

# LEHMAN BROWN

律華會計師事務所

International Accountants

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## "PEELING THE ONION - Part 7"

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### Internal controls in China

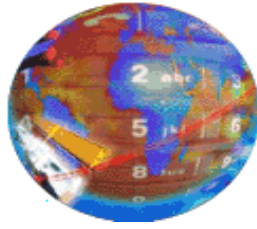
**Managing risk** is essential for positioning a company for growth in the current business environment. Yet as companies around the world clamber to implement integrated risk controls and measures in light of corporate meltdowns and terrorist concerns, many firms fail to pull the onions out of their own backyard in China before trying to harvest the profitable crops ... assuming they are still there!

A large majority of foreign enterprises with operations in China continue to rely on annual statutory audit reports and monthly accounting statements to monitor potential financial risks. Yet even in highly developed and mature financial environments, **reliance on such limited information has been proven to be ill-conceived**. The Enron debacle is a perfect case in point - the company was given a clean bill of health by the auditors and seemed financially stable based on statutory financial statements, yet the material business risks of the company's concentration of revenue flows and extraordinary profits which caused the collapse were not even properly examined.

As management accountants will poignantly argue, only by "evaluating factors such as quality of revenues, relevance of costs and accruals, quality and relevance of assets and liabilities, capital adequacy and structure and major projects" can a comprehensive enterprise risk management assessment be made. Such factors are not necessarily published in statutory reports and, thus, such statements can potentially be misleading as to the true health of a business.

Further clouding the validity of financial statements and accounting reports in China is the current business and professional environment. With the **new Accounting System for Business**

**Enterprises expected to adversely effect company profits** (including Foreign Invested Enterprises), taxation bureaus cracking down on avoidance and noncompliance, and with regulations on foreign exchange and treasury management relaxing, companies now, more so than ever, must fully understand the new risks in the China marketplace affecting their business.



### **Business environment driving professional direction!**

The current environment in China epitomizes the precise reasons why measures such as internal audits (IA), management system compliance, business reviews and extra internal controls are **becoming a fundamental aspect of surviving and being profitable in China.**

Due to a whole variety of reasons a company often becomes very 'blinkered' and often does not have the resources or expertise required to review existing internal processes and procedures. As a result there are often many areas in a company which can possibly benefit from greater integration and system/process improvement. The most influential factors in China creating this lack of efficiency and integration at present include:

- **Cost pressures and expense cutbacks** - Many companies have frozen headcounts, slashed budgets and wound back corporate spending globally. This has seen a push for localization of staff in China, reliance on junior (inexperienced) staff and a cutback in non core-business services (e.g. finance and legal). As such many companies are not streamlining core business operations and implementing cost savings due to process improvements.
- **Boom in M&A activity** - A surge in M&A activity attributed to an easing of industry restrictions, sales of SOEs and a more sophisticated stock market is causing many companies to operate fragmented businesses and not capitalize on synergy savings and cost efficiencies.
- **Increased dependence on technology** - Companies in China have spent large amounts of money on Enterprise Management Systems as part of their growth strategies yet surrounding processes have not been re-engineered to drive such efficiencies.
- **Opaque corporate governance** - A lack of a comprehensive legal and accounting framework, as well as unclear government directions, mean that corporate governance standards and professional ethics are only just beginning to be developed and put into practice.
- **Underdevelopment of professional bodies and services** - Professional bodies such as the Chinese Institute of Certified Public Accountants (CICPA) and the China Law Committee have only been in existence for a short number of years. As such they have limited control over professional ethics and regulatory standards which are enforced by government legislation.
- **Rapid changes in regulations** - Development of the new accounting system, changes to the taxation system and filing procedures, developments of industry regulations and WTO commitments have meant that firms are continually grappling to understand the rules and regulations effective in China.

Given the above issues, there is burgeoning gap appearing in the relevance of traditional external and internal audit functions. This has seen **greater risks for companies** to ensure compliance (financial, legal and tax) and also a growing need for company risk assessments to cover both financial issues and a comprehensive business analysis. Where as a financial auditor will usually simply cross check and reference invoices, receipts, cheques and other such 'supporting documents', an IA will review the business as a whole and identify key areas of risk and possible weaknesses in control systems accross all business functions.

