

China Internal Control Regulation Update Newswire

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China became the latest country to issue legislation specifying comprehensive requirements over a company's Internal Control framework¹.

The Basic Standard for Enterprise Internal Control

(企业内部控制基本规范 "the Standard") [http://www.casc.gov.cn/gnxw/200807/t20080715_751587.htm] was launched on 28 June 2008 jointly by the Chinese Ministry of Finance (MOF), the National Audit Office, and all three major industry regulators: the China Securities Regulatory Commission (CSRC), the China Banking Regulatory Commission (CBRC), and the China Insurance Regulatory Commission (CIRC).

The official pronouncement of the issue was made through an accompanying document: "Caikuai [2008] No. 7 - Circular Regarding the Issue of The Basic Standard for Enterprise Internal Control" ("the Circular"), dated 22 May 2008. The Circular contains additional instructions that need to be considered when interpreting the Standard.

In addition to the Standard, three other Guidance documents, which are intended to support the implementation of the Standard, were issued for public consultation.

In this Newswire, we aim to provide a brief overview of the key requirements specified in the Standard and the accompanying Circular, as well as the three draft supporting guidance documents. We will also discuss the potential impact on companies operating in China, and our recommendations on the next steps that should be taken. In addition, we aim to provide a brief overview of several existing internal control related regulations that were issued by various Chinese regulators prior to the issue of the Standard.

The Standard: Overview of Key Requirements

The Standard contains 50 articles set out in 7 Chapters. Chapter 1 defines the scope and applicability of the Standard, including the requirement for annual assessment. Chapters 2 to 6 discuss the principles that need to be considered in the context of a company's internal control, covering: **Internal Environment, Risk Assessment, Control Activities, Information and Communication, and Internal Monitoring**. The final Chapter sets out the effective date, and provides for supplementary guidelines to be issued by MOF and other relevant government departments. Key elements of the Standard are summarized in the following sections.

¹On 30 July 2002, the United States enacted the Public Company Accounting Reform and Investor Protection Act of 2002 (commonly known as the Sarbanes Oxley Act of 2002 and generally referred to as SOX or SARBOX) requiring listed companies to undertake annual assessment of the effectiveness of its internal controls over financial reporting. Since then, a number of countries and territories have enacted similar legislation / regulations on corporate governance and internal controls related aspects. Examples include National Instrument 52-109 (NI 52-109, Canada); European Union - 8th Company Law Directive (Directive 2006/43/EC); Swiss Code of Obligations and the SWX Swiss Exchange Directive on Information Relating to Corporate Governance 2002/2006; Deutscher Corporate Governance Kodex (German Corporate Governance Code); CLERP9 (Australian Corporate Reporting and Disclosure Law); Loi sur la Sécurité Financière" (French Law on Financial Security); Disposizioni per la tutela del risparmio e la disciplina dei mercati finanziari (L262/2005 - Italian legislation for financial services institutions); The King Code of 2002 (Corporate Practices and Conduct - the King II Report on Corporate Governance, South Africa); the Financial Instruments and Exchange Law enacted on 14 June 2006 (commonly referred to as J-SOX); and Hong Kong Code On Corporate Governance Practices (Hong Kong Stock Exchange Listing Rule Appendix 14).

Effective Date

The Standard will be effective from 1 July 2009² (BS-50). The Circular further clarifies that the Standard is to be enforced initially amongst listed companies, while encouraging early adoption by other large and medium size unlisted companies.

Applicability

The Standard is applicable to all large and medium size³ companies established in China, and does not differentiate between domestic and foreign companies (BS-2).

Definition of Internal Control and Core Principles

The elements of internal control as defined under the Standard are broadly consistent with the five elements of internal controls detailed in the 1992 COSO Internal Control - Integrated Framework, and incorporate concepts discussed in the 2004 COSO Enterprise Risk Management Framework. In substance, therefore, the Standard combines core principles taken from the two COSO publications.

