

A Brief Analysis on the Internal Control of China's Commercial Banks

Taking the Zhongyuan Bank XX Branch as an Example

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Abstract—Commercial banks are of special importance in economic development. With the continuous deepening of reform and opening up and the rapid growth of market economy, risk is however concomitant with the continuous evolution of commercial banks. For commercial banks, risk presents both opportunities and challenges. The coexistence of opportunities and challenges requires that commercial banks should not put up a tenacious struggle for high yield while neglecting the establishment of internal control. Especially on the present day when various high risks are frequent, the building of effective internal control is conducive to the attainment of the business objectives of a bank.

Keywords—commercial banks; internal control; risk

I. AN OVERVIEW OF THE INTERNAL CONTROL OF COMMERCIAL BANKS

A. Meanings of the Internal Control of Commercial Banks

With the development of market economy and the continuous evolution of financial innovation, every commercial bank attaches more and more importance to internal control to seek assets safety, benefit growth and accounting authenticity, reliability and scientificity. Thus, the internal control of commercial banks refers to the general name for a series of activities of control, supervision and prevention carried out by the bank management for the business involvement of every branch, department and employee so as to prevent risks and improve benefit. With economic globalization nowadays making the markets around the world closely connected, effective internal control is part of enterprise management, so that both listed companies and unlisted companies should deal with risks in a reasonable and effective manner. In short, internal control is a self-discipline system, a systematic summary of various measures, procedures and methods of guarding against risks.

B. The Evolution of the Internal Control Theories of Commercial Banks

The continuing development of commercial banks accompanies the constant improvement of internal control theories. A survey of the development process of internal control theories can sum up it into four phases: the internal

check, the internal control system, the internal control structure and the internal control integrated framework.¹ (Yuan Guanhua. An Introduction to the System Innovation of State-owned Commercial Banks under the Conditions of Reform and Opening-Up. 2000. Page 25-26).

1) *The internal check phase.* Before the 1940s, the internal control theory stayed in the internal check phase. The internal check theory believe that two or more people have a less chance of making a mistake than one does, so that the internal check theory is a procedure of employing cross supervision and cooperation for a business process or a business post to gain effective benefit and prevent improper errors.

2) *The internal control system phase.* From the 1940s to the 1970s, the internal control theory stepped in the phase of internal control systems. In 1949, the Committee on Auditing Procedure of American Certified Public Accountants put forward a relatively comprehensive definition of internal control, that is, internal control involves all the design plans and measures adopted in an enterprise for coordinating organizational structures.¹ (Yang Ziqiang. Financial Risk Control and Management. 2001. Page 10-11) These plans and measures are basically to protect the assets safety of enterprises, improve business efficiency and check the accuracy of accounting information, and eventually to ensure enterprises their adherence to the established overall management and development.

3) *The internal control structure phase.* From the 1980s to the 1990s, the internal control theory made a breakthrough. It is believed to involve a series of policies and measures adopted to achieve development and integrate control environment. Hence, the internal control theory is composed of three parts: control environment, accounting systems and control procedures. Control environment, what it is called, indicates all factors having an impact on the efficiency of establishing, strengthening and crippling specific policies and procedures. An accounting system specifies the methods of authentication, analysis, classification, registration and statement of business transactions and defines management responsibilities of all assets and liabilities. A control procedure is the policies and procedures established by the management to ensure attainment of certain goals.² (Song

Liangrong. Accounting and Internal Control of Commercial Banks. 2004. Page 7-8)

4) *The internal control integrated framework phase*. Since the 1990s, the world pattern has changed. A COSO report in 1992 put forward the theory of the internal control integrated framework. The report believes internal control to be a self-discipline system running through the whole business process of an enterprise and composed of five elements as control environment, risk assessment, control activities, information exchange, and supervision and feedback.¹ (Liu Chunhao. Analysis and Suggestions of Internal Control of Commercial Banks. 2010, Page 4)

II. THE STATUS QUO AND THE EXISTING PROBLEMS OF THE INTERNAL CONTROL OF THE ZHONGYUAN BANK XX BRANCH

A. Basic Information of the Zhongyuan Bank and the XX Branch

The Zhengzhou-based Zhongyuan Bank Co., Ltd, established by the amalgamation of 13 municipal commercial banks of the original Kaifeng Bank, Anyang Bank, Xuchang Bank, Luohe Bank, Sanmenxia Bank, Nanyang Bank, Shangqiu Bank, Xinyang Bank, Zhoukou Bank and Zhumadian Bank, officially opened on December 26, 2014, with registered capital of RMB 209.4 billion and a head office and 14 branches under it. The Zhongyuan Bank XX Branch earned a net profit of RMB 0.12 billion in 2014.

