Instituto Superior de Ciências do Trabalho e da Empresa

Research of internal control of Chinese enterprises based on Sarbanes-Oxley Act

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Resumo

Os grandes escândalos empresariais e falências, como a da Enron e da Worldcom, que ocorreram nos Estados Unidos provocaram o aperfeiçoamento das leis que protegem os interesses dos investidores e o aumento da transparência das operações comercias das empresas cotadas em Bolsa. A Lei SOX (Sarbanes-Oxley), que visou o aumento da confiança nos relatórios financeiros e o melhor controlo interno dá a necessária garantia do reforço dessa confiança. As directivas do SOX são o momento em que o mercado de capitais passou a exigir um nível mais elevado da exigência da forma da administração das empresas e da transparência das suas informações. A gestão tem que prever e provar um sistema eficaz de controlo interno, devendo as suas concluções serem publicadas no respectivo Relatório Anual. Ao longo do desenvolvimento económico da China, as empresas chinesas enfrentam o desafio do controlo interno eficaz.

Para analisar a importância de tal controlo e os perigos decorrentes da sua negligência, esta dissertação parte de um estudo de caso para tomar o pulso à influência da Sarbanes-Oxley sobre o controlo interno das empresas chinesas. Por força dessa investigação, pretende-se também propor medidas administrativas no sentido de assegurar a correcta implementação de um sistema do controlo interno. Sabendo que orientação e regulamentação do controlo interno obedecem a abordagens diferentes e a sua convergência é incerteza absoluta, não há dúvida de que o controlo interno é condição prioritária para uma boa governação empresarial.

Key words: Sarbanes-Oxley controlo interno empresas cotadas empresas chinesas

JEL Classification: G32 G38

Abstract

Prominent corporate scandals and bankruptcies, such as Enron and WorldCom, have occurred in the US and have led to enhanced legislation to protect investors' interests and increase transparency of business operations in the listed companies. The Sarbanes-Oxley legislation (SOX) improved the reliability of financial reporting and established internal accounting controls, which will serve to provide reasonable assurance of such reporting. SOX enforcement marks a new epoch in which capital markets require establishment of corporate governance and information exposure. The management of these corporations must evaluate and test the internal control system effectively and results should be published in the annual report. Along with the economic development of China, Chinese enterprises face the challenge of providing effective internal financial control.

In order to analyze the importance of internal control, as well as threats brought about by ignorance of internal control, this dissertation is based on a case study of UT Starcom, which analyzes the Sarbanes-Oxley Act and the influence of internal control on Chinese enterprises. Through this case study, suggestions can be made to Chinese government bodies and the management of companies to ensure their organizations utilize effective internal control systems. Despite global differences in the approach to guidance and regulation on internal control, the prospects for convergence are uncertain. The only firm point of effective internal control is fundamental prerequisites of good corporate governance.

Key words: Sarbanes-Oxley Act Internal control

Public company Chinese enterprise

JEL Classification: G32 G38

1. Introduction

1.1 Objective

Chinese enterprises have developed quickly by adopting advanced technology and absorbing overseas capital. Since the implementation of the open door policy in late 1978 and particularly China's entry into the WTO in 2000, the Chinese economy has become an indispensable part of world's economy. Over the past several years, it was very popular for Chinese enterprises to enter overseas markets in order to pursue high profit margins. Currently, more than 50 Chinese companies are listed on the US Securities and Exchange market.

However, the scandal of public companies gave investors a shock in the Chinese stock market. Also, UT Starcom[1] and LUCENT[2] were fined by the SEC in the US. These situations should make other public companies aware of the benefits of implementing internal controls effectively in corporate governance. This thesis shows it will help companies when they achieve objectives related to the reliability of financial reporting, compliance with laws and regulations, and effectiveness and efficiency of operations. Chinese listed companies lack effective internal control mechanisms and it is the lack of official strict regulations and relevant punitive measures that make them vulnerable to scandal and corruption. The Sarbanes-Oxley Act of 2002 ushered in a new era of supervision in the capital markets. It establishes the framework for accounting, auditing, corporate governance and securities supervision. In Section 404, it requires issuers to assess the effectiveness of the internal control, and a registered accounting firm must attest to and report on the assessment. This thesis intends to coordinate related internal control theories and the Sarbanes-Oxley Act with Chinese enterprises and the case study. Therefore, it will provide helpful information to Chinese listed companies with the problem of internal control both in China and in overseas capital markets.

[1] 2 May, 2008 Two UT Starcom executives were fined by the US Securities and Exchange Commission , settling allegations of false financial reporting.
[2] 2 January, 2008 Alcatel-Lucent says it has reached an intercession agreement with the United States Department of Justice on the bribery scandal in China and will pay US$2.5 million in fine.

1.2 Research Background

Enron's [3] sudden application for bankruptcy protection in December 2001 as well as WorldCom's account scandal in June 2002, has had an "absolute striking impact on the confidence of American investors in the capital market in the US". In order to restore investor confidence, the US government formulated and enacted a series of legal regulations in which the most important is the Sarbanes-Oxley Act[4] (hereafter referred to as Sarbanes Act). The Sarbanes Act is an important law and adds to investor protections provided by the Securities Law of 1933 and the Securities Exchange Law of 1934. During a press conference held at the signing of the Sarbanes Act, US President Bush called it "the most influential and revolutionary legal act in the business community since President Roosevelt".

Compared with existing securities acts in the US, the Sarbanes Act requires periodic evaluation of the effectiveness of internal controls from the executive level in public companies and results must be stated in the latest annual report with emphasis on its importance. Within the Sarbanes Act, one of the most important articles is 404, with specifications that corporate executive levels of public companies and external auditors must make evaluations and report with respect to the internal control system in the financial report generated by the company. External auditors must also conduct corresponding checks and issue official opinions on the evaluation process at corporate executive levels, as well as their conclusions on the internal control system. For example, opinion reports must be issued on the accuracy and integrity of management applications based on the previous financial report and they must also report on the existence and effectiveness of internal control systems in the company[5]. Therefore, article 404 of the Sarbanes Act establishes higher requirements for the effectiveness of internal governance and improvement of internal control systems within the company.

[3] In December 2,2001,the America based Enron Corp. filed for bankruptcy protection with the New York Bankruptcy Court and set a record of biggest bankruptcy case in U.S. history.
[4] Responding to a number of corporate scandals, the United States federal government has enacted the Sarbanes-Oxley Act of 2002. The Act, among other things, creates a framework at enhancing the duties and obligations of corporate directors and officers by imposing thereon responsibilities and strengthens the oversight function of the Securities and Exchange Commission.
Sarbanes-Oxley Act2002 from http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf
[5] Price-Waterhouse .Guidance of 404 Act of SOX source from http://www.pwc.fr/fr/pwc_pdf/pwc_soa_guide.pdf

Obligatory requirements of the US Securities and Exchange Commission along with pioneering legislation for establishing internal controls, the Sarbanes Act is becoming a major influence to more and more Chinese enterprises. This is especially true for those enterprises already listed in the US as well as those planning to be listed in the US[6]. To be in compliance with the validity date of the Sarbanes Act, companies in the US must conform to Article 404 in the financial year after Nov.15, 2004. Apart from that, the date for other companies to comply was July 15, 2006. Therefore, it is imperative to comply with the Sarbanes Act for Chinese enterprises listed in US stock exchanges. Furthermore, internal control is the product of a social economy with development in certain stages. It is an important approach for modern enterprise management. In modern society with an advanced information industry, consistent improvement of an internal corporate control system is of great significance regarding the prevention of corruption and a reduction of earning losses. This will also lead to a promotion of capital regenerating capacity. As China has started late in terms of corporate internal control and without established theoretical systems, there is a large gap compared with developed countries in the west. Therefore, in consideration of the newest and most established theories in the world, as well as the search for various inspirations of corporate internal controls and formulating systems in China, it is viable to effectively promote these ideas to corporate management levels in China and increase enterprise value. Quick implementation of internal controls associated with enterprise and finance in China's businesses will result in avoidance of risk and promotion of international competency.

1.3 Research Method

This dissertation is based on a case study of the UT Starcom company with a combination of theory and practices regarding the corporate evaluation of the internal control process. This dissertation will investigate and analyze relevant data from UT Starcom to demonstrate the importance of internal controls as well as problems caused by the lack of controls. In 2006, UT Starcom delayed publishing its 2005 annual report. Price-Waterhouse-Coopers, the external auditor of the company, had issued an audit report indicating that UT Starcom does not have adequate internal control, and corporate executive levels could not confirm the accuracy of

[6] E&Y.Emerging Trends in Internal Controls-U.S. Listed Foreign Private Issuers Second Survey and Section 404 References.

financial statement in 2005. According to the auditing report, there were 10 pages describing flaws in several aspects of the internal controls. The internal controls used by UT Starcom were found to be substandard and did not meet requirements of the Sarbanes-Oxley Act and therefore, the Securities and Exchange Commission fined the company.

1.4 Structure of the Dissertation

The structure of this dissertation includes 6 parts. Part one, the introduction, describes the background, significance, and objective of this dissertation.

Part two explains the basic theory of internal controls. It introduces the evolutionary process of internal control theories and policies.

Part three examines the influence brought about by internal controls in Chinese enterprises. It mainly introduces the background and main content for the formulation of the Sarbanes-Oxley Act, and conducts analysis on important articles about internal control. It also looks at the considerations that go into establishing an internal control system.

Part four features a case analysis. It analyzes problems caused by UT Starcom's inadequate internal controls, thus showing the importance of proper internal controls.

Part five contains implications and suggestions from the Sarbanes Act for corporate internal controls in China. The Sarbanes Act features guidelines for establishing and implementing corporate internal control systems and capital market supervision and governance in China.

Part six is the summary and conclusion.

2. Basic Theory on Internal Control

2.1 The Concept of Internal Control

Internal control is a product of a social economy with development into certain stages. It is an important approach for modern enterprise management, with the idea that internal controls are established and implemented in stages along with the development of the company's management. Compliance with social requirements from the environment outside the company, gradual introduction of auditing theories, methods and systems, has become one of the basic characteristics for development of modern auditing. In modern society, with a developed information industry, continuous improvement of corporate internal control systems has a positive impact on prevention of corrupt practices, reduction of losses and promotion of capital regenerating capacity. Simply put, *internal control means different things to different people. This causes confusion among business people, legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an enterprise*[7].

Internal control is integrated through all aspects of the corporate management process, and it will expand to every level of the corporate operation and management. Internal control is not only a crucial part of corporate management, but also functions as a guarantee for financial security and authenticity of account information in corporate management. More importantly, internal control is also an element for corporate governance. Internal control in relation to corporate governance is not merely an approach for the daily management of the company so that management can achieve accurate knowledge of the essence of internal control as well as internal control functions. It is much more.

