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Disclosure of internal control information by Chinese cross listed companies

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Abstract

This study examines the internal control disclosures mandated for Chinese cross-listed companies in 2011. These were the first Chinese companies required to comply with the Basic Standards of Enterprise Internal Control. The study documents the level of compliance with the requirements, analyses the nature of the internal control weaknesses, and examines the quality of disclosures. The study also examines differences in characteristics between firms that report internal weaknesses and those that do not. Using descriptive statistics this study found a high degree of compliance from Chinese cross-listed companies in disclosing internal control information in accordance with the regulations. However, the analysis shows that there is some inconsistency in the application of the requirements, especially with regard to disclosures relating to internal control deficiencies, identification criteria and improving internal controls. The disclosures lack detail as to the number and nature of internal control weaknesses and often only provide generic statements on corrective measures. Firms with internal control weaknesses were less likely to have a Big 4 auditor. This study contributes to the research literature in respect of the compliance with disclosure standards for internal control weaknesses in China and the quality of internal control reporting of Chinese cross-listing companies.

Keywords: Internal control; Internal control weaknesses disclosure; Chinese cross listed companies.

Introduction

In the United States the Sarbanes-Oxley (SOX) Act 2002 requires listed companies to disclose internal control deficiencies and to provide an internal control self-assessment report assured by the external auditor. China's equivalent regulatory requirement is the Basic Standards for Enterprises Internal Control issued in 2008 (hereafter referred to as the Basic Standards) by the Chinese Ministry of Finance (MOF). The objective of the Basic Standards is to strengthen internal controls of businesses in order to promote sustainable development, improve risk management and avoid disruption to markets resulting from financial scandals (MOF, 2008). Specific guidelines to help achieve the Basic Standards were issued in 2010 under the title The Enterprise Internal Control Supporting Guidelines (hereinafter referred to as Supporting Guidelines). These guidelines were first to be applied by companies cross-listed on the Shanghai and Shenzhen Stock Exchanges from January 1, 2011.

This study examines the application of the Chinese internal control regulations by the cross-listed companies. The study assesses how well the companies complied with the guidelines and identifies the nature and the quality of disclosures reporting internal control deficiencies. The paper also investigates characteristics of firms with internal control weaknesses.

The remainder of the study is structured as follows: The first section describes the development of the internal control regulatory requirements. This is followed by a review of the literature on the disclosure of internal control weaknesses. The following sections describe the research questions, the sample selected, the research method employed and data analysis. The final sections discuss the findings and conclude the study.

Background

Background to Internal Control Guidelines

An effective internal control system is fundamental for a business to achieve its objectives relating to effective and efficient operations, business continuity and compliance with laws and regulations (Committee of Sponsoring Organizations of the Treadway Commission, 2013). The importance of internal control is recognized by the Chinese MOF when it states that the Basic Standards are issued to "promote sustainable development of enterprises, maintain the socialist market economic order and the public interest" (MOF, 2008).

In 2006, prior to the Basic Standards being issued, the Shanghai Stock Exchange issued internal control guidelines for listed companies (Shanghai Stock Exchange, 2006). In the following year the guidelines were published by the Shenzhen Stock Exchange (Shenzhen Stock Exchange, 2006). The introduction of these guidelines meant that some internal control information was being disclosed to investors of Chinese listed public companies. However, Fang and Sun (2007) state that the disclosure of internal control information by Chinese listed companies was largely a formality with no substantive content with the vast majority of Shanghai-listed companies not complying with the disclosure guidelines.

In 2008, the Chinese MOF and other authorities: the Securities Regulatory Commission, National Audit Office, Banking Regulatory Committee and Insurance Regulatory Committee, issued the Basic Standards. The Basic Standards provide an internal control framework comprising the control environment, risk evaluation, control activities, information and communication, and control monitoring. The Basic Standards were first made mandatory for cross-listed companies from January 2011 and for all other listed companies from 2012.

The Basic Standards require listed companies to prepare a self-evaluation report on the effectiveness of their internal controls and have an auditor give an opinion on this assessment. The Basic Standards are supported by the Supporting Guidelines issued in 2010.

The Guidelines comprise three sets of implementation guidance:

Application Guidelines

This regulation identifies eighteen business areas to develop internal control systems. The areas range from organisational structure and procurement activities to financial reporting. A complete list of the business areas is provided in the Appendix.

