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Internal Control Reporting

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An Empirical Analysis

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Dedicated to my family

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List of Abbreviations

CAGR Compound Annual Growth Rate

CAS/ASBE Chinese Accounting Standards/Accounting Standards for Business Enterprises

CBRC China Banking Regulatory Commission

CIIA China Institute of Internal Audit

CIRC China Insurance Regulatory Commission

CNAO China National Audit Office

COSO Committee of Sponsoring Organizations of the Treadway Commission

CPA Certified Public Accountant

C-SOX The Basic Standard on Enterprise Internal Control and its supporting guidelines

CSRC China Securities Regulatory Commission

E&Y Ernst&Young (accounting firm of the Big 4 group)

GDP Gross Domestic Product

HKFRS Hong Kong Financial Reporting Standards

HKSE Hong Kong Stock Exchange

ICE Internal Control Employee

ICW Internal Control Weakness

IFRS International Financial Reporting Standards issued by the International Accounting Standards Board

IIA The Institute of Internal Auditors

IPO Initial Public Offering

KPMG Klynveld Peat Marwick Goerdeler (accounting firm of the Big 4 group)

LSE London Stock Exchange

MOF Ministry of Finance of the People's Republic of China

NYSE New York Stock Exchange

PwC PricewaterhouseCoupers (accounting firm of the Big 4 group)

ROA Return on Assets

ROE Return on Equity

SEC Securities Exchange Commission (US)

SOE State Owned Enterprise

SOX Sarbanes-Oxley Act

SSE Shanghai Stock Exchange

SZSE/SHZ Shenzhen Stock Exchange

前言

这篇论文研究中国大陆企业的内部控制规律。谈到这个话题的研究者并不多。这篇论文的主要目的是分析中国企业的内部控制制度（以下简称内控）及内部审计制度。同时，也要分析中国内控法规的发展阶段以及评价中国上市公司内部控制制度的有效性和质量。

公司内部控制的目标是保证经营管理合法合规、资产安全、财务报告及相关信息真实完整，提高经营效率和效果，促进实现发展战略。总的来说，一个有效的内控制度不仅可以防止经济诈骗， 还是提高运营效率的一个重要条件。此外，财务报告内披露信息的真实性和完整性可以增强企业的公信力。内部控制实现增值的主要途径有公司治理、完善内部控制制度、风险管理、内部控制自我评价等 (ZHANG, 2015)。

内部控制和内部审计的起源可以追溯到西周王朝（1046-771 公元前） (LU & MA, 2017)。中华人民共和国成立后 （1949 年）， 新中国的内部控制制度和做法受到了苏联监督制度的影响。由于中国计划经济的特点，企业基本上都是国有企业，新中国成立后形成的内部控制和内部审计与国家审计相吻合。 所以，从 1949 年到 1982 年，中国企业和政府部门之间缺乏统一的内部控制和内部审计制度。另外，中华人民共和国缺乏独立国家内部审计协会 (LI, 2007)。

中国的经济环境在邓小平实行对外开放政策的时期发生了改变。从 1978 年起，中国开始吸引外资、从国外引进先进的技术设备， 但是中国保留了她的根本制度，即社会主义制度。 1982 年邓小平在《中国共产党第十二次全国代表大会开幕词》中提出了中国建设有中国特色社会主义。中国特色社会主义是指以经济建设为中心、实行改革开放而坚持四项基本原则 (Baidu baike 百度百科, 2018)。随着中国改革步伐的加快，以及经济的迅速发展，中国企业不断走向世界，走向亚非欧等国家。这些国家的经济环境，要求中国企业要不断适应新情况 (LAI, 2018)。同时，许多中国国有企业经历了私有化的过程。经济全球化给企业带来巨大机遇，也带来了巨大的挑战。很多中国企业在竞争日益激烈的外部环境中，为了增强自身的竞争能力，需不断改善内部管理，提高工作效率、提高产品质量。这些中国企业，特别是上市公司，成为民营企业或是走向世界后，急需建立健全一个有效的内部控制制度。然而那一时期关于内部控制的中国法律体制还不完善。 也是从那时起，中国政府开始制定全面的内控法律体制。

文章旨在从企业内控的含义和提升内控质量的意义谈起,分析企业内控符合法规的程度、内部控制的缺陷，从而为评估内控质量提出方法。 这篇论文分为四章。

第一章理论部分分析介绍内控和审计的发展阶段，研究从1949年至2008年国务院颁布的有关内控的法规。第一阶段包括从1949 年到2003 年之间颁布的那些法规。在这一阶段中中国政府颁布了一些基于财务报告内控和审计法律。这些法律是《中华人民共和国会计法》（1985 年）和《中华人民共和国审计法》（1994 年）。这一阶段的主要特点是自我管理，中国缺乏一个关于内控的完整法律。所有的规定和其它内部控制监管要求都是根据不同行业类型不同部门制定的。第二阶段包括从2003年到2008 年之间颁布的那些法规。在这一阶段里中国政府制定了现行的内部控制规定。2008 年，中华人民共和国财政部、中国银行业监督管理委员会、中国保险监督管理委员会、中华人民共和国审计署和中国证券监督管理委员会共同地颁布了《企业内部控制基本规范》。2010 年中华人民共和国财政部颁布了企业内部控制基本规范的配套指引——《企业内部控制应用指引》、《企业内部控制评价指引》和《企业内部控制审计指引》。这一阶段的主要特点是国际准则对中国的内控法制产生了影响。美国的《萨班斯—奥克斯利法案》（2002年）和反虚假财务报告委员会下属的发起人委员会COSO，尤其是COSO委员会颁布的《内部控制整合框架》（1992年），都对中国内控法律的制定产生了影响。企业内部控制基本规范和它的配套指引从2012年开始对所有在上海证券交易所和深圳证券交易所主板上市的公司生效。

第二章仍然是理论分析，它是关于内部控制的实践和内控信息披露的文献回顾。第三和第四章把从该分析收集的数据用于进行实证研究。 由于《企业内部控制基本规范》公布的时间不长，因此关于国内上市公司披露的内部控制评价报告的实证研究还比较少。本章根据四个话题对内部控制的文献进行回顾。三个话题包括内部控制质量、内部控制评价报告的合规性和内部控制报告内披露的财务报告和非财务报告内部控制缺陷。最后一个话题将中国的《企业内部控制基本规范》（2008）与美国的《萨班斯—奥克斯利法案》（2002）进行比较。通过在第二章进行的研究可以看出：内部控制信息披露行为会对企业经营管理产生怎样的经济效应、披露之后能促进企业内部控制的完善。

第三章提供实证研究的介绍。分析了中国内控的法制以后，这篇论文的目的还包括核实中国上市公司在内控方面遵守中国内部控制法规的程度。并且这篇论文还要评价中国上市公司内控制度的质量。中国上市公司每年初应该披露关于上一年的一份年度报告、一份内部控制评价报告和一份内部控制审计报告。根据《企业内部控制评价指引》，中国上市公司在编写它们内部控制评价报告的时候，还要评价那些非财务报告的内部控制缺陷，也就是那些跟财务报告没关系的内部控制缺陷。这个是中国内控法规独特的特点。第三章提供的信息包括: 实证研究的目的、研究的方法、研究的问题和公司样本的选择。公司的样本包括 30 个 A 股上市公司，这些公司都在 Nikkei 亚洲 300 指数内，并且它们都在上海证券交易所和深圳证券交易所主板上市。这篇论文分析了公司从 2015 年初到 2018 年初（关于 2014、2015、2016 和 2017 年）披露的年度报告、内部控制评价报告和内部控制审计报告。这一章还包括内部控制评价报告合法合规的计量方法、对披露内部控制缺陷信息进行整理研究以及内部控制质量的评价方法。

第四章解释实证研究的结果。 第四章的第一部分表明样本公司内控制度合法合规的结果。通过公司披露的内部控制评价报告的分析，可以看出所有公司都披露了内部控制评价报告并且遵守了中国的法规。公司内部控制自我评价报告可见其内部控制既遵循了国家的法律规章又有助于提升运作的效率效果 (XIE, 2018)。正是因为内部控制发挥了作用，公司的业绩才能逐年攀升。在第四章的第二个部分，作者通过披露内部控制缺陷信息的研究，发现了内部控制缺陷信息披露中存在许多问题，披露的方法还需要改善。第四章的第三个部分分析了样本公司披露的内部控制审计报告。这个分析的结果是公司的大多数都引用了从Big 4四大会计师事务所来的会计师审计它们的内部控制的评价报告，因为Big 4会计师可以确保提供高质量的审计服务。第四章的最后一部分评价了样本公司的内部控制质量。从那些公司的年度报告中，实证检验用了四个财务和非财务指标来计量样本公司内部控制质量的影响因素。这些指标是公司的盈利能力的比率、销售增长或营业收入的比率、国有性质股东持股的百分率和 Big 4 会计师的选用。年度报告的分析结果表明：公司盈利能力越强，内部控制质量越好。营业收入不稳定，内部控制质量不高。国有性质的前十大股东持股比例越高，内部控制质量越低。选择高质量会计师事务所的公司，出现内部控制缺陷的可能性比较低，所以内部控制质量比较高 (LIN, 2017)。最后将所有的结果与以前的文献结果进行了比较。

最后，这篇论文以2014—2017年沪深两市A股上市公司为研究对象。论文的结论包括中国内部控制的全局和实证研究的结果：总体来看，内部控制对企业绩效也具有显著正向影响。本文阐述了企业内控质量的重要性意义，提示人们关注、重视企业面临的内控质量困境，并且根据实证研究对内控困境的解决提出建设意见 (LAI, 2018)。另外论文的结论包括作者提出的假设以及观察结果是否符合假设。结论里还提出了一些为能对中国企业的内部控制进一步进行研究的建议，论文作者希望在不断的探索实践中，中国企业能发展得越来越好。

INTRODUCTION

This thesis considers internal control in Mainland China as the main subject of its study. The reason for this choice is that only a few studies have shown the development of internal control and internal audit in the People's Republic of China. Moreover, the disclosure of internal control information under the new regulations has rarely been studied directly. The aim of this study is that of covering this uncharted area, in order to provide a comprehensive view of laws and regulations on the topic and assess the effectiveness of internal controls in Chinese listed companies.

An effective system of internal control is an essential prerequisite for an organisation's efficiency of operations other than being an instrument for limiting the risks of fraud (Dezan Shira & Associates, 2012). Compliance with laws and regulations, the achievement of organisational and strategic goals and reporting transparency are the main objectives of internal control and risk management. The disclosure of truthfully accounting information enhances the credibility of an organisation, while constant monitoring and supervision enhance efficiency of operations. One of the characteristics that determines the effectiveness of internal control is adaptability, because it ensures the adaptation of the controls to dynamic environments.

The Chinese one can be exactly defined as a dynamic environment. The aim here is to investigate into the adaptation of internal control frameworks to the Chinese economic environment. The origins of internal control in China trace back to the imperial period, to the Western Zhou Dynasty in particular (1046-771 B.C.) (LU & MA, 2017). The audit system during the Western Zhou dynasty focused on two aspects. The first system was in control of the annual examination and supervision of the officials' financial performance, while the second system was responsible for auditing the financial accounts of the country (LI, 2007). Internal control practices adapted again in the liberated areas before the establishment of the People's Republic of China. After the establishment of the People's Republic of China in 1949, internal control systems were inspired by the Soviet systems of supervision. Due to the fact that State ownership and State supervision were at the basis of the Chinese planned economy, at the time, internal control and internal audit coincided in fact with State audit. Between 1949 and 1982, China was lacking a unified system of audit supervision, and did not have independent national audit institutions. It is worth mentioning that, although at the time some State departments formulated their own specific rules on internal audit, a unified national internal audit system did not exist.

The economic environment in China changed once again with the "Open-Door Policy" introduced by Deng Xiaoping in 1978. The "Open-door Policy" helped China to attract foreign

investments and to become more active in international economic organizations. The People's Republic of China started a course of reforms and opening-up, established a socialist market economic system and improved the nation's economic power (LI, 2007). Building socialism with Chinese characteristics was put forward at the Twelfth Party Congress in 1982 (LI, 2007), and since then, the Chinese economy has been rapidly growing. The Chinese stock market experienced a rapid growth that led to the gradual development of modern corporate management among listed firms (JI, et al., 2018); (LAI, 2018). In the late 1980s and at the beginning of the 1990s, many state-owned enterprises (SOEs) that operated under the planned economy went through the process of privatization. However, at the beginning, these enterprises did not have a sound system of internal control and lacked any awareness concerning risk management. Consequently, establishing internal controls and an independent audit supervision system became an urgent issue (LI, 2007). Moreover, in that period internal audit and internal control started to be seen as two separate concepts: an effective system of internal audit could not serve as a substitute for a system of internal control and vice versa (XIE, 2018). From that period on, the Chinese Government started to work on a comprehensive regulatory framework on internal control.

The organisation of this work follows the two main objectives of exploring the development stages of internal audit and internal control in China and of assessing and evaluating companies' compliance with the current regulatory framework.

Only a few studies have shown the development of the Chinese regulatory framework on internal control. To tackle this problem, the first part of this thesis is theoretical and it introduces the stages of development of internal control and audit. The first chapter retraces the laws and regulations on internal audit and control promulgated in the People's Republic of China between 1949 and 2012. The chapter introduces a first stage of development, going from 1949 to 2003, in which the first provisions were issued. In this stage China promulgated the laws at the basis of audit and control related to financial reporting. These laws were the Audit Law (1994) and the Accounting Law (1999). Additionally, this stage was characterised by the lack of a comprehensive regulatory framework for internal control and therefore by self-governance. Internal control rules were adapted to each sector and were established within departments, according to the industry type. The second stage, going from 2003 to 2008, is the period in which The People's Republic of China develops the regulation on internal control currently in force, the Basic Standard for Enterprise Internal Control promulgated in 2008. This stage is characterised by the influence of the American Sarbanes-Oxley Act (2002) and COSO's international frameworks for internal control and risk management (1992 and 2004). The third part of the first chapter is exclusively intended for the analysis of the Basic Standard for

Enterprise Internal Control (2008) and its supporting guidelines, which entered into force in 2012 for all the companies listed on the Shanghai Stock Exchange and on the main board of the Shenzhen Stock Exchange.

The second chapter provides a theoretical framework for the analysis of previous literature on internal control. The data collected from this analysis will be then used for the empirical research. Due to the fact that the regulation on internal control was published in 2008 and its application is very recent, only a few studies focus on the disclosure of internal control information by Chinese listed companies. However, there are studies which analyse the determinants of internal control quality in American companies under the Sarbanes-Oxley Act that can be also applied to the Chinese model. Due to the fact that some Chinese studies on internal control quality used the determinants analysed in American studies, those American studies are included in the second chapter. The chapter proposes a review of the literature on internal control by dividing it according to topics such as internal control quality, compliance with the regulations and disclosure of ICWs. Lastly, the chapter proposes some studies which compare the Chinese Basic Standard for Enterprise Internal Control (2008) and the American Sarbanes-Oxley Act (2002).

The third chapter is an introduction to the empirical part of this thesis. The other two objectives of the thesis are to study the compliance of a sample of Chinese listed companies with the regulation currently in force and to evaluate the quality of their internal control systems. Chinese companies have to disclose annual reports containing information on the self-assessment of their internal controls, together with their financial annual reports. What characterises the Chinese regulation is that listed companies have to assess both internal controls related and unrelated to financial reporting. This means that China, unlike any other country in the world, has a unique requirement, that is the disclosure of either internal control weaknesses related and unrelated to financial reporting. The third chapter provides information on the research approach, research questions and sample selection. It is important to mention, that the companies included in the sample are companies listed in Mainland China (Shanghai or Shenzhen). The reports analysed are the companies' Self-assessment Reports on Internal Control, Audit Reports on Internal Control and Annual Reports. This chapter also contains the methodology for the measurement of internal control disclosure, internal control weaknesses disclosure and for the evaluation of the companies' internal control quality.

The fourth chapter presents the results of the empirical analysis concerning the companies' compliance with the regulation in the annual self-evaluation reports on internal control disclosed for the years 2014, 2015, 2016 and 2017. In addition, the results of the analysis of the audit reports on internal control disclosed between 2015 and 2018 for the years 2014, 2015, 2016 and 2017 are

included in the second part of the fourth chapter. The analysis of the financial annual reports disclosed in the time frame going from 2015 to 2018 is included in the third part of chapter four. The results of this last analysis provide evidence of the financial, ownership and auditor-related factors that influence internal control quality. Lastly, the results obtained by previous researches and the results obtained in this thesis are presented in the final part of the fourth chapter.

Finally, the conclusions of this thesis will be presented in order to allow a comprehensive evaluation of the internal control situation in China. In addition, the conclusions contain a statement in which the author explains whether the hypotheses made at the beginning of the research have been confirmed or rejected. Lastly, this study offers some insights for further studies.

CHAPTER 1

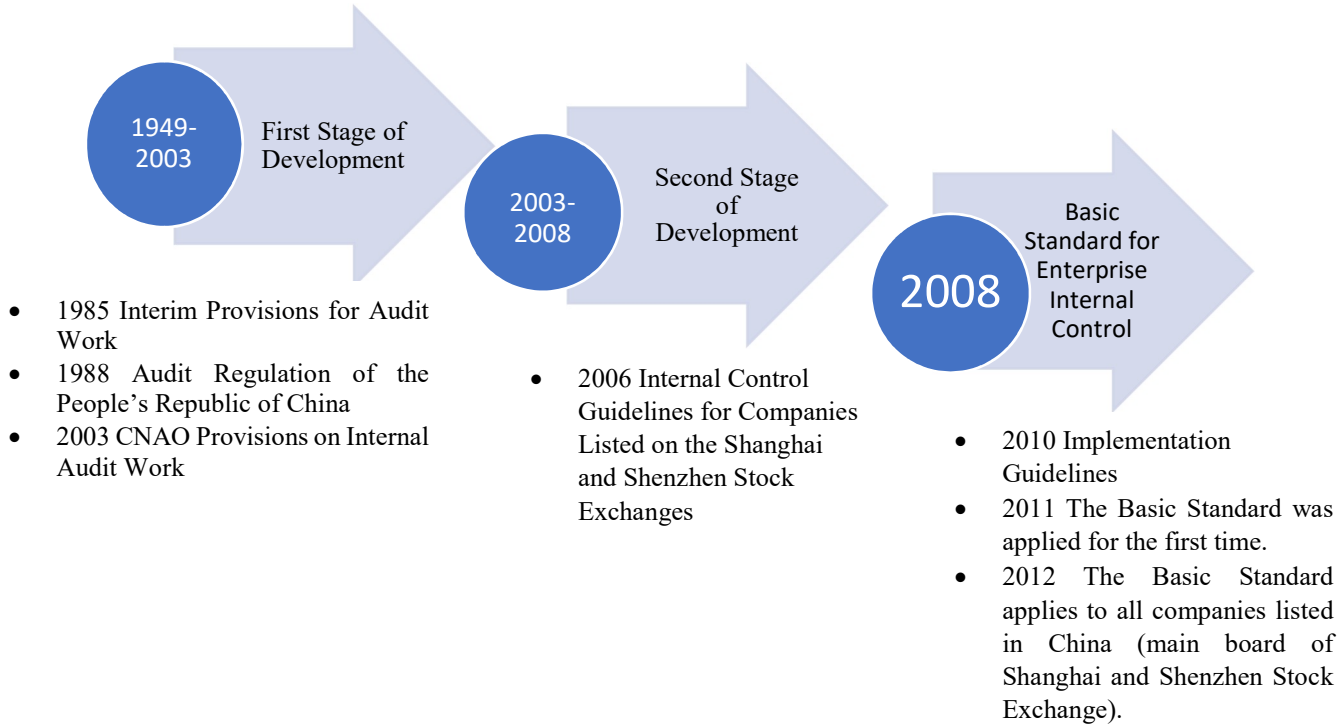
1. Regulations on Internal Control and Audit of Internal Control

Internal control in China has a long history, it traces back to the Imperial period, in particular during the period of the Western Zhou Dynasty (1046-771 B.C.). Since the establishment of the People's Republic of China in 1949, the Government and its departments carried out practices of internal control and enacted laws and regulations. At the beginning, the practices were learnt from the Soviet supervision system and internal audit institutions did not exist. Basing their systems on the experience of the audit practices of the liberated areas, some departments and units set up internal control systems and internal audit organs. It is worth mentioning that, although at the time some State departments formulated their own specific rules on internal audit, a unified national internal audit system did not exist. It can be asserted that in that period internal audit developed together with State audit, due to the fact that the state-owned economy was predominant in the market.

According to the characteristics of the regulations on internal control, the development of internal control and audit of internal control in China after 1949 can be divided in two stages. The first stage goes from 1949 to 2003, with the last important set of rules promulgated in 2003, year in which the National Audit Office[1] (CNAO) of the People's Republic of China issued the Provisions on Internal Audit Work. The second stage starts in 2003 and the most significant year is 2006, because of the Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies published by the Shanghai Stock Exchange. The second stage is a period of innovation, that will lead to the formulation of the current regulation on internal control and audit, promulgated in 2008 under the name of Basic Standard of Enterprise Internal Control. The characteristics of the two stages, as well as an analysis of the regulations will be provided in the next paragraphs.

[1] National Audit Office of The People's Republic of China, established in 1983. http://www.audit.gov.cn/en/index.html

Figure 1.1 The stages of development of internal control and audit in China.



Source: elaborated by the author.

1.1 First stage of development (1949-2003)

Since the establishment of the People's Republic of China, many Government divisions have participated in the development of internal control and have tried to establish their own rules. It has been mentioned above that in this period internal audit developed together with State audit. This happened because the Chinese Government had so many departments and units that controlling all of them with only an audit institution was a very complex task. For this reason, they needed to set up internal audit committees or audit sections for ministries with many subordinate units and for large enterprise groups, with the aim of intensifying supervision and combating malpractices. Supervision was believed to be important because it could contribute to build a socialist society. This meant that supervision was important for protecting State property and ensuring rational utilization of State Capital. However, at the time internal control was rudimental, it had characteristics of the Soviet system of internal control and had features of government dominance. At the time internal audit institutions did not exist, and a unified system with set of rules that could be used by any industry was lacking. In fact, regulations on internal control were designed according to the actual firms in their specific industry, and were more similar to accepted practices than to actual rules. It can be asserted that since the introduction of the reforms and opening-up policies, and since the establishment of audit institutions, an internal audit system has been gradually set up and the number

of pilot units engaged in internal audit has increased. In particular, when state-owned enterprises started to be transformed into corporations, internal audit departments and internal control gained significant importance. With the establishment of the socialist market economic system, some state-owned enterprises became legal entities that could operate independently, assuming sole responsibility for their profits and losses. A sound system of internal audit helped to ensure the fairness of the accounting records of these companies and, consequently, helped to improve their economic efficiency.

Three are the most important characteristics of this stage. As it has been mentioned above, during the first stage, China did not have a comprehensive regulatory framework for internal control. In fact, the first characteristic of internal control in the period that goes from 1949 to 2000 is self-governance. This means that rules for internal control were established within departments, each specific department had its own set of rules designed according to the industry type. Therefore, a uniform guidance was lacking. In order to provide evidence of this characteristic, a table (Table 1.1) with the most important provisions regarding different government departments and organizations is included below.

Table 1.1 Table on Regulations and Guidelines on Internal Control in China during the first stage of development.

Date of Implementation	Enacting entity	Name of the regulations or guidelines
1951	Ministry of Public Health	Interim Audit Rules of the Ministry of Public Health of the Central People's Government
1953	Ministry of Textiles Industry	Interim Audit Rules for the Economic and Business Institutions Affiliated with the Ministry of the Textiles Industry of the Central People's Government
1953	Ministry of Railways	Organization of the Financial Audit in the Ministry of Railways
1996	Ministry of Communication	Reviewing Method for Internal Control System with Bank and Communications
1997	Electric Power Department	Auditing and Trial Methods for Internal Control System Within Electric Power Enterprises
1997	China Association of Registered Accountants	Specifications of Independent Auditing, Internal Control and Auditing Risks
1997	State Education Commission	Implementation Method for Enterprise Internal Control System Reviews in the Education System
1999	China Insurance Regulatory Commission	Construction and Guiding Principles of Internal Control System within Insurance Companies
2001	China Securities Regulatory Commission	Guidance of Internal Control for Securities Company
2002	The People's Bank of China	Guidance on Internal Control of Business Banks

Source: elaborated by the author.

The second characteristic is that, at the time, financial departments were those involved in internal control and there were different opinions on the definition of internal control. For this reason, internal control systems were merely concentrating on accounting and auditing. Conversely, a comprehensive internal control system should be concerned with financial control but it should also integrate management control and risk management control.

Thirdly, in the final years of the first stage, international views on internal control were introduced. This allowed major changes in the operational environment and in the traditional internal control theories. Overall, this stage was characterized by discordant requirements, there were different opinions on the definition of internal control, and a unified and comprehensive internal control system was lacking.

1983 was an important year, since the CNAO (National Audit Office) was founded. Its first item on the agenda was the establishment of internal audit departments in various departments and organizations, with the aim of improving management and economic efficiency as well as working as a basis for government audit work. With these objectives, the CNAO started to work on a series of provisions and regulations.

The first regulation that signed the official establishment of the internal audit system in China was promulgated in 1985 under the name of State Council's Interim Provisions for Audit Work. This regulation was issued after a series of projects concerning internal control were launched by internal audit departments at various levels and after the establishment of government audit institutions (LI, 2007). In 1988 the Audit Regulation of the People's Republic of China was promulgated by the State Council and it provided the legal basis for carrying out internal control. It contained provisions on functions, tasks and leadership of internal audit departments. These first sets of rules can be considered as part of a stage in which government audit institutions were learning and exploring the matter. The objectives and definitions of internal control in this first stage, that goes from 1949 to 2003 (LU & MA, 2017), were those of developing requirements about responsibilities and duties, appointments and removal, rewards and punishment of accountants. Standardization of practices was also an important matter. The Accounting Law, first promulgated in 1985, revised in 1993 and in 1999, contained some requirements about internal control at the accounting-control level (Art.27), but did not cover requirements about assessment and reporting.

The Audit law of the People's Republic of China[2] was promulgated in 1994 and amended in 2006, it further enhanced internal audit's legal status and was the basis for promoting its development. In the period between 1998 and 2003 the CNAO promulgated more regulations based on the laws existing at the time.

The first guidelines that tried to create a comprehensive set of standards on internal auditing will be analysed in the next paragraphs.

1.1.2 State Council's Interim Provisions for Audit Work of 1985

According to this regulation the departments of the State Council and local governments should set up their own audit institutions and assign auditors. Large and medium enterprises and non-profit organizations had to set up internal audit departments responsible for the audit, and internal control supervision systems. The auditors had to report their findings to the audit department at the next-higher level.

1.1.3 Audit Regulation of the People's Republic of China, 1988

This new set of rules specifically stipulated the functions, tasks and leadership of internal audit departments (LI, 2007). According to this regulation, State finance institutions, large and medium-sized state-owned enterprises, construction units of large-scale capital construction projects and state-owned non-profit organizations, had to establish internal audit departments. Auditors and internal audit offices should conduct, in accordance with this regulation and internal policies, internal audit of revenues and expenditures. This regulation also specified the matters on which internal auditors should conduct internal audit. These matters included the financial plans of the institution and of its subordinate units; the implementation of the budgets of the units and final accounts; the economic activities and benefits related to revenues and expenditures; the management of state assets; activities violating financial and economic laws and regulations, and the audit items assigned by the leaders of these institutions, units or enterprises (LI, 2007).

1.1.4 Audit Law 1994 and Accounting Law 1999

The promulgation of the Audit Law in 1994 was of particular importance because it stipulated that internal audit systems must be established. Article 29 (1994) states that:

> Departments of the State Council and of the local people's governments at various levels, state-owned monetary organizations, enterprises and institutions shall establish and improve their internal auditing

[2] The Audit Law of the People's Republic of China was adopted at the 9th Meeting of the Standing Committee of the Eighth National People's Congress on August 31, l994 and amended in accordance with the Decision on Amending the Audit Law of the People's Republic of China adopted at the 20th Meeting of the Standing Committee of the Tenth National People's Congress on February 28, 2006.

systems in accordance with the relevant regulations of the State. Such internal auditing shall be subject to the professional guidance and supervision of audit institutions. [3]

Moreover, other relevant laws and regulations, such as the Accounting Law (2009), contained internal audit-related provisions. Article 27 of the Accounting Law, revised in 1999, stated that all units should establish and improve their internal accounting supervision systems. The supervision system of each unit should define the methods and procedures for conducting regular internal audit.

