"China SOX": What Is It and Why Was It Introduced?

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Abstract: China released the first Basic Standard for Internal Control on July, 2008, "China SOX". It is a regulation adopted in China in order to enhance risk management and prevent business disasters, and requires detailed disclosure of internal control for public and private Chinese firms. The purpose of this essay is to analyse and discuss China SOX. This paper reviews the history of internal control in China, explains what China SOX is and analyses why it was introduced to China. This article also compares US SOX and China SOX. Lastly, this essay discusses the advantages and disadvantages of China SOX and offers some suggestions about how to improve internal control quality in China. This paper points out that although there are some limitations to China SOX, it is expected to be effective in implementing improved internal control in China.

Key-Words: China SOX, Internal control, risk management, business disasters

1. Introduction

Since the beginning of the 21st century, a series of serious financial scandals has happened worldwide. For example, famous enterprises such as Lehman Brothers, General Motors, Enron and WorldCom went bankrupt due to accounting fraud and management failure. In China, China Aviation Oil, CITIC Pacific, Eastern Airlines, Lantian Stock and Yili also suffered from financial failures (Chi et al. 2010). These egregious cases correlated with the ineffectiveness of enterprise internal control (COSO 1992, CIFAS 2010), which has since focused public attention upon the importance of internal control (Li 2011). Internal control is implemented by an entity's board of directors, boards of supervisors, management and other personnel to realize management control goals of a firm. In order to enhance and standardise internal control, the Chinese government attempted to develop a series of internal control standards. China's version of the Sarbanes-Oxley Act of 2002, The Basic Standard for Enterprise Internal Control ("Basic Standard") was issued in 2008. China SOX became effective on January 1, 2012, requiring Chinese listed firms and their auditors to "evaluate the effectiveness of enterprise internal control over both financial reporting and non-financial reporting and provide the annual opinions" (Basic Standard). China SOX plays a vital role in the development of internal control in China. This paper reviews the historical development of internal control in China. It then analyses related concepts and the reasons for introducing China SOX. By comparing it with US SOX, this article also assesses and discusses the merits and demerits of China SOX as well as its effectiveness.

2 Background: the history and development of internal control in China

Internal control in China has a long history. During the West Zhou Period (BC1046-BC771), an internal check system was formed (Li, 2001). In China, many divisions of Government have participated in the construction of internal control and enacted a great many laws and regulations since new China was founded in 1949. The development of internal control of Chinese enterprises can be divided into two stages. The first stage was learning and exploring (1949-2005) and the second stage is development and innovation (2006 onwards).

Stage 1 Learning and Exploring

During this stage, various requirements about responsibilities and duties, appointments and removal, rewards and punishment of accountants were developed in relation to internal accounting control. Others regulations concerned the accounting system.

These are some of the characteristics concerning the objectives and definitions of internal control during the period 1949 to 2005. Firstly, the requirements covering internal control in Accounting Law are limited to the accounting-control level. However, there are no general requirements about the assessment and reporting of internal control. Secondly, the aim of the Chinese internal controls not only learns from COSO framework, but also takes Chinese characteristics into consideration. Thirdly, apart from Internal Accounting Control Standards, all other regulations are designed according to the actual firms in the industry. In general, a unified, authoritative and comprehensive internal control system is lacking. Fourthly, the logic and levels of the internal control system is not very clear. Lastly, there are different opinions about internal control definitions, such as accounting control, internal control and risk control. In terms of the basic principle of internal control, there are some discordant regulations. When it comes to the contents and structure of internal controls, they are similar to the COSO framework, although there are some differences in detail. What is more, there are obvious industry characteristics differences. Lastly, there are different internal control structures and there is no unified internal control framework in China (Chen et al. 2009).

Stage 2 Innovation and Development

In 2002, the USA released the Sarbanes-Oxley Act of 2002 (SOX 2002), which exerted a great influence on China. Chinese internal control developed quickly from 2006. Many departments began to engage in drawing up regulations and standards. The China Securities Regulatory Commission released "The Management of IPO", which states that the internal control of (IPO) must be effective and a CPA must sign internal control assessment reports. The State-owned Assets Supervision and Administration Commission released "Guidelines on Overall Risk Management of Central Enterprises" in June, 2006. It is similar to the Enterprise Risk Management-Integrated Framework (COSO 2004), which enriches the contents of internal control systems in China and indicates a breakthrough in the construction of internal control norms. The Ministry of Finance launched the "Internal Control Standards Commission" on the 15^{th} of July 2006. At the same time, the Shanghai Stock Exchange released "Internal Control Guidelines of Listed Companies of SSE". In September 2006, the Shenzhen Stock Exchange released "Internal Control Guidelines of Listed Companies of Shenzhen Stock Exchange". In March 2007, the Internal Control Standards Commission [1] released Internal Control Basic Standards and 17 Draft Versions. In Beijing, the Ministry of Finance, SCF, CBRC, and Audit Commission released the first Basic Standard for Internal Control in July, 2008. However, it was not formally implemented until 26 April, 2010, the five Chinese Ministries (Ministry of Finance, China Securities Regulatory Commission, China Banking Regulatory Commission, China Insurance Regulatory Commission and National Audit Office) released "Implementation Guidelines for Enterprise Internal Control" ("Implementation Guidelines"). The release of these Basic Standard and Implementation Guidelines indicates that the internal control system which adapts to the actual situation of Chinese companies and integrates advanced global experience has basically been completed (Liu, 2010b). The implementation of mandatory disclosure of internal control information will promote internal control effectiveness in China in the future.