Further, there is clear reference to controls over safeguarding of assets (BS-32), and requirements for the establishment of anti-fraud controls (BS-42), as well as a fraud reporting mechanism and means to protect whistle-blowers (BS-43).

The definition of Internal Control under the Standard is thus all encompassing, and is more extensive than “internal controls over financial reporting” defined by both SOX and J-SOX.

Responsibility for Internal Control

The Board of Directors is ultimately responsible for establishing and implementing an effective internal control system, with the Supervisory Board monitoring the Board’s activities in this area. Enterprise management is responsible for organising and leading the proper daily operations of internal control (BS-12).

The Standard further requires an audit committee to be established and to be responsible for examining the company’s internal control, as well as monitoring the effective operation of internal control and control self-assessment (BS-13).

Management’s Annual Self Assessment

The Circular requires that listed companies adopting the Standard should undertake a self assessment of the effectiveness of their internal control, and disclose the conclusion in an annual self assessment report.

Implementation Considerations

The Standard promotes the use of information technology and automated controls to enhance a company’s internal control (BS-7), as well as requiring companies to define policies on rewards and penalties to support the proper implementation of internal control, and to incorporate this as part of departmental and staff performance appraisals (BS-8).

Audit Opinion

Neither the Standard nor the Circular mandate an audit opinion on the effectiveness of a Company’s internal controls; this remains optional and is left to the discretion of company management. A public accounting firm commissioned by a company to conduct an audit on its internal control should perform the audit in accordance with the Standard and its supporting regulations, as well as any relevant professional guidance (BS-10).

Auditor’s Qualification

The Circular requires any public accounting firm that is commissioned by a company to express an opinion on the effectiveness of internal controls to be certified to undertake Securities and Futures related business (具有证券、期货业务资格的会计师事务所).

² Chinese legislations and regulations usually refer only to an effective date and not the financial year. Since the financial year for Chinese companies is typically aligned with the calendar year, the 2009 financial year will effectively be the first year where the Standard will be enforced.

³ Classification of company size varies by industry and is based on three metrics – total assets, revenue, and number of staff. The latest set of industry classification standards was issued by the National Bureau of Statistics of China (NBS) in 2003. However, the standard is not comprehensive and supplementary measures are typically adopted by respective regulators to classify entities in industries (e.g. financial services) not covered by the NBS standard.

Auditor's Independence

The Standard specifies that firms providing internal control consulting services to companies “cannot also provide internal control auditing services at the same time” (BS-10). The Standard is silent as to whether the public accounting firm that undertakes the financial report audit would also be the firm that performs the internal control audit.

Outline of Supporting Guidance Documents (Exposure Drafts)

Three supporting guidance documents have been issued for public consultation and are summarised below. These are intended to provide additional guidance and directions to support the implementation of the Standard.

- **Enterprise Internal Control Assessment Guidance (企业内部控制评价指引):** This MOF guidance is aimed at supporting management in conducting an annual control effectiveness assessment. The document sets out guidance on the procedures and methods of assessing and evaluating internal controls, and on the classification of deficiencies and reporting requirements.
- **Enterprise Internal Control Practical Guidance (企业内部控制应用指引):** This MOF guidance is intended to provide guidance for management on implementing internal controls. This guidance document is a collection of 22⁴ separate documents, which cover specific operational processes and internal control elements.
- **Enterprise Internal Control Assurance Guidance (企业内部控制鉴证指引):** Drafted by the Chinese Institute of Certified Public Accountants (CICPA), this guidance is aimed at providing general guidelines for accounting firms commissioned to perform assessments of the effectiveness of internal controls. The current proposed scope is confined to internal controls over financial reporting, which appears narrower than the definition of internal controls set out the Standard.

PwC is monitoring the development of these and other guidance documents, and seeking further clarifications on specific aspects. We shall provide further updates and analysis in due course.