B. The Status Quo of the Internal Control of the Zhongyuan Bank Xx Branch

1) *Control environment*. The Zhongyuan Bank establishes a modern enterprise system and the governance pattern of “three boards and one management”, carries out “first-class legal entity, unified leadership, operation by different levels and authorization management”, and sets up 22 functional divisions under it. The Zhongyuan Bank builds a governance pattern of checks and balances between the general meeting of stockholders, the board of directors and the board of supervisors, implements the governor responsibility system under the leadership of the board of directors and complies with the operation mechanism in which proprietary rights separate from management rights, and management rights separate from supervision rights while all of them are subject to checks and balances.

2) *Risk assessment*. Like any other financial institution, the Zhongyuan Bank XX Branch faces various risks from both inside and outside. The risk assessment of the Zhongyuan Bank XX Branch is a process in which the risk control department carries out “pre-loan investigation, loan review and post-loan inspection” and the systems of “separating loan inspection from granting, and examining and approving at different levels” and the governor sign for approval, so as to reduce decision-making risk and try to avoid loss.

3) *Control activities*. In order to realize the capital efficiency, safety and liquidity, the Zhongyuan Bank, based on the principles of “centralized management, unified

allocation and management by different levels”, boosts the reasonable flow of assets and improves the operation efficiency of capital. On the other hand, it strengthens the internal control management of accounting, places institutional restriction and basically formulates for every operation link of the Branch’s accounting the code of conduct including post responsibilities, department systems and business processes. Besides, it carries out timely inspection and analysis of accounting to accelerate the improvement of accounting and tighten the loophole in accounting management.

4) *Information exchange and feedback*. In terms of information systems, the Zhongyuan Bank XX Branch organically combines the upstream and the downstream and internally builds office networks and business networks, so that the information between the employees and the departments can be transferred from top to bottom and laterally. The office networks are mainly for the exchange and communication between the bank employees and the business networks for business processing and customer relation maintenance. The information system maintenance shall be strictly checked so as to practically guarantee the update and confidentiality of information systems.

5) *Supervision and evaluation*. The Zhongyuan Bank XX Branch builds supervision and evaluation system focusing on internal credit control, external audit and safety protection.

a) *Internal credit control*: in terms of post-loan management, not only the account manager should make an investigation into the operation and management of the credit-granting enterprise one or three months later, but also the branch needs to make a regular report to the head office of the post-loan management.

b) *External audit*: a senior accounting firm should be invited to make audit and assessment of the authenticity of the commercial bank’s finance and the effectiveness of the internal control.

c) *Safety protection*: the governor responsibility system is carried out to maintain the bank’s safety and stability. Safety knowledge training is arranged for employees to enhance their security consciousness. Casual inspection will be made to timely rectify the noncompliance.

C. Problems in the Internal Control of the Zhongyuan Bank XX Branch

1) *Lack of the awareness of internal control and failure to build a real internal control culture*. The effective play of internal control is a process of the joint efforts of the management and the execution and needs the involvement of all employees. In the Zhongyuan Bank XX Branch, the management fails to correctly play the role of internal control construction, while the employees, generally dimly aware of risks and inferior in the quality of professional ethics, think the risk control to be the business of the risk control department, misunderstand the internal control and neglect the fact that the play of internal control is a dynamic mechanism in which every department, business and employee are closed linked. Long neglect of internal control,

pursuit of short-term profit and lack of necessary prudence of business amplify the level of guarding against risks.

2) *Lagged building of internal control.* Lacking reasonable overall planning for the labor division of the departments and the rules and regulations in formulating internal control, the Zhongyan Bank XX Branch has such phenomena as one holding more posts, overlapping responsibilities and powers and unclear reward and punishment. Thus, in case of problems, it is impossible to make the responsibilities come down to specific individuals. As time passes, the internal control system is just like a paper ornament. Especially these years when financial markets develop rapidly, the financial derivatives are of a great variety, magnifying the uncontrollable factors of the financial markets.

