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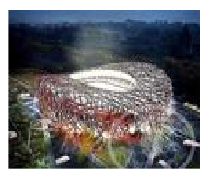

China Newsletter - March 2013

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Audit Evolution In China

Over the past several years working in China, we have witnessed a marked evolution in the practices employed by auditors in auditing Chinese companies. Many of these changes were brought about in direct response to repeated accounting frauds perpetrated by Chinese companies – Sino Forest Corporation and Longtop Financial Technologies are two of the most commonly referenced – but just as many reflect the education of audit firms operating in China.

When the Chinese listing and reverse merger boom began to heat up in the mid-2000s, not all of the audits were being performed by Big 4 firms with an established presence in China. In fact, a substantial number of audits of Chinese companies listing in the United States were being performed by smaller US-based firms with no presence whatsoever in China. It was common practice for such firms to outsource most, if not all, of the onsite work to local Chinese firms with Chinese staff who spoke and read the local language. While the audit program would be designed and supervised by the US staff, their lack of understanding of local customs and Chinese business practices led to many of the audit problems that we saw arise in this sector. Many of these firms would apply boilerplate US-type audit procedures in order to "check the box" that a particular procedure had been completed, without giving much consideration to the complexity of the

Chinese fraud machine.

As these firms went through multiple audit cycles and became more familiar with Chinese accounting and business practices, their procedures have begun to evolve. There are several areas where, in our experience, Chinese audit procedures have changed considerably over the past several years:

1. **Bank confirmations**

In the US, bank information (principally cash balances, but also information regarding loans, lines of credits, interest rates, etc.) has historically been independently informed by the bank through a mailed confirmation. The confirmation is prepared by the company (in order to authorize the bank to complete it), mailed directly by the auditors (in order to maintain control of the document and insure that it is mailed to the bank and not another address), completed by the bank, and returned directly to the auditors. This is a time-honored confirmation procedure, with low instances of fraud due to the severe criminal penalties that would be imposed on a company or bank representative attempting fraud. Bank addresses can be easily verified by the auditors, and a simple follow up phone call to the bank's main number can confirm the employment of the bank employee completing the confirmation. Bank statements provided by the company to the auditors are generally assumed to be valid, and most can easily be visually verified. Transactional data during the audit period is verified to these statements.

In China, this type of confirmation procedure is highly unreliable, since most Chinese CEOs are very close with the manager of the local branch of their bank. Companies that are large or prestigious enough to go public in the US have a much higher likelihood of being a prominent client of the bank. If the company is perpetrating a fraud, it is not unlikely that an influential CEO could convince the bank manager to falsify the confirmation. This is even more likely when the confirmation is prepared for a non-Chinese entity like a US audit firm, which the bank manager would perceive as having little or no authority in China. The value provided by the relationship with the CEO is perceived by the bank manager to be greater than the risk of any enforcement by the foreign audit firm, especially if the bank manger need only complete and mail a falsified confirmation without ever having contact with the auditors, as

opposed to creating an entire fraudulent set of bank records or having to answer questions in person. If the auditors were to receive and rely on a fraudulent confirmation, this not only falsely confirms the ending cash balance, but also all of the cash transactions during the period reflected on the bank statements provided by the company. This is the most critical issue, as we have seen more than one Chinese company create their own set of counterfeit bank statements, with fake chop and all, to match their fake set of books. Nearly any type of fraud designed to inflate sales or income will eventually wash out in the cash accounts, so it is critical for the auditors to start with a totally reliable, independently corroborated set of bank statements.

As audit firms realized the weakness of this process, they began requiring in person bank visits by their staff. In our experience, it is now common practice for auditors to require an in-person bank visit for each and every bank account on the company's books. During these visits, it is common for the auditors to meet with bank personnel and have them print bank statements directly from the bank's computer system for the entire period under audit, for comparison to the statements provided by the company. They also confirm any lending facilities, and obtain bank copies of documentation regarding any such arrangements. For accounts that have online access, the auditors will also logon to the banking system using the company's access codes, verify account balances, and download available statements.

These procedures make it much more difficult and complex for a lone bank manager to collude with a client and simply confirm the year-end cash balance on a mailed confirmation. It can also be a hindrance to performing audits of non-current periods, as branch banks rarely keep archived records of more than about 6 months worth of data locally. Archived statements for older periods must be requisitioned through a time-consuming application process to the bank headquarters. This archiving process, which is common for every bank we have worked with in China, can act as a major hindrance when performing multiple-period audits.

