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CHINA BRIEFING

From Dezan Shira & Associates



Navigating HR Audits in China

P.04 Why HR Audits are Important for Foreign Companies in China

P.11 Getting the Most from China's Employee Handbook

P.07 Conducting a Successful HR Audit in China

Introduction



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Labor dispute and industrial action cases have continued to rise in China over the past two years. In 2015, new labor disputes in the country amounted to 483,311 – an increase of 25 percent from 2014 – while strikes and protests in the first half of 2016 rose almost 20 percent compared to the previous year.

There are a myriad of reasons for these developments in China's workforce, but the most commonly cited causes are the changing nature of the Chinese economy, as well as its recent slowdown, and rising wage expectations. Traditionally, disputes and strikes in the country spike just before Chinese New Year holidays and then soon peter out, but since 2015 – when problems in the economy became especially apparent – they have become a regular feature throughout the calendar year for both foreign and domestic companies alike.

These changes in China's labor market have underscored the importance of having both an efficient HR system and a satisfied and reliable workforce, and the HR audit is a useful tool to ensure this. HR audits identify problems in a company's HR policies, documentation, and procedures to mitigate against employee dissatisfaction and legal non-compliance. For foreign companies unfamiliar with China's idiosyncratic and ever-changing regulations and market trends, they can be essential.

In this issue of China Briefing magazine, we provide a guide for conducting HR audits in China. We analyze why the HR audit is especially important for foreign companies operating in the country, and then detail the different HR audit models and procedures that are available to firms. Lastly, we explain how the employee handbook can serve as a year-round safeguard against labor disputes in the Middle Kingdom.

With kind regards,

Adam Livermore



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Why HR Audits are Important for Foreign Companies in China

By Dezan Shira & Associates
Editor: Zolzaya Erdenebileg

Foreign companies operating in China are increasingly finding themselves in the uncomfortable position of undergoing an internal investigation or encountering a potential labor dispute. According to national statistics released by China's Supreme People's Court (SPC), 2015 saw a sharp rise in labor disputes. New labor disputes, meaning disputes that arise during a contractual relationship between employee and employer, accepted by the Chinese courts totaled 483,311 – an increase of 25 percent from 2014. Labor service disputes, meaning disputes arising from "independent contractor" agreements with quasi-employment relationships, totaled 162,920 – an increase of 38.7 percent from 2014.

Labor disputes can be costly, both in terms of money and reputation. Oftentimes, and especially for foreign firms, the issue stems from a lack of HR oversight. An HR audit can reveal such inconsistencies and determine whether or not the company faces any employment-related liabilities.

What is a Human Resources (HR) audit?

Like a financial audit, an HR audit is an independent and objective evaluation of the current state of an organization's HR policies, practices, documentation, and systems. An HR audit can alert a company about hidden HR-related problems and errors, as well as possible compliance issues against a backdrop of China's ever-evolving rules and regulations. This can allow an organization to establish best practices, thereby protecting it against possible operational and legal risk.

An HR auditing process can be conducted in-house, but preferably should be carried out by a qualified independent and objective third-party, and should provide the following assurances:

1. Compliance with all government regulations;
2. Business talent requirements are being met;
3. HR management risks are being managed;
4. Human capital at the organization adds value to the overall operations of the company.

2015 Labor Dispute Cases in China

Number of cases accepted in court



Risks Related to HR in China

Government

- > State, municipal
- > Penalties, tax deductions
- > Employment contract issues

People

- > Recruiting and retaining talent
- > Individual lawsuits
- > Organizational sustainability



Financial

- > Wages
- > Healthcare, welfare payment pensions
- > Accounting treatment
- > Taxes

Reputational

- > Branding
- > HR effects on customers, partners, investors, etc.

From the list above, it is clear that HR audits can go beyond ensuring compliance; they can also identify weaknesses in a company's overall talent structure and streamline inefficiencies.

It is important to regard the HR audit as a diagnostic tool. It can help identify areas of improvement within an organization, but cannot prescribe solutions. The role of the auditor is to give professional advice, but the decision of how to solve the problems will be left up to the organization itself. To make the most of an HR audit, companies must be ready and willing to take the next steps to ameliorate any possible issues that are revealed.