1.1.5 Other stipulations promulgated by the CNAO

From 1985 to 2003, the CNAO, in order to promote the development of internal audit, promulgated four regulations on internal audit work. These regulations were issued in accordance with the above-mentioned relevant State laws.

On December 5, 1985, the CNAO proposed the Several Provisions on Internal Audit Work, in accordance with Article 10 of the Interim Provisions for Audit Work (State Council, 1985). These provisions recognized the importance of internal audit for strengthening financial supervision. State administration organs, state-owned enterprises and non-profit organizations should establish or improve their internal audit systems, in order to promote internal control; enforce financial discipline, improve management and boost economic benefits. Internal audit institutions should be independent, in the case of large and medium-sized enterprises, State Finance institutions and other important departments. Li Jinhua, in the monography "History of Audit in China" (2007) summarized the tasks and powers of internal audit departments after the promulgation of these provisions. According to the above- mentioned provisions the main tasks of internal audit departments included:

- conducting supervision on the integrity and safety of capital and assets;
- carrying out audit of the implementation of the plans for revenues and expenditures, expense budgets, plans for foreign exchange revenues and expenditures, as well as economic contracts;
- conducting supervision and inspection of the integrity and effectiveness of internal control systems;
- conducting audit of the accuracy, compliance and legitimacy of accounting statements and final accounts;
- conducting special-case audits of practices that could violate financial and economic laws;
- implementing the State audit laws;
- assisting the State audit institutions to carry out audit of the appropriate units.

[3] Audit Law, 1994. Adopted at the Ninth Meeting of the Standing Committee of the Eighth National People's Congress on August 31, 1994, promulgated by Order No. 32 of the President of the People's Republic of China on August 31, 1994 and effective as of January 1, 1995.

The functions and powers of internal audit departments included:

- examining the account vouchers and books, final accounts, founds and assets;
- carrying out investigations of the units;
- obtaining the evidence materials in order to solve the problems disclosed through audit;
- proposing comments on the prevention, correction and addressing of practices in violation of financial and economic laws;
- putting forward suggestions for the improvement of management and efficiency;
- making suggestions to the leaders on investigating people engaged in practices severely violating financial and economic laws, or causing serious economic losses due to negligence;
- taking temporary measures as sealing account books as well as funds and assets, against units which failed to cooperate in internal audit work.

For what it may concern the procedure for internal audit work, the first step is to make an audit plan. The plan is then to be reported to the leaders of the unit for approval. After the approval, the audit is conducted focusing on all units. If during the audit problems are detected, the auditor should make suggestions for correction to the relevant unit. When the audit is completed, the auditor should draft an audit report and submit it to the leaders of the unit. In case the report contains significant findings, the report should also be delivered to the government audit institution at the corresponding level. The auditor should also report to the leaders of the unit the disposition decision on any significant audit matter, these arrangements shall be applied addressing the issues found.

Internal auditors should be appointed or removed in accordance with the norms of the cadre management authorization. The assessment of the professional titles of internal auditors and appointment of internal audit professionals should be in accordance with the State regulations. For what it may concern the ethics and the professional qualifications of internal auditors, they should combat practices that violate laws and regulation, be faithful to their duties and perform their job impartially. Moreover, they should not abuse their functions and powers, commit malpractices for selfish ends or disclose secrets. Any units or individuals violating these regulations shall be given economic, administrative or disciplinary sanctions.

In 1989, the CNAO promulgated the Provisions on Internal Audit Work, in accordance with the provisions contained in the Audit Regulations (1988). These provisions were an answer to a growing demand for improving the economic system reform and were an attempt to standardize internal audit work. In comparison with the former Provisions on Internal Audit Work (December

1985), these provisions presented more complete and specific guidelines for the establishment of internal audit departments and contained guidelines for conducting internal audit in collective economic organizations. In addition, there were more details on the following matters: the personnel responsible for audit work, audit scope, audit objects, main functions, audit procedures, appointment and removal of auditors, professional qualifications and punishment for violation of laws and regulations. New contents were also added for what it concerns the response to severe violation of financial and economic laws, or to acts that could cause heavy losses. Furthermore, internal audit departments had the power to impose penalties and economic sanctions. In these provisions there were also new contents concerning the establishment of internal audit archives. Lastly, there were also specific stipulations on professional qualification for internal auditors and on principles such as fairness and objectivity.

In July 1995, after the promulgation of the Audit Law in 1994, the CNAO promulgated new provisions: Provisions on Internal Audit Work. They were an expansion of the previous rules issued in 1989 and their aim was to strengthen internal audit and to adjust internal audit to the new concept of "socialist market economy". The definition of internal audit was more complete, there were clearer provisions concerning the establishment of internal audit departments, and it was strongly advised to appoint a General Auditor. If on one hand State audit institutions supervised the internal audit business, on the other hand the internal audit departments had to conduct industry-specific audit investigation on significant issues in the economic management. Most importantly, the Article in 1989's provisions concerning the internal audit of collective economic organizations was revised, the new Article concerned "the internal audit work of non-state-owned economic organizations."

In 2003, in accordance with the Audit Law (Art.1), the CNAO promulgated the Provisions on Internal Audit Work and the provisions promulgated in 1995 were annulled. Article 2 defines internal audit as an act of independent supervision and appraisal of the effectiveness of economic activities, financial revenues and expenditures of the selected unit and its subsidiaries. It is important to notice, that this definition, within the aim of internal audit, includes the improvement of management and the achievement of economic objectives. These provisions explicitly indicate the organizations that need to set up internal audit departments (Art.3). State organizations, monetary institutions, state-owned enterprises, non-profit organizations and non-state-owned enterprises are required to set up internal audit departments or, in case the conditions for the establishment of an audit department lacks, another authorized department should be entrusted with performing internal control. For what it may concern the qualification and the education system of the auditors, they may receive further on-the-job education (Art.5). The conditions for a work environment that allows auditors to operate in

compliance with the law must be guaranteed by the leaders of a unit or of an organization (Art. 6). The funds for allowing this type of work environment are included in the budgets of local governments and guaranteed by the organization that sets up the department (Art.8). Moreover, internal auditors must operate professionally, be independent and honest, maintain their integrity and must not disclose confidential information (Art.7). If they perform their duties earnestly, or achieve remarkable accomplishment, they should be given a reward; contrarily, if they commit malpractices, disclose confidential information or neglect their duties, have to pay a sanction.

Fort what it may concern the duties and responsibilities of an internal audit department, these extend to the main unit and to its subordinates. Article 9 defines the main functions of an internal audit department (CNAO, 2003). An internal audit department should audit the financial revenues and expenditures, as well as relevant economic activities of its unit and subordinate units; audit the management and utilization of on-budget and extra budget funds; conduct term-end accountability audit of the leaders of the institutions; check fixed-assets investment projects, carry out a review of the effectiveness of the internal control system and risk-control and perform other audit items in accordance with the requirements of the main principals of the unit to which the internal audit department belongs. Article 9 points out that internal control covers many aspects and extends also to management and risk. For this reason, it can be asserted that the 2003 provisions are in line with the modern definition of internal control. Once the internal audit department has collected the annual results and findings about internal audit, the report containing this information must be sent to competent authorities or to the people in charge of the organization (Art.10). Article 11 states that the internal audit department is established by the people in charge of the organization, and these authorities shall allow the auditors to fulfil their duties, by allowing them to attend meeting related to audit matters; participate in the research and formulation of regulations; examine the data obtained from field investigation; check electronic data; investigate units and individuals; make decisions about stopping projects that violate the law; and so on. In addition, the competent authorities must promptly provide the auditors with any document they may need for the investigation, the documentation includes account books and accounting statements. Internal audit departments must search for innovation and improve the quality of their operations, and can be inspected by government audit institutions (Art.17). In case of disclosure of falsified information or violation of the law by the auditee, if the facts constitute a crime, the audit department may impose sanctions or refer the facts to a judicial organization for further investigation. Article 15 defines an internal audit institution as a self-disciplined organization, and a legal entity. The China Institute of Internal Audit is a State organization, while local institutes should be set up, if needed. Internal audit institutions are directed,

supervised and administered by government audit institutions (Art.16). These provisions entered into force on the 1st of May 2003.

In conjunction with the Audit Law and the CNAO Provisions on Internal Audit Work, it is important to mention a series of specific standards that were issued to standardize the practices of internal auditing, strengthen internal control, improve risk management and perfect organizational governance. Among these aims there were also those of guaranteeing the quality of internal audit, improving the efficiency of internal audit, preventing audit risks and facilitating the self-improvement of organizations. These specifications were developed and issued by the Standard Board of China Institute of Internal Audit[4]. In March 2003, the Basic Standards for Internal Audit, the Code of Ethics and Professional Practices for Internal Auditors and ten specific standards were promulgated. These standards were the result of years of work, in fact in 2000 the Standards Board of China Institute of Internal Audit started to study and draft China's internal audit standards. The standards covered three levels of content: the basic standards for internal audit, the specific standards for internal audit, and the guidance for internal audit practices. The basic standards contained a series of general principles that should be followed by internal audit institutions and individuals when conducting internal audit. They worked as a basis for the specific standards for internal audit and the guidance for internal audit practices. The guidance for internal audit practices contained the operative scheme for conducting internal audit. The Basic Standards for Internal Audit were applicable to all internal audit departments and auditors, as well as to all kinds of organizations (LI, 2007). For what it concerns the definition of internal audit the Basic Standards for Internal Audit asserted that internal audit refers to an independent and objective supervision and appraisal activity inside an organization, which stimulates an organization to fulfil its goals by auditing and appraising the propriety and the effectiveness of operation activities and internal control. Furthermore, these standards also contained guidance for preparing the internal audit report and for managing internal control. On the other hand, the Code of Ethics and Professional Practices for Internal Auditors contains principles regarding duties and responsibilities of internal auditors. Internal auditors should act independently, objectively, honestly and diligently. Any action in violation of professional standards must be avoided and all the important matters must be objectively disclosed in the internal audit report. The specific standards covered audit

[4] CHINA INSTITUTE OF INTERNAL AUDIT OR CIIA (中国内部审计协会) was founded in 1987 under the name of China Internal Audit Society and renamed in 2002. It is a non-governmental academic organization. In 1998 the CNAO transferred some of the functions of supervising internal audit to the China Internal Audit Society and planned to change its name.

planning, internal control, malpractice prevention, examination and report, internal audit supervision, and guidance on the coordination between internal and external audits.

1.2 Second stage (2003-2008)

In the early days of the PRC, the development of China's internal audit was closely linked with the development of State audit (LI, 2007). Internal audit was regarded as the basis for government audit supervision. Thus, internal audit, in its initial stage, had obvious features of government dominance (LI, 2007). However, with the introduction of the policies of reform and opening up, audit institutions and systems were introduced. The constant progress of enterprise reform led companies to become independent market subjects and internal audit increasingly became an indispensable need for enterprise management (LAI, 2018). Consequently, more and more enterprises started to voluntarily use internal audit as an effective means for improving their internal control systems. In the second stage of development of internal audit, internal audit work became more and more sophisticated. Moreover, internal audit institutions gradually developed. For example, the China Internal Audit Society, whose main function was that of conducting academic research, was gradually transformed into an industry-specific, self-regulatory organization, the China Institute of Internal Audit. Internal audit institutions gradually developed and adapted to the economic environment, internal control systems gained significant importance. Internal control and audit made great contributions to the companies' attempts to strengthen management, avoid risks, enforce financial and economic laws and disciplines, improve economic efficiency, and build a clean and honest work style.

The second stage of development of internal control in China can be said to start in 2003, with the occurrence of important improvements in the development of modern internal control. Firstly, internal audit and internal control started to be regarded as two different concepts (XIE, 2018). However, in order to understand what influenced and led to the beginning of this stage, it is necessary to consider the context of the time. One of the factors that influenced these changes traces back to 2002. 2002 was a year of significant importance, because the US released the *Sarbanes-Oxley Act*[5] (SOX 2002). This regulation on the disclosure of firms' internal control required listed companies to disclose internal control deficiencies and an internal self-assessment report signed by external

[5] Sarbanes Oxley Act (SOX): The legislation was enacted by the federal government in the US and came into force in 2002. It introduced major changes to the regulation of financial practice and corporate governance. It mandated strict reforms to improve financial disclosures from corporations and prevent accounting fraud. It aims at protecting investors from the possibility of fraudulent activities by corporations. From: https://www.investopedia.com/terms/s/sarbanesoxleyact.asp

auditors (HAO & RAINSBURY, 2014). This legislation was enacted after the occurrence of corporate scandals and bankruptcies, such as those of Enron[6] and WorldCom[7], with the aim of protecting investors' interests and intensifying transparency of business operations in listed companies. The US government had to restore investors' confidence after the significant impact that those scandals had on the confidence of American investors in the US capital market. From that point on, internal accounting controls were established in order to ensure more reliable financial reporting and the results of the efficiency of the internal control system had to be published in a firm's annual report. One of the most important articles within the SOX is Section 404. Section 404 of the Act requires management to assess and report on the effectiveness of internal control over financial reporting (SARBANES OXLEY 101, 2018). Issuers are required to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting. This statement shall also assess the effectiveness of such internal controls and procedures. The registered accounting firm shall, in the same report, attest to and report on the assessment of the effectiveness of the internal control structure and procedures for financial reporting. This legislation, along with the requirements of the US Security Exchange Commission, had a strong influence on companies worldwide and also on Chinese companies, especially on those Chinese companies that planned to list in the US.

The second factor influencing the characteristics of this second stage is represented by the international models for conducting internal control. In particular, the Committee of Sponsoring Organizations of the Treadway Commission or COSO[8], proposed frameworks for enterprise risk management and for an enterprise's internal control system. In this stage, COSO's frameworks exerted significant influence on the formulation of the Chinese regulatory framework on internal control. These models provide guidance on the organization of internal control and consider five

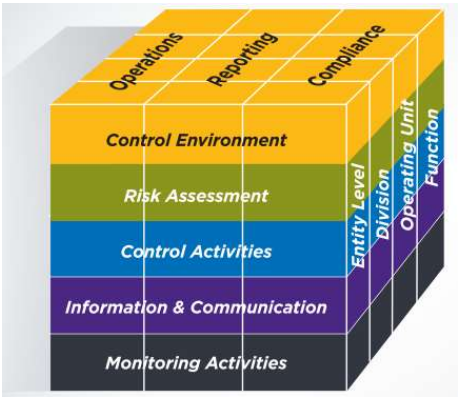
[6] The Enron scandal involved a series of events that resulted in the bankruptcy of the U.S. energy, commodities, and services company Enron Corporation and the dissolution of Arthur Andersen LLP, which had been one of the largest auditing and accounting companies in the world. The collapse of Enron involved one of the biggest bankruptcy filings in the history of the United States, and it generated much debate as well as legislation designed to improve accounting standards and practices, with long-lasting repercussions in the financial world. Source: Encyclopaedia Britannica https://www.britannica.com/event/Enron-scandal

[7] Worldcom represented one of the biggest accounting scandals in the history of the United States and one of the biggest bankruptcies. This corporation performed fraudulent activities to falsify its financial statements. Source: https://www.investopedia.com/terms/w/worldcom.asp

[8] COSO or Committee of Sponsoring Organizations of the Treadway Commission, is a joint initiative of five private sector organizations (*American Accounting Association; American Institute of Certified Public Accountants; Financial Executives International; The Association of Accountants and Financial professionals in Business and the Institute of Internal Auditors*) founded in 1985 and dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence. Source: https://www.coso.org/Pages/aboutus.aspx

important components: control environment; risk assessment; control activities; information communication and monitoring activities. These components operate at any level and must operate together in order to reach operational objectives, reporting objectives and compliance objectives. The first Internal Control-Integrated Framework was published in 1992 and updated in 2013, while the Enterprise Risk Management-Integrated Framework was issued in 2004 and updated in 2017. Currently COSO's frameworks are widely recognized and are adopted as the generally accepted framework for internal control. The COSO model for internal control defines internal control as a process conducted by a company's board of directors that leads to the achievement of three major objectives. The three-dimensional diagram below (Figure 1.2) represents the COSO framework for internal control. The three objectives (top level) include effectiveness and efficiency of operations; reliability of financial reporting and compliance with laws and regulations. In order to reach these objectives at any level (right side), the five activities (front side) are necessary.

Figure 1.2 COSO Internal Control Integrated Framework



Source: https://www.coso.org/Documents/COSO-ICIF-11x17-Cube-Graphic.pdf

The five components of control on the front side are: control environment; risk assessment; control activities; information and communication and monitoring activities. These activities not only are of significant importance because they constitute a model for conducting internal control, but are also a guidance for information disclosure. Control environment is the basis for the all systems of internal control, because it concerns the ethical values, the operating style and the organizational structure of the company. Risk evaluation is the point from where internal control starts; every risk must be identified, analysed and evaluated. A well-conducted evaluation allows to adopt the appropriate measures for managing the risks encountered. The third component is represented by control activities. These activities have the aim of approving, authenticating, verifying and reviewing work achievements, asset security and assignment of obligations. Various types of organically integrated control activities ensure the second objective of reliability of reporting and address the significant risks. The information and communication component refers both to external and internal

information. The information collected must be accurate and communicated timely and effectively. The last component concerns the supervision of the entire system of internal control. Executive levels evaluate the quality of corporate internal control through ongoing monitoring, periodical supervision and exception reporting.

Moreover, it can be stated that internal control is the product of developed economies, and it represents an important approach for modern enterprise management. This is because an efficient internal corporate control system can prevent corruption and reduce earning losses. Given the importance of considering internal control from a comprehensive point of view, as a matter of fact, many departments in China began to engage in drawing up regulations and standards. For example, in 2006, the China Securities Regulatory Commission released The Management of IPO (LU & MA, 2017), which recognized the importance of an effective internal control of IPO[9] and stipulated that a CPA must sign internal control assessment reports. In June, 2006, the State-owned Assets Supervision and Administration Commission released the Guidelines on Overall Risk Management of Central Enterprises. These guidelines, in line with the Enterprise Risk Management Integrated Framework released by COSO in 2004, improved the internal control system in China and represented a breakthrough in the development of internal control norms (LU & MA, 2017). Later on, in July 2006 the Ministry of Finance launched the Internal Control Standards Commission[10]. In the same period, the Shanghai Stock Exchange released the Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies, which went into effect on the 1st of July, 2006. In September 2006, the Shenzhen Stock Exchange also released the Guidelines of Shenzhen Stock Exchange for the Internal Control of Listed Companies. The Internal Control Standards Commission released 17 drafts concerning internal control in March 2007. The aim of the Internal Control Standards Commission was to design, control and asses standards to protect companies and improve corporate governance and internal control mechanisms. The Internal Control Standards Commission chose a "1+x" model, that formulates one internal control basic standard, and based on this, issues implementation guidelines according to specific economic business activities.

[9] An Initial Public Offering, or IPO, is the very first sale of stock issued by a company to the public. Prior to an IPO the company is considered private, with a relatively small number of shareholders made up primarily of early investors and professional investors. Public companies, on the other hand, have sold at least a portion of their shares to the public to be traded on a stock exchange. Source: https://www.investopedia.com/university/ipo/ipo.asp

[10] THE INTERNAL CONTROL STANDARDS COMMISSION was established in Beijing on 15th July 2006 by the Ministry of Finance, the State-owned Assets Supervision and Administration Commission of State Council, the Securities Supervision Commission, Audit Commission, the China Banking Regulatory Commission and the China Insurance Regulatory Commission. These entities jointly established the standard system for companies' internal control. Source: https://baike.baidu.com/item/企业内部控制标准委员会/918512

1.2.1 Internal control Guidelines of Listed Companies of the Shanghai Stock Exchange, 2006

These guidelines provide a broad structure for internal control and strict demands for assessment and reports. Being detailed and providing such a structure, the Shanghai Stock Exchange model of Internal Control Guidelines is of significant importance for the development of internal control in China. The circular of Shanghai Stock Exchange "Issuing the Guidelines of Shanghai Stock Exchange for the Internal Control of listed Companies" states:

> All listed companies,
>
> In order to push forward and direct the listed companies to set up a sound internal control system, enhance the risk management level of companies and protect the legitimate rights and interests of investors, the Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies are instituted by this Stock Exchange according to the Company Law, Securities Law, Circular of the State Council on Approving and Forwarding the Opinions of China Securities Regulatory Commission concerning Promoting the Quality of Listed Companies, other laws, regulations and regulatory documents, and the Rules of Shanghai Stock Exchange concerning the Listing of Stocks, and hereby are promulgated for implementation.[11]

These guidelines, which consist of 35 articles and 6 chapters, were released in June 2006 and went into effect as of July 1, 2006.

Chapter I goes from Article 1 to Article 4 and concerns General Provisions.

Article 2 (SHANGHAI STOCK EXCHANGE, 2006) provides a definition of internal control:

> The term internal control refers to the related rules and arrangements which are made for the management of the risks underlying the strategies making and business operating of a listed company to ensure the realization of the strategic aims of the company. It is an activity in which the board of directors, the management level and the staff jointly take part.[12]

Article 3 concerns the addressee of these guidelines: any company listed in the Stock Exchange shall set up and perfect an internal control system. These companies shall engage in activities that ensure the completeness, reasonableness and effectiveness of their internal control system, in order to create a positive effect on company operations. Furthermore, the internal control

[11] Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies, June 5, 2006, issued by Shanghai Stock Exchange.
[12] Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies, June 5, 2006, issued by Shanghai Stock Exchange.

system will promote the reliability of the information disclosed by the company, and will ensure that the information complies with the laws and regulations. Article 4 clarifies that the board of directors should be in charge of the establishment, inspection and supervision of a company's internal control system. According to the Shanghai Stock Exchange the board of directors and all the members of a company must make sure that the information disclosure concerning the internal control is truthful, exact and complete.

Chapter II deals with the Framework of Internal Control and goes from Article 5 to Article 13.

Starting with the main components of internal control, Article 6 sets the basic elements that a company should consider when establishing and carrying out its internal control system.

1. The company has to set its goal, the regulation defines the expression "to set a goal" as the strategic aim set by the board of directors and the management level, considering the security preferences of the company (SHANGHAI STOCK EXCHANGE, 2006).
2. The regulation also defines the term "internal environment". It refers to the organizational culture other factors that may affect the company's awareness of the securities. The other factors can be the perspectives of the staff on the securities, the security preferences of the management level, the working environment, professional ethic norms, and the directions on the securities given by the board of directors and the board of supervisors.
3. The third element is the "confirmation of securities", it means that the board of directors and the management level have to acknowledge the internal and external factors that could affect the realization of the aim of the company.
4. The fourth element is "security evaluation". The board of directors and the management of a company have to make sure that the methods for managing the securities are in line with the likelihood and consequences of these securities.
5. "Selection of security management strategies" means that the board of directors and the management level, when choosing the security management strategies, consider the security bearing ability and the security preferences.
6. "Control activities" refers to the procedures that ensure the implementation of the security management strategies. These procedures include the approval, authorization, verification, adjustment, review, periodic check, recording and checking up, functional division, asset preservation, performance evaluation, and so on.
7. "Information communication" indicates the communication to the users of the information resulting from the planning, implementation, supervision and other activities.

8. Lastly, the term “inspection and supervision” refers to the process in which the company itself examines and supervises its internal control system.

Article 5, concerns the activities and the arrangements that a company should make in order to render the internal control system of a company more and more comprehensive. The arrangements are to be made at least in three aspects. The first aspect is that of the company; the second is the aspect of the departments and the affiliated companies and the third one is the aspect of the business links of the company. Article 7 is also related to a series of arrangements in terms of internal control, in particular it requires that the company sets up internal control systems for its subordinate departments, affiliated companies and for its business links. Article 8 elaborates upon the meaning of business links; it states that: “the internal control of a company shall cover all business links in the business operation activities” (SHANGHAI STOCK EXCHANGE, 2006).

These links and activities are described below and include, but are not limited to:

1. The sale of goods and the receipt of payments. In particular, conducting orders, credit management, transport and delivery of goods, received cash payments and so on, are part of this category.
2. The link of purchase and payment. It consists of placing procurement orders, checking and accepting of goods, recording payments on accounts payable, approving payments and so on.
3. Production. It consists of the production plan, the checklist of materials to be used, storage of raw materials, operational process, calculation of production costs, quality control and so on.
4. Management of fixed assets. Construction, purchase, maintenance, preservation and record of the fixed assets belong to this category.
5. The link of management on monetary fund, that consists of the reporting of monetary fund, entries, transfers, recording and authorizations financial accountants.
6. Relevant transactions also constitute a business link. They include the pricing, authorization, implementation, reporting and record of relevant transactions.
7. Guaranty and financing. This link covers all those activities concerning the leasing, borrowing, acceptance and issuance of new stocks and issuance of bonds.
8. Long and short-terms investments in the negotiable securities, stock right, real property, financial derivatives, and the use of funds raised are part of the investment link.
9. Research and development and the preservation of the related documents constitute another link.

10. Management of personnel, consists of employment, training, overtime work, leaving post, dismissal, retirement, calculation of salaries and wages and their payments, supervision of work attendance records, evaluation, and all those matters relating to personnel management.

Article 9 remarks the fact that the internal control system of a company shall not only exercise control over all the business activities, but it should also consider management rules of the business activities. Management rules include asset management, budget management, quality management, guaranty management, communication rules, information disclosure management rules and rules concerning the management of affiliated companies. Moreover, internal control rules on information management should be instituted and they should cover several contents linked to data processing, safety of archives and information disclosure (Art.10). For what it concerns the control of public information disclosure activities, this is conducted through the use of the website of Shanghai Stock Exchange or through the website of the company. Articles 11,12 and 13 concern internal control rules for setting up a sound internal control system. Article 11 states that companies must set up internal control rules that follow the provisions on internal control of the State finance administrative department, while Article 12 concerns the rules that may be applied to specific sectors. In Article 13 of Chapter II the Shanghai Stock Exchange encourages companies to employ an intermediary institution that helps them to set up an internal control system.

Chapter III considers the Internal Control of Special Risks and has three sections. The first section concerns the Management and Control of Affiliated Companies (Article 14-16); the second Internal Control of Transactions of Financial Derivatives (Article 17-19) and the third Internal Control of Other Risks (Article 20-21).

In the first section, the guidelines require a company to set up a control structure for its controlling subsidiaries (Art.14). A company has to coordinate the business strategies of the subsidiaries and their security management strategies and make sure that these are in line with the strategic plan of the company. In addition, a company should impose rules for evaluating the business performances of its subsidiaries, and should institute an internal reporting system of the important matters concerning its controlling subsidiaries. At the same time, the subsidiaries should deliver monthly financial and management reports to the company, the reports will be audited by an accounting firm. Moreover, a company not only should arrange the internal control system of its branch companies, but should also supervise and evaluate it (Art.15). According to the second section, if a company wants to be involved with transactions of financial derivatives, it has to make evaluations and set up a specific internal control system first (Art.17). The evaluations concern the

company's security control capability. The guidelines provided by the Shanghai Stock Exchange define a transaction of financial relatives as a contract between two or more parties whose value is agreed upon underlying financial assets or set of assets. Financial derivatives consist of, but are not limited to, future transactions, options transactions, forward transactions, and swap transactions on the basis of commodities or securities. According to Article 18 the board of directors of a company is aware of the nature of transactions of financial derivatives and, basing the decision on the security bearing ability of the company, shall reasonably set the security limits and transaction parameters of the financial derivatives (Art.18). The company has to properly conduct internal control over those transactions by setting up an aim, hedging strategies and procedures for the qualification, evaluation, implementation, stop-loss, record and reports of the traders (Art.19). In addition, a company has to set up a reporting system for the aforementioned transactions, as well as setting up a security management system for the same transactions (Art.19). The third section deals with internal control arrangements for particular securities (Art.20), and with the institution of a control system for crisis management (Art.21).

Chapter IV relates to the Inspection and Supervision of Internal Control (Article 22-29).

A company has to regularly inspect the operation of its internal control system (Art.22). By supervising the internal control system, the board of directors and the management level have to find whether it presents any defects. These problems need to be solved in time in order to ensure the effective implementation of internal control. For what it concerns the responsible for routine inspection and supervision of internal control, according to Article 23, a company shall agree on a special functional department. Moreover, the company shall arrange full-time personnel for conducting the supervision thereof. The special functional department may directly report to the board of directors. Concerning the measures adopted by a company to inspect and supervise internal control, these should at least encompass the following issues (Art.24):

- The board of directors granting the authorization for the supervision of internal control;
- The cooperative obligations of the departments and subordinate institutions of the company in the inspection of internal control;
- The time, procedures, methods and items for the inspection;
- The procedures for reporting the work of supervision.
- The division of the responsibilities for the work of inspection;
- The incentive system for the inspection and supervision of internal control.

