

# Peeling the Onion



Issue of Sept

Peeling the Onion provides an in-depth analysis of the major issues facing multinationals doing business in China in today's environment. It features a regular update of regulations, taxation, business environment and accounting legislation affecting foreign invested enterprises in China.

## Table of Contents

Internal controls in China	<a href="#">read</a>
New taxation rule	<a href="#">read</a>
New Curbs	<a href="#">read</a>
Career Opportunity	<a href="#">read</a>

## "Zhong Qiu Kuai Le" ---- Happy Mid Autumn Festival !!!!



The Moon festival (also called the Mooncake or Mid-Autumn festival) falls on October 6 in the year 2006. What is the Moon festival? Every year on the fifteenth day of the eighth month of the lunar calendar, when the moon is at its maximum brightness for the entire year, the Chinese celebrate "zhong qiu jie." Children are told the story of the moon fairy living in a crystal palace, who comes out to dance on the moon's shadowed surface. The legend surrounding the "lady living in the moon" dates back to ancient times, to a day when ten suns appeared at once in the sky. The Emperor ordered a famous archer to shoot down the nine extra suns. Once the task was accomplished, Goddess of Western Heaven rewarded the archer with a pill that would make him immortal. However, his wife found the pill, took it, and was banished to the moon as a result.

feature article

## Internal controls in China

**Managing risk** is essential for positioning a company for growth in the current business environment. Yet as companies around the world implement integrated risk controls, policies and procedures, the management and enforcement of these often lacks further a field in developing markets such as China.

A large majority of foreign enterprises with operations in China continue to rely on annual statutory audit reports and monthly financial statements to monitor potential financial and business risks. Yet even in highly developed and mature financial environments, **reliance on such limited information has been proven to be ill-conceived**. The Enron debacle is a perfect case in point - the company was given a clean bill of health by the auditors and seemed financially stable based on statutory financial statements, yet it was the material business risks associated with the company's concentration on revenue flows and extraordinary profits which caused the collapse. Such was not even properly examined by the auditors.

As management accountants will poignantly argue, only by "evaluating factors such as quality of revenues, relevance of costs and accruals, quality and relevance of assets and liabilities, capital adequacy and structure, secureness of and management of controls and organizational and supervisory structure" can a comprehensive enterprise risk management assessment be made. Such factors are not necessarily published in statutory reports and, thus, such statements can potentially be misleading as to the true health of a business.

## **Business environment driving professional direction!**

The current environment in China epitomizes the precise reasons why measures such as internal audits (IA), management system evaluations, business reviews, due diligence, special audits, and extra internal controls are **becoming a fundamental aspect of surviving and being profitable in China**.

Due to a whole variety of reasons a company can become very 'blinkered' and often does not have the resources or expertise required to review existing internal processes and procedures. As a result there can be many areas in a company that could possibly benefit from greater integration and system/process improvement. The most influential factors in China creating this lack of efficiency and integration at present include:

- **Cost pressures and expense cutbacks** - Many companies have frozen headcounts, slashed budgets and wound back corporate spending globally. This has seen a push for localization of staff in China, reliance on junior (inexperienced) staff and a cutback in non core-business services (e.g. finance and legal). As such many companies are not able to segregate duties as required and the focus has shifted to reducing cost base rather than improving processes and checks and balances against fraudulent or improper activities.
- **Increased dependence on technology** - Companies in China have spent large amounts of money on Enterprise Resource Planning (ERP) systems as part of their growth strategies, yet surrounding processes have not been re-engineered to drive such efficiencies. Similarly, many firms are not realising the benefits of such enterprise systems as they are not integrated with, or being used properly by the business or their people.
- **Opaque corporate governance** - A lack of a comprehensive legal and accounting framework, as well as unclear government directions, mean that corporate governance standards and professional ethics are only just beginning to be developed and put into practice.
- **Rapid changes in regulations** - Development of the new accounting system, changes to the taxation system and filing procedures, developments of industry regulations and WTO commitments have meant that firms are continually grappling to understand the rules and regulations effective in China.

Given the above issues, there is burgeoning gap appearing in the relevance of traditional external and internal audit functions. This has seen **greater risks for companies** to ensure compliance (financial, legal and tax) and also a growing need for company risk assessments to cover both financial issues and a comprehensive business analysis. Where as a financial auditor will usually simply cross check and reference invoices, receipts, cheques and other such 'supporting documents', an IA will review the business as a whole and identify key areas of risk and possible weaknesses in control systems across all business functions.