With regards to the definition of internal control, there are various viewpoints within the domestic academic community:

In 1949, the auditing program commission with the US Accountant Association had a definition for internal control in their report "Internal Control". It was titled "One Coordination

[7] Adapted from Executive Summary of Internal Control – Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission on website (www.coso.org).

System Factor and Its Importance on Management Authority and Independent Accountant" and put forth the following definition:

> "Internal control includes organizational structure design and methods and measures of all mutual coordination adopted within the enterprise. Such methods and measures are all applied to the protection of corporate property and inspection on accuracy of account information so as to promote operational efficiency and inspire companies to stick to predetermined management policies."

In 1992, The Committee of Sponsoring Organizations of the Treadway Commission (hereafter referred to as COSO), jointly organized by the US Account Academy, the Registered Accountant Association, the International Internal Auditors Association, the Financial Manager Association and the Management Account Academy to release the report Integrated Framework of Internal Control. The report states that internal control is affected by the enterprises board of directors, governance authorities and other employees, with purposes for the provision of a reasonable guarantee for acquiring operational effects and efficiency, reliability of financial report as well as compliance with appropriate regulations.

No.9 Specifications of Independent Auditing—Internal Control and Auditing Risk [8] implemented in 1997 defined it as:

> "Internal control is policies and programs formulated and implemented for effective processing of business activities, protection of capital security and integrity, for avoidance, detection and rectification of mistakes and corrupt practices, and guarantee of authenticity, legality and integrity of account material."

In 2006, the Shanghai Securities and Exchange Office released *Guidance on Internal Control of Listed Companies in Shanghai Securities and Exchange Office* [9] with the following definition:

> "It is the related system arrangements by which listed companies ensure the realization of corporate strategic goals and conduct management over formulation of strategies within the company and existing risks within operational activities. It is an activity participated with joint efforts from board of directors, executive level as well as all staff members of the company."

[8] No.9 Specification of Independent Auditing—Internal Control and Auditing Risk.This standard takes effect from 1 January 1997 Source from http://www.9iwm.com/english/arc/legal_flyy/z709f13477709.htm

[9] Guidance on Internal Control of Listed Companies in Shanghai Securities and Exchange Office from http://www.lawinfochina.com/law/displayModeTwo.asp?id=5229

In the same year, the Shenzhen Securities and Exchange Office released *Corporate Internal Control Guidance of Listed Companies at Shenzhen Securities and Exchange Office*[10]. It stated that internal management is:

> "A process for providing reasonable guarantee for realization of the following purposes from board of directors, board of supervisors, senior management staff and other related staff: (I) compliance with stipulations under state laws, regulations, formulations as well as other related stipulations; (II) promotion of operational performance and efficiency of the company; (III) guaranteeing company asset security; (IV) guaranteeing the authenticity, accuracy, integrity and fairness of corporate information disclosure."

With a synthesis of the above definitions, it is viable to conclude:

First, the definition of internal control in China develops with the evolution of the economy. For the requirement of corporate operations, functions of internal control have developed from error inspection and prevention of deception at an early stage to promote corporate management efficiency. The Shanghai Securities and Exchange Office and Shenzhen Securities and Stock Office have reached consistent ideas on the definition of internal control similar to viewpoints in America.

Secondly, the comprehension of internal control in the past indicates this is one set of "policies and programs"[11], i.e. as an enterprise, it is viable to follow this procedure. It is perceivable from recent definitions that the definition on existing internal control focuses on two factors. One is its emphasis on all-member participation, especially participation from owner, managers and all-board members. The other is that it down plays the viewpoint that internal control is merely a process, indicating that the set up and execution of an internal control system has activity with emphasis on the promotion of corporate operational efficiency as a basic objective.

Thirdly, COSO considers that internal control promotes management efficiency, reliable reporting and operational legality. The view of the Shanghai Securities and Exchange Office shares similarities with that of COSO. Viewpoints of the Shenzhen Securities and Exchange Office that offer a "guarantee of corporate asset security" reflect~~s~~ the combination between globalization and the traditional viewpoint in China. Both are recently released systems with

[10] Corporate Internal Control Guidance of Listed Companies at Shenzhen Securities and Exchange Office from http://www.daretechnology.com/products/fg3-3.pdf

[11] Chen xin sheng Research of Interactive Relation among Corporate Governance, Internal Control and Organization Structure

results that are awaiting the achievement of expectations. However, as China is within the gradual process of entry into the international market, enterprises should understand and accept such a trend of reform.

2.2 Integral Framework of Internal Control in the US

The Integral Framework of Internal Control in US is a research report released by The Committee of Sponsoring Organizations of the National Commission of Fraudulent Financial Reporting. COSO is an independent organization established in 1985 and devoted its research on possible factors leading to fraudulent financial reporting, and make suggestions to public companies, auditing companies, securities and exchange commissions as well as other organizations. COSO has five main sponsors: The American Accounting Association, American Registered Accountant Association, the American Financial Managers Association, the American Internal Auditing Association as well as the American Management Accountant Association. In addition, COSO also includes representatives from industry, public accounting, the American Investment Company, and the New York Securities and Exchange Office. COSO focuses on research independent from the individual status of each sponsor, so as to ensure justice of the research.

COSO has defined internal control as: influenced by corporate board of directors, government authorities and other staff members, it is a process of rational guarantee with purposes of achieving operational effects and efficiency, reliability of financial reporting, and compliance with appropriate laws and regulations. In other words, COSO has four core concepts for internal control.

First, internal control is a process. It is an approach for achieving purposes, but not the objective itself.

Secondly, internal control is operated by human beings. It is not solely policy and regulations, but a process of common operations from people in various aspects of the organization.

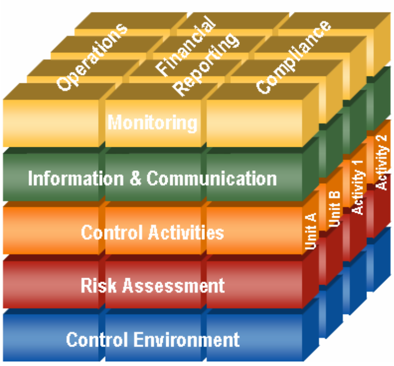
Thirdly, for the executive level and the board of directors in a company, internal control could only provide a reasonable guarantee but not an absolute guarantee.

Last of all, each internal control process has one or several different control points. With a combination of such processes, it is viable to repeatedly confirm the overall control objectives for the business.

So far, COSO has released research reports including: the TREADWAY report in 1987; the *Internal Control Integral Framework* in 1992; the *Internal Control Problem Research Used by Financial Derivative Tools* in 1996; the *Report of Fraudulent Financial Report* in 1999; *Overall Framework for Enterprise Risk Management* in 2004; and most recently, the *Internal Control Guidance of Financial Report on Small Scale Listed Companies*. Two of the reports, *Internal Control Integral Framework* and *Overall Framework for Enterprise Risk Management,* contain subject matter and research about public companies in America.

The *Internal Control Integral Framework* (hereafter referred to as IC-IF framework) report published in 1992 includes 5 parts of control. They are the environment, risk evaluation, control activities, information and communications, and supervision. The IC-IF framework uses a three-dimensional diagram to provide standards of evaluation internal control for executive levels[12]. Refer to figure 1[13]:

Figure 1 - Framework of internal control from COSO



[12] Internal Control-Integrated Frame work COSO, http://www.COSO.org
[13] Figure 1 of Overall Framework of Internal Control from COSO Framework P.69

The first dimension (top) is the internal control design and its function is to confirm the achievement of the following objectives: operational activities are effective, financial reporting is reliable, and corporate operations are in compliance with laws and regulations.

The second dimension (right Side) is the corporate management and operational activity aspect for implementing internal control. Internal control must conduct evaluations in terms of two such aspects: the corporate aspect and the process flow aspect.

The third dimension (front) shows the use of internal control and lists the five required activities: control environment, risk evaluation, control activities, information and communications, and monitoring. For evaluation, these are also five important activities for the IC-IF framework. They provide the framework for internal control as well as a basis for information disclosure (from lower to upper side at front side of the figure). Aligning the sequence like this also serves as a method for setting up internal control in the company or for evaluation of internal control by foreign staff. Specifically, the control environment represents the enterprise's attitude towards internal control and serves a basis for the overall system. COSO thinks that controlling the environment has seven elements: integrity and ethic values; dedication to promotion of staff capacity; concept and style of management level; organizational institutions; distribution of rights and responsibilities; HR policies; and a degree of involvement with supervising authorities.

Risk evaluation is the starting point of the internal control system. The management level must analyze risks they will encounter as well as determine what their influences will be in conjunction with possible mistakes in important account data, disclosure of events and related financial reports. Risk evaluation has sub-elements of existing business risk evaluation and fixed risk evaluation and only accurate risk evaluation and knowledge could purposely formulate internal control policies.

Control activities include approval, authorization, authentication, verification, review of work achievements, asset security and assignment of obligations. Analysis of control over such activities includes several types: precautionary control and inspection-based control; manual control and computer control; management level control and process flow control. In compliance with the business nature and sophistication, the company needs to organically integrate various control activities so as to confirm one objective of corporate financial reporting.

There are two types of information, external and internal. External information mainly refers to information on industry, economy and laws; internal information refers to business information in dissemination in several aspects. The management level must pay attention to systems and programs dedicated to the collection of financial information as well as confirmation of appropriate, timely and accurate acquired information.

Supervision is a process for executive levels to evaluate the quality of corporate internal control. Supervision consists of the following three elements: consistent supervision; periodical supervision; and, exception reporting. Theses three aspects represent the operational roadmap of the IC-IF framework. For any objective that the management levels need to conduct evaluations, they should use the elements of internal control from the viewpoints of the company and process flows.

2.3 Integral Framework of Internal Control in China

Establishing an internal control system not only requires attention from the American Securities and Exchange Commission, but also an eternal theme for modern corporate governance. There has been a series of operational failures and fraudulent practices in companies that are associated with design, execution, and supervision of internal control. We can say that the reasonable and careful construction of an internal control system and the establishment of effective and orderly process implementations are requirements for the promotion of core corporate competency. This applies to listed companies and those in the process of becoming listed in the US.

