending December 31, 2011).

### **Compliance for Shanghai-based companies**

To determine whether there is need to adopt CAS, Shanghai-based companies must first assess whether they fall into one of the following sectors, Industrial Manufacturing, Construction, Retail, Wholesale, Transportation, Postal Service and Hospitality/Catering. Companies operating in one of these sectors will then have to assess the various dimensions of the size criteria to conclude if they need to apply CAS. The size criteria are based on staff headcount, total revenues, and total assets. Any entity that falls within the threshold of each of the size criteria, which vary by sector, or

exceeds the threshold of any one criterion is required to adopt CAS. For instance, a company operating in the Construction sector will have to adopt CAS if its staff headcount falls between 600 and 3000, its total revenues and total assets are between RMB 30 million (approximately US\$5 million) and RMB 300 million (approximately US\$46 million) and RMB 40 million (approximately US\$6 million) and RMB 400 million (approximately US\$61 million), respectively (all US\$ equivalents determined using an exchange rate of RMB 6.551 per US\$). Another company in the same sector would have to adopt CAS if it exceeded the top end of the range for any one of these criteria.

## **What are the key challenges and considerations for MNCs?**

The MOF is weighing the costs and benefits before deciding on any broader CAS adoption mandate on a national basis. However, any company can request approval for early adoption of CAS on a voluntary basis. Otherwise, the result of this **staggered and seemingly uncoordinated timetable for adoption, as well as the flexibility provided for implementation** is that different entities within the same consolidated group of companies can potentially have varying adoption dates and accounting treatments if those entities are incorporated in different jurisdictions. **This is especially challenging where there are different forms of JBRs and levels of management control within China with different partners.** Such a varied accounting policy landscape within a single consolidated entity can greatly complicate and reduce efficiency in systems and processes, consolidation and internal control. It can also **increase complexity in M&A activity, sourcing talent and training staff.** However, these challenges are

opportunities to work closer with Chinese partners to enhance the quality of the financial reporting, reduce differences and complexity in the application of the accounting, and build a better relationship in the finance function.

The changes in the accounting also provide an opportunity to broaden the scope of review and work closely with the Chinese partner to ascertain the terms, inputs, data collection, and claims process—historical as well as the legalities or rights enforceable. Diving into areas that may not have been impacted by the change in accounting will also highlight areas of risk, standardization, opportunities, and/or internal control improvements that will deepen the understanding of the business, and of the business practices within the automotive industry in China. The key is to initiate the improvement process on areas where there is a clear mutual interest. Thus developing trust and respect in the process in order to build the foundation of understanding to reconcile and work through the differences over the longer term.

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*The challenges from the seemingly uncoordinated timetable for adoption also present opportunities to work closer with Chinese partners and build a better relationship in the finance function.*

## **C-SOX—Improved internal controls in the Chinese context**

### **What is the new regulation?**

On June 28, 2008, China became the latest country to issue legislation specifying comprehensive requirements over a company's internal control framework. The new standard, known as the Basic Standard for Enterprise Internal Control, is issued jointly by the MOF, the National Audit Office and all three major industry regulators (the China Securities Regulatory Commission (CSRC), the China Banking Regulatory Commission, and the China Insurance Regulatory Commission). The Basic Standard contains 50 articles set out in seven chapters.

Under the standard, management is required to undertake an annual self assessment of the effectiveness of their internal controls and disclose the conclusion in an annual self assessment report. An opinion by the independent external auditor on effectiveness of a company's internal control was originally optional, but has been made mandatory with the issue of detailed guidelines in April 2010. A public accounting firm engaged by a company to conduct such an audit should do so in accordance with the standard and its supporting regulations as well as any relevant professional guidance.

### **How does it differ from existing regulations?**

With the exception of Foreign Private Issuers subject to foreign regulations (e.g. the Sarbanes-Oxley Act of 2002), there has been no comprehensive corresponding regulatory requirements for mandatory implementation of internal controls for Chinese entities. When the Basic Standard was first conceived, the general view of the regulators was that internal control should support all aspects of a company's operations. For this reason, the Basic Standard itself was designed to address all aspects of internal control. While the five key elements: internal environment, risk assessment, control activities, information and communication, and internal monitoring are broadly in alignment with the COSO framework, the Basic Standard places equal emphasis on both the financial reporting related and non-financial reporting related controls objective.



Following the launch of the Basic Standard, key regulators undertook extensive studies on the subject, and visited those companies that are listed overseas (especially in the US) to learn about their experience and efforts on internal control implementation. After close to two years of deliberation, a set of Supplementary Guidance was issued on April 26, 2010, clarifying that the internal control audit shall be focused on 'Internal Control over Financial Reporting,' or ICFR. However, it was not until January 2011 when Q&As issued by key regulators further clarified that management's annual self assessment should also be focused on ICFR.

