

# The Analysis of Necessity to Bring in the Audit System in Non-profit Private Schools of Higher Education

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## Abstract

*After the publishing of the “Chinese private schools promotion law”, the private schools of higher education have to make a choice of whether to transfer to a non-profit private school to avoid the tax, however, the non-profit private school requires the investors to abandon all the profits on the school. To transfer the income, investors may consider the unfair related transaction. For the purpose of avoiding and recognizing the unfair related transaction, it is necessary to bring in the audit system, which includes the government audit, external audit, and the internal audit.*

## Keywords

*Non-profit private schools; related transaction; affiliated transaction; audit system; internal audit; external audit; government audit.*

## 1. Introduction of the Non-profit Private Schools of Higher Education

According to the “Chinese private schools promotion law”, the Chinese government divided the private schools of Higher Education into the non-profit private schools and profit-making private schools. Then the publishing of the “Rules for the Implementation of Classified Registration of Private Schools” forced the private schools to choose which kind of private schools they would be. The purpose of these rules is to enhance the supervision of the private schools, especially the private schools of higher education.

In China, most universities and colleges are run by the government, and these schools are supervised by the government strictly. Because of the government-run universities and colleges mainly rely on the financial allocation funds, any of their financial movement would be directed by the preparation and the budget which were directed by the government, and the government audit would monitor them strongly. Besides that, the government-run universities and colleges have formed an internal sound system to make sure all the financial funds are used under control [1]. However, the private schools of higher education are not in the scope of the supervision.

The government required that if a private school of higher education choose to be a non-profit private school, the government require the organizer that all the income and the remaining

balance should be used for running the school, and non of them could be obtained by individual. And the government would provide financial funds support and make the school enjoy the same preferential tax policies and educational land policies at the government-run universities and colleges, which would also bring more supervision. However, if a private school of higher education choose to be a profit-making private school, the school would be regarded as giving up all the rights and the organizer of the school would obtain the income from running the school and the surplus shall be handled in accordance with the Company Law and other relevant laws and administrative regulations [2].

The main difference of the non-profit private schools and profit-making private schools is how to allocate the income and the remaining balance. Therefore, the guarantee of the non-profit to non-profit private schools would be the focus of the attention.

## **2. The Current Status of the Non-profit Private Schools of Higher Education**

Non-profit private colleges and universities take non-profit as the purpose of running schools, emphasize the public interest of running schools, implement the school legal person system, and all assets belong to the school legal person. The income obtained during the operation of the school, including government subsidies, social donations, income from projects entrusted by the government or enterprises, and income from paid services, cannot be distributed among the members of the school organization, all of them are used for the development of private higher education. When a school dissolves, it cannot distribute the remaining assets to its members. Instead, the government will use the remaining assets for higher education. The ultimate beneficiaries of the educational services provided by non-profit private colleges and universities are the students, the country and the society, and the main mission is to train high-quality talents for scientific research and social services. Therefore, the property of the school is a social asset with no clear owner [3].

### **2.1. The Main Forms of the Non-profit Private Schools of Higher Education**

Currently, most of the non-profit private schools of higher education were invested by the individual, private company or organization, or the cooperative between the government-run universities or colleges and the group company. The essential feature of the Chinese private schools of higher education is that they always run by the investors, and the nature of the investors is chasing the profit [4].

Before the "Chinese private schools promotion law" published, the profit of the private school was defined as reasonable return and the investors get a huge profit from the school. As early as 2001, some scholars found that private colleges and universities with more than 10,000 students could have a surplus of 50 percent. In recent years, with the investment of school funds and the expansion of the scale, the balance of private colleges and universities is increasing. In December 2017, Hua Li University Group went public. According to its disclosure of listing information, the annual revenue of the university is 540 million yuan, the net profit is about 230 million yuan, and the gross profit rate is about 50%, which caused an uproar. It received government subsidies of 3.2 million yuan in 2015, 1.2 million yuan in 2016 and 7.8 million yuan in 2017. The vague provision of "reasonable return" actually gives the school organizers a window to make profits in a disguised way, allowing the organizers

involved in private higher education to take advantage of the opportunity to make a lot of profits, and some schools become profit-making machines [5].

After the “Chinese private schools promotion law” published, to avoid the substantial tax cost, the investors have to choose “non-profit”. Even through the private schools have turned into non-profit, the nature of the form determines that the organizers could transfer the profit to themselves. Such as become a senior executive in school with high salary, but most of them would transfer the profit through the related transactions [6], which could be named unfair related transactions. It means the related party transfers the interests of the school to the related party through related party transaction by taking advantage of its control and influence in the school. Unfair related party transaction refers to that the price of the transferred object is often not the fair price, the transaction is not necessary, the transaction form may not violate the law, but its essence deviates from the law of value. In the process of transaction, one party obtains illegitimate interests, and the other party's reasonable interests are eroded. The related party uses its control and influence on the target to import or export benefits between them in the form of related party transactions, thus distorting financial information and seeking improper benefits.