Advantages of conducting HR audits

From carrying out an HR audit, an organization can gain two main advantages: compliance assurance and efficiency review.

1. Compliance assurance

In many countries, there are a number of laws that affect each stage of the employment process, from recruitment to onboarding to dismissals. Nowhere is this more true than in the Middle Kingdom, where regulatory changes can happen quickly. As such, it is critical that employers conduct regular assessments of their HR policies and practices.

Additionally, the penalties for overlooking HR regulatory compliance can be costly. If an employer is found to be in violation of HR requirements, then they may face fines and potential HR blacklisting. If a company is blacklisted, it will be listed with the local authority as having had transgressions and could face more scrutiny when hiring, as well as be subject to impromptu checks by the labor authority.

2. Efficiency review

An HR audit can also help ensure that company policies and procedures are being followed by HR staff. This is particularly important for foreign companies in China that decide to outsource part or all of their HR operations, and do not have complete oversight over the process.

An audit can reveal the strengths and weaknesses within the HR system. By knowing where the system can be improved, the organization can work to maintain or increase employee satisfaction and decrease costly turnover of staff. By one estimate, losing an employee can cost a company 50 to 150 percent of the said employee's salary, in addition to the time and effort spent to replace that position.

Who conducts HR audits?

An HR audit can be conducted in-house if the organization's own HR staff have the necessary expertise and know-how. However, the organization should be aware that, if an audit is performed in-

house or by outside consultants who are not lawyers, the results of the audit are subject to litigation. Therefore, it is recommended that the organization considers hiring outside legally-qualified counsel to perform the audit. By doing so, it can protect itself through the legal privileges against disclosure.

It is also important to note that the organization is responsible for ensuring HR compliance, and is therefore ultimately responsible for any liabilities that may arise.

Common difficulties encountered during an HR audit

1. China's new legal developments

An audit is a comprehensive and time-consuming task. In China, it can be particularly formidable, given the dynamisms of the country's legal environment that requires HR professionals to be constantly aware of new regulations. If performing the audit in-house, the main obstacle will be surveying the legal landscape and ensuring that the organization is compliant with all relevant and necessary requirements. Given these difficulties, an outside party may be best placed to objectively review the current status of compliance, and bring additional expertise to the audit.

2. Documentation

A particularly prominent issue in China is sufficient record-keeping. For example, since 2008, it has been mandatory in China for employers to keep written contracts with their employees. However, China continues to lack a uniform legal standard for collection, processing, and use of personal information. This can lead to uncertainties in a court of law when it comes to alleged employee misconduct. Additionally, many foreign companies in China keep contracts under the Chinese name of their employees, but daily work is conducted using their English names. If an investigation of such an employee is necessary, it would be very difficult to keep track of that person's identity.

To aid the process, organizations should be prepared to provide a number of documents and internal

policies, as well as feedback from selected members of staff, such as managers and HR personnel. The total amount of effort and time spent on an HR audit will depend on the size and scope of the organization, as well as the availability of necessary documentation. It may be the case that HR documentation is lacking or disorganized. In these cases, the audit will be delayed.

Remember, in China, the burden of proof lies with the employer in the event of a dispute. Therefore, it is imperative that detailed records are kept.


3. Company cooperativeness

If the audit is being conducted by an outside source, the HR staff members may feel that they are under scrutiny. In China, this feeling may become magnified in connection to the idea of face, or of reputation and dignity. Some managers may be particularly afraid of losing face, or of facing embarrassment and damaging their reputation, if the audit finds HR irregularities. To avoid this, they may try to cover up existing issues by denying access to information, documentation, or even the company facilities. Additionally, they may try to mislead the auditor about the management styles or procedures that are typically followed at the company.

Frequency of HR audits

It is recommended to conduct HR audits on an annual basis. This may seem infeasible, but in actuality, the regularity of the audit lessens the time and effort needed.

Firstly, the amount of HR documentation needed to be found, compiled, investigated, and analyzed will be lessened if the time between audits is shorter. Secondly, it is less likely that the company will need major changes to its HR policies and procedures if a well-run and efficient audit had been conducted earlier.

HR audits, while time-consuming, can decrease costs, minimize legal liabilities, and streamline the HR processes that a company depends on. In China, where foreign firms must take on many responsibilities in an employer-employee relationship, and where labor disputes are on the rise, reviewing the compliance and efficiency of HR workings can go a long way. 