Internal Control Guidelines of Listed Companies of the Shanghai Stock Exchange

On July, 2006, the Shanghai Stock Exchange released Internal Control Guidelines of Listed Companies of SSE. There are five notable characteristics in these regulations. Firstly, the contents of internal controls are similar to COSO Risk Management. Secondly, the contents of internal control rely on a three goals model including operation, reports and compliance, which are similar to the goals of the COSO Internal Control-Integrated Framework. Thirdly, the factors of internal control are similar to the COSO Internal Control Integrated Framework. Fourthly, the body responsible for internal control is similar to the Turnbull Report in the UK (2005). Lastly, the reporting of internal controls is similar to SOX and SEC in the USA. However, there are more general principles in terms of demands. The model of the Internal Control Guidelines of Listed Companies of the Shanghai Stock Exchange can be described as a broad internal control structure with strict demands for assessment and reports.

Internal Control Guidelines of Listed Companies on the Shenzhen Stock Exchange

The model of the Internal Control Guidelines of Listed Companies of the Shenzhen Stock Exchange is similar to the Internal Control Guidelines of Listed Companies of the Shanghai Stock Exchange. Its contents are fewer, however. There is a process

[1] On 15^{th} July 2006, the Internal Control Standards Commission was established in Beijing. They are responsible for the establishment and implementation of internal control systems in China.

for introducing the opinions of boards of supervisors and independent directors. Auditors only assess internal controls over financial reporting. A comparison of the Internal Control Guidelines of Listed Companies of Shenzhen Stock Exchange and the Internal Control Guidelines of Listed Companies of Shanghai Stock Exchange is as follows.

Table 1 Comparison of Internal Control Guidelines of Listed Companies of Shenzhen Stock Exchange and Shanghai Stock Exchange

Items	Shanghai Stock Exchange	Shenzhen Stock Exchange
Contents	It is similar to COSO risk management.	It is similar to COSO internal control.
Goals	strategies, operation, reports and compliance	operation, reports, compliance and asset safety
Responsible Body	board of directors, inspection and supervision departments	board of directors, internal audit department
Structure	They are similar to the COSO risk management structure.	
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 disagreement, a 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：Hanwen Chen, Honglin Han, Yixia Zhang.2009

Internal Control Standards of Internal Control Standards Commission

The goal the of Internal Control Standards Commission is to establish an internal control standards system, a center to deal with risk prevention and control of corruption and to control and assess standards to promote and protect companies and perfect corporate governance and internal constraint mechanisms in the near future. It seeks to become the most authoritative organisation that designs internal control standards. Internal Control Standards choose a “1+x” model, that is, to make one Internal Control Basic Standard, and based on this, the design of some Internal Control Implementation Guidelines according to common economic business activities can be undertaken.

‘Basic Standard’ is a regulation designed to improve risk management and avoid business disasters in China. It was announced in 2008 and will be phased in over the next few years. It was to be carried out from 1st July 2009, but was delayed until 1st January, 2011. Requirements are limited to mainland-based companies listed domestically and abroad, [2] as an initial step (Implementation Guidelines 2010 p1). It will then be extended to all companies listed in China (the main board of the Shanghai Stock Exchange and the Shenzhen Stock Exchange) on 1st January 2012. Companies listed on the small and medium-sized enterprise board and the Growth Enterprise Market will be required to adopt these guidelines “when appropriate.” Non-listed large and medium-sized enterprises are merely encouraged to adapt to the guidelines. At the same time, Assessment Guidelines, Practical Guidelines and Auditing Guidelines of Internal Control were also released and came into effect immediately. Introducing new standards increases the effectiveness of internal controls in listed Chinese firms, thus reducing risks for films and their stakeholders (Raymond 2009). It is intended to place different requirements on firms based on their size, ownership structure and so on, just as with the Sarbanes-Oxley in America.

[2] These are Chinese firms listed in both China and other countries or districts such as London, New York and Hong Kong. They are large firms with good performance and have foreign branches.

Yan (2010) argues that, in China, internal control practice is rooted deeply in the Chinese cultural environment and is affected by the values and traditions of Confucius [3]. These traditional thoughts exert great influence on the development of internal control. Therefore, even if the ideas of the Integrated Framework were implemented in 2006, many companies still only rely on accounting control and have not established corporate-governance guided internal controls. China started to construct internal control theory and practice late, and is thus far behind developed countries. However, with the release on the guidelines, there will be some processes established in China. These guidelines should improve internal control in China, thus improving accounting information quality, auditing effectiveness, perfecting internal control information disclosure and ensuring the capital market operates effectively.

