

Insight

Quarterly newsletter on important accounting and finance issues
Winter 2008

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Introducing the Basic Standard for Enterprise Internal Control

The Basic Standard for Enterprise Internal Control (企業內部控制基本規範) (the Standard) was jointly released on 28 June 2008 by five Chinese government authorities and regulators, namely the Ministry of Finance (MOF), National Audit Office, China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), and China Insurance Regulatory Commission (CIRC). It will come into force on 1 July 2009, and it will apply to all companies listed on the Shanghai and Shenzhen stock exchanges. Large non-listed Chinese companies and listed medium-sized ones will also be encouraged to adopt its provisions.

Besides publishing the Standard, these bodies also issued three draft guideline documents on its interpretation and implementation for public comment and feedback by 30 September 2008.

This article aims to provide a brief overview of the key elements contained in the Standard and the draft guideline documents. It also discusses their implications for auditors and the companies concerned.

Overview of the Standard

The Standard defines effective internal controls in similar terms to the five elements of the COSO framework that has already been adopted in the US and Hong Kong, namely the control environment, risk assessment, control activities, communication

and information, and monitoring. It therefore aligns with international standards.

According to the Standard, the key requirements for Chinese companies are to:

- include the five COSO control elements in the internal control framework that they establish and implement (article 5);
- define and implement internal control policies with reference to relevant laws and regulations (article 6);
- promote the integration of IT controls into their business operations, in order to reduce manual manipulation (article 7);
- establish policies relating to the effective implementation of internal controls as the key factor in the performance appraisals of all their units and staff members (article 8);
- define a clear corporate governance structure and procedures for effective segregation of responsibilities (article 11);
- establish the ultimate responsibility of the Board of Directors for implementing an effective internal control system (article 12);

- establish an audit committee responsible for examining and monitoring the effectiveness of internal controls (article 13);
- establish standards for classifying internal control deficiencies, and report such deficiencies and remedial plans for them to the Board of Directors and Board of Supervisors (article 45); and
- conduct regular self-assessments of the effectiveness of their internal controls, and issue reports concerning these (article 46).

Overview of the three guideline documents

The draft supporting guideline documents are intended to provide additional directions for the Standard's implementation. The documents and their main contents are:

- **The Enterprise Internal Control Assessment Guideline** (企業內部控制評價指引) provides companies and their managements with standards, procedures and methods for evaluating and assessing internal controls and reporting on their effectiveness in annual reports. It also covers the risk-based approach, entity-level controls (COSO framework), and design and operating effectiveness of internal controls; IT general controls; application system controls; self-

assessment and reporting of internal controls; and remedial and action plans. Its scope is not specifically limited to internal controls over financial reporting, as it also appears to cover aspects of operational controls.

- **The Enterprise Internal Control Implementation Guideline** (企業內部控制應用指引) specifies process-level internal control requirements for 22 financial and operational processes.
- **The Enterprise Internal Control Assurance Guideline** (企業內部控制鑒證指引) sets out general guidelines for public accounting firms about evaluating and assessing the effectiveness of internal controls, and preparing reports concerning them.

Management self-assessments and auditors' opinions

The Standard requires a company's management to conduct self-assessments of the effectiveness of its internal control environment and periodically report the results of these. An independent auditor's opinion about the effectiveness of the company's internal control environment is also required.

In addition, the Standard stipulates that a listed company must appoint certified public accounting firms with the business qualifications stated in Circular CaiKuai [2008] No.7, in order to audit the effectiveness of its internal controls (article 10). An accounting firm that currently provides a company with internal control consulting services is not allowed to provide it with internal control auditing services.

Complementing the Enterprise Internal Control Assurance Guideline, further development of assurance standards and methodology for auditing internal controls would be needed. We look forward to seeing more initiatives to assist the managements of businesses and their independent auditors to perform such assessments and audits.

Implications for Chinese companies

The deadline for compliance with the Standard is now less than a year away, so most Chinese companies have only a very short time to prepare for it. Those without good internal controls will lack the experience and expertise needed to do so; and they will have to change their ways of doing business in order to integrate internal controls into their daily operations.