Furthermore, a company should set up an annual plan aimed at inspecting and supervising internal control and use it as a basis for the evaluation of the operation of internal control (Art.25). Article 26 establishes the timing for the submission of the report on the work of inspection to the board of directors. This report should be submitted by the inspection and supervision department at the end of the year and every half a year. The board of directors makes requirements for the contents and formats of the previously mentioned report, and is responsible for guiding the inspection and reviewing the report (Art.27). In case there is an audit committee under the board of directors, the review may be carried out by the audit committee. If the report shows that the internal control system has any defects and its implementation has any problems, the board of directors has to make sure that related department adopts the appropriate measures in time (Art.28). Problems identified in internal control in a department are items of significant importance for the performance evaluation of that department. Lastly, Article 29 requires that the working materials of the supervision department, the reports concerning the work of inspection of internal control and related materials must be preserved for 10 years or more.

Chapter V deals with Information Disclosure of Internal Control (Article 30-34).

Article 30 concerns the reporting of deficiencies occurring in the internal control to the Shanghai Stock Exchange. If during the inspection, a serious defect in internal control is found, this defect must be reported to the board of directors, and the board has to report it to the Shanghai Stock Exchange in time. The company shall explain in a public announcement the business activities in which the defects in internal control appeared, the consequences of these defects and the corrective measures adopted (Article 30). The board of directors shall evaluate the implementation of the internal control system of the company according to the report delivered by the inspection and supervision department, and prepare a report concerning the self-evaluation of internal control. The report concerning the self-evaluation of internal control should be presented when the board deliberates the annual financial report (Article 31). If there is an audit committee, this audit committee may prepare a draft of the report concerning the self-evaluation of internal control and submit it to the board of directors. Article 32 further clarifies that the annual report concerning the self-evaluation of internal control and the verification and opinions of the accounting firm on the report thereof, shall be disclosed together with the annual report by the board of directors. Additionally, Article 33 specifies the contents that the report on the self-evaluation of internal control must at least contain. The report shall specify whether or not an internal control system has been established; whether or not internal control has been carried out effectively; the context for the work of inspection and supervision of internal control; whether serious events occurred in the internal control system and during the period of implementation;

whether the plan concerning the work of inspection for the year in question has been completed; measures for improving internal control system and the plan concerning the internal control for the next year. With regard to the verification and evaluation of the report disclosed by the company, an accounting firm will have this responsibility and will conduct this job according to the provisions of the competent organ.

Chapter VI specifies the supplementary provisions.

Article 34 clarifies that the Shanghai Stock Exchange is responsible for the interpretation of the guidelines, while Article 35 states that the guidelines shall go into effect as of July 1, 2006.

This regulation presents important features. To begin with, the contents of internal controls are similar to those of COSO Risk Management. It has been already mentioned that the main goal of COSO (Committee of Sponsoring Organizations of the Treadway Commission) is to provide thought leadership dealing with the interrelated enterprise risk management (ERM), internal control, and fraud deterrence. Enterprise Risk Management- Integrated Framework issued in 2004 and updated in 2017, states that Enterprise Risk Management consists of eight interrelated components (COSO, 2004):

- *Internal Environment* – The internal environment encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which the entity operates.
- *Objective Setting* – Goals must exist before management can identify potential events affecting their achievement. Enterprise risk management ensures that the chosen objectives support and align with the entity's mission and are consistent with its risk appetite.
- *Event Identification* – Internal and external events affecting achievement of an entity's objectives must be identified, distinguishing between risks and opportunities.
- *Risk Assessment* – Risks are analysed, considering likelihood and impact, as a basis for determining how they should be managed.
- *Risk Response* – Management selects risk responses – avoiding, accepting, reducing, or sharing risk – developing a set of actions to align risks with the entity's risk tolerances and risk appetite.

- *Control Activities* – Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
- *Information and Communication* – Relevant information is identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities.
- *Monitoring* – The work of enterprise risk management needs to be monitored. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

Article 6 of the Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies (2006) presents the basic components of Internal Control. As it is evident, in the COSO ERM Framework, the definitions are similar. In particular the content "to set a goal" of the SSE Guidelines can be associated with the component "objective setting" of COSO's ERM Integrated Framework. "internal environment", the second content of Article 6 of SSE Guidelines can be related to "Internal Environment", the first component in COSO's ERM Integrated Framework. In addition, "confirmation of security" can be associated with "event identification", "security evaluation" with "risk assessment", "selection of security management strategies" with "risk response", "control activities" with "control activities", "information communication" with "information and communication" and "inspection and supervision with "monitoring".

Secondly, the contents of internal control in the analysed guidelines rely on a three objectives model including operation, reports and compliance, which are exactly the same goals of the COSO Internal Control Integrated Framework issued in 1992 and superseded by a new version issued in 2013 and effective from 2014. COSO's three objectives model (COSO, 2013) includes

- Operation Objectives relate to effectiveness and efficiency of the entity's operations, including operational and financial performance targets, and safeguarding assets against loss.
- Reporting Objectives deal with internal and external financial and non-financial reporting. These objectives may include reliability, timeliness, transparency, or other terms as set forth by regulators.
- Compliance Objectives relate to adherence to laws and regulations to which the entity is subject.

Thirdly, for what it may concern the body responsible for internal control, as in other international regulations, there is an emphasis on the participation of all members. The board of directors should be responsible for establishing a system of internal control and guaranteeing its efficiency. Moreover, the management of a company has the role of implementing board policies on risk and control. Management should identify and evaluate the risks faced by the company, operate and monitor a suitable system of internal control which implements the policies adopted by the board. Also, all employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge and skills to establish, operate and monitor the system of internal control. This will require a comprehensive understanding of the company, its objectives, the markets in which it operates, and the risks it faces. Article 2 of the Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies (2006) states that "Internal control is an activity in which the board of directors, the management level and the staff jointly take part". Article 4 further explains that the establishment, implementation, inspection and supervision of a sound internal control system of the company shall be in the charge of the board of directors of a company. The board also shall ensure the authenticity and completeness of the information disclosed on internal control. It is indeed responsible for guiding the work of inspection and supervision of internal control.

Lastly, reporting on internal control is similar to the SOX in the USA. Section 404 of the SOX asserts that:

> The Commission shall prescribe rules requiring each annual report […] to contain an internal control report, which shall
> (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
> (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. […] Each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board […].[13]

In line with section 404 of the Sarbanes Oxley Act, Article 32 of the Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies (2006) requires the board of directors of a

[13] Sarbanes Oxley 101, 2018. *SOX Section 404: Management and Assessment of Internal Controls*. Available at: http://sarbanes-oxley-101.com/SOX-404.htm

company to disclose the annual report together with the annual report concerning the self-evaluation of internal control and the opinions of the accounting firm on the self-evaluation of internal control.

The content of the Internal Control Guidelines of Listed Companies on the Shenzhen Stock Exchange is very similar to that of the previously analysed guidelines issued by the Shanghai Stock Exchange. The Shenzhen Securities and Exchange Office defined internal control as a process that provides guarantee for the realization of a series of objectives from board of directors, board of supervisors, senior management staff and other related staff. The objectives include compliance with stipulations under state laws and regulations; the promotion of operational performance and efficiency of the company; guaranteeing the company asset security and guaranteeing the authenticity and fairness of corporate information disclosure. Although compared to the guidelines of the other Stock Exchange in the Mainland of the People's Republic of China these guidelines are less rich in details, they also provide details on the process for introducing the opinions of board of supervisors and independent directors. Overall, both the Shanghai Securities and Exchange Office and the Shenzhen Securities and Exchange Office have reached consistent views on the definition of internal control. "Consistent views" means that those viewpoints are in line with the development of internal control in other market economies. These types of viewpoint on internal control allowed functions of internal control to develop from error inspections and prevention of deception (first stage), to the promotion of corporate management efficiency. A comparison of the Internal Control Guidelines of Listed Companies of both Shenzhen Stock Exchange and Shanghai Stock Exchange will be presented in the following table (Table 1.2).

Table 1.2 Comparison of Shanghai SE and Shenzhen SE Guidelines on internal control.

Items	Shanghai Stock Exchange	Shenzhen Stock Exchange
Contents	In line with COSO Enterprise Risk Management Framework.	Similar to COSO Internal Control Framework.
Goals	Strategies, operation, reports and compliance.	Operation, reports, compliance and asset safety.
Responsible Body Structure	Board of directors, inspection and supervision departments.	Board of directors, internal audit department.
Structure	Similar to the structure of COSO Enterprise Risk Management Framework.	
Assessment	An accounting firm verifies the evaluation opinions on internal control self-assessment reports.	An auditor verifies the evaluation opinions on internal control. If there is a disagreement, the company adds a special statement.
Regulation Characteristics	Risk-management, effective conclusions and verification of CPA.	Internal control, effective conclusions and evaluation opinions on internal control over financial reporting of CPA.

Source: Lu, Y. & Ma, D., 2017. "China SOX": What Is It and Why Was It Introduced? WSEAS Transactions on Business and Economics, Volume 14.

1.3 Basic Standard for Enterprise Internal Control or China SOX, 2008

The Basic Standard for Enterprise Internal control 企业内部控制基本规范 *Qiye Neibu Kongzhi Jiben Guifa*n was released on the 22nd of May, 2008. The Ministry of Finance (MOF), the China Securities Regulatory Commission (CSRC), the National Audit Office (CNAO), the China Banking Regulatory Commission (CBRC) and the China Insurance Regulatory Commission (CIRC) jointly worked on the formulation of this set of standards. This regulation was formally implemented on the 15th of April, 2010, when the Ministry of Finance, CSRC, CNAO, CBRC and CIRC issued the Implementation Guidelines for Enterprise Internal Control. The implementation guidelines include the Application Guidelines, the Guidelines for Assessment of Enterprise Internal Control and the Guidelines for Audit of Enterprise Internal Control. The Implementation guidelines offer an implementation framework for the Basic Standard, by specifying the scope, effective dates and requirements. (LU & MA, 2017). The relevant authorities, for Basic Standard and its supporting guidelines, chose the "1+x" model, that associates a supporting specification with each general standard, according to common economic business activities. The regulation was first to be applied to cross-listed[14] companies on the Shanghai and Shenzhen Stock Exchanges from January 1, 2011 (HAO & RAINSBURY, 2016). From January 1, 2012, the regulation was then extended to all companies listed in China (the Shanghai Stock Exchange and the main board of the Shenzhen Stock Exchange). Companies listed on the small and medium-sized enterprise board and the Growth Enterprise Market will be required to adopt these guidelines "when appropriate" (HAO & RAINSBURY, 2016). Non-listed large and medium-sized enterprises were only encouraged to adapt to the guidelines. This regulation is also known as China SOX or C-SOX because the Sarbanes Oxley Act in the US (2002) exerted a significant influence on the formulation of these standards. In addition, the Basic Standard for Enterprise Internal Control, specifying the elements and principles of internal control, is in line with the COSO Internal Control Integrated Framework.

Although internal control practice is deeply rooted in the Chinese cultural environment, it has always received the influence of the values and traditions of Confucianism (LU & MA, 2017). This means that even if in the second stage of development the concepts of COSO Integrated Framework were introduced in the issued standards and regulations, many companies still relied on traditional internal control and did not establish corporate-governance guided systems of internal control. For this reason, the Basic Standard for Enterprise Internal Control represented a significant improvement in internal control and in its disclosure. This set of rules improved accounting information quality,

[14] Mainland-based companies listed domestically and abroad.

auditing effectiveness, information disclosure of internal control and ensured the effective operation of the capital market. Chinese internal control changed the focus from accounting control to risk control, and finally this characteristic helped companies grow stronger and improved core competitive ability and management. Today internal control effectiveness is common in China, and China, given its unique institutional background, with these regulations on internal control focusing on non-financial internal control and requiring mandatory disclosure, could be an example for other countries with a similar institutional background. The Basic Standard for Enterprise Internal Control and the related supporting guidelines will be analysed in detail in the next paragraphs.

1.3.1 Reasons for the introduction of China SOX

One of the reasons behind the introduction of China SOX is the influence that the US Sarbanes-Oxley Act exerted on China and Chinese Government. In fact, also in China, there had been a series of high-profile internal control scandals. Chinese Government needed to enhance and standardize internal control in order to avoid future scandals, because although many Chinese companies had reached world-class levels at the industrial scale, if compared with large international companies, they still had weak internal control. It was then necessary to further regulate enterprise governance structure. Secondly, Chinese companies listed in the US needed to achieve compliance with the operations of the US SOX. This compliance led to a consistent improvement, since the implementation of article 404 of the US SOX provided the opportunity to achieve high standards and to promote the competitiveness of the companies. Moreover, internal control helped the process of building an information-based system within companies. Although these initial operations were costly and needed refined management practices, they helped to reduce the fabrication of false financial information, improved corporate performance and the long-term development of companies. This led Chinese companies to grow a certain interest for the benefits deriving from an efficient internal control system.

1.3.2 Basic Standard for Enterprise Internal Control

The Basic Standard for Enterprise Internal Control consists of 7 chapters and 50 items. Chapter 1 regards General Provisions, Chapter 2 Internal Environment, Chapter 3 Risk Assessment, Chapter 4 Control Activities, Chapter 5 Information and Communication and Chapter 6 Internal Monitoring.

Article 1 of General Provisions states that this set of standards has been formulated in accordance with Company Law, Securities Law, Accounting Law and other relevant laws of the People's Republic of China and it specifies the objectives of the Basic Standard.

> The purposes of Basic Standard are those of improving and standardising internal control; enhancing business management standards and risk prevention capability; promoting sustainable business development; safeguarding the proper functioning of the socialist market economy and protecting the interests of the general public.[15]

This regulation applies to large and medium-sized enterprises established within the territory of the People's Republic of China (Art.2).

The definition of internal control is provided by Article 3: internal control is defined as the process through which a company's board of directors, supervisory board, management and all other members of staff operate in order to achieve the established control objectives. The main objective of internal control is to reasonably assure that management and operations are legal (LU & MA, 2017). Hence, a company must comply with relevant laws and regulations. Assets of the company must be properly safeguarded, the company has to operate efficiently, the information disclosed must be authentic and complete and, additionally, business development strategies must be properly implemented. These five factors are in line with the afore-mentioned three model objectives of COSO Internal Control Integrated Framework.

Article 4 (MOF , 2008) formulates the principles a company must observe when establishing and implementing internal control. The first is the holistic principle: internal control should be comprehensive, it should include the whole process of policy-making, execution and monitoring of the enterprise and its affiliates. Secondly, the prioritisation principle is about giving higher priority to material operations and transactions, as well as to high risk areas. The third principle is called "the proper checks and balances principle". According to this principle, a company shall incorporate checks and balances into its governance framework, organizational structure, allocation of authorities and responsibilities and operational processes, while ensuring operational efficiency. Fourthly, the suitability principle asserts that internal control should fit the business size, the scope of operations, and the risk level faced by an enterprise, and should be modified in time if any change occurs. Lastly, the fifth principle, regarding costs and benefits, states that internal control should be achieved in a cost-effective manner, through balancing implementation costs against expected benefits.

Article 5 sets the basic components of internal control, or the elements a company has to consider when establishing and implementing internal control. These factors, including Internal environment, risk assessment, control activities, information and communication and internal monitoring are analogous to the basic components described in COSO Enterprise Risk Management

[15] Ministry of Finance of The People's Republic of China, Basic Standard for Enterprise Internal Control, 2008.

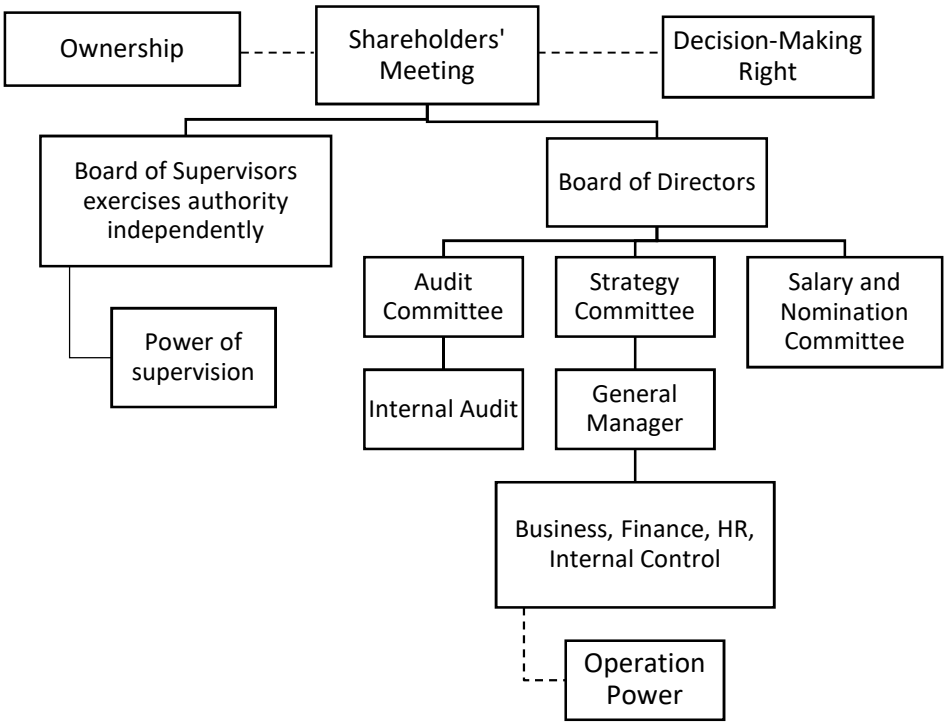
Integrated Framework and to those contained in Article 6 of the Shanghai Stock Exchange Guidelines on Internal Control.

Article 7 stresses the importance of applying information technology to enhance internal control. A suitable business management information technology with embedded control is necessary in order to maximise automated control of business processes, and reduce manual control related-factors.

Article 10 concerns the appointment of auditors. A firm of accountants is appointed to perform the audit on the effectiveness of an enterprise's internal control, the firm shall perform the audit and issue an audit report in accordance with this Standard. When appointed to perform an audit of the internal control of a company, the firm of reporting accountants cannot provide internal control consulting services to that enterprise.

The second chapter concerns the internal environment of an enterprise that, in order to ensure proper segregation of duties, shall establish a corporate governance framework and clearly define authorities of those in charge of policy-making, execution and monitoring (Art.11). The shareholders of a company, through shareholders' general meetings, exercise their voting rights to determine the company's business direction, financing, investment and other major concerns. The board of directors is responsible for making business decisions; the supervisory board is responsible for monitoring the actions of directors, chief executive officer and other senior managers, and shall report to shareholders. The company's management is responsible for implementing decisions made by the board of directors, and directing the management of production. For what it may concern internal control, the board of directors is responsible for establishing and implementing effective internal control. It is responsible for the publication of a self-assessment report in which information on the effectiveness of internal control is disclosed. The supervisory board monitors the board of directors' activities concerning internal control. The management is responsible for conducting daily operations of internal control. In addition, the company needs to set up a specialist department (audit department), or assign to a suitable department, the role of organising and co-ordinating internal control daily activities. Article 13 clearly specifies that the board of directors shall set up an audit committee. The audit committee is in charge of monitoring the company's internal control and its effective operation. Moreover, it controls self-assessment, co-ordinates internal control audit and other related activities. The audit committee chairman shall be independent and have professional integrity. Article 14 summarizes the articles above, stating that the organisational structure must reflect the business nature of the company and clearly allocate responsibilities to accountable parties.

Figure 1.3 The Structure of Corporate Governance in China.



Source: Lu, Y. & Ma, D., 2017. "China SOX": What Is It and Why Was It Introduced? WSEAS Transactions on Business and Economics, Volume 14.

Article 15 is about the independence of the internal audit department. The company shall ensure that the audit department and its staff are independent. The main responsibility of the internal audit department is to examine the effectiveness of the internal control system. Whether there are control weaknesses, the audit department shall report them, following the internal audit procedures. If the control weaknesses are significant, the department has the power to report such matters directly to the board of directors, audit committee and supervisory board.

Article 16 and 17 concerns human resource policies, while Article 18 concerns corporate culture. A strong corporate culture shall be maintained by promoting values, social responsibility honesty and integrity, personal accountability, innovation and risk awareness and management.

Chapter 3 concerns risk assessment. According to Article 20, in order to implement internal control, a company has to adopt a systematic approach to collect risk information and perform risk assessment. It is important to identify the internal and external risks that affect the accomplishment of control objectives and set the appropriate risk appetite for the identified risks (Art. 21). The Basic Standard defines “risk appetite” as the limit at which an enterprise is willing to tolerate a risk. In the process for identifying internal risks, a company must consider various factors (Art. 22). These factors include human resource factors, such as the integrity and competency of the directors, supervisors,

chief executive officer, other senior managers; management factors like the organisational structure, business model and asset management and innovation factors like research and development and technological inputs. Moreover, financial factors must be considered, these include financial position, business performance and cash flows. Safety factors like operational safety, staff welfare and environmental protection are also of extreme importance. If on one hand internal risks must be kept under control, on the other hand external risks are expected, and a strategy to assess and minimize these risks is necessary. When identifying external risks, a company should consider economic, legal, social, technological, environmental and other factors (Art.23). For example, economic factors include industrial policies, financial conditions, market competition and so on, while legal factors include laws and regulation as well as regulatory requirements. Social factors concern social safety and stability, culture and traditions and consumer behaviour; technological factors include innovations and environmental factors include natural disasters and geographical conditions. All these risks need to be identified and assessed applying qualitative and quantitative methods. Of particular importance is the likelihood of their occurrence and their potential impact (Art. 24). A risk assessment team should ensure an accurate outcome of risk assessment. After establishing its risk appetite and considering the outcome of its risk analysis, a company has to determine its risk responses in order to prevent the occurrence of significant losses (Art. 25). Risk response measures consist of risk avoidance, risk reduction, risk sharing or risk acceptance (Art. 26). If the identified risk exceeds a company's risk appetite then risk avoidance is adopted, in order to avoid potential loss; on the contrary, risk acceptance is adopted when the identified risk is considered to be within the risk appetite of the company. Risk reduction involves taking appropriate measures to reduce risk or potential loss after having considered costs and benefits. Risk sharing is adopted when a company, in order to reduce the risk within its risk appetite, decides to transfer a portion of the risk to third parties through outsourcing, purchasing insurance cover and other measures. At the end of the chapter, Article 27 states that as a company develops and grows in business, it shall continuously collect risk information and modify its risk responses accordingly.

Chapter 4 concerns control activities that reduce risks such as:

- Segregation of duties,
- delegation of authority approval;
- accounting system control;
- safeguarding of properties;
- budgeting control;
- operational analysis;

- performance appraisal.

In the following lines, these control activities will be analysed in detail. In order to implement segregation of duties control, a company must take a holistic approach to the task of analysing its operational process (Art. 29). The chapter then moves its focus on delegation of authority approval control. It requires that a company, following delegation of authority criteria, defines the authority and limits of each staff position, approval procedures and responsibilities (Art. 30). Delegated normal authority refers to that conferred by the company to those with the role of performing duties and responsibilities. On the other hand, delegated special authority refers to that authority conferred by the company to a person holding a position and performing duties under a special condition or situation. Moreover, major operational issues and projects must be addressed by adopting a collective approval or sign-off policy. This means that no individual should be allowed to make decisions without a prior collective decision (Art.30). Accounting system control concerns the compliance with the country's general accepted accounting principles. A company must perform accounting activities accurately and must clearly document the procedures relating to bookkeeping and financial reporting. Accounting system control ensures that accounting information are valid and complete (Art.31). For what it may concern accountants, they are required to gain professional accounting qualifications and the head of the accounting office should be a qualified accountant. The chief accountant position should be instituted by large and medium-sized enterprises. Article 32 concerns control over the safeguarding of properties. Companies have to establish routine properties management and regular inventory checking policies, they shall keep a proper record of the properties owned and shall regularly perform inventory counts and reconciliations. Budgetary control requires the implementation of a comprehensive budgetary management system policy that formalises budget setting, approval and execution of procedures and exercises budgetary constraints (Art. 33). Operational analysis control involves the establishment of operational analysis policies that allow a company's management to apply analytical techniques to analyse operations on a periodic basis. In case shortcomings are discovered, the management of a company has to identify their causes and promptly make appropriate rectifications (Art. 34). Performance appraisal control means that a company has to develop and implement a set of performance indicators and carry out regular appraisals of performances of departments employees (Art.35). The results can work as a basis to support employee's remuneration, resignation, and other human resource management activities. Lastly, Article 37 concerns the establishment of advance risk warning and emergency response mechanisms. Advance risk warning criteria must be clearly defined, and emergency response plans should be promptly adopted in response to environmental protection and other major risks or emergencies.

Chapter 5 sets out rules related to the establishment of information and communication policies. Additionally, with the objective of ensuring a timely communication of information on internal control, the articles of this chapter define procedures relating to the gathering, handling and communication of internal control related information (Art. 38). Enterprises can collect internal information from their financial accounting data, business management data, research reports, special information, corporate periodicals and office networks and other internal sources of data and channels. External information, on the other hand, can be gathered through industry associations, social agencies, business related parties, market research, business networks, press and regulatory bodies and other external sources channels (Art. 39). The communication of internal control related information between managers and departments, and between the company and external parties such as investors and so on, is of extreme importance, and should be always facilitated. Key information should always be communicated to the board of directors or supervisory board (Art. 40). As Article 41 states, information technology should be applied and monitored through maintenance and development mechanisms, in order to improve information gathering and sharing. Article 42 relates to the establishment of anti-fraud policies, and it focuses on the importance of preventing frauds. A company needs to clearly define anti-fraud activities, authorities and limits of interested parties and should formalise reporting, investigation, handling and remediation procedures. Anti-fraud activities should concentrate upon the following key areas:

- Through illegal methods, employees may misappropriate corporate property or embezzle corporate funds for personal gains.
- Financial reports contain falsified information and material omission of key information.
- Directors, supervisors, chief executive officer and other senior managers abuse their authority.
- Collusion between departments or employees to deprive the company of its rights, money or property by fraud.

Chapter 6 relates to the process of internal monitoring. A company shall establish internal control monitoring policies, define the responsibilities of the internal audit department, or of another department in charge of monitoring, and shall formalise internal monitoring procedures and methodology. Article 44 specifies that internal monitoring consists of regular and special monitoring. The former relates to the routine examination of existing internal control established and operated by the company, while the latter relates to the targeted examination of one or several aspects of internal control that are affected by a significant change. In order to implement internal monitoring, companies shall clearly define what could constitute control weaknesses, carry out proper analysis of the nature and causes of these weaknesses and take appropriate corrective actions. It is important to

promptly report any weakness to the board of directors or supervisory board (Art. 45). Internal control weaknesses may include design weaknesses or operational weaknesses. What a company must do, as a part of internal monitoring, is to perform a self- assessment of the effectiveness of its internal control on a periodic basis and issue a control self-assessment report (Art.46). Moreover, proper records of the internal control should be kept by the company, so as to provide evidence and auditable trails of its internal control implementation activities (Art. 47).

Chapter 7 specifies some supplementary provisions. According to article 49, the Ministry of Finance of the People's Republic of China and relevant and governmental regulatory bodies shall formulate specific measures relating to the introduction of the Basic Standard for Enterprise Internal Contro*l*. This standard shall come into effect from 1 July, 2009 (Art. 50).

1.3.3 The Application Guidelines for Enterprise Internal Control

The Application Guidelines for Enterprise Internal Control were released in 2010, they provide guidelines that help companies to establish and perfect their internal control systems. These guidelines consist of 18 aspects, definitions and examples. Table 1.3 summarizes the 18 aspects.

Table 1.3 Aspects of Internal Control in the Application Guidelines.

