Internal Controls in China – an Often "Under-Looked" Success Factor!

Mike Corkran
CEO, China Centric Associates

Consider the following two scenarios: The local General Manager of a U.S.-owned China company forms a trading entity to redirect the Company's purchases of production materials through his trading company. This leads to a siphoning of Company margins to the General Manager, that otherwise would have resulted in lower Company costs. At a second un-related U.S.-owned China company, the Chinese General Manager coordinates with the purchasing manager to arrange "facilitation payments" from suppliers to their personal bank accounts. These are unethical actions by both Western and Chinese standards of conduct, but unfortunately these situations are not uncommon in China. The good news is that these problems are completely avoidable.

It would be easy to blame the offending Chinese General Managers, but the reality is not quite so simple. Neither U.S. parent company proactively installed appropriate policies and practices that would have set clear behavior and control rules which likely would have prevented the offending actions.

Internal Control in China

Internal control is NOT limited only to the finance department. Internal control is the overarching process and practice of defining, monitoring and controlling employee behaviors to assure compliance involving: a) relevant regulations in China and the parent company's country; b) financial integrity; c) corporate conduct and procedural policies. Effective internal controls extend to essentially all functions of a company. It can be likened to a "closed-loop ecosystem" of interrelated company policies, documents and processes that manage and monitor employee behaviors, customized to each company's needs.

Installing an effective internal control process is complicated in China by a number of factors not encountered in a company's developed home environment.

First, the China cultural norms surrounding gifting and Guanxi, a system of social networks and influential relationships that facilitate business, introduce factors that are inconsistent with Western paradigms. For example, giving a cash gift to a supplier or customer is abhorrent by all Western standards. However, high-value entertainment such as lavish trips masquerading as business meetings, golf outings and skyboxes at sporting events are not considered inappropriate. In China, gifts in the form of cash do not carry the inherent negative as in the West. In the West, we see a cash gift as a bribe, but high value entertainment as relationship development. In China, smaller cash payments are generally considered customer relationship development. If a Western company wants practices in China to depart from cultural norms, clear policy and practices to the contrary must be documented and trained. Otherwise, default cultural norms will take over. In the second China case sited above, the U.S. company had no formal gift policy in China prohibiting cash payments, so local management deferred to local paradigms, and then abused this practice to extraordinary personal benefit and at Company expense.

Second, the average "Western-grade" experience level of Chinese management teams is far less developed than Western teams. China management teams do not start with a baseline of understanding of Western norms and expectations. In both scenarios above, the U.S. company made a false presumption that Western expectations were understood and internalized in local management processes.

Third, the China management teams assembled were new to their company, most were also new to the industry and they were all new to each other. None of them had previous exposure to the U.S. companies' management expectations, further compounded by the incomplete internal control systems installed in China by the U.S. parent company. This left too much discretion in the hands of local management. The results were highly undesirable to both U.S. parent companies.

Lastly, the fact that China 7,000 miles and at least 12 time zones apart from the U.S. parent company management creates other difficulties in daily real-time communication and frequency of direct management interface. Off-hour conference calls and quarterly business trips are poor substitutes for routine personal interaction. This geography challenge limits the direct oversight. This big challenge can be overcome with foundational processes and internal controls in the beginning at the startup of the China company.

In each of the real-world cases sited, none of the bad behaviors of local management can be condoned. Dishonest people exist globally, and business management must involve a level of trust. However, the prudent approach is proactive communication and management of acceptable employee behavior by U.S. management, through carefully structured and monitored internal control systems.

Four Levels of Internal Control

Effective internal control is a "company-specific" process at a detailed level and can be defined and structured within four general categories of standard policy and procedural documentation:

1. Articles of Association
2. Employee Handbooks
3. Quality Systems
4. Other Policy Documents

<u>Articles of Association (Corporate Governance)</u> – Every company is managed through a structure of shareholders, boards, officers and other key positions. The AoA is a legal document that defines the roles, responsibilities, authorities and accountabilities of each of these individuals or groups. The AoA also clearly defines the decision and approval authority chains for major activities of the company. In China, this document must be filed with the government as part of the business licensing process and any changes to the AoA must be refiled.

<u>Employee Handbook</u> – Establishing rules of employment and conduct with individual employees is an essential part of managing acceptable employee behavior. The employee handbook has many elements, but employee disciplinary processes which include consequences for non-compliance is an important element of effective internal control.

<u>Quality System (Quality Manuals and procedural functional practices)</u> – A company may or may not elect to obtain formal quality certification (e.g. ISO). However, installing a comprehensive Quality System across all functions is an important element of a complete internal control system. The Quality System includes a formal quality manual that is supplemented with Company-specific procedural documentation used to train and manage operational and administrative activities at a company. This package of documents defines acceptable process and documentation practices that feed the monitoring and management processes directly, providing transparency to key activities. If properly constructed, the processes defined in the Quality System provides separation of tasks and transparency in specific functions to minimize problem potential.

<u>Other Policy Documents</u> – Some critical internal control elements do not fit easily into the first three levels. For example, such documents as NDA's, Non-Compete Agreements, Conflicts of Interest Policy by individual employees or employee travel expense policies that generally focus on specific groups of employees and functional teams. These documents are often referenced in one or more of the first three levels but not always physically incorporated.

Summary

No internal control system can eliminate all potential exposures. Dishonest employees can cheat and circumvent the most structured and tightly managed internal control systems. However, in CCA's experience, many internal control problems are relatively innocent mismatches of expectations which are avoidable with formal start-up communication that is supported with process and control documentation.

There is only one chance to make a first impression with a new team. The importance and long-term value of investing the time and focused effort to install a foundational internal control process during the start-up of any China organization cannot be over-emphasized. The financial cost of this up-front investment is low compared to the exposure, but the payback is enormous. CCA advises that Western Companies prioritize that internal control investment starting a China operation of any kind, based on the concept of "Trust, but Verify!"