China Alert

Issue 5 – January 2011

Customs will scrutinise ERP system of certain Processing Companies

The General Administration of Customs issued Circular 93 to further explain measures that the Customs authority is implementing to enhance supervision over processing trade. In addition to expanding previously introduced measures, it appears that there will be an increased focus by the Customs authority on companies' internal control systems as well.

Regulations discussed in this issue:

- Circular on the Implementation Issues of Administrative Measures of Customs on the Supervision of Processing Trade Goods, GAC Circular No.93, issued by GAC on 31 December 2010, effective from 31 December 2010.

- Decision (II) about Modifying Administrative Measures of Customs on the Supervision of Processing Trade Goods, GAC Decree No.195, issued by GAC on 1 November 2010, effective from 5 December 2010.

Main content

In order to facilitate the implementation of the General Administration of Customs (GAC) Decree No. 195, the GAC issued Circular 93 to clarify several ambiguities in Decree No.195. The main clarifications are as follows:

- Decree No.195 states that bonded and non-bonded goods must be managed separately. Circular 93 defines "manage separately" as the keeping and recording of bonded and non-bonded goods separately. For enterprises in some industries and large enterprises that adopt integrated logistics management, the Customs authority will evaluate their internal ERP systems (Enterprise Resource Planning systems such as SAP) to verify the systems' ability to segregate processing trade related data and non-processing trade related data through the network supervision system. Upon positive verification, the Customs authority will recognise the entities as having met the condition of separate management.

- Decree No.195 also states that bonded goods should be kept at places registered with Customs. Circular 93 defines "places registered with Customs" as places that were registered when the companies applied for customs registration and processing trade. Furthermore, except for outsourced processing and related activities, bonded goods cannot be stored across different customs districts.

- Decree No. 195 states that without Customs' approval, bonded goods cannot be used as collateral. Circular 93 further outlines the eight scenarios where using bonded goods as collateral is explicitly prohibited. For those cases that may obtain the Customs' approval for collateralising the bonded goods, deposits or bank warrants for the amount of total duties and taxes that would otherwise be applicable are required to be made to Customs.

KPMG Observations

Some of the clarifications made in Circular 93 provide additional guidance for local Customs authorities and companies in implementing Decree No. 195. Some, on the other hand, may have added new considerations that companies may need to address and new uncertainties.

- **Requirement on ERP system**
  - *Trend of increasing emphasis on internal control*

    It is very interesting to note that Circular 93 states that in certain cases, the Customs bureau will evaluate the companies' internal ERP systems to verify the systems' ability to segregate processing trade related data and non-processing trade related data through the network supervision system. Customs inspections on whether bonded goods have been physically segregated from non-bonded goods and stored in designated areas are very common. However, expanding the scope to whether ERP systems are able to support the same segregation suggests that the customs authority is shifting its focus from outcome-oriented (i.e. whether it is compliant with customs regulations) to whether the company has the right internal control mechanism in place to ensure such compliance.

    This echoes other Chinese authorities' growing emphasis on companies' internal control systems. Readers may recall the issuance of tax circular Guoshuifa [2009] No.90 in which the State Administration of Taxation set out the Provisional Guide for Large-scale Enterprises to Manage Taxation Risks, and the subsequent efforts by companies and tax authorities on improving and monitoring large companies' internal control mechanisms in tax areas. Could Customs compliance enforcement be aimed in the same direction?

  - *Undefined terms*

    This leads to one of the main uncertainties posed by Circular 93. The circular indicated that Customs will evaluate the internal ERP systems of "enterprises in some industries" and "large enterprises" that "adopt integrated logistics management". However, none of these three terms have been defined.

  - *Potentially significant increase of compliance costs for mid to small companies in certain industries*

    Most large multinational companies have already invested significant amounts of time and money to strengthen their internal control across functions in the last few years, and may be relatively well prepared for an ERP system examination by the Customs authority. However, many mid to small size companies may not have the resources to do so. By including "enterprises in some industries" in the circular, does the Customs authority suggest that even mid to small companies may be subject to such stringent and likely costly standard if they happen to be in "some industries" to be defined later?

Given the uncertainty and the potentially significant additional compliance costs, companies may wish to discuss this circular with their in-charge customs authorities as soon as possible.

Companies that plan on implementing new or modifying current ERP systems may also wish to take Circular 93 into consideration if they will be engaged in both processing trade and non-processing trade.

- **Storage of bonded goods**

  Companies involved in processing trade should evaluate whether the storage of their bonded goods complies with Customs' requirements, particularly if the bonded goods are stored temporarily at third party/leased warehouses.

- **Bonded goods as collateral**

  While Circular 93 provides the eight scenarios under which using bonded goods as collateral is explicitly prohibited, in practice, most companies' situations will not fall within those scenarios. Nevertheless, companies that currently use bonded goods as collateral should check whether their arrangements meet Customs' requirements, whether Customs authority's approval has been duly obtained, and whether additional paperwork needs to be put in place. Further, companies should also assess the impact that the deposit or bank warrants provided to the Customs would have on the company's cash flow.

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