



Research on Issues in Cross Border Audits of Commercial Banks in China and Countermeasures

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Abstract

By analyzing the current situation of the cross border audits of the commercial banks in China initially, the author then reveals the issues in the cross border audits in this thesis. Finally, the countermeasures for such issues are listed in the effort to provide the commercial banks in China with recommendations in dealing with such issues.

Key words: Commercial Bank; Audit; Issue; Countermeasure

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1. CURRENT SITUATION OF THE CROSS BORDER AUDITS CONDUCTED BY THE CHINESE BANKING INDUSTRY

Since the State Council authorized the People's Bank of China (PBC) with the power and duty to audit and monitor the businesses and activities of financial organizations by deciding that the PBC shall perform the function as the central bank of China in September 1983, the financial auditing systems and methods have witnessed significant changes due to the reform on the financial system in China. With the advancing financial system and the business electronization, the development of the auditing

works of commercial banks could be divided into three stages:

Stage 1 (before the mid-1980s): Manual business processing. In this stage, the monopoly of the PBC was broken. The Bank of China (BC), the People's Construction Banks of China (PCBC) and the Agricultural Bank of China (ABC) were restored or established. The PBC both performed the function as the central bank and dealt with detailed financial businesses. Since there was no scientific business auditing system, the audits were conducted manually and aimed at the matching of the cash and accounts.

Stage 2 (mid- and late-1980s): Single machine business processing. In this stage, the auditing system was established gradually. With the using of computers in the banking industry, some banks developed the post-monitoring system, and began to establish the centralized post monitoring center with such processes as on-site data collection, analog accounting and result comparison checks.

Stage 3 (1990s to present): business network processing. The banking industry witnessed the development situation with data centralization, terminal distribution and universal cash saving and withdrawing. With the rapid development of the Internet, various financial products such as ATM, CDM, POS, phone bank, online bank and self-service terminals are widely used. The limitations in terms of time and locations are broken for the operations and businesses. The objects of the internal control have been expanded from the counter businesses to the open terminals. The management systems and operation technologies for audits have been improved, emphasizing real-time monitoring and control, auditing analysis and risk warning. Many electric auditing systems have become necessary auditing tools.

See Table 1 for the major features of each stage.

Table 1
Development of Auditing Works

Stage	Business Features	Working Principle	Auditing Focus	Major Auditing Method
Stage 1	Manual accounting	Simple calculation	Matching of cash and accounts	Auditing on files
Stage 2	Single machine accounting Computer accounting	Data collection, analog accounting and result comparison	Standardization of account processing and real-time monitoring	Centralized off-site auditing
Stage 3	Online auditing, universal cash saving and withdrawing, and real-time payment	Online real-time monitoring, and auditing analysis and early-warning.	Pre-control, and real-time comprehensive monitoring and controlling	Combination of off-site auditing and on-site auditing

The cross border audits of the commercial banks in China are still in the early stage. Compared to the developed financial markets in foreign countries, the commercial banks of China lag behind in terms of the internal control and auditing, which are mainly reflected in the following aspects:

(1) The ideological foundations and environments of the internal control and auditing are different

In the countries with developed financial markets, the management of banks has strong awareness of the internal control auditing, and they consider it as an important management ideology throughout the operation and the management works. For example, the banks in the United States consider the internal control department as a monitoring and control department that is independent from other business departments. The business departments of the head office of a bank will receive the auditing and evaluation actively without exception. The external environment of the internal control and audits is relatively loose, and it has become a common view to acknowledge, respect and perform the function of the internal control and auditing of the banks in the Western countries. The top management of a bank will attach great importance to and discuss preferentially the reports of the internal control and auditing.

In China, the ideological foundation and environment for commercial banks in supporting and understanding the internal control and auditing is quite different from the management requirements of the modern commercial banks. ① The commercial banks in China lack the comprehensive and deep understanding of the internal control and auditing; ② The traditional cultural environment and the ideology of ruling by people in China have hindered the management of the commercial banks.

(2) The main bodies conducting internal control and auditing are different

From the governance structure of the mature commercial banks in foreign countries we can see that a bank is organized by the asset contributors who, as the principals, will hire agents, the management of the bank, to operate and manage the bank. They will establish an economic contract relationship featuring the separation of ownership and operation right. The owner of the bank

will entrust the manager to manage the investments of the owner, which includes the management over the internal control. Most of the commercial banks in foreign countries will directly implement the internal control and auditing as the management activities of the shareholder meeting (the contributors).

