

## On the Improvement of Chinese Enterprise Internal Control Standard System and Implementation Mechanism

Luo Anguo

Hunan Science and Technology Economy Trade Vocation College, Hengyang,  
Hunan, P.R.China. 421009  
E-mail: luoag1023@126.com

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**Abstract.** At present, to accelerate the Chinese establishment of enterprise internal control, it is necessary to continuously improve Chinese enterprise internal control standard system and emphasize on the establishment of enterprise internal control implementation mechanism.

### To continuously improve Chinese enterprise internal control standard system

The study on Chinese enterprise internal control standard develops gradually along with the recovery of China's auditing. In 1980s, the academia firstly took the lead in exploration and research on this field. In the middle and later period of 1990s, relevant authorities in finance, state-owned assets, etc. gradually realized the significance of internal control to ensure the legality, truthfulness and validity of enterprise operation and management, and began paying attention to formulation of internal control standard and promotion of establishment of enterprise internal controls. However, on the one hand, the theoretical research and practices operating in Chinese enterprise internal control start late at a lower level, and it's impossible for China to consciously form a clear and definite main line and center on the line to establish an internal control standard system at the very beginning being like crossing a river by feeling his way over the stones; on the other hand, under the planned economic system with the influence of industrially centralized administration of Chinese enterprise, the formulation of internal control standard was largely administered in an industry-specific mode, that is, each industrial authority or department formulated separate standard for specific industry. This system of multiple leaderships benefited reflect the special requirements of some industries for internal control system to certain extent, but was not helpful to form a unified standard system. Therefore, for a long time, China hadn't a recognized and authoritative internal control standard document, let alone forming a scientific internal control element framework and standard system. It was until June 2008 that *The Basic Standard for Enterprise Internal Control* was jointly printed and released by five Chinese government authorities and regulators, namely the Ministry of Finance of the People's Republic of China, China Securities Regulatory Commission, National Audit Office, China Banking Regulatory Commission, and China Insurance Regulatory Commission, which builds the basic framework for Chinese enterprises to establish and implement internal control. On April 26, 2010, these five authorities and regulators jointly issued *The Enterprise Internal Control Supporting Guidelines*, including 18 items of *The Enterprise Internal Control Application Guideline*, *The Enterprise Internal Control Assessment Guideline* and *The Enterprise Internal Control Audit Guideline*. The release of this basic standard and supporting guidelines marked the basic establishment of Chinese enterprise internal control standard system. Chinese newly-established enterprise internal control standard system gives full play to the late-mover advantage, borrows a lot from internationally advanced internal control standard like COSO's *Internal Control-Integrated Framework*, and aligns with internal standard in all major aspects with striving for some innovation and breakthrough. However, as a new thing, it needs improvement in the ever-changing practices. To this end, we should especially pay attention to the following matters:

#### 1. To attach great importance to legislation for enterprise internal control standard

Developed European countries and America have attached great importance to legislation for enterprise internal control and established a multiple-level enterprise internal control standard system based on their own conditions and legal traditions. In this system, basic laws, such as the

basic laws of commerce, the subject laws of commerce (like company law), securities laws, accounting laws, etc., often generally stipulate the major matters with respect to enterprise accounting regulation and enterprise governance structure, then, on the legal level, the competent administrative organs formulate concrete rules and regulations to specifically detail the legal requirements and additionally often support and recognize detailed operational guidelines and research reports prepared by relevant bodies (legislative advisory bodies or professional bodies). As a result, a complete, inter-coordinated and operational standard system is formed. It is especially notable that before Enron event in 2001, basically, there was no special legislation for enterprise internal control initiated in each country, but only nine months after this event, exactly on June 18, 2002, U.S. Senate Banking Committee passed *Listed Company Accounting Reform and Investor Protection Act in 2002*, namely, *The Sarbanes-Oxley Act*, and formulated implementation rules and operational guidelines to perform this act. EU and its inside major members also examined and reformed their company law and corporate governance rules, partly referring to *The Sarbanes-Oxley Act*, and partly reviewing and improving their own corporate governance and internal control practices.

