

Internal Control & Audit in PRC Context

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Legal framework

Part I

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Legal framework

1. PRC Company Law, 1993 revised on 2005
2. PRC Anti-unfair Competition Law 1993
3. PRC Tender and Bidding Law 2000
4. PRC Internal auditing standards 2003-2005
5. PRC Internal Accounting Control Guidelines 2001
6. Report on Improvement of Internal Control for Listed Companies with references to SOX legislations, jointly issued by CSRC, SASAC, MOF of PRC on June 2005

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Revision in PRC Company Law

1. Shareholders have the right to examine company secretarial documents and financial information including the accounting ledgers and vouchers. (Art. 34 of the Co Law)
2. Threshold of holding EGM is reduced from proposal by 1/4 of the members to that of 1/10. (Article 40)
3. Directors' fiduciary duty, (Art. 149);
4. Directors are prohibited from practicing internal corruption: (Art. 148)
5. Scope in Article 148 and 149 is extended to members of the senior management (Art. 217)
6. Company shall pay cost of investigation by the supervising board into the affairs of the Company (Art. 55, 57, 119)

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Internal Auditing Standards

20 IAS have been issued by China Internal Audit Association between 2003 and 2005, including

1. Audit on internal control;
2. Fraud prevention and detection;
3. Compliance audit;
4. Use of external experts;
5. Analytical review;
6. Audit and evaluation on risk management

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PRC Internal accounting control guideline

Issued by Ministry of Finance on 22nd June 2001

1. Procurement and payment
2. Sales and receipts
3. Costs and expenses
4. External investment
5. Construction projects
6. Monetary assets
7. Providing security
8. Budgetary control
9. Fund raising
10. Inventory
11. Fixed assets

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Internal control

Part II

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Definition of Internal control (MOF)

Internal Control is a series of controlling activities carried out by the BOD, the management and staff to achieve and give effect to the following objectives:

1. Corporate strategy
2. Operation efficiency and effectiveness
3. True, reliable and complete accounting & management information
4. Security and integrity of corporate assets
5. Compliance with laws and regulations

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Internal control environment

1. Legal framework
2. BOD support
3. Provision of internal audit in JV Agreement / Articles;
4. Organizational design
5. Corporate culture
6. HR policy (IA head count)
7. Internal audit (Resources)
8. Preventive mechanism on internal corruption

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Internal control procedures

1. Proper authorization
2. Segregation of duty
3. Approval system
4. Maintaining and controlling operation records
5. Assets protection
6. Accounting system
7. Internal control reports
8. Budgetary system
9. Performance appraisal
10. Information technology control

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Segregation of duty in a purchase cycle

1. Purchase requisition vs. approval
2. Obtaining quotes vs. deciding on the vendor
3. Execution of P.O. vs. approval
4. Execution of purchase vs. goods receipt
5. Execution of purchase vs. goods inspection
6. Goods returned vs. approval
7. Payment approval vs. payment processing

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Designing a purchase system

1. Qualified vendor system
2. Tender and bidding procedure
3. Approval limits
4. Authority to make purchase requisition
5. Document flows & inter-departmental communication

Qualified vendor system includes:

1. Vendor approval
2. Vendor performance appraisal
3. Periodic review and amendment of vendor lists

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Segregation of duty in a sale system

1. Signing sales agreement vs. approving SA
2. Sales department vs. goods delivery department
3. Sales department vs. billing department
4. Delivery vs. warehousing
5. Accounting vs. treasury/cashier (custody of checks and bills receivable)
6. Goods return approval vs. goods receipt
7. Account confirmation vs. sales staff
8. Warehousing vs. record keeping
9. Credit department vs. sales department

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Designing a sale system

Sales Agreement

- Approval
- Execution and signing
- Authority to sign

Credit department

- Approval
- Credit policy
- Credit monitoring (i.e. check tax defaulter list on website of tax bureau)

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Principles of designing Internal control system

1. Compliance with laws and regulations
2. Completeness
3. Effectiveness
4. Check and balance
5. Adoptability
6. Cost and benefit
7. Existence of Internal audit

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Social, economic and cultural factors

1. Ethical and moral standards
2. Non-compliance with legal regulations
3. Changing and complicated business environment
4. Transparency in administrative authorities
5. China is not a Christian / Catholic country
6. Honor (trust) systems yet to be built up

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Risk Assessment Procedure

1. Specific objectives
2. Identification
3. Analysis
4. Management (avoidance, reduction, containment and sharing)

Example of compliance risk:

What are the impacts of PRC Employment Contract Law effective from 2008?