We advise companies not to wait for the final versions of the compliance guidelines to be issued. Furthermore, we suggest companies take the following steps to ensure they are ready:

- actively involve their executives and senior management in their preparations, because the Standard will broadly cover every aspect of the company's operations, and the process of building the internal control framework will start with the corporate governance process;
- appoint internal control professionals where necessary in areas of risk assessment and IT-related solutions;
- start conducting diagnostic reviews, build up basic and essential key control components, and rectify significant and material control weaknesses, particularly over financial reporting, as early as possible. This is especially important for companies that are implementing internal controls from scratch;
- discuss with the external auditor how the Standard will impact on their audit engagement as soon as possible; and
- if a company is listed overseas, it should make a quick start on sorting out gaps in the internal control requirements of the Standard and relevant overseas regulations. It should also enhance its current controls and have supporting documentation ready for compliance.

Further information

Details of the regulations are available from the following links:

- The Basic Standard for Enterprise Internal Control (企業內部控制基本規範)
http://www.casc.gov.cn/gnxw/200807/t20080715_751587.htm
- The Enterprise Internal Control Assessment Guideline (企業內部控制評價指引)
http://www.casc.gov.cn/gnxw/200807/t20080715_751591.htm
- The Enterprise Internal Control Implementation Guideline (企業內部控制應用指引)
http://www.casc.gov.cn/gnxw/200807/t20080715_751591.htm
- The Enterprise Internal Control Assurance Guideline (企業內部控制鑒證指引)
http://www.cicpa.org.cn/professional_standards/comments/200807/t20080701_13474.htm

The MOF and other Chinese government authorities and regulators are expected to issue the revised guidelines with further clarification very soon. We look forward to seeing the finalised guidelines, and we will continue to provide further insights into the development of this important initiative for Chinese enterprises.

Effe Tang
Business Risk Services
effe.tang@gthk.com.hk

For enquiries, please contact:

Patrick Rozario
Principal and Head of
Business Risk Services
patrick.rozario@gthk.com.hk

Corporate Governance Review 2008

We are delighted to present our third annual review of the corporate governance practices of the 200 companies that constitute the Hang Seng Composite Index (HSCI). The information it contains was obtained by reviewing the disclosures that they made in their 2007/2008 annual reports.

The current volatility of the business environment has meant that the demands for companies to have a strong set of corporate governance principles in place have risen to unprecedented levels. With this in mind, our review helps reveal how well they have done – in quantitative and qualitative terms – in disclosing their approach to satisfying the requirements of the Code on Corporate Governance Practices to their stakeholders.

The latest edition benefits from the information we have gathered during the past two years, which we have used to gain greater insight into how well companies comply with the Code, as well as with the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, which was compiled by the Hong Kong Stock Exchange (HKEx).

Local corporate governance requirements

HKEx launched its initiative to enhance corporate governance in 2005. It has not revised the Code since then. This consistency has given companies an opportunity to understand its requirements and recommendations fully, and to respond accordingly.

However, the recent economic crisis is proving to be a strong argument that global corporate governance guidelines are generally inadequate. We have already seen incremental changes that affect corporate governance requirements in other financial markets during the past months, and we can expect more to follow in the coming year.

The potential of corporate governance to increase the level of investor confidence means that improving it should be a priority. Areas for such improvements can always be identified, and companies should remain on the lookout for them while they review their own practices on a regular basis. Companies that vigilantly monitor their strengths and weaknesses will go far in improving their existing processes, and they will lead the way for others to follow.



Worldwide changes to reporting requirements

Corporate governance is regarded as an important aspect of a responsible business in every economy in the world. It is therefore no surprise to see that evolutionary changes to corporate governance guidelines and recommendations have been taking place in leading international financial marketplaces during the past year.

China has taken an important step forward with the release of a joint circular concerning the establishment of internal control structures by the Ministry of Finance and various other regulatory authorities. It requires

Chinese listed companies to address specific control factors by developing effective internal control policies and conducting periodic assessments of the effectiveness of their control structures.