3) *Lack of Rigid Execution of Internal Control.* The internal control system, no matter how strict it is, is a dead letter if it is lack of action. If only one department or only one person strictly complies with job requirements, non-performing loans will be avoided. However, in practice, a blind eye is always turned to some sophistication. Although some post-loan follow-up requires an investigation into the operation of the credit-granting enterprise three or one month later, some account managers who can't be bothered to make such on-the-spot investigations just ask for a report. Thus, the post-loan management is just a formality and does not play its real role that is designed.

4) *Lack of effective contents and criteria of evaluation.* The Zhongyuan Bank XX Branch's lack of the awareness of risk prevention is mainly showed in its failure to "give priority to internal control" in every business. However, with the continuous innovation in the financial markets, the improvement of systems failing to keep pace with the time will cause blind spots for risks. Due to lack of matched internal control systems for prevention of risks before their emergence, some financial products suffer from losses.

In loan management, the limitation of investigations into the operation and management capacities to the analysis of accounting reports and a certain percentage of subjective factors make it difficult to correctly reflect their real operation and management capacities of enterprises. The lack of unified standards for risk assessment results in incorrect assessment of risks. Furthermore, the internal control system of the Zhongyuan Bank XX Branch mainly deals with the credit operations, lacking the ability to screen risks of such services as bank acceptances.

III. THE IMPROVEMENT PROGRAM OF THE INTERNAL CONTROL OF THE ZHONGYUAN BANK XX BRANCH

A. *Strengthening Management and Creating A Good Internal Control Culture*

The view that "the fortune creates culture and the culture, in return, creates fortune" spread in the Western culture sums up the importance of culture. The internal control culture refers to the implementation of the values formed in the long-term internal control practice of the subject. Common

recognition is the important part of an enterprise culture. The culture can exert a subtle influence on a person's behavior.

1) *Construct a good internal control environment.* Building a good internal control environment should improve the internal governance pattern of a bank, optimize its allocation of sources and define the responsibilities of every level. First of all, the board of directors should provide a unified program and the departments concerned define their responsibilities and obligations to jointly advance the structuring of the governance pattern. Second, the internal audit powers and responsibilities shall be standardized to prevent exaggerated powers of the board of directors and the management.

2) *Pay attention to strengthening the employees' ideology of internal control.* While a good internal control environment is built, importance shall be attached to the enhancement of the employees' awareness of internal control. The employees actively fulfilling their responsibilities should be praised and rewarded so as to foster a high consistence in the interests between the employees and the bank and reduce losses resulted from employees' negligence.

B. *Build A Comprehensive Risk Assessment System*

Risk assessment, an important way for the organization to make clear the requirements of information security, is a process of the organization's planning of information security management systems. An assessment system addressing risks in a comprehensive and efficient way can reasonably assess a risk and give optimum solutions, reducing bank risks accordingly.

1) *Build a reasonable risk assessment system.* Building a reasonable risk assessment system should consider three aspects: comprehension, scientificity and operability. The comprehension means that the analysis based on the assessment system can reflect both a bank's operation management and its accounting. The scientificity means that the indices of the assessment system should be scientific and reasonable, and consistent with a bank's objective fact. The operability means that the assessment system shall be easily understandable and the requirements of its indices are simple and easily comprehensible. 1 (Jiao Min. A Study on the Internal Control of Commercial Banks in China. 2010. Page 2)

C. *Further Improve the Incentive and Restraining Mechanism of A Company*

Improving the incentive and restraining mechanism of a bank can ensure the internal control system to bring its long-acting mechanism into play. The Zhongyan Bank can adopt the incentive systems like performance incentives, employee stock ownership and encourage-oriented dividends, especially the stock incentive system for the top management. The long-acting incentive and effective restraining mechanism shall be built and bettered for the operation management and bank staff. 2 (Qu Guoquan. Thoughts On Improving the Internal Control System of the Commercial Banks in China. 2013. Page 6.)