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Common type of risks in China business

Compliance risks on importing bonded goods (export processing)

- Imbalance among the warehousing, accounting and the customs ledgers (i.e. AL balance > WL balance > CL balance);
- Transfer of bonded goods to and from other manufacturing entity

Fraud prevention:

- Control over unauthorized importation of bonded goods

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Common type of risks in China business

Compliance risk on importing general goods

- Wrong (short/over) shipment or delivery by 3rd party or own mistakes
- Incorrect declaration (classification code, description, quantity, unit of measurement, price, country of origin, etc)

Error detection and risk reduction:

- Performing inspection before submitting import declaration
- Statutory rights of consignee

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Common type of risks in China business

Tax related risks

1. Deemed sale rules under VAT regulations: – goods given up as gifts; change in possession; change in use
2. Control over VAT special invoices: – issue and custody – invoice stamps
3. Centralized inventory system: bonded goods (untaxed) are mixed with the general goods (taxed)

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Common type of risks in China business

Non-tax related risks

1. Staff loyalty and integrity – character checks; authentication on employee ID cards
2. Control over stamps: (i) types of stamps, corporate stamp (公章), contract stamp (合同章), finance stamp (财务章), invoice stamp (发票章), customs stamp (報關章) individual stamp (私章); (ii) Stamps in physical and electronic forms

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Coping with risks in China business

Information asymmetry

1. What is it meant?
2. Why is it important?
3. How to close the gap?

Typical Questions

- Is it lawful to discipline the employee by deducting money from his/her gross pay?
- Does the legal rule of endorsement work for post-dated cheques?

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Common type of fraudulent activities

1. Commercial corruption
2. Infringement on IPR
3. Forgery / deception
4. Theft (commercial / technical secret)
5. Embezzlement

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Case 1 – A planned fraud penetration

The Company hired Mr. Li, who worked as a clerk in the general office for RMB2,000 a month. Later the accounting department found that company's payroll was fraudulently manipulated and all the money was transferred to a lady's bank account already opened using a fake ID card. The money was withdrawn by the lady. Mr. Li resigned subsequently. After investigation by the public security, it was found that "Mr. Li" was actually an expert in computing science with a master degree. He had also deceived the company by using yet another forged identity card upon joining the company.

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Case 2 – Internal corruption

- Issue: (i) Canteen & catering services are thorny problems for labor intensive manufacturing company. Very often it is difficult to segregate the duty between checking prices and deciding on suppliers: same person to bargain price, select goods and the supplier; same person to make payment and receive goods; (ii) No tax invoices for most purchases. Most vendors for animal products, crops, vegetable and aqua-products cannot issue tax invoices.
- Solution: outsourcing the canteen and catering services by inviting qualified vendors to submit bids under tender

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Preventive measures for some Chinese business irregularities

1. Theft on commercial and technical secret → non competition and confidentiality clause in employment contract; control over documentation & information flows
2. Frauds relating to procurement → (i) whether tender and bidding procedures in place; approved vendor system; post-transaction audits; (ii) independent construction work evaluation agent (cost of construction projects)
3. Frauds on ID cards → Authentication checks performed for identity documents

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Tools for internal control and audit

1. Company policy (organization) manual – guiding management process and organizing resources to achieve company objectives
2. Re-organization – (i) implementing company policy; (ii) wiping out vested interests
3. Job rotation – irregularities are brought to light
4. Character check – screening candidates for senior posts before and after recruitment

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Internal audit

Part III

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Internal audit

- Objectives
- Classification of internal audits
- Comparison between IC and IA

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Internal audit

Objectives

- Detecting irregularity and fraud prevention
- Safeguarding company's assets
- Evaluating operating efficiency and effectiveness
- Evaluating performance of the management

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Internal audit

Classification of internal audit

- Financial and accounting audit
- Operating efficiency audit
- Management audit

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Classification of internal audit

Operating efficiency audit (OA):

- It is aimed at measuring the yield between the input and output against bench mark for a certain period
- Scope: financial, physical and human resources that are used in the business activities

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Classification of internal audit

Financial audit vs. Operation audit:

- Focus on past data vs. both past data and future plans
- Whether financial information is true vs. whether there is room for improving productivity
- FA is protective in nature; whether financial information contains error and whether frauds exists vs. OA is constructive in nature; evaluation of operating efficiency.
- Using legal and accounting rules vs. technical standard or other non-financial benchmarks