The UK Financial Reporting Council has made limited changes to The Combined Code on Corporate Governance (UK Code). The changes to the UK Code can be interpreted as an indication that the current system is operating satisfactorily.

In Australia, the ASX Corporate Governance Council approved more substantive changes in 2007.

Going beyond mandatory requirements

Although Hong Kong's Code currently addresses all the key elements of a well-designed and balanced corporate governance structure in some form, the recent activities of certain companies make it apparent that more needs to be done. In the meantime, companies should strive to go above and beyond the existing minimum requirements. The trends concerning compliance with these provisions and recommendations, as well as others, have been analysed in this report.

This full report will be published on 15 December 2008. If you would like to receive a copy of it, please contact us at info@gthk.com.hk

International Business Report

Taxes play big role in determining where companies locate operations

The Grant Thornton International Business Report 2008 has revealed that 77% of privately held businesses around the world regard tax issues as a significant factor when they decide where to establish an overseas operating base.

Nearly half the respondents (48%) surveyed say that tax incentives – such as a five-year tax-free period and low rates of tax on business profits – influence their choice of location. In addition, 46% cite a stable tax regime, and 41% incentives for capital investment as important considerations.

Generally speaking, Hong Kong has very low taxes. However, respondents regard any corporate taxes as a burden. Some 40% of privately held businesses in Hong Kong identify taxes on business profits as their most troublesome domestic taxes.

The results provide a comprehensive picture of opinions about tax issues in this pivotal sector for economic growth. If you are interested in obtaining a copy, please contact us at info@gthk.com.hk



Tax Demands – Can a holdover help your cash flow?

Hong Kong's tax system for direct taxes (Profits Tax, Salaries Tax and Property Tax) requires each taxpayer to file the appropriate Tax Return each year with the Hong Kong Inland Revenue Department (IRD). The IRD then review the Return and issue an assessment setting out the details of the assessable income and the tax due, together with the due dates for payment of the tax.

It is often overlooked that taxpayers have very important rights regarding the tax demanded in the Tax Assessments that are issued by the IRD following the filing of a Tax Return, and these rights may be lost if action is not taken within statutory time limits.

A Tax Assessment is normally in two parts. The first part is the Final Assessment for the year just finished, which (at present) is the Year of Assessment 2007/08. The second part is a demand for payment of provisional tax for the current year, that is the Year of Assessment 2008/09.

The first part of the Assessment which deals with the tax for the Year of Assessment 2007/08 should agree with the 2007/08 Tax Return submitted to the IRD. If the profits or income assessed are not in accordance with the Tax Return filed the taxpayer is entitled to lodge a written objection against the Assessment giving the detailed grounds for objection. This objection must be lodged with the Commissioner **within one month after the date of issue** of the Assessment. If no objection is lodged in that time the Assessment will become final and conclusive, even if the tax demanded is excessive.

Where the taxpayer has lodged a valid objection against an Assessment and considers that the tax demanded is overstated then the taxpayer may also request a holdover of the tax which is in dispute for 2007/08 (that is the tax which the taxpayer believes has been over assessed) pending settlement of the objection. If no request for a holdover of tax is made when filing the objection the Commissioner is under no obligation to offer a holdover of the tax in dispute.

The second part of the Tax Assessment is a demand for payment of provisional tax for the current year, that is the Year of Assessment 2008/09. This payment is normally calculated on the same profits or income as those assessed for the previous year, i.e. the Year of Assessment 2007/08.

The taxpayer cannot object to this part of the assessment but can, in certain circumstances, ask for all or part of the provisional tax to be held over. This applies for all three direct taxes, whether the assessment is for Profits Tax, Salaries Tax or Property Tax.

One of the most common cases for a holdover of provisional tax is where an objection is lodged against the Final Assessment for 2007/08 and asks for a holdover of the tax in dispute for that year. In such cases the Commissioner will usually also entertain a request for holdover of provisional tax in dispute for 2008/09 on the same basis as the holdover for 2007/08.

Another common reason for requesting a holdover of provisional tax is that the taxpayer's assessable profits or income for the current year (2008/09) **are, or are likely to be, less than 90%** of the income or profits assessed to provisional tax.

