



# INTERNATIONAL AUDITING

# Practical examples

## Joint venture

### Background facts:

A German medium-sized Mittelstand production company maintains a joint venture with a local partner in Brazil. The plan is to process the market in South America starting from a base in Brazil. In the course of time a number of changes in the joint venture contract are discussed. In a marginal change to the joint venture relationship a change of the regulations regarding the selling rights is foisted on the German company. The existing right of first refusal for the shares of the joint venture partner was withdrawn. The German company feels it is faced with removal of access to the further shares and therefore also to the business possibilities in South America.

### What can be done now?

The German company must immediately obtain legal advice locally in Brazil. Measures have to be taken to prevent the sale at short notice of the company shares by the joint venture partner. Furthermore, a check must be made of the extent to which the previous change to the contract was wilfully made with a possible fraudulent intention in mind.

### What should one have done differently from the beginning?

It is essential that each legal change to a joint venture contract with a foreign business partner is preceded by contact with a local legal advisor with corresponding knowledge of the subject matter and possible corresponding knowledge of the local business practices.

## The sales office

### Background facts:

A Mittelstand company maintains a number of small sales offices in the form of own subsidiaries in Europe. Due to the organisational structure of the group and the size of the individual companies the managing director of the parent company is also simultaneously managing director of the respective sales subsidiary companies.

Purely due to logistical reasons, the managing director is not able to adequately carry out his legal duties in the individual subsidiaries. As the subsidiaries are not well staffed, the basic principle of monitoring, i.e. the dual control principle and separation of functions is frequently not possible.

### What can be done now?

Firstly, it is necessary from an organisational point of view to ensure a local and legally appropriate representation of the respective distribution company. The company management function must be transferred to a local representative of the company and also to the managing director of the parent company. Important decisions in principle require the joint signature of both managing directors. For this purpose, it is necessary to draw up a list of transactions which require joint approval.

Furthermore, in the course of an audit or separate commission from the subsidiaries explicit reference should be made to the weaknesses in the internal control system and the associated risks or possibilities of incorrect actions.

### What should one have done differently from the beginning?

In connection with sales offices of a small size the question often arises whether the organisation of the local presence should be made in the form of an own subsidiary. In particular in Europe the possibility of an integrated branch office structure should be considered. The representation of organisational and tax processes can also be improved under consideration of the tax advantages.

## 'Money on paper'

### Background facts:

A German Mittelstand company maintains a sales office as an own company in a neighbouring European country. The distribution company has existed for some time and has been very successful in its activity on a low level. It has accumulated a considerable amount of cash which, however, for various reasons was not distributed by the parent company. In recent years, the managing director was a long-serving employee of the parent company. Due to the low significance for the company group, the annual financial statement of the small distribution company is not audited, but support is provided by a local tax consultant to prepare the financial statement.

When the parent company decides to distribute the generated funds, it determines that the high cash reserves only exist on paper and that in recent years the managing director has invested the funds in dubious financial transactions with prospect of high returns. The result is a seven digit loss.

### What can be done now?

In order to establish the facts, a special team consisting of auditors and lawyers, the so called white-collar crime team, is used. This team examines in detail whether civil and criminal proceedings can be brought against the former managing director.

### What should one have done differently from the beginning?

Even small subsidiaries should in principle not be excluded from an audit of the annual financial statement. Essential audit actions such as the obtaining of bank confirmations should have been undertaken much earlier to indicate the non-existence of the liquid funds. Furthermore, there would have been the possibility in connection with the company group auditor of arranging specific investigative actions in the small subsidiary. For example, there is also the possibility of organising the obtaining of bank confirmations for subsidiaries which are not audited. Such easy, low-cost measures can possibly make a contribution towards avoiding a great deal of damage.

## Closely-linked third parties

### Background facts:

A German production company with international operations maintains subsidiaries in a number of countries, including India and Russia. As time passes there are occasional anonymous reports from the respective countries that the local managing director is involved in illegal activities and that the managing director in particular has used connections to third parties to his advantage and to the disadvantage of the company. The accusations are made anonymously in a very polemic manner, but do contain a number of points which seem to appear believable.

### What can be done now?

In principle, there is the possibility of reacting to these accusations with specific investigations undertaken by an auditing firm. An embezzlement audit would have to be carried out in the local subsidiary. However, this usually leads to the undermining or even shattering of the trust relationship with the local responsible persons.

An alternative is offered by the possibility of reacting to the specific accusations in the course of a standard audit of the financial statement and to carry out selective investigative actions under the cover of a regular audit of the financial statement. After the appropriate knowledge is established with corresponding usable evidence which confirms the anonymous accusations, there would be the possibility of expanding the investigations with regard to an actual embezzlement audit.

### What should one have done differently from the beginning?

It is basically difficult to avoid such situations in a company with subsidiaries some distance away, as in particular anonymous tips due to bad feelings in the company may occur. Nevertheless it is conceivable that in countries where such accusations due to established structures are often not ill-founded, the above-mentioned assignment to audit the financial statement can always be extended to include specific investigative actions. As a result, one is continually in a position to react to such situations. The approach becomes the norm in the company in the company group and to a certain extent also has a preventive effect. Rödl & Partner offers such extensions to the usual audit within the framework of the international financial & performance audit.

## 'Paper is accommodating'

### Background facts:

A German industrial company with international operations wishes to publish an accounting manual for its subsidiaries operating worldwide. This accounting manual must also include specific rules for the valuation of inventories.

After an intensive investigation it turns out that specific rules for the valuation of the inventories are frequently not applied and the local auditors of the annual financial statements had not adequately referred to the rules. The objective of uniform group reporting standards in the group was therefore not achieved.

### What can be done now?

In order to ensure uniform group reporting standards, measures must be taken by the company and by the auditor of the annual financial statement.

The company must instruct its individual units abroad to comply with regulations, whereby this must be accompanied by training of the corresponding employees and the parent company must become familiar with the specific facts at the local level. At the same time the company group auditor must co-ordinate with the individual auditors of the annual financial statements to ensure that said auditors actually use the regulations of the group accounting guideline as a benchmark for their assessment. There must be explicit reporting on this theme. In addition, there is the opportunity of arranging a meeting for all those concerned in order to exchange experiences.

### What should one have done differently from the beginning?

The facts of the case indicate that the implementation of uniform regulations worldwide will not happen on its own. The behaviour of the individuals in almost all cases in practice is not due to malicious intent or disregard, but rather a lack of understanding of the subject. Due to the frequent existence of different applicable regulations in the local offices, the necessity of adjustment to the parent company is not perceived to be absolutely necessary. In this respect it is important that the parent company informs the individual companies about this necessity and that the persons responsible for supervising the respective countries also become familiar with the specific implementation possibilities at the subsidiary and understand the associated problems.

Furthermore, the corresponding auditors of the annual financial statement at the subsidiary must be instructed about the necessity of ensuring the implementation. The securing of uniform group reporting standards according to specific regulations will not happen by itself, but requires a continual improvement process which requires the active participation of all those involved right from beginning.