## **2.2. The Potential Methods of Unfair Related Transactions in Non-profit Private School**

### **2.2.1 The related party transfers the profit through the capital loan**

In the actual operation of the school, if there is a large amount of capital demand, the sponsor often raises and borrows funds from both external and internal sources in various ways. Since the money is borrowed in the name of the school, the debtor becomes the school and the school pays the interest. Through this operation mode, the related parties obtain excess interest income which is obviously higher than market interest rate.

### **2.2.2 The related party transfer the profit through the sale of goods or services**

In general, the related parties through the establishment of educational consulting service companies, collectivized logistics support service companies, cultural products companies and other forms, provide all kinds of goods and services to obtain a single source and stable income. In a large number of private schools, the procurement of dormitory, canteen and other logistics services was not open to public bidding, but controlled by investors. Some international schools, due to the particularity of their teaching materials, the education books are controlled by their related parties. Besides that, some directors and other senior executives of non-profit private schools are held by related parties and receive high remuneration.

### **2.2.3 The related party transfers the profit through leasing the property without market evaluation**

Many sponsors of private schools do not fulfill their obligations of capital contribution, and the equipment and houses required by the school need to be solved by leasing, which provides operational space for related parties to transfer profits. Due to the lack of transparency in the transaction, the relevant market transaction price cannot be obtained. The price is generally controlled by the organizer, who usually rents fixed assets they owned to the school at a high price in order to obtain long-term and stable earnings.

2.2.4 The related party transfers the profit through the form of guarantee, mortgage or development project

The sponsor of a private school could use the school's goodwill or real estate as a mortgage guarantee to raise funds for related parties, enterprises or individuals. In the end, due to the failure to repay the loan, the school bears the guarantee responsibility, which leads to the transfer of the profit [7].

### **3. The Necessity to Bring in the Audit System in Non-profit Private Schools of Higher Education**

#### **3.1. The Necessity of Improving the Supervision Mechanism for Non-profit Private Schools of Higher Education**

Although in the “Chinese private schools promotion law”, the government stipulated the supervision law and supervision department of the profit-making private schools, the related management files of non-profit private schools is missing. Which means, the schools and the society need to bring in more supervision on them. To avoid the unfair related transactions, the supervision of the non-profit private schools' financial problem should be improved.

#### **3.2. Specific Contents of the Financial Supervision: the Impact of Different Audit Systems**

##### 3.2.1 The government audit

When the private school needs to be recognized as a non-private school, the government audit should examine strictly, and with the increasing financial support of the government to non-profit private schools, the government audit also needs to carry out necessary audit supervision on this part of financial funds. On the other hand, it also forms an outside-in supervision mechanism to strengthen the consciousness of standardizing the running of private colleges and universities. Besides that, the government audit should set up a unified accounting system for the non-profit private school, to help the financial supervision, which would help the external auditor to recognize the related unfair transactions.

##### 3.2.2 The external audit

The external audit always means the accounting firm which would issue the audit report for the school every year. An external audit could improve the supervision over the implementation of property rights of legal persons. The external audit could supervise the legal person to transfer the land and other assets invested in running schools in the full amount after capital verification and confirmation according to law, and help the schools to set up the standard account of the assets and the profits.

The external audit could recognize the unfair related transaction, such as the leasing of related party's assets in a higher price, and the abnormal mortgage guarantee for the related party.

##### 3.2.3 The internal audit

At present, due to the lack of external internal control system for private colleges and universities, the lack of internal awareness and ability to establish and improve internal control, private colleges and universities internal control is very weak. The internal audit could be based on the cost of running a school and market demand factors, standardize the

management of fees and bills; Standardize and improve the school financial work flow and management system, improve the financial work efficiency; Strengthen the internal control of non-profit private colleges and universities, and form a financial supervision mechanism combining internal supervision and external supervision. The internal audit will improve oversight of the power and interests of internal members. Supervise the business dealings between non-profit private colleges and universities and the related parties, and prevent the improper profit-making of school insiders that may arise. Strengthen the bank account management of non-profit private colleges and universities, standardize the financing channels of non-profit private colleges and universities, focus on the supervision of educational projects with major risks, and establish a dynamic evaluation mechanism for fund security, prevent the abnormal mortgage guarantee for the related party. It is reasonable to ensure the safety of private colleges' assets, the effective use of resources and the realization of the school's strategic goals [8].

## Summary

Based on the "Chinese private schools promotion law", Chinese non-profit private schools of higher education should give up all their income and profit, which could cause some cheating behavior such as unfair related transactions, to transfer their profit snugly. To avoid the behavior, it is necessary for the government and the society to bring in the audit system, make the government audit, external audit, and the internal audit to cooperate, to help the recognizing of the unfair and illegal related transactions.

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