Evaluation Guidelines

The guidelines provide a framework for assessing the effectiveness of internal controls. Guidance is given on internal control procedures, identifying criteria for internal control deficiencies and specifying the contents of the internal control reports. The internal control report, as a minimum must include:

1. An authenticity statement by the board of directors;
2. An overview of the internal control environment;
3. The basis of internal control evaluation;
4. The scope of internal control evaluation;
5. The procedures and methods of internal control evaluation;
6. Recognition of internal control deficiencies;
7. Disclosures on how internal control deficiencies are to be rectified and corrective actions to be taken when there is a material deficiency; and
8. A conclusion on the effectiveness of internal controls. According to the Evaluation Guidelines, internal control deficiencies include either design or operational deficiencies. A design deficiency is mainly at the entity level and an operational deficiency mainly exists at an activity level. Internal control deficiencies are classified as material, significant, or insignificant based on their economic impact on a business.

Audit Guidelines

These are guidelines for the auditing firms setting out their responsibilities and the audit standards for the assurance engagement.

Literature Review

The literature on internal control reporting is wide-ranging (see for example Schneider, Gramling, Hermanson and Ye (2009) which provides an overview of the literature and the research strands). Many research studies relate to the implementation of Section 404 of the Sarbanes-Oxley Act, of 2002 which requires senior managers and auditors to report on the effectiveness of internal control for financial reporting.

Our focus is on the disclosure of internal control weaknesses. Ashbaugh-Skaife, Collins and Kinney (2007) provide a conceptual model for the disclosure internal control weaknesses (hereafter ACK model). The model identifies three elements: (1) the risk of the existence of an internal control weakness, (2) the detection of an internal control weakness, and (3) the disclosure of an internal control weakness.

Asbaugh-Skaife et al. (2007) argue that management's incentive to disclose an internal control weakness is a trade-off between the benefits of detecting and disclosing a weakness against the costs of disclosing the weakness. The benefits of reporting internal control weaknesses relate to transparency and reputation in the capital markets and cost savings in audit fees (Bedard, Graham, Hoitash and Hoitash, 2007). The costs of disclosure include compliance costs, the potential loss of reputation for not providing reliable financial reports and potential litigation risks arising from reporting weaknesses.

Each of the three elements in the AKC model have been the subject of prior research. For element (1), research studies have investigated firm factors associated with the increased likelihood of internal control weaknesses. The findings show that smaller firms and less profitable firms are more likely to have internal control deficiencies because they have limited resources to invest in and monitor internal control systems (Ashbaugh-Skaife et al. 2007; Bryan and Lilien, 2005; Doyle, Ge & McVay, 2007; Ji, Lu & Qu, 2013). Other factors associated with the increased likelihood of internal control weaknesses include firm growth which puts pressure on internal control systems and processes resulting from firm growth (Ashbaugh-Skaife et al. 2007; Doyle et al. 2007), complexity of operations and major organisational changes such as restructures, mergers and acquisitions (Ashbaugh-Skaife et al. 2007; Ji et al. 2013).

In reference to element 2 of the ACK model, Ashbaugh-Skaife et al. (2007) argue that Big 4 auditors have reputations to protect and are motivated to conduct high quality reviews of internal controls and make SURE that firms disclose internal control weaknesses. Big 4 firms have the resources to invest in systems, processes and training to produce high quality audits. However, in the United States Big 4 auditors dominate the supply of audit services whereas in China the concentration of the Big 4 is not as high although it is growing (Li, Song and Wong, 2008). The lack of Big 4 dominance is attributed to the lack of demand for high quality audits (DeFond, Wong and Li, 1999) as Chinese firms are unlikely to identify material weaknesses because of concentrated ownership by the state (Piotroski, 2014).

For element 3 in the ACK model, Ashbaugh-Skaife et al. (2007) argue that United States firms with a high institutional ownership face greater monitoring pressure from these owners as they have the power and influence to make changes. In the Chinese context there is significant state ownership and control of listed companies. Consequently, the demand for corporate transparency is low as concentrated ownership by the state and state control over appointments of key executives means that information can be accessed privately (Piotroski and Wong, 2012).