3 China SOX: what is it and why it was introduced?

This section explains in detail what China SOX is and discusses why China SOX was introduced to China by the Chinese government.

The release of SOX 2002 exerted a significant influence on China. In response to the recent wave of high-profile internal control scandals, in order to enhance and standardize internal control, the Chinese government has been attempting to establish internal control standards. Learning from SOX and taking the Chinese context into consideration, the Basic Standard was released. It is called “China SOX” or “C-SOX “and employs the COSO Internal Control- Integrated Framework. China SOX requires detailed disclosure of internal control for public and private Chinese firms.

The purpose of this standard is to enhance and standardize internal control, improve the level of operating and management of firms, promote the sustainable development of firms, maintain the order of socialism market economics and interests of social public” (Basic Standard 2008 Section1). [In

[3] The core of Confucianism is humanism. The focus of spiritual concern is this world and the family. It relies on the belief that human beings are improvable, teachable and perfectible by personal and communal efforts, particularly self-creation and self-cultivation. It pays attention to the cultivation of maintenance and virtue of ethics.

full] (PWC 2012) believes that because the stature of China in the world economy is rising significantly, the Chinese government realised that it is necessary to enhance financial reporting quality and align with international standards. The Chinese government is encouraging the creation of a good business environment with high-quality accounting and internal controls. At the same time, in order to provide guidance in implementing "Internal Control Basic Standards" (Implementation Guidelines 2010 p1), five Chinese authorities released Implementation Guidelines for Enterprise Internal Control including Assessment Guidelines, Practical Guidelines and Auditing Guidelines of Internal Control on 26th April 2010.

Internal Control Standards' chosen "1+x" model includes one Internal Control Basic Standard and Internal Control Guidelines according to common economic business activities. The Internal Control Basic Standard specifies the elements and principles of internal control, which is similar to the COSO framework (KPMG 2010). The Internal Control Implementation Guidelines offer an implementation framework for an "Internal Control Basic Standard". It specifies the scope, effective dates and requirements for the implementation of Basic Standard (KPMG 2010). Head of the National Accounting Office, Liu Yuting (2010b), claims that the Chinese internal control system has been built up since the issuance of Implementation Guidelines. This is helpful to strengthen comprehensive management and improve the operational ability of listed companies as well as unlisted large and medium-sized enterprises.

It establishes a broad definition of internal control covering the whole organization. According to the Basic Standard, internal control is defined as "a process that is carried out by the board of directors, the board of supervisors, management level and all staff with the aim of realizing the goal of internal control. The goal of internal control is to reasonably assure that management and operations are legal, the assets are safe, financial report and relative information are true and complete, the effectiveness and efficiency of operation are improved and development strategy is realized". The contents of internal control are similar to the COSO Internal Control Integrated Framework and COSO Enterprise Risk Management-Integrated Framework. There are five progressive goals including legitimacy, compliance, the safety of assets, the truth and completeness of reports and relative information, the effectiveness and efficiency of operation and the development of strategy goals. The relevant factors of internal control assessment include recognition, analysis and response to risk. Thus, there are five main factors in the structure of COSO internal control as well as the Internal Control-Integration Framework. They are: internal environment, the foundation of all internal control components; risk assessment, analysis and identification of risks regarding the achievement of firm objectives; control activities, the procedures and policies that ensure the execution of directives; information and communication tools, systems to exchange and information to support business objectives; internal monitoring, the process of evaluating internal control quality.

The Basic Standard (2008) became effective on January 1, 2012, requiring "Chinese listed firms and their auditors to evaluate the effectiveness of enterprise internal control and provide annual opinions". Internal control deficiencies and material weakness remediation are required to be disclosed in internal control self-assessment reports (Basic Standard 2008, Section 6).

In China, boards of supervisors are responsible for internal control supervision, top management takes responsibility for daily operations and the obligations of audit committee are internal control checks. Boards of directors are especially responsible for the implementation and evaluation of internal control. The Basic Standard (2008) requires a board of directors to disclose the effectiveness of internal control in self-assessment reports and the auditors are also required to formally opine in their annual internal control auditing reports on the effectiveness of internal control. Internal control weakness disclosure includes both financial reporting weakness and non-financial reporting weakness. Specifically, Evaluation Guidelines (2010) require firms to disclose internal control weaknesses, the assertion of weakness, material weakness remediation and the measures of remediation in self-assessment reports.

The Auditing Guidelines (2010) state that auditors should treat differently any detected internal controls over non-financial reporting. That is, simply a general disclosure rather than a detailed disclosure. They do not need to disclose control deficiencies in the report, instead, they only need to communicate with firms and remind them to improve internal control. If they detect significant deficiencies, they need to write to the board of directors and management. When they detect material weaknesses, apart from writing to management and the board of directors, they are also required to disclose the nature and severity of internal control material weakness in the annual reports.

