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## **NYSE-Traded Chinese Company CYD Settles Accounting Case with SEC**

The world is changing. Quickly. And it is taking a form that many of us no longer recognize. What better proof could I offer than to report about a recent United States Securities and Exchange Commission (SEC) case against a Bermuda holding company based in Singapore, which is a subsidiary of a People's Republic of China holding company, which trades on the New York Stock Exchange.

*Chew on that for a while. Draw up a flowchart. Scratch your head. Smile. Shrug your shoulders. Welcome to the brave new world.*

According to its [website](#), China Yuchai International Limited ("CYI") is a Bermuda holding company established on April 29, 1993, whose principal office is located in Singapore. CYI is a subsidiary of Hong Leong Asia Ltd ("HLA"), which indirectly holds 27.5% of CYI's outstanding ordinary shares as well as one special share. The common stock of CYI is traded on the New York Stock Exchange under the symbol "CYD".

CYI currently holds a 34.4% interest in Thakral Corporation Ltd ("TCL") and a 46.4% interest in HL Global Enterprises Limited ("HLGE"). TCL is a distributor of consumer electronics products with operations mainly in the People's Republic of China (including Hong Kong). HLGE's core businesses are hospitality operations and property development. TCL and HLGE are listed on the Main Board of the Singapore Exchange Securities Trading Limited.

### **GYMCL -- the little engine that misfired**

Guangxi Yuchai Machinery Company Limited ("GYMCL"), which is located in Yulin City, Guangxi Zhuang Autonomous Region in southern China. GYMCL is one of the largest medium-duty diesel engine manufacturers in China. CYI currently own through six of its wholly-owned subsidiaries 76.4% of the outstanding shares of GYMCL.

## **2005 Discrepancy**

Between 1998 and 2004, CYI's GYMCL subsidiary had been consistently profitable; however, in the second half of 2005, GYMCL's financial statements began to reflect monthly losses, which worsened as the year progressed. Because the "Goods Received/Invoices Not Received" ("GR/IR") account year-end balance had grown significantly over the previous year, GYMCL's management and finance department were concerned that technical problems with new accounting software installed earlier that year had overstated the GR/IR account.

*The GR/IR account tracks the cost of raw materials delivered to GYMCL's warehouse prior to the receipt of invoices from vendors. GR/IR is consolidated with Accounts Payable on the balance sheet.*

In an effort to determine the cause of the financial discrepancy, GYMCL's procurement department staff manually counted warehouse receiving documents and called suppliers to discuss shipments and invoices. Using the procurement department data, the finance department staff substantiated a GR/IR account balance of Renminbi (Rmb) 400 million, but the accounting software indicated a balance of Rmb 568 million.

*The Rmb 168 million discrepancy converted to about \$21 million U.S. Dollars as of the 2006 exchange rate and about \$24.6 million U.S. Dollars as of the June 2010 exchange rate.*

### **168 Million Renminbi Plug -- but further leaks**

On January 20, 2006, the finance department input an adjusting entry of Rmb 168 million into the GR/IR account for the period ending December 31, 2005. After the adjusting entry had been made, personnel in the GYMCL finance department discovered additional warehouse receipts that had not been included in the January 2006 count. As a result, the January 2006 adjusting entry was partially erroneous; however, no one at GYMCL informed anyone at CYI of the discovery of the additional receipts or that the adjusting journal entry was now rendered partially erroneous.

On August 8, 2006, CYI filed its 2005 annual report via Form 20-F with the SEC. The 20-F incorrectly reported \$8.5 million net income as a result of the erroneous adjusting entry noted above.

Form 20-F is an attempt to provide investors with a standardized annual report for foreign private issuers with shares listed on U.S. exchanges.