2. Customer procedures

Another area where audit procedures have become notably more thorough is in the area of customer confirmations. Similar to bank confirmations, in the US

common practice calls for mailed confirmations of accounts receivable ("AR"). Auditors will make sample selections from the year-end AR listing, and mail confirmations to customers asking them to confirm certain information. This can be done by leaving a blank on the confirmation and asking the customer to fill in the information (such as period end balance owed to the company and purchases made from the company during the period) from their records, or by providing the company's balances in the confirmation and asking the customer to confirm. The mailing process is controlled by the auditors to insure independence.

However, like mailed bank confirmations, this approach proved to be riddled with problems when employed in China. The first set of problems occurs when the customer actually exists. The auditors are seen as outsiders, and any request they make for information is usually trumped by the relationship between the company and the customer. Especially for small businesses in China, a confirmation from a US auditor means nothing. They likely will not even understand what it is for, let alone hold any respect for its purpose or the audit firm. It is very common for a customer, especially an important one, to immediately call the company upon receipt of the confirmation and ask how the company would like it to be handled; in other words, what balance the company would like the customer to write on the confirmation.

The mailed customer confirmation becomes even more problematic when the customer is not real. There are many types of customer fraud that can be perpetrated, but common versions in China include making shipments to fake customers and recording revenue, or shipping products to real companies that are friendly with the CEO with the understanding that the customer will never actually pay for the goods. Mailing a customer confirmation is ineffective in both circumstances. If the customer is bogus, then the company will provide an address to the auditors such that the company, or someone they trust, will be on the receiving end and will complete and return the confirmation to the auditors' satisfaction, often using a counterfeit chop that can be purchased fairly easily in China. If the customer is real but not actually purchasing the goods for use or resale, then they will likely have made an arrangement with the company to complete and return the confirmation, and since they are a legitimate

company they simply apply their chop.

The problem with these types of frauds is that, eventually, the customers have to pay their bill or the receivables will start to age past reasonable levels, the auditors will require large bad debt reserves, and will become suspicious of irregular accounting practices. But by that point the damage is done, and many questions are raised about the procedures that were followed by the auditors. As auditors have grown wise to these practices, they have begun to employ additional tactics to "confirm the confirmations," or verify the existence of purported customers.

Probably the most common countermeasure taken by audit firms is to perform in-person customer interviews, rather than mailing confirmations. The ideal scenario is to interview the customer at their place of business, so the existence and scope of their business can be visually verified, and the employment and position of interviewee (who would be the person responding to the mailed confirmation) can be confirmed. It is usually logistically impossible to perform these types of interviews for all customers, so many are performed over the phone or at the company's offices, so at least an independent person is available to answer questions and confirm information about the company.

Another common method is for auditors to corroborate the existence, scope, and physical location of the customer. Auditors can use a variety of methods, including (i) looking up the customer's address that is registered with the local administration and commerce office, and comparing it to the address in the company's records, (ii) performing online searches for customer websites or other independent online information about the company, and (iii) physically visiting the registered address, the address in the company records, and the address to which a confirmation is mailed and determining whether the customer actually exists and carries out business there.

In addition to strengthening their procedures surrounding customer confirmations, auditors also focus substantial efforts on the bad debt reserve. In audits around the world, auditing the bad debt reserve is usually a touchy process, as the reserve amount is wholly subjective and usually represents one of the most significant management estimates encountered in an audit. However, in China, it can be even trickier. There is generally little in the

way of empirical industry-relevant collection data on which to base a reserve. In addition, the collection process in China is not as regimented as it is in the US. Stated payment terms and actual collection cycles are often longer in China than in the US. In some cases there are no payment terms stated in the purchase contract, and in other cases the payment terms are unreasonably long. Quantifying the reserve can be difficult, and there are often serious disagreements between management, who want to avoid taking what they view as unnecessary charges to earnings, and the auditors, who are typically much more conservative and don't want to underestimate the risk of bad debt.

3. Government relationships

Government relationships are critical to almost every aspect of Chinese business, from obtaining initial licenses and approvals to start a business, to business referrals, to financing in the form of loans, subsidies, and tax incentives, and everything in between. When many US firms began to audit Chinese, companies, they often did little in the way of interacting with government officials, except in cases where a company transacted business directly with a government office. And as with banks and customers, the procedures often consisted of a simple mailed confirmation, asking the official to confirm information that was provided in the confirmation letter from the company's records. Because the CEO often had a close relationship with the government official in question, getting their signature or chop on the letter was usually not too difficult.

However, in recent years we have noticed that auditors have become much more probing in their inquiries with government officials. First, we have noted that it has become more common for auditors to meet in person and have a Chinese speaking staff interview the government official, so that the auditors are able to probe more deeply into areas where red flags are raised. The auditors will also often have the official sign a confirmation letter in their presence at the end of the meeting to provide hard documentation of the discussion.