Foresaid international experience shows that many countries are paying more and more attention to the role of law in adjustment of enterprise internal control. China should also follow the trend to supplement and improve relevant universal standard of internal control by amending its existing laws and regulations like *Accounting Law*, *Company Law* and *Securities Law*, and put important matters of internal control in to law to increase the effectiveness of those laws. For example, present legislation can make mandatory provisions for the enterprises' financial report control and governance structure as a dominant part while making advocacy provisions for principle of other fields. At the same time, Coordination shall be intensified between rules or normative documents prepared by different departments to avoid differentiated understanding and appeals of industry sectors with respect to internal control due to private interests and knowledge limitation. The forms of Departmental regulations and normative documents should be intensified and stabilized, so as to effectively solve the problem of multiple leaderships, differential requirements and enterprises' confusion and to practically increase the regulatory efficiency for internal control and reduce regulatory costs.

## **2. To attach great importance to interaction and interconnection of enterprise internal control with other relevant matters**

Enterprise internal control directly affects three key groups of stakeholders, namely, enterprise owner and operator, state regulator and independent auditor, which covers risk control, financial management, governance structure, strategic development, etc., and involves international market, domestic market, physical market and virtual market under the context of economic globalization and asset securitization. Some standards seem slight, but actually are highly interconnected. Therefore, when reviewing, formulating, applying and improving Chinese enterprise internal control standard, the democratic and scientific decision-making mechanism shall be consolidated strongly, and the activity, initiative, and creativity of all aspects concerned shall be aroused fully to provide strong intellectual supports for establishing a high-quality internal control standard system; characteristics of financial industry and financial risk shall be fully considered, the initiative shall be taken to comply with financial laws and regulations, three guidelines with respect to banking, securities and insurance shall be issued as soon as possible; relation between external regulatory requirements and internal management requirements shall be managed well, enterprise's endogenous impetus shall be strengthened; mandatory legal requirements for important internal control matters shall be raised, more importantly, optional examples shall be available for various enterprises to establish and improve internal control system; the interconnection relation of accounting rules, auditing rules, internal control standard and accounting education with talent evaluation, informationization construction and credit system construction shall be studied and analyzed, the relation of certified public accountant auditing with corporate self-evaluation shall be managed well, and a mechanism to discover problems through self-evaluation and external auditing shall be established to give full play to overall interconnection effect and to better serve the

sustainable economic and social development; relation between internal control system based on overall risk management and internal control on financial report shall be managed well, and the information quality of corporate report shall be improved by strengthening internal control management; efforts shall be made to align domestic internal control with international standards based on Chinese actual conditions, and Chinese internal control standard shall be improved to converge with or equal international internal control framework so as to actively support Chinese enterprise to implement the “going out” strategy.

### **To strengthen establishment of enterprise internal control implementation mechanism**

The old saying goes, for everything in the world, it is more difficult to implement laws than to legislate laws. To ensure the smooth and successful implementation of Chinese enterprise internal control standard system, its designers have made a great deal of efforts: firstly, in consideration of different effects of various types of enterprises on social and economic life, and their different urgency and adaptive capacity in implementation of internal control, the schedule and roadmap to implement internal control were made scientifically on the principle of distinction. That is, *The Basic Standard of Enterprise Internal Control* and *Enterprise Internal Control supporting guidelines* are initially applicable to companies listed simultaneously home and abroad from January 1, 2011, and then applicable to companies listed on the Main Board of Shanghai Stock Exchange or Shenzhen Stock Exchange from January 1, 2012, and on this basis, if necessary, later applicable to companies listed on SMEs Board and on GEM. At the same time, early implement by large and medium size unlisted companies are encouraged. Secondly, on the basis of formulating application guidelines, detailing specific standard of internal control elements, enterprise self-evaluation guidelines and certified public accountant audit guidelines with respect to enterprise internal control were established. That is, enterprises that are required to implement enterprise internal control standard system must conduct a self-evaluation of the effectiveness of its internal control, disclose annual self-evaluation report, appoint accountants firms with qualification for the business of securities and futures to audit the effectiveness of its internal control over financial report with audit report issued, and remind investors, creditors and other stakeholders to pay attention to any great defect in internal control over matters of non financial report discovered in the course of internal control auditing.