Impact on companies operating in China

Listed companies in China will be among the first to implement the Standard by July 2009, and it is important that companies should start preparations early to ensure compliance with the Standard.

Based on our experience from advising Chinese companies in their preparation for SOX compliance over the past few years, and considering the complexity and extensive scope of the Standard, we anticipate that companies will encounter a number of challenges in their readiness efforts. We have highlighted below some of these challenges and our recommended approach for management to consider as part of their readiness efforts:

- **Senior level management sponsorship:** the Standard has very broad coverage and covers all aspects of the company's operations. As such, management needs to establish a cross-functional project team to take charge of this enterprise-wide initiative. Senior management sponsorship and active involvement would be a key to the success of the readiness efforts.
- **Adopt a phased approach:** it is important for management to take a phased approach to ensure that the efforts are manageable. Management can consider selecting one or more focus areas to be a pilot, through which to accumulate knowledge and experience, as well as to fine tune the approach to suit the specific needs of the company. Controls over financial reporting and information technology are two areas that should be given early priority. Undertaking an early diagnostic review of the company's overall internal control system would also help identify focus areas as well as areas requiring rectification to address any significant and material weaknesses that may exist.
- **Emphasis on training and knowledge:** this is important as new concepts are involved and existing personnel may have limited knowledge and understanding on internal controls. Training is necessary not just for those involved in the readiness efforts, but also for all levels of management. Companies should consider using external expert resources to assist with readiness efforts as necessary, but ensure an emphasis on skill and knowledge transfer.

⁴ The 22 areas currently covered include Cash/Funds; Procurement; Inventory; Sales; Construction Projects; Fixed Assets; Intangible Assets; Long Term Equity Investment; Fund Raising Activities; Budgeting; Costs; Guarantees; Contractual Agreements; Control over Subsidiaries; Financial Reporting and Disclosures; Human Resources Management Policies; General IT Controls; Derivative Instruments; Enterprise Mergers and Acquisitions; Related Parties Transactions; Outsourcing; and Internal Audit.

- Build upon the current control infrastructure: all companies have controls in one form or another, and the first step to enhancing control to be ready for assessment is to clarify current controls that are in place, ascertain whether these are meeting their intended control objectives, and ensure their consistent execution and sustainable maintenance through clearly defined policies and supporting documentation.
- Strengthen basic control components: achieve quick wins by focusing on strengthening basic control elements, such as enforcing segregation of duties; ensuring effectiveness of monitoring functions including the Supervisory Board and the Audit Committee; enhancing the Internal Audit function.

Impact on Chinese listed companies that are also listed in the US

Chinese companies that are listed in the US have already needed to comply with SOX requirements since 2006, and a lot of efforts have been made to address internal controls over financial reporting, as well as other “indirect” controls over financial reporting, such as the company’s control environment; monitoring by board and senior management; effectiveness of audit committee; controls relating to fraud risk and safeguarding of assets; effectiveness of the internal audit function; etc. While the above elements of internal control are also required by the Standard, as already discussed, the Standard defines internal control in a broad term and extends beyond “internal control over financial reporting”.

Consequently, despite the efforts already made in relation to SOX, management will still need to put in additional efforts to ensure compliance with the Standard. To this end, management should leverage as far as possible the practical knowledge and skills accumulated during the SOX readiness efforts.

Impact on Chinese companies listed after May 2006

Under an Administrative Measure issued by the CSRC in May 2006, companies seeking a listing in mainland China (A-share) are required to submit as part of their listing application an unqualified audit opinion pertaining to the effectiveness of their internal controls.

In assessing the effectiveness of internal controls, the series of Guidance on Internal Accounting Control issued by the MOF between 2001 and 2004 was used as the basis. The scope of these standards is narrower in coverage than that defined in the Standard.

More importantly, the CSRC Administrative Measure only requires a one-off audit opinion prior to listing, and did not mandate management to conduct its own annual effectiveness assessment. Consequently, for companies listed after May 2006, significant readiness efforts will still be required in order to comply with the provisions of the Standard.