Conducting a Successful HR Audit in China

By Dezan Shira & Associates

Editor: Zhou Qian

The process of conducting an HR audit in China is nuanced, and needs to be fully understood in order for the audit to have any meaningful impact. In this article, we provide a step-by-step guide on what is involved.

Step 1: Decide whether to conduct the HR audit internally or externally

The first decision for companies conducting an HR audit is that of who should take charge of the whole process. As discussed in the first article of this magazine, HR audits can be conducted by either an internal team, or outsourced to trained professionals. While internally conducting an HR audit is typically less costly and more confidential, there are a range of other issues for foreign companies to consider. For example, if the company applies a confidential wage system to safeguard against competition and resentment between employees, the risk of information disclosure will be higher if the audit is carried out by internal personnel. To deal with this problem, a foreign company may dispatch an internal team from its

overseas headquarters to take charge of the audit process. However, this then raises the additional issue of these employees not being familiar with China's unique HR laws, potentially rendering the audit ineffective.

Outsourcing the HR audit then offers a solution. External HR experts can add more value to the whole process, not only because of their impartiality to the HR issues discussed above, but also because of their expertise and experience in identifying HR problems.

We therefore suggest that using a qualified third party is the optimal method of conducting an HR audit in China. More often than not, consultancies or law firms focusing on FIEs can provide professional HR audit services to foreign companies. To further reduce any possible risk, companies are advised to carry out due diligence on potential candidates by checking their past practices and verifying their registration and certification on the official website of the Administration of Industry and Commerce (AIC).



Related Reading

This guide provides a firm understanding of China's laws and regulations related to human resources and payroll management, which is essential for foreign investors who want to establish or are already running foreign invested entities in China to keep in compliance.

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Step 2: Clarify the scope of the HR audit based on actual needs

The next preliminary issue for companies to consider is the scope of the audit. An HR audit can be structured to be either comprehensive or specifically focused. With different areas to cover, the audit method, the audit process, as well as the timeframe and cost could be very different.

Type	Typical Items	Objective
Compliance	<ul style="list-style-type: none"> • Mandatory social securities – paid or not; paid in accordance with the correct contribution base/rate or not • Salary and overtime payment – minimum wage requirements • Work hour system and overtime payment • Work safety requirements • Leaves and holidays 	Ensure company is in line with current and local employment requirements and thus minimize future penalties from HR bureaus
Employment relationship management	<ul style="list-style-type: none"> • Whether the contract is signed in time or not; • Legitimacy of the contract clauses, such as the probation period, the termination, the confidentiality and non-competition clauses, etc. • Proper job analysis, including job standards/job description/job specification • Consistency of the Chinese and English versions of the contract • Due process of internal rules • Termination 	Manage the employment relationship to reduce future risk of labor disputes
HR functions	<ul style="list-style-type: none"> • Recruiting/selection/training/career development • Payroll • Performance appraisals 	Ensure specific HR function works well
HR strategy & best practice	<ul style="list-style-type: none"> • HR supply and demand situation • Compensation management: whether the salary structure of the company can attract and retain talent for the company or not • Appraisal of the effectiveness of the HR working process 	Help the organization maintain or improve a competitive advantage

There are several types of audits, and each is designed to accomplish different objectives, as shown in the above chart.

If an HR audit has never been conducted, a comprehensive review of all policies and procedures is recommended. After this, businesses often choose to conduct audits that focus on more specific HR functions, such as payroll or record-keeping, and based on its actual needs, purpose, and, of course, its budget.