China SOX – Aspects of Internal Control	
Organizational Structure	• Ensure that decision-making, execution and supervision are separate and form adequate checks and balances • Conduct an overall evaluation of the efficiency and effectiveness of the design and operation of its organization on a regular basis
Development Strategy	• Set up a strategy committee to be in charge of the management of development strategies and formulation of a development strategy proposal, which will be implemented after adoption upon deliberation by the board of directors and approval at the shareholders' meeting
Human Resources	• Formulate annual plans on human resource needs and evaluate its execution on a regular basis
Social Responsibilities	• Establish stringent work safety management systems, rigorous product quality control and inspection systems • Diligently perform energy conservation and emission reduction responsibilities • Establish a scientific employee remuneration system and incentive mechanism • Ensure the entitlement of staff members to rest and leave days
Corporate Culture	• Actively cultivate a corporate culture and a corporate culture assessment system which focuses on whether the directors, supervisors, managers and other senior management personnel have performed their duties in corporate cultural building and whether all employees identify with the enterprise's core values
Fund-related Activities	• Based on its fund-raising goals and planning, draft fund-raising programs in light of the annual overall budget, specify the purposes, amount and structure of the funds to be raised and the fund-raising methods, and make sufficient estimates of the fund-raising costs and potential risks
Procurement Activities	• Put procurement operations under centralized management, and avoid procurement from too many suppliers or decentralized procurement
Asset Management	• Adopt advanced inventory management technologies and methods and standardize inventory management processes • Establish inventory management post accountability system
Sales	• Strengthen market research and promptly adjust sales strategies according to market changes • Strengthen the management of bad debts of accounts receivable • Where the accounts receivables cannot be recovered in whole or in part, the enterprise should find out the reasons, clarify the responsibilities, and handle the issues in strict compliance with the examination and approval procedures and pursuant to China's uniform accounting standards
Research and Development	• Establish a research achievement protection system, and strengthen the management of patents, non-patented technologies, trade secrets, as well as various kind of confidential drawings, programs and data formed during the R&D process • Establish a R&D activity assessment system to enhance the comprehensive assessment of project initiation and research, and other process
Engineering Projects	• Designate a special department to manage engineering projects on a centralized basis • Select contractors and supervision entities based on merits for its engineering projects through open bidding.
Guarantee	• Designate relevant departments to be responsible for guarantee operations, conduct credit investigation and risk assessment of applicants, and issue written reports on assessment results • Establish a guarantee accountability system, and strictly hold accountable the departments and personnel that make major errors in guarantee decision-making, fail to go through the collective examination and approval process, or fail to manage guarantee operations as required

Business Outsourcing	• Establish and improve the business outsourcing management systems, specifying the scope, manner, conditions, procedures and implementation of business outsourcing, make clear the duties and authority of relevant departments and positions, and reinforce the monitoring of the entire outsourcing process
Financial Reports	• Hold financial analysis meetings on a regular basis, and make full use of the comprehensive information reflected in the financial reports to conduct a thorough analysis of the operation and management situation and the existing problems of the enterprise, and constantly improve its operation and management level
Comprehensive Budgeting	• Establish a budgeting management committee to perform the duties of comprehensive budgeting management • Prepare an annual comprehensive budget by adhering to its development strategies and annual production and operation plan, by taking into comprehensive consideration the economic policies, market conditions and other factors during the budget period
Contract Management	• Designate a centralized contract management department; specify the procedures and requirements for contract drafting, examination and approval, performance and other aspects, conduct regular inspection and evaluation. • Establish a contract performance assessment system, analyze and assess the overall situation of contract performance and the specific situations of the performance of major contracts at least once at the end of each year
Internal Informal Communication	• Formulate a rigorous internal reporting process, make full use of information technology, reinforce the integration and sharing of internal reporting information, and include internal reports into its unified information platform, so as to build a scientific internal reporting network • Make effective use of internal reports in risk assessment, accurately identify and systemically analyze the internal and external risks in its production and operation activities, and determine the strategies to tackle such risks, so as to achieve effective control of risks
Information Systems	• Designate a department to manage the building of information systems on a centralized basis • Strengthen the management of critical information equipment such as the servers

Source: Hao, X. & Rainsbury, E. A., 2016. Disclosure of Internal Control Information by Chinese Cross Listed Companies. Unitec ePress Research Report Series.

The Application Guidelines (MOF, 2010) provide different rules on internal control for each aspect described in table 1.3. For instance, aspect number 11 refers to Construction Projects. The Application Guidelines concerning Construction Projects are composed of 6 chapters and 27 articles. The main objective of the Application Guidelines No. 11 for the internal control of construction projects is to enhance the management of the projects and construction quality, to monitor the progress of construction, control construction costs and prevent commercial bribery. When undertaking construction projects, or any other project, a company shall address risks such as lack of feasibility studies for project initiation, inappropriate decision making; malpractices or commercial bribery; inaccurate information on project pricing; lack of supervision of project funding; unregulated inspection and so on. It is important to assess potential risks and standardize procedures, to define responsibilities and separate duties, to monitor the project and to implement final accounting and audit of projects upon completion.

It can be reasonably assumed that Application Guidelines contain very detailed provisions for the implementation of internal control of each special activity an enterprise may undertake and for each aspect of daily operations, specifying the actual steps a company must follow in order to put internal control into practice.

1.3.4 Guidelines for Assessment of Enterprise Internal Control

The Guidelines for Assessment of Enterprise Internal Control, or Evaluation Guidelines (MOF, 2010), have the function to help companies to assess the effectiveness of their internal control system. Overall, although before this regulation some of the listed companies in the Shanghai and Shenzhen Stock Exchange produced disclosure internal-control assessment reports, these reports were difficult to compare and understand due to the lack of detailed guidelines (LU & MA, 2017). The Guidelines for the Assessment of Enterprise Internal Control are of significant importance because they contain the guidelines for the disclosure of the self-assessment reports on internal control (CHEN, 2016). What the Evaluation Guidelines request companies to do is very detailed, in fact, companies are required to disclose the following factors in assessment reports:

- The statement of authority of internal control report of the Board of directors. This means that all members of boards of directors are responsible for the effectiveness of internal control.
- The objective and the business items that are being assessed.
- The evidence of assessment, including assessment methods.
- The overall situation of internal control assessment.
- The conclusion of effective internal control.
- The measures adopted to address internal control deficiencies and major defects.
- The process and means of assessment.

The objective of the Ministry of Finance is to employ an internal control assessment table, which could allow easier comparison of internal control assessment reports of different companies and help users. These guidelines are in line with the SOX in the US and include 5 chapters and 27 articles: Chapter 1 provides the General Provisions, Chapter 2 the contents of internal control assessment, Chapter 3 the procedures of internal control assessment, Chapter 4 the determination of internal control deficiencies and Chapter 5 gives instructions on the design and disclosure of internal control assessment report.

"Internal control assessment" is defined in Article 2 as the process performed by a company's board of directors or similar authority to assess the effectiveness of the internal control system, draw conclusions and issue assessment reports. The principles that must be followed when performing internal control assessment are those of Comprehensiveness, Significance and Objectivity (Art.3). Comprehensiveness implies that the assessment has to cover each business of the company as well as the internal control system's implementation of the enterprise and its subsidiaries. The assessment should focus on key units, major business activities and high-risk areas; if the assessment covers these factors then there is compliance with the principle of significance. Objectivity requires the assessment

to be an accurate reflection of a company's operating and management risk profile, and of the effectiveness of its internal control system. Moreover, an enterprise shall establish detailed procedures for assessing internal control, and it shall define assessment principles, contents, methods and reporting mode. Also, responsibilities and a system of accountability must be defined. The Board of directors is responsible for the truthfulness of the internal control assessment report (Art.4).

Chapter 2 deals with the Contents of Internal Control Assessment. When assessing the design and operation of its internal control system, an enterprise has to cover various components such as internal environment, risk assessment, control activities, information communication and internal monitoring (Art.5).

- Assessing internal environment means to verify the actual operation status of the company. The elements to consider are the Application guidelines on organisational structure, development strategies, human resources, corporate culture, corporate social responsibilities and the internal control system (Art.6).
- When evaluating the risk assessment mechanism, a company verifies and evaluates major risks, risk analysis and risk responses in the management process of daily operations. The company must refer to the Basic Standard previously described and to the major risks included in various Application Guidelines (Art.7).
- Assessing control activities means to assess the design and operation status of relevant control measures. In order to do that, a company must follow the control measures stipulated in the Basic Standard (Art.8).
- The information and communication assessment requires an appraisal of the timeliness of information gathering, processing and communication. Additionally, anti-fraud control must be verified; financial reporting must be truthful and the information system must be effective in implementing internal accounting. This assessment must be carried out with reference to the Application Guidelines on communication of internal information (Art.9).
- Internal monitoring must be verified by assessing the effectiveness of internal monitoring mechanisms; by focusing on the effectiveness of the board of supervisors, the audit committee and the internal audit department in monitoring internal control's operations. The Basic Standard and the provisions on routine monitoring contained in various Application Guidelines must be followed when carrying out these operations (Art.10).
- The assessment of internal control requires a company to produce working papers that document in details the contents of the assessment process, including major risks, adopted

control measures and the results of verification. The assessment working papers shall contain sufficient evidence (Art.11).

Chapter 3 contains provisions regarding the procedures of internal control assessment. An internal control assessment usually requires the procedures of developing a working plan, establishing an assessment team, performing on-site testing, determining control deficiencies, summarising assessment results and preparing a report. The authorization for the organisation and performance of the assessment of internal control is given to the internal audit function or to a designated department, that the guidelines call "IC assessment function" (Art. 12). Developing a working plan is useful in order to define the scope of the assessment and other organisational factors. The plan then is implemented after the approval of the Board (Art.13). The IC assessment function shall establish an assessment team to perform the detailed assessment. This team shall comprise people from a company's internal departments who should conduct an assessment on their own department's internal control. Otherwise, a company may appoint an intermediary organisation to perform this function. It is important to underline that the accounting firm that audits an enterprise's internal control is not allowed to simultaneously provide the internal control assessment service for the same client (Art.14). The means for conducting the assessment include individual interviews, on-site examinations, questionnaires, sampling tests and so on. The internal control deficiencies are then analysed on the basis of the evidence obtained (Art.15).

Chapter 4 specifies how to determine design deficiencies and operating deficiencies in internal control. Routine, special monitoring and the annual internal control assessment work as the basis for detecting internal control deficiencies. Once these deficiencies have been determined, the IC assessment function submits the results to be reviewed before approval (Art.16). The deficiencies must be classified, in terms of their impact, into material deficiencies, significant deficiencies and general deficiencies. In Article 17 the guidelines provide the definition of "material deficiency": a material deficiency refers to a control deficiency or a combination of control deficiencies that may lead to a company's material deviation from its objectives. A "significant deficiency" is a control deficiency, with a lesser significance and economic consequence than a material deficiency, but that may still lead to a company's deviation from its control objectives. "General deficiencies" refer to all other deficiencies apart from the above-mentioned material and significant deficiencies. The criteria for determining material, significant or other deficiencies are established by the company.

Once the working papers are ready, the internal control assessment team shall establish a system of quality cross-check, meaning that the head of the team reviews the assessment working

papers and accepts the results obtained before submitting them to the IC assessment function (Art.18). At that point, the IC assessment function shall prepare a summary of the internal control deficiencies. During this process, the control deficiencies are reviewed and their causes, forms and impact are ascertained. The IC assessment function reports its opinion to the Board, the board of supervisors or the management, while material deficiencies shall be submitted to the Board for final identification. Responses against material deficiencies must be prompt, in order to control risk within tolerable limits. The functions or personnel concerned are accountable for any material deficiency identified.

Chapter 5 provides the guidelines for redacting the internal control assessment report. It is the company who, in accordance with the Basic Standard and the supporting guidelines, designs the format and content of its internal control assessment report and defines the preparation procedures (Art.20). The assessment report shall contain separate sections for internal environment, risk assessment, control activities, information and communication and internal monitoring. Additionally, the report shall disclose the assessment process, the determination of control deficiencies, the remediation status and the conclusion on the effectiveness of internal control (Art.21). Article 22 sets the minimum requirements for disclosure; the report must at least contain:

- The Board's representation regarding the truthfulness of the internal control report.
- An overview of the internal control assessment.
- The basis of the internal control assessment.
- The scope of the internal control assessment.
- The procedures and methods used in the internal control assessment.
- Identified internal control deficiencies.
- Details on the measures adopted for fixing material deficiencies.
- Conclusion on the effectiveness of internal control.

The disclosure and the submission of the report to relevant departments occur after the report has been submitted to the Board for approval (Art.24). If, in the period before the issuance date of the internal control assessment report, other factors affecting the effectiveness of internal control arise, the IC assessment function of a company has to adjust the assessment conclusion according to the impact of these factors. Moreover, the guidelines state that the internal control assessment report shall be disclosed together with the audit report on internal control on the 31st of December (Art.25, Art.26).

1.3.5 Guidelines for the Audit of Enterprise Internal Control

These guidelines are the professional norms for CPAs and accounting firms to implement internal-control auditing. This section of the supporting guidelines provides basic requirements for performing internal control audits, while Notice on Issuing the Enterprise Internal Control Guidelines and Notice on the Implementation of Internal Control System by Companies Listed on the Main Board under Different Categories and Groups are more detailed and specify the scope, effective dates and requirements for implementing the Basic Standard (LU & MA, 2017). To give a general illustration, the Auditing Guidelines (MOF, 2010) state that auditors should treat differently any detected internal control over non-financial reporting. If they detect significant deficiencies, they need to contact the board of directors or the management. On the contrary, if they detect material deficiencies, apart from contacting the board of directors, they will also need to disclose the nature and severity of the material weakness in the annual reports. Specifically, the Auditing Guidelines include 7 chapters plus an appendix containing the form of the Auditor's report on internal control.

Chapter 1 contains the general provisions. The main aim of these standards is to regulate the performance of the audit of internal control by auditors, in order to ensure the quality of audit (Art.1). "Audit of Internal Control" is the process in which an accounting firm accepts the engagement to perform an audit of the design and operating effectiveness of a company's internal control at a specific base date (Art.2). Article 3 states that, while the Board is responsible for establishing, implementing and assessing the effectiveness of internal control, the auditor is responsible for expressing an opinion on the effectiveness of internal control based on the audit work. Furthermore, the evidence obtained by the CPA (Certified Public Accountant) must be appropriate for the purpose of expressing an audit opinion on the effectiveness of internal control over financial reporting. Expressing an audit opinion includes describing material deficiencies. Material deficiencies in internal control that are unrelated to financial reporting are to be included in a specific section of the auditor's report called "explanatory paragraph of material deficiency in internal control unrelated to financial reporting" (Art.4). The CPA may integrate the audit of internal control with an audit of financial statements (integrated audit), or perform an audit of internal control separately. If performing an integrated audit, the CPA shall accomplish the objectives of both auditing simultaneously. The objectives are:

1. To obtain appropriate evidence to support the auditor's opinion on the effectiveness of internal control;
2. To obtain sufficient evidence to support the auditor's control risk assessment for the purpose of the audit of financial statements.

The second chapter contains 4 articles concerning the planning of the audit. According to this chapter, the audit shall be properly planned, and a team with professional competence shall be engaged. There are some factors that may create an impact on internal control, financial statements and the audit (Art.7). These factors include at least:

- Risks relating to the enterprise.
- Relevant laws and Regulations and industry profile.
- Organizational structure, operating characteristics and capital structures of the enterprise.
- Recent changes in the enterprise's internal control system.
- Internal control deficiencies.
- Materiality and risks that are related to the determination of material internal control deficiencies.
- Preliminary judgments about the effectiveness of internal control.
- Type and extent of the available evidence related to the effectiveness of internal control.

A CPA chooses the controls that need to be tested, and it is common for a CPA to concentrate more attention on the area of internal control with the higher risk of existence of material deficiencies (Art.8). The CPA evaluates the enterprise's self-assessment of internal control and decides if and to what extent the work performed by the company's internal auditors can be used. If the auditor plans to use the work of the company's internal auditors, or of the employees involved in internal control assessment, the CPA needs to assess their competence and objectivity. When a particular control is associated with higher risk, it is not advised to rely on the work of others. However, it is important to note that whether the CPA uses the work of others or not, he or she shall take the sole responsibility for the audit opinion expressed (Art.9).

Chapter 3 concerns the performing of the audit, providing guidelines on the approach, the focus and the procedures of the audit. To perform the audit, a top-down approach should be used, it creates a basis for the CPA to identify risk and select the controls to test (Art.10). Controls can be divided into entity-level controls and activity-levels control and they can be tested together. In order to test entity-level controls the CPA applies the principle of materiality, and should at least focus on factors such as the controls related to the internal environment; the controls that address the risk of the Board or management overriding controls and the enterprise's risk assessment process (Art.11). Other factors relate to the controls over the communication of internal information and financial reporting process and to the internal monitoring and self-assessment of internal control effectiveness (Art.11). On the other hand, when testing activity-level controls, the CPA shall apply the principle of materiality and consider the company's actual situation, the requirements of the supporting guidelines

for internal control and the results of the testing on the company's entity-level controls. The focus should be on controls over significant elements in the company's production and operating activities (Art.12). Another key thing to remember is that the CPA must ascertain that fraud risks are sufficiently addressed by internal control (Art.13). After having tested the design and operating effectiveness of internal control, if the results are positive, the internal control can be regarded as effective in design and in operation (Art.14). For what it concerns the nature, timing and extent of audit procedures, these are determined by the CPA. The most important condition is that evidence obtained on the risk of internal control is sufficient and appropriate (Art.15). The techniques used by the CPA include inquiring with appropriate personnel, observing business activities, inspecting documentation and so on, while inquiry alone is not sufficient (Art.16). For what it may concern the timing of a test, the CPA shall find a balance between performing the test close to the base date of the company's self-assessment of internal control, and performing the test over a longer period of time (Art.17). Article 18 provides a guidance in case there is a deviation from the initial design of the operation of internal control (control deviation). In this case the CPA has to determine whether the deviation had an impact on the relevant risk assessment. Lastly, Article 19 asserts that in the event of recurring audits the CPA should incorporate the knowledge obtained from previous audit of internal control.

Chapter 4 specifically addresses the issue of the assessment of internal control deficiencies. Basing the classification on their causes, deficiencies can be divided into operating and material. Basing the classification on their impact, deficiencies can be divided into significant and general. It is the CPA who evaluates the severity of the deficiencies and determines if these may constitute a material deficiency (Art.20). In order to do that the CPA has to assess the effect of compensating controls (Art.21). Article 22 shows that there are some indicators of the existence of material deficiencies, these could include the identification by the CPA of fraud on the part of directors, supervisors and senior management; the restatement of previously released financial statements by the company; the identification by the CPA of a material misstatement in financial statements in the current period that is not detected by the company's internal control and the ineffective oversight of the company's internal control by its audit committee and internal audit function.

Chapter 5 concerns completing an audit, which means that the CPA shall obtain signed written representation from the company when completing the audit. The written representation must include the statements described below (Art.23).

1. The Board acknowledges its responsibility for establishing sound internal control and implementing such control effectively.

2. The company has made a self-assessment on the effectiveness of internal control.
3. The company did not use the auditor's procedures and the relative findings as the basis for the company's self-assessment.
4. The company has disclosed to the CPA all the deficiencies identified in internal control, with material deficiencies disclosed separately.
5. Whether the company has solved deficiencies identified by the CPA during previous audits.
6. Whether there were, after the base date of the internal control self-assessment, any significant changes in internal control.

In case the company refuses to provide the written representation, the CPA shall consider it as a scope limitation of the audit and therefore withdraw from the engagement, or disclaim an opinion (Art.24). All the deficiencies identified by the CPA must be communicated to the company, while it is important that material and significant deficiencies are communicated to the Board and management in writing. In case the CPA believes that the oversight by the audit committee and the internal audit function is ineffective, the CPA shall communicate its conclusion in writing directly to the Board. All the written communications shall be made prior to the issuance of the auditor's report on internal control (Art.25).

Chapter 6 sets the rules for issuing the auditor's report. The auditor's report on internal control is issued by the CPA when the audit is complete. The report expressing unqualified opinion shall contain a title, an addressee, an introduction paragraph, a paragraph on the company's responsibility for internal control, one on the CPA's responsibility, one describing inherent limitations of internal control and one containing the auditor's opinion on the internal control over financial reporting. Additionally, the report must include an explanatory paragraph of material deficiencies in internal control unrelated to financial reporting, the signature and stamp of the CPA, the name, address and stamp of the accounting firm and the date of the auditor's report (Art.27). However, there are two conditions that must be met in order for the CPA to express an unqualified opinion on internal control over financial reporting. The first is that the company has maintained effective internal control in accordance with the law and regulations (Basic Standard and supporting guidelines); the second is that the CPA has planned and performed the audit in accordance with the requirements of the Guidelines for an Audit of Enterprise Internal Control, and there have been no restrictions on the scope of the audit (Art.28).

In case the CPA did not identify any material deficiency, but believes there are significant matters that need to be considered by the users of the internal control audit report, the CPA shall include a paragraph called "Emphasis of Matter" in the auditor's report (Art.29). Article 30 states that

if the CPA believes there are material deficiencies, he/she shall express an adverse opinion on internal control over financial reporting, unless there is a limitation on the scope of audit. If the auditor's report is expressing an adverse opinion it must include the definition of the material deficiency, its nature and its effect on internal control over financial reporting. In case the scope of the audit is limited, the auditor shall withdraw from the engagement or disclaim an opinion and communicate to the Board the scope of limitation of the audit (Art.31). For what it may concern deficiencies, the CPA shall address them depending on their specific context. In the first circumstance, the deficiency in internal control unrelated to financial reporting is a general deficiency and, in this case, the CPA shall communicate this to the company, reminding them to remediate it, but the CPA does not need to mention the deficiency in the audit report. In the second case, if the CPA believes that the deficiency detected is a significant deficiency, the CPA has to communicate it to the Board and management in writing, and remind the company to remediate it, but does not need to mention the deficiency in the auditor's report. In the third case, the CPA detects a material deficiency and shall communicate it to the Board in a written form. In this case the CPA has to include an "explanatory paragraph of material deficiencies in internal control unrelated to financial reporting" in the auditor's report. In this paragraph the CPA explains the nature and the effects of the deficiency and alerts the auditor's report users of the relevant risks. Article 33 concerns changes in internal control that might affect internal control occurred subsequent to the date of the company's internal control self-assessment but before the date of the auditor's report. If the CPA obtains knowledge of such changes, he/she should issue an adverse opinion on internal control over financial reporting.

Chapter 7 deals with the documentation of an audit. The auditor shall document the audit work in accordance with the China Standard on Auditing No. 1131 "Audit Documentation" (Art.34). The audit documentation shall include the plan for internal control audit; the major procedures and results of relevant risk assessment; the procedures and results of the testing of internal control; the evaluation of control deficiencies identified; the audit conclusion and the opinion formed and, lastly, other significant matters.

The Basic Standard and the guidelines concerning the application, evaluation and audit of internal control, are measures introduced by the Chinese government with the aim of standardizing and regulating internal control and the disclosure by listed companies of the report containing the assessment and auditor's opinion on the effectiveness of their internal control systems. A group of pilot companies listed both in China and abroad were required to comply with this regulation from 2011. From January 2012, the compliance was then extended to all companies listed in China.

By issuing the Basic Standard, the Chinese Government has tried to encourage the creation of a good business environment with high quality accounting and internal control. With the Company Law promulgated in 2005[16], the Audit Law amended in 2006, and the Basic Standard issued in 2008, the Chinese relevant Ministries reached the objective of completing the project to enhance the quality of the financial reporting process of listed companies and strengthen China's capital market. In detail, 2005 Company Law regulating obligations from the Board of directors to the company and introducing a program of risk evaluation; Audit Law with its articles concerning internal control and the Basic Standard with its supporting guidelines eventually created a comprehensive regulatory framework.

[16] Company Law of the People's Republic of China was adopted in 1993, revised in 1999 for the first time, and then revised in 2004, 2005 and 2013 and 2018. Source: http://www.fdi.gov.cn/1800000121_39_4814_0_7.html

CHAPTER 2

2. Literature Review

The "Open-door Policy" officially started in 1978 and helped China to attract foreign investments and to become more active in international economic organizations. This policy allowed China to achieve one of the fastest periods of economic growth in history. The Chinese stock market experienced a rapid growth that led to the gradual development of modern corporate management among listed firms (JI, et al., 2018). In the late 1980s and at the beginning of the 1990s, many state-owned enterprises (SOEs) that operated under the planned economy went through the process of privatization. However, at the beginning, these enterprises had not a sound system of internal control and lacked any awareness concerning risk management. From that period on, the Chinese Government started to work on an internal control regulatory framework that could solve the afore-mentioned problems and, contemporarily, companies started to voluntarily improve their internal control systems. Internal control in China has been gaining more and more importance, mostly because an effective internal control system is of primary importance in order for a business to carry out operations efficiently. In addition, internal control is important because of the role it plays on accounting information quality (LUO, 2017). In particular, internal control helps companies to improve transparency, validity and authenticity of accounting information. The main objectives of an effective internal control system are included in Table 2.1.

Table 2.1 Objectives of Internal Control

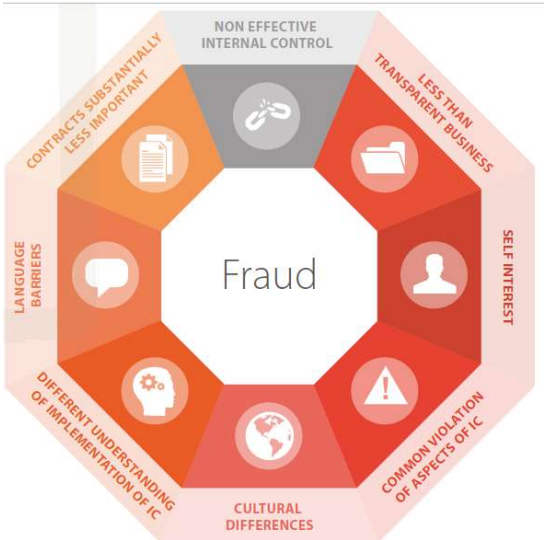
Internal Control and Relevant Business Objectives	
Protect assets	Controls employed to ensure the proper deployment and allocation of a company's tangible and intangible assets.
Smooth business operations	Controls employed to make sure that all aspects of business operations run smoothly and unhindered; serving to mitigate inefficiencies that may threaten the generation of added value.
Prevent fraud	Controls that safeguard against all types of fraudulent behaviours, which may be embedded into the company culture or operation.
Reliability of financial records and reporting	Controls that are deployed to maintain efficient and reliable transaction records and financial accounts, and are essential for producing accurate financial statements to both authorities and shareholders in a timely fashion.
Compliance with laws and regulations	Controls that are used to ensure that all aspects of business operations keep within the law and the legal framework of IC.

Source: Dezan Shira & Associates, 2017. Internal Control in China. *China Briefing*, Issue 175.

The figure below (Figure 2.1) provides an accurate summary of the major issues specific to the Chinese business environment that could lead to fraud. In particular, non-effective internal control,

different understanding of implementation of internal control and common violation of aspects of internal control are all IC-related factors that could cause to fraud. For this reason, all the factors in the figure underline the need for the establishment of an effective internal control system.

Figure 2.1 Issues that could lead to fraud in the Chinese business environment.



Source: Dezan Shira & Associates, 2017. Internal Control in China. *China Briefing*, Issue 175.

The People's Republic of China developed a thorough regulatory framework on internal control, and this allowed the disclosure of many research data that gave life to a wide-ranging literature on the topic. The Basic Standard for Enterprise internal Control issued in 2008 clearly states that improving internal control will consequently promote sustainable business development, will enhance business management and risk prevention (Art.1). In addition, standardising the internal control system of Chinese listed companies would maintain the socialist market economic order and protect the public interest. Although in 2006 both the Shanghai and Shenzhen stock exchanges had already released their guidelines on internal control, these guidelines did not represent an integrated framework (HAO & RAINSBURY, 2016). The disclosure of internal control information was not detailed enough and it was considered a formality (YAN, et al., 2016). The Basic Standard, on the other hand, specifically requires listed companies to set up a system of internal control and to document it by disclosing a self-evaluation report on internal control. The self-evaluation report then needs to be audited by a CPA. The Basic Standard and its supporting guidelines, also called China SOX or C-SOX, are a comprehensive set of rules. C-SOX extends the scope of internal control to a broader concept of business management and to more operation areas. In fact, the Application Guidelines, by identifying eighteen areas of management and operation in which internal control risks may appear, provide an integrated view of the scope of internal control (JI, et al., 2018). C-SOX not only places importance on the internal control directly related to the preparation of financial reporting,

but it also focuses on other components of internal control such as risk assessment, risk management, internal monitoring and internal weaknesses. This results in the comprehensiveness of the Chinese regulatory system on internal control. In addition, the internal control weaknesses disclosed provide research data both on financial reporting and on other operation areas, and therefore allow researchers to deeply observe internal control (JI, et al., 2018).