There are many inadequacies in the construction of internal control. Domestic enterprise managers have a long history of people governance and the traditional eastern thought process has difficulties in formulating internal control systems with concrete objectives and complete factors and functions. Even though there must certainly be a system, it is difficult to guarantee complete execution based solely upon the system. As China is currently at a stage of transition towards a market economy, the state-owned economy has a predominant status in the market. Under conditions of the coexistence of multiple ownership systems, there are large differences in degrees of marketization in various regions and industries. Enterprise objectives often seek more market opportunities and ignore the requirement of internal control[14]. Although there are some requirements in corporate laws, securities law, and accounting laws, there are no all-encompassing descriptions. It has taken into account the statistics in recent years that national laws and regulations on "internal control" have specific reflections as shown in the following table:

Table 1 – General Table on Laws and Regulations over Internal Control in China[15]

Laws and Regulations	Enacting agency	Date of implementation
Implementation Procedures of Reviewing Solutions for Internal Control System	People's Insurance Bank of China	April, 1994
Reviewing Method for Internal Control System with Bank of Communications	Ministry of Communication	July, 1996
Auditing and Trial Methods for Internal Control System Within Electric Power Enterprises	Electric power Department	January, 1997
No.9 Specifications of Independent Auditing—Internal Control and Auditing Risks	Financial Department, China Association of Registered Accountants	January, 1997
Guiding Principles for Strengthening Internal Control of Financial Institutions	Farmer's Bank of China	May, 1997

[14] Feng jun ke :Study on Internal Control Effectiveness Under the Different Property-right Structure China Industrial Economics 2001：8 P28-33

[15] table 1 the relevant contents are collected from http://www.chinalawandpractice.com/Channel/9846/Capital-Markets.html?Year=2007

Various Stipulations for Further Strengthening Internal Control and Management in Bank Accounting	The People's Bank of China	July, 1997
Implementation Method for Enterprise Internal Control System Reviews In Education System (trial)	State Education Commission	December,1997
Decisions by China Agricultural Bank On Further Enhancement and Improvement for Internal Control	China Agricultural Bank	January, 1998
Implementation Method of Auditing for Internal Control of Coal Enterprises	Coal Industrial Department	February, 1998
Temporary Stipulations On Internal Control of Commercial and Industrial Bank of China	Industrial and Commercial Bank of China	December,1998
Construction and Guiding Principles of Internal Control System within Insurance Companies	China Insurance Regulatory Commission	August, 1999
Guiding Principles On Strengthening Internal Control of Futures Corporation	China Securities Regulatory Commission	April, 2000
Guidance of Internal Control for Securities Company	China Securities Regulatory Commission	February, 2001
Guidance Opinions for Internal Control Reviewing	China Association of Registered Accountants	February, 2002
Guidance on Internal Control of Business Bank	The People's Bank of China	September,2002
Guiding Opinions on Internal Control in Securities and Investment Fund Management Company	China Securities Regulatory Commission	January, 2003
Guidance on Internal Control in Securities Companies	China Securities Regulatory Commission	December,2003
Opinions on Strengthening Various Measures for Internal Control at Office In Securities Companies	China Securities Regulatory Commission	December,2003

Evaluation and Trial Method for Internal Control of Business Banks	China Banking Regulatory Commission	December,2004
Guidance of Internal Control within Insurance Agencies (trial)	China Insurance Regulatory Commission	February, 2005
Internal Control Evaluation Method of Life Insurance Companies (trial)	China Insurance Regulatory Commission	January, 2006
Internal Control Stipulations in Financial Accounting of Healthcare Organizations (trial)	Health department	June, 2006
Internal Control Guidance for Investment Business Trials of Securities Companies	China Securities Regulatory Commission	June, 2006
Internal Control Guidance of Listed Companies in Shanghai Securities and Exchange Office	Shanghai Stock Exchange	July, 2006
Guidance of Internal Control for Listed Companies in Shenzhen Securities and Exchange Office	Shenzhen Stock Exchange	July, 2007

From the statistics above, we can see that laws and regulations in China have the following characteristics for establishing an internal control system.

The first characteristic is self-governance. From 1994 to 2000, internal control has mostly been aimed at internal control regulations within departments. Such regulations are limited to the statement of terms and clauses with common characteristics lacking conclusive uniform guidance and it requires highlighting department features when there are no specific operations. Internal control regulations without the support of real practices could only be viewed as a status because there are no good or bad evaluation standards.

Secondly, from 1997 to 2002, the China Association of Registered Accountants released auditing regulations and review opinions for internal control. In public corporations, financial departments are involved with internal control, but with viewpoints of the enterprise other than the design of internal control. The research of internal control from only the perspectives of accounting and auditing will inevitably lead to narrow viewpoints. Nowadays enterprises have experienced stages such as association of financial and management control and the integration of internal control and risk management, with its connotation far beyond its concept boundary of the original accounting control[16].

The third characteristic is the introduction of foreign opinions. As corporate operational methods and the operational environment go through major changes, there are many enterprises in China that already have or are planning to get listed abroad. Traditional internal control theories and real practices all need to be appropriately adjusted and the concept of internal control also must draw upon advanced theories and operational practices from outside of the country. This is the background for enactment of the Shanghai Stock Exchange Internal Control Introduction and the Shenzhen Stock Exchange Internal Control Introduction within the framework of COSO in China. These two introductions basically used the COSO framework as a model.

In summary, the overall status of internal control in China is not made up of rigid laws and numerous regulations rather it is a loose system of accepted practices.

In the latter half of 2006, many new guidelines were issued on internal control and risk management. An internal control system introduced by the Shanghai Stock Exchange Internal Control and the Shenzhen Stock Exchange Internal Control makes use of regulated controls over main business activities in compliance with actual domestic business conditions. It required listed companies to conduct self-evaluation over internal control, while external auditing would prepare its statement for the annual report. It released opinions about internal control reporting at executive levels. However the question is, does the corporate executive level have the capacity to design complete and reasonable control systems and insure effective operations? Do accounting business firms have opinions on internal control reporting at the executive levels with an independent and objective attitude? As there are no specific punitive

[16] Fang hong xing Internal Control, Auditing and Organizational Efficiency
Journal of Accounting Research 2002.7 P 41-44

measures for enterprises with disqualified internal controls or accounting firms that do not perform their full obligations, how can markets be assured the internal controls are valid? Additional observations are needed to reach a conclusion[17].

In addition, a report titled the *Guidance of Full-Round Risk Management in Central Enterprises*, was released by nation resource control committee in June 2006. It indicated that the full risk management process includes initial information collected about risk management, risk evaluation, formulation of risk management strategies, issuance and implementation of risk management solutions, and supervision and improvement of risk management. Is there only one introduction that could guarantee real implementation of risk management? The question remains of exactly how to design the assessment system, and the supervision and regulatory system for state-owned enterprise management levels. Such problems await further solutions[18].

In July 2006, The Financial Department established the "Standard Commission for Enterprise Internal Control", while the China Association of Registered Accountants established the "Internal Governance Commission With Accounting Firms". In December 2006, the Finance Affairs Department of the Accounting Regulating Commission established an auditing regulation commission with the China Association of Registered Accountants. In a board between the Enterprise Internal Control and Standards Commission and the Guidance Commission for Internal Governance of Accounting Firms, in-depth discussions were held on the construction of enterprise internal control and internal governance regulation systems with accounting firms. In January 2007, they released an opinion draft titled the "Accounting Firm Governance Guidance". As accounting authorities, this action carried out by the Finance Department has major influences on the enterprise. These actions will inevitably boost the development of internal control for Chinese enterprises, but enactment of the system can only provide the basics. There must be strict definitions for construction methods for complete implementation of the enterprise risk management and internal control system, adherence to the supervision mechanisms, and strict enforcement of legal penalties. Lastly, these systems must

[17] Deng chun hua: Economics Basic Analysis on Founding Enterprises' Internal Control System

[18] Han hui bo. Corporate Governance, Disclosure Transparency and Earnings Management (Thesis)

be regulated to a uniform legal aspect from an overall perspective.

2.4 Sino-US Comparison of the Internal Control Framework

As stated in the previous section, China has various laws and regulations over internal control but without the formation of system-based achievements. Therefore, comparisons will be made between Sino and US internal control systems from three viewpoints. The first comparison is between the COSO framework and Guiding Opinions on Internal Control Reviews, released by the China Association of Registered Accountants in 2002. The second regards the concept of "internal control" and the COSO framework in various laws and regulations of China. The third comparison will be made between the COSO framework and the Internal Control Guidance of Listed Companies put forth by the Shanghai Stock Exchange and the Shenzhen Stock Exchange.

2.4.1 Comparison between COSO Framework and Guiding Opinions of Internal Control Review

In 2002, the China Association of Registered Accountants released Guiding Opinions on Internal Control Reviewing, which regulates over the connotation of internal control review, program and reporting. It is guidance over corporate internal control from the aspect of auditing and it varies greatly when compared with the COSO framework. A brief comparison and analysis are made in the following table (refer to table 2):

Table 2 – Table of Comparison between Guiding Opinions of Internal Control Reviewing and COSO framework[19]

	Reviewing and Guiding Opinions on Internal Control	COSO framework
	Registered accountants should take into consideration	Evaluation of working capacity of management

[19] Table 2 is summarized and classified according to Audit Research 5.2002 -32-37 and COSO framework

Control environment	of the following factors: conditions of the industry with the reviewing unit, internal conditions with the reviewed unit, including organizational structure, operational characteristics, capital configuration, production, business process flow, staff quality etc; integrity of governance authorities, capacity and possibility of mal-practices;	levels, compliance with integrity and ethic values, HR resource policies, impeachment program against mal-practices as well as effectiveness of auditing commission etc;
Risk evaluation	Registered accountant's initial judgment on the importance, fixed risks and other major flaws related to internal control;	The management level needs to evaluate business risks, fixed risks and risks in corrupt practices. In which business risks need to judge whether objectives are in compliance with strategies, and countermeasures in regular events as well as temporary events. In addition, management level and internal reviewing department respectively conduct risk evaluation;
Control activities	Registered accountants should check on documents and recordings generated from internal control, and evaluate the rationality of internal control designs in	Control activities at management level include senior level evaluations, supervision program of the field at functional level, accuracy, integrity and

	compliance with the fact that whether internal control is capable of preventing and detecting major false alarms on authentications in accounting report;	authentication for information processing, asset and real object control, distribution of responsibilities;
Information and communications	For major flaws detected in internal controls, registered accountants should conduct timely communications with reviewed unit with written form;	The management level should consider methods for corporate information delivery: including accounting system, policy handbook, the latest technology and training;
supervision	Registered accountants should acquire written statement from governance authorities on the following major items: governance authorities undertake to establish and improve internal control and maintain its effectiveness;	Multiple-facet supervision within the company includes internal supervision, management level auditing, auditing commission and disclosure commission.