In these cases the Commissioner will entertain a request for holdover of the provisional tax which appears to be over assessed if the taxpayer lodges a written request setting out the reason for the reduction in income accompanied by suitable evidence of the reduction in income.

In the case of Profits Tax this means that the holdover request should be accompanied by a set of management accounts for a period of no less than eight months of basis period for the current tax year.

In the case of Salaries Tax evidence of reduced income subject to Salaries Tax is required (for example reduced or no bonuses compared with 2007/08). This **type of request for holdover** of provisional tax must be **made at least 28 days before the due date for payment** of the tax and can be made even if no objection is lodged against the 2007/08 tax liability.

This form of holdover can be an important form of relief if a business is suffering a short term dip in its profitability due to the current economic climate and should not be overlooked as this could have a significant effect on cash flow.

Similarly individuals who face a reduction in income, due perhaps to reduced bonuses or stock options etc, should consider the effect a holdover could have on their cash flow.

However both objections and holdovers **involve time limits**. These time limits are strictly enforced by the IRD. It is therefore important that action is taken as soon as an Assessment is received by the taxpayer and also that taxpayers continue to monitor the question of a holdover before paying the tax demanded.

David Southwood
Tax Services
david.southwood@gthk.com.hk



Watch out for the financial tsunami

The credit crunch is beginning to squeeze enterprises. Slowing growth, weakening demand, rising commodity prices and reduced lending by banks are compounding an already difficult situation for them. As governments prepare to pour more money into the markets and implement new policies to tackle the financial crisis, Grant Thornton is keen to share our 10-point health check of areas that companies should pay extra attention to during the possible economic downturn.

1 Cash is king

Everything slows down and cash is in short supply in a tough market. The critical issue for you in the near-term is your ability to conserve and control cash, and you need to be relentlessly attentive about doing this.

Do

- calculate your short-term cash requirements and forecast your long-term cash flow;
- negotiate longer credit terms with your suppliers and shorter terms with your customers;
- focus on key metrics, such as debtor and creditor days;
- manage stock cycles efficiently to generate cash; and
- consider increasing your prices.

Don't

- take on new customers without considering the impact they may have on your capital cycle and working practices.

2 Get closer to your bank

Banks may be more cautious and concerned about bad debts, so you will have to persuade them harder to lend you more money if you need it. They will focus increasingly on loan recoverability.

Do

- keep your banker fully informed about what's going on in your business;
- talk to your professional advisers about ways to improve the credibility of your plans;
- consider alternative sources of re-financing; and
- check the availability of trade finance or stock finance if you are importing.

Don't

- let the banks guide you through any issues or problems that arise.

3 Be relentless on cost control

Tougher conditions will require much more focused cost management, so that you will at least maintain your current level of profitability.



Do

- review all your costs in terms of their value to your business;
- consider two major cost areas: tax and people;
- negotiate the terms of leases and your use of capital equipment;
- pay attention to variable costs;
- look out for cancelled contracts; and
- take steps to guarantee supplies.

Don't

- automatically cut all your marketing expenditure.

4 Revisit your strategy

Changing market conditions can often be a catalyst for reviewing difficult strategic decisions. You may need to stop, think, and take a fresh look at your business.

Do

- understand your core capabilities and strengths, and where your best opportunities exist;
- consider disposing of non-core assets and business streams;
- review your business's performance and focus your resources effectively;
- look at acquiring assets, expertise or local competitors, if you have liquidity or access to investment funds;
- revisit the trade barriers that previously existed, and see if they have now been reduced or relaxed; and
- consider shifts in currency markets.

Don't

- feel that you need to change your entire business model overnight.

5 Get smarter on tax

Tax is usually one of the biggest overheads in business, and you need to look carefully at how to manage that cost and your cash flows.

Do

- check your tax assessment and your eligibility for a holdover of tax provision; and
- schedule any revenue expenses and purchases of items in order to receive tax reliefs and/or allowances.

Don't

- fall behind with your tax payments and compliance requirements.

6 Sanity check new investment plans

Investing in new assets during a downturn can bleed you of cash when you need it most. Carefully consider your investment plans and question their proposed value and timing.