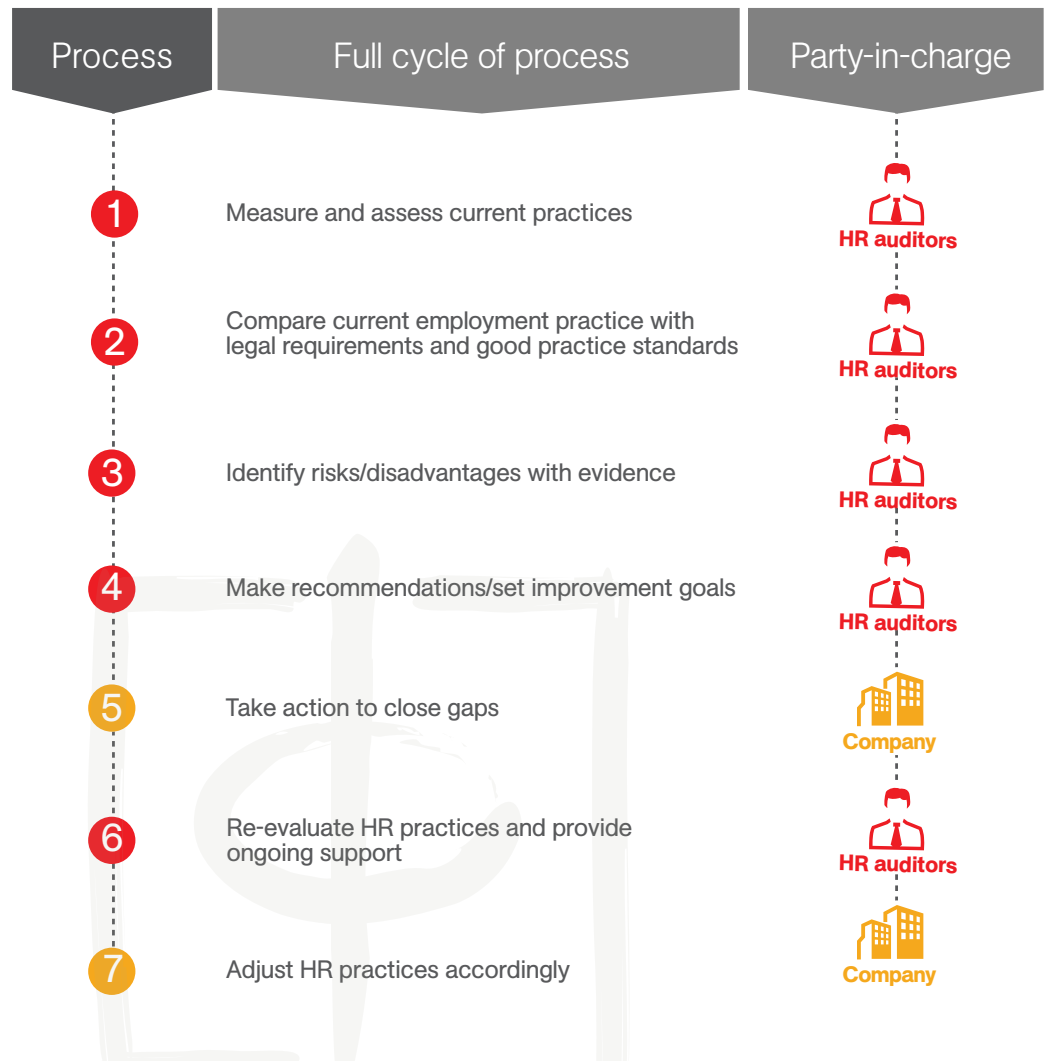
Step 3: Develop a detailed audit plan, with audit methods and detailed checklists

When the scope of the audit has been clarified, the next step is to actually develop a plan for conducting the audit, which should include the

intended method, process, as well as a timeline for completion. For outsourced HR audits, the audit plan is provided by the chosen third party. However, companies will still need to review these plans carefully to ascertain whether they fully meet their needs.

To diagnose problems, the most common method used by third party HR auditors is to analyze reports, records, manuals, contracts, and other documentation produced in the company's daily HR process. But depending on the specific scope of the audit, other methods, such as individual or group interviews, observation, and questionnaires, might be employed as well. While the documentation analysis method is generally more suitable for compliance and employment

Full Cycle of the HR Audit Process



relationship management audits, the interview/observation/questionnaire method is more efficient for HR function/best practice audits.

The full audit process cycle is illustrated in the above chart. However, it is up to the company to decide whether certain processes are necessary or not. Companies may decide that the re-evaluation is too much to be included in the audit process, taking into consideration budgetary constraints and the time needed.

At this stage, HR auditors should also prepare customized checklists to reflect the needs of the company and to ensure the efficiency of the audit process.

