A COMPARATIVE STUDY ABOUT INTERNAL AUDITING APPROACH BETWEEN GERMANY AND CHINA

Yuedong Li
Southwestern University of Finance & Economics
College of Accountancy
Chengdu City, Sichuan Province, China

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Please Address All Correspondence To:
Yuedong Li
0303GaoZhi Building, No.16 at 3rd of Renminnan Road,
Chengdu, Sichuan Province, China, 610041.
Phone: (86) (28) 8735-0589 or (86) 13980436234
E-mail: liyuedong@swufe.edu.cn or liyuedong2002@yahoo.com

ABSTRACT

While internal audit is one of the most important function and procedure for internal control of the firms’ normal operations from the perspective of financial terms, however, different nations, due to their stages of economic developments (developed nations vs. developing nations), unique governmental regulations, and different societal and cultural traditions, have implemented different internal audit systems and approaches. This paper describes a comparative study exploring some key differences between the internal audit system in China and its counterpart in Germany – from the following five important aspects: the origin and development of internal audit, the structure of internal audit system, the relationship between firms’ internal audit and the government agency, the responsibility and accountability of internal audit, and the quality of internal auditors. Based on the comparative analysis, four suggestions are made for future improvement on the internal audit system in China, along with managerial discussions.
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1. Introduction

As the Chinese economic reform started in 1980s, the demand for a better internal control of enterprises forced the need of a formal internal audit and the development of a complete internal audit system. While internal audit has been recognized as an important function and procedure for internal control of the firms’ normal operations from the perspective of financial terms, however, different nations, due to their stages of economic developments (developed nations vs. developing nations), unique governmental regulations, and different social and cultural traditions, have implemented different internal audit systems and approaches. From a historical and comparative view of point, while the internal audit process in China has only started two decades ago and been actually developed during last ten years with many weaknesses and problems to be further addressed and improved, the internal audit in Germany, in comparison, has been evolved and developed over the last hundred years and its internal audit system has been well established and proven to be an effective internal control tool for enterprises in Germany. As such, it is believed that Chinese internal audit professionals can learn important and meaningful lessons from a comparative analysis between the two internal audit systems. That is the primary motivation for this research. This paper describes a comparative study exploring some key differences between the internal audit systems in China and its counterpart in Germany. Specifically, the five key differences will be discussed and examined in the following sections of this paper: (1) the origin and development of internal audit, (2) the structure of internal audit system, (3) the relationship between firms’ internal audit and the government agency, (4) the responsibility and accountability of internal audit, and (5) the quality of internal auditors. Based on the analysis above, four suggestions are made for future improvement on the internal audit system in China, along with managerial discussions.

2. A Comparative Study

Five key differences in their internal audit systems between China and Germany are discussed and explored in this section: (1) the origin and development of internal audit, (2) the structure of internal audit system, (3) the relationship between firms’ internal audit and the government agency, (4) the responsibility and accountability of internal audit, and (5) the quality of internal auditors.

(1) The Origin and Development of Internal Audit:

In China, the development and establishment and of firms’ internal audit has been pushed by the rapid development and growth of national market economy along with the implementation of government’s administrative policies (Jou 1997). In August 1983, the
State Council approved and circulated the *Request for Instructions on Several Issues Concerning audit Work by the National Audit Office*, requiring the conduct of internal audit through setting up internal audit units within competent departments exercising unified leadership of their subsidiaries or with many subsidiaries, and large- and medium-sized enterprises and undertakings. In 1987, Chinese Institute of Internal Auditors was established, and it joined International Institute of Internal Auditors in December in the same year. In 1988, The State Council issued *People’s Republic of China’s Auditing Standards*, in which chapter VI stipulated the establishment and responsibilities of internal audit units, and the relationship between internal audit units and government audit institutions in its internal audit. In 1994, The State Council issued *The Law of Auditing*, and it also determined the legal status for internal audit. In 1995, The China National Audit Office published *The Regulations on Internal Audit*, making more specific rules on internal audit. In 2003, The China National Audit Office implemented *The China National Audit Office’s Regulations on Internal Audit* (2003), Which improved the regulations issued in 1994. On the other hand, the internal audit professionals have increased dramatically since 1987, and there are more than 10 test centers established up for the qualification examination of CIA (certified Internal Auditor). At the end of 2001, there were about 76,000 internal audit units in China with 193,000 certified professionals.

In Germany, the establishment and development of internal auditing is the product of rapid development of the market economy and the changing objectives of internal audit (Wang 2003). The first modern internal audit department emerged in Friedrich Krupp Company in 1875. The internal audit developed quickly in Germany in sixty years after the middle of 20th century. At beginning, the objective of internal audit was checking error and protecting malpractices. Along with the development of economy, the structure of business companies becomes complicated, and the need to strengthen internal control and management was intensified. So the objective of internal audit is changed to improving economic benefits of company. The internal auditors are not only the member of management team, but also the protectors of company. Currently, there are about 50,000 certified professionals in the internal audit units in Germany.

(2) The Structure and Establishment of Internal Audit System:

Based on the current international practice, there are three different system structures of establishment of internal audit units in a business enterprise. In the first structure, the internal audit unit is established parallel to the Board of Directors and is directed by the leader of the monitoring committee. In comparison, under the second structure, the internal audit unit is established parallel to the other departments in the company and is administered by the Board of Directors. Finally, with the third structure, the internal audit unit is placed inside the finance unit, as internal auditing is one of key functions of the finance department. Under the first structure, the internal auditors can keep independence during the audit process as the internal audit unit can set up and do...
auditing work without outside interference and any influences from other departments. Under the second structure, the internal auditors’ independence is limited and it is difficult for internal audit unit to audit the other departments at the same level. Under the third structure, it is obvious that the internal auditors can hardly keep independence during the audit process because finance department has financial supervisory function on its subsidiary and other departments and the internal audit is also one function of finance department.