The Basic Standard consists of seven chapters and 50 items including general rules, internal environment, risk assessment, control activities, information and communication, internal supervision and supplementary articles. It confirms that the basic principles for the establishment of internal control include comprehensiveness, importance, balance, adaptability and cost efficiency. It only states the principle of demand for assessment; "A company should do self-assessment on the effectiveness of internal control regularly and issue internal control self-assessment reports combined with internal supervision." The firms also must submit an internal-control auditing report audited by an accounting firm every year. The regulations of internal control reports are quite different from COSO's.

The "Implementation Guidelines", issued by five authorities, include the Application Guidelines for Enterprise Internal Control, the Guidelines for Assessment of Enterprise International Control and the Guidelines for Audit of Enterprise Internal Control. Application Guidelines provide guidelines for companies to establish and perfect internal control according to internal control principles and five factors, which play a dominant role in the internal control norms system. The Guidelines for Assessment of Enterprise International Control are to help enterprise managements to assess the effectiveness of internal control. The Guidelines for Audit of Enterprise Internal Control are the professional norms for CPAs and accounting firms to implement internal-control auditing. They are both independent and related, forming an organic entirety (Liu, 2010).

In terms of internal control assessment reports, before the release of the Guidelines for Assessment of Enterprise International Control, some of the listed companies in the Shanghai and Shenzhen Exchanges produced disclosure internal-control assessment reports, however, these reports are different in content and style due to the lack of guidelines, making them difficult to compare and understand. Therefore, the Guidelines for Assessment of Enterprise International Control require companies to disclose some important aspects in assessment reports.

a) The statement of authority of internal control report of boards of directors. In essence, all members of boards of directors are responsible for the effectiveness of internal control
b) The scope, which is objective, and business items that are assessed
c) The evidence of assessment including basic guidelines, assessment guidelines and assessment methods
d) The overall situation of internal control assessment
e) The conclusion of effective internal control
f) The measures to address internal control deficiencies and major defects
g) The process and means of assessment. Internal control weakness and affirmation, which mainly describes the measurement of internal weakness. This should remain the same as the previous year. It also needs to ensure the major defects, important defects and general defects are revealed

The Ministry of Finance is trying to employ an internal control assessment table, which will make it easy to compare the internal control assessment reports of different companies and is beneficial for the user to read and understand (Liu, 2010).

China SOX is an important tool to strength management of listed companies and unlisted large and medium-sized enterprises comprehensively, as well as an important institutional arrangement in order to respond to the international financial crisis (Liu, 2010a). The Application Guidelines consist of 18 aspects, definitions and examples. The Evaluation Guidelines require firms to perform comprehensive assessments on internal controls. They are generally in line with the United States' SOX. The audit section of the Supplementing Guidelines provides basic requirements for performing internal control audits. *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* specifies the scope, effective dates and requirements for implementing the Internal Control Basic Standard and signifies that the Chinese regulators are finally mandating this compliance requirement.

To make companies grow stronger and bigger, improve core competitive ability and management as well as win in the global market, Chinese companies must convert from accounting control to risk control (Liu 2010b). Chinese internal control indeed has its special characteristics. China places more value now on internal control to ensure economic information safety. Low internal-control effectiveness is common in China today, so it is urgent to pinpoint the determinants of internal-control effectiveness and find solutions to these problems. Chinese internal-control new regulations (non-financial internal control and mandatory disclosure) and unique institutional background (political, culture, legal, capital market and corporate governance) provide a unique opportunity. The implementation of China SOX will be useful to improve internal-control effectiveness in China. Based on an emerging economy and a non-U.S. single-country, China SOX may set an example and provide advice for other countries that have a similar institutional background.

4. Comparison between China SOX and US SOX

There are “quite a lot of similarities between the PRC regulatory requirements and the American Sarbanes-Oxley Act section 404”, according to KPMG’s China Boardroom Update: International Regulatory Development, (Issue 2, April). But there are also some differences between the China SOX and US SOX. In this section, we compare the definitions, classifications, disclosure and person in charge of China SOX and US SOX.

Definitions

The backbone of China SOX is the COSO risk framework. However, Basic Standard (2008) uses a broader definition of effective internal control than SOX 2002. Internal control is defined as “a process, implemented by an entities’ board of directors, board of supervisors, management and other personnel, with the aim of realizing control goals. There are three goals including the effectiveness and efficiency of operations, the reliability of financial reporting and compliance with applicable laws and regulations (Basic Standard 2008, Section 1). The definitions of SOX (2002) focus on the reliability of financial reporting, while the Basic Standard (2008) pays more attention to deviation from the control goal. That is, the Basic Standard (2008) not only focuses on internal-control weaknesses over financial reporting, but also concentrates on internal-control weaknesses over non-financial reporting. Li (2011) explains that China is in a period of transformation of its economy and society, where-in the capital market is comparatively weak, resulting in the Chinese government needing to take prudent measures. China SOX has proposed internal control over non-financial reporting and required Chinese listed firms to disclose and audit internal control deficiencies over non-financial reporting only since 2012. Overall internal control should include both financial reporting and non-financial reporting. China is the first country to include non-financial reporting in internal control. China SOX provides a unique setting to study internal control over non-financial reporting. In the internal control international seminar (South Africa, 2008), international experts consider it is an important institutional arrangement that respond to many accounting scandals and international financial crisis.

