Internal control
Observations

1. Internal controls and corporate governance evaluations are often not part of due diligence in China.

2. Systems and processes between Chinese and Western companies can often be dissimilar.

3. The business volume of Chinese operations can sometimes be too much for global systems to handle.

4. Business technological innovation in China is advancing quickly.

5. Variations in Chinese tax and accounting laws can affect the migration of reporting systems.

6. Businesses need to account for long-and medium-term risks such as carbon taxes and carbon trading mechanisms.

Recommendations

1. Internal audit functions should play an advisory role in both pre-deal due diligence and post-deal integration teams.

2. Global systems must be tailored for local application.

3. Secure the commitment of the local workforce through regular visits; demonstrate your commitment by taking part in local training programme delivery.

4. Locally based advisers can serve bridging roles between foreign IT directors and China IT staff during the systems integration process.

5. Building up China integrated reporting capacity will result in improved corporate governance and cost efficiencies for tax and resource consumption.
Many years ago, a European multinational acquired a Chinese company, for which they went through the motions of completing the mandatory financial due diligence. Once the books seemed to be in order, the deal closed, and a solitary manager was sent from the head office to oversee the country’s operations. A few years down the road, things began to go wrong. The China chief, who operated without much communication with the head office, had completely lost the trust of the local staff, and operations were in disarray. As the subsidiary began to unravel, the European head office contracted an external adviser, PwC, to conduct an independent review of all of the company’s systems and processes. This review included an investigation on everything about its operations, from its internal controls on sales and key business cycles, to its tax and environmental compliance.

The report, produced some months later, offered some intriguing insights into the nature of the China business and its controls environment. A number of these issues were quite pressing: Some internal procedures and best practices were not followed, and systems were improperly implemented in some places. Even more problematic was the fact that the entity was not in compliance with many local tax and environmental rules, and the non-compliance risks were great enough that the company could have faced substantial regulatory challenges. On the strength of the report’s findings and recommendations, the company was able to focus its resources in China, and turn around the operation.

“This is not an uncommon story in China,” says John Barnes, a PwC Risk and Controls Solutions Partner. “But it’s one which could be easily avoided with due diligence that’s focused on the right internal and environmental controls and corporate governance structures.” To remedy this, foreign investors could simply opt to conduct an evaluation of a target company’s internal and environmental controls and corporate governance procedures in their due diligence, a practice which is still quite rare in this market. Processes in which to delegate authority, allocate responsibility, as well as standards and procedures, are often very different in China. For example, if a Chinese company lacks effective internal controls, all exceptions to the rule may simply be passed to senior management for approval. Your primary areas of focus can include order to cash, treasury, procurement, capital expenditure and regulatory compliance for environmental and social considerations.

For mergers and acquisitions, internal audit functions should be involved in the merger and acquisition process from pre-acquisition due diligence to post-deal integration. Businesses should look at the governance; risk and control environments; primary business processes controls; information technology (IT) systems; compliance programmes; environmental and health and safety processes; and the risk and control culture of the target company.1 By understanding the differences in culture and audit and risk management strategies in China, the company can then develop a plan to integrate internal audit, systems, risk management, Sarbanes-Oxley compliance and other compliance functions, or even use best practices from the target, should they be more practical. Generally speaking, internal controls evaluations tend to be reactionary, as in the case of PN21 Hong Kong listing rules on internal controls reporting.2

However, a proactive assessment of a

1. See also Doing deals chapter for a discussion on due diligence considerations
2. The Stock Exchange of Hong Kong Ltd. “Practice Note 21: “Due diligence by sponsors in respect of initial listing applications”
Management and the audit committee must have a common understanding of the appropriate timeline in the China setting for a company to achieve standards that are consistent with the head office, as compliance may be a drawn-out process, due to potential regulatory complications.