Do

- consider deferring new plans if they are not business critical;
- negotiate more favourable terms for critical assets;
- try borrowing money instead of using all your cash; and
- check out possible tax reliefs and depreciation allowances.

Don't

- invest your profits in status symbols

7 Keep an eye out for bargains

Grant Thornton's International Business Report 2008 shows that private companies in mainland China and Hong Kong are still seeking funds to expand, despite the current climate. Funding will probably still be available for the right propositions.

Do

- be alert to opportunities when business valuations are dropping and owners are looking for a quick exit; and
- take professional advice to ensure that you properly assess and target any acquisitions.

Don't

- distract yourself and lose your focus on the day-to-day running of your business; and
- overstretch debt capacity.

8 Align performance and rewards

After you've used strategic planning and zero-based budgeting exercises to define your key objectives, you need to make sure your staff understand and are rewarded for achieving those objectives.

Do

- consider the golden thread that runs between the business, individual objectives and remuneration;
- reward your sales team according to profit per unit or the speed of cash flow, rather than simply the number of units they sell; and
- pay bonuses when minimum profits and cash flows have been achieved.

Don't

- put your head in the sand when you have no cash to make bonus payments.

9 Right-size

Labour is the biggest single cost that enterprises may need to trim. This is never an easy thing to do, and it's important to do it as objectively as possible.

Do

- consider the skills, commitment and capabilities you will need;
- communicate well and maintain your integrity, but move quickly;
- reinvigorate and re-motivate those who stay;
- use incentives and personal development plans to lock in your key talent; and
- obtain appropriate advice about your decisions.

Don't

- allow your emotions to make your decisions, or base them only on relationships and length of service.

10 Protect your personal wealth

When business is thin on the ground, it's important to avoid being too reliant on it. You need a clear view of how to separate your personal wealth from your business finances.

Do

- consider taking out the profits generated in previous years and putting them into your personal account;
- ensure that you make any decisions about putting money back into the business, rather than simply because you have money left in your personal account; and
- everything possible to improve the prospects for recovering your funds if you need to lend money to the company as an individual.

Don't

- throw good money after bad.

Most of our tips and recommendations are basic good business practice. You should implement them in a disciplined way during the coming months.

And, by doing the right things quickly and decisively, companies that are well structured and well managed will see opportunities amid the uncertainties. For further information and advice about the specific issues that face your business, please contact us at info@gthk.com.hk

Friends of Grant Thornton Dinner in Shanghai



Grant Thornton was one of the main sponsors of the INSOL International Annual Regional Conference held in Shanghai from 14 – 16 September 2008. Immediately following the INSOL conference, the Association of Insolvency and Restructuring Advisors held their 2nd Annual Conference in the same city and Grant Thornton was also one of their main sponsors.

Our Partner Alan Tang spoke at both conferences on topics focusing on the new PRC bankruptcy law and its practical implications to date. Other Grant Thornton Partners also spoke on different topics.

Over 350 delegates including government officials, solicitors, bankers as well as partners and colleagues of Grant Thornton from Australia, Canada, Hong Kong, New Zealand, Singapore, Thailand, the UK and the US attended the conferences.

It is with interest to note that while most of the world's top insolvency practitioners were attending these conferences in Shanghai, the collapse of Lehman Brothers Group took place. Many of the US lawyers were immediately finding the earliest flights back to New York!



Alan Tang on behalf of Grant Thornton International Recovery and Restructuring, hosted a "Friends of Grant Thornton" dinner during the INSOL Conference at a Chinese restaurant, Xian Qiang Fang, Shanghai, which is set in a 90-year-old traditional Shanghai style building. We were honoured to have as our distinguished guests, Mr Cao Si Yuan (曹思源, known to many as the "Father of Bankruptcy" in China), Professor Li Shu Guang (李曙光, a member of the Drafting Committee for the new Bankruptcy Law), Judge Fu Wang (符望, a bankruptcy judge from Shanghai) and the Honourable Chief Justice Spigelman AC from New South Wales, Australia, together with over 100 guests from different parts of the world.