Step 4: Set up an efficient internal cooperation system for the HR audit

As mentioned in the first article, company cooperativeness is one of the biggest obstacles for successful HR audits. It is therefore necessary to set up an internal cooperation system before the audit process actually starts up. Generally, the following applies:

- The HR auditors must be properly empowered either by the overseas headquarters or by other personnel who have actual control over the company.
- The company should appoint internal personnel, or form an ad hoc team, to assist the audit process. To maintain the objectiveness and independence of the audit, the personnel or the team members should be chosen from those who have no stake in the HR audit.

- The company should develop some mechanism to assist auditors in gathering the information needed. For example, with resistance expected from the Chinese affiliates being audited, the headquarters could set up an ad hoc reporting line to help the auditors gain timely access to HR documentation.

Step 5: Conduct the audit and generate the audit report

Once the audit begins, the audit team should gather all applicable documents and forms as listed in the checklist. In some circumstances, the auditors should also conduct necessary observations to discover whether HR policies on paper are in sync with actual HR practices.

After all necessary information has been analyzed, the auditors will create a report on the agreed template. A qualified report should identify any weaknesses or potential risks found during the audit, as well as provide practical and professional advice for companies to correct their non-compliance or make improvements.


Of particular importance throughout this process is the confidentiality of the HR audit, including not only the sensitive information contained in the audited documentation, but also the issues detected in the findings. Usually, there will be a confidentiality agreement between the company and the auditors that addresses this.

Step 6: Actions after the audit

After the audit report has been submitted, the company should have obtained a thorough insight into its HR practices, especially the areas with room for improvement. However, the audit report is not the end-point of the HR audit process. As mentioned in our first article, the audit is just a diagnostic tool. How to solve the problems detected is ultimately up to the company itself.

To take the most from the HR audit, companies are advised to develop a realistic and achievable action plan to solve the risks discovered and make improvements to their overall HR structure. Any compliance issues detected, such as mandatory social welfare for employees, take priority. Delaying corrective actions will only exacerbate these problems, and could lead to not only costly fines and penalties, but also potentially permanent reputational damages.

Following this, companies should clear up potential risks to their employment relationships; for example, by adding an amended job description to employees' labor contracts. Companies can then move on to other areas that need long-term improvement, such as a revamp of their documentation systems, optimization of specific HR functions, and implementation of new best practices. Though it is not required, companies are also advised to consult with their chosen audit team to ensure that all issues discovered are fully understood and that action is being taken to address them. Where necessary, the company could also arrange training sessions to help its staff understand the corrected policies and procedures.

Lastly, it is important to emphasize that the HR audit is not a one-time-fix-all solution. Companies are advised to continuously monitor and periodically review their new processes to ensure they remain compliant and efficient as an employer. 



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Getting the Most from China's Employee Handbook

By Helen Kong, Manager, Human Resources

Editor: Jake Liddle



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While China's labor laws contain detailed provisions regarding employment rights, they only contain general requirements on an employee's obligations. In order to clearly lay out expectations of staff and managers, companies therefore must provide an employee handbook.

An employee handbook is a document that stipulates all company rules, regulations, and operations, as well as obligations and expectations of employees. They can be an effective method to communicate the company's organization philosophy to its workers, and can also serve as a handy point of reference for managers, providing key policy information.

Where a labor contract details the main rules specific to an employee, the employee handbook expands that information, providing a safeguard for the company against possible labor disputes that may arise. If an employer takes action against the company for any given reason, the handbook can serve as a form of employment liability risk management, and provides an extra layer of legal protection.


However, this does not mean that employers can write out an exhaustive set of rules in order to defend against any complaint. If a dispute is taken to court, the ruling may favor the employee if the handbook is found to be overly verbose.

China has no laws that specifically and definitively govern what must go into an employee handbook

– it is ultimately the responsibility of the employer to decide what is included. That said, given the legal and operational importance of the employee handbook, it should at least cover the following:

- Employee performance measures;
- Consequences for breaching company rules;
- Confidentiality and noncompetition clauses;
- Approval process for absences, leave, and overtime; and
- Termination.