They also argue that the risk of restatements and legal actions are key drivers for managers to identify and disclose internal control weaknesses. However, restatement and litigation risks are not so relevant in the Chinese environment while state ownership of a number of Chinese listed firms has resulted in a large number of politicians and ex-bureaucrats serving as senior executives and board members. Such types of board members may be more motivated in extending their political connections and building their reputations instead if monitoring firm performance (Xiao et al. 2004). The business relationships and political connections form part of a corporate culture which reduces the external demand for high quality information for decision making and stewardship purposes (Piotroski and Wong, 2012). The quality of earnings of politically connected companies is lower compared with other companies. In addition firms with political connections do not appear to suffer financial consequences as a result of the opacity of accounting information disclosures (Chaney, Faccio and Parsley, 2011).

Research Questions

In this study we analyse how well Chinese cross-listed companies complied with the internal control regulations and the nature of the internal control weaknesses disclosed. We evaluate the quality of the internal control disclosures and examine the factors associated with the existence of internal control weaknesses. The research questions are:

1. How well did cross-listed companies apply the internal control regulations?
2. What types of internal control weaknesses are disclosed?
3. What is the quality of disclosure of internal control weaknesses?
4. What firm characteristics are associated with the existence of internal control weaknesses?

Sample and Research Method

This study examines the internal control disclosures of 67 cross-listed companies on the Shanghai and Shenzhen stock exchanges at the time the internal control regulations were first introduced for cross listed companies on January 1, 2011. All these companies were cross-listed on the Hong Kong stock exchange with the exception of one company that was cross-listed on the Singapore stock exchange. Nine companies were also listed on the New York Stock Exchange.

The 2011 annual reports for the 67 companies were downloaded from the website http://www.cninfo.com.cn/. The internal control reports for each of the companies were reviewed and each section of the report analysed to determine if the guidelines had been met and to assess the quality of disclosures.

All 67 companies disclosed their annual financial reports, internal control evaluation reports and internal control audit reports by 30 April 2012. All but one of the 67 companies received unqualified opinions on their internal control audit reports.

Findings

Table 1 shows an analysis of the companies by industry. The companies cover nine of thirteen industry categories specified by the Chinese securities regulations. They include mining, manufacturing, electricity, construction, transportation, information technology, finance and insurance, real estate, and social services. The majority of companies are involved in manufacturing (40.3%), transportation (17.9%), finance and insurance (16.4%) and mining (10.4%). There are 27 companies operating in the manufacturing industry with 27 companies producing mechanical equipment and metals and non-metals.

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

Table 1. Industry Distribution

Table 2, Panel A categorises the companies by the size of revenue. The cross listed companies are very large with all but three generating total revenue of more than ￥1 billion. The total revenue generated in 2011 by the 67 companies is RMB ￥12,133 billion, representing about a quarter of China's GDP of the same year.

The firms are profitable with an average return of 9.27% (see Table 2, Panel B). State ownership is high with an average shareholding in the sample of 46% with a maximum shareholding of 86%. A total of 12 accounting firms audited the internal control reports of the 67 cross listed companies. The Big 4 accounting firms dominated, auditing 46 (69%) of the companies with PWC auditing 16 of these. The remaining 21 (31%) of companies, were audited by China domestic accounting firms.

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

Table 2. Total Revenue of the 67 Cross Listed Companies
Panel A. Total Revenue (n=67)

	Mean	Median	Std dev	Maximum	Minimum
Profitability	9.27	9.70	14.34	29.17	-55.88
State Ownership	45.97	48.20	19.29	86.37	0.00
Auditor	0.69	1.00	0.47	1.00	0.00

Profitability is the return on average equity, State Ownership is the proportion of shares held by the state, Auditor is 1 if a Big 4 auditor, 0 otherwise.

Table 2. Total Revenue of the 67 Cross Listed Companies
Panel B. Descriptive Statistics (n= 67)

Compliance with Evaluation Guidelines

The Evaluation Guidelines list seven elements to be included in the Internal Control Evaluation Report. Table 3 lists the number of companies which completed each of the seven elements – "Yes" indicates that the company complied with the section while "not disclosed" indicates non-compliance.

The Authenticity Statement requires the Board of Directors to confirm that they are responsible for establishing and maintaining an effective system of internal control and the truthfulness of the information disclosed. All 67 companies provided the statements with 35 companies using a standard "Board Statement".