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Classification of internal audit

Scope of management audit includes:

- Management audit includes business contract, purchase and sales price, construction project, tendering and bidding procedure, risk management, staff development, HR policy, compliance audit, internal control audit, marketing audit, etc
- Example: audit on change of corporate strategy and marketing strategy, branding strategy, marketing mix ,etc

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Classification of internal audit

Comparison between internal control and internal audit:

- Scope of IA includes (i) the evaluation on effectiveness of IC; and (ii) management audit
- IA is an integral part of the internal control
- IA ensures (i) IC policy is in place, (ii) IC procedures are carried out, (iii) organization design is appropriate.


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Classification of internal audit

Scope of compliance audit includes:


- National law and regulations, local regulations and
- Industry or Sector-specific regulations


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Scope of compliance audit

- National law and local regulations includes
- Accounting, invoice, taxation, company, foreign exchange, customs, labor, social security, advertising, consumer right protection, product quality, S&P contracts, employment contract, environment, fire safety, etc.
- Order of Authority: (1) Law, (2) Regulations, (3) Ministerial and local regulations, (4) local rules
- Source of legal authority: legislative and administrative branches


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Scope of compliance audit

- Industry or sector specific regulations (i.e. a pharmaceutical production company) includes
- Drugs administration law, Food hygiene law, Product quality law, Advertising law, Consumers' right protection law, Good manufacturing practices (GMP) *


* GMP is a set of rules and procedures that a licensed manufacturer must follow relating to the purchase, goods inspection, production flows, design and construction of the manufacturing plant, quality checking and testing, packaging, storage and transportation of pharmaceutical products.


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Compliance audit

1. Legal Rules Database
 - National law and regulations
 - Industry specific law and regulations
 - Source of legal rules: legislative and administrative bodies
2. Skill set of IA staff


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Compliance audit vs. statutory audit

Similarity

- The expression of opinion on the degree of correspondence between management assertion and established criteria / benchmark


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Compliance audit vs. statutory audit

Differences


- Report's Addressee
- Frequency of reporting
- Reporting period
- Financial and non financial information
- Scope of coverage: company wide or departmental, specific transaction, project, contract performance
- Mandatory or voluntary

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Tendering & Bidding

Part IV

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Tendering and Bidding Policy (Engineering & construction)

Division of duty and authority

- Engineering department
- Project teams
- Project supervising committee
- Bidders management (qualification and periodic review)
- Tender and bidding administration team
- Bids evaluation team
- Legal department
- Internal audit
- Investment department
- Accounting and finance department

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Tendering and Bidding Policy

Management process and procedures

1. Project classification and approval limits
2. Feasibility study, project proposal and approval
3. Organization of departments and authority
4. Project administration
5. Internal control system
6. File management

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Tendering and Bidding Issues

Types of Insurance policy

- Performance policy
- Property insurance
- Third party liability insurance (3rd party liability cannot be excluded by mutual agreement)

Q: Who buys insurance? Landlord (developer), tenant (occupant), or the construction company?

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PRC Tendering and Bidding Law 2000

- Legal rules: national law, provincial regulations, and ministerial regulations
- Scope of applications: SOE, EJV with state owned equity, CJV with a SOE party; projects funded by international organizations and foreign government (Article 3)

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Tendering and Bidding law and regulations

- Model contracts
- Types of contracts: design contracts, construction contracts; materials and equipment procurement contracts; project supervision contract, tender agent contract, etc

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Tendering and Bidding law and regulations

Bidder's security deposit

- Not exceeding 2% total bidding sum or 0.8 million, whichever is less;
- Not exceeding 0.1 million for ground investigation or design contracts

Performance bond

- Performance bond or insurance policy for failure to perform contractual duties

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Tendering and Bidding Law and Regulations

Relevant provisions in the legal rules

- Minimum no. of bidders: ≥ 3 (Art. 28)
- Tenderor may appoint agent to act (Art. 12)
- Time and venue for opening bids (Art. 34)
- Verifying the seal integrity by public notary (Art. 36)
- Bid evaluation committee (Art. 37)
- Giving notice to bid-winner in 7 days (Reg. 47 GD)
- Signing contract with bid-winner within 30 days of notice of bid winning; Contract terms differing from tendering documents are unlawful (Art. 46)

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