



## Internal Auditing in China: Best practices for US companies



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## Leading today's discussion

<b>McGladrey LLP</b>	 <b>Frank Ji</b> National China Desk Leader  McGladrey LLP Chicago	 <b>Christina Ng-Tran</b> China Desk Leader – Consulting Services  McGladrey LLP Chicago	
	<b>RSM China Consulting</b>	 <b>Harley Dou</b> CEO  RSM China Consulting Beijing	 <b>Vincent Cai</b> Managing Director  RSM China Consulting Shanghai

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## Today's agenda

- **Top 10 Challenges in Doing Business in China**
- **Red Flags in Internal Controls for U.S. Enterprises Operating in China**
- **Leading Practices in Building a Sound Control Environment**
- **Strategies in Performing Internal Audits for China-based U.S. Enterprises**
- **Q & A**

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## Top 10 challenges in doing business in China

1. Human Resources Constraints
2. Corruption
3. Difficulty Enforcing Contract Terms
4. Lack of Transparency
5. Intellectual Property Rights Infringement
6. Inconsistent Regulatory Interpretation
7. Unclear Regulations
8. Bureaucracy
9. Tax Administration
10. Irregular Licensing Practice

(The survey conducted by AmCham during 2010 and 2011 for 322 U.S. companies operating in China)



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Red flags and common internal control weaknesses for U.S. enterprises operating in China	
<b>Procurement and supply chain management</b> <ul style="list-style-type: none"> <li>Falsified contracts/invoices</li> <li>Lack of competitive bidding process</li> <li>Purchasing of overpriced raw materials</li> <li>Discrepancies of bills of lading and goods received</li> <li>Improper storage of raw materials and safeguarding inventory</li> <li>Improper disposal of scrap</li> </ul>	<b>Sales and marketing</b> <ul style="list-style-type: none"> <li>Incorrect accounting of sales and marketing expenses</li> <li>Sales of goods below cost to related parties</li> <li>Payment of unauthorized sales</li> <li>'Fake' official invoices</li> <li>Unsupported consulting, sales, and marketing expenses</li> <li>Unjustified entertainment reimbursement</li> </ul>
<b>Human resources/payroll</b> <ul style="list-style-type: none"> <li>Deliberate over-accrual</li> <li>Ghost employees</li> <li>Unauthorized/improper reimbursements</li> <li>Discrepancies between contract salary and payroll payment</li> <li>Non-payment of taxes and social security</li> </ul>	<b>Provisions and accruals</b> <ul style="list-style-type: none"> <li>Over-provisioning to create 'slush' funds</li> <li>Lack of company policies</li> </ul>



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Key areas of focus for fraud prevention/loss mitigation	
<b>Legal</b>	<ul style="list-style-type: none"> <li>Legal establishment (position appointments)</li> <li>Business License &amp; Chops</li> <li>Intellectual Property</li> </ul>
<b>Financial</b>	<ul style="list-style-type: none"> <li>Electronic password</li> <li>Multiple company accounts</li> <li>Accounting checks and audits</li> </ul>
<b>Operational</b>	<ul style="list-style-type: none"> <li>Inventory control</li> <li>Recruitment &amp; payroll</li> <li>Purchasing, sales and distribution</li> </ul>



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## Leading practices for building a sound control environment

<b>Tone at top and corporate governance</b>	<ul style="list-style-type: none"> <li>▪ To set up a sound organizational structure (e.g. check and balance)</li> <li>▪ To develop leadership initiative and accountability system</li> <li>▪ To focus on "soft" controls</li> </ul>
<b>Knowledge and culture transfer</b>	<ul style="list-style-type: none"> <li>▪ To use cross-culture tactics</li> <li>▪ To find consensus and common ground</li> <li>▪ To change communication tactics</li> <li>▪ To build trust</li> </ul>
<b>Training</b>	<ul style="list-style-type: none"> <li>▪ U.S. regulations</li> <li>▪ Internal compliance</li> <li>▪ Company's culture and value</li> </ul>
<b>Whistleblower program</b>	<ul style="list-style-type: none"> <li>▪ Anonymity</li> <li>▪ Multiple ways to report</li> <li>▪ Repercussions</li> <li>▪ Resolutions</li> </ul>
<b>Documentation of business procedures and processes</b>	<ul style="list-style-type: none"> <li>▪ Detail and specification</li> <li>▪ Individual or department accountability</li> </ul>
<b>Integration of information system</b>	<ul style="list-style-type: none"> <li>▪ System compatibility between parent and subsidiaries</li> <li>▪ Process and management automation</li> </ul>