Additionally, auditors are much more careful about the presentation of the letter. We have experienced instances where a government office has provided a confirmation letter on unofficial letterhead, or has used an unofficial chop, because they do not want to risk their political capital by

officially confirming or endorsing any transactions, whether legitimate or not. In a country rife with political and economic fraud, it is often better for the official to keep his head down, rather than stick his neck out on behalf of a CEO. Auditors are much keener to the intricacies of how the letter should be presented, and often require that the letter be hand delivered by the government official to their staff, at the government office. They can even go as far as requiring identification from the government official to confirm his identity.

4. Taxes

Taxation is another area that has been the source of problems for Chinese companies listing in the US. It is commonly understood that most privately-owned Chinese companies under-report revenue and income to the government tax bureau, in order to lower their value-added tax (VAT) and/or income tax liability. It is essentially a requirement to operate profitably, since it is difficult for most companies to compete on price if they are paying their full tax bill (or in the case of VAT, reporting and passing along the full amount of VAT to their customers) when their competitors are not. Taxes are collected at the local branches of the tax bureau, and the officials at that office generally have an arrangement with business owners in the area with regard to how much tax they must pay to stay in the good graces of the tax office. As a result, the sales and income reported on the companies' VAT and income tax returns filed with the tax bureau were substantially lower than those reported in their audited financial statements.

This creates a major audit issue in how to deal with past unreported tax liabilities. In theory, if a company underreported tax liability since it was formed, then tax liability should be accrued back to its inception date (or date that any applicable tax holiday expired). For companies with some operating history, this is usually a prohibitively high number because of unpaid VAT. In order to avoid paying VAT, companies sell goods to their customers without issuing government invoice that captures the sale for VAT purposes. However, if a company is selling VAT-free they also must buy their raw materials free of VAT in order to maintain their margins, and so they cannot deduct the input costs from their VAT liability as a fully reporting entity could. So they end up having to accrue the VAT rate (usually 17%) on the full value of under-reported sales. This is usually a very large number, large enough to be a non-starter for a financing

transaction.

To avoid this issue, many companies would obtain a waiver letter from the local office of the tax bureau, stating that the company was in good tax standing and did not have any unpaid tax liabilities. Because the tax bureau is a government entity and a branch of the national tax bureau, these types of letters were accepted by many audit firms. The company would agree to fully report its taxes going forward, and the auditors would audit the ongoing tax returns accordingly. The problem with this approach is that the local tax bureaus do not have the authority to waive tax liabilities. Tax incentives and waivers can only be issued at the central government level. While a local tax bureau waiver may be effective in practice, since the local tax official issuing the letter would be unlikely to impose any collection actions against the company as long as he's in charge, it carries no formal authority.

As Chinese listed companies became more popular, the discrepancy between the past tax returns was exploited by short sellers, who would publish articles noting the substantial differences between audited sales and income in the companies' financial filings and their government filings (certain non-tax government filings, such as annual reports required to be filed with the local industry and commerce bureau, are publicly available; tax returns are not public in China, but industrious short sellers figured out how to pay for them). The discrepancies were often related to audit years prior to the companies listing in the US, as it was common for companies to discontinue these practices once public.

As this issue became much more visible, auditors tightened their procedures in response. Additional steps that they required included obtaining a tax opinion from a reputable international tax firm addressing the legitimacy of any waivers or incentives, requiring any waivers to be issued from the central government (which in essence was impossible), requiring accrual of the liabilities altogether, and/or requiring substantial additional disclosure in the footnotes about the nature of any waivers or incentives and any related contingent liabilities such as penalties or interest.

5. Supervision of the engagement

Another significant all-around change that we have experienced in dealing with audit firms in China is

that they have better staffed their engagements. A substantial part of the change has been driven by the Public Company accounting Oversight Board (PCAOB), the organization that regulates public company audits and auditors. The PCAOB took action against several small firms and even some sole practitioners for allowing foreign subcontractors to plan and perform audits of public companies without proper supervision or documentation of their work and findings.

This drove many smaller firms out of the China segment, and those that stayed took action such as (i) employing Chinese-speaking staff in their US office to supervise engagements, (ii) becoming more actively involved in the planning of the audit engagement with the local firm, (iii) sending staff to China to supervise fieldwork, and (iv) requiring more extensive documentation of procedures performed by the local firm.

More recently, the Chinese affiliates of Deloitte, Ernst & Young, KPMG, PwC and BDO were charged by the SEC with violating the US Securities Exchange Act and the Sarbanes-Oxley Act for not providing access to their audit workpapers of US listed clients. While this action is far from being resolved, the level of scrutiny that these audits are under has forced audit firms to constantly evaluate the staffing, oversight, and audit procedures that they employ on Chinese companies listed in the US.

If you have any questions please e-mail them to info@thornhillcapital.net

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