In China, all internal audit units are structured into the business enterprises according to either the second or the third structures described above. Comparatively, in Germany, all internal audit units are established based on the first structure. As such, the internal audit units in Germany can keep much more independence during the audit process than their Chinese counterparts in China.

(3) The Relationship between Internal Audit and Government:

In China, the internal audit units in the government owned companies have a close relationship with the government regulation agency. All business internal audit units are established according to the government’s administrative guidelines. The No. 29 Standards in National Auditing Law regulates the establishment of internal audit units, and the internal audit units in government owned companies must be guided and supervised by local government. This standard clarifies the legal relationship between business internal audit units and government audit agency and does not lay down rigid rules for setting up of internal audit functions allowing for difference between business internal audit units and government audit agencies. That is, in China, a business internal audit unit is under dual-supervision. One is from the leadership of its own department or enterprise, and another is from the guidance and supervision of the state auditing departments, which represent the government (Jou 1997; and Cai 1997).

In comparison, there is no law or regulations about establishment of internal audit units in Germany. The internal audit units are set up as self-discipline mechanism of enterprises, and the internal audit units in any business entities will not be supervised by local government (He 2001). In fact, the Internal Auditor Association in Germany functions as a bridge and bond between government and business and professional enterprises. Through enacting audit standards, Internal Auditor Association functions in communicating audit work experience, conveying audit messages, developing related working theory, and guiding internal audit practice.

(4) The Responsibility, Accountability, and Content of Internal Audit:

The article No. 9 in The Regulations on Internal Audit published by the China National Audit Office regulates the responsibilities of internal auditors in China: (1) the internal auditors should audit the economic activities about public finance revenue, the public finance expenditure, financial revenue, and financial expenditure in the enterprises
and their subordinates. (2) The internal auditors should audit the management and application of capital inside budget and outside the budget. (3) The internal auditors should audit the accountability of leaders during their terms of office. (4) The internal auditors should audit project construction. (5) The internal auditors should examine and evaluate soundness and efficiency of internal control system and risk management. (6) The internal auditors should do operational or performance auditing. (7) And finally, the internal auditors should perform other auditing works required and regulated by laws or regulations. From the standards listed above, it can be seen that the China’s internal audit systems pay more attention on financial audit and compliance audit – a single function. That is, the internal audit stresses on supervision function only, checking out violation of rules and regulations, but ignoring how to strengthen the ability of administration, or improve service efficiency to help business managers make related important decisions.

In Germany, the responsibilities of internal auditors include: (1) determining whether the internal control and monitoring system are perfect and effective; (2) evaluating the economic benefits of enterprises; (3) evaluating whether the laws and regulations are observed (Wang 1999). In addition, the internal auditors also provide services, such as consulting, guiding the departments to improve operations and helping them to resolve the problems. The Germany’s internal audit systems focus more on management audit and performance audit – with multiple functions including both supervision and providing service.

(5) The Quality of Internal Auditors:

In China, the number and professional quality of auditors are far from sufficient and satisfied to the practice requirements. Many current internal auditors are trained before the China’s economic reform in 1980s without college education, and thus lack of necessary professional trainings. Although many young professionals have joined in this professional field, but most of them are just out the college and coming from the accounting major only.

In contrast, in Germany, almost all internal auditors have the appropriate college education, and they also can speak one or two foreign languages and use computers to do auditing work. The internal audit professionals are coming from a very diversified fields such as: accountants, auditors familiar with financial management, economists familiar with business management, engineers familiar with engineering technology, lawyers with necessary legal experiences, and IT personnel who expertise in computer software. More impressively, the Internal Auditor Association in Germany also publishes and distributes over 120 monographs annually to communicate the experience among internal auditors (Wang 2003).
3. Conclusions and Suggestions

Based on the comparative analysis above, the following suggestions are made to the internal audit systems in China. It is believed that implementing these suggestions will significantly improve the current internal audit systems in China.

1) **Strengthening the independence of internal audit:** Independence is the key of audit. The independence lies in the fact that an independent unit should be set up without interference and influences from other departments. The audit unit should be able to give independent opinions and make decisions on how to handle the problems arising from the audits (Chen and Sun, 1997). In China, because the internal audit has a close relationship with government and it is structured at the same level with other departments or it is inside the finance department, the audit work cannot be independent of other influences. The internal audit must be structured in a way that it is only under the Directors of Broad, and the people working in internal audit unit should be rotated, reassigned, and relocated on a regular basis.

2) **Increasing the quality of internal auditors:** The Internal Auditor Association in China should establish the local Internal Auditor Association chapters and should publish and distribute professional monographs to communicate the experience among internal auditors. On the other hand, all the internal auditors must pass the required qualification examination. In addition, the recruitment of future internal auditors must be expanded to all related professional fields.

3) **Changing the mission of internal audit from simple-function to multi-function:** The current mission of internal audit in China just includes only financial auditing and compliance auditing, and concentrates solely on supervision. Learning from Germany, the mission of internal audit in China must be expanded to include both supervision and providing professional services, and to emphasize the audit of economic benefits, which are the key to enlivening enterprises and developing the national economy. That is, the internal audit in China should concentrate on – how to improve economic benefit of business enterprises and the economy as a whole.

4) **Enhancing the employment of new technology in internal audit:** Because the internal auditors need to deal with more and more financial data, developing new auditing procedures and using the new technology and evaluation methods are clearly in need, such as: sampling audit, feasibility study, and computer-assisted audit.
References


The China National Audit Office’s Regulations on Internal Audit, May 1\(^{st}\), 2003.