All the companies provided an overview of the internal control environment and the name of the company unit responsible for internal control matters. In many cases companies have established an internal control committee reporting to the board of directors.

Fifty two (77.6% of total) companies provide a section which identifies the business areas (refer to the Appendix) that are included in the evaluation of the internal control system. Eight companies did not have a separate section but disclosed the required information in sections in other areas of the report such as in 'overall information', 'evaluation contents', 'specific implementation' or listed them in an appendix. Seven companies did not comply with the Internal Control Evaluation Guidelines.

According to the Supporting Guidelines, an internal control evaluation process should include a plan and an

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

Table 3. Compliance with Elements of the Internal Control Evaluation Report

evaluation working group. On-site testing is required to identify control deficiencies with the results summarised and evaluated with an overall assessment documented in the evaluation report. Evaluation methods are to be integrated and can include individual interviews, questionnaires, walk-throughs, field inspections, sampling, and comparative analysis. Fifty-nine of the sixty-seven companies (88.1 % of the total) disclosed their internal control evaluation procedures and methods. The methods most commonly used were interviews and sampling.

Table 3 shows that 49 out of the 67 companies (73.2% of total) disclosed internal control deficiencies. The remaining 18 companies had no internal control weaknesses simply stating that according to the company standard, combined with daily supervision and special supervision, they did not find material defects during the reporting period. The percentage of companies with weaknesses is high in comparison to studies in the United States where the percentage of firms with weaknesses is much lower. For example, Ashbaugh-Skaife et al. (2007) use a sample beginning with 585 firms (the number is later reduced to 326 firms) with weaknesses and a control sample of firms not reporting weaknesses of 4,484 firms. Ji et al. (2013) document the percentage of firms with weakness averaged 55% and is decreasing overtime.

The severity of internal control deficiencies are classified as material, significant or insignificant. Only one company, Xinhua Pharmaceutical, had a material deficiency; two companies: Jiangxi Copper and China Shipping Container Lines had significant deficiencies (see text box 1. on the following page).

The remaining 46 companies with insignificant deficiencies described them vaguely referring to defects in systems, processes, and procedures. Very few companies provided actions to eliminate the internal control deficiencies. However, companies that did disclose corrective measures lacked detail and used generic statements such as "adjusting staff positions", "amending systems" and "business process reengineering". There was little evidence of a detailed corrective plan to fix an internal control deficiency.

According to Supporting Guidelines, the effectiveness of internal controls has to be clearly described in the internal control evaluation report and a conclusion on the overall effectiveness of the internal control systems made by the board of directors. All the companies, except for Xinhua Pharmaceutical, concluded that the internal control system was effective. There were 57 companies which had a dedicated section for "internal control effectiveness conclusions."

Disclosure of Internal Control Weaknesses

The quality of disclosures of the internal control weaknesses was evaluated. Four categories of disclosure were applied: superficial, quantitative, descriptive, and detailed. A disclosure category is described as superficial when a company reports the existence of internal control deficiencies but not the number or their severity. When a company only discloses the number of deficiencies the disclosure is rated quantitative or if only the severity of the weakness is reported but without the number of weaknesses it is labelled descriptive. If both the number of weaknesses and their severity are disclosed, we

Text Box 1. The following is an extract translated from the Internal Control Evaluation Report of Xinhua Pharmaceutical.

Extract 1: Material Deficiency - Xinhua Pharmaceutical

According to the standards above, combined with results of daily supervision and project supervision, during our evaluation we found a material deficiency in the reporting period that the customer lines of credit had become too large, causing significant losses for a subsidiary, Shandong Xinhua Pharmaceutical Medical Trading Ltd (hereinafter referred to as the MTL). The internal control system of the MTL lacks a clear policy on provision of multilateral credits. The MTL's Lu Zhong Branch, industrial department and Commercial Department gave credit to the same customers, which led to an increase in the amount of credit provided. The policy of the MTL is that lines of credit cannot be greater than the customer's registered capital. Some customers have been given credit which exceeds the registered capital. The material deficiency caused the company to have accounts receivable to Shandong Xin Kang Qi Pharmaceutical Ltd (SDXKQ) of ￥60,730,000. SDXKQ is experiencing financial difficulties, which may cause the MTL to suffer even more serious losses.