In recognising such problems, the Chartered Institute of Management Accountants (CIMA), in late October 2002, submitted a proposal to the Hong Kong government calling on the government "to impose on listed companies, the need to conduct Independent Business Risk Reviews and publish Management Accountant's Reports annually." Such reviews and reports would be conducted in a similar manner to internal audits **"with the aim of enriching existing statutory statements with an additional opinion on whether the reported state of company affairs carries exceptional material business risks."**

The body has also submitted the same proposal to the China Securities Regulatory Commission so as **"to promote good corporate governance in the Mainland"** and restore investor confidence. Mr. Albert YK Law, CIMA Vice President (Hong Kong), notes that these measures will surely "reinforce investor protection, speed up development of financial market, assist China in her integration with other financial markets after entry into WTO, and **facilitate mainland enterprises in tapping funding at more reasonable costs.**"



### **The changing face of internal audits!**

Internal Audit was once simply the domain of financial accountants and auditors concerned only with providing a "watch dog" function. However, nowadays companies need to understand the risks inherent in their industry, the market and within their entire business, as well as identifying areas for process improvement, enhancing revenue, generating cost savings and exposing areas of weak internal controls. As Bill Connell, Chairman of the IFAC's Financial and Management Accounting Committee and Director of Risk Management at BOC once explained:

*"Corporate governance has made risk management very topical, but you cannot go through the risk management process for those reasons. **You have to do it because it helps the business.** If you go through the process ... for corporate governance reasons you simply end up with bureaucracy"*

To facilitate this process and extrapolate the benefits many companies are currently looking to **out-source their IA and business review functions to external consultants**. Professional advisors often provide a "new set of eyes" to the company's problems, offer a greater level of understanding of the corporate environment and also bring to the table experience and best practice across all business functions - from finance, accounting, legal, IT, supply chain management etc.

In the P.R.C. these reviews are imperative. Companies must have the appropriate financial systems

and internal regulations to retain control over the company's day-to-day activities and mitigate any financial and business risks. Given the place of relationships in business practices, along with the above-identified factors, such risks are inherent in all aspects of business in China, and are particularly prevalent in the following areas:

- **Procurement and Supply Chain Management** - Many companies do not adequately control procurement, inventory utilization and disposal of inventory.

Common problems include purchasing of overpriced raw materials (usually through a company related to a member of staff), discrepancies of bills of lading and goods received, improper storage of raw materials and safeguarding of inventory, sales of goods at/below cost to related parties, and illegitimate disposal of scrap materials and containers.

- **Sales and marketing expenses** - Incorrect accounting for such expenses incurred by China Holding Companies and Headquarters (severe tax consequences), unauthorized and illegitimate reimbursement expenses, "fake" official invoices and false transfer pricing agreements.
- **Corporate compliance** - unauthorized and incorrect tax registration, under-reporting of tax liabilities, unauthorized use of company chops, and payment of Representative Office expenses by offshore entities without correct accounting and taxation payments.
- **Human resources/payroll** - deliberate over-accrual of company welfare benefits (not in line with government requirements), unauthorized use of staff benefit funds, ghost employees, discrepancies between contract salary and payroll salary payments.
- **Provisions and accruals** - over-provisioning to create "slush" funds, lack of company policy and/or experience for accruals for bad debts, lack of company policies.

This is certainly not an exhaustive list of all risk areas in the P.R.C. Thorough internal audits and business reviews directed at the above issues do, however, provide an additional level of analysis to complement financial statements and often raises serious issues that management is unaware of.

Where as statutory audits tend to be historically focused in nature and only centered on financial figures presented, internal audits and business reviews are aimed to provide strategic and proactive management recommendations focused on improving company performance primarily through process improvement and, in China particularly, **identification of fraudulent and corrupt behaviour.**



### The final word

To safeguard investments in China, many experts recommend that companies conduct **comprehensive reviews of financial system controls and the general financial control environment** on a regular basis. Similar reviews have resulted in companies identifying serious breaches of control and well-hidden business risks. Rectification and management of these issues almost always provides the company with a competitive advantage of sorts, and almost always adds to the corporate bottom line.

As the face of business in China develops and advances, companies are under greater cost cutting pressures and face a more competitive environment. Whilst some companies look to cutback on the fertilizer and water to grow their crops, **the smart companies may consider pulling the onions out before they reap the fields.**

*Cameron Hume, LehmanBrown, Beijing*

### **Special Seminar Opportunity - "Accounting System for Business Enterprises"**

LehmanBrown China is pleased to announce a seminar to explain the inner workings of the new "Accounting System for Business Enterprises". The seminar will be held in Beijing from

**December 18-19th.**

These seminars present an opportunity for bookkeepers, accountants, financial managers and directors, as well as other interested parties, to get up to date on the changes and application of the new Accounting System for Business Enterprises in China which is mandatory for all companies in China from January 1, 2002. With the crackdown on taxation, especially for FIE companies, currently underway this seminar is integral for anyone preparing, interpreting or using financial statements in the P.R.C.

The seminar will also cover certain topical business issues in China at present including changes to taxation regulations, FOREX regulations and other issues applicable to FIEs in China.

**For registration** information visit: [www.lehmanbrown.com/Seminars.htm](http://www.lehmanbrown.com/Seminars.htm) or for phone registration call: **Rachel Wan, Tel: (86 10) 8532 1720** today.

Space is available for a maximum of 15 participants at the 2 day seminar, so be sure to book early.

*"Peeling the Onion" is a series of newsletters designed to assist in the financial and accounting control of your China operations. We would love to hear what issues you would like to know about in coming articles, so please contact us with any questions."*

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