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Risks to be managed	
<b>Fraud, bribery and corruption</b>	
<b>Issues</b>	<b>Leading Practices</b>
<ul style="list-style-type: none"> <li>Compliance with the Foreign Corrupt Practices Act</li> <li>Facilitation fees and corrupt business practices</li> <li>Supply chain: vendor collusion, conflicts of interest</li> <li>Asset misappropriation: cash, inventory</li> <li>Fraudulent financial reporting</li> </ul>	<ul style="list-style-type: none"> <li>Anti-bribery controls</li> <li>Procure to pay reviews, general vendor controls, targeted vendor reviews</li> <li>Cash and inventory controls</li> <li>Process controls and financial statement close reviews</li> <li>Periodic unannounced audits to monitor control compliance</li> </ul>
<b>Agreements with joint ventures, suppliers and other partners</b>	
<b>Issues</b>	<b>Leading Practices</b>
<ul style="list-style-type: none"> <li>Cultural, value and standards differences (product safety, labor, environmental, others)</li> <li>Records not easily accessible and easy to falsify</li> <li>Restricted right to audit</li> <li>Intellectual Property: counterfeiting, gray market, trade secrets</li> </ul>	<ul style="list-style-type: none"> <li>Involvement of risk control professionals at contract development stage</li> <li>Operational controls that reduce product, brand and reputational risks</li> <li>Periodic unannounced audits to monitor control compliance</li> <li>Clearly define scope of "right to audit" beyond "books and records"</li> <li>Contract protection, controls reviews, and acting on infringement</li> </ul>

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Risks to be managed	
<b>Information technology</b>	
<b>Issues</b>	<b>Leading Practices</b>
<ul style="list-style-type: none"> <li>Local application of home-market information technology</li> <li>Ability of enterprise IT to support compliance with local, home-market and global financial and operating standards and practices</li> <li>Vulnerability of misappropriation or inappropriate use of IT assets</li> <li>Technical and program management skills required to effectively execute major IT capital programs</li> <li>Availability/sustainability of locally-managed information technology</li> </ul>	<ul style="list-style-type: none"> <li>Define standards for locally-managed IT, use of home-market technology, information access and utilization, and work with local partners to determine how best to comply</li> <li>Analyze and fill gaps in the home-market IT function required to support operations in emerging markets</li> <li>Limit local access to non-essential home-market information and apply stringent security/privacy practices to information made available</li> <li>Incorporate globally accepted third party reporting standards and right to audit into service agreements with local providers</li> <li>Evaluate adequacy and efficiency of IT expenditure plans and strengthen controls to improve IT capital program execution (schedule, cost, value)</li> </ul>

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## Risks to be managed

### Tax

#### Issues

- Tax rules vary by jurisdiction, are not well documented, and are subject to inconsistent interpretation
- Frequent changes to tax and accounting laws
- Incorrect transfer pricing as well as customs/duties arrangements
- Incorrect and incomplete compliance reporting
- Misalignment between head office and local tax authorities

#### Leading Practices

- Local tax advisors working closely with headquarters tax team
- Formal tax risk assessment by country and key processes, policies, controls and procedures documented for tax risks
- Maintenance of a registry for current and prospective regulatory changes, by country
- Close interaction between Operations, Legal, Finance, HR and Tax
- Controls for documentation and consistent interpretation of tax positions



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## Strategies in performing internal audits for China-based foreign enterprises

### Challenges

- Language and culture barriers
- Cost and time constraints
- Lack of trust between parent companies and its China subsidiaries

### Strategies to consider

- Extension of risk assessment for China operations
- Multi-disciplinary audit approach (e.g. outsourcing, co-sourcing, or hybrid)
- Development a collaborative tie with local management

## Our solution: Diagnostic review

RSM Diagnostic Review for China Operation uses a structured, consultative - but snapshot - approach to analyze “What Could Go Wrong” with our clients’ China operation. We then blueprint longer term enhancements to warrant sustainability and continuity on the existing operations.

### As a result of engaging RSM China Consulting to undertake this assignment, the expected outcomes include:

**Current state:** We will work with our clients’ China operation personnel to obtain an understanding of what’s going on in the areas of financials, operation, compliance, information technology and personnel and help our clients analyze the current strength and opportunities for improvement.