In the commercial banks in China, the vague definition of the ownership and the information asymmetry of ownership and operation right in the actual utilization have led to the insufficient foundation for the internal control and auditing.

(3) The representations of independence of the internal control and auditing are different

To prevent the fraudulent conducts due to the improper operation and management activities of the departments and employees, the developed commercial banks in foreign countries will normally establish internal auditing organizations that are independent from other departments and directly reported to the top authorities of the banks.

In China, most of the commercial banks have established internal auditing departments. After the reform on the auditing system, the independence and authority of the auditing have been improved but are still not enough. A sharp contradiction has been formed between the duties of the auditing departments and their insufficient independence and authorities.

(4) The applications of the advanced technologies in internal control and auditing are different

With the modernization of the financial tools, most of the commercial banks in foreign countries have strengthened the applications of computers in the internal control and auditing to improve the methods of internal control and auditing.

The commercial banks in China have fully recognized the importance of the scientific operation tools and methods, and are making large investments to update management facilities and improve control methods. However, how to control the risks accompanying the high technologies has become a new challenge to the internal control and auditing. In fact, we are still exploring the internal control and auditing for the bank card business, e-bank businesses, the accounting business analysis system and the credit management and analysis system.

(5) The information communication channels and methods for internal control and auditing are different

To achieve the harmony of works and communication of internal control information, the foreign commercial banks will focus on the communications between different auditing department, between auditing department and other business departments, between different employees and between the employees and the management. The branches of the Societe Generale will hold a meeting in Hong Kong on the monthly basis to communicate the business information and exchange the conditions of the internal control.

The commercial banks of China have not done this in a good way. For example, on one hand, the communication between the auditing department and other departments is insufficient, they can not communicate their information timely, and the communication channels are not smooth enough. On the other hand, the necessity of the internal control and auditing has not been fully recognized, and the coordination between the internal control and auditing and other businesses shall be achieved by strengthening the communication.

2. MAJOR ISSUES TO BE ENCOUNTERED BY COMMERCIAL BANKS OF CHINA IN CONDUCTING CROSS BORDER AUDITING

2.1 The Laws and Regulations Related to Auditing are Insufficient and can not Meet the Requirements of Transnational Auditing

PBC has issued more than 1,000 documents regarding to the management regulations and standards for banks. Despite the numerous supervision regulations for commercial banks, the construction of laws still lags behind, and there are still many problems in place, such as law gaps, and the inability of adapting to the development of the banking industry. At present, China has not established a completed legal system regarding to the transnational auditing. The commercial banks of China have their own way to conduct internal auditing, and the uniform standard has not been established for their operations. For example, there are not uniform standards for the aims, requirements, references, methods and reporting formats for office leaving auditing, financial auditing, credit auditing, capital auditing and international business auditing.

The Commercial Bank Law of China has not speculated that the commercial banks shall establish specific monitoring organizations internally. The Guidance of Internal Control for Commercial Banks issued by PBC in September 2002, has only specified that the commercial banks shall establish the specific department to perform the risk management function, but not requested them to establish the specific internal auditing department. In June

2002, PBC specified in the Section 2, Article 51 of the Governance Guidance for Joint-Stock Commercial Bank Companies that the vertical leadership shall be used for the internal auditing organizations in commercial banks. In practical, however, the establishments of internal auditing departments in commercial banks are imbalance, and those established are not independent since most of the commercial banks in China are using the accountability system of the presidents of branches under one legal representative, in which the presidents of the banks are the representatives of the owners, the policy-makers for the operation of the banks and the responsible persons of the internal auditing departments in the banks. Since the supervisor and the responsible person are the same person, the internal auditing departments would not like to report the issues they have found, and the dependence of the internal auditing department has adversely influenced the authority and monitoring nature of the auditing works.

