

Internal Auditing in China

June 2008

Agenda

Introduction to China
Internal Control Risks
PwC China Solutions
Q & A

PricewaterhouseCoopers in China

Our speakers today:

Duncan Fitzgerald, Hong Kong

Cimi Leung, Guangzhou

Stephen Ducker, Beijing

Jasper Xu, Shanghai

Mark Lange, Shanghai



12 offices in China. Our SPA locations are marked with a ★.

PwC in China

The leading professional services firms in mainland China, Hong Kong and Macau with over 9,000 people, including over 330 partners.

A fully integrated internal controls practice with over 500 specialists.

Accomplished in working with our clients to deliver the solutions that help them take on the challenges of our rapidly and ever-changing business environment.

China is one of the fastest growing markets in the world

GDP has grown at an annual rate of 9.5% for the past 3 decades

In 2007, USD1.5 billion was invested weekly by foreign entities.

In 2007, the foreign trade surplus was USD262 billion.

China Accounting Standards are very close to IFRS

The growth of Chinese companies is astounding. Did you know that?

The growth of Chinese multi-nationals is allowing them to stockpile cash which eventually will be used for acquisitions of companies around the world.

Only 11% of sales are currently sourced from outside China, compared to 44% for the typical multi-national company.

Chinese companies invested over USD19 billion in foreign companies in the first quarter of 2008 alone.

“China’s companies are on the cusp of a major period of foreign expansion.” - The McKinsey Quarterly, May 2008

China is different

There are many significant and unique internal control risks doing business in China. This section summarises some of the most important risks that you should consider when designing an internal controls system, performing a risk assessment or planning an internal audit. Some of these risks can lead to severe issues for companies, such as violations of the US Foreign Corrupt Practices Act.

Revenue, Credit & AR Management

Credit terms/limits granted to customers that are not properly evaluated

Unauthorized credit limits accepted

No formal sales contract review resulting in unfavourable contract terms

Orders are accepted at unauthorized discounts

Revenue is recorded for goods or services that are either unauthorized and/or not shipped or provided

Revenue is not recorded for goods or services shipped or provided

Improperly calculated and reported AR aging statistics

Debt collection efforts not effectively monitored and/or lack of accountability over AR collection

Unauthorized bad debt provisions and write-offs

Unauthorized sales commissions paid to employees or friends

Poor choice of distributors leading to erosion of sales prices and revenues

Disbursements & Vendor Qualification

Bribery to/by company purchasing personnel not detected and/or reported

Competitive bidding process not in place

Unqualified vendors selected resulting in higher costs and/or poor services

Lack of formalisation of purchasing contracts resulting in fraudulent behaviour

Unauthorized purchase orders

Acceptance of terms unfavourable to the company

Improper payments to unauthorized or fictitious suppliers

Invalid, incomplete and inaccurate receipts received

T&E transactions not effectively monitored

Human Resource and Payroll Management

Incorrect/unauthorized information in the payroll master file, including employee name and salary resulting in inappropriate payments

Undetected intentional or unintentional payroll processing errors

Unauthorized and unusual payments may be made and funds may be misappropriated

Lack of performance contracts may lead to uncertainty of legal obligations and increased risk of disputes

Understated social welfare contributions (lack of compliance with social security regulations)

Financial Reporting

Complex company structures results in increased risk of accounting errors

Accounting policies misunderstood or inconsistently followed by company accounting personnel

Lack of qualified accounting personnel and knowledge of local and international GAAP

Improper and/or untimely account cut-offs resulting in inaccurate financial information

Excessive use of spreadsheets results in intentional or unintentional accounting errors

Lack of fundamental IT general controls

Tax

Lack of adequate personnel to understand and handle the daily practice of tax compliance due to turnover, changes in rules and interpretation by local tax officials, and changes in the business model

Lack of awareness of unwritten common taxation practices which vary depending on location

Incomplete documentation for both direct and indirect tax matters, especially contracts and invoices

Lack of support for inter-company charges (i.e. transfer pricing).

Complex company structures creates a web of cross-charges often lacking adequate documentary support

Undefined policies regarding responsibility of individual income tax filings for expatriate employees results in inappropriate payments made for tax equalization and protection claims

Customs/duties--linkage/review of decisions taken by logistics personnel that potentially have tax consequences.

Cash Management

Lack of segregation of duties

Bank reconciliations not properly prepared and reviewed

Authorization over cash transactions not enforced

Lack of adequate safeguarding of large amounts of petty cash

Poor management of foreign exchange exposure

Ethics & Fraud Prevention

Unclear organization structures and reporting lines

Improper or unethical employee behaviour may not be recognised and/or reported

General managers can easily override internal controls without being confronted by employees

Lack of fraud awareness for analysis and reporting

Non-compliance with laws such as the US Foreign Corrupt Practices Act

Local Partner Audits

Many multinational companies have some type of contract with a local Chinese company to sell and/or distribute products.

Many forms including licensing, agencies, joint ventures, distribution agreements, subsidiaries, etc.

The structure of the agreement may include remuneration in many forms including sales commissions, a percentage share of revenue, gross margin or net income, a fixed return based on cost, etc.

Each type of agreement and payment method has unique risks associated with it.

Local Partner Audits

These business relationships create special risks that may not be well understood by the multinational company

Mis-alignment of goals and objectives, weaknesses in internal controls due to differences in culture and management philosophy, etc.

If these risks are not properly addressed, it could result in the venture being inefficient and under-performing.

Local Partner Audits

PwC provides a special type of internal audit designed to assess these risks. Our internal audit services are especially attractive to those companies who are looking to:

- Achieve timely and accurate financial and management reporting
- Assess and improve internal control
- Establish and reinforce standards of corporate governance and compliance
- Safeguard assets
- Improve revenue and reduce costs
- Control reputational risks

Local Partner Audits

Our internal audits of local business partner relationships are customised to the needs of our clients and the risks inherent in the relationship under audit. We provide our clients an independent review that is performed by experienced bi-lingual staff with knowledge and respect of the local culture and business practices.

Local Partner Audits

Our procedures include the following:

- Risk assessment
- Fraud risk assessment and fraud testing
- Tone at the top and code of conduct compliance
- Contract compliance
- Revenue recognition
- Inventory control
- Expense audits
- Management reporting
- Intellectual property
- Information systems and data security

Local Partner Audits

Recent projects we have performed include:

- For a European automotive company, conduct a full internal controls review of their Chinese subsidiary, including an assessment of the tone at the top and compliance with the parent company's code of conduct.
- For a US pharmaceutical company, conduct a review of their Chinese sales agents and distributors to determine their extent of knowledge of the company's code of ethics, review the internal controls that apply to the code of ethics, and examine evidence concerning specific contractual terms regarding business licenses, inventory control and sale of competitors' products.

Internal Controls Practice

Systems and Process Assurance

A line of service within Assurance

20 partners and over 500 staff in HK, Beijing, Shanghai, Guangzhou and Shenzhen

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Forensics Practice

Investigations and Forensic Services

Part of Advisory

Over 50 forensic specialists in HK, Beijing and Shanghai and
2 partners

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Questions & Answers

Please submit your questions
via the Centra software program
being used to hold this conference.

Just click on the button at the top of your screen:



Thank You!

The Beijing Organising Committee for the Games of the XXIX Olympiad has named PricewaterhouseCoopers as the Accounting Services Supplier of the Beijing 2008 Olympic Games