## **The changing face of internal audits!**

Internal Audit was once simply the domain of financial accountants and auditors concerned only with providing a "watch dog" function. However, nowadays companies need to understand the risks inherent in their industry, the market and within their entire business, as well as identifying areas for process improvement, enhancing revenue, generating cost savings and exposing areas of weak internal controls, and possible gaps where fraud could occur. As Bill Connell, Chairman of the IFAC's Financial and Management Accounting Committee and Director of Risk Management at BOC once explained:

*"Corporate governance has made risk management very topical, but you cannot go through the risk management process for those reasons. **You have to do it because it helps the business**. If you go through the process ... for corporate governance reasons you simply end up with bureaucracy"*

To facilitate this process and extrapolate the benefits many companies look to **out-source their IA and business review functions to external consultants**. Professional advisors often provide a "new set of eyes" to the company's problems, offer a greater level of understanding of the corporate environment and also bring to the table experience and best practice across all business functions - from finance, accounting, legal, IT, supply chain management etc. They also have no undue influence and so can ensure that any review is independent.

In the P.R.C. these reviews are imperative. Companies must have the appropriate financial systems and internal regulations to retain control over the company's day-to-day activities and mitigate any financial and business risks. Given the place of relationships in business practices, along with the above-identified factors, such risks are inherent in all aspects of business in China, and are particularly prevalent in the following areas:

- **Procurement and Supply Chain Management** - Many companies do not adequately control procurement, inventory utilization and disposal of inventory. Common problems include purchasing of overpriced raw materials (usually through a company related to a member of staff), discrepancies of bills of lading and goods received, improper storage of raw materials and safeguarding of inventory, sales of goods at/below cost to related parties, and illegitimate disposal of scrap materials and containers.
- **Sales and marketing expenses** - Incorrect accounting for such expenses, unauthorized and illegitimate reimbursement expenses, "fake" official invoices and false transfer pricing agreements.
- **Corporate compliance** - unauthorized and improper tax registration, under-reporting of tax liabilities, unauthorized use of company chops, and payment of expenses by offshore entities without correct accounting and taxation payments.
- **Human resources/payroll** - deliberate over-accrual of company welfare benefits (not in line with government requirements), unauthorized use of staff benefit funds, dummy employees, discrepancies between contract salary and payroll salary payments.
- **Provisions and accruals** - over-provisioning to create "slush" funds, lack of company policy and/or experience for accruals for bad debts, lack of company policies.

This is certainly not an exhaustive list of all risk areas in the P.R.C. Comprehensive internal audits and business reviews directed at the above issues do, however, provide an additional level of analysis to complement financial statements and often raises serious issues that management is unaware of.

Where as statutory audits tend to be historically focused in nature and only centered on financial figures presented and for statutory filing purposes only, internal audits and business reviews are aimed to provide strategic and proactive management recommendations focused on improving company performance primarily through process improvement and, in China particularly, **establish a control culture to reduce the risk of irregularities.**

### The final word

The best way of managing risk and reducing irregularities is by implementing preventative measures. This requires proper internal controls, policies and procedures, with oversight, accountability and regular reviews. Such helps to create a control culture, plus it is always cheaper to be preventative rather than corrective.

[>>Back to top of page](#)

## **China' s First Comprehensive Taxation Rule on Asset Securitisation**

As an important step in its financial reforms aiming at optimizing the bank' s structure of asset and liabilities, promoting financial innovations; China kicked off the experiment on securitisation of credit assets in March 2005, which allows banks to sell their credit assets through issuing the securities in the capital market for refinancing. The related products are referred as asset-backed securities (ABS).

However, the taxation policies related to the assets securitisation has been remained unclear until a year after, in March 2006, the PRC State Administration on Taxation (SAT) issued a circular {Caishui (2006), No5}. laid down the taxation frame

for asset securitisation in the banking industry. The involved taxes include Stamp Duty, Turnover Tax known as “Business Tax” in China and the income tax.

1. On the stamp duty policies, the initiator of an ABS product and the trustee of the securities are generally exempted from stamp duty in selling and managing the product. The exempted documents mainly include:

- Agreement on assignment of credit assets from the initiator to the trustee.
- Trustee management agreement
- Various agreements executed by initiator or trustee with the custodian, the central clearing registration house and other securitisation service providers involved at various stages of the securitisation process;
- Securities sales documents executed by the trustee;
- Investor’ s sales and purchase contracts of asset-backed securities;
- Accounting books established by the initiator or trustee in bookkeeping of the securitisation transaction.