Using the table of comparison, we can see that from the perspectives of auditors, the Guiding Opinions of Internal Control Examination basically has a consistent requirement with that of the COSO framework. However, the difference is that the Guiding Opinions of Internal Control Examination is a regulatory guidance, with purposes of examination solely for the auditors. There are no methods for measuring the quality of enterprises' internal control. Auditors rely on individual experience to accomplish the examination of enterprise internal control. From the Guiding Opinions, it is only viable to know how to work together with the auditors, and there are no answers to the problem of establishing a reasonable and complete internal control system[20]. While the COSO framework originates from the management level and brings up specific and highly operational requirements in which special emphasis is placed on requirements for a prosecution program and information and communication against corrupt practices. These factors are given little attention from internal control systems in China. Compared to each other, the COSO framework has more specific requirements for both management levels and auditors.

2.4.2 Comparison of the Concept of "Internal Control" and the COSO Framework in Various Regulations in China

In our research, we find that there is a lot of regulation for internal control in China, however, there is no one systemic or effective regulation in China. For instance, in 2002 the Governance Guidelines for Listed Companies was released by the China Securities Regulatory Commission, in which obligations for the auditing commission are discussed. From 2002 to 2004, within the articles of the Internal Accounting Control report released by the Finance Department, it mentions authorizing post assignment, monitoring and supervision. In 2005, Company Law released by the People's Congress regulates obligations from the board of directors to the company, a risk evaluation program, and so on within each of the Auditing Guidelines in 2006. However, such regulations only involve some of the content from various aspects of control. With respect to risk evaluation, control activities, and supervision in the COSO framework, the regulations are not oriented to internal control and there are no basic references to the content of environment control and information communication etc.

2.4.3 Comparison of the Internal Control Framework and the COSO Framework in the Shanghai Stock Exchange and the Shenzhen Stock Exchange

Internal Control Guidance in listed companies with the Shanghai Securities and Exchange

[20] LI MING HUI: A Positive Research into the Inner Controlled Information Releasing for the Listed Companies SHENZHEN Economy 2005.10 P104-105

Office is sub-divided into: overview; internal control framework; internal control elements; business links and computer system control; special risk control; internal control over financial product exchanges; examination and supervision on internal control; etc. These are consistent with the COSO framework. However, the COSO framework is primarily aimed at research and conclusions for internal control systems in large-scale American companies. Whether a company in our country could smoothly implement internal controls as well as to properly perform after the implementation is difficult to guarantee[21]. The content of the Introduction on Internal Control of Listed Companies in the Shenzhen Securities Exchange Office is an integration based on globalization and China, with overview and basic elements similar to the introduction in the Shanghai Stock Exchange. While focusing on the content of controlling activities, its stipulations are more formatted, with little attention paid to the control environment and communication mechanism for the company. It is viable to say that the guidelines on the Shenzhen Stock Exchange are basically the conclusions for past internal control systems in China, while there is inadequate emphasis on the COSO framework or the corporate liberal environment. It is doubtful whether that or the internal effects will ever come to the surface[22].

[21] Luo zhao de and tang quan li. An Analysis on the Neo- institutional Economics for Internal Control of Enterprises Audit & Economy Research 2003,(11):58- 60.

[22] liu ming hui and zhang yi xia.Economics thinking of internal control Journal of Accounting Research 2002.8 P54-56

3. The Influence of Sarbanes Act on Internal Control of Chinese Enterprises

3.1 Background on the Enactment of the Sarbanes Act

At the turn of this century, there were of a series of financial scandals which lead to the bankruptcies of large companies such as Enron and WorldCom, exposing serious problems in the American examination system, absolutely impacting investors' confidence on American capital market. For a transformation of such framework, in July 2002, the American Congress formulated and enacted the Sarbanes-Oxley Act, i.e. Sarbanes Act. The act was jointly drafted by democratic senator Sarbanes and republican senator Oxley, and went to effect with the signature of President Bush. As mentioned in former articles, the Sarbanes Act is important law in addition to the Securities Law of 1933 and the Securities Exchange Law of 1934. The Sarbanes Act was even proclaimed as "one of the most influential revolutionary acts in the US business community since President Roosevelt" at the press conference by US president Bush at the signing ceremony. It would have great influence on accounting methods and corporate governance in securities markets of the world rather than just America itself.

Superficially, the Sarbanes Act was generated from the Enron scandal. However, we can deduct that there must have been serious problems and ethical issues in the background at Enron as well as other American corporations. The enactment of the Sarbanes Act has deep roots in corporate organizational systems, accounting systems and the corporate culture as well. From the corporate organizational system standpoint, enterprise incentive mechanisms and fraudulent motives at management levels, as well as inappropriate corporate supervision, are rudimentary reasons behind the act. A major benefit of the act is that it has greatly reduced the independence of financial system accounting firms by establishing objective rules and checks to eliminate system flaws that could easily lead to fraud. It also established a legal penalty mechanism to deal with inappropriate accounting procedures and fraud. In many respects, the advocacy of a powerful corporate culture can be considered the reason it was necessary to enact the Sarbanes Act. Therefore, from the analysis above we can see that the cause of this act is not something that was random, but something that was inevitable[23].

The Sarbanes Act requires establishment of the Public Company Accounting Oversight Board (PCAOB) and authorizes the SEC to implement independent supervision over the board. The act also requires a management level evaluation of public companies as well as financial reporting on the effectiveness of internal controls. This mandates corporate responsibility at executive levels. In addition, Article 404 requires corporate external auditors to issue "proof" of their evaluation opinions from executive levels. In other words, they must provide an independent reason with reliance on the description of internal controls for the corporate financial report from the executive level to shareholders and the public.

Since the great depression in the American economy in 1930s, the government has formulated corporate laws with the widest coverage and the most stringent penalties.

The purpose of Sarbanes Act is to promote the accuracy and reliability of corporate information disclosure, enhance corporate responsibilities, and regulate more severe punishment for inappropriate actions of public corporate accountants and auditors while protecting the investors. The act is applicable to companies which submit or are required to submit periodical reports to SEC in compliance with American Securities Trade Law in 1934, including American companies as well as non-American companies, along with various large listed telecom operators in China.

3.2 Interpretation of Main Content of Sarbanes Act

Compared with existing securities regulations in US, the Sarbanes Act has emphasized the importance of corporate internal control. It makes specific stipulations over corporate internal control in several aspects of managers, internal and external auditors, and it sets up a system of responsibility and corresponding punitive measures.

[23] He xia. The inspiration of SOX
China-CBN 2006.7

The Sarbanes Act consists of 11 chapters. Chapters 1-7 have designs for supervision over the accounting function and corporate actions, while chapters 8-11 mainly aim to enforce the penalty guidelines for corporate senior executives and white collar crimes. The main content discusses the following six aspects:

1. Strict definitions of responsibilities and obligations of corporate managers.
2. Emphasis on functions and effects of the auditing commission of the company.
3. Enhancements for the independence of external auditing.
4. Improvement of financial affair disclosure obligations.
5. Enforcement of penalty measures and severity of illegal actions.
6. Increased funding for enforcement of the SEC functions.

3.2.1 Strict Definition of Responsibilities and Obligations of Corporate Managers

Sarbanes Act has strictly outlined the responsibilities and obligations for corporate managers, mainly reflected in article 302 and article 404 in Sarbanes Act. According to requirement in article 302, the chief executive officer and the chief financial officer from listed companies in the US must sign the annual report or seasonal report each year to guarantee that they have examined the report. In doing so, they attest that there are no major errors or omissions in the report and that accounting table and other financial information in the report have fairly reflected financial status and operational achievements at the end of the reporting period. According to stipulations in the act, if the CEO or CFO within listed companies knowingly attached their signatures to a periodical report that contains discredited financial information or false financial reporting with the nature of “intentional deception” and still submit the report to the American Securities and Exchange Committee, they will be subject to severe punitive measures. Therefore, Article 302 is proclaimed as the article that brought penalty law into the business field with severe punishment for fraudulent actions.

Article 404 of the Sarbanes Act is mainly associated with public companies and is very sophisticated, requiring the use of internal controls and issuance of written evaluations to the SEC on the effectiveness of the controls. Internal control reports delivered to SEC are based on the following factors:

(1) Corporate executive levels have responsibility for establishing and maintaining internal control systems as well as the corresponding control programs.

(2) Corporate executive levels must conduct effective evaluations on the internal control system at the end of the financial year and issue an internal control evaluation report. With respect to evaluations on internal control by executive levels, independent accounting firms undertaking the company's annual report auditing must conduct testing to determine the validity of the control system and issue a written evaluation report.

3.2.2 Emphasis on Functions and Obligations of the Corporate Auditing Commission

Sarbanes Act emphasizes the function and obligation of the corporate auditing commission. Article 301 in the act requires all listed companies to set up an auditing commissions with members from the board of directors with at least one financial expert, and supervise the editing process for the financial report.

3.2.3 Independence of External Auditing

The Sarbanes Act has strict regulations over the external auditing of the company. The Act regulates to establish one independent supervising organization, The Public Company Accounting Oversight Board (PCAOB), which is an independent organization overseeing public corporate accounting and auditing in the US. PCAOB receives guidance from the US Securities and Exchange Commission with a wide range of power in formulation of auditing guidance. Since its establishment, PCAOB has already formulated four auditing guidelines as well as nine relevant regulations. Meanwhile, stipulations on the auditing scope of external auditors have been implemented. While conducting audits of external auditors is one of the primary functions of the PCAOB, it also oversees non-auditing services.

(1) An amendment was made to the Securities and Exchange Law of 1934 to forbid accounting firms, which executes public company auditing to provide non-auditing services that are not enlisted by the board. Non-auditing services with non-specific inclusion into the forbidden list should have prior approval from the company's auditing commission.

(2) Auditing partners and double-check partners must shift turns every 5 years, mandating that only registered accountants report to the auditing commission.

(3) If corporate senior managers such as a CEO, CFO or CCO were working in an accounting firm within the previous year, the firm will be forbidden from providing legal auditing services to the company.

In addition, the board advises supervising organizations in each state to decide whether independent standards for PCAOB are applicable to medium and small firms registered at the commission.

3.2.4 Financial Affair Disclosure Obligations

The Sarbanes Act requires public companies to implement real-time disclosure which means to conduct timely disclosure of information that causes major changes in the corporate operational and financial status.

The SEC undertakes formulation of regulations and requires public companies to disclose all important trading and relations activity that has significant influence on corporate financial status. It also prohibits formulating projections with simulated financial information that would not pass an audit. The SEC conducts research on disclosure of off-sheet trades as related to entities with special purposes, and reports to Congress with recommendations based on their findings.

The obligatory reporting period for main shareholders or senior managers related to disclosure of equity modifications or exchange contracts is reduced from the previous 10 workdays to 2 workdays.

The SEC formulates regulations with compulsory requirements that public companies should include internal control reports and evaluations within their annual report, and requires accounting firms to issue an authentication report for evaluations made by corporate executive levels.

The SEC also formulates regulations with compulsory requirements that the company's auditing commission should have at least one financial expert for disclosure.

