

# China boardroom update

## Internal control regulatory developments

18 August 2008

## The Basic Standard for Enterprise Internal Control

### In brief

Five Chinese government authorities and regulatory bodies have jointly issued a circular on 28 June 2008 on the release of The Basic Standard for Enterprise Internal Control, dated 22 May 2008 (企业内部控制基本规范; The Basic Standard). This issue of *China boardroom update* discusses the newly released Basic Standard and its implications for Chinese enterprises.

### Relevant regulations discussed in this issue:

*Circular jointly issued by the MOF, CSRC, NAO, CBRC and CIRC under Caikuai [2008] No.7 on 28 June 2008 regarding the release of The Basic Standard for Enterprise Internal Control, dated 22 May 2008 which will become effective on 1 July 2009.*

*Guidelines for Evaluation and Assessment of Effectiveness of Enterprise Internal Control (Exposure Draft), Implementation Guidelines for Enterprise Internal Control (Exposure Draft) and Guidelines for Performing Assurance Engagements in relation to Assessing Effectiveness of Enterprise Internal Control (Exposure Draft), under CaiBanKuai [2008] No.7, issued on 27 June 2008 by the MOF, for public comment and feedback by 30 September 2008.*

### Background

In July 2006, the Ministry of Finance (MOF), together with relevant government authorities, formed an Enterprise Internal Control Standard Committee (企业内部控制标准委员会; the Committee) in accordance with the instructions of the State Council.

On 28 June 2008, the MOF, the China Securities Regulatory Commission (CSRC), the National Audit Office (NAO), the China Banking Regulatory Commission (CBRC), and the China Insurance Regulatory Commission (CIRC) jointly released a circular on the release of The Basic Standard for Enterprise Internal Control under CaiKuai [2008] No.7 (财会[2008]7号) dated 22 May 2008 (the Circular). This Basic Standard outlines the regulatory requirements for Chinese enterprises to establish, evaluate and assess effectiveness of their internal controls, and for accounting firms to audit the effectiveness of Chinese enterprises' internal controls. The release of The Basic Standard signifies a unified and recognised internal control framework to strengthen the internal controls of Chinese enterprises.

With a view to facilitating the implementation of The Basic Standard, on 27 June 2008 the MOF issued exposure drafts (征求意见稿) of the following three guidelines:

- *Guidelines for Evaluation and Assessment of Effectiveness of Enterprise Internal Control (企业内部控制评价指引)*
- *Implementation Guidelines for Enterprise Internal Control (企业内部控制应用指引)*
- *Guidelines for Performing Assurance Engagements in relation to Assessing Effectiveness of Enterprise Internal Control (企业内部控制鉴证指引)* under CaiBanKuai [2008] No.7 (财办会[2008]7号) dated 12 June 2008.

All listed companies established within the territory of mainland China will be required to comply with The Basic Standard with effect from 1 July 2009. Non-listed large and medium-sized Chinese enterprises are

encouraged to adopt The Basic Standard. The Basic Standard, therefore, will have direct impact on over 900 companies listed on the Shanghai Stock Exchange and about 800 companies listed on the Shenzhen Stock Exchange.



### Key elements of The Basic Standard

The Basic Standard comprises seven chapters and describes the general provisions and the five control elements. These are internal environment, risk assessment, control activities, information and communication, and internal monitoring. The definitions for these are similar to those in the COSO framework.

In accordance with The Basic Standard, a Chinese enterprise should:

- Include the above five control elements when establishing and implementing effective internal control (Chapter 1 Article 5)
- Establish and implement internal control policies (Chapter 1 Article 6)
- Establish a suitable business management information technology system with embedded controls (Chapter 1 Article 7)
- Set clear policies on the rewards and disciplines relating to the proper implementation of internal control. Effectiveness of internal control implementation should be treated as a key element of performance appraisals for departmental and staff levels (Chapter 1 Article 8)
- Perform self-assessment of the effectiveness of its internal control on a periodic basis and issue control self-assessment reports (Chapter 6 Article 46).

In addition, the Circular states that listed enterprises may appoint accounting firms with certificates to undertake business relating to securities and futures (具有证券、期货业务资格的会计师事务所) to audit the effectiveness of their internal control. The Basic Standard addresses the independence of auditors in Chapter 1 Article 10 which states that “when appointed to provide internal control consulting of an enterprise, the accounting firm shall not perform an audit of the internal control to that enterprise at the same time”. (In respect of Chapter 1 Article 10, the Chinese and English versions of The Basic Standard appear inconsistent. The above follows the Chinese version.)