It can be asserted that C-SOX also pays attention to the human factors in a firm, because participation is required at every level and the prerequisite for compliance with the regulation is the support of the whole firm. This is a core area of study mostly because setting internal control objectives, conducting effective training, managing control processes and preparing for internal control audits are tasks carried out by people. Consequently, people are more important than the system. The main challenges are those of maintaining perfect systems of internal control and ensuring that risks from people's behaviours do not undermine the security of operations (LU & MA, 2017). The importance placed on the human factor allowed the literature on internal control in China to study the connection between the quality of internal control reporting and the characteristics of internal control employees, audit committees, Board of directors and the management of firms.

Another factor that stimulated the interest in internal control and the proliferation of literature sources on the topic is the significant role of internal control in enterprise risk management (ERM). If, on one hand, prior studies ignored the fact that the control of operational risks could affect financial reporting quality and hence only focused on financial reporting, current studies, on the other hand, focus on financial reporting as a part of an evaluation of overall internal controls (JI, et al., 2018). Enterprise Risk Management, as it has been remarked by the Internal Control-Integrated Framework issued by COSO, in order to effectively judge financial statements and to make estimates, requires the adoption of a broader view that considers factors such as risk management and internal control at the management level, rather than solely considering accounting errors.

It has been already mentioned that the literature on internal control in China is wide-ranging. Due to this fact, it has to be classified into different categories. Analysing the literature on internal control, the first distinction that has to be made concerns the period of publication. The first empirical studies on internal control and audit of internal control belong to the period before the publication of the Basic Standard for Enterprise Internal Control and therefore investigate internal control in China as a voluntary activity. The other set of studies belongs to the period after the publication of the regulation currently in force.

The second classification is content-related. The first category of the content-related classification includes researches on internal control quality, not necessarily in China. In fact, in order to study the quality of internal control disclosure and the connection between the existence of internal control deficiencies and corporate factors, the literature on internal control in China considers variables obtained by some studies under the US SOX of 2002. The studies conducted by Ashbaugh-Skaife, et al. (2007); Doyle, et al. (2007); Ji, et al. (2015) and Hoitash, et al. (2009) are important because they formulate a model for the evaluation of internal control quality. The second part of the literature on internal control analyses the disclosure of internal control information in China, and the main aim is to ascertain the compliance of a sample of companies with the Basic Standard for Enterprise Internal Control (2008). Moreover, the studies belonging to this category analyse the criteria for deciding whether a deficiency is material or significant and connect the disclosure of internal control weaknesses to investments, firm valuation, corporate fraud, audit fees and corporate governance. Thus, this second category concentrates on internal control weaknesses. The third category focuses on the comparison of the Chinese regulation framework (C-SOX) with international frameworks or regulatory systems of other countries, in particular the American Sarbanes-Oxley Act (SOX). Lu and Ma (2017) and Wang Xin 王新 (2014) provide a detailed view of the Chinese regulatory framework, promulgated in 2008, and of the Sarbanes-Oxley Act promulgated in the US in 2002.

2.1 Studies on internal control quality

In relation to the first group of studies on internal control, it is important to mention a series of research works that consider the quality of internal control disclosure and provide a set of variables that define the quality of disclosure. These variables relate to factors such as corporate governance, the appointed auditing firm, ownership and so on. These variables are also developed from studies on the implementation of Section 404 of the Sarbanes-Oxley Act. Although these data are not necessarily obtained from researches on the implementation of the Chinese regulation, they are still useful to study internal control quality in the Chinese regulatory system. In particular, the research works by Ashbaugh-Skaife, Colling and Kinney (2007); Doyle, Ge and McVay (2007); Ji, Lu and Qu (2015) and Leng & Ding (2011) provide a model to analyse internal control weaknesses and the quality of internal control under the US SOX and under the Chinese regulation.

For what it concerns the quality of disclosure of internal control, a relevant model is provided by Ashbaugh-Skaife, Collins and Kinney (2007). This model, also known as ACK model, theorises that there are three factors related to ICWs and they include probability of existence, detection and disclosure of internal control deficiencies. Disclosing an internal control weakness means that a

choice has been made between the benefits of determining the weakness and the cost of the disclosure. The benefits include transparency and reputation in the capital markets, while costs relate to compliance costs and potential losses (HAO & RAINSBURY, 2016). From this it is evident that Ashbaugh-Skaife, Collins and Kinney (2007) see the disclosure of ICWs as a trade-off between costs and benefits. In relation to the first element, that is the risk of existence of an ICWs, there are firm characteristics such as size and profitability associated with the occurrence of internal control deficiencies. In general, in smaller and less profitable firms, due to the lack of resources and investments in internal control, the likelihood of the appearance of ICWs increases. Other characteristics include the rate of growth of a company (DOYLE, et al., 2007), complexity of operations and organisational changes such as mergers and acquisitions (JI, et al., 2015). The second element concerns the detection of ICWs. In relation to this element, the role of the auditor is of significant importance. Ashbaugh-Skaife et. al. (2007) state that auditors appointed from Big 4[17] firms, in order to maintain their reputation, tend to provide a high-quality assessment of the internal control system of companies and therefore they will ascertain that companies disclose their ICWs, if these occur. In relation to the third element, the actual disclosure of ICWs, Ashbaugh-Skaife et. al. (2007) claim that companies with a high percentage of institutional ownership undergo thorough assessments and monitoring due to the fact that the power of these owners exercise significant influence on internal control. This assertion was made by the authors with regard to the US system and the disclosure of ICWs under the SOX. In China the context is different. Although the percentage of State ownership is usually high, this may result in less corporate transparency and distribution of information (YE, et al., 2016), (WANG, et al., 2013). Moreover, when institutional figures become members of the board or senior executives, these figures may pay less attention to the assessment of internal control and to the disclosure of transparent financial information (ASHBAUGH-SKAIFE, et al., 2007). Ye, Qiu and Zhang 叶陈刚、裘丽 和张立娟 (2016) studied the relation between the percentage of State Ownership and internal control quality basing their research on a sample of Chinese listed companies. The research demonstrated that the internal control performance of state-owned companies is lower than the performance of private companies, resulting in a high number of ICWs disclosed by state-owned companies. On the contrary, in private companies, or companies with a lower percentage of shares held by the State, the percentage of disclosure of ICWs is not high and internal control works as a valid instrument for promoting corporate financial performance.

[17] "Big 4" refers to the four largest accounting firms in the world. These firms provide an extensive range of accounting and auditing services including external audit, taxation services, management and business consultancy, and risk assessment and control. The following are the members of this internationally renowned group: Deloitte Touche Tohmatsu Limited; Ernst and Young (E&Y); Klynveld Peat Marwick Goerdeler (KPMG) and PricewaterhouseCoupers (PwC). Source: www.accountingverse.com

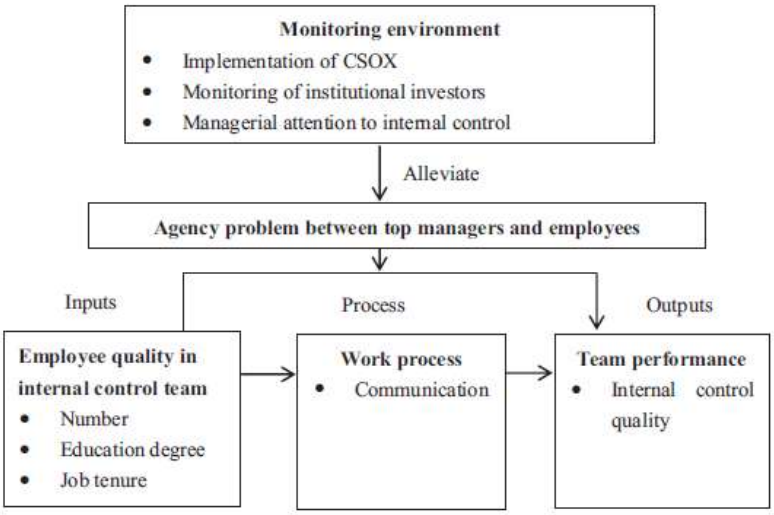
During the construction of a model for evaluating the quality of internal control disclosure, it is also important to relate internal control disclosure to the characteristics of the Board of directors. The work by Hoitash, Hoitash and Bedard (2009) uses material weaknesses reported under SOX Section 302 and 404 and demonstrates that ICWs are less likely to appear in companies in which the Board of directors is strong and audit committee members have supervisory experience. In order to evaluate the Board of directors, Hoitash, Hoitash and Bedard (2009) theorize an evaluation model that includes the independence of the analysed boards, their size and the frequency of meetings. Moreover, the research studies by Ji, Lu and Qu (2015) and by Li Yuhong 李育红 (2011) concerning the determinants of the disclosure of ICW in China, focus on corporate governance. The reason of this focus is that corporate governance and ownership structure in China present unique characteristics. To give an example, Chinese listed companies have a dual board monitoring system including the Board of Directors and the Supervisory Board (JI, et al., 2015). Other factors related to corporate governance are the independence of the supervisory board, the concentration of top 3 shareholders' ownership and the tradability of shares (JI, et al., 2015). In addition, as it has been already mentioned in the analysis of the AKC model, political connections are an important determinant of the disclosure of ICWs. Leng and Ding (2011) also investigate the influence of corporate governance structure on internal control disclosure in a sample of Chinese non-financial listed companies. The authors of the research discovered that internal control disclosure is positively related to a series of factors that include directors' remuneration, two part-time positions of chairman, directors' education level and supervisors' education level.

Another important factor that may influence internal control disclosure is the sector in which companies operate. In China, companies on the main boards of the Shanghai and Shenzhen stock exchanges have to comply with the same regulation on internal control (Basic Standard and supporting guidelines). However, as a matter of fact, the requirements concerning internal control in the financial industry are stricter than in any other sector, and therefore internal control in the financial sector is more effective (LU & MA, 2017).

Concerning the effect of internal control employees (ICEs) on internal control quality, Liu, Lin and Shu (2017) used survey data from Chinese listed companies and found out that ICEs played a significant role in the implementation of internal control, which is a core component of corporate activities. Companies which implemented the Chinese regulation on internal control (C-SOX) and attached more importance on the effect human capital in internal control as well as on the monitoring process, obtained an effective implementation of their internal control systems. Moreover, the afore-mentioned factors had a positive effect on the internal control quality of the analysed companies.

Basing their research on the input-process-output theory, Liu; Lin and Shu (2017) found out that internal control quality is positively influenced by ICE quality and this effect is significant in firms which are under a strict monitoring environment. In the following figure (Figure 2.2), Liu, Lin and Shu (2017) formulate the theoretical framework according to which ICE quality has a positive influence on internal control quality.

Figure 2.2 H1. ICE quality has a positive influence on internal control quality.



Source: Liu, C., Lin, B. & Shu, W., 2017. Employee Quality, Monitoring Environment and Internal Control. China Journal of Accounting Research, 10(1), pp. 51-70.

2.2 Studies on the analysis of internal control disclosure by Chinese listed companies

Many studies examine the internal control disclosure of listed companies in China, in particular these studies focus on the compliance with the regulation and on the internal control weaknesses disclosed.

In order to ascertain how the regulation was adopted for the first time by a group of pilot companies, the research published by Hao and Rainsbury in 2016 – "Disclosure of Internal Control Information by Chinese Cross Listed Companies" – deserves consideration. Hao and Rainsbury (2016) examine the internal control disclosure by Chinese listed companies considering the period in which only cross-listed companies had to disclose a self-evaluation report on internal control. Indeed, the regulation was introduced for cross-listed companies on the Shanghai and Shenzhen stock exchanges on January,1, 2011. This study considered the 2011 self-evaluation reports on internal control disclosed by the 67 cross-listed companies. Of these, 66 companies were cross-listed on the Hong Kong Stock Exchange, while one was cross-listed on the Singapore Stock Exchange. In addition, 9 companies were also listed in New York. The research investigated whether the companies were complying with the regulation and provided an assessment of the quality of the elements disclosed. To sum up, the research main aims were to check:

1. Whether cross-listed companies complied with the regulation on internal control.
2. Whether the selected companies disclosed internal control weaknesses; the types of weaknesses disclosed.
3. The quality of disclosure of the ICWs.
4. Whether the existence of ICWs could be associated with some firm characteristics.

Hao and Rainsbury (2016) analysed the reports published in Chinese and found out that all the 67 enterprises, by the beginning of 2012, had disclosed the internal control evaluation reports together with their annual financial reports and the reports on audit of internal control. For what it may concern the research findings, firstly the companies were classified according to their industry, and to the size of revenue.

In table 2.2 the authors provide an analysis of the 67 listed companies according to their industry. Industry categories are established according to the dispositions of the Chinese Securities Regulatory Commission (CSRC). In 2006, the CSRC, by issuing the "Guidelines on Industry Classification of Listed Companies", specified the existence of thirteen industry categories (CSRC, 2006). In 2012 the document was revised and six new categories were added (CSRC, 2013). In this case, the 67 cross-

listed companies belong to nine categories, including mining, manufacturing, electricity, construction, transportation, information technology, finance and insurance, real estate and social services. It can be observed from the table that the majority of the companies belong to the manufacturing category (40.3%) and most of them produce metal and non-metal or mechanical equipment. On the other hand, only 2 companies operate in real estate or social services industries.

Table 2.2 Industry Distribution.

Industry	**No.**	**%**	**No.**	**%**
Mining			7	10.4
Manufacturing			27	40.3
- Food and beverage	1	1.5		
- Paper making and printing	1	1.5		
- Petrochemical	2	3.0		
- Metal and non-metal	7	10.4		
- Mechanical equipment	13	19.4		
- Pharmacy	3	4.5		
Electricity			3	4.5
Construction			3	4.5
Transportation			12	17.9
- Railway transportation	1	1.5		
- Highway transportation	4	6.0		
- Water transportation	3	4.5		
- Air transportation	3	4.5		
- Supporting and auxiliary	1	1.5		
Information Technology			2	3.0
Finance and Insurance			11	16.4
- Banking	8	11.8		
- Insurance	3	4.5		
Real Estate			1	1.5
Social Services			1	1.5
Total			**67**	**100.0**

Source*:* Hao, X. & Rainsbury, E. A., 2016. Disclosure of Internal Control: Information by Chinese Cross Listed Companies. Unitec ePress Research Report Series.

In the next two tables (Table 2.3, Panels A and B), the companies are analysed according to their revenue. It is evident from the first panel that all except three companies are very large and in 2011 generated a revenue of more than 1 billion Yuan (¥). The total revenue for the companies was of 12,133 billion CNY. To give a clear example, the total revenue can be compared to Chinese GDP for the year 2011. In 2011 the total revenue of 12,133 billion CNY represented about a quarter of China GDP, which was of 48,930.06 billion CNY.

Table 2.3, Panel A. Total Revenue of the 67 companies.

Total Revenue	No.	%
More than 10 billion Yuan	50	74.6
1 billion-10 billion Yuan	14	20.9
Less than 1 billion Yuan	3	4.5
Total	67	100.0

Source: Hao, X. & Rainsbury, E. A., 2016. Disclosure of Internal Control: Information by Chinese Cross Listed Companies. Unitec ePress Research Report Series.

Panel B shows the descriptive statistics related to the total revenue of the companies analysed. In this panel the authors consider the profitability, the ownership and the auditors of the companies. In particular, the authors consider State Ownership, or the proportion of shares held by the state, and whether the auditor belonged to the "Big 4" or not. For the profitability indicator, the return on average equity (ROAE) is considered and its mean is of 9.27%. The table shows that State ownership is high, since the average shareholding is around 46% and the maximum is of 86%. For what it may concern the auditors of the analysed companies, it can be seen that the Big 4 accounting firms occupy a predominant position. In fact, the Big 4 audited 69% of the companies (46 companies). The remaining 31% of the companies (21 companies) were audited by domestic accounting firms (HAO & RAINSBURY, 2016).

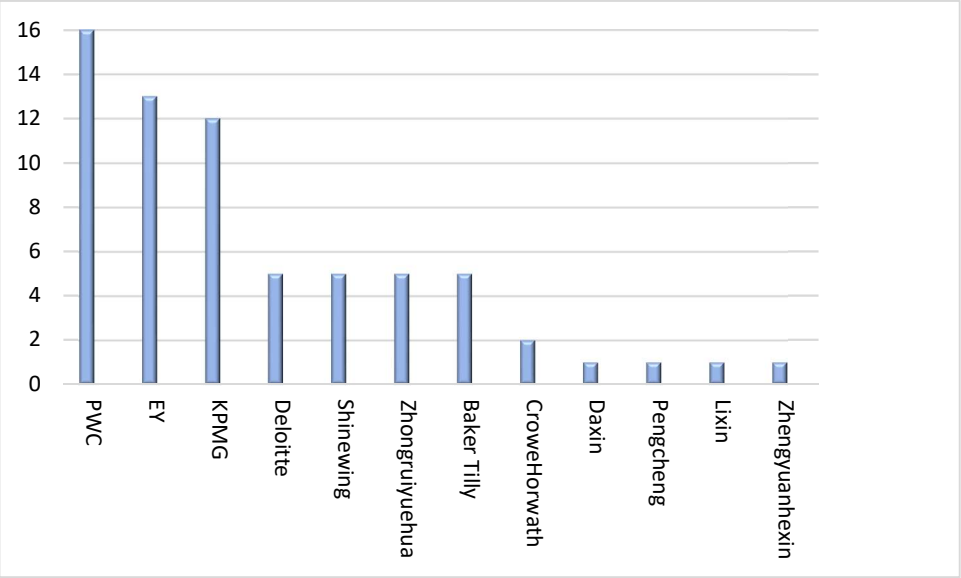
Table 2.3, Panel B. Descriptive Statistics.

	Mean	Median	Std dev	Maximum	Minimum
Profitability	9.27	9.70	14.34	29.17	-55.88
State ownership	45.94	48.20	19.29	86.37	0.00
Auditor	0.69	1.00	0.47	1.00	0.00
State Ownership is the proportion of shares held by the State, Auditor is 1 if a Big 4 auditor, 0 otherwise.					

Source: Hao, X. & Rainsbury, E. A., 2016. Disclosure of Internal Control Information by Chinese Cross Listed Companies. Unitec ePress Research Report Series.

Concerning the appointment of auditors for the audit of self-evaluation reports on internal control, the next graph (Figure 2.3) illustrates to which accounting firm belonged the auditors chosen by the analysed companies. Sixteen companies chose auditors from PricewaterhouseCoupers (PwC), which is an accounting firm belonging to the Big 4 group. Similarly, the other firms belonging to the Big 4 – EY, KPMG and Deloitte – occupy a predominant position in the chart.

Figure 2.3 Auditors of Internal Control Reports.



Source: Hao, X. R. & Rainsbury, E., 2014. Analysis of Disclosure of Internal Control Information from Chinese Listed Companies. Paper presented at Auckland Region Accounting (ARA) Conference.

The second part of the research concerns the compliance of the self-evaluation reports with the Basic Standard, in particular with the Guidelines for Assessment of Enterprise Internal Control. It has already been mentioned in the analysis of the regulation provided in the first chapter that the Guidelines for Assessment of Enterprise Internal Control (2011) require that the self-assessment report on internal control disclosed by companies includes at least seven components. The components are the following:

- An authenticity statement, containing the statement of Authority of Internal control report of the Board.
- A general description of internal control.
- The evidence of assessment, including assessment guidelines.
- The scope of the internal control assessment.
- The procedures and methods adopted in the process of evaluation.
- The internal control deficiencies identified during the assessment and the measures adopted to address deficiencies and major defects.
- The conclusion of effective internal control.

The next table (Table 2.4) provides evidence of the compliance with the regulation, by identifying the seven components in the self-evaluation reports released by the 67 companies. “Yes” means that

there is compliance with the regulation, while "Not disclosed" means that the report lacks the elements required by the regulation.

Table 2.4 Compliance with the Guidelines for Assessment of Internal Control.

Compliance		**No.**	**%**
Authenticity Statement	Yes	67	100
	Not disclosed	0	0
Overview Description of Internal Control		**67**	**100**
	Yes	62	92.5
	Not disclosed	5	7.5
Evaluation Guidelines		**67**	**100**
	Yes	63	94.0
	Not disclosed	4	6.0
Evaluation Scope		**67**	**100**
	In a separate section	52	77.6
	Not in a separate section	8	11.9
	Not disclosed	7	10.5
Evaluation Procedures and Methods		**67**	**100**
	Yes	59	88.1
	Not disclosed	8	11.9
Internal Control Deficiencies		**67**	**100**
	Material Deficiencies	1	1.5
	Significant Deficiencies	2	3.0
	Insignificant Deficiencies	46	68.7
	Total Deficiencies	49	73.2
	No Deficiencies Disclosed	18	26.8
Effectiveness Conclusions		**67**	**100**
	Yes	66	98.5
	No	1	1.5
		67	**100.0**

Source: Hao, X. & Rainsbury, E. A., 2016. Disclosure of Internal Control Information by Chinese Cross Listed Companies. Unitec ePress Research Report Series.

For what it concerns the first element, all the 67 companies disclosed an authenticity statement in which the Board of Directors confirmed its responsibility for the internal control system of the company. In addition, the Board declared that the information disclosed is truthful. Not all the companies provided a description of their internal control situation or mentioned the evaluation guidelines they adopted. Considering the evaluation scope, 77.6 % of the companies (fifty-two) included a separate section with the business areas involved in the evaluation, while 11.9 % of the companies (eight) disclosed this information in other sections called "overall information", "evaluation contents" or "specific implementation" (HAO & RAINSBURY, 2016). On the other hand, seven companies (10.5 %) did not comply with the regulation. Considering the evaluation procedures

and methods, Chapter 3 of the Guidelines for Assessment of Enterprise Internal Control, Article 12 in particular, describes the procedures for conducting the assessment of internal control. The procedures involve: developing a working plan, establishing an assessment team, performing on-site testing, determining control deficiencies, summarising assessment results and preparing a report. In addition, an IC assessment function – internal audit function – will be responsible for organising and performing the assessment. The authors of the research in question found out that the evaluation procedures were included in the report by 59 companies (88.1 %) and that the most common methods were interviews and sampling.

One of the most important parts of self-evaluation reports on internal control is that in which deficiencies are disclosed. For the year 2011, 49 out of the 67 companies included internal control deficiencies in the report. The other companies (26.8 %) stated that no defects were found during the reporting period. Only one company disclosed a material deficiency (HAO & RAINSBURY, 2016), while two companies disclosed significant deficiencies. The companies which had general deficiencies only provided very brief descriptions. The section concerned with internal control deficiencies should also include a corrective plan to eliminate the deficiencies discovered. However, the authors only found corrective measures that did not contain enough details. The reports contained vague statements such as "amending systems" or "business process reengineering" (HAO & RAINSBURY, 2016). The Board of Directors should also conclude the report stating the effectiveness of the internal control system of the company. In this case, all the companies, except the one that disclosed a material deficiency, stated that their internal control systems were effective.

The third part of the research focuses on the disclosure of ICWs and the quality of the disclosure. The disclosures were classified as superficial, quantitative, descriptive and detailed (HAO & RAINSBURY, 2016). If a company declares the existence of deficiencies but does not report the number of their severity, the disclosure is regarded as superficial. Other cases are those in which companies only disclose the numbers of deficiencies or those in which companies report the severity without the numbers. Those disclosures are respectively regarded as quantitative and descriptive. The last case is that of a detailed disclosure, in which a company discloses both the number of weaknesses and their severity. Table 2.5 introduces the focus on ICWs and provides the results concerning the quality of disclosure.

Table 2.5 Disclosure Quality of Internal Control Deficiencies.

Disclosure Quality	No.	%
Superficial	25	51.0
Quantitative	9	18.4
Descriptive	9	18.4
Detailed	6	12.2
Total	**49**	**100.0**

Source: Hao, X. & Rainsbury, E. A., 2016. Disclosure of Internal Control Information by Chinese Cross Listed Companies. Unitec ePress Research Report Series.

Of the 49 companies which disclosed internal control deficiencies, the majority of them (51%) reported ICWs superficially, while only 12.2% of them provided a detailed description of each ICW. At this point, the ICWs of 15 of the 49 companies were studied. Internal control deficiencies appeared at the entity level for 62.7 % of the companies, and at the activity level for 37.3% of the companies. Entity-level deficiencies appeared mostly in the control environment, in control activities or in the monitoring process. For what it concerns deficiencies at the activity level, these involved mostly the control of purchases, revenue and non-current assets.

The fourth and last part of the research concentrates its attention on the characteristics of the 49 companies that reported internal control deficiencies. In order to conduct this analysis, the authors not only adapt the variables from the afore-mentioned model provided by Ashbaugh-Skaife, Collins and Kinney (2007), but also add some firm characteristics that may be linked to ICWs. These characteristics concern firm size, profitability, growth and so on. Moreover, Ashbaugh-Skaife et al. (2007) associate auditors appointed from the Big 4 accounting firms with high quality reviews of internal control and with the tendency on the part of companies to disclose internal control deficiencies, if these appear. The authors include variables from the model provided by Ashbaugh-Skaife, Collins and Kinney (2007), or AKC model, such as the appointment of a Big 4 auditor, percentage of state ownership and political connections. For what it may concern the influence of corporate governance factors on the disclosure of ICWs, Hao and Rainsbury (2016) add two factors such as Board independence and independent chair. These two factors have already been studied by Hoitash et al. (2009) who demonstrated that in companies with strong boards and professional audit committee members, internal control deficiencies are less likely to appear. Table 2.6 contains the characteristics of the 67 cross-listed companies, including both those companies which disclosed ICWs and those which did not. The table provides evidence of the fact that the companies which disclosed ICWs were less profitable and smaller, if compared with the firms which did not disclose ICWs. Considering operations and acquisition activities, companies with more complex operations are more likely to report ICWs. The influence of state ownership and political connections plays a

particular role: companies with lower state ownership and less political connections usually disclose more ICWs (HAO & RAINSBURY, 2016). Moreover, the disclosure of ICWs is also linked to the percentage of board chairs who are not independent. If this percentage is high, the company is likely to experience deficiencies in internal control. The results elaborated by Hao and Rainsbury (2016) are in line with prior research. The part related to Board independence is not in line with prior research, in fact companies which disclosed ICWs have a more independent Board (HAO & RAINSBURY, 2016). In addition, appointing an auditor from a Big 4 firm has a strong impact on the disclosure. In this case 63% of the companies with ICWs and 83% of the companies which did not disclose ICWs were audited by one of the Big 4 firms. The explanation could be that Big 4 companies may focus on less risky and therefore more profitable and larger companies (HAO & RAINSBURY, 2016).

Table 2.6 Companies with and without ICWs.

	With ICWs (n=49) Mean	**No ICWs (n=18) Mean**	**p-value**	**M-W***
Size	10.40	10.41	0.99	0.92
Profitability	9.19	9.48	0.94	0.65
Complexity	3.76	3.56	0.68	0.93
Growth	15.28	19.63	0.40	0.59
Acquisitions	0.93	0.06	0.40	0.28
State Ownership	45.81	46.41		0.94
Political connections	0.69	0.83		0.26
Auditor	0.63	0.83		0.12
Independent chair	0.78	0.83		0.61
Board independence	38.19	35.81		0.33

*Mann-Whitney test[18]

Size is the book value of shareholder's equity (logged) as at 21 December 2011. Profitability is the return on average equity. Complexity is the number of operating segments. Growth is the percentage change in sales from the prior year. Acquisitions is the market value of the firms' aggregate acquisitions scaled by the firm's book value as at 31 December 2011. "Political connections" equals 1 if the chairperson of the Board of Directors is or was a representative of National People's Congress, government official or military officer; 0 otherwise. Board chair is coded 1 if the chairperson and chief executive officer positions are not held by one person; 0 otherwise. Board independence is the ratio of independent directors to the total number of board members. State ownership is the percentage of shares owned by the State. Auditors is binary variable, 1 if the company is audited by a Big 4 auditor and 0 otherwise.

Source: Hao, X. & Rainsbury, E. A., 2016. Disclosure of Internal Control Information by Chinese Cross Listed Companies. Unitec ePress Research Report Series.

By observing these data, Hao and Rainsbury (2016) concluded that for the year 2011, the overall regulatory compliance concerning internal control was positive for Chinese cross-listed companies. Although there were companies which did not disclose the required information thoroughly, all the 67 companies issued a self-evaluation report on internal control. Taking this into account, the authors concluded that even if compliance was high, some issues were identified for

[18] Mann-Whitney test is a non-parametric test that is used to compare two sample means that come from the same population, and used to test whether two sample means are equal or not. Usually, the Mann-Whitney U test is used when the data is ordinal or when the assumptions of the t-test are not met. Source: www.statisticssolutions.com

what it may concern the quality of the information disclosed. For this reason, more importance should be placed on the quality of internal control disclosure. Hao and Rainsbury added that the solution to this problem would be to include a set report format to the Guidelines for Assessment of Internal Control. This is because a report structure for disclosing the self-evaluation report on internal control would simplify the identification of relevant information comparison with other companies, and, at the same time, would increase information transparency (YAN, et al., 2016).