3.2.5 Measures and Rigidity on Illegal Actions

Sarbanes Act has strengthened penalty measures for illegal actions with specific regulations as follows:

(1) Crimes with deliberate securities frauds can be sentenced to prison for a maximum of 25 years. Monetary penalty charges for individuals and companies with a crime of false pretenses range from $5 million to a maximum of $25 million.

(2) Actions with deliberate damage or fabrication of documents to prevent, obstruct or affect investigations will be perceived as serious crimes which can be fined or sentenced to prison for 20 years, or both.

(3) Auditing and double check reports and documentation from accounting firms that execute securities publications should be retained in storage for at least 5 years. Any deliberate actions in violation of such regulations can be fined or sentenced to prison for 20 years, or both.

(4) The CEO and financial director of the company must provide a guarantee on the legality and legitimacy of the financial report submitted to the SEC. Actions in violation of this stipulation can be sentenced to fines under $500,000 or prison for 5 years.

(5) Lawsuits with prosecution of securities frauds are prolonged to 5 years and 2 years from the previous 3 years and 1 year respectively after violation actions.

(6) Implement protection measures for corporate staff with prosecution on fraudulent corporate financial affairs, and compensate its special losses and attorney fees.

3.2.6 SEC Supervision Functions

Funding for the SEC was increased to $776 in 2003, to facilitate fraud prevention, risk management, market supervision and investment management. $98 million of this amount was used to hire 200 staff members and strengthen supervision over registered accountants and auditing business.

The Sarbanes Act is corporate law formulated by the government with the widest coverage and severest punishment measures since the American economic depression in the 1930s. Powerful prevention and punishment measures are outlined on weaknesses in American corporate system and social supervision systems with in-depth influences that are far-reaching.

From the content of the act, there are many positive aspects for corporate transparency. This article makes the case for management levels to explore Sarbanes' influence upon internal control of Chinese enterprises.

3.3 Sarbanes Act's Influence on Internal Control of Chinese Enterprises

The effectiveness of the Sarbanes Act will not only impose major influences on American companies, but it will also extend influence on Chinese enterprises, and there are both opportunities and challenges.

3.3.1 Opportunities to Chinese Enterprises from Sarbanes Act

First of all, it has brought about good opportunities to self-management levels and comprehensive qualities of Chinese enterprises. Although part of Chinese enterprises have reached world-class levels at the industrial scale, compared with large international companies, they still have weak internal control and weak integral preparations. Careful, refined and precise management practices have inadequacies that demand urgent efforts to overcome challenges and make progress.

Listed companies are in compliance with the set of methods and systems under article 404 under Sarbanes Act, which can be fully utilized to control corporate operational risks and promote corporate operational performances. The COSO internal control framework provides very fundamental basics and tools for compliance with Article 404, while the actual internal control framework itself has its focus not only on controlling risks of financial reporting but also on obligatory control of operational risks. Compliance operations with the Sarbanes Act only apply to part of the functions in the COSO internal control framework, i.e. the part of financial reporting of risk controls. The application of the COSO internal control framework over operational risk controls should promote operational efficiencies with principles and methods similar to the control of financial report risks. Therefore, Chinese enterprises listed in America can integrate compliance operations of the Sarbanes Act into the integral operations of "consistent improvement". Based on opportunities in the implementation of article 404, the capital market can be used to achieve high standards and fundamentally promote the management levels and competitiveness of the enterprise. It will improve the modern enterprise system, which can help domestic enterprises to quickly realize the objective of making a world-class enterprise[24].

Internal controls also speed up the process of building an information-based enterprise. For meeting the demands of Article 404, listed companies should guarantee correspondence of the internal control system at each link of financial recordings on trade. Each company should have a clear description on tasks and obligations for any position even though this task requires massive amounts of materials and documentation. It is worth of pointing that there are flaws within internal controls. The act also requires the company to implement detailed content on internal control as well as document evaluation methods for recording control measures and conduct testing on policies and processes that are used for compensating control flaws in the future. This process confirms precautionary functions over control measures and remedial approaches. Obviously, these are not easy tasks. Pure manual operations could hardly realize

[24] Hu jing .The inspiration of financial reporting under SOX for Chinese enterprises
Metallurgical Financial Accounting 2007：11 P33-34

the goal of an information-based enterprise. Therefore, an active search for internal control software appropriate for the enterprise's characteristics should be made in order to realize an integration of a self-management information system and a financial information system. This would be a great tool for managers to quickly establish enterprise internal control system solutions. Through the establishment of an Information Technology (IT) system, enterprises could consolidate good management approaches into an information database of regulations and processes. This database of good management principles and control system solutions could be used to create corporate management practices and promote the corporate management levels.

In addition, information technology system can prevent internal problems from accumulating and thereby avoid a large crisis. There are strict requirements for internal control and responsibilities of senior managers within article 404, which could further promote corporate governance and improvement of risk management. Such systems could largely reduce the motives of executive levels for fabrication of false financial information so as to focus on improvement of real corporate performance and long-term development, which are conducive to the prevention of hazards and reduction of a greater crisis. At the end of 2004, there was major scandal at CAOHC (Singapore)[25], resulting from inadequacies within the corporate internal control system that allowed senior mangers to have unchecked dominant control and lead to a major disaster. Currently, the majority of companies that are affected by the Sarbanes Act are improving their control information storage and testing of flaws in the system. They utilize the latest treatment programs to strengthen behavioral ethical standards. The improvement of corporate internal control has been regarded as the priority issue facing all industries[26].

3.3.2 Challenges to Chinese Enterprises from the Sarbanes Act

After the "pain" for CEOs and CFOs in listed companies in America, now it's the time for

[25] On November 30, 2004, China Aviation Oil, which, the overseastate-owners enterprise, realized the assets appreciation to 800 times during only 7 years, applied for bankruptcy because of the speculative operation in futures market resulted in the huge debt of US＄550 million in a few months.

[26] NI ying .Inspiration of enterprise's internal control Economic Management 2007：24 P171

senior managers in listed American overseas companies to endure the pain. For Chinese enterprises to get listed in the US, challenges for execution of Sarbanes Act can summarized in the following points:

1. Expensive Execution Cost

According to Li Xiaofeng, counselor of the China Institute of Internal Audit, the cost for Chinese enterprises that are listed in the US to implement compliant standards of the Sarbanes Article 404 is exhorbadant. According to statistics from US firms, implementation costs in the first year surpassed $4.6 million, including software expenditures, extra-auditing expenditures and external consulting expenditures, as well as 35,000 man hours of internal labor costs.

For example, the General Electric Company spent $30 million for improvement of internal control systems to reach the standards required under Article 404 of the Sarbanes Act. According to predictions made by international CFO organizations, there will be a much higher input for Chinese enterprises listed in the US. As of October 2005, such expenditures for 44 Chinese enterprises listed in the US will be no less than $200 million.

2. Potential Prosecution Risks

Apart from expensive execution costs, Chinese enterprises listed in the US will be faced with potential prosecution risks brought about by the Sarbanes Act. Specifically, Chinese enterprises listed in US must implement the framework of securities laws and securities trade laws, and they should also use the framework of the Sarbanes Act. If they are not diligent, collective lawsuits can be brought forth by American investors based on the Sarbanes Act[27]. Such collective legal actions were taken against China Life, 51job web, Netease, China Aviation Oil, etc., for being in violation of American Securities Laws and the Securities and Exchange Law. Chinese listed companies in the US faced the increased possibility of prosecution as a result of the Sarbanes Act; they also faced corresponding indemnification charges.

3. Additional Workload Brought About by Internal Control Standard Compliance

The tremendous workload brought about by internal control standards compliance can be viewed in the following two aspects. One is the added work of constructing internal control systems and the other is workload brought about by organizational changes. If the enterprise

[27] Zhang yu. SOX Challenge to Chinese enterprise CEO
China internal audit 2006.4 sourcing from http://cfo.icxo.com/htmlnews/2006/04/18/841087_0.htm

changes are too large, the requirement of standard compliance in Article 404 of the Sarbanes Act will directly lead to appropriate changes to the enterprises' internal structure. While the working content of Article 404 in the Sarbanes Act will consistently renew with a progression of time, the work effort required will increase substantially because of it. Recording for internal control activities not only involves details such as "product payment time" but also the disclosure major flaws in the system.

4. Internal Auditing Resource Scarcity

Relevant investigation indicates[28] the actual gap for implementation of the Sarbanes Act in Chinese enterprises still lacks internal auditing resources and the legitimacy requirement for listed enterprises in the Sarbanes Act includes many internal auditing functions.

5. Small Enterprises Are Faced with Huge Cost Pressures

For many innovation-based small enterprises, market and technology are key factors. Due to the Sarbanes Act, many of these innovation-based enterprises are losing their flexibility. In addition, internal control has brought about increased costs, which are major burdens for small enterprises.

Apart from various challenges of the above, a key problem lies in the fact that even though enterprises have made tremendous efforts, they cannot possibly acquire the "qualification certificate". Research data has indicated that more than one year after the Sarbanes Act's official implementation, Chinese listed enterprises in the US are mostly implementing it to fulfill all the requirements under this act. However, there are still over 500 listed enterprises that were recognized as non-compliant with the standard, making up 14% of listed enterprises in the US. For these companies in non-compliance with the Sarbanes Act, they will receive slight punishments of dropping stock prices. More severe punishments such as monetary penalty charges from supervising institutions, collective prosecution due to the "provision of false information", and "deception of major events", will continue to be levied until the listed enterprises are de-listed[29].

[28] This research originates from the online investigation carried out by IIA member in March 2006. The data is collected from the feedbacks of internal auditing experts of companies with annual revenue exceeding 1 billion US dollars (72% of researchers), 500 million US dollars (17% of researchers) as well as less than 500 million US dollars (11% of researchers).

[29] Qiu yue hua. Analysis of SOX cost and benefit
Communication of Finance and Accounting 2007.1P96-98

4. The Case study

4.1 UT Starcom Introduction

UT Starcom is an international high-tech communications company dedicated to research, development, production and sales of cutting edge technologies and products in the field of modern communications. UT Starcom was established in 1995 with its headquarters in America's Silicon Valley and there are more than ten R&D centers in the US, China, India, Korea and Canada. Additionally, there are established branch offices around the world to expand the global communications market with its innovative and competitive products and expert services.

In October 2005, UT Starcom launched a brand-new global brand and enterprise symbol. The new symbol was meant to represent "innovation, percipience, integration and inspiration" in their corporate concept. UT Starcom was trying to portray itself as a telecom industry leader, bolstering the development of world communications featuring its principles of "innovation, percipience, integration and inspiration".