1) *Advance the improvement of internal control by incentive measures.* To formulate a scientific and reasonable internal control system, the performance incentive needs to be adopted in combination with financial incentives, objective encouragement, work motivation, honors and promotion to recognize and encourage the departments and employees that do an efficient job in internal control management. A play should be given to the radiation effects of talented people. The effects of internal control shall be expanded. The employees should be urged to pursue a higher standard of internal control. The bank benefit should be improved based on the internal control system. On the other hand, the organizations, departments and employees that fail to do an efficient job in internal control management shall be criticized and disciplined. Efforts should be made to let responsibilities come down to individuals, making every employee really responsible for their own post and tolerating no rule-breaking operations.

2) *Plan incentive and restraining mechanisms and implement talent programs.* With the paid-in capital of RMB 15.42 billion, the Zhongyuan Bank ranks first in the municipal commercial banks in China. With the advantage of sufficient assets, it should plan a reasonable and scientific restraining mechanism to recruit, cherish, trust and retain talents, treating the talents as the primary productive force of its long-term growth.

D. Advance and Improve the Building of the Internal Control System of the Company

As the systematic process, the building of internal control systems must have a framework for internal control building from top to bottom, from the management to the employees and from the administrative laws to rules and regulations and a complete system which translates to pre-event prevention, in-event supervision and post-event assessment from post-event make-up, not a “patch-like” building, that is, making up after problems occurring. Nowadays, the financial markets are flourishing, new banks are mushrooming and the financial innovation is increasingly matured, bringing about high yield and high risks accordingly. China’s reform and opening-up and the new situation of the new century’s Internet makes it impossible for any enterprise to keep out of the problem of world peace and development. Internal control building is an increasing recognized risk response system and a basis for commercial banks to effectively guard against risks and a self-discipline system having pre-event prevention, in-event supervision and post-event assessment. On the whole, advancing and improving the building of the internal control system of a company should start from two aspects.

1) *Refined processes and individual responsibility.* Advancing the building of the internal control system in a company should be a closely connected reticulated system. First, the government should launch administrative laws and regulations to advance the improvement of the internal control system of commercial banks. Second, the China Banking Regulatory Commission and the People’s Bank of China need to strengthen their supervision on commercial banks to ensure the enforcement of internal control. 1 (An

Yuxue. Discussion Based on the Risk Management of the Commercial Banks in China. 2012. Page 3) Finally, the responsibilities shall be come down to the departments, the services and the employees. Whichever department is susceptible to whichever risk and whichever service to whichever risk. The occurrence of risks should be accountable to specific individuals. In this way, every department and employee can foster self-discipline and the awareness of guarding against risks to practically keep away the impact of risks.

2) *Building an internal control system and paying attention to overlapping responsibilities.* According to the internal control theory, any business should be dealt with through the procedures of authorization, approval, execution, record and inspection. These procedures cannot be completed by one department or one person with full powers, but have reasonable formalities. They should pay attention to the overlapping of powers and responsibilities, rights accompanying obligations. They not only specify the rights of every department and every business personnel, but only define the responsibilities for them. Besides, the powers and responsibilities for every department and every officer should be matched.

IV. CONCLUSION

A. Main Conclusion

The internal control of commercial banks is an open system composed of five elements: control environment, risk identification and assessment, control activities, information exchange and feedback, and supervision and evaluation and correction. These five elements are mutually independent and interacted. The internal control system depends on the elements’ function and interaction to play an effective role. A scientific and reasonable internal control system is a basic guarantee for the operations and management of commercial banks and the core competitiveness of commercial banks. Its improvement has a great bearing on the survival of commercial banks. Therefore, strengthening the internal control building of commercial banks is of profound significance. 1 (Cai Zhong. Study on the Internal Control of the State-owned Commercial Banks. 2011. Page 7)

All in all, the Zhongyuan Bank XX Branch needs to deepen the building of internal control systems from the following four aspects: first, to develop a good internal control culture; second, to building a comprehensive risk assessment system; third, to further improve the incentive and restraining mechanism of the company; and fourth, to advance and improve the building of the internal control system of the company.

B. An Outlook for the Internal Control System of the Zhongyuan Bank XX Branch

With the prosperous growth of financial markets, internal control is increasingly important. Although the internal control of China’s commercial banks is among the latecomers, it has made remarkable advances these years. Adhering to the principle of “standing in the Central Plains

to connect the whole country”, the Zhongyuan Bank XX Branch makes continuous improvement and refinement with respect to internal control. The Zhongyuan Bank is believed to mount a higher step with the efforts of the whole staff and the support of the government.

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