Classifications

There are three weakness-classification schemes. Based on the reasons for internal control problem, internal-control weaknesses include design weaknesses and operating weaknesses (Basic Standard 2008). In common with SOX (2002), three types of internal-control weakness are defined by Evaluation Guidelines (2010). Listed in increasing order of severity, there are control deficiencies, significant deficiencies and material weaknesses. Material weaknesses are defined as a significant deficiency or combination of control deficiencies, which causes the firm to deviate from the goal seriously. Finally, the monitoring of audit committee and internal audit over internal control is ineffective. Significant deficiencies are defined as a control deficiency or combination of control deficiencies that may cause the firm to deviate from their goals. The severity and economic consequences of significant deficiencies are lower than for material weaknesses. Other deficiencies are control deficiencies. However, unlike in SOX (2002), there are no clear definitions and assertions of internal control weaknesses in the Evaluation Guidelines (2008), but firms make their own assertions on internal control weakness and must keep the assertions unchanged once they are made. There are three aspects showing potential material weaknesses. First, auditor-detected fraud by boards, supervisors or senior managers. Second, the firm restating their financial reporting. Third, auditor-detected material misstatements in financial reporting, where the firms failed to detect them. Given the varying effectiveness of internal controls among Chinese firms and the general low level of internal control, it is reasonable for firms to assert their own internal control weaknesses. But lack of conformity in assertions may result in difficulties of operation and high cost for firms. Chinese firms may refer to [in full] (PCAOB, 2004) definitions on weaknesses to assert [define?] their internal control weaknesses. These detailed definitions and assertions should be issued in the near future.

The Evaluation Guidelines (2010) classify internal control weaknesses based on economic consequences, while the Auditing Guidelines (2010) deeply analyse the resources of internal-control weaknesses and divide internal-control weaknesses into internal-control weaknesses of financial reporting and internal-control weaknesses of non-financial reporting. Internal-control weaknesses of financial reporting may lead to firms providing false accounting information for the market, which causes investors to make wrong decisions. When internal-control weaknesses in non-financial reporting results in a decline of profits and wrong material decisions, this damages the interests of investors. However, the definitions and assertions of internal control of non-financial reporting are also missing in the Basic Standard (2008). The three classifications of internal-control weaknesses can be used to fully measure the various types of weakness disclosure in China.

Disclosure

SOX 2002 only requires firms to disclose internal control over financial reporting, rather than overall internal-control information based on the consideration of cost-effectiveness. Unlike SOX 2002, in the China SOX internal control, material weaknesses in non-financial reporting are also required to be disclosed in internal- control auditing reports. Internal control of non-financial reporting refers to other controls apart from internal control of financial reporting. The goals include maintaining the safety of assets, the effectiveness and efficiency of operations, compliance with applicable laws and regulations, and realising development strategy. The Audit Guidelines (2010) declare that auditors should treat differently any detected internal controls of non-financial reporting. They do not need to disclose control deficiencies in the report, instead, they only need to communicate with firms and remind them to improve internal control. If they detect significant deficiencies, they need to write to the board of directors and management. When they detect material weaknesses, apart from writing to management and the board of directors, they are also required to disclose the nature and severity of internal-control material weakness in the annual reports (Audit Guidelines 2010, p.9). Basic Standard (2008) requires a board of directors to disclose the effectiveness of internal control in self-assessment reports and the auditors are also required to formally opine in the annual internal control auditing reports on the effectiveness of internal control. Internal-control weakness disclosure includes both financial reporting weakness and non-financial reporting weakness. Specifically, the Evaluation Guidelines (2010) require firms to disclose internal-control weaknesses, the assertion of weakness, material-weakness remediation and measures for remediation in a self-assessment report.

Person in charge

SOX (2002) regulated that management should take the main responsibility in internal control. Unlike the American regulation, the Basic Standard (2008) regulates that the board of directors is responsible for the establishment and implementation of internal control and disclosing the effectiveness of internal control in self-assessment reports. It emphasizes that boards of directors have the highest responsibility. It also points out that boards of directors should fully recognise responsibility for internal control, and strengthen their guidance and supervision of the establishment and implementation of internal control (Basic Standard 2008, Section 2). Specifically, the Implementation Guidelines (2010) demonstrate that the board of directors is in charge of management development strategies. Directors need to play a leading role and set a good example through the establishment of effective internal control. They should lead and influence the whole team with their good characteristics and earnest attitudes to collectively create a positive work-culture environment (Implementation Guidelines 2010). The requirements for boards in China SOX differ from those in SOX, hence the Chinese case can be used to study the impact of boards, as the board is an important monitoring mechanism in internal control. Apart from boards of directors (implementation and perfection; evaluation), other important departments, including the supervisory board (supervision), top management (daily operations) and audit committee are responsible for internal control (evaluation) also. Every member in the organization is involved with internal control, in a similar manner to the United States' SOX.