Other studies that deserve to be mentioned also focus on internal control deficiencies disclosed in China and associate their presence with corporate factors. In particular, Wu and Wang (2018) research into the selection of materiality criteria for internal control weaknesses and associate this first-time decision with the possibility of committing corporate fraud. Due to the fact that the Chinese regulation on internal control does not include the criteria for determining material weaknesses, companies have to establish their own criteria to differentiate among material, significant or general deficiencies once for all (WU & WANG, 2018). As a consequence of this, the benchmark used for materiality is usually subject to manipulation. Pre-tax income and revenue are two alternatives that usually work as benchmarks. According to the research work of Wu and Wang (2018), revenue, being a financial amount more significant than pre-tax income, tends to be susceptible to manipulation. When managers are aware of fraud that has not been detected yet, they could manipulate materiality criteria because this allows them to justify the non-disclosure of a material weakness and gives them more freedom in case of future fraud. Hence, Wu and Wang (2018) assert that the choice of materiality metrics could reveal management attitude toward existing fraud. In China, after the regulation entered into force for cross-listed companies in 2011, these companies started to disclose the materiality criteria for internal control deficiencies and by 2014 almost 82% of Chinese listed companies had established their criteria (WU & WANG, 2018). For this reason, Wu and Wang (2018) consider the period between 2011 and 2014. Their study contributes to the literature on internal control weaknesses, to the literature on fraud and to that on accounting materiality. In addition, this study is useful for investors, auditors and regulators that operate in markets in which corporate fraud is frequent.

Lastly, the third research is provided by Ji, Lu and Qu (2018). The authors of this study on ICWs and audit fees assert that the Chinese regulatory framework on internal control is more comprehensive than regulations on internal control issued by other countries. This is due to the fact that the ICWs disclosed by Chinese firms also include deficiencies unrelated to financial reporting and therefore allow the research to concentrate on different areas, such as management and operations. In particular, Ji, Lu and Qu (2018) enquire into the relationship between internal control deficiencies

disclosed and audit fees. The ICWs studied are both those related and unrelated to financial reporting. The research provides evidence of the fact that auditors of internal control charge higher fees for companies with a high internal control risk. Internal control risk is measured as the ICWs disclosed in internal control reports (JI, et al., 2018). The reason for that is to be found in the greater audit effort required. It is worth mentioning that control deficiencies unrelated to financial reporting are those significantly associated with higher audit fees.

2.3 Studies on the comparison between C-SOX and US SOX

The content-related distinction has been made in order to better provide an insight into the literature on internal control. According to this classification, the comparison between the Chinese regulatory framework and other systems is an angle of view that could provide relevant information. The work by Lu and Ma (2017) and by Wang Xin 王新 (2014) provide an insight into the Chinese regulatory framework by focusing on the Basic Standard for Enterprise Internal Control and by comparing this regulation and its supporting guidelines with the US SOX. In particular, the authors state that there are many similarities between the Basic Standard for Enterprise Internal Control (Basic Standard) and Section 404 of the Sarbanes-Oxley Act. For what it may concern the differences between the two regulatory frameworks, these exist in the definitions of internal control, classifications, disclosure and person in charge of internal control (WANG, 2014).

With regard to the definitions, the one provided by the Basic Standard is wider than that in the SOX. The Basic Standard defines internal control as the process through which a firm operates in order to achieve the established control objectives. The objectives include compliance with laws and regulations, the safeguard of assets, operational efficiency, proper implementation of development strategies and completeness of financial information and other information (Art.3). The definition provided by the *SOX,* on the other hand, only focuses on regulatory compliance and on the reliability of financial reporting. In fact, section 404 of the SOX defines "internal control over financial reporting" as a process designed in order to provide reasonable assurance over the reliability of a firm's financial reporting. This means that procedures and policies must provide reasonable assurance that all the transactions are recorded, in order to allow the preparation of financial statements in accordance with laws and regulations (U.S. SECURITIES AND EXCHANGE COMMISSION, 2013). It is clear from the definitions that the Basic Standard not only pays attention to internal control over financial reporting but also to internal control unrelated to financial reporting. Lu and Ma (2017) argue that China was the first country to also require the disclosure of internal control deficiencies over non-financial reporting. The reason for that can be found in the relative weakness of the Chinese capital market. In fact, although China has been experiencing a rapid change in its economy and

society, before the Basic Standard, the capital market still needed provisions on internal control that could suit the rapid growth and the connected risks. Lu and Ma (2017) conclude that the Chinese government, by issuing the Basic Standard and its supporting guidelines, created a unique occasion for studying internal control in relation to other factors, such as corporate governance, and management. In addition, Lu and Ma (2017) report the opinion of international experts who consider C-SOX as a relevant institutional measure for avoiding accounting scandals and for responding to the international financial crisis.

The second part of the study focuses on the classification of internal control weaknesses. The Basic Standard includes weaknesses of the design type (entity level) and of the operating type (activity level). The Basic Standard, in Article 45, clearly states the distinction between these two types. In addition, the Guidelines for Assessment of Enterprise Internal Control or Evaluation Guidelines (2010) classify internal control weaknesses according to the degree of severity. Hence, there are material, significant and general deficiencies. The Guidelines for Auditing of Enterprise Internal Control or Auditing Guidelines (2010) provide further classification by separating internal-control weaknesses of financial reporting and internal-control weaknesses of non-financial reporting. ICWs related to financial reporting are those in which the company provides false accounting information, resulting in the investors making wrong decisions, while ICWs unrelated to financial reporting are those weaknesses that could result in wrong decisions and in a decline of profits (LU & MA, 2017). The Evaluation Guidelines (2010) define material and significant weaknesses respectively as one or a combination of control deficiencies that may cause a company's material deviation from its control objectives and a series of less severe deficiencies that may still lead to an enterprise's deviation from its control objectives. General deficiencies are all the other weaknesses that are not classified as material or significant. However, the Evaluation Guidelines (2010) do not provide detailed criteria for identifying these deficiencies. Article 17 clearly states that it is the firm which defines its own criteria for determining material, significant and general ICWs. The Auditing Guidelines (2010) further clarify the indicators of the possible existence of material deficiencies in Article 21. In particular, if the CPA identifies a fraud on the part of directors, supervisors or senior management and, if previously issued financial statement are restated by the company, there might be a material deficiency. Additionally, the identification by the CPA of a material misstatement in financial statements that is not detected by the company's assessment of internal control, or the ineffective oversight of the company's internal control by its audit committee are indicators of the possible presence of material weaknesses. Lu and ma (2017) assert that the Chinese regulatory system is in line with Section 404 of the Sarbanes Oxley Act (2002) when identifying three types of deficiencies. The SOX includes a framework for evaluating internal control weaknesses and all the

factors that must be considered during the process of evaluation (PROTIVITI, 2018). However, the Chinese regulatory framework, unlike the American SOX, does not provide specific criteria for deciding to what extent a deficiency can be considered material or significant. Chinese firms have to establish their own criteria, that once established must remain unchanged, and report those criteria in their self-evaluation reports on internal control. The fact that Chinese companies have to establish their own criteria and the lack of uniformity might cause difficulties of operation and high costs. Moreover, Wu and Wang (2018) conducted a research on materiality criteria of internal control weaknesses and concluded that the financial benchmark used for establishing internal control-related materiality criteria has consequences on a company's chances of fraud perpetration. For this reason, Lu and Ma (2017) concluded that detailed definitions for evaluating deficiencies should be issued in order to render the Chinese regulatory system more complete.

Disclosure is the third important element to consider. The Sarbanes-Oxley Act requires publicly held American companies and international companies that have registered equity or debt securities with the U.S. Securities and Exchange Commission (SEC) to disclose the report on internal control over financial reporting. Section 404 of the SOX involves the publication of an annual report which states who are the parties responsible for maintaining an adequate internal control system for financial reporting. Additionally, the report must contain an assessment of the effectiveness of the internal control system for financial reporting and the procedures adopted in order to conduct the assessment (SARBANES OXLEY 101, 2018). Considering the disclosure factor, there is a considerable difference between the US and the Chinese internal control regulatory systems. This difference is due to the scope of internal control. As a matter of fact, China SOX defines a wider scope of internal control and requires companies to disclose also those material weaknesses that appear in non-financial reporting. Internal control over non-financial reporting refers to those controls that do not concern the internal control of financial reporting and concern daily operations, safety of assets, compliance with laws and regulations and the design of a development strategy (LU & MA, 2017). The Evaluation Guidelines (2010) require companies to disclose internal-control weaknesses, being these related to financial reporting or to any other operation interested by internal control. The Audit Guidelines (2010) treat internal control unrelated to financial reporting in Article 32. If during the audit any deficiency in internal control unrelated to financial reporting is detected, the CPA has to take the appropriate measures according to the severity of the deficiency. The CPA reports a general weakness to the company and asks the company to rectify it. In the case of a significant deficiency, the CPA has to communicate it to the Board in the written form, and ask the company to rectify it. In case the CPA detects a material weakness, he/she has to follow the same procedures used for significant deficiencies and, in addition, he/she needs to include an explanatory paragraph related

to the material weakness in the auditor's report. The aim of the disclosure of this paragraph is to describe the effect of the deficiency on the accomplishment of the company's objectives in order to alert the users of the report of the risks they may incur.

The fourth factor that has to be considered is that of the person in charge of internal control. In order to comply with the SOX, it is the management of a company who has to prepare an annual assessment of the firm's internal control over financial reporting (PROTIVITI, 2018). As a matter of fact, Section 302 specifies that the CFO and the CEO are the certifying officers of the annual report (THE INSTITUTE OF INTERNAL AUDITORS IIA, 2008). Section 302 states that:

> "The CEO and CFO
>
> I) are responsible for establishing and maintaining internal controls.
>
> II) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared.
>
> III) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report.
>
> IV) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date."[19]

In China, the Basic Standard states that the main body in charge of internal control is the Board of directors. The Board is also responsible for the disclosure of the self-assessment report on internal control. In particular, the Board is in charge of guiding and supervising the establishment and implementation of the internal control system and of managing development strategies (LU & MA, 2017). According to the authors of the research Lu and Ma (2017), the Chinese case is useful in order to study the impact of the Board of directors in internal control and in the strategies of a company. Moreover, both the US SOX and the Chinese regulatory-system involve the participation of every member of the organization in internal control operations. In particular, the Basic Standard (2008) mentions important departments such as the supervisory board, top management and audit committee. In relation to departments involved in internal control, the Basic Standard (2008) requires the presence of a specialist department, referred as "internal-control team". The leaders of this team are usually board members, and the team leader is the board chairman (LU & MA, 2017). Considering this aspect, it is clear that in China the Chairman not only is the highest authority and the legal representative of the firm, he/she is also the main responsible for internal control and for the overall

[19] THE INSTITUTE OF INTERNAL AUDITORS IIA, 2008. *Sarbanes-Oxley Section 404: A Guide For Management by Internal Control Practicioners.* (Available online)

operations. It can be fairly assumed that the Chinese Chairman is the most influential figure who guides the firm towards its objectives (LU & MA, 2017). In order to provide a general view of the differences between C-SOX and US SOX, a summary table (Table 2.7) published by KPMG (2010) is included below.

Table 2.7 Comparison of US SOX 404 and China SOX.

Issue	Comment
General	
Major implementation requirement	Very similar
Scope for implementation	There is similar statutory scope for implementation.
Targeted internal control categories	China significantly increases the workload of enterprises and auditors. Internal control includes not only financial control, but also non-financial control.
Compliance sequence	They both have considered the differences in the level of enterprise internal control and resources applicable to different-sized companies.
Waiver	There are no waiver provisions in newly listed Chinese companies.
Person in charge	The board of directors rather than managers in China are responsible for the implementation and perfection of internal control.
Enterprises' internal control assessment	
Guidelines on internal control assessment	China appears to be mandatory in terms of words.
The details of the assessment guidelines	China also focuses more on practical operations rather than on underlying principles and rules.
The responsibility of the assessment	They both think the management or those charged with governance should be responsible for internal control assessment.
Scope of internal control	Same
General approach and internal control framework for assessment	China does not go into detail regarding the assessment approach and there is no special guideline on the effective planning of the assessment.
Classification of internal control deficiencies	Chinese companies are required to adopt an internal-control framework. Chinese companies and auditors are also required to focus on different categories of internal control. However, the scope for enterprises is wider than that for auditors. The definition of deficiencies is only available for enterprises, but not for editors.
Criteria for assessment conclusion	Ambiguity in China in criteria for assessment conclusions may cause difficulties in comparing the assessment conclusions of different companies.
Date of assessment conclusion	Chinese regulatory agencies need to further clarify whether the assessment conclusion is for a year-end or for a year.
Contents requirements on an enterprise's report and outline of assessment guidelines	It is more difficult to compare the reports of different companies in China, as the reports are required to be more comprehensive and informative. The outline of assessment guidelines is similar in contents.
Auditor's internal control audit	
Express their opinion	Same
Date of the auditor opinion	Same
Objectives of planning an audit	China may increase auditor workloads
General approach of an audit	Same
Internal control framework	Similar
Using of the work of others	Similar
Types of audit opinion	Same
Content requirement on auditors' report	Same

Source: KPMG, 2010. China Boardroom Update: Internal Control Regulatory Developments.

The authors Lu and Ma (2017) introduce three additional factors that the American SOX and the Chinese regulatory framework could improve. These factors include the enforcement of the law, the importance of corporate governance and cost effectiveness. For what it concerns enforcement, the Chinese regulatory system lacks a strong enforcement, because of weak legal liabilities for those firms which do not comply with the regulation. The corporate governance factor also needs improvement, because the unique structure of corporate governance in China plays an important role in internal control. As a matter of fact, Chinese governance has a predominant role in accounting regulations and in the economy. In addition, Chinese companies benefit from political ties because of the strong intervention of the government in Chinese economy and of its strong influence on corporate governance (LU & MA, 2017). The third factor is cost-effectiveness. Cost-effectiveness has to be considered before a regulation is promulgated and its precondition is that the costs of implementation should be lower than investment for establishing a system of internal control. Due to the fact that in China firms also need to consider internal control over non-financial reporting, it is possible that firms may bear high expenses for implementing internal control. However, the authors conclude that the cost-effectiveness of the Chinese regulatory framework on internal control still needs more testing.

The conclusion of this study on the comparison between C-SOX and US SOX by Lu and Ma (2017) and Wang Xin 王新 (2014) is that, when studying the case of the Chinese regulatory system, culture is an aspect of significant importance. The reason for that is that the traditional Confucian culture influences firm culture and a good business culture is essential for establishing an effective system of internal control. The authors assert that one of the good aspects of the Chinese culture is related to the importance placed on the human factor. This means that control goals cannot be realised without the initiative and the active participation of the whole staff. However, there is a negative aspect related to the 关系 *Guanxi* culture of building personal relationships and networks. This aspect negatively affects the distribution of information and communication. Moreover, the authors also praise the uniqueness of the Chinese regulation on internal control, because it has the innovative characteristic of considering internal control over both financial reporting and non-financial reporting and because it is characterized by constant development.

CHAPTER 3

3. Methodology

3.1 Research Approach and Research Questions

The main aim of this research is that of evaluating the internal control reports disclosed by a sample of Chinese listed companies for the year 2017. After having considered the framework of the self-evaluation reports on internal control, the focus of the analysis shifts towards the disclosure of internal control weaknesses in the IC reports published between 31 December 2014 and 31 December 2017. Together with the self-assessment reports on internal control, also the reports concerning the audit of internal control for 2014, 2015, 2016 and 2017 are analysed. In particular, the analysis concerns the identification of the audit firms which audited the self-assessment reports on internal control. Lastly, the annual report of each company is analysed, with the aim of studying the indicators that may influence IC quality. The annual reports contain financial indicators, information on corporate governance and information on the ownership structure of the companies that are used to formulate a framework for the analysis of the companies' internal control quality.

In the first part of the research the self-evaluation reports on internal control 内部控制评价报告 *Neibu kongzhi pingjia baogao* are considered. The first important concern is to determine whether the companies in the sample complied with the regulation currently in force. Consequently, the first important question concerns compliance.

Q1: Do the self-evaluation reports on internal control disclosed at the end of 2017 comply with the regulation currently in force?

The regulations currently in force are the Basic Standard for Enterprise Internal Control (2008) and its supporting guidelines. For the particular disclosure of self-evaluation reports on internal control, companies have to comply with the Guidelines for the Assessment of Enterprise Internal Control (2010).

The first question concerns compliance, while the second question specifically concerns the disclosure of ICWs in the 2014, 2015, 2016 and 2017 IC reports. The disclosure of ICWs is a very important indicator, because many researchers agree on considering the disclosure of ICWs as an indicator for measuring the quality of internal control reporting. Thus, the second question aims to inquire into the ICWs disclosed by the sample companies. According to the Guidelines for the Assessment of Enterprise Internal Control (2010), if companies incur in 重大 *Zhongda* Material,

Zhongyao 重要 Significant or *Yiban* 一般 General deficiencies in internal control related or unrelated to financial reporting, they have to include these deficiencies in their self-assessment report on internal control. Each deficiency should be introduced with a description, and methods for the rectification of each deficiency should be included.

Q2: To what extent the sample companies which disclose ICWs include ICWs descriptions and rectification methods?

Lastly, the first part of the research considers the Auditing Reports on Internal Control 内部控制审计报告 *Neibu kongzhi shenji baogao* published by the companies but issued by the audit firms which audited the companies' self-evaluation reports on internal control. In this case, the question concerns the appointment of the audit firm. The research focuses on the extent to which companies appointed audit firms belonging to the Big 4 group for auditing their IC report disclosed between the end of 2014 and the end of 2017.

Q3: To what extent companies chose a Big 4 audit firm for the audit of their IC reports?

The second part of the research focuses on the annual reports for 2014, 2015, 2016 and 2017 published by the sample companies, and studies the financial, corporate governance-related or ownership related variables that influence IC quality. Due to the fact that IC quality is determined by the rate of disclosure of ICWs, the companies were divided into companies which disclosed ICWs between 2014 and 2017 and companies which did not disclose ICWs in the period in question. Subsequently, by taking into account the literature on internal control quality (HAO & RAINSBURY, 2014); (ASHBAUGH-SKAIFE, et al., 2007) and (DOYLE, et al., 2007), some indicators were collected from the annual reports and used for the formulation of a framework. The indicators, calculated using the information disclosed in the financial reports, concern the companies' profitability (ASHBAUGH-SKAIFE, et al., 2007), (WANG, et al., 2013) and (LIN, 2017), growth (DOYLE, et al., 2007) and ownership structure (ASHBAUGH-SKAIFE, et al., 2007), (YE, et al., 2016) and (LENG & DING, 2011). Moreover, the factor of the auditor of internal control was added to the framework (HAO & RAINSBURY, 2016), (LIN, 2017). On the basis of these four determinants of IC quality, four hypotheses have been formulated. The results obtained from the calculation related to the indicators in the framework were then compared with the results obtained by prior researches.

3.2 Sample Selection

In order to conduct the empirical research, a sample of companies needs to be selected. The sample of companies has been selected from the Asia 300 Nikkei index. Nikkei group is involved in activities that include publishing information about Asian markets ("Asian Review") and calculating the "Nikkei 225" stock index. Asia 300's list contains the fastest growing companies in Asia. The list contains more than 80 companies from China and Hong Kong (https://asia.nikkei.com/Asia300/Welcome-to-Asia300-list-of-the-region-s-top-companies).

The criteria for selecting the companies are included below.

1. Firstly, a time frame has been selected. The sample contains those companies which had available self-assessment reports on internal control and annual reports for 2014, 2015, 2016 and 2017.
2. Secondly, it is important to distinguish between companies listed in Mainland China and companies listed in Hong Kong. Due to the fact that in Hong Kong there are different rules for internal control reporting, the companies in the sample are those companies listed in the Shanghai Stock Exchange 上海证券交易所 *Shanghai zhengquan jiaoyisuo* (SSE) or in the Shenzhen Stock Exchange 深圳证券交易所 *Shenzhen zhengquan jiaoyisuo* (SZSE).
3. Thirdly, only the companies which published their annual reports in English are included in the sample.
4. Fourthly, it is important to ascertain the accounting standards used for the preparation of the consolidated financial statements. The reason for this is that the financial indicators used for calculation may be different if disclosed under different accounting standards. This sample includes only those companies which used IFRS (International Financial Reporting Standards) or HKFRS (Hong Kong Financial Reporting Standards). The reason for the acceptance of financial statements prepared under HKFRS is that HKFRS have reached total convergence with IFRS since 2005 (IFRS Foundation, 2015). Moreover, the sample also includes those companies which used CAS/ASBE (China Accounting Standards for Business Enterprises) and provided a reconciliation of CAS to IFRS. The companies which prepared their financial statements in accordance with the requirements of China Accounting Standards for Business Enterprises (CAS/ASBE) without providing a table with the reconciliation of differences between accounting data under IFRS and accounting data under CAS are excluded from the sample.
5. Lastly, the companies which did not disclose their self-evaluation of internal control reports, or whose self-evaluation IC reports were unavailable, are not included in the

sample. The reason for this is that it is impossible to analyse a company's IC quality if the self-assessment IC report is not available.

In light of these considerations, the sample contains 30 companies and is included in Appendix B. The next table (Table 3.1) summarises the criteria used for the selection of the sample.

Table 3.1: Criteria used for the selection of the sample (Nikkei Asia 300 index, 31/12/2018)

Nikkei Asia 300 total number of companies	300
LESS	
Total number of non-Chinese companies	(219)
SUBTOTAL	
Chinese companies (including Hong Kong)	81
LESS	
Chinese companies listed in Hong Kong or in New York and not in Shanghai or Shenzhen	(40)
LESS	
Companies listed in Shanghai or Shenzhen which did not publish their annual reports in English	(9)
LESS	
Companies that used CAS accounting standards without providing a reconciliation table	(1)
LESS	
Companies that did not publish the self-evaluation report on internal control	(1)
TOTAL	**30**

Source: elaborated by the author.

As it has been mentioned above, the companies in the sample are all listed in the Shanghai Stock Exchange or Shenzhen Stock Exchange. Excluding 4 companies, the majority of them is also listed in Hong Kong. Five companies are also listed in the New York Stock Exchange other than being listed in Hong Kong, and two companies are also listed in the London Stock Exchange.

For what it may concern the operating sectors of the companies in the sample, these have been classified according to the Guidelines on industry Classification of Listed Companies issued by the CSRC. The sample companies cover 7 of the 13 sectors. In details, the majority of the companies belongs to the manufacturing sector. Finance, Transport, Mining, Construction and Engineering, Electric Power Production and Supply and Information Technology are the remaining sectors. Table 3.2 provides information about the number of companies belonging to each sector.

Table 3.2 Operating sectors according to CSRC's Guidelines on Industry Classification of Listed Companies.

Sector	Sub-Sector	Number of companies
Finance	-Banking -Insurance -Real Estate	4 2 2
Manufacturing	-Automobile -Cement -Electric equipment and parts -Electrical machinery and equipment -Food and beverage -Manufacturing of special equipment for metallurgy, mining and electromechanical industries -Oil processing and refining	5 1 1 1 1 1 1
Transport	-Air transportation of passengers and goods -Waterway Transport	3 1
Mining	-Coal mining -Petroleum and gas extraction	1 1
Construction and Engineering	- Railway Construction	2
Electric Power Production and Supply		1
Information Technology	-Computers, communication equipment, and other electronic Equipment	2

Source: elaborated by the author.

In order to provide more information on the financial situation of the sample companies, the companies have been classified according to their current total revenue (Table 3.3). The data were obtained from the companies' Consolidated Statements of Profit or Loss for the year 2017 (31 December 2017)

Table 3.3 Total Revenue of the sample companies.

Total Revenue	No.	%
More than 1000 billion Yuan RMB	2	6.67
100 billion- 1000 billion Yuan RMB	20	66.67
Less than 100 billion Yuan RMB	8	26.67
Total	30	100

Source: elaborated by the author.

An inspection of the data in the table clearly shows that the majority of the companies (20 companies) disclosed a revenue between 100 billion and 1000 billion RMB in their consolidated income statements. In addition, 8 companies had a total revenue lower that 100 billion RMB, while 2 companies had a revenue of more than 1000 billion RMB at the end of 2017.

Moreover, the values of the companies' revenues, profitability and ownership structure for the year 2017 have been summarised using the descriptive statistical method (Table 3.4).

- Revenue was obtained from the companies' Consolidated Statements of Profit or Loss for the year 2017 (31 December 2017).
- Profitability is calculated using ROE (Return on Equity) and ROA (Return on Assets) indicators. ROE and ROA are calculated using the data obtained from the companies' Consolidated Statements of Profit or Loss and Consolidated Statements of Financial Position contained in 2017 Annual Reports.
- The ownership structure of the companies, State ownership in particular, is measured as the percentage of shares owned by the State. The data have been collected from the 2017 annual reports and are contained in the reports' section "Top-ten shareholders".

Table 3.4 Financial and structural information on the sample companies for the year 2017.

		Mean	**Median**	**Minimum**	**Maximum**	**Std Dev**
Revenue (in RMB billions)		461.00	222.00	2.00	2,360.00	560.00
Profitability	ROE	11.6%	11.0%	1.5%	22.4%	4.9%
	ROA	3.8%	3.1%	0.4%	13.5%	3.1%
State Ownership		49.3%	56.2 %	0.0 %	87.1%	25.4 %

Source: elaborated by the author

As the table shows, one company disclosed a revenue of 2 billion RMB, while the maximum revenue was of 2,360 billion RMB. The average value is of 461 billion RMB, while the standard deviation is of 560 billion RMB. The average of the companies' Return on Equity for 2017 is 11.6%, the maximum 22.4%, while the minimum 1.5%. The average of the companies' Return on Assets for 2017 year is 3.8 %, the maximum is 13.5 % and the minimum 0.4%. As we can see for both the profitability indicators, there are companies with very high profitability, and companies which do not perform very well. For both ROE and ROA, the variation of the values from the mean is quite high. To provide an example, the company with the minimum ROA, from each RMB of assets invested generates a profit of 0.4 RMB. On the other hand, the company with the maximum ROA for each RMB of assets invested generates a profit of 13.5 RMB. Table 3.4 also provides information on the State ownership of the companies. In general, the percentage of State ownership in China is high. In

this case, the mean of State ownership in 2017 is 49.3%, the minimum is 0% and the maximum 87.1%. With the exception of 6 companies whose percentage of State ownership is below 30%, all the other companies show a very high percentage of State ownership.

3.3 Measurement of Disclosure

3.3.1 Measurement of Disclosure for the Analysis of the IC Reports

In order to assess the degree of compliance with the Basic Standard (2008) and with the Guidelines for the Assessment of Enterprise Internal Control (2010), and therefore to answer to Q1 is necessary to analyse the internal control self-evaluation reports disclosed by the companies. The reports considered are those issued at the beginning of 2018 for the year 2017. All the reports were downloaded from the websites CNINFO (www.cninfo.com.cn) JRJ 金融界 *Jinrongjie* (http://stock.jrj.com.cn).

To study the compliance with the regulation for the disclosure of IC reports, it is necessary to introduce a framework and to measure the disclosure of each section and subsection contained in the framework. In order to evaluate the disclosure or non-disclosure of an element, the method used is that of the "two-point scale" or "dichotomous scale". This method allows to assign two different values to an item, in this case to a section or subsection.

- "0" is assigned to the sections or subsections which were not included in the report.
- "1" is assigned to the sections or subsections which were included in the report.
- "Not applicable" is used when a section is not disclosed because in that case its disclosure was not required by the regulation.

3.3.2 Measurement of Disclosure for the ICWs contained in the self-assessment IC Report

In order to answer to Q2 it is necessary to check the number of companies which disclosed ICWs in their 2014, 2015, 2016 and 2017 self-assessment IC reports. All the reports were downloaded from the websites CNINFO (www.cninfo.com.cn) and JRJ 金融界 *Jinrongjie* (http://stock.jrj.com.cn). For this analysis, the "two-point scale" method is used.

- "1" is assigned to the companies which disclosed ICWs in the four annual IC reports (three different sections for Material, Significant and General weaknesses).
- "0" is assigned to the companies which did not disclose ICWs in the four annual IC reports (three different sections for Material, Significant and General weaknesses).