The exemption scope is quite broad which shall reduce the related transaction costs substantially.

2. On Business Tax (BT) Policies,

- The financial institutions operating the ABS products in various capacities, such as trustee of the ABS, initiator of the ABS are subject to BT in respect of the gain derived from selling ABS products and the various service charges received.
- The BT exemption is only granted to the non-financial institutional investors in respect of the gain on disposal of ABS products.

3. On income tax policies,

- The income derived from the ABS project that is distributed to the institutional investors in the current year is exempted from the income tax whilst the portion that is not distributed to the institutional investors in the current year is taxable.
- Full consideration has been made to avoidance of dual tax collection and tax burdens of all sections in the securitisation program.

Overall speaking, this first taxation policy is quite generous which is viewed as an policy direction in encouraging for the ABS product development in China.

[>>Back to top of page](#)

## **New Curbs put on foreign investors to cool property market**

Further to a series of measures curbing speculations in the property market early this year, six Chinese government authorities jointly issued a new regulation on 11 July 2006, specifically targeting on the foreign investors. The new Circular “Jianzhufang [2006] No. 171” (Circular 171) provides a number of new measures restricting the foreigner from participating in the Chinese real estate market.

**Q: What is the key policy change on overseas investment in the Chinese property market**

So-called “principle of commercial existence” is firstly introduced in addressing the entry of foreign investment into the Chinese property market. Where any foreign institution or individual wants to buy real estate within the territory of China for pure investment or non-self-use, the purchase should invest into a China incorporated company to create the commercial existence in China first and then through the Chinese company to purchase properties. Under the new policy, foreign institution and individuals without formal business presence in China are now denied for direct purchase of Chinese properties for investment or non-self-use.

**Q: What are the new restrictions on foreign buyers buying real estate in China**

Whilst buying property for non-self-use is banned, foreigners can still buy properties for self-use subject to certain restrictions.

**Residency restrictions**

Under the new regulation, foreign enterprises having no branches or representative offices in China and foreign individuals who have worked or studied in China for less than one year are not qualified to buy real properties in China. Such residency restriction does not apply to overseas Chinese or compatriots from Hong Kong, Macao or Taiwan who may buy residential property for self-use even staying in China under one year.

***Restrictions on buyable properties***

Firstly, qualified foreign enterprise and individuals are now confined to purchase properties for self-use only.

Secondly, a foreign individual is allowed to purchase only ONE real property for self-use where a qualified foreign institution is allowed to purchase real property only in the city where its branches or representative offices are located.

***Approval required on property purchase***

In order to implement the above new restrictions, qualified foreign buyers must use their “real names” to register for property purchase. When apply for obtain the “Real Estate Certificate” (REC) which is the official legal document certifying the property’ s ownership in China, foreign buyers will need to go through an approving procedures which through such process, government can evaluate whether the purchase under application fulfills the restrictions. No REC will be granted for the properties that violate the restrictions.

**Q: What are the new restrictions on foreign property developer doing business in China**

***Higher Capital Requirement***

For establishing a foreign invested real estate enterprise, if total investment is more than US\$10 million, the registered capital should be no lower than 50% of the total investment (the normal rate is 40%).

***New control on issuance of Business License***

When initially set up, foreign invested real estate enterprise may obtain a one-year provisional Approval Certificate and Business License only. The formal Business License and Approval Certificate can be granted upon the full payment for purchasing the land that is to be developed is made before the expiry of the provisional Business License.

***Restrictions on debt financing***

Foreign invested real estate developer will not be allowed to borrow loans domestically or overseas if any of the following circumstances occur:

- The Company’ s registered capital is not fully paid up.
- The land use right certificate of the land to be developed has not been obtained yet.

- The capital injection is below 35% of the total investment declared for the project.

### ***No guarantee on a fixed return can be prescribed***

For a sino-foreign joint venture property development company, it is not permitted to include any provisions guaranteeing a fixed return to any of the investing parties in the legal JV contract, articles of association, equity transfer contract or any relevant documents.

### ***Restrictions on M&A activities concerning the property development business***

- Where foreign investors acquire the equity interests of a property development enterprise in China, the relevant consideration should be settled in one lump sum payment with the investor's own equity capital.
- Regarding disposal of a foreign invested property development company in China or a property development project held by a foreign invested property developer, approval from the Ministry of Commerce shall be required.