The Basic Standard (2008) advises that specialised organizations such as internal control teams should be established in firms. In order to design, establish, operate and improve internal control, a board should assign a special team to bear the responsibility and direct the construction and implementation of internal control. The internal-control team is responsible for the whole process of internal control including establishment, implementation and daily application of internal control (Basic Standard 2008, Section 2). The members of an internal-control team are generally board members and the board chairman is often the team leader. The establishment of an internal-control team will make it clear who is responsible for internal control and avoid any disorder caused by multiple management. This also provides an opportunity to study the role of internal-control teams, given that it is not a mandatory requirement.

Unlike the American setting, an enterprise's internal control is the "boss" project (Wang 2012) in China. The chairman is the head of the internal-control team and is responsible for the construction of the internal-control system. In fact, the main responsible person in internal control in Chinese joint-stock enterprises and the final controller of internal-control system contracture is the board chairman (Li 2002). The top executive in a Chinese firm is the Board Chairman. He is the legal representative and the highest authority in the firm. The Chairman is also responsible for overall operations (Wu, Wu, Zhou and Wu, 2012). A Chinese Chairman is regarded as the top manager (Firth et al., 2007). Culture factors and the individual characteristics of key firm personnel may play an invaluable role in Chinese internal control. The board chairman is at the core of the internal control framework and the most influential figure at the centre of power (Dalton and Kesner, 1985). He or she commands and controls an enterprise in reaching a goal. KPMG (2010) compared the similarities and differences of Sarbanes-Oxley 404 and China SOX. The contents are listed in the below table.

Table 2 The Comparison of 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: China Boardroom Update: Internal Control Regulatory Developments. KPMG, 2010.

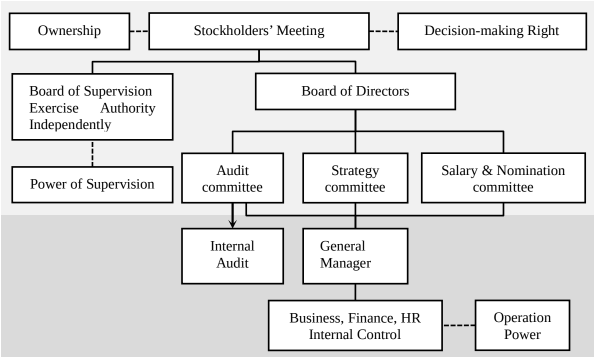
In summary, America has built a comparatively complete internal-control system based on the COSO framework, including many rules, standards, guidelines and interpretations (KPMG, 2010). By borrowing from SOX, China has started to construct an internal control theory and practice system. However, the Chinese people, politics, economics, market regulations, social environment and traditional culture are quite different from America. These factors enable Chinese internal control to have its own special characteristics (Li, 2009). The rich history, economic reform and unique culture offer a setting to study whether the internal control theories and practices of western countries can be applicable in a Chinese institutional environment (Peng, 2009). Business culture influences internal control (COSO, 1992). The Chinese business culture is affected greatly by traditional Confucian culture, which is quite different from western countries. China's unique cultural setting provides a research opportunity in internal control. Autocracy and democratic culture are significantly related to internal control. The democratic culture is beneficial to the improvement of internal-control effectiveness (Li 2012). When China implements and develops internal control, not only will China endeavour to learn advanced ideas and methods from America and other developed countries in order to perfect Chinese internal control, but also it will be necessary to consider China's unique context.

5 Discussions

China SOX is an underdeveloped legal framework and there are no relative punishment measures for those firms with poor internal control, which may cause questions about its weak enforcement. Enforcement is more important than the standard itself (Ding and Su, 2008). Compared with the US SOX, the China SOX seems to lack strong implementation due to weak legal liabilities. This may influence the consequences of China SOX. The capital market is also weak in China, while the government remains dominant (Hao, 1999). Because incentives to improve internal control are lacking, the human capital and social capital of key members in Chinese firms play a more vital role in maintaining good internal control than regulations and systems do.

Corporate governance in many developed states with strong law protection is effective (Wang and Xiao 2011). But in China, corporate governance is weak (Chen and Chan 2009) and the governance structure is unique (Firth et al. 2007). The Chinese governance mechanism is interesting, but puzzling, because it is hampered by minimum protection of property rights and charged with monitoring growth of finance and economics (Chan et al. 2007). It is also difficult to explain how weak governance can result in strong economic performance. More importantly, Chinese government plays a critical role in corporate governance (Chambers 2005) and attempts to improve governance level (Lin 2001). Corporate governance plays a critical role in internal control enforcement. As can be seen from Table 4, in China, the structure of corporate governance is different from western countries. Boards of directors have decision-making power and are at the top of the internal control system.