After having collected the data on the ICWs disclosed in the 4-year time frame, the ICWs disclosed in the most recent (2017) self-assessment IC report are analysed in detail together with rectification methods included in the reports.

3.3.3 Measurement for the Analysis of Audit Reports on IC

For the Audit reports on IC, the focus was on the audit firm which audited the self-assessment Reports on Internal Control disclosed by the sample companies. The audit of an organization's system of internal control in necessary in order to discover possible fraud and guarantee the implementation of a company's system of internal control (CHENG, 2015). As it has been already mentioned in the Research Approach section (Section 3.1), the details on the audit firm which signed the Audit Reports on Internal Control are of significant importance for the construction of a framework for the analysis of Internal Control Quality. In fact, the choice of the auditor is a variable that may influence ICWs disclosure in two different ways. On one side, if there are ICWs, companies audited by a Big 4 audit firm will certainly disclose the ICWs in their self-assessment reports on internal control (ASHBAUGH-SKAIFE, et al., 2007). This first point of view is related to the reputation of Big4 audit firms. On the other side, the literature on internal control also provides an explanation from the point of view of the auditor. Having higher professional reputation, Big 4 audit firms tend to audit only those companies whose internal control system is particularly effective and thus do not have ICWs (HAO & RAINSBURY, 2016), (LIN, 2017).

The Audit Reports on Internal Control for 2014, 2015, 2016 and 2017 were downloaded from the websites CNINFO (www.cninfo.com.cn) and JRJ 金融界 *Jinrongjie* (http://stock.jrj.com.cn).

For the measurement of the choice of the audit firm for IC reports, the "two-point scale" method has been used.

- The value "1" is assigned in case the audit firm is part of the Big 4 group.
- The value "0" is assigned in case the audit firm is not part of the Big 4 group.

Subsequently, the descriptive statistical method was used to provide a summary of the results.

3.4 Evaluation of Internal Control Quality

The second part of the research focuses on internal control quality. The quality of a company's internal control is measured in terms of the ICWs the company discloses (LIU, et al., 2017). For this reason, it is important to find the determinants that may cause ICWs or, on the contrary, inhibit them. Considering prior studies on internal control quality, a framework with the determinants that influence ICWs was established.

The literature on internal control quality demonstrated that some financial indicators, corporate governance-related, ownership-related or audit-related factors may have a strong influence on the disclosure of internal control weaknesses related or unrelated to financial reporting. These factors include the profitability of a company (ASHBAUGH-SKAIFE, et al., 2007), the rate of growth (DOYLE, et al., 2007), complexity of operations and organisational changes (JI, et al., 2015). The audit firm which will audit the company's self-assessment report on internal control is also another factor that influences the disclosure of ICWs. According to Ashbaugh-Skaife, Collins and Kinney (2007), audit firms belonging to the Big 4 group are more likely to provide higher quality audit service and consequently, through systematic examination of internal controls, are more likely to detect ICWs. For this reason, companies audited by Big 4 audit firms tend to provide a transparent disclosure of their ICWs. On the other hand, auditors belonging to the Big 4 groups, because of their high reputation, tend to audit the self-assessment reports of those companies which have very effective internal controls and thus disclose less ICWs (LIN, 2017). Moreover, the ownership structure of a company influences its internal control system. Ye, Qiu and Zhang 叶陈刚 裘丽 张立娟 (2016) demonstrated that the internal control performance of state-owned companies is lower than the IC performance of private companies, resulting in a higher number of ICWs disclosed by state-owned companies. Finally, internal control disclosure is also influenced by some corporate governance factors. In particular, these factors include the characteristics of the Board of directors, its independence and the characteristics of the audit committee (HOITASH, et al., 2009).

The framework used in this research for the analysis of IC quality of the companies in the sample includes the following factors: profitability, growth, appointment of the audit firm and ownership structure.

The analysis concentrates its attention on the 2014, 2015, 2016 and 2017 annual reports of the companies in the sample and on the ICWs disclosed in those years. The method for the measurement of these factors is now introduced in detail.

- The companies were first classified in "Companies with ICWs" and "Companies with no ICWs" according to the data obtained in the first part of the research. Companies with ICWs disclosed internal control deficiencies in the considered time frame.
- PROFITABILITY. **H1** The first hypothesis is that poorly performing companies tend to invest less in internal control and consequently the probability of disclosing ICWs is higher (ASHBAUGH-SKAIFE, et al., 2007), (HAO & RAINSBURY, 2016) and (LIN, 2017). In order to measure profitability, accounting-based performance metrics such as return-on-equity (ROE) and return-on-assets (ROA) were used. The data for calculating ROE and ROA were collected from the companies' Consolidated Statements of Profit or Loss and Consolidated Statements of Financial Position contained in 2014, 2015, 2016 and 2017 annual reports. After having found the value of ROA and ROE in the different years for each company, the average ROA and ROE for each company were determined.
- GROWTH. **H2** The second hypothesis is that rapid growth, measured in terms of change in sales tends to limit companies in their efforts to maintain an effective internal control system and thus it may be positively related to the disclosure of ICWs (DOYLE, et al., 2007). However, growth may hider companies in maintaining a high-quality system of IC only in case there is an "abnormal" sales growth. Growth was measured for each of the companies using the compound growth rate formula.
- STATE OWNERSHIP. **H3** The third hypothesis is that companies with a higher percentage of state ownership tend to have less incentives to establish effective internal controls and appropriate supervision systems (YE, et al., 2016), (LENG & DING, 2011). This leads to the disclosure of more ICWs and poor internal control quality (WANG, et al., 2013). In brief, the process of communication and supervision in state-owned companies tends to be less transparent. The data on state ownership were obtained from the companies' annual reports. The annual report's section containing details on the shareholders is called "Changes in Ordinary Shares and Particulars of Shareholders" and the subsection is "Particulars of Top 10 Shareholders". The indicator identified is the sum of the percentages of shares held by those shareholders classified as "State-owned". The percentage of state ownership was identified for each company in the four years and then the mean value of "State ownership" for each company was determined.
- AUDITOR. **H4** The fourth hypothesis is that in China, audit firms belonging to the Big 4 group tend to audit the IC reports of those companies which established a more effective system of internal control, (HAO & RAINSBURY, 2016) and (LIN, 2017). The choice of the auditor was measured in the analysis of the Audit Reports on Internal Control.

"1" was assigned for the appointment of auditors of the Big 4 group.

"0" was assigned for the appointment of Chinese audit firms.

These results were obtained by calculating the mean for the choice (0 or 1) of each company in the time frame going from 2014 to 2017.

- Lastly, through descriptive statistics, the data in the framework were used to compare companies with ICWs and companies with no ICWs. For example, the mean of ROA in those companies with ICWs is compared to the mean of ROA in those companies which did not disclose ICWs.

The methods used for the measurement are summarised in the following table (Table 3.5).

Table 3.5 Variable Formulas and Calculation

Variable		**Formula**	**Calculation**
PROFITABILITY	ROE	$\frac{Net\ Income}{Shareholders'Equity}$	Average of each company's ROE in 2014, 2015, 2016 and 2017.
	ROA	$\frac{Net\ Income}{Total\ Assets}$	Average of each company's ROA in 2014, 2015, 2016 and 2017.
GROWTH	CAGR	$\left(\frac{Ending\ Value}{Beginning\ Value}\right)^{\left(\frac{1}{number\ of\ years}\right)} - 1$	Compound Annual Growth rate of each of the companies.
STATE OWNERSHIP		Sum of the percentages of shares held by those shareholders classified as "State-owned" in the annual report section "Top ten Shareholders".	Mean of each company's % of State ownership in 2014, 2015, 2016 and 2017.
AUDITOR		Coded one if the firms' IC report was audited by one of the Big 4 audit firms and zero otherwise.	Mean of each company's AUDITOR variable in 2014, 2015, 2016 and 2017.

Source: elaborated by the author.

CHAPTER 4

4. Empirical Results

4.1 Analysis of the Self-Assessment Reports on Internal Control

4.1.1 Assessment of the Compliance with the Regulation

Q1: Do the self-evaluation reports on internal control disclosed in 2017 comply with the regulation currently in force?

According to the regulation, all the companies listed on the Shanghai Stock Exchange and on the main board of the Shenzhen Stock Exchange are required to disclose their self-evaluation reports on internal control and to appoint a Certified Public Accountant for the audit of the report in question.

Self-assessment reports on internal control guarantee the companies' effectiveness of their internal control system and therefore their disclosure is required by the law (CHEN, 2016). The regulation requires that each report at least contains the following information:

- 重要声明 *Zhongyao Shengming* An authenticity statement, containing the statement of Authority of Internal Control report of the Board.
- A general overview of internal control.
- 内部控制评价范围 *Neibu kongzhi pingjia fanwei* The scope of the internal control assessment.
- 控制评价工作情况 *Kongzhi pingjia gongzuo qingkuang* The procedures and methods adopted in the process of evaluation.
- The internal control deficiencies identified during the assessment and the measures adopted to address deficiencies and major defects.
- 内部控制评价结论 *Neibu kongzhi pingjia jielun* The conclusion on the effectiveness of internal control.

The literature on Internal Control in China unanimously agrees on the fact that the regulation on internal control needs further improvement. The improvement concerns the publication of a standardised model of Internal Control Self-Assessment Report which would simplify the comparison of the various reports and would ensure the disclosure of more transparent information (HAO & RAINSBURY, 2016). Although the Guidelines for the Assessment (2010) do not contain a standardised report writing format, the majority of the sample companies disclosed reports which

have an identical writing format. The following paragraphs will analyse the sections and subsections of the reports.

Firstly, all the reports provide a general overview of internal control and make reference to the regulation – 企业内部控制基本规范 *Qiye neibu kongzhi jiben guifan* Basic Standard (2008) – currently in force and to the internal rules for internal control adopted by each company. In some cases, the general overviews contain detailed information on the procedures for the assessment, on the objectives obtained during the year and on the goals set to reach in the next year.

Secondly, all the reports include an "Authenticity Statement" 重要声明 *Zhongyao Shengming* which defines the entities responsible for internal control. The authenticity statements of all the reports state clearly that the Board of Directors is responsible for the establishment, implementation and effectiveness of the companies' internal controls. Moreover, the Board of Supervisors is in charge of supervising the work of the Board of Directors. Management is responsible for carrying out daily operations for internal control. In the authenticity statement, the Board of Directors, Board of Supervisors and Senior Management declare that the reports do not contain false information, omissions or misleading information and assume responsibility for the disclosure of authentic, accurate and complete information. In addition, the authenticity statement defines the objectives of internal control that include compliance with laws and regulations, safety of the assets and disclosure of truthful information. An effective system of internal control would help to reach the most important objective, that is the improvement of the companies' efficiency and the implementation of the development strategies.

The third important section is "The Scope of the IC assessment" 内部控制评价范围 *Neibu kongzhi pingjia fanwei*. The section concerning the scope of internal control can be divided into four sub-sections.

1. Areas of major focus 评价范围的主要单位 *Pingjia fanwei de zhuyao danwei*;
2. Total assets and income assessed 资产总和和 营业收入 *Zichan zonghe he yingye shouru*;
3. Main activities and business segments involved in the assessment 主要业务和事项 *Zhuyao yewu he shixiang*;
4. Areas of major risk 重要关注的高风险领域 *Zhongyao guanzhu de gao fengxian lingyu*.

The fourth section is that concerning the "Methods and Procedures for the Assessment" 控制评价工作情况 *Kongzhi pingjia gongzuo qingkuang*. This section mainly contains the criteria for the

identification of internal control weaknesses (ICWs), while detailed procedures for the assessment are never included in this section. When the procedures are included in the reports, these appear in the section dedicated to a general overview of internal control. The criteria for the identification of ICWs 内部控制缺陷认定标准 *Neibu kongzhi quexian rending biaozhun*, must include the criteria for the identification of ICWs related to financial reporting and those for the identification of ICWs unrelated to financial reporting. For each of the two activities in which ICWs may appear there must be the qualitative and quantitative criteria for the identification of material, significant and general weaknesses, as well as the definitions of the three types of weaknesses. Due to the fact that the Basic Standard (2008) allows Chinese companies to formulate their own criteria for ICW identification, this section is of extreme importance and must be very detailed. Otherwise, it is possible that the benchmark used for determining the criteria may lead to committing fraud (WU & WANG, 2018).

1. Identification criteria for ICWs related to financial reporting 财务报告内部控制缺陷认定标准 *Caiwu baogao neibu kongzhi quexian rending biaozhun*.
    - Quantitative criteria 定量标准 *Dingliang biaozhun* for ICWs related to financial reporting are established comparing the percentage of total assets to the amount of errors in financial reporting. For example, if the error amounts to more than 1% of total assets, then the deficiency is material.
    - Qualitative criteria 定性标准 *Dingxing biaozhun* for ICWs related to financial reporting include the detailed descriptions of possible material, significant or general deficiencies. To provide an example, if the company decides to introduce considerable modification to the financial report that has already been published (restatement), there is a material deficiency in internal control over financial reporting.
2. Identification criteria for ICWs not related to financial reporting 非财务报告内部控制缺陷认定标准 *Fei-caiwu baogao neibu kongzhi quexian rending biaozhun*.
    - Quantitative criteria 定量标准 *Dingliang biaozhun* for ICWs not related to financial reporting are established comparing the percentage of total assets to the amount of losses. For example, if the loss amounts to more than 1% of total assets, then the deficiency is material.
    - Qualitative criteria 定性标准 *Dingxing biaozhun* for ICWs not related to financial reporting include the detailed descriptions of possible material, significant or general deficiencies. For example, to violate State laws and regulations is included in the

qualitative criteria for identifying a material deficiency in internal control unrelated to financial reporting.

The fifth section contains the deficiencies in internal control related or unrelated to financial reporting discovered during the assessment. If the deficiencies are Material 重大 *Zhongda* or Significant 重要 *Zhongyao* the report includes specific subsections with the amount of deficiencies and with detailed descriptions. If the ICWs are general 一般 *Yiban*, the reports do not include details and only mention that there were general deficiencies and whether these had been rectified.

The sixth section related to the "Methods of Rectification of ICWs" is included in the report only when the fifth section includes material or significant deficiencies. Only a few sample companies which only disclosed general deficiencies included the section with the methods for the rectification of general deficiencies.

The last section "Conclusion on the Effectiveness of Internal Control" 内部控制评价结论 *Neibu kongzhi pingjia jielun*, usually presents the same writing format in all reports. The conclusion contains a statement that confirms the absence of Material 重大 *Zhongda* deficiencies in internal control over financial reporting and unrelated to financial reporting. Moreover, this section contains a statement of the Board of Directors that declares that the self-assessment of Internal Control is effective. In the conclusion are recorded also those events that may have occurred during the period before the disclosure of the IC report and that may have affected internal control. This section also includes information on the consistence of the Self-assessment Report on Internal Control with the content of the Audit Report on Internal Control.

4.1.2 Results of the Assessment

After having analysed the sections required by the regulation for the disclosure of self-assessment IC reports, in order to study the compliance with the regulation for the disclosure of IC reports, it is necessary to produce a checklist and to measure the disclosure of each section and subsection. the method used for the measurement of disclosure is that of the "two-point scale". As it has been mentioned in section 3.3.1., this method allows to assign two different values to an item, in this case to a section or subsection.

- "0" is assigned to the sections or subsections which were not included in the report.
- "1" is assigned to the sections or subsections which were included in the report.
- "Not applicable" is used when a section is not disclosed because in that case its disclosure was not required by the regulation.

To start with, by April 20, 2018, all the sample companies had disclosed their self-evaluation reports on internal control and the audit reports on internal control. The next tables show the results obtained from the analysis of the self-assessment reports on internal control based on a checklist that contains report sections and sub-sections. The first table (Table 4.1) shows the rate of disclosure of each section and the detailed number of companies which disclosed or not disclosed ICWs. The second table (Table 4.2) includes the results obtained using descriptive statistics for the evaluation of the compliance with the regulation. The values included are: mean, median, minimum, maximum and standard deviation.

Table 4.1 Rate of disclosure of the elements required by the regulation.

Report Section	Sub-section	Disclosed	Not Disclosed	Not Applicable	Rate of Disclosure (%)
		Total 30			**100**
Name of the Regulation 企业内部控制基本规范		30	0		100
		Total 30			**100**
Authenticity Statement 重要声明		30	0		100
Overview of the assessment		**Total 30**			**100**
	General overview	30	0		100
	Detailed procedures for the assessment	6	24		20
	Objectives reached in 2017 and objectives for 2018	16	14		54.8
Scope 范围		**Total 30**			**100**
	Areas of major focus	30	0		100
	Percentage of Assets and Income assessed	30	0		100
	Main activities and items involved	30	0		100
	Areas of major risk	30	0		100
Methods and procedures 内部控制评价工作情况		**Total 30**			**100**
	ICW over financial reporting qualitative and quantitative identification criteria	30	0		100
	ICW unrelated to financial reporting qualitative and quantitative identification criteria	30	0		100
Companies which disclosed ICWs		**Total 23**			**76.7**
	Material 重大	0	30		0
	Significant 重要	1	29		3.3
	General 一般	23	7		76.7
Methods for the rectification of ICWs		**Total 7**			**23.3**
		7	16	7	23.3
Conclusion of the assessment 内部控制评价结论		**Total 30**			100

Source: elaborated by the author.

Table 4.2 Compliance with the regulation of the companies' self-assessment reports on IC in 2017

Report section	Sub-section	Mean	Median	Minimum	Maximum	Std Dev
Name of the Regulation 企业内部控制基本规范		1	1	1	1	0
Authenticity Statement 重要声明		1	1	1	1	0
Overview of the assessment						
	General overview	1	1	1	1	0
	Detailed procedures for the assessment	0.20	0	0	1	0.41
	Objectives reached in 2017 and objectives for 2018	0.53	1	0	1	0.51
Scope 范围						
	Areas of major focus	1	1	1	1	0
	Percentage of Assets and Income assessed	1	1	1	1	0
	Main activities and items involved	1	1	1	1	0
	Areas of major risk	1	1	1	1	0
Methods and procedures 内部控制评价工作情况						
	ICW over financial reporting qualitative and quantitative identification criteria	1	1	1	1	0
	ICW unrelated to financial reporting qualitative and quantitative identification criteria	1	1	1	1	0
Companies which disclosed ICWs						
	Material 重大	0	0	0	0	0
	Significant 重要	0.03	0	0	1	0.18
	General 一般	0.77	1	0	1	0.43
Methods for the rectification of ICWs*		0.30	0	0	1	0.47
Conclusion of the assessment 内部控制评价结论		1	1	1	1	0
*Not applicable for 7 companies.						

Source: elaborated by the author.

The table provides evidence of the fact that all the sample companies included the information required by the regulation in their self-assessment report of internal control. It can be also observed that only 6 companies (20% of the total) included detailed procedures for the IC assessment in the "Overview" section of their IC self-assessment reports, while 16 companies (54.8%) included the objectives reached in 2017 and the objectives to reach in 2018. For what it may concern the "Methods and Procedures" section, all the companies provided the identification criteria for ICWs related and unrelated to financial reporting. However, some companies provided more detailed definitions than others. Considering the ICWs disclosed, in the reports analysed there were no material deficiencies and only one company disclosed significant deficiencies. The company which disclosed significant deficiencies and 22 other companies disclosed general deficiencies. When disclosing general deficiencies, apart from the 7 (23.3%) companies which voluntarily included rectification methods,

the majority of the companies did not include specific details or rectification methods, because the regulation states that it is compulsory only for significant and material ICWs. In fact, 16 of the companies which disclosed general deficiencies did not include details or rectification methods. One company included rectification methods both for its significant and general ICWs.

In relation to the "Conclusion of the Assessment", all the companies (100%) confirmed that no material deficiencies related and unrelated to financial reporting were found during the assessment of internal control. Moreover, all the 30 companies stated that their internal control assessment was effective and that the content of the Audit Report on Internal Control was consistent with their Self-Evaluation IC report.

4.1.3 Analysis of the ICWs disclosed

The analysis of the self-evaluation reports on internal control also provides important results for answering to the second question (Q2).

Q2: To what extent the sample companies which disclose ICWs include ICWs descriptions and rectification methods?

Firstly, the weaknesses disclosed by the sample companies in their four IC self-assessment reports (2014, 2015, 2016 and 2017) were analysed. The measurement method for the disclosure has been discussed in Chapter 3 section 3.3.2.

- "1" is assigned to the companies which disclosed ICWs in the four annual IC reports (three different sections for Material, Significant and General weaknesses).
- "0" is assigned to the companies which did not disclose ICWs in the four annual IC reports (three different sections for Material, Significant and General weaknesses).

Secondly, the ICWs disclosed in the 2017 self-assessment IC reports published are studied in detail.

Table 4.3 Disclosure of ICWs in the four-year time period.

Year	Material ICWs	Significant ICWs	General ICWs	Total number of companies with ICWs	Companies with no ICWs	Total number of companies
2014	0	1	23	23	7	30
2015	0	2	23	23	7	30
2016	0	2	23	23	7	30
2017	0	1	23	23	7	30

Source: elaborated by the author.

What stands out in Table 4.3 is that exactly the same number of sample companies disclosed ICWs in their self-assessment reports on internal control. It is important to underline that the

companies which disclosed ICWs in 2017 were exactly the same companies which disclosed internal control deficiencies in the previous years. This also implies that the companies which did not disclose ICWs in 2017 were the same companies which did not disclose deficiencies in 2014, 2015 and 2016. For what it concerns Significant ICWs, in 2015 and 2016 there were two companies instead of one to disclose Significant deficiencies not related to financial reporting. Although there was this change if the number of companies which disclosed significant deficiencies, the overall number of companies that disclosed ICWs does not change. This is because the companies which disclosed significant ICWs also disclosed general ICWs.

After having studied the overall disclosure of ICWs in a time frame of four years, due to the fact that the companies which disclosed ICWs are the same throughout the period of time, the research focuses on the deficiencies disclosed by the sample companies for 2017 (the reports were published at the beginning of 2018). This section analyses in detail the deficiencies disclosed, their nature and their rectification methods, if these are included.

From the previous analysis concerning the self-assessment reports disclosed in 2017 (section 4.1.2), it emerges that the only company which disclosed a significant ICW included ICWs descriptions and rectification methods. This company also disclosed general deficiencies and therefore also included the details concerning general ICWs. Due to the fact that it is not compulsory to include details for general deficiencies, 16 Companies disclosed general ICWs but did not include any explanation. 7 companies did not disclose any deficiency and for this reason the disclosure for them was “not applicable”. The other 7 companies (including the company which disclosed significant ICWs), although the information was not detailed, voluntarily included some information on ICWs and rectification methods. The next table (Table 4.4) shows the number of companies which disclosed rectification methods for General and Significant ICWs. Through the analysis of the reports containing the rectification methods for ICWs, it can be noticed that the rectification methods included by the companies are not detailed enough.

Table 4.4 Companies which disclosed ICWs rectification methods for the year 2017.

Name		Stock code	Stock Exchange	Rectification methods for Significant ICWs	Rectification methods for General ICWs
中远海控	China COSCO SHIPPING Holdings Co., Ltd.	601919	SSE, HKSE	1	1
中国人寿	China Life Insurance Co., Ltd.	601628	SSE, HKSE, NYSE	Not applicable	1
中国铁建	China Railway Construction Co., Ltd.	601186	SSE, HKSE	Not applicable	1
中国中铁	China Railway Group Limited	601390	SSE, HKSE	Not applicable	1
绿地控股	Greenland Holdings Corporation Limited	600606	SSE, HKSE	Not applicable	1
广汽集团	Guangzhou Automobile Group Co., Ltd.	601238	SSE, HKSE	Not applicable	1
上海电气	Shanghai Electric Group Co., Ltd.	601727	SSE, HKSE	Not applicable	1

Source: elaborated by the author.

In order to fully answer to Q2, Text box 4.1 contains details on the Significant ICW disclosed by China COSCO SHIPPING Holdings Co., Ltd. 中远海运控股股份有限公司 *Zhongyuan haiyun konggu gufen youxian gongsi* in its 2017 self-assessment evaluation report on internal control.

Text Box 4.1 Summary of the significant deficiency disclosed by China COSCO SHIPPING Holdings Co., Ltd. in its 2017 self-assessment IC report.

Internal Control Weaknesses unrelated to financial reporting.

Significant Deficiencies

During the assessment the company found significant deficiencies not related to financial reporting in its Internal Control system.

Yes ☑ No □

According to the criteria for the identification of ICWs unrelated to financial reporting included in the "Methods and Procedures" section, the Company found 1 Significant deficiency in IC unrelated to financial reporting.

Source: elaborated by the author

In addition, in order to include a description of the deficiency and its rectification methods, a text box summarising all these aspects has been elaborated and included below (Text box 4.2).

Text Box 4.2 Details of the significant deficiency disclosed by China COSCO SHIPPING Holdings Co., Ltd. in its 2017 self-assessment IC report.

Significant deficiency unrelated to financial reporting	The control and supervision system of the company is still incomplete and thus is not fully efficient.
Description of the deficiency	Currently, the organisational structure of the company includes 5 departments. The activities of Corporate Planning and Strategy department and Compliance and Risk Management department are performed by the corresponding departments of the subsidiary COSCO SHIPPING Lines Co., Ltd 中远海运集运. The communication between the Holding and the departments shared with the subsidiaries is not effective, smooth and timely. COSCO SHIPPING Lines and COSCO SHIPPING Ports are controlled by COSCO SHIPPING Holding, however the processes of supervision and control are not comprehensive and effective.
Entity/Activity level	Corporate supervision and control system
Rectification plan	Constant improvement of the Group's supervision and control systems.
The rectification has been completed by the end of the base period of the report	Yes
The rectification has been completed by the date of publication of the report	Yes

Source: elaborated by the author.

An inspection of Text box 4.2 reveals that China COSCO SHIPPING Holdings Co., Ltd. 中远海运控股股份有限公司 *Zhongyuan haiyun konggu gufen youxian gongsi* disclosed a Significant deficiency unrelated to financial reporting that occurred at the entity level. Although the description of the deficiency is exhaustive, the rectification methods are not detailed enough.

From the analysis of the self-evaluation IC reports it is clear that the disclosure of General deficiencies is superficial and not at all exhaustive; the disclosure of Significant deficiencies is both "Quantitative" (it includes the quantity of weaknesses) and "Descriptive" (it includes a description of the weakness) and thus can be considered "Detailed". According to the regulation, the disclosure of Material deficiencies should include more details, but in this case, none the sample companies disclosed a Material deficiency. For this reason, it is not possible to study the disclosure of a Material deficiency for this sample of companies. The next table (Table 4.5) summarises the information on the quality of disclosure of ICWs for the total amount of companies which disclosed ICWs in their 2017 self-assessment report on internal control (23 companies).

Table 4.5 Quality of disclosure of ICWs for the 2017 self-assessment reports on internal control.

ICWs Disclosure Quality	Number of companies	%
Superficial	22	95.65%
Detailed	1	4.35%

Source: elaborated by the author.

4.1.4 Analysis of Audit Reports on Internal Control

The third question (Q3) concerns the appointment of the Certified Public Accountant for the audit of the IC report.

Q3: To what extent companies chose a Big 4 audit firm for the audit of their IC reports?

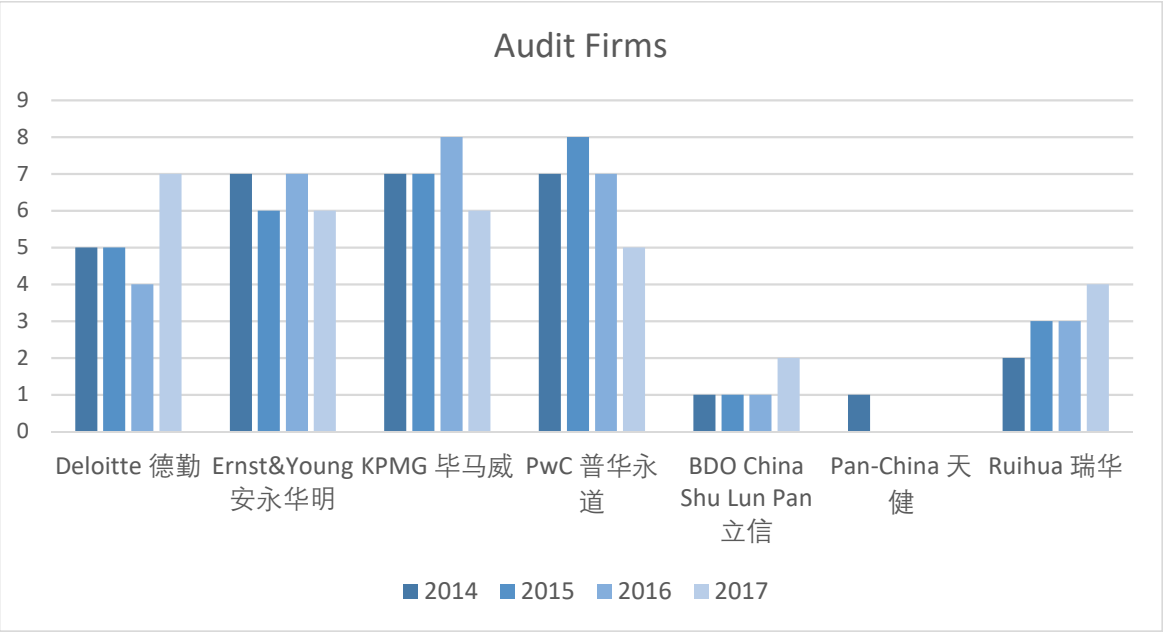
To know who disclosed the Audit Report on Internal Control is important in order to study the quality of internal control disclosure. The reason for this is that the choice of the auditor is a variable that influences ICWs disclosure.