Two companies reported the existence of significant deficiencies. Jiangxi Copper reports the existence of seven major deficiencies but fails to disclose details as shown in Extract 2.

Extract 2: Significant Deficiency – Jiangxi Copper

According to the above criteria, combined with the daily supervision and special supervision, we found that there are 1,017 deficiencies during the reporting period, including seven significant deficiencies, and no material deficiency.

Similarly, in Extract 3, China Shipping Container Lines reports one significant deficiency without any information on the nature of the defect.

Extract 3: Significant Deficiency – China Shipping Container Lines

According to the above criteria, there are six internal control deficiencies during the report period. Among them, one is a significant deficiency, the other five are insignificant deficiencies.

Text Box 2. Disclosure Quality Categories

Extract 1: Hisense Kelon: Superficial

In accordance with the above standards, combined with the daily supervision and special supervision situation, we found that during the reporting period there are no material defects or significant deficiencies. There are still insignificant internal control deficiencies in some control processes.

Extract 2: Jiangxi Copper: Quantitative

According to the above criteria, combined with the daily supervision and special supervision, we found that there are 1,017 deficiencies during the reporting period, including seven significant deficiencies, and no material deficiencies.

Extract 3: Guangzhou Pharmaceutical: Description

During the reporting period, the company's internal control has obtained certain results, but the overall planning of human resources, information system emergency response and system recovery plans, regular check on the quality of outsourcing work remain to be strengthened.

Extract 4: Chenming: Detailed

In accordance with the above standards, combined with the daily supervision and special supervision, we find three internal control deficiencies during the reporting period which are all identified as insignificant deficiencies:

1. Subsidiary Wuhan Chenming did not record one purchase on time in January.
2. Some of the delivery notes in subsidiary Qihe Chenming have not been stamped with a special seal for sales office delivery.
3. There was no notice form in a thick slurry pump equipment transfer inside subsidiary Wuhan Chenming in September.

define the disclosure 'detailed'. Extracts 1 to 4 give an example of each disclosure category translated from the Internal Control Evaluation Report (see text box 2. on the previous page).

Table 4 summarises the disclosure quality results. The majority (51%) of the disclosures are superficial lacking any depth of explanation. Only six companies (12.2%) provided detailed disclosures.

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

Table 4. Disclosure Quality of Internal Control Deficiencies (n=49)

Fifteen companies gave descriptions of their internal control deficiencies (disclosure categories descriptive and detailed) and disclosed 66 internal control deficiencies with 42 (62.7%) entity-level deficiencies and 25 (37.3%) activity-level deficiencies. The list of deficiencies are categorised into entity or activity level deficiencies in Table 5.

Deficiencies in the control environment are the most prominent problem, accounting for 13 out of the 42 entity level deficiencies, followed by monitoring and control activities. In terms of activity-level deficiencies, internal controls over purchase and sale activities are the most prevalent areas of weakness.

	No of Companies	No of ICDs	%
Entity Level			
Control environment	11	13	19.4
Risk assessment	4	4	6.0
Control activities	8	8	11.9
Information communications	2	2	3.0
Monitoring	8	10	14.9
ITGC	5	5	7.5
Subtotal		**42**	**62.7**
Activity Level			
Purchases	7	7	10.4
Revenue	7	7	10.4
Inventory	2	2	3.0
Non-current assets	5	5	7.5
Investments	2	2	3.0
Liabilities	1	1	1.5
Financial instrument	1	1	1.5
Subtotal		**25**	**37.3**
Total		**67**	**100.0**

Table 5. Internal Control Deficiencies (ICDs)

Firm Characteristics and Internal Control Deficiencies

In further analysis we investigate differences in the characteristics of firms that report internal control deficiencies. We adapt the variables from Ashbaugh-Skaife et al. (2007) and include firm characteristics that may result in weaknesses of firm size, profitability, complexity and growth. For incentives to report and disclose internal control weaknesses we adapt the variables to include Big 4 auditor, state ownership and political connections. Finally we include two corporate governance factors: independent chair and board independence as Hoitash, Hoitash and Bedard (2009) find that firms with strong boards (a composite of board qualities including size, independence and frequency of meetings) and audit committee members with more accounting and supervisory experience are less likely to have internal control weaknesses.