2.2 The Simple and Backward Auditing Methods will Adversely Influence the Effect of Transnational Auditing

With the rapid development of the banking operations and computerization operation in China, the speed of processing banking businesses have increased by several times, but the methods of internal auditing have been lagged behind relative to the business development, forming a sharp contradiction between the backward auditing methods and the application of the modern tools in financial management. Firstly, the manual checking of the accounts and certificates could not meet the auditing needs and will affect the realization of the auditing targets. Secondly, the computer monitoring system established by the auditing department has not been connected to the operations systems of other business departments for a long time, and the transformation from on-site auditing to off-site auditing and from the post auditing to the processing auditing could not be realized timely, increasing the costs of auditing and the risks in terms of the real-time monitoring on business processes and the real-time warning. Finally, under the current auditing system, the auditing departments have used self-auditing methods for a long time, and the auditing results could not be reflected actually, reducing the deterrent force of the results and limiting the effects of the auditing functions. All of these conditions have influenced the effectiveness of the internal auditing and supervision of the commercial banks, limited the effects of the functions, neglected the requirement of "Putting Internal Control First" put forward by PBC, and become a major obstacle for the transnational auditing of commercial banks.

2.3 The Unreasonable Structure of the Auditing Team has Limited the Implementation of the Transnational Auditing

One of the key steps of the effective bank monitoring and management is to identify and evaluate the risks existing

in the banks, which has put forward high requirements for the knowledge of the auditing personnel. However, the auditing personnel of China can not meet these requirements at present. At first, the professional auditing team with reasonable structure has not been established. The transnational risk auditing and monitoring request that the auditors shall be familiar with the related financial laws and system in their countries, and the product structure, business process, risk management model, internal control mechanism and computer systems of the objects of the auditing, so as to evaluate and check the rationality, reliability and effectiveness of the risk management system, and the compliance and risk degrees of the businesses. At present, the financial monitoring and management teams of China can not meet the requirements of transnational auditing especially in terms of financial derivative instruments, accounting business operation and financial analysis. Secondly, the specific training mechanism has not been established for the transnational auditors. The banking auditors shall have comprehensive basic knowledge and handle systematic checking methods and skills. Meanwhile, the development of the financial market and technologies have created a lot of new knowledge, management technologies and products, therefore the auditors will not be able to adapt to the development of the banking industries in their countries and implement effective management and monitoring without learning constantly. Finally, the language obstacles in transnational audits will also influence the authenticity and effectiveness of the audits. China has not established a comprehensive and constant training plan for the transnational auditors at different levels and with different professions, nor the graded auditor qualification standard. A lot of auditors could not catch up with the development of the auditing and management in terms of knowledge, which has become a large obstacle for the effective implementation of transnational audits conducted by the commercial banks of China.

3. COUNTERMEASURES FOR TRANSNATIONAL AUDITING ESTABLISHED BY COMMERCIAL BANKS OF CHINA

3.1 The Related Laws and Regulations shall be Improved to Meet the Transnational Auditing Requirements

(1) It shall be specified that the auditing right shall be exercised by the head office of the commercial bank and no auditing department shall be established in branches. For example, the Citibank has only established one auditing department at its head office, with no auditing department in branches, so as to directly implement the wholly administrative auditing and dispatch auditing directors to different regions according to the sizes of

the businesses of the branches, who are responsible for auditing the businesses of the branches and not connected to the regions of the branches.

(2) The internal auditing departments and personnel shall be independent. The administration and daily management of a bank shall not have the right to intervene the operation of the internal auditing system in the bank, and actual measures shall be taken to ensure the manpower and supplies. We will take the Citibank as an instance again. In Citibank, the vice president and the chief auditor will report to the board of directors directly. The auditors will be selected independently by the auditing department of the head office from the business departments. The auditing department has independent financial budget which could not be influenced by the business departments. The welfares of the auditors are better and their wages are determined by the head office, which shall not be less than that of the employees of the business departments. In this way, the independence of the auditing department and personnel could be ensured effectively. The auditors shall exchange their information periodically to ensure the objectiveness of their monitoring.

(3) The internal auditing department shall conduct the constant and regular monitoring and control. At present, some problems could not be thoroughly eliminated in many commercial banks after several audits. The reason is related to the One-Time check. Some auditors don't concern about the follow-up monitoring, and the units that have been audited will not solve their problems seriously and carefully. Therefore, the auditing department should use the re-visiting system to conduct the on-site or off-site audits suddenly to the audited units within several days after the previous audits to verify that if the management and the business departments have adopted necessary measures. If it is not the case, the internal auditors shall report the conditions to the auditing committee timely to request the management and the business department to make remedy or correction.