Many of these principles also apply to newly established China operations, as businesses need to establish a strong system of internal controls from the very start. Policies and procedures at the local level must balance the objectives of the following:

1. Corporate standards and values
2. Regional and national laws
3. Regulations
4. China accounting standards
5. Sustainability in the Chinese work culture (to ensure employee engagement and well being)

Internal audit functions should also play an advisory role in post-deal integration teams for process and control design; IT systems integration; data migration, quality and security; validation and tracking of benefits and cost savings; and product management assurance.

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1. Corporate standards and values
2. Regional and national laws
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5. Sustainability in the Chinese work culture (to ensure employee engagement and well being)
Considerations in systems and process integration

Integrating systems requires more than just a change in process and procedure; it involves wide-scale culture change for the target. With cultural change, buy-in and engagement from staff is critical, as the acquiring company is asking that they work in different ways and follow a set of different rules. Businesses must ensure leadership and staff support, to ensure the success of any cultural change in a target company.5

The Chinese work environment could potentially influence systems implementation in a number of ways. While most Western firms use internal checks and automated systems, for instance, they are not universally relied on in China. Manual systems that incorporate chops, stamps and signatures are preferred, and some companies might appear to be slightly over-staffed, as manual systems run parallel with computer systems. Therefore, many of the efficiencies and synergies that foreign investors may expect to achieve in combining systems may not be realised, as the Chinese preference has been to maintain the status quo. Global headquarters should take into account the time needed for staff to adjust to a migration from a system of physical documentation and signature to a paperless system, as a degree of organisational change is inevitable.

In addition, language may precipitate the need for a Chinese front-end interface. More importantly, systems for domestics may at times be drastically dissimilar from global products, with processes and work flows that are also quite different. Work flow arrangements would have to be reorganised within the company and a suitable strategy proposed to match the work flows of the system. Chinese domestic companies also tend to have fewer systems overall, but these systems are relatively new and advanced – another potential point of departure.

“Global policies and standards must be tailored for local application,” says John Barnes. “Otherwise, they will lose their relevance and be ignored.” While global standards can be quite extensive, Chinese businesses often operate under different regulatory and work environments, and custom tailoring will be required.

You may need to look at your target’s occupational health and safety policies, for example, as China has very specific rules and guidelines on health and safety, including overtime, engagement controls, leave and social security.

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5. See also Doing deals chapter for a discussion on deal integration considerations
The government also has its own set of environmental regulations, for which policies will need to be amended to reflect. Other regulatory considerations may also apply, particularly in the financial services industry, where systems are highly regulated in the way business is done in China, and the different approvals processes required.

Variations in Chinese tax and accounting laws also have significance on the migration of reporting systems. These differences often result in a local company operating a blanket system that can process and report on financial data for purposes of both tax and accounting requirements. As a result, reasons of practicality may require that tax reporting systems be maintained alongside global systems, as incorporating China-specific considerations to a global system to accommodate one country unit is often not cost-effective. China operations may therefore be faced with the prospect of running two systems, one to report to global headquarters, and another for China tax filing purposes.

Of course, you will still need timely, reliable and consistent financial and operational information to support your decision making. Identify the gaps between your business requirements and current system capabilities. If management reporting needs can’t be met at your China target, make sure there are short-and long-term solutions in place to meet these needs before undertaking full integration.

Due to the size of the China market, companies should also consider the effect that their target’s business volume may have on global systems. In pursuing mergers or acquisitions, a component of due diligence on internal controls should factor in a close examination of the IT environment and existing IT infrastructure. One should consider whether the systems used in the head office can scale up to accommodate for the amount of business in China.

The company may even opt to commission a report on the target’s technological infrastructure, turnover and amount of data that may have to be uploaded onto the group system. This is particularly pertinent when the turnover of the China business is based on thousands of relatively minor orders, which means that the acquiring company’s systems have to be able to cope with that level of data demand.