### ***How does it apply to Chinese entities?***

The Basic Standard is aimed at companies listed in China as part of a broader initiative to enhance the quality of the financial reporting process of listed companies and strengthen China's capital market. Similar to the period immediately following the enactment of the Sarbanes-Oxley Act of 2002, detailed

rules and interpretations are still being clarified and developed. **For US automotive MNCs, the companies with the highest relevance are JBRs where the Chinese partner is a listed company and the MNC company is a minority shareholder.**

Based on the current rules, listed companies and its subsidiaries will be affected. Newly acquired entities can be exempted in their first year of acquisition. While technically foreign operating units of a Chinese company are not in scope, given the difference in organisational structure, culture and other factors, the extent to which these entities will be considered in scope remains unclear.

For joint ventures and other investments where the Chinese listed entity does not have a controlling interest (i.e. not consolidated in its financial statements), it is unlikely that they will be considered in scope.

That said, certain unlisted companies are encouraged to adopt the Basic Standard. In addition individual companies may choose to broaden the scope of work than what is technically required.

### ***What is the implementation timetable?***

Owing to the practical challenges that listed Chinese companies will face in implementing the new rules, the timetable was delayed from the original date of July 1, 2009. Implementation will be effected in two stages: companies that are listed in China (A-Share) and on one or more overseas exchanges will need to comply with the Basic Standard from January 1, 2011, and companies that are listed only in China will follow one year later (i.e., from January 1, 2012).

Early adoption is encouraged for unlisted large and medium-sized companies. Listed companies and unlisted large and medium-sized companies are urged to prepare for the implementation.

No specific timetables are defined for companies listed on the Small and Medium Enterprise Board and the ChiNext Board.

In February 2011, the CSRC issued a circular announcing the selection of an additional 216 A-Share companies as pilots for early adoption from FY2011, a year earlier than their normal implementation timeframe.

### **What are the key challenges and considerations for foreign investors?**

Based on our experience from advising Chinese companies in preparation of compliance with the provisions of the Sarbanes-Oxley Act of 2002 over the past few years, and considering the scope and complexity of the Basic Standard, we anticipate that companies will encounter a number of challenges in their readiness efforts. Some of the challenges and our recommended approach for management to consider as part of their readiness efforts include:

*Senior level management leadership:* Without adequate involvement from the leadership, there would be a high risk where internal control efforts will be aimed at meeting compliance requirements, with little or no benefits to the business. Worse, it may create additional costs, such as the need to document the ‘evidence’ of control execution, but these were purely for leaving an ‘audit trail’, focusing on form rather than the substance of internal controls.

*Emphasis on training and knowledge:* The terms ‘internal control’ and for that matter ‘enterprise risk management’ are still relatively new to Chinese companies, and only those companies that are listed overseas, such as in the US, are exposed to these concepts to any great extent. Training and knowledge accumulation is therefore critical for companies to truly understand the meaning of these terms, and to be familiar with the underlying framework.

*Adopt a phased approach:* With the complex and diverse group structure often seen among Chinese companies, coupled with the lack of experience, a phased approach (i.e., assess, implement and embed), is essential to ensure a smooth implementation and maintain the correct focus of any internal control projects.

*Build upon the current control infrastructure:* Key regulators have rightly emphasised that internal control regulations do not mean companies need to re-create a new control framework. Indeed, there were misconceptions in the

early days, where many embarked on the development of new and comprehensive 'internal control manuals'. It is important for companies to recognise that maintaining effective internal control is a continuous process, and the starting point must be the current control or management framework of the company. **It's also important that the processes and controls account for local regulations and operating conditions (e.g. tax).**

*Strengthen 'soft' control components:* One of the often misunderstood areas is the concept of 'soft' control components such as corporate culture and ethics. These components take time to embed into a company, and cannot be implemented in a day.

*Leverage on internal control:* The Basic Standard and related regulations require a company to undertake an annual assessment of the effectiveness of ICFR. It does not make sense for this annual assessment to be undertaken literally as a 'once-a-year' exercise for two reasons: organising a major annual exercise may be very costly and

disruptive to business operations, but more importantly, formally assessing control effectiveness once a year could encourage a 'form over substance' approach to internal control. The need for a strong and risk-based internal audit function therefore becomes another key success factor to the successful implementation of internal control.

The new Basic Standard is an important milestone in internal control reporting for companies operating in China. The general lack of experience among Chinese companies with internal control assessments and reporting combined with the unique operating environment increases the difficulty and complexity of the adoption and implementation of the Basic Standard.

The Chinese automotive industry has leveraged many aspects of product development, manufacturing processes and technology from those partners with global operations to improve the quality of vehicles and components. This is another opportunity to leverage the knowledge and experience of

those that have implemented such an internal controls framework. When implemented effectively, internal controls designed, documented, and tested can enhance the quality of the operations, improve productivity and reduce the potential for material misstatements. Many foreign automotive enterprises with joint ventures and investments in China have such experience and can provide assistance to the extent possible to improve efficiency and process capabilities with respect to the internal controls over financial reporting. The approach must be collaborative for all involved to be successful because there are differences in operating practices, culture and requirements. **Again, the focus for improvement should be to start with areas of common interest rather than points of divergence and build on the partnership for continued longer term improvements.**

**To have a deeper conversation about how this subject may affect your business, please contact:**

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