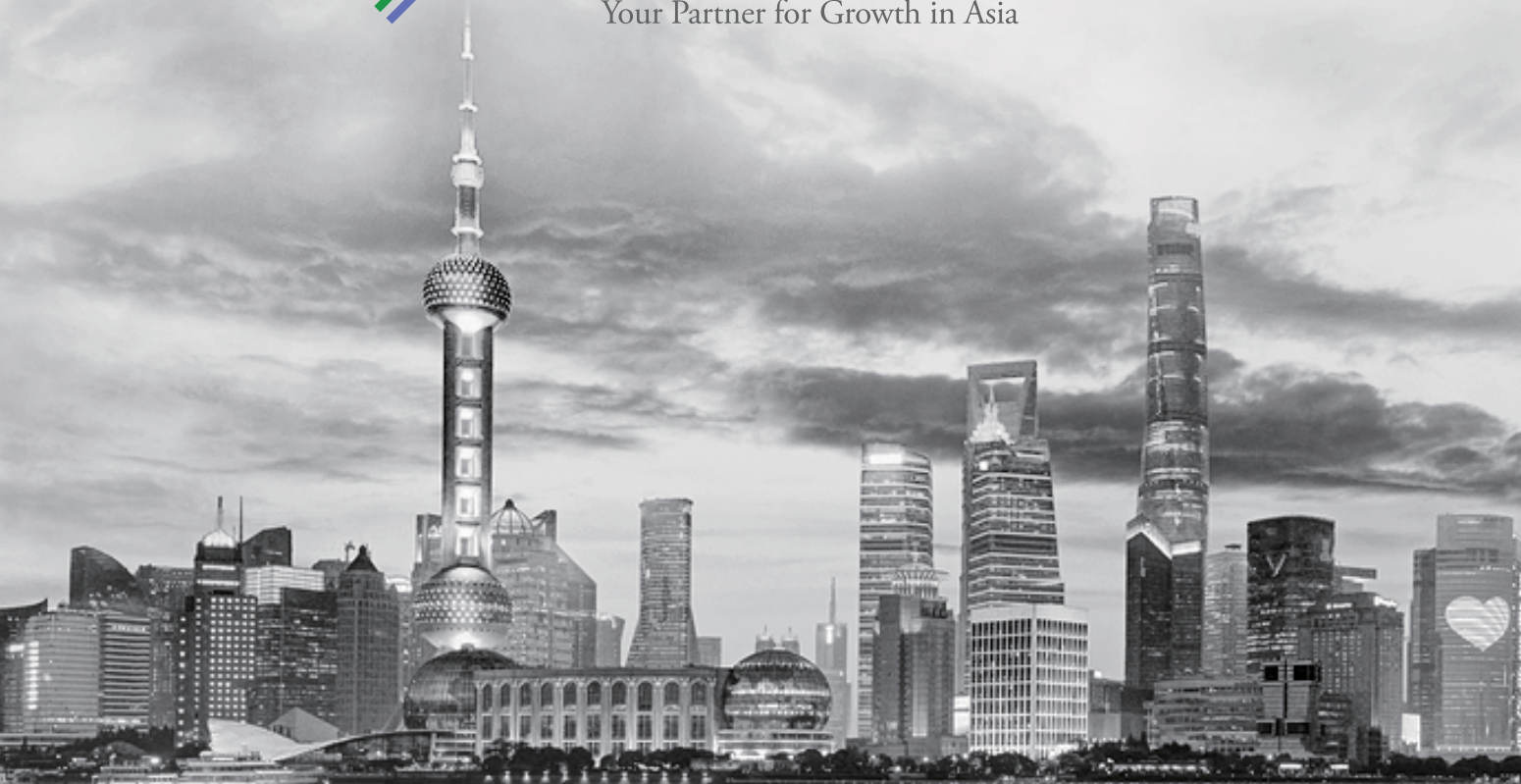
Moreover, the employee handbook should provide specification on areas where China's Labor Law is vague. For example, the Labor Law states that employers have the right to review an employee's position if the employee is found to be incompetent. The definition for incompetence, however, is not defined, and should be included in the employee handbook.

For the employee handbook to be fully effective, employees must sign a form acknowledging that they have read and understand its contents. The rules contained in the handbook must comply with national laws, meaning that employers cannot fire employees for a handbook infraction unless it is also allowed according to China's Labor Law. Importantly, when drafting the employee handbook, or when introducing changes that directly affect employees, the employer is legally obligated to discuss and negotiate with all staff before arriving at a final decision. 



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