4.2 The UT Starcom Case

In March 2006, UT Starcom received a notice from Nasdaq, stating they have violated the regulations of the Nasdaq stock market due to an undelivered annual report for 2005. Their failure to file an annual report resulted in UT Starcom's management undergoing several reviews by consultants to determine the reasons their financial report was not submitted and to go through a court hearing for non-compliance. In April 2006 UT Starcom released a statement that the 2000 annual report and the 2006 first quarter report would have a late release. The reports were eventually released in June 2006.

UT Starcom announced that the financial reporting was late primarily for two reasons. One of the reasons was that a contract with a client in India had been reported as business income prematurely, requiring the company's auditing commission to conduct an emergency inquiry.

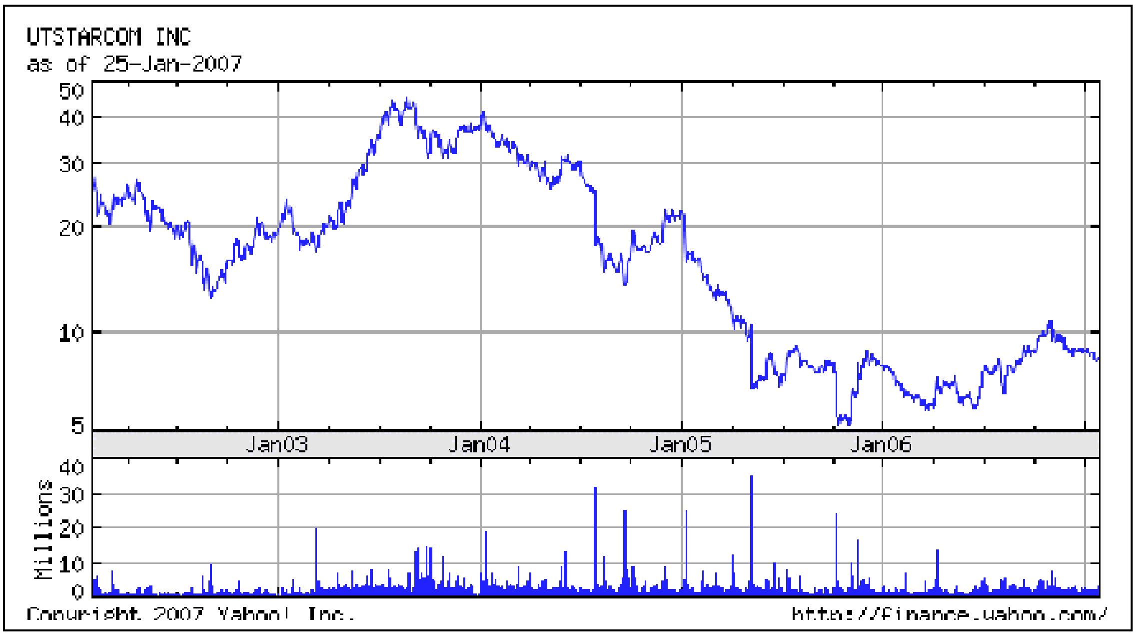
The other reason is that corporate managers needed more time to complete the M&A financial statement in 2005 and evaluate corporate internal control conditions to insure compliance with relevant acts in the US. It is perceivable that these reasons have a clear connection with the Sarbanes Act.

In a report, there were ten pages describing flaws in UT Starcom's internal control system. Price-Waterhouse-Coopers, an external auditor of the company, issued an audit report indicating UT Starcom does not have adequate internal control and that corporate executive levels could not confirm the accuracy of the 2005 financial statement.

After enactment of the Sarbanes Act, many companies that have been listed in the US think that it is time and labor consuming regulation, requiring large monetary expenditures with little in actual achievements. At times, incomplete execution of internal control does not reflect on financial statement in short periods of time, however, there are inadequacies will accumulate and eventually will show up in the statement. When we actually see problems on the financial statement, we can always associate them with some defect in the internal control system. Therefore, it is perceivable that Article 404 of the Sarbanes Act can actually strengthen and maximize the prevention of risks. Some existing internal control issues in the case of UT Starcom, as well as the problems reflected on the financial statement, are indications of the threats posed by defects in the internal control system.

The primary business of UT Starcom is research, development, production and sales of products and technologies in the field of communications. In 1997, UT Starcom started from a cellular wireless urban telephone system and become the absolute leader in cellular system terminals and created value added business. However, as the company had monolithic clients in business and technologies, its indecisiveness in dealing with the 3 Ghz problems and promotion of returns to investors, the market value of its stock was impacted. UT Starcom began to take the road of diversification, expending more resources for network TV, mobile phone terminals and the 3 Ghz business. UT Starcom was listed in Nasdaq in 2000. The value of stock prices in recent 5 years between 2000 and 2006 is as follows:

Figure 2 - Stock Roadmap of UT Starcom between 2000 –2006 [30]



From 2004 to 2006, the stock price of Starcom was consistently dropping. Bad operational performance is the main reason for the declining stock price. The annual net profit for Starcom dropped from $200 million in 2003 to $70 million in 2004 and by 2005, it had a profit loss of $487 million. In 2006, UT Starcom delayed its publication of the 2005 annual report, mainly because there were problems with income confirmation associated with some clients in India. The inability to confirm income is undoubtedly a major defect in the internal control system. This question was brought up in the annual report of 2004, but unfortunately the problem was not solved in 2005. In fact, apart from the confirmation of income, there are also many internal control issues at UT Starcom. These issues are enumerated as follow:

First is the confirmation process on income and deferred income. There is no adequate control over the recording and reviewing of corporate income and deferred income. Especially, the company does not have a specific process within its articles for non-standard income contracts and supplementary income contracts. This was the primary reason for the company's adjustment of the 2005 annual report, as well as the income and cost of sales adjustments for the previous years of 2003, 2004 and 2005.

[30] Figure 2 Stock Roadmap of UTStarcom between 2000 -2006 Image Source: HTTP://finance.yahoo.com

Second, there are flaws in the inventory management controls. The company does not have enough internal control processes to judge the turnover of inventory. Corporate records do not support inventory integrity and the accuracy of sales costs. This led to an adjustment on inventory and deferred costs in 2005.

Third, there are control problems with corporate pre-extraction expenditures. There is no adequate control over pre-extraction expenditures for the operations in China. Without this there were no accurate divisions within the period, leading to an adjustment of the annual statement in 2005.

Fourth, there is an incomplete corporate contract statement process. This could not ensure integrity and accuracy of the financial statement and its full disclosure. The company has incomplete disclosure methods and statement combination processes in terms of irregular trade, auxiliary asset and liabilities, subdivision statement, income tax accounting, accurate division storage and deferred costs, insurance storage, deferred income, debts receivable, income and costs, leading to various auditing adjustments and supplementary disclosures.

Fifth, the corporate tax process has significant errors. The company had mistakes on income tax for submission and deferred tax, leading to an auditing adjustment in 3rd quarter of 2005.

Sixth, the corporate information system management has defects. The corporate information system does not have strict obligatory isolation or user rights confidentiality, affecting the reliability of automatic data generation from the system used in the corporate financial statement, including system processes such as income, inventory, procurement, etc.

Seventh, the company has problems with control over the trades of associated parties. The company could not provide timely recognition towards connection side transactions. As there are no recognition processes for connection side transactions, the corporate combined financial statement could not accurately reflect these transactions.

Eighth, there are problems with the supervision in the corporate divisions. The senior levels of the financial of group did not have adequate supervision over businesses and financial affairs in Japan, Mainland China and New York. Most internal control problems originated from these three regions. There is no adequate supervision and that could possibly lead to corporate financial statement issues.

Ninth, the corporate contract management system has defects. The company currently has controls in place that can not prevent or detect a subordinate company's obligatory agreement. Specifically, division managers have no discussions with the corporate financial department or the external auditors, yet they sign specific legal agreements with customers, thus requiring the company to fulfill its obligations for taking on businesses required by the agreement.

Tenth, there are functional issues in the corporate financial department. The corporate financial department is not sufficient to maintain its operational activities and complicated businesses. Particularly, the company does not have an accountant with adequate capacity to process financial statement combinations. In addition, the company does not have policy and process on accountants based on system and organization.

Eleventh, the corporate legal department has functional issues. Internal control of the company currently could not prevent or recognize non-compliance with legal regulations. Specifically, such a shortcoming could possibly generate actions that are in violation of related regulations under the securities and trade commission. For example, there might be bribery issues with government officials.

4.3 UT Starcom Case Analysis

We can deduct from this case that the defects of each internal control influence the financial statement and the company's specific improvement measures and progress. However, UT Starcom has mentioned in the statement that the company should build corporate internal control in compliance with the COSO framework. It classifies and concludes such internal control measures and suggests some solutions per the following:

Table 3 Internal Control Issues and Suggested Solutions of UT Starcom[31]

Internal control link	Specific internal control problems	Advised solutions
Control activities	Income circulation—income, delivery income and sales cost	Non-standard contract should go through four examinations of sales, operation, finance and law prior to confirmation of revenue
Control activities	Inventory and production circulation – storage, delivery cost and sales cost	Use the system to record processing of inventory; formulate internal control processes to make judgments for whether the inventory level are relevant to sales in the market
Control activities	Procurement circulation-Drawing expense in advance	Strengthen compliance with procurement list and expense account so as to accurately differentiate expense by divisions
Control activities	Financial statement circulation-M&A financial statement	Merge the statement process based on standards; expand the headquarters' demand of information from each company; design approval procedures for irregular trades
Control activities	Tax circulation –income tax issues	Hire and trade tax managers with experience, or foreign experts to help finish tax issues
Control activities	information system circulation	Examine the current system rights, and remove inappropriate rights; respectively set up account management documentation,

[31] Table 3 is classified and summarized according to COSO framework

		invoice articles as well as storage documents
Control activities	Financial statement circulation –associated party recognition	Strengthen training for each managers and accountants to recognize associated parties
Supervision	distribution supervision	The headquarter periodically examines documents from subdivisions; increase the reporting content submitted to the headquarter from subdivisions; increase internal auditing department staff to enhance internal auditing operations
Control environment	Control environment -contract	Non-standardized contract should go through four examinations of sales, operation, finance and law
Control environment	Control environment -finance	Clarify financial departments and specify staff posts and introduce experienced and talented staff
Control environment	Control environment -law	Strengthen controls from auditing department over this portion; especially expenditure auditing on senior managers, along with large sum expense auditing

It is worth noting that such problems were mostly brought up in the 2004 annual report. UT Starcom management levels have also mentioned some predictable solutions which are similar to the above suggestions. However, in 2005 only the simplest problems of preparation of the intangible asset value reduction and the exchange rate adjustment are alleviated while most internal control flaws still exist. A looming question remains. Why did management levels discover problems, develop ideas for a solution, but not achieved their objectives?