Global multinationals may also have to be prepared to account for resistance from their joint venture or merger partners, should these partners be expected to absorb costs of systems change. Joint venture partners, for instance, may opt to simply combine the books on the financial side. There have been cases in which Chinese partners have been reticent to take on capital costs associated with operational software, especially if they perceive the benefit as chiefly for the foreign partner or global headquarters.

With all these considerations to account for, our position is that such challenges are not insurmountable, and the advantages of combining systems with the head office, which allow for quick and easy access of key management information, still outweigh the perceived disadvantages.

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6. See also Accounting and reporting chapter for a discussion on differences between accounting and tax laws.
The state of systems and IT in China

Compared with the IT environment about 10 years ago, data and information systems in China such as enterprise resource management (ERP) are no longer outdated, with many systems in China even surpassing the technology of legacy systems found in many Western multinational companies. The new Chinese systems are now streamlined and efficient, and many domestic companies are technologically very flexible, using international systems and standards to meet the demands of constantly shifting market conditions and a high growth rate. Innovation in the field of information technology is now commonplace.

At the moment, chief information officers are working hard to keep up with the current wave of business technological innovation in China. Information and communications technology, and in particular, cloud computing and mobility, have enormous potential to improve the productivity of the small and medium enterprises segment in how they create, commercialise and collaborate on innovations.7

The new wave of systems implemented over the last five years has taken on increased sophistication. Chinese and Hong Kong domestic firms have made technology improvements a priority, with 78% of CEOs stating that they would be making technology investments in their company in the next 12 months.

There have also been significant advancements in channel systems, customer management systems, marketing, background data, management accounting and SIPs. Another wave is also emerging from the e-commerce industry, with traditional channels expanding to mobile and e-channels.

In China, cloud computing, as a replacement for traditional data centre infrastructure technologies and management processes, are no longer just theoretical, and are starting to be used in the real business world. Hong Kong in particular is becoming a popular cloud computing hub for China and the rest of the Asia Pacific.8 The US telco giant, Verizon, also opened a new 3,000-square-metre Hong Kong-based data centre as a hub to roll out IT cloud services to multinationals and local companies in China and India.9

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8. PwC. “10Minutes on expanding business in the Asia Pacific.” 2012
A total of 42% of China’s CEOs in 2012, higher than the global average, expressed willingness to make technology investments to circumvent skills shortages. This may be a signal that CEOs in China are prepared to accept a move towards more automation and systems, though partnerships with other organisations remain a top priority, which may also suggest a rise in the use of service providers. 10 While labour of this nature may still be relatively cheap, these numbers suggest that domestic companies may be beginning to consider relying more on technology and automation, instead of manual checks, due to growing wages.

Technology replacing people

There may be resistance in Chinese corporate culture against replacing people with machines, the sentiment might be taking a new direction in the future, according to PwC’s 2012 Global CEO Survey responses (see table to the right).

Dealing with skills shortages: CEOs looking to technology, partnerships and acquisitions

To what extent do you agree or disagree with the following statements about the future of your global workforce?

<table>
<thead>
<tr>
<th>Percentage of respondents who stated ‘agree’ or ‘agree strongly’</th>
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<tbody>
<tr>
<td>In three years, we will have made significant technology investments specifically to circumvent skills shortages</td>
</tr>
<tr>
<td>China/Hong Kong (160)</td>
</tr>
<tr>
<td>22</td>
</tr>
<tr>
<td>In three years, we will have partnered with other organisations specifically to circumvent skills shortages</td>
</tr>
<tr>
<td>China/Hong Kong (160)</td>
</tr>
<tr>
<td>28</td>
</tr>
<tr>
<td>In three years, we will have acquired other companies specifically to circumvent skills shortages</td>
</tr>
<tr>
<td>China/Hong Kong (160)</td>
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<td>22</td>
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Source: PwC 15th Global CEO Survey 2012

10. Also see a discussion on service providers and shared service centres in China in this chapter.
Bridging the skills gap

Too often, head office people pay only cursory visits to their local operations in China, focusing only on head office strategies and head office plans. If you are serious about your operations in China, then you need to roll up your sleeves, get in there and look at things from the other side. Delivering key and strategic messages about the importance of local operations to the head office and giving them recognition for the contribution they make to head office profitability and to local environmental and social communities will engender a more committed local management and workforce.