Special cultural performance of Chinese musical instruments, Chinese opera, changing of faces and a number of Chinese folk artists demonstrating cartoon caricature, paper cutting silhouette, and malt sugar painting, Tanghua were highlights of the evening. Many of these performances were eye-opening experiences for most of our expatriate (and even local) guests.



Grant Thornton Hong Kong first held the "Friends of Grant Thornton Dinner" in Beijing in 2002 when INSOL International hosted its first ever conference in the PRC. The tradition was continued by Grant Thornton Sydney when INSOL International held its conference there in 2005. Our theme dinner has become (to regular delegates of these conferences) an unofficial itinerary of major INSOL conferences. Grant Thornton International plans to organise one next year during the INSOL Conference in Vancouver.

Christina Lam
Recovery & reorganisation
christina.lam@gthk.com.hk



New Partners and directors



Fanny Hsiang
Partner of Professional Practice

Fanny Hsiang has been admitted as Partner of Professional Practice.

Fanny provides advisory services to the Firm's assurance practice and facilitates the proper application of accounting standard requirements.

Prior to joining Grant Thornton, she has accumulated over 15 years of professional experience in international and major accounting firms.

She has extensive experience in financial reporting related work and researches on topical accounting issues. She specialises in financial reporting support in relation to Hong Kong Financial Reporting Standards (HKFRS), International Financial Reporting Standards (IFRS) and Hong Kong Companies Ordinance requirements.

Fanny is a Certified Public Accountant (Practising) in Hong Kong.



Anita Hou
Director of Forensic and Investigation Services

Anita Hou has been appointed as Director of Forensic and Investigation Services.

She comes with a variety of solid experiences in auditing, listing and investigation work. Anita handles both local and international enterprises covering a wide spectrum of industries including property investment, manufacturing, trading, retailing, infrastructure and construction. She is now specialising in providing services in forensic, investigation and litigation support assignments involving asset tracing and recovery, anti-money laundering investigation and compliance, as well as fraud investigations. She also handles assignments in relation to liquidation, bankruptcy and receivership.

Anita holds an MBA and is a Certified Public Accountant in Hong Kong. She is also a Fellow of the Association of Chartered Certified Accountants, member of the Chartered Institute of Management Accountants and the Association of Certified Fraud Examiners.



Estella Tsui
Marketing Director

Estella Tsui has been appointed as Marketing Director.

Estella takes charge of the Firm's marketing department and oversees the Firm's integrated marketing initiatives, including branding, communications, publications, PR, events and website. She is also a member of Grant Thornton International's international brand hub team.

Prior to joining Grant Thornton in 2001, she has worked with a variety of companies ranging from trading to technology and telecom service to professional service. She has extensive experience in the marketing field especially in the areas of strategic marketing and communications.

Estella holds an MBA degree and majored in Translation in her bachelor degree.

Global Growth Markets Guide



The Global Growth Markets Guide 2008 has now been published. The Guide analyses the performances of the world's eight main global growth markets between 2005 and 2007, and it is one of a series of capital market guides that Grant Thornton has compiled over the past seven years. If you are interested in obtaining a copy, please contact us at info@gthk.com.hk

Grant Thornton International member firm news

Green light for Irish merger

Grant Thornton Ireland officially merged with Foster McAteer on 31 October 2008 to form the country's biggest recovery and insolvency unit. Prior to the merger, Foster McAteer was one of Ireland's leading insolvency practices and a significant audit, tax

and corporate finance firm with fees in excess of €4 million this year. All its five partners and 24 staff have joined the new firm, which will have total fees of more than €50 million, as well as 450 staff and partners working throughout the country.



About Insight
The aim of this newsletter is to provide information relating to recent business developments. The information is general in nature and it is not to be taken as a substitute for specific advice. Accordingly, Grant Thornton accepts no responsibility for any loss that occurs to any party who acts on information contained herein without further consultation with ourselves.

We welcome your feedback and suggestions. Please continue to send them in.

Insight Editorial Team
T +852 2218 3165
E info@gthk.com.hk

www.gthk.com.hk

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