See sample of Form 20-F: <http://www.sec.gov/about/forms/form20-f.pdf>

In June 2007, CYI finance personnel learned that the January 2006 adjusting entry was erroneous when an accountant in the GYMCL's finance department proposed a partial reversal of the adjusting entry. CYI's Audit Committee was informed of the issue and hired outside counsel to conduct an internal investigation of the issue. Following a preliminary investigation, CYI

publicly disclosed in August 2007 that it was conducting an investigation into a possible accounting error and that "Rmb 168 million . . . may have to be reversed."

On May 30, 2008, CYI filed an amended Form 20-F which reversed the entire January 2006 adjusting entry and restated its financial results for 2005, thus reporting a \$4 million net annual loss instead of the previously reported \$8.5 million net income (a decrease of approximately \$12.5 million). CYI also identified certain other accounting errors not previously known and corrected these other accounting errors in its restated financial results for 2005. CYI changed GYMCL's internal controls in an effort to diminish the likelihood of such problems in the future. CYI made GYMCL finance department personnel changes, adopted new procedures for posting accounting entries, and trained finance personnel in U.S. Generally Accepted Accounting Principles.

### **SEC Imposes C&D**

In the Matter of China Yuchai International Limited (Order Instituting and Imposing Cease-And-Desist, Securities Exchange Act Rel. No. 62235 / Administrative Proc. File No. 3-13925, June 7, 2010) <http://sec.gov/litigation/admin/2010/34-62235.pdf>, CYI's Offer of Settlement was accepted by the SEC, whereby CYI consented to the entry of a Cease and Desist Order.

As a result of the above conduct, the SEC determined that CYI violated

- Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the SEC information, documents, and annual reports as the SEC may require, and mandate that reports contain such further material information as may be necessary to make the required statements not misleading;
- Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets. As a result of the erroneous material adjustment to the GR/IR account, CYI's books, records, and accounts were materially misstated and did not accurately and fairly reflect the transactions and dispositions of the company's assets; and
- Section 13(b)(2)(B) of the Exchange Act, which requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles. CYI's internal controls were not sufficient to prevent the entry of an erroneous material adjustment to the accounts of its majority-owned subsidiary, or to require the reversal of that adjustment when it became apparent that it was erroneous.

## The Quality of Mercy

In determining to accept the offer of the Cease-And-Desist, the SEC considered the prompt remedial acts undertaken by CYI and the cooperation the company afforded to its Staff.

**Bill Singer's Comment:** They still manufacture pencils with erasers, and, yes, the old "Backspace" key gets plenty of use as a means to delete computer-entered errors. Human beings make mistakes. Sometimes, our imperfection is merely a minor misspelling or the typical bookkeeping error that plagues many businesses. Other times, our failings can be cataclysmic, as in the case of BP's spewing oil pipe. There is a world of difference between inadvertent and avoidable.

It does not appear that CYD had adequate and reasonable measures in place in 2005 to detect the accounting errors at issue. That only the tool shed burned down and not the entire plant is irrelevant. The fire should not have ignited in the first place, and when it did, all sorts of alarms and sprinklers malfunctioned. Nonetheless, in this case, the SEC seems to have been impressed by CYD's fire drill. The company smelled smoke, found the source of the fire, put out the fire, and installed additional sprinklers and smoke detectors.

In determining the degree and extent of punishment for our individual and corporate failings, it is important to take into account whether a given error was intentional and/or easily prevented. Moreover, it is also appropriate to consider the steps taken to confirm the error, how quickly those inquiries were undertaken, how soon following confirmation remedial changes were set in place, and what assurances we have that a recurrence of the same problem has been eliminated or reasonably reduced.

The fear of excessive regulatory reprisal contributes to cover-ups that inflict far more danger on our society. Regulation works best when those regulated timely uncover their own mistakes, promptly move to correct the damage, and fully disclose the causes, effects, and remedies.

On the other hand, sometimes individuals and corporations just don't seem to get it. They handicap the regulatory system as the cost-of-doing business -- it is merely another gaming scenario inputted into a computer simulation. The probability of getting caught versus the cost of preventative measures versus the likely range of fines are nothing more than data points. For such miscreants, a measured response is useless.

Speaking of which, what are we going to do about BP?