The measurement method for the appointment of the audit firm for IC reports has already been discussed in Chapter 3 section 3.3.3 and included below.

- The value "1" is assigned in case the audit firm is part of the Big 4 group.
- The value "0" is assigned in case the audit firm is not part of the Big 4 group.
- Big 4 refers to the four largest accounting firms in the world. The members of this internationally renowned group are Deloitte Touche Tohmatsu Limited; Ernst and Young (E&Y); Klynveld Peat Marwick Goerdeler (KPMG) and PricewaterhouseCoupers (PwC).

Firstly, the data on the audit firm were collected from the 2014, 2015, 2016 and 2017 Audit Reports on Internal Control. The results of the research for the four-year time frame are included in Figure 4.1. An inspection of the data in the figure reveals that in 2014 and 2015, 27 companies (90%) chose an auditor of the Big 4 group. In 2016, 26 companies (87%) appointed an auditor from the Big 4 accounting firms. In 2017, 24 companies (80%) appointed Big 4 auditors such as Deloitte, Ernst&Young, KPMG and PwC. The reason for this decrease in the appointment of Big 4 auditors is that some companies that in 2014 or 2015 appointed a Big 4 audit firm, in 2016 and 2017 decided to appoint auditors from Chinese accounting firms for the audit of their self-assessment reports on internal control.

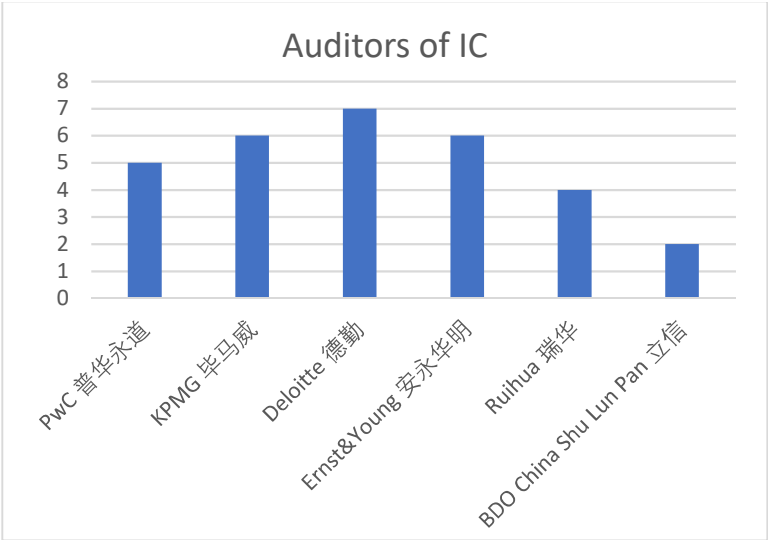
Figure 4.1 Results of the analysis of the Audit Reports on Internal Control.



Source: elaborated by the author.

The next figure (Figure 4.2) shows the details of the appointment of audit firms for the audit of the 2017 self-assessment reports on internal control.

Figure 4.2 Audit firms which signed the 2017 Audit Reports on Internal Control



Source: elaborated by the author.

As it is evident from the figure, the majority of the companies (80%) chose auditors from the Big 4 audit firms. In particular, 5 companies chose PwC, 6 companies KPMG, 7 companies Deloitte and 6 Ernst and Young. Only 6 companies chose audit firms which are not included in the Big 4 group.

The details on the audit firms which audited the companies' 2017 IC reports using descriptive statistics for the calculation have been included in the next table.

- The value "1" is assigned in case the audit firm is part of the Big 4 group.
- The value "0" is assigned in case the audit firm is not part of the Big 4 group.

Table 4.6 Audit firms which signed the 2017 Audit Reports on Internal Control (Descriptive Statistics)

	Mean	Median	Minimum	Maximum	Std Dev
Auditors of the internal control reports (2017)	0.80	1.00	0.00	1.00	0.4

Source: elaborated by the author.

From the descriptive statistics it can be noticed that 80% of the companies appointed an audit firm from the Big 4 group.

4.2 Analysis of the Determinants of ICWs and Results

To evaluate the determinants of ICWs is the first important step for the analysis of the internal control quality of the sampled firms.

The research has been conducted by selecting four firm characteristics which, according to the literature in Chapter 2 (Section 2.1), may influence a company's disclosure of ICWs and investments in internal control.

The variables are represented by the average value calculated over the 3 years prior the disclosure of the 2017 self-assessment report on Internal control and over 2017 (from 2014 to 2017).

The results of the analysis of the ICWs disclosed show that the same number of companies disclosed ICWs in 2014, 2015, 2016 and 2017. Moreover, the companies which disclosed ICWs were exactly the same throughout the years and companies which did not have ICWs in 2014 maintained that position. For this reason, the analysis of the determinants of ICWs is focused on the companies which disclosed ICWs in 2017, being these identical to those which disclosed ICWs in 2014, 2015 and 2016.

The four variables are PROFITABILITY, GROWTH, AUDITOR and STATE OWNERSHIP.

H1: PROFITABILITY measured in terms of average ROA and average ROE is expected to be higher in those companies which did not disclose ICWs.

H2: Sales GROWTH measured in terms of compound growth rate is expected to be higher in those companies which disclosed ICWs. The sales growth must be "abnormal" in order to actually influence the disclosure of ICWs.

H3: STATE OWNERSHIP. A high percentage of shares held by the State is expected to discourage transparency of operations and the implementation of an effective system of internal control. Thus, companies with a high rate of state ownership are expected to disclose ICWs.

H4: AUDITOR. Audit firms included in the Big 4 group are expected to audit high quality internal control systems. Consequently, Big 4 accounting firms tend to audit companies which do not disclose, or disclose less ICWs.

The summary statistics included in Table 4.7 show the results of the analysis for the total number of sampled companies including mean, first quartile, median, third quartile and standard deviation. Subsequently, the descriptive statistics in Table 4.8 show the results of the analysis distinguishing between companies which disclosed ICWs and companies which did not disclose internal control weaknesses.

Table 4.7 Descriptive Statistics on the determinants of ICWs disclosure for the sampled companies

		Sampled firms (30)					
Variable	**Mean**	**Q1**	**Median**	**Q3**	**Minimum**	**Maximum**	**Std Dev**
PROFITABILITY: ROA (%)	3.6	1.3	2.4	4.0	(0.7)	11.3	3.2
PROFITABILITY: ROE (%)	11.3	7.6	10.6	15.2	(1.4)	24.4	6.3
GROWTH (%)	12.1	1.9	7.2	16.7	(5.8)	72.7	16.3
STATE OWNERSHIP (%)	48.7	36.8	55.8	66.8	0.0	87.0	25.6
AUDITOR	0.9	1	1	1	0	1	0.3
	Time frame: from 2014 to 2017						

Source: elaborated by the author.

Table 4.8 Descriptive Statistics on the determinants of ICWs disclosure.

Variable	**Firms with ICWs (23)**						**Firms with no ICWs (7)**				
	Mean	Q1	Median	Q3	Std Dev	Predicted difference	Mean	Q1	Median	Q3	Std Dev
PROFITABILITY: ROA (%)	3.5	1.2	2.3	5.5	3.5	<	3.8	2.3	3.6	3.7	2.6
PROFITABILITY: ROE (%)	11.5	9.0	10.9	15.1	6.0	<	10.8	5.6	7.1	14.7	8.0
GROWTH (%)	12.2	2.6	6.9	14.1	17.0	>	11.8	1.3	10.1	19.6	15.0
STATE OWNERSHIP (%)	49.9	42.4	55.8	66.7	25.0	>	45.0	27.2	40.6	64.7	29.2
AUDITOR	0.85	0.88	1.0	1.0	0.33	<	0.93	0.75	1.0	1.0	0.12

Source: elaborated by the author.

An inspection of the data in Table 4.8 clearly shows that, with only one exception, the descriptive statistics support the predictions in the hypotheses.

To begin with, ROA is higher in companies which did not disclose ICWs (mean 3.8%) that in companies which disclosed ICWs (mean 3.5%). Two of the 23 companies which disclosed ICWs actually had a negative average of ROA from 2014 to 2017 (Table 4.7 minimum -0.7). Only in the second quartile, the average ROA for companies that disclosed ICWs is higher than the average ROA for companies whose system of internal control did not have defects. The results of descriptive statistics for ROE do not support the predictions. In fact, the mean of ROE from 2014 to 2017 is higher in companies which disclosed internal control deficiencies. However, the differences in the results are not significant, because of the small sample. Overall, companies which perform well have the opportunity to invest more in internal control and in sophisticated communication systems.

For what it may concern GROWTH, the results are in line with the prediction in the second hypothesis. The average compound annual growth rate from 2014 to 2017 is higher in those companies which disclosed ICWs. Exceptions appear in the values of the median and in the third quartile. Considering companies with an "abnormal" growth of sales, among the companies which did not disclose ICWs, there are two values in the higher quartile that are 47.3% and 72.7% (maximum) and therefore represent "abnormal" growth rates. Firms with this kind of growth, have to face operational issues because of the rapid expansion of their operations and sales.

Furthermore, the values resulting from descriptive statistics for STATE OWNERSHIP also confirms the predictions. There is in fact a positive correlation between the percentage of State ownership and the disclosure of ICWs. All the values except standard deviation are higher for companies which disclosed ICWs. In details, the average percentage of shares held by the State from 2014 to 2017 is 49.9%, while it is 45% in companies which did not disclose ICWs. There are two companies whose percentage of State ownership is 0% (minimum) and one company whose rate of State ownership is 87% (maximum).

Lastly, analysing the results for the variable AUDITOR, the predictions in the fourth hypothesis are confirmed. The mean of the variable auditor from 2014 to 2017 is higher in those companies that did not disclose ICWs (0.93). Overall, the majority of the companies on average appointed auditors from audit firms belonging to the Big 4 group.

4.3 Comparison of the findings

For what it may concern the compliance with the regulation and its guidelines, what emerged from the analysis of the self-assessment reports on internal control disclosed by the sampled companies is that overall all the companies complied with the regulation. Some of them also disclosed more details and included each stage of the process of assessment of internal control. The findings of this analysis are in line with prior researches on the topic published by Hao and Rainsbury (2016) and by Chen Huili 陈慧莉 (2016). Prior researchers analysed the self-assessment reports on internal control published in 2011 and 2012, when the regulation entered into force, and concluded that those reports lacked a unified framework and thus were difficult to compare (HAO & RAINSBURY, 2016). From the analysis of the reports published from the end of 2014 to the beginning of 2018, it emerges that although the regulation has not provided a unified framework, companies voluntarily utilised the same model for the redaction of their IC reports and therefore the reports are easier to compare.

The disclosure of ICWs was not very detailed in the 2011 self-evaluation reports on internal control (HAO & RAINSBURY, 2016). The reports considered in this analysis provide more details of the internal control deficiencies disclosed, although these details only concern material and significant deficiencies. General deficiencies included in the reports still lack descriptions and rectification methods. The descriptions provided for significant deficiencies are more accurate, while rectification methods are still vague. According to the regulation, material deficiencies should be accompanied by very accurate descriptions and comprehensive rectification methods. However, the companies analysed in this research did not disclose any material deficiencies. It can be stated that the disclosure of ICWs still lacks detailed descriptions and the rectification methods are rarely included (JIANG, 2018). Furthermore, it is important to mention that Chinese listed companies also carry out the assessment of their internal controls unrelated to financial reporting and thus they may disclose a series of deficiencies related to operations not linked to financial reporting.

Compared to the researches on the 2011 and 2012 IC reports, the 2014, 2015, 2016 and 2017 self-evaluation reports on Internal Control are audited by a higher percentage of audit firms of the Big 4 group. The reason for this may be in the higher reputation established by these international audit firms.

The second part of the research hypothesises that four variables may determine the disclosure of internal control weaknesses and consequently influence internal control quality. The four variables analysed are PROFITABILITY, GROWTH, STATE OWNERSHIP and AUDITOR.

The results of this research point out that profitable companies have the opportunity to invest more in internal control, consequently new technologies stimulate supervision and ensure a more transparent communication. The financial indicators that were used in this thesis to express profitability are ROE and ROA. The analysis finds out that higher ROA is a characteristic of those companies which did not disclose ICWs, and therefore higher ROA is associated to higher internal control quality. ROE was higher in those companies which disclosed ICWs and therefore this result did not confirm the expected results. The results concerning ROA are in line with the previous literature on internal control quality. In particular, Ashbaugh-Skaife, Collins and Kinney (2007) theorised a model for finding the determinants of internal control quality and included the profitability variable in this model. In addition, Doyle, Ge and McVay (2007), Hao and Rainsbury (2016) Wang Peng, Dou Huan and Liu Weiyi 王鹏、窦欢和刘威仪 (2013) and Lin Suyan 林素燕 (2017) found out that profitability is negatively associated with the disclosure of ICWs, or, in other words, positively related to internal control quality.

Concerning GROWTH, the previous literature on internal control quality agrees on the negative influence that an excessive growth may have on IC quality. The results of the analysis conducted in this thesis clearly show that the compound annual growth rate in sales is higher in those companies which disclosed ICWs. According to Doyle, Ge and McVay (2007) and Lin Suyan 林素燕 (LIN, 2017)rapid growth may negatively affect the balance between internal controls and operations, causing ICWs. In fact, while a firm experiences an excessively rapid growth, the establishment of new control procedures may require more time. Ashbaugh-Skaife, Collins and Kinney (2007) also found out that firms with higher sales growth and larger inventory holdings are more likely to disclose internal control deficiencies. In the final analysis, the data concerning growth are in line with previous findings.

The variable STATE OWNERSHIP is the percentage of a firm's shares held by the State. The final percentage is a sum of all the percentages of the state-owned shares included in the annual report's section dedicated to the "top ten shareholders". The analysis carried out in this paper indicates that the percentage of state ownership positively influences the disclosure of internal control weaknesses. The literature on internal control quality presents two different opinions. Ashbaugh-Skaife, Collins and Kinney (2007) study internal control quality in American companies under the Sarbanes-Oxley Act (2002) and conclude that higher institutional ownership is negatively related to the disclosure of material ICWs. On the other hand, the literature using samples of Chinese companies under the Basic Standard on internal Control concludes that a higher percentage of state ownership is positively related to the disclosure of ICWs (YE, et al., 2016), (LENG & DING, 2011) and (WANG,

et al., 2013). This happens because in China State ownership is a factor that characterises the majority of the companies. For this reason, the disclosure of information is not meant for a large number of investors and shareholders and this may result in less transparency (WANG, et al., 2013). The results of the research conducted in this paper are in line with the literature on internal control quality that studied internal control under Chinese regulations.

With reference to the influence of the appointment of the auditor on internal control quality, the literature on internal control quality presents a dual-perspective explanation. On one hand, Ashbaugh-Skaife, Collins and Kinney (2007) present the matter from the point of view of the firms which are audited. The companies which appoint an auditor belonging to the Big 4 group of audit firms will certainly disclose ICWs in the self-assessment IC report, if these appear in their internal control systems. This happens because Big 4 auditors provide higher quality audits and thus will certainly uncover ICWs in case these exist but are not disclosed. On the other hand, auditors from the Big 4 audit firms, conducting high quality audits, in order not to lose their reputation tend to audit firms whose internal control system is effective and without deficiencies, (HAO & RAINSBURY, 2016) and (LIN, 2017). The results of the analysis conducted in this paper show that the AUDITOR variable is negatively related to the disclosure of ICWs, and that the appointment of an audit firm from the Big 4 group is a sign of higher internal control quality. This result is in line with the empirical analysis conducted by Hao and Rainsbury (2016) and by Lin Suyan 林素燕 (LIN, 2017)on the disclosure of ICWs by Chinese listed companies.

The four hypotheses in the third chapter of this empirical research are supported by the empirical results discussed in section 4.2. All things considered, the results obtained are in line with the data retrieved from prior literature on internal control quality.

CONCLUSIONS

Along with the rapid growth of Chinese economy and the development of modern corporate management among listed firms, instances of fraud rose as well. According to *China Briefing*, a publication by Dezan Shira & Associates (2017), and to government statistics, in 2016 the fraud market in China was worth RMB 100 billion – about US$ 14.8 billion. In some cases, the organizations themselves underestimate the risks of fraud. Fraud may be caused by many factors, and some of these factors, such as violations of IC aspects and not transparent business, can be addressed by improving the organisation's internal control system. Moreover, an effective system of internal control, other than limiting the company's exposure to fraud, helps the company to achieve its objectives. The objectives concern the protection of the assets, efficiency of operations, reliability of financial reporting and regulatory compliance (Dezan Shira & Associates, 2017).

From the research conducted in this thesis, it emerges that the Chinese regulatory framework on internal control rapidly adapted to the economic environment and is characterised by constant development. Moreover, the Basic Standard on Enterprise Internal Control promulgated in 2008 and its supporting guidelines have a unique feature: they require companies to conduct also the assessment of internal control not related to financial reporting and to report the ICWs found during the assessment. Whereas the Sarbanes Oxley Act promulgated in 2002 in the US only requires the disclosure of internal control deficiencies related to financial reporting.

After having analysed the IC regulations issued in China, it can be stated that the Chinese government, by requiring all the Chinese listed companies to implement and assess their internal control systems from 2012, achieved the objective of creating a comprehensive regulatory framework on internal control.

For what it concerns the analysis of compliance with the regulation of the companies' self-assessment reports on internal control, taking into account prior literature on the topic, this study concludes by arguing that the companies in the sample and, and in general Chinese listed companies, complied with the regulation by disclosing all the aspects required by the regulation and contained in the checklist produced during this research.

Trough the analysis of IC self-assessment reports, it was possible to analyse the internal control deficiencies disclosed by the companies in the sample. Due to the uniqueness of the Chinese regulatory framework, it was also possible to analyse those internal control deficiencies unrelated to financial reporting. The analysis led to the following conclusions: the disclosure of ICWs needs

further improvement, because although the deficiencies are descripted in details, their rectification methods are vague.

The analysis of the audit reports on internal control suggests that companies tend to appoint CPAs from the Big 4 group of audit firms for the audit or their self-assessment reports on internal control. This could be because international audit firms are associated with higher quality audits.

The last part of the empirical research in this thesis uses descriptive statistics in order to demonstrate that the determinants which were supposed to be associated with internal control quality, actually influence IC quality and ICWs disclosure. After having selected some determinants of IC quality from the research works included in the literature review, the data related to these determinants were retrieved from the annual report disclosed by the sample companies for the years 2014, 2015, 2016 and 2017. Despite the limitations due to the small amount of companies in the sample, the results are still significant because they are consistent with the results obtained by previous researchers. The data indicate that a company's performance or profitability and the appointment of auditors from the Big 4 group for the audit of its IC report are positively related to internal control quality and negatively related to the disclosure of ICWs. On the other hand, the data indicate that a company's excessively rapid growth in sales and high percentage of state ownership are negatively related to internal control quality and positively related to ICWs.

Overall, the results suggest that internal control quality among the companies in the sample is high, because none of the companies disclosed any material weaknesses in internal control related or unrelated to financial reporting.

This research has some limitations associated with the limited amount of companies included in the sample. It could be argued that the results are not significant because the data consider only a small percentage of Chinese companies. Moreover Asia 300 Nikkei's list, the list used for the selection of the companies, only contains the fastest-growing and biggest companies in China and thus internal control quality is certainly high. However, even if the sample presents limited characteristics, the results are consistent with the results from prior researches. Another limitation is to be attributed to the availability of studies on Chinese regulations and guidelines on internal control. Most of the reference sources are in Chinese or do not adequately address the topic. Moreover, very few Chinese companies listed only in Shanghai or Shenzhen release their annual reports in English. The self-assessment reports on internal control are not issued in English. For what it may concern the literature assessing Chinese companies' compliance with the regulations, this is also very limited. Almost no study published in English has yielded this topic. This may be because the regulation has

been applied to all Chinese listed companies from 2012, and therefore the number of reports disclosed through the years is still limited to assess the topic thoroughly.

In light of these limitations, further research could aim to replicate the research with a larger sample of companies. At present circumstances, the regulatory framework is comprehensive and constantly developing. However, due to the rapid changing economic environment, further research should focus on compliance and on the adaptation of the regulation and guidelines to the development of new business models, innovation in operations and the introduction of new technologies. Moreover, the study of determinants of internal control quality could be extended to other determinants related to corporate governance, to the size of companies, to their internationalization and relationships with other countries and to their mergers and acquisitions. Internal control is becoming a priority for Chinese organisations and therefore it might prove an important area for future research. In particular, interesting research questions could derive from the compliance with the regulation after ten years from the first application of the regulation.

In conclusion, this study provides a starting point for future discussion and research on internal control. This study also shows that the Chinese regulatory framework on internal control has unique characteristics that involve a new concept of internal control which is not only related to the control of financial reporting activities. Therefore, it would be desirable for future work to compare the Chinese model to other models and to check whether the Chinese concept of internal control could be exported to other countries with different economic environments.

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APPENDICES

APPENDIX A: Laws and regulations of the People's Republic of China

- Accounting Law of the People's Republic of China
  中华人民共和国会计法 *Zhonghua Renmin Gongheguo kuaiji fa*
  Promulgated in 1985, amended in 1993, 1999 and 2017.
  Available at: http://en.pkulaw.cn/display.aspx?cgid=1e86c873697cef40bdfb&lib=law

- Audit Law of the People's Republic of China
  中华人民共和国审计法 *Zhonghua Renmin Gongheguo shenji fa*
  Promulgated on August 31, 1994 and amended on February 28, 2006.
  Available at: http://en.pkulaw.cn/display.aspx?cgid=29bdaa74b23e153bbdfb&lib=law

- Basic Standard for Enterprise Internal Control
  企业内部控制基本规范 *Qiye neibu kongzhi jiben guifan*
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- Company Law of the People's Republic of China
  中华人民共和国公司法 *Zhonghua Renmin Gongheguo gongsi fa*
  Promulgated on December 25, 1999 and amended in 2004, 2005, 2013 and 2018.
  Available at: http://en.pkulaw.cn/display.aspx?cgid=aec0c211a78989e9bdfb&lib=law

- Guidelines for Assessment of Enterprise Internal Control
  企业内部控制评价指引 *Qiye neibu kongzhi pingjia zhiyin*
  Promulgated on April 15, 2010.
  Available at: http://en.pkulaw.cn/display.aspx?cgid=427b287d1fac6255bdfb&lib=law

- Guidelines for Auditing of Enterprise Internal Control
  企业内部控制审计指引 *Qiye neibu kongzhi shenji zhiyin*
  Promulgated on April 15, 2010.
  Available at: http://en.pkulaw.cn/display.aspx?cgid=427b287d1fac6255bdfb&lib=law

- The Application Guidelines for Enterprise Internal Control
  企业内部控制应用指引 *Qiye neibu kongzhi yingyong zhiyin*
  Promulgated on April 15, 2010.
  Available at: http://en.pkulaw.cn/display.aspx?cgid=427b287d1fac6255bdfb&lib=law

APPENDIX B: List of the companies in the sample

	Constituent Name (in Chinese)	Constituent Name	Stock Exchange	Stock Code	Sector
1	农业银行	Agricultural Bank of China ABC	SSE, HKSE	601288	Finance
2	中国国航	Air China Ltd.	SSE, HKSE, LSE	601111	Transport
3	海螺水泥	Anhui Conch Cement Co., Ltd.	SSE, HKSE	600585	Manufacturing
4	中国银行	Bank of China BOC	SSE, HKSE	601988	Finance
5	京东方 A	BOE Technology Group Co., Ltd.	SZSE	000725	Information Technology
6	比亚迪	BYD Co., Ltd.	SZSE, HKSE	002594	Manufacturing
7	中国交建	China Communications Construction Co., Ltd.	SSE, HKSE	601800	Construction and Engineering
8	建设银行	China Construction Bank Corp.	SSE, HKSE	601939	Finance
9	中远海控	China COSCO SHIPPING Holdings Co., Ltd.	SSE, HKSE	601919	Transport
10	中国人寿	China Life Insurance Co., Ltd.	SSE, HKSE, NYSE	601628	Finance
11	中国石化	China Petroleum & Chemical Corporation	SSE, HKSE, NYSE, LSE	600028	Manufacturing
12	中国铁建	China Railway Construction Co., Ltd.	SSE, HKSE	601186	Construction
13	中国中铁	China Railway Group Limited	SSE, HKSE	601390	Construction
14	中国神华	China Shenhua Energy Co., Ltd.	SSE, HKSE	601088	Mining
15	南方航空	China Southern Airlines Co., Ltd.	SSE, HKSE	600029	Transportation
16	万科A	China Vanke Co., Ltd.	SZSE, HKSE	000002	Finance
17	长安汽车	Chongqing Changan Automobile Co., Ltd.	SZSE	000625	Manufacturing
18	中国中车	CRRC Corporation Limited	SSE, HKSE	601766	Manufacturing
19	长城汽车	Great Wall Motor Co., Ltd.	SSE, HKSE	601633	Manufacturing
20	绿地控股	Greenland Holdings Corporation Limited	SSE, HKSE	600606	Finance
21	广汽集团	Guangzhou Automobile Group Co., Ltd.	SSE, HKSE	601238	Manufacturing
22	华能国际	Huaneng Power International Inc.	SSE, HKSE, NYSE	600011	Electric Power Production and Supply
23	工商银行	Industrial and Commercial Bank of China Ltd.	SSE, HKSE, NYSE	601398	Finance
24	美的集团	Midea Group Co., Ltd.	SZSE	000333	Manufacturing
25	中国石油	PetroChina Co., Ltd.	SSE, HKSE, NYSE	601857	Mining
26	中国平安	Ping An Insurance (Group) Company of China Ltd.	SSE, HKSE	601318	Finance
27	上汽集团	SAIC Motor Co., Ltd.	SSE	600104	Manufacturing
28	三一重工	Sany Heavy Industry Co., Ltd.	SSE, HKSE	600031	Manufacturing
29	上海电气	Shanghai Electric Group Co., Ltd.	SSE, HKSE	601727	Manufacturing
30	中兴通讯	ZTE Corporation	SZSE, HKSE	000063	Information Technology

APPENDIX C: Chinese government institutions, commissions and stock exchanges

- **CBRC** China Banking Regulatory Commission
  Zhongguo yinhangye jiandu guanli weiyuanhui 中国银行业监督管理委员会
- **CICPA** Chinese Institute of Certified Public Accountants
  Zhongguo zhuce kuaijishi xiehui 中国注册会计师协会
- **CIIA** China Institute of Internal Audit
  Zhongguo neibu shenji xiehui 中国内部审计协会
- **CIRC** China Insurance Regulatory Commission
  Zhongguo baoxian jiandu guanli weiyuanhui 中国保险监督管理委员会
- **CNAO** China National Audit Office
  Zhonghua Renmin Gongheguo shenjishu 中华人民共和国审计署
- **CSRC** China Securities Regulatory Commission
  Zhongguo zhengquan jiandu guanli weiyuanhui 中国证券监督管理委员会
- **MOF** Ministry of Finance of the People's Republic of China
  Zhonghua Renmin Gongheguo Caizhengbu 中华人民共和国财政部
- **State Council** of the People's Republic of China
  Zhonghua Renmin Gongheguo Guowuyuan 中华人民共和国国务院
- **SSE** Shanghai Stock Exchange Shanghai
  Shanghai Zhengquan Jiaoyisuo 上海证券交易所
- **SZSE** Shenzhen Stock Exchange
  Shenzhen Zhengquan Jiaoyisuo 深圳证券交易所