Table 6 shows the firm characteristics of the 49 firms

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

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

Table 6. Companies With and Without Internal Control Weaknesses

with internal control deficiencies and the 18 companies with no deficiencies. In line with prior research, firms with internal control deficiencies are smaller and less profitable compared with other firms. Firms with deficiencies have on average more complex operations and greater acquisition activity compared with those firms that do not, which is also consistent with prior research. In terms of the factors relating to the propensity for firms to disclose weaknesses, firms that disclose internal control weaknesses have lower state ownership and less political connections which is in line with expectations. Firms with internal control weakness also have a higher percentage of board chairs which are not independent. However, the mean/median differences between the two sets of companies are not significant as shown by the t and Mann-Whitney tests. The exception is Big 4 auditors where companies with internal control deficiencies are less likely to have a Big 4 auditor.

However, contrary to prior research firms with internal control deficiencies have lower growth rates and more independent boards but the differences between firms with and without deficiencies is not significant.

Discussion of Findings

Compliance with the internal control regulations for Chinese cross-listed companies in 2011 is generally positive. The study shows that 59 companies met or basically met the Internal Control Basic Standard and its Supporting Guidelines, while eight did not cover the deficiencies and rectification of internal controls problems.

While compliance was high there are issues around the quality of information disclosed. The quality of disclosure of internal control deficiencies was superficial with very brief disclosures and little explanation of the nature of the deficiencies and remedies to correct them.

The Supporting Guidelines specify the disclosure areas, however, there is no set report format used by companies. The lack of consistent structure of the reports made it difficult to identify the relevant information and compare with other companies. There appears to be a need for further regulation to standardise the format of the internal control reports.

Companies with internal control weaknesses had characteristics that differed from the other companies consistent with prior research. However, due to our small sample none of the characteristics was significantly different except for Big 4 firms – 63% of firms with internal control deficiencies were audited by Big 4 compared with 83% for firms without deficiencies. This result may be explained by the fact that Big 4 firms may focus on less risky clients – those that are larger and more profitable. Further research is required to assess this trend given that this is a small sample consisting of the companies that first implemented the guidelines.

Conclusion

The Chinese government introduced regulations requiring listed companies to disclose management's assessment of the effectiveness of the internal controls of the firm together with an auditor's opinion. This study examines four aspects of the application of the regulations for cross-listed companies, the first group of companies required to implement the regulations. We examine (1) compliance with the regulations, (2) the nature of the internal control deficiencies, (3) the quality of disclosures in the internal control report, and (4) the characteristic of cross listed firms reporting internal control weaknesses.

Our analysis shows that Chinese companies have complied with the legal form of the regulations providing the necessary disclosures. A high proportion of companies (73% of total) disclosed internal control deficiencies. However, the quality of the disclosures around the deficiencies is poor especially in relation to discussing the nature of the internal control deficiencies and the plans and processes in place to eliminate them. Improvements may occur in the future as firms familarise themselves with applying the regulations. However there are features of the Chinese business environment, such as a lack of demand for high quality reporting, that may mitigate an improvement in the quality of disclosures in the future. This is an area of future research.

The study finds that firms with internal control weakness are less likely to have a Big 4 auditor. Other characteristics of firms with deficiencies were not statistically different from other firms. Further work can be done in this area to assess the demand for high-quality internal control evaluation reports.

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Appendix.

China SOX – Aspects of Internal Control According to Internal Control Application Guidance

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

Contract Management	• Designate a centralized contract management department; specify the procedures and requirements for contract drafting, examination and approval, performance and aspects, conduct regular inspection and evaluation. • Establish a contract performance assessment system, analyse and assess the overall situation of contract performance and the specific situation of the performance of major contracts at least once at the end of each year.
Internal Informal Communication	• Formulate a rigorous internal reporting process. Make full use of communication information technology, reinforce the integration and sharing of internal reporting information, and include internal reports into its unified information platform, so as to build a scientific internal reporting network. • Make effective use of internal reports in risk assessment, accurately identify and systemically analyse the internal and external risks in its production and operation activities, and determine the strategies to tackle such risks, so as to achieve effective control of risks.
Information Systems	• Designate a department to manage the building of information systems on a centralized basis. • Strengthen the management of critical information equipment such as the servers.

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