### **Q: What is the impact of the new policy?**

As currently, the Chinese property market is mainly driven by local developers and local buyers, the proportion of foreign investors buying properties in China is still small, approximately 4% in Shanghai and around 2% in Beijing, thus it is generally believed that the new measures would not cause substantial impact on the property price as a whole. However, since foreign investors generally focus on the high-end apartments and villas, a drop in demand due to the restrictions might hit the property price of this particular sector.

On the investor's side, foreign individuals or foreign companies without presence in China who are contemplating for property leasing business in China are the group that is affected seriously. Nevertheless, there are still options available to achieve their business objectives.

[>>Back to top of page](#)

<http://www.lehmanbrown.com/Career/careers.htm>



LehmanBrown is hiring across the board for all positions from Junior Associate to Senior Manager level, Chinese or Foreign. Experienced professionals are also being sought in Beijing, Shanghai and Shenzhen for the positions of :

Directors/Partners, all disciplines,  
Manager and Senior Associate, Audit Associate & Advisory,  
Manager and Senior Associate, Tax,  
Manager, US GAAP Team,  
Manager and Senior Associates, Outsource Accounting.

&n! bsp; If you are interested in joining our exciting practice, [please visit our website for further details and submit your resume](#). Interested parties can also send their CV quoting "location and position - responding to Peeling The Onion" to: [beijingcareer@lehmanbrown.com](mailto:beijingcareer@lehmanbrown.com) for Beijing location and other cities

[shanghaicareer@lehmanbrown.com](mailto:shanghaicareer@lehmanbrown.com) for shanghai location  
[shenzhencareer@lehmanbrown.com](mailto:shenzhencareer@lehmanbrown.com) for shenzhen location

We are interested in receiving your feedback on our articles and any suggestions as to future topics are more than welcome at <mailto:newsletter@lehmanbrown.com>



"Providing an Alternative in China"

#### Beijing Office

6/F, Dongwai Diplomatic Building  
23 Dongzhimenwai Dajie  
Beijing 100600  
Tel: 86 10 8532 1720  
Fax: 86 10 6532 3270  
E-mail: [beijing@lehmanbrown.com](mailto:beijing@lehmanbrown.com)

#### Hong Kong Office

Level 25, Bank of China Tower  
1 Garden Road Central,  
Hong Kong  
Tel: 852 2251 8486  
Fax: 852 2537 5649  
E-mail: [hongkong@lehmanbrown.com](mailto:hongkong@lehmanbrown.com)

#### Mongolia Office

3rd Floor, Dalaivan Building  
Bayangol District Amarsanaa Street  
Ulaanbaatar-44, Mongolia  
Tel: 976 11 305 271  
Fax: 976 11 329 050  
E-mail: [mongolia@lehmanbrown.com](mailto:mongolia@lehmanbrown.com)

#### Shanghai Office

Room 902, Shanghai Universal Mansion,  
Tower A 172 Yu Yuan Lu  
Shanghai 200040  
Tel: 86 21 6249 0055  
Fax: 86 21 6288 1636  
E-mail: [shanghai@lehmanbrown.com](mailto:shanghai@lehmanbrown.com)

#### Shenzhen Office

Room 3206, News Building  
2 Shennan Middle Road  
Shenzhen 518027  
Tel: 86 755 8209 1244  
Fax: 86 755 8209 0672  
E-mail: [shenzhen@lehmanbrown.com](mailto:shenzhen@lehmanbrown.com)

#### Guangzhou Office

418-4 Goldlion Digital Network Center 138  
Tiyu Road East, Tianhe  
Guangzhou 510620, China  
Tel: 86 20 2886 0636  
Fax: 86 20 3878 1801  
E-mail: [guangzhou@lehmanbrown.com](mailto:guangzhou@lehmanbrown.com)

#### Tianjin Office

02nd Floor, No.22 Hongkong Road,  
Heping District, Tianjin 300050  
Tel: 86 22 2330 6573  
Fax: 86 22 2330 6583  
E-mail: [tianjin@lehmanbrown.com](mailto:tianjin@lehmanbrown.com)

[Services](#)

[FAQs](#)

[Library](#)

[Useful Links](#)

[Seminars](#)

[Careers](#)

[Contact Us](#)