The three separate factors of corporate performance, financial reporting and internal control create a misleading perception. When the companies' performance is good, all internal control issues are covered and financial reporting looks promising. When the companies' income is falling, whether it is for external auditors or public investors, there would be special attention given to the previous financial report to detect possible errors. Why has the previous report not detected signs of income reduction? Now people realize that the former financial report is not correct and while investigating the reasons, eventually find flaws in the internal controls. Therefore, internal control was brought up as the source of one series of inaccurate financial reporting. However, this viewpoint is misleading. We should clearly be aware that the internal control system is improved but it does not represent the business performance. Similarly, the internal control system has flaws, which does not reflect that the company does not have a promising future. Article 404 of Sarbanes Act is pushing managers to improve their internal control systems and ensure data is correct in their financial reports, which essentially reflects the company's status, sharing no connection with current profits.

In this case analysis of UT Starcom, inferences can be drawn that indicate a search should be made for better accountants, but this would only be a temporary strategy. Fiscal accountants with good performance records could adjust the report to relatively accurate figures, but it would still likely be an estimated value. If it is to make an accurate financial report, all of UT Starcom's staff must work together.

UT Starcom has experienced a series of mergers and acquisitions resulting in rapid growth. It merged with 3COM's subsidiary Comm Works in March 2004. That same month it acquired Hyundai Syscomm of Korean and in April, it acquired the TELOS company in Canada. In June, it acquired Audiovox (ACC) in America, in 2005 the company sold the chip designing department to Marvell Group and again sold 10% of its stock in the SBCH company to Softbank in Japan. In November, the Shanghai Research Institute as well as the WIFI department with the Hangzhou Mobile Phone division were sold. From these rapid capital transactions, it is viable to find the source for various internal control flaws. There is no buffering process for corporate integration. There is no uniform corporate culture or time to unify the corporate system. They could not train management and financial level personnel in this short period of time. There was a policy of lax supervision of the company divisions at the corporate level and this was a flaw in their internal control system. How could they guarantee requirements were met on each internal control be in compliance with corporate headquarters in such a short period of time? Therefore, the accuracy of financial reporting relies on the level of improvement on internal control but the improvement of internal control is dependent on corporate governance. Corporate governance must solve the communication issues among the shareholders, the board of directors and the management levels, while internal control serves as the infrastructure for corporate governance. If there are no systematic and concrete internal controls, corporate governance could only be a blank piece of paper. Without going through the top to bottom corporate governance, internal control could not be effectively implemented.

5. Implications and Suggestions of the Sarbanes Act for the Construction of Corporate Internal Control

Since the end of the 1990's, the government's financial department in China has developed the Basic Regulations on Internal Control and a series of other specific regulations. Successive enforcement of such regulations has certain impacts on corporate internal control construction in Chinese companies and will improve the corporate operational and management mechanism. However, along with changes in the economic environment and consistently facing new problems, how to integrate industries and enterprises, especially with the characteristics of listed companies is to say the least, a challenge. To reasonably and feasibly design internal control systems as well as carry out consistent and effective implementations is the focus and it is a difficult issue using acceptable practices of internal control. One of the approaches insuring the effective function internal control is internal auditing and it is rapidly becoming a popular tool. In 2002, the Sarbanes Act was implemented in the US. It has pushed forward the step of internal control system construction. In view of the content of related articles in the Sarbanes Act, explorations of different aspects for internal control and internal auditing in China have become significantly more important.

5.1 Implications

The Enron and WorldCom incidents in the US have exposed flaws within the internal control systems of public companies. Similarly, listed companies in China also demonstrate flaws of weak internal control and imperfect information disclosure. Chinese listed companies in the US should follow the Sarbanes Act, however, "one man's trash can be another man's treasure" with respect to actual conditions in China. The introduction and reference of advanced concepts from foreign countries, as well as improvement of internal control system, are measures whose implementation is inevitable. The formulation and implementation of the Sarbanes Act have brought about many implications towards system construction for internal control in Chinese enterprises. Specific implications include the following points:

1. Establish and improve the internal control system framework. The Sarbanes Act, Article 404, regulates the management and evaluation of internal control requiring strict, refined, careful, and precise oversight. Each link of the operation should be under corporate control, which will directly pose challenges to extent of management's capacity. In complying with the requirements of the Sarbanes Act, some domestic large scale enterprises that are listed in the US have established or are establishing control systems that are in compliance with local laws in the listed region and in China. Listed companies should quickly establish internal control systems that are based on the framework of the act and operate under the regulations that are in compliance with it. The design and operation of the control system should based on the framework of the Sarbanes Act, but it must also blend with the actual operating systems of the company. For enterprises, the establishment and improvement of the internal control system is a gradual process. It is viable to establish an internal control evaluation system worthy of gaining people's attention. Control measures implemented into the existing flow process should cover risks, be reasonable, provide verification, and be relevant to the regulations and other systems existing in the enterprise. As problems or changes in the company's environment occur, it is imperative to make timely rectification or establish new systems for existing internal control systems in order to remain in compliance.

2. Clarify the evaluation standards of internal control. SEC guidelines suggest using the internal control framework recommended by COSO, but there are no mandates for obligatory regulations in this framework, rather they are only mentioned for inclusion in a control system. Internal control regulations in China are still in an explorative state. There were no dedicated guidelines in 2006. Although several guidelines have been published, Guidelines for the Shanghai Stock Exchange on Internal Control, Guidelines for the Shenzhen Stock Exchange on Internal Control, and Guidelines for Central Enterprise Comprehensive Risk Management, they are quite different in their scope and vastly different in content. A comprehensive and unified guideline to establish evaluation standards is needed to reflect the current status of enterprises in the country.

3. Establish sound control activities. Control activities are policies and programs insuring that instructions at management levels are practiced, with the objective of helping enterprises guarantee necessary actions are taken with respect to out of control situations and unnecessary risks in the enterprise. Practical applications of control activities have emphasis on the enhancement of internal control in the business operations. While many methods of internal control reflect on aspects of business levels, the design of an internal control system based on the business program is conducive to accelerate the promotion of the integral level of corporate internal control. In addition, it also requires strengthening internal control information flow and communications with a sound information system. This in turn promotes internal control efficiency and performance. The enterprise should properly research and decide how to acquire the appropriate information from in a timely manner so that it enables the staff easily fulfill their obligations. Information systems deal with internally generated corporate information while also processing relevant information associated with external communications and the business environment[32].

4. Confirm the range of the internal control system. The SEC only requires disclosing relevant internal control information with respect to financial report, with objectives to confirm accuracy and reliability of the financial statement. Such actions have caused many controversies. Two examples of these controversies are whether or not to integrate corporate asset guarantees into the internal control system and whether or not the corporate management strategy should be integrated into the internal control system. Such issues are still under discussion. It is imperative for our country to draw upon various opinions from the current critics to formulate internal control guidelines. With regard to the author, the COSO framework has placed requirements upon the corporate control environment and corporate culture that are worthy of review by our country. Therefore, the guarantee of asset value is a requirement for the financial guidelines in our country. The internal control system should also include such content in order to guarantee enterprise operational performance.

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[32] Yu yi . Discusses the Sarbanes bill and the company internal control shallowly
Storage Transportation & Preservation of Commodities 2007：3 P109-110

5. Strengthen internal auditing operations. Standards are required for making any judgment on whether the design of an internal control is appropriate or its implementation is effective. These are evaluation standards and apply to integral and operational aspects of the five factors for internal control listed by COSO. Regarding who should conduct internal control evaluations, the COSO report suggests that it primarily be enterprise management authorities or designated individuals, such as internal auditing committee. This group periodically conducts effective evaluations on the internal control design for the unit and issues an evaluation report. Next, registered accountants are required to examine and check thee evaluation report. The Sarbanes Act also has the same regulations. Corporate internal auditing plays an important role in developing corporate internal control evaluations. Within the Sarbanes Act is process of implementation, due to active participation from the IIA, defining and enabling roles for internal auditing and the obligations to be met under the terms of the regulation. Relevant guidelines within the Sarbanes Act and the American Securities and Trade Commission require senior managers within listed companies to submit a financial report and provide guarantees that the information is correct. Therefore, the executive managers are the responsible persons for control of the environment and financial materials. The external auditor notarizes the information for financial report and he needs to insure the financial report recipients that information in the report is accurately reflects the financial status of the organization. The internal auditors verify to the auditing commission that the internal control system set by the organization for the purpose of formulating the financial report is effective. Internal auditing executives should constantly communicate with the auditing commission in a timely manner. The auditing commission should evaluate the report's coverage and adequacy from internal auditing executive directors.

6. Facilitate a responsible person and assign responsibilities within the internal control system. The Sarbanes Act emphasizes responsibilities of the financial report and internal control should be assigned to actual corporate persons and the act has specified penalties for unfinished task requirements by the management levels. Currently, internal control systems in Chinese enterprises do not focus on the business process flow. Therefore, there are stipulations on each key responsible person. In view of corporate conditions in China, it is viable to require

corporate legal representatives, real operators, finance directors, etc., to be responsible persons and take on responsibilities for internal control design and effective operations.

7. Should disclosure of conditions on internal control be necessary? Previously, enterprises in the US were voluntarily disclosing corporate conditions about internal control. With the Sarbanes Act, it has become obligatorily for companies to disclose that information. Currently, *Guidelines on Internal Control of Shanghai Stock Exchange* and *Guidelines on Internal Control of Shenzhen Stock Exchange* in China also require listed companies to disclose internal control information. While internal control regulations have not improved much due to a weak infrastructure in Chinese enterprises, it is worthwhile to observe whether or not they can attain the requirements of the stock exchange office. It's unrealistic to think that listed companies could attain the requirements of the Securities Regulatory Commission in the short term, but in order to confirm the company's gradual improvement isn't superficial, will require coordination and supervision from stock exchange offices[33].

8. The inspection report's effect on efficiency and internal control. The Sarbanes Act requires registered accountants to independently issue a copy of their internal control report to the management level, stating the internal control conditions within the company. The management level report should then go through examinations, both internally and externally, in order to guarantee accuracy. When registered accountants from the past inspect the financial report of the enterprise, normally they examine the enterprise's internal control system and look for abnormalities and defects. The internal control test is also an inevitable process to insure auditing efficiency and increase credibility of the financial report. Therefore, it is an inevitable process for registered accountants with experience and skill, to inspect reports on corporate internal control in order to insure compliance with the Sarbanes Act.

[33] ZHOU QIN YE ,WANG XIAO : Internal Control Report and Disclosure: Experience in the United States and Proposal for China's Security Market
Journal of accounting research 2004.8 P 97-99

5.2 Suggestions

The Sarbanes Act has an important significance as a statement on the development of the Chinese market economy. The process is more importantly a reference to its spiritual essence but not dependent on form. Financial fraud in the Chinese market economy has similarities with America, but it must be noted that they are not all the same. Through an analysis of the influences of Sarbanes Act on Chinese enterprises, the following suggestions can be inferred with respect to various government departments and the enterprise management levels to strengthen the integrity of financial reporting.