(4) The scientific and standard auditing procedures shall be made to improve the auditing efficiency. The establishment of the scientific and standard auditing procedures includes the establishments of on-site auditing work procedure, off-site auditing work procedure, office leaving or performance auditing work procedure, credit auditing procedure, asset management auditing procedure and financial management auditing procedure, and the establishments of the auditing quality management procedure, such as the management of the auditing items, forms, evidence collection, reporting and file management.

3.2 The Auditing Experiences of Developed Countries shall be Learned to Eliminate the Shortages of the Traditional Auditing Methods

The off-site auditing is a widely recognized method for effective internal monitoring in the world, which could be used to constantly monitor the capital operation of the whole bank and is effective in terms of analyzing,

predicating, controlling, preventing and eliminating the operation risks and financial risks. The off-site auditing could effectively overcome the shortages related to long auditing intervals, small monitoring scopes, improper reflection and insensitivity, and show the direction for on-site auditing. Therefore, the combination of on-site and off-site audits is a necessary method for the scientific, standardized and regular internal audits for commercial banks.

In China, the on-site auditing is mainly used. The procedures of the on-site auditing mainly include the auditing preparation, auditing implementation, auditing report, auditing treatment and auditing file management. See *On-Site Auditing Procedure* by People's Bank of China (on trail), 1997: (1) Preparation; (2) Implementation; (3) Reporting; (4) Treatment; and (5) File Management.

The off-site auditing monitoring means that the financial organizations shall periodically submit the materials related to the business operations according to the requirements specified by PBC which will then audit, treat and analyze such materials, make the auditing reports, and conclude the auditing results and handling decisions for the violation activities or improper operations after verification. In the off-site auditing, various mathematic methods will be used to analyze the operations of the financial organizations, identify risk points and provide the policy makers with important information. The scientific advancement and the development of the banking industry have promoted the transformation of the traditional on-site auditing to the combination of the on-site and off-site audits and finally to the mode focusing on off-site auditing.

The on-site auditing and off-site auditing are two inalienable parts of the financial auditing, which are supplementary to each other. The on-site auditing is to directly check, analyze and verify the accounting documents, accounts, statements, cashes, assets and written materials, and directly interview related persons to grasp the first hand information, which is an effective method to identify problems. The off-site auditing is to analyze and calculate the operation materials submitted by the units to be audited according to certain procedures and standards to judge the conditions and development trends of the banking organizations, send warning signals to the financial organizations facing relatively large risks, help them correct defective activities, control risks and reduce losses. The on-site and off-site audits have different aims, but they are complementary to each other and have the same function, namely, to reduce losses and prevent risks in the operations of the financial organizations and achieve the stable and health development of the financial industry.

3.3 The Efforts in Training Auditors shall be Strengthened to Establish a Transnational Auditing Team with Reasonable Structure

The improvement of the internal auditing works in commercial banks depends on the improved working system and high quality auditors in essences. The high quality is reflected in terms of the working experiences and new knowledge and skills of the auditors.

(1) The shifting system shall be used for the auditors to promote the flowing of the auditing team and realize the reasonable adjustment to the structure of the team. The auditors shall be selected openly like the selection of customer managers, and the control activities shall be controlled by the personnel with good sense of responsibility and strong abilities.

(2) Investment in training auditors shall be increased. ①After using the comprehensive business system, the auditors could not fully understand all of the business procedures, and they could not understand the related business procedures through specific audits. Therefore, certain period of time is needed to conduct the post training or synchronization training for the auditors, so as to make the auditors follow the whole procedure of a business to understand the operation procedure and the aim. ②The auditors shall understand the financial laws and systems of the related countries. For transnational auditing, the auditing objects are conducting their businesses in different legal frameworks; therefore, in the opinion of the author, the auditors shall fully understand the legal systems, especially the financial monitoring and management systems, in the registration countries. ③During the transnational auditing, the auditors shall be able to handle the languages in the related countries and regions so as to facilitate the transnational auditing works. For example, in African countries, the prevailing languages are English, French and Arabic and the invoices and certificates shall be issued in these three languages. During a cross border auditing, the author met the original certificate in Arabic and had to ask the favor of the local accountant, which influenced the independence of the auditing.

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