Table 3. The Structure of Corporate Governance in China



Unlike in other states, Chinese governance dominates the regulation and enforcement of internal control (Wu et al. 2012). To some degree, governance completely dominates, affecting standard setting and international harmonisation of Chinese accounting regulation and enforcement. In developing countries, political ties are a widespread phenomenon. Chinese firms, especially, benefit much from political ties due to highly interventionist governments and weak rights protection (Wu et al. 2012). Chinese governance is always the principal player in the economy. It has controlling shares in almost all large listed firms and also controls most resource allocation channels (Ding and Su 2008).

Based on the unique setting in China, the Chinese government made a decision to implement China SOX in different enterprises in batches. That is because money, human resources and technology support are needed in order to implement internal control in a firm. Firms listed both domestically and abroad tend to be stronger, have better financial performance, more advanced technology and better staff. In particular, firms also listed in the United States of America have set up complete internal control systems according to the requirements of SOX. It is easier for them to set up internal control systems according to China SOX than for firms only listed in Mainland China. It is wise to let the firms listed both domestically and abroad implement internal control first. Then when other firms are ready to apply China SOX, they can start to implement internal control. The quality of internal control is different in those firms listed in both domestically and abroad and those only listed in China. The firms listed both domestically and abroad are considered to have better internal control (Accounting Department of the Ministry of Finance and China Securities Regulatory Commission 2012).

Different owners (state-owned enterprises and non-state-owned enterprises) have different influences on internal control in Chinese enterprises. Furthermore, local enterprises (where the ultimate shareholder is a local government) and central enterprises (where the ultimate shareholder is central government), family enterprises and non-family firms may have different levels of internal control. Firms in different industries also have different internal-control quality in China. Internal control in the financial industry, especially, is more effective than in non-financial industry, due to strict regulations (LaFond and You 2010). Similarly, Chinese regional development is uneven (Wu et al. 2012). The situation in China is complex and quite different from the [in full] USA. The design of China SOX takes Chinese characteristics into consideration. The differences between China SOX and US SOX reflect the unique Chinese background. During the process of implementing China SOX, there will be some problems. When the Chinese government solves these problems, they must consider the unique Chinese setting. It is not wise to only learn from the US SOX.

Cost-effectiveness is an important issue when a new regulation or law is promulgated. Cost-effectiveness means that the cost of implementation should be lower than investment. Only in that case can the business gain profit and the new regulation or law be effective. The cost of implementing an internal control should not exceed the expected benefit. The main reason why the American SOX defines internal control as only financial reporting aspects is that it is too costly to consider internal control of both financial and non-financial reporting. In fact, the implementation of SOX has greatly increased the cost of business in the USA. When China SOX requires listed firms to disclose both internal control over financial reporting and non-financial reporting in internal-control self-assessment reports and internal-control auditing reports, similar problems may appear. Enterprises need to spend more energy, time and money on the establishment and implementation of internal control. If a firm fails to obtain enough profits to cover the cost of internal control, the internal control system is ineffective. Whether China SOX is cost-effective needs further testing.

According to China SOX, internal control includes financial control and non-financial control. Internal control of non-financial reporting refers to other controls besides internal control over financial reporting. The goals include maintaining the safety of assets, the effectiveness of operations, compliance with applicable laws and regulations and realising development strategies. China SOX requires "Chinese listed firms and their auditors to evaluate the effectiveness of enterprise internal control over both financial reporting and non-financial reporting and provide [the] annual opinions". Unlike US SOX, China SOX focuses on both internal control over financial reporting and non-financial reporting. Only China SOX proposes internal control over non-financial reporting and has required Chinese listed firms to disclose and audit internal-control deficiencies in non-financial reporting since 2012. Overall internal control should include both financial reporting and non-financial reporting. China is the first country to include non-financial reporting in internal control. China SOX provides a unique setting to study internal control of non-financial reporting.In the internal control international seminar (South Africa, 2008), international experts consider internal control over both financial reporting and non-financial reporting to be the most effective response to the international financial crisis. It is an innovation to consider internal control of non-financial reporting, because internal control of non-financial reporting may be more important and have a greater influence on internal control over financial reporting and economic safety.

China SOX pays attention to human rights as well as financial performance. This is important because it makes people focus on human factors in a firm. Under the guidelines of non-financial internal control, Chinese firms set internal-control objectives, conduct effective and low-cost training, manage control documents and processes, prepare for internal control audits and improve the quality of internal controls. “Internal control is the control of people” (Carmichael 2005). In essence, people are more important than the system. Even if an internal control system is perfect, it still needs people (Wang 2012). The core problem of internal control is to establish a complete internal-control system to control possible risks from the behaviours of different people, and then ensure that risk is controllable and bearable, which is the most important problem to be considered in order to control risk and protect the security of operations (Li 2007). The nature and form of an internal control system is materially affected by the view of human behaviours held by those who design, operate and audit it (Carmichael 2005). Internal control is established and implemented according to each person. Control concepts will be formed in the company, which will affect the effectiveness and efficiency of internal control directly. The internal control system consists of people and procedure. People are expected to perform and report according to rules and regulations. If they do not perform as expected, then the internal control will lose effectiveness (Carmichael 2005).