5.2.1 Suggestions to Government Bodies

1. <u>Strengthen legal supervision measures at the appropriate rate to also allow growth</u>

China has made many changes to legal regulations in recent years, including the new Company Law and new accounting guidelines. Very close attention was paid to general international regulations while facing many difficulties. The Sarbanes Act has created a general realization that formulation and supervision of laws and regulations in capital markets should take into comprehensive consideration the developing market conditions. Laws and regulatory supervision must pay attention to the effectiveness of the controls. The purpose of laws and supervision is to cultivate a positive environment conducive to the healthy development of the market and to realize market development goals.

Currently, related laws in China have not adequately improved. They require constant review, learning from the impact of their implementation, and drawing the proper conclusions from their results. For economic cases caused by imperfections in the laws, there are less severe penalties. There are unspecified legal obligations between departments leading to loopholes in law enforcement and such cases are constantly occurring. Therefore, while paying close attention to the development and improvement of legal regulations in China, the Chinese government should seek to establish a highly efficient government with clear obligations.

In general, the formulation and supervision efforts on laws and regulations create progressive penalties based on the seriousness of the crime. However, any implementation of severe punishment comes with high social costs. While this cost is a factor that requires serious consideration from management levels, formulation of laws and regulations need to be kept within a reasonable scope. If the focus is only to increase penalties for violations while not taking into consideration the regulations on company activities, it is possible to cause more fraudulent actions, which may in the end reduce the severity and efficiency of laws and regulations.

In a broader sense, the development of capital markets is as rapid as traveling thousands of miles per day. In the international market, there are many financial products, which were not seen ten years ago and now they have grown into mainstream products with a high number of daily transactions. While a majority of these products have skirted around the law for many years, if they were to completely die off, the largest tradeoff would the market losing its drive for progress.

Supervision and innovation are a pair of conflicts. It is difficult to reach the maximum value for both. While assuming healthy and comprehensive market development as the eventual goal, objectives for laws, regulations and market supervision should not be to monolithically strengthen its severity, but to cultivate the optimal environment for market development.

2. <u>Promote the quality of information disclosure</u>

China should structure a set of various levels of evaluation systems for information disclosure, so as to conduct a scientific evaluation on the quality of information disclosures for listed companies. Established and standardized capital markets are built on improved information disclosure systems and accounting information disclosure is at the core of the system. The quality of disclosure for accounting information of listed companies will directly impact the judgment and decisions for capital market participants, affecting the health and operation in the securities market. Currently, apart from the evaluation mechanism on information disclosure for listed companies by Shenzhen Securities and Stock Office, there are no accurate, complete and prestigious information disclosure grading systems. Relying on honest and independent institutions, it is necessary to develop and establish a set of parameters for evaluation of the quality of information disclosed by listed companies. This will be conducive to effective stock pricing functions and to bring a social economic resource configuration leading to positive development of the markets.

3. Consistent Strengthening of Accounting Guidelines Construction

Along the with consistent improvement of accounting guideline development, draw upon experience from international accounting guideline formulation and construction, and establish a well rounded accounting guideline system. The Financial Department in China should establish long term and consistent guideline goals and attach an explanation on the importance for construction of the accounting guideline system[34]. In 2002, Ge Jiashu stated [35]that although the solution for redundant management requires both ends of the efforts, the essential part of the problem would be to promote the quality of accounting guidelines to clog the loophole from the source. Therefore, China should draw upon international experience for accounting guideline formulation and develop ideas to conduct research operations in financial accounting concepts and frameworks for our country. China should expand the scope of business in accounting guideline regulation and strengthen well-rounded accounting regulations. The formulation procedures for accounting guidelines should also be improved and the representative level of designated institutions should also be expanded. On one hand, it is viable to integrate accounting knowledge to enhance the quality of accounting guidelines in China. On the other hand, it is viable to promote its compliance with accounting guidelines through expression of the legal aspects to related interest groups.

4. Promote Positive Culture Construction

The positive development of capital markets not only requires legal construction, but cultural construction is equally important. It is strategically important for domestic enterprises to believe that governance can create more value for the company and form a positive culture. The

[34] According to Yao Haixin (2001), the establishment of a long term and consistent goal is very important. This goal is not subject to state policy requirements or senior official's willingness, but conducive to consistency and steadiness of accounting guidelines, so as to reduce executive cost for the guidelines and promote its reliability.

[35] Ge jia shu Theory .method. guidance of financial accounting
China financial &economic publishing house 2002 P212

Chinese economy is a market economy with Chinese characteristics, therefore it requires a market supervision mechanism with Chinese characteristics. The spirit of the Sarbanes Act appears to be comparatively more advanced at the scope of the world. There are many concepts left in regulations and laws of other countries without highlighted presentations. However, legislation should be based on a country's market conditions, including inter-media agencies, bond dealers, listed companies, investors and even levels of supervision. It is imperative to look at the status from a perspective of historical viewpoints, and take control of actions in the promotion of reforms.

During the several past years, the Chinese securities market has experienced dramatic changes and some of the ideals in the Sarbanes Act have been realized. For example, significant affects have been achieved in aspects for the promotion of information disclosure and the governance structure of listed companies, as well as external commitments on the actions of listed enterprises by institutional investors.

We have also realized that with the Sarbanes Act, established markets in the US still consistently improve and upgrade its supervision system with the starting point for consistent strengthening of its competency in capital markets. For the aspects of international competency, this also requires us to associate with Chinese characteristics objectively and speed up regulation constructions in the Chinese capital market, thus building it into a world-class capital market. China should actively acquire the essence of foreign frameworks and keep consistent with some standards. Formulation of framework based on global mainstream frameworks will strengthen communications for further development.

5.2.2 Suggestions on Management Levels

1. Management levels clarify the positioning of enterprise internal control. From existing internal control regulation standards in China, most internal control is positioned based on standards without being elevated to the aspect of legal measures. This is not in compliance with actualities of our country. People with inadequate modern management and operational skills

do not have a strong awareness of what is needed to be in compliance with regulations. Under circumstances of integral and comprehensive quality for standards that require self-awareness for compliance, people will not automatically follow general rules. Even in America with a highly modernized system, its internal control is still at a level that has been advanced to judicial levels. For instance, there are many stipulations in the Sarbanes Act demanding enterprises in China establish and disclose their internal control systems. Therefore, positioning of internal control in the future of China should be promoted with the aspects of the laws and regulations that enable its lawfulness being kept in mind. This is both to be in compliance with practical conditions and effective for future implementations in China.

2. Enterprise management levels formulate models for internal control, formulate standards and strengthen authenticity. Formulation models of internal control in existing enterprises are still carrying on the traditional industry-based formulations. Such management models of multiple governance systems and distributed functions are either adaptable to requirements for the development of a modern market economy or conducive to the management of uniform standards. Therefore, formulation models of enterprise internal control in China should avoid the path of repeated traditional models oriented to national uniform formulation models[36]. On July 15th, 2006, the Enterprise Internal Control Standards Commission was established. It is a consultation institution positioned for enterprise internal control systems, with the purpose to provide opinions and suggestions for formulation and improvement of enterprise internal control standard systems. Enterprise internal control standards should be in compliance with the formulation models of corporate accounting, and reflecting on experiences in the US, using main formulation standards from the commission in order to facilitate its authenticity.

3. Management levels should associate with formulation standards of internal control regulated according to national conditions, and form a strict structural system. Existing enterprises in China lack rigidity in their internal control structural system. These are regulations made based on a particular industry or enterprise internal control without formation of an established

[36] Zhang xia :Thinking on the control system construction inside the enterprises Journal of Dalian Official 2005.2

internal control framework system. These do not have impact on the enterprise internal control and therefore are ineffective. A new framework system should be fully-covered, have concrete purposes, with emphasis focused on controls over capital security, risk prevention, governance structure, rights of mutual restriction and balance, as well as implementations and supervision. Additionally, special internal control regulations should be formulated for high-risk industries. Development of the framework must be based on Chinese realities and it cannot blindly follow western and international practices. Internal control should be focused on Chinese characteristics, giving full consideration to the actual environment in China, so as to enable internal control regulation standards with controlling functions for real practices.

4. Management levels should establish an effective implementation mechanism for internal control regulations. Standard systems for internal control should be formulated by authentic departments, and conduct an obligatory arrangement on auditing work for enterprise internal control. Comrade Wang Jun, vice minister of the Financial Department and chairman of the Enterprise Internal Control Standard Commission, pointed out that the implementation of enterprise internal control standards is the soul of enterprise internal control and internal management. This argument unveils the essence of internal control. From practices for internal control in recent years in China, it is viable to see that enterprises with occurrences of major cases or key cases, all have regulations and standards on internal control but there were no effective implementations.

In the case of China Aviation Oil (Singapore), PWC Consulting, one of the four international accounting firms, formulated its internal control regulations. It was based on regulations for operation, with its highest allowance for losses not exceeding $5,000,000, but its actual loss was hundreds of millions of US dollars. In the Nanhai Huaguang case of the Shanghai Commercial Bank, the Shanghai Commercial Bank in Guangdong found existing problems at an early stage and brought up concrete suggestions for its loan fund to limit losses at 1695 million Yuan. However, the Shanghai Commercial Bank in Nanhai refused to implement the suggestions and that decision resulted in the loss of additional millions. With these cases in mind, it is paramount to establish effective internal control regulation and an implementation mechanism along with solid guarantees in each internal control system for an effective implementation. Otherwise, it will eventually fail.

6. Conclusion

Despite the globally different approaches to guidance and regulation on internal control, the prospects for convergence are uncertain. The only firm point of effective internal control is fundamental prerequisites of good corporate governance. The Sarbanes-Oxley Act (SOX) is a good example in this respect. Chinese listed companies in the US have to comply with SOX and relevant regulations have to be considered when establishing an effective internal control system. The SOX and COSO frameworks impact on Chinese listed companies is to build effective and feasible internal control systems. SOX also influences further development of regulatory requirements on internal control for Chinese enterprises. Not only that Chinese enterprises should integrate regulations characteristic to themselves for establishing reasonable and feasible internal control systems, but also that the Chinese government should implement the effective supervision of laws to cultivate a positive environment conducive to healthy development of capital market.

Due to the different sources and various methods of calculation, the data of case studies may differ slightly from current actual data. Furthermore, for publishing and other reasons, it was not possible to have access to the latest data. As a result, this report is based primarily on data up to 2006. Finally, due to the time pressure of research on internal control of Chinese enterprises, the topic should be reviewed again in my future job career.

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