**Desired state:** We also work closely with our clients’ parent companies to deeply understand their expectation and strategic goals set for their China operation and in the meantime, using RSM leading practice as a framework, we define the desired state of their current China operation and hence the actions required to achieve that goals or meet the expectation.

**Recommendations & implementation road map:** Pertaining to the goals and expectation set for China operation, we identify “What Could Go Wrong” of various aspects that would adversely impact on achieving the goals or meeting the expectation. We will work with our clients to gain a consensus on a targeted action plan for moving China operation forward.



## Case study: Procurement

### Background

The client is one of the largest U.S. consumer product manufacturer (the Company) listed in the NYSE. The products were sold over 100 countries and its net sales of 2011 totaled \$817 million. One of the company's subsidiaries is located in China which supplies 60% of its products globally. In 2011, its China operation still maintained its 45% growth sales rate amid the downturn of global economy and became a top growing region in its global operation due to a strong demand of the local market.

### Triggering Factor

One of the employees in the China subsidiary reported through its global whistleblower hotline a possible fraudulent act of taking bribes and kickbacks committed by its head of procurement. The company's audit committee requested its corporate audit in the U.S. to have a full investigation of the incident and a report to the committee immediately. The director of corporate audit was aware that the investigation would involve a wide range of interviews and understanding of the existing system from both internal and external sources. In consideration of costs and timing and language and culture barriers, the director hired RSM professionals to facilitate the investigation fully.

### RSM China Consulting's Solution

- Interviewed more than a dozen of China staff to obtain the facts and evidence
- Through our local resources, examined the registration documents of its key vendors for legitimacy
- Identified key weaknesses for its procurement operations in relation to its vendor review process, bidding requirements, segregation of duties and responsibilities and system control
- Streamlined its procurement procedures and enhanced its policy
- Gathered key evidences and supports directed to the individuals responsible for the wrongdoing
- Provided a report with the facts and improvement opportunities



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## Case study: Revenue recognition

### Background

The client is a U.S. globally-recognized leading provider (the Company) of end-to-end, vertically-integrated global supply chain services through designing, building, shipping and service a complete packaged product for OEM customers. The sales revenue of the company traded in the NASDAQ reached \$35 billion in 2011 and among them, its China operation generated its 35% of the total sales globally.

### Triggering Factor

In 2011, the company launched its global review of revenue recognition as a result of the incidents occurred in its global regional offices in connection with non-compliance of U.S. GAAP rules pertaining to revenue recognition (e.g. VSOE). The incidents exposed the Company a great risk of being fined by the SEC for overstating the revenue and adversely impacted the value of its traded stock. The international controller's office hired RSM China Consulting to perform a full review of its China revenue recognition process and subsequently identify any non-compliance incidents occurred.

### RSM China Consulting's Solution

- Through our analysis and examination, identified a number of revenue items being backdated and lacked customers' confirmation
- Found a few incidents pertaining to a possible collusion of the sales staff and distributors to manipulate returned items in taking advantage of the sales incentive scheme
- Identified the process improvements of revenue recognition by setting up a checklist on line and approval process in its existing ERP system
- Provided a U.S. GAAP training pertaining to revenue recognition



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## Case study: Inventory management

### Background

The client is a U.S. leading heavy machinery manufacturer (the Company) traded in the NYSE. The Company finished 2011 with revenues of \$335 million. During 2011 and 2010, approximately 63% and 58%, respectively, of its sales were to customers outside the United States, principally in Europe and China. Revenues in China increased 67% in 2011 compared to the prior year.

### Triggering Factor

Due to the nature of the business, the company carries a significant amount of inventory for both raw material, work in process and finished goods. In addition, the inventory items for raw material consists of thousands of different parts, steel plates and tubes and bars. Therefore safeguarding and existence of inventory become a challenging aspect of its operational management including physical inventory. Its corporate controller's office noted that in the past years, the variances of inventory cycle count were unreasonably low at its China subsidiary given its amount of inventory and thousands of types of items. The controller hired RSM China Consulting to perform an inventory existence review and expected improvement opportunities pertaining to its cycle count process.

### RSM China Consulting's Solution

- Identified significant control weaknesses related to unauthorized access to the inventory database, inappropriate calculation of inventory variances, incomplete inventory cycle count, etc.
- Identified more than a million of dollar value of uncounted inventory items
- Documented the entire inventory flow process including receipts, dispatch, transformation and scraps
- Submitted a report with a dozen of improvement recommendations

## Who to contact with additional questions

### In the United States

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