Impact on foreign companies operating in China

In theory, the Standard is equally applicable to all domestic and foreign companies operating in China. Domestic listed entities of foreign enterprise will be required to adopt the Standard on 1 July 2009, while unlisted large and medium size entities are encouraged to adopt.

Conclusions

The Basic Standard for Enterprise Internal Control is an important milestone in internal control reporting for companies operating in China. To date, only a small number of Chinese companies that are listed overseas have experience of internal control assessment and reporting. This general lack of experience coupled with the broad scope of the Standard and several uncertainties that currently exist within the draft guidance documents inevitably increase the difficulty and complexity of the adoption and implementation of the Standard.

The public consultation period for the three detailed guidance documents that support the implementation of the Standard closed on 30 September 2008, and we anticipate revised versions to be issued after the respective authorities have considered the comments from the consultation process.

To date, it is unclear if the other regulators will amend or revise existing internal control regulations set out above to align with the Standard.

PwC China has formed a Task Force to actively monitor emerging development in this area. We are in discussion and liaison with the relevant regulators and will issue further briefings to provide updates on the latest developments or clarifications as information becomes available.

Other relevant Chinese regulatory requirements on internal control

The following is a summary of certain key internal control requirements released in the past few years. This list is not comprehensive, and is intended to illustrate the variety and complexity of the current internal control related regulatory landscape within China.

- Between 2001 and 2004, the Ministry of Finance issued a series of "Guidance on Internal Accounting Control. The first of these documents: "Guidance on Internal Accounting Control - Basic Standards (Trial)" (MOF [2001] No. 41) was issued in June 2001. This series of guidance documents comprise six trial standards, including those relating to Cash, Purchases and Payments, Sales and Receipts, Construction Projects, Foreign Investment and Guarantees, and an additional five draft standards for consultation, covering Costing, Budgeting, Inventory, Fixed Assets, and Fund Raising.
- On 18 May 2006, the China Securities Regulatory Commission (CSRC) issued the "Guidance on Initial Public Offerings of listed companies "(CSRC Administrative Measure No.32, "CSRC Guidance"). Article 29 of the CSRC Guidance requires the IPO applicant's internal control system "should be effective in all significant aspects", and the listing application to include an unqualified Internal Control Assurance Report issued by a CPA.
- On 5 June 2006, the Shanghai Stock Exchange (SSE) issued the "SSE Guidelines for Internal Control of Listed Companies (Guidelines)" (Permit [2006] 420), requiring companies listed on the Shanghai Stock Exchange to assess the effectiveness of internal control and to be subject to annual audit. As of today, this guideline has not been formally enforced although its official effective date was 1 July 2006.
- On 28 September 2006, the Shenzhen Stock Exchange (SZSE) issued the "SZSE listed company internal controls Guidance", requiring the board to assess the effectiveness of internal control and to be subject to annual audit. As of today, this guideline has not been formally enforced although its official effective date was 1 July 2007.
- On 6 June 2006, the State-owned Assets Supervision and Administration Commission of the State Council of China (SASAC) issued the "Central state-owned enterprises comprehensive risk management guidance" (SASAC [2006] No.108), which was effective immediately on the date of issue. The "Guidance" requires state-owned enterprises to implement an enterprise risk management framework. Subsequently, in February 2008, the SASAC announced a pilot exercise where 31 selected state-owned enterprises are to submit their 2008 Enterprise Risk Management Report.
- On 6 April 2007, the China Insurance Regulatory Commission (CIRC) issued the "Insurance Risk Management Guidance (Pilot)" as the internal control guidance for regulating the insurance industry.
- On 3 July 2007, the China Banking Regulatory Commission issued a "Commercial Banks Internal Control Guidance" intended to provide guidelines on internal controls within commercial banks. The document provides requirements in process level controls and IT controls relating to different banking businesses.

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