Businesses operating in China will need to consider attracting IT talent to support its systems integration and management, as key infrastructure, such as data centres and support infrastructure, may have to be put in place to support the business. Fortunately, information technology is not an area in which China is lacking in talent, as this technical skill is arguably easier to develop in this market than capabilities in management and strategy.

But while the market is rich in young and technologically savvy professionals and systems engineers, it lacks in staff with sufficient years of experience in managing information technology. A global survey of chief audit executives listed soft skills, in addition to technology expertise, as invaluable in today’s environment: critical thinking skills, understanding the strategy and business model, communications and leadership. Businesses might therefore wish to contract local advisers to fill in the gap, or send IT managers to the country to work with the local IT team on implementation.

Locally based advisers can also be invaluable in acting as bridges between foreign IT directors and China staff in the project management of systems and process integration. A neutral party sensitive to the personal and professional cultural gaps from both sides in a merger, acquisition or joint venture can go a long way in ensuring that personal and professional culture differences are smoothed out, and properly mediated.

11. PwC. “State of the internal audit profession study.” 2011
**Service providers and shared service centres in China**

As CEOs with operations in China look to circumvent skills shortages by partnering with other organisations, service providers in China are stepping up to diversify their offerings, as the country emerges as a new magnet for outsourcing firms. With the growth and maturation of the China workforce, routine transactional processes, as well as some value-added processes, are becoming possible in the country. They are providing a cost-reduction opportunity that would not have been possible a decade ago, and are even beginning to threaten the current dominance of Indian and US centres.

In addition, shared service centres are gaining in popularity in China. Domestic and multinational players in China have expressed the intention or have already implemented shared service centres locally. Indeed, approximately 28% of businesses intend to acquire other companies in three years to deal with their talent shortages.

Given the relative importance of treasury operations in China, some multinationals have set up finance processing shared service centres in China to serve the greater region around the country.

In one instance, a global multi-industry manufacturer on the Financial Times 500 established a shared service centre in Shanghai, initially to serve its China operations. However, it later expanded this centre to serve the entire Asia Pacific area, covering 14 countries. The firm overcame an initial challenge of integrating the multiple enterprise resource planning platforms to increase control and optimise efficiency for financial processing work. The company was thereby able to set up a talent pool in the Shanghai shared service centre, boasting extensive knowledge and experience in finance.

In another example, one global manufacturer of engineered electronics components merged its dispersed finance shared service functions into one single centralised organisation. With the improved operational efficiency and internal control, the company is now considering expanding the financial shared services centre to cover all of the Asia Pacific.

It’s also worthwhile to look at the growing range of service provider offerings here. As new entrants in China aggressively plan to enter high-value-added markets for application development and maintenance (ADM), R&D and design services, they are beginning to grab market share from incumbent providers. The challenge here is in choosing good providers, which may also depend on your IT strategy.

In China, the growth in the number of providers offering and targeting ADM services is continuing to expand, followed by IT infrastructure and engineering services. Chinese service providers are also targeting new offerings in high value-added services such as R&D and product design. Meanwhile, 35% of Chinese service providers intend to introduce human resources services, compared with the 10% average in the Asia Pacific. Management training has become a greater focus for these providers, along with language skills enhancement.

14. See also Finance and treasury chapter for a discussion on treasury strategies
Obtaining sustainability data and information that’s reliable, measured and balanced requires robust internal controls and monitoring systems and processes. Effective and audited measurement and reporting systems and processes for energy consumption, paper use, water efficiency, waste-water and carbon emissions should be developed as early as possible in the lifecycle of your China operations. They should also be considered when undertaking due diligence for joint ventures, mergers and acquisitions.