### Three guidelines (exposure drafts) relating to the implementation of The Basic Standard

The Basic Standard will become effective on 1 July 2009. The MOF, with the assistance of relevant government authorities and regulatory bodies, has prepared three sets of guidelines (exposure drafts) to assist Chinese enterprises and accounting firms in implementing The Basic Standard. Brief descriptions of these guidelines are as follows:

- *Guidelines for Evaluation and Assessment on Effectiveness of Enterprise Internal Control* (企业内部控制评价指引): Provide Chinese enterprises with a framework in performing control self-assessment and preparing annual reports, including the responsibilities and principles of evaluation and assessment, the content and standard of assessment, the procedures and methods of assessment, the identification and evaluation of internal control weaknesses, and reporting.
- *Implementation Guidelines for Enterprise Internal Control* (企业内部控制应用指引): Provide specific requirements in relation to process level controls of 22 typical financial/operational processes.
- *Guidelines for Performing Assurance Engagements in relation to Assessing Effectiveness of Enterprise Internal Control* (企业内部控制鉴证指引): Provide general guidelines for accounting firms to perform assurance engagements in relation to effectiveness of enterprise internal controls, including definitions and responsibilities of auditing services, planning, implementation, evaluation of internal control weaknesses, basis of opinion, maintenance of working papers and four internal control audit report templates (these templates are unqualified, unqualified with explanatory paragraph, adverse opinion and disclaimer of opinion).

The Guidelines, released on 27 June 2008, are open for public comment and feedback by 30 September 2008.

### Implications for Chinese enterprises

The Basic Standard has a direct impact on enterprises established and listed in mainland China. In view of the anticipated complexities in the implementation process, the management of listed Chinese enterprises should plan early for compliance with The Basic Standard. We set out below certain action points for management consideration:

- Review the relevant authoritative literature issued by the MOF, and relevant government authorities and regulatory bodies to gain a better understanding of what actions are expected from a Chinese enterprise in relation to The Basic Standard.
- Consider carrying out a diagnostic review of the enterprise internal control system and rectifying significant/material weaknesses on a timely basis, if any.
- For Chinese enterprises which are currently listed in the US, UK, Hong Kong, other regimes and/or in the regulated industries, compare the internal control requirements of the relevant regulatory regimes to the requirements of The Basic Standard with a view to determining efficient and effective ways to comply with all relevant rules, regulations and guidelines.

## Contact us

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- Start liaising with their independent auditors (and other relevant advisors) to assess the potential impact on future external audit arrangements that the Basic Standard or any of its future revisions, and/or the Guidelines may bring in light of the specific circumstances of the enterprise.
- Consider the implications on resources (in terms of skill sets required and increase in workload) and whether or not to appoint a qualified accounting firm to assist the enterprise in preparing for compliance with The Basic Standard.

It is expected that the MOF, along with other relevant government authorities and regulated bodies, will issue revised guidelines and further clarifications on The Basic Standard and Guidelines discussed above. Any further developments will be communicated in due course.

## Reference

Details of the relevant regulations can be obtained from the following sources:

- The Basic Standard for Enterprise Internal Control  
[http://www.casc.gov.cn/gnxw/200807/t20080715\\_751587.htm](http://www.casc.gov.cn/gnxw/200807/t20080715_751587.htm)
- Guidelines for Evaluation and Assessment of Effectiveness of Enterprise Internal Control (Exposure Draft)  
[http://www.casc.gov.cn/gnxw/200807/t20080715\\_751591.htm](http://www.casc.gov.cn/gnxw/200807/t20080715_751591.htm)
- Implementation Guidelines for Enterprise Internal Control (Exposure Draft)  
[http://www.casc.gov.cn/gnxw/200807/t20080715\\_751591.htm](http://www.casc.gov.cn/gnxw/200807/t20080715_751591.htm)
- Guidelines for Performing Assurance Engagements in relation to Assessing Effectiveness of Enterprise Internal Control (Exposure Draft)  
[http://www.cicpa.org.cn/Professional\\_standards/comments/200807/t20080701\\_13474.htm](http://www.cicpa.org.cn/Professional_standards/comments/200807/t20080701_13474.htm)

## By Risk Advisory Services, KPMG China

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