The life of enterprise internal control standard system lies in implementation. However, any law can't work by itself, and without an effective implementation mechanism of the internal control system will exist in name only and will be out of action as an “alarm” and “firewall”. Therefore, we now should strengthen establishment of enterprise internal control implementation mechanism from many aspects, and efforts should be made to form an implementation mechanism guided by laws and standard system, implemented mainly by enterprises, guaranteed by government supervision and social appraisal, and promoted by all parties taking part in actively. Generally speaking, we can take actions as follows:

#### **1. To further regulate enterprise governance structure by laws and regulations**

Modern enterprise internal control shall cover all staff. But a great deal of facts, such as Enron event, China Aviation Oil incident, Sanlu incident, China Railway Construction incident, etc., show that enterprise's top executives who have big power, especially the head, tend to put themselves above the system, which becomes the blind area or weak point in enterprise internal control. To implement well enterprise internal control, the initial thing is to effectively limit the power of enterprise's top executives, which requires the use of law and regulations to regulate the design and operation of enterprise governance structure, and intensify the obligations and responsibilities of shareholders, directors, supervisors and senior executives. Otherwise, enterprise internal control system is hardly binding on its designers, managers and supervisors, and consequently internal control abnormally changes to be insider control.

#### **2. To further cultivate a culture and a mechanism in enterprises in favor of internal control**

Enterprises should attach great importance to develop internal control culture and idea, improve legal affairs mechanism, increase staff's awareness of compliance, and continuously boost

capacity and level of evaluation, prevention and risk elimination. Enterprises should attach great importance and give full play to the supervisory role of audit committee in internal control implementation, give the audit committee functions to supervise the effective implementation of internal control and self-evaluation on internal control, and coordinate internal control audit, and guarantee the authoritativeness and relative independence of the audit committee to the best of its ability. Enterprises should establish a system which can tie the internal control implementation to staff performance evaluation so as to actually increase the pressure and motivation of staff to participate in internal control.

### **3. To further explore and detail the operation of internal control assessment and auditing mechanism**

Subject to the requirements of laws, rules and appropriate regulations, Ministry of Finance of the People's Republic of China and other relevant governmental bodies should provide further guidelines for the contents of enterprise internal control assessment report, can try to introduce and use standard text like internal control assessment form, sort out and summarize assessment manuscripts formed during the assessment, and write down assessment contents, business description, effectiveness, defect and assessment records, as further supplement to internal control assessment report. This makes internal control assessment reports of different enterprises are comparable, and is beneficial to reading and understanding for report users, to system detailing, reduction of enterprise burdens, and to legal protection of enterprises' business secrets and information. Meanwhile, to ensure the independence of certified public accountant in auditing, the provision "when appointed to provide internal control consulting for an enterprise, the accountant firm shall not perform an audit of the internal control to that enterprise at the same time" should be incorporated into *Law on Certified Public Accountant* as it is amended.

### **4. To further improve governmental regulation and strengthen guidance and coordination**

As the principal designers of enterprise internal control standard system, Ministry of Finance of the People's Republic of China and other supervisory authorities should develop the idea that administration and service should be consistent, combine supervision and inspection with policy guidance, closely track the implementation of internal control standard, establish fast and efficient warning, response and management mechanisms, and handle well all problems occurring at the initial period of the system. In supervision and examination, responsibility group shall be identified, legal accountability shall be implemented, and abnormality of "nobody responsible for collective decision" or "the hand of punishment lifted high, but coming down gently" shall be prevented so that the system will not exist in name only. All regulatory departments shall not only make full use of joint session, case delivery and other ways to further improve information sharing, strengthen communication and consultation, coordinate regulatory policies, standardize regulatory approaches, build synergy on regulation and improve regulatory efficiency, but also emancipate minds, innovate in the mode of social management, make full use of advantages like being close to market and highly professionalized, etc. enjoyed by industry associations and social intermediary organizations, and encourage and support them to give play to self-regulation, so as to realize the interconnection, complementarity and interaction between governmental regulation and social management.

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