What you’ll need to consider
Getting this information, however, is often not straightforward, due to less developed local market conditions and the current state of the talent pool for monitoring and reporting. Companies should therefore consider the following issues and challenges:

• Access to the relevant data. Working with local partners and suppliers to access relevant data or establish the required monitoring systems and processes can be challenging, given their relative lack of awareness in this field. While there’s little complexity in China pricing models for electricity or water, internal monitoring IT systems and processes for energy and water use may also be poor to non-existent, particularly in older plants, buildings and factories. Make this a consideration when purchasing or renting capital infrastructure, and when entering into relationships with your suppliers and partners.

• Transparency over your value chains. Due to practical considerations and reputational issues, substantiating claims of reliability for China-sourced non-financial information can sometimes prove difficult. The challenge lies in obtaining reliable information across your whole supply chain that account for an accurate overview of your reputational risks.

• Balanced information from Chinese partners. Due to the still-emergent conditions for non-financial reporting and the low cost-related incentives for increasing energy and water efficiency in China, foreign investors will need to work proactively with partners to encourage balanced data reporting, should they miss sustainability key performance indicators such as energy efficiency targets.

Traditionally, sustainability reporting has framed the creation of the report for stakeholders as a primary objective. However, the process of developing the report could also yield a more holistic view of your operations in China, lead to greater insights and help map new avenues for improvement. Such improvements can range from bolstering your governance procedures and strengthening risk management, to driving new cost efficiencies.

John Barnes, PwC China Head of Sustainability and Climate Change
Companies wanting to bolster their capacity for sustainability reporting in China should first acknowledge that quick and clear solutions can be elusive. The China environment currently is more suited for gradual evolution and capacity building. Below are three steps for gradually putting the right reporting infrastructure in place.

1. **Set up a baseline year for measurement.** Arriving at this preliminary baseline can yield several benefits. It can jump-start the process of implementing adequate internal controls, while allowing you to discover various ways to improve your operations. Another potential advantage is the increase in visibility for your tax positions, which, depending on your industry and geography, may encompass a wide range of China-specific environmental, social and governance-related taxes and levies. As businesses increase their transparency with a range of stakeholders on these tax positions, they can also demonstrate their wider social and economic impact and better monitor and manage their tax risks.

2. **Identify your skills and infrastructure gaps, and build a team with the right experience.** With a comprehensive reporting infrastructure in place, you can now look more closely at your specific systems and processes. Companies can consider how to tighten up reporting, verification and monitoring processes. Management can then determine what they need to do to take their reporting to the next level (whether through third party assurance or the layering or streamlining of checks and balances). One particular concern, however, is that the skills necessary to implement and maintain the reporting and monitoring of these systems may lag behind that of other economies, so time and patience are necessary to finding the right expertise.

3. **Address reporting deficiencies.** Take the time to invest in training, while raising awareness with business partners and suppliers. Once you’ve understood your deficiencies and assembled an experienced team with the right skills, you can begin to address these gaps. Invest the time to train your partners and suppliers in monitoring and reporting their inputs, outputs and performance. This becomes particularly crucial should your China presence take the form of a joint venture or acquired subsidiary. If your partner does the bulk of the heavy lifting in your China operations, you’ll need to assign additional resources and people on the ground to assist in training and awareness raising on the importance of sustainability reporting.

One notable development is the potential for a domestic carbon market in China. The central government has a stated goal of launching a unified national carbon trading platform by 2015, while carbon tax and cap-and-trade systems are becoming a major point of policy discussions. Implementation is still years away, and questions such as tax neutrality, revenue management and incentives for greentech solutions are still unresolved. But should such systems be introduced in the near future, businesses may be left exposed to heightened disclosure requirements for energy use and emissions. Many China operations have not shown the capacity to deal with the consequences of carbon taxes or the eventuality of emissions caps.