To decrease cost in the long term, firms must integrate internal control into their business culture. Business culture influences internal control (COSO 1992). Chinese business culture is affected greatly by traditional Confucian culture, which is quite different from western countries’. In a firm with an autocratic culture, lower labour levels are respected and trusted, and control goals are realised by the initiative and enthusiasm of the staff. Encouragement rather than punishment is used in this culture. In contrast, enough communication is absent in democratic culture. Power and authority are employed to manage from top to bottom. Wrong behaviour and disobedience are punished severely (Li 2012). A good business culture should be built in a firm in order to maintain a high quality of internal control. The organisation culture of Chinese enterprises should shift to risk management and responsibility awareness as soon as possible.

“Guanxi” or personal relationships are very important in China, and this affects internal control and firm management. Guanxi influences firm performance (Nahapiet and Ghoshal, 1998) and the outcomes of boards (Tian et al. 2011). Group performance depends on the capacity to deal with internal and external information obtained from relationship networks. Boards with stronger networks can better access more information, which leads to better advice and counsel, financial results (Carpenter and Westphal, 2001) and corporate governance (Wu et al. 2008).

There are a lot of things needed in adopting China SOX. It introduces new ideas and theories. For a great many Chinese companies of different sizes and situations, there may be some confusion and resistance to deal with. China SOX is a complex and broad regulatory requirement. The most important criterion of whether the implementation of China SOX will be successful in a Chinese firm is to maintain support from the whole firm. Though the Board of Directors is responsible for internal control and risk management, various departments and all members should also take responsibility. Participation from every level of a firm is required to ensure good internal control, so a firm must ensure all workers participate actively in internal control implementation. Chinese firms also must take advantage of good outside consultants (Raymond 2009).

In terms of the effectiveness of China SOX, Wang and Zhang (2009) used hand-collected Chinese listed companies that have implemented China SOX in 2008 to study the effects of China SOX. They found that the implementation of China SOX is different from US SOX 2002. China SOX shows a significant positive effect. The internal-control reporting system greatly improved internal-control report quality. The existing penalty measures have a strong substitutionary effect, which decreases the cost of regulation. Different auditing firms issue internal-control reporting and financial reporting, which makes the internal-control reporting effect more significant.

Similarly, Accounting Departments of both the China Securities Regulatory Commission and

Ministry of Finance (2012) analyse the implementation conditions of internal control for firms listed both domestically and abroad, based on information disclosures from internal-control self-assessment reports and internal-control auditing reports. The firms listed both domestically and abroad first carried out China SOX from the beginning of 2011. There are sixty-seven such firms listed in Hong Kong, London and the USA. All firms disclosed an internal-control self-assessment report, internal-control auditing report and a financial report. Sixty-six firms offered positive opinions about internal control. Only one company assessed its internal control as ineffective and there was internal-control material weakness in this firm. Forty firms reported internal-control deficiencies. But only six firms among them disclosed both numbers and contents of internal-control deficiencies. Some firms only found one deficiency, while some companies discovered one thousand deficiencies. The differences are huge between those firms. Five firms did not mention remediation measures or plans. Among the firms that disclosed remediation methods, some descriptions are quite simple. None of firms disclosed internal-control weaknesses in non-financial reporting. Sixty-five firms omitted this. In general, these firms implemented internal control well in 2011 and set a good example for other Chinese firms. However, there are still some problems. Firstly, firms should raise their awareness of internal control. Secondly, internal-control professionals are lacking, which restricts the development of internal control. Thirdly, method guides for the implementation and assessment of internal control are needed. Lastly, the effectiveness of internal-control report information needs to be improved. With internal-control consultants, personal quality and service quality are uneven. The pertinence of service is not strong and is not combined with business management. When it comes to internal-control auditing, more attention should be paid to internal-control auditing and skills standards and training should be strengthened. The personal structure of auditing teams needs to be perfected and information auditing is weak.

In conclusion, as a formal internal control regulation, Basic Standard has important implications for the development of internal control. China SOX is changing the way China does business. It has required listed firms to disclose material weaknesses and provide remediation of both financial reporting and non-financial reporting in internal-control self-assessment reports and verification reports since 2012. It also points out the vital role of boards in internal control. Chinese new internal-control regulations and its unique institutional background offer research opportunities to study non-financial reporting before and after China SOX.

6 Conclusions

China SOX, China's version of the SOX 2002 with supporting guidelines, was issued in 2008 and 2010. The Basic Standard mirrors its counterpart (in the United States of America) in many aspects. The aim of China SOX is to improve financial reporting quality, increase internal control effectiveness and reduce risks of stakeholders and firms. Although internal control theory and practice in China falls behind America and other developed countries, China SOX contributes to the development of internal control, which has made great progress recently. In comparison with similar countries in the world, China has done better because it has an evolving internal control regulatory framework (Ku 2012). US SOX offers experience in implementation, which will be helpful to China in tackling difficulties and problems during the implementation of new internal control standards in a short period of time. There are some flaws in "China SOX", but it is necessary and will be effective in introducing and implementing internal control in China.

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