



# Chinese Operations of Audit Committee and Supervisory Board - A Case Study

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## ABSTRACT

**Imposing the mechanism of a single audit committee (AC) on the dual supervisory mechanism of a Board of Directors alongside a supervisory board (SB) has raised questions regarding the problems in implementing effective monitoring. How the SB and the AC operated in a Chinese listed company is documented in this article by interviewing the secretary of BoD; the SB chairmen and an AC member. The issues rose in the interview point out the problems and evidences presented provide useful guidelines of how key characteristics of effectiveness and co-ordination can be improved to make supervisory functions in China more effective.**

**Key Words:** Audit Committee, Supervisory Board, Corporate Governance

## INTRODUCTION

The Chinese Company Law adopted in December 1993 became the first piece of Chinese legislation specifying that every listed company establish a Supervisory Board (SB) to supervise the company's financial activities and the conduct of its directors. Since the 1997 the Asian financial crisis, the establishment of Corporate Governance (CG) in the region has started being regarded as a critical priority for government. Subsequently, various Asian administrations have initiated serious efforts to develop CGs to improve their international competitiveness. China introduced additional regulations involving the appointment of independent directors. Initially, starting in 1997, independent directors were optional, but they became compulsory for listed companies from 2005. China applied to join the World Trade Organization (WTO) in September 2001 and was admitted in November of the same year. Since joining the WTO, China has strengthened its supervision of domestic listed companies in order to align itself with the international market, gradually moving toward an export-oriented economy and eventually implementing an open economic system, for example, the shareholding structure of wholly state-owned companies have been significantly reformed and reconstructed into joint stock companies and have been listed in various inland stock markets. The changes in their roles and functions have opened a new chapter in China's history of financial reform. Presently, while China has left no stone unturned in luring foreign capital into the country, it has also encouraged local enterprises to focus on the global market and become competitive internationally. To ensure success, the next milestone for China's ongoing reform will be to actively promote the implementation of CG systems as the international trend dictates.

In 2002, China announced the regulation of the Code of CG for Listed Companies (CSRC and SETC 2002: Section 52), encouraging listed companies to set up an Audit Committee voluntarily, although its installation is not mandatory. In countries such as the United States and the United Kingdom, it is compulsory for listed companies to establish an AC to oversee the aspects of the company's internal control and financial reporting (Sarbanes-Oxley Act [SOX], 2002: Sec.2 (a) (3); Combined Code, 2003: Sec.C3.1). In China, under the equivalent regulation, the establishment of an AC is voluntary rather than mandatory. In practice, the willingness to

install the AC has increased and given that many Chinese companies have introduced ACs into their governance structures, it is indeed a peculiar system of implementing a singular mechanism of the AC on top of the dual supervisory mechanism of the SB. Given that the SB in the Chinese system has similar duties to that of the AC in the Anglo-American system, it is unclear how these two bodies will operate together and interact with each other and whether this will result in the duplication of supervision. The issue in this article may be summarized as follows: ***What are the Chinese operations through implementing both the AC and the SB simultaneously in China?*** Particular attention is aroused to the problems that the SB is facing and to the likely causes to the installation and cooperation with the AC.

This article intends to elucidate the Chinese internal supervisory mechanism, and to better understand the operation contents of the SB and the AC supervisory functions and coexistence information obtained from a case study by interviewing both of the SB chairmen; an AC member and the secretary of BoD who is the coordinator of the SB and the BoD of a listed company in China. The evidence presented forms a basis for proposals of how key operations of monitoring and co-ordination can be improved to make supervisory functions in China more effective.

The remainder of this article is organized as follows: Section “Literature and Regulation” discusses literature studies and regulation; the section “Research Methodology” describes research design, and the “Empirical Studies” section presents the empirical findings and section “Conclusion” concludes with the assessment of the finding as well as proposals for future research on the subject matter.

## LITERATURE AND REGULATION

### Literature

ACs. Be ´dard, Chtourou, and Courteau (2004) find a significant association between earnings management and AC governance practices. Goodwin-Stewart and Kent (2006) find that the existence of an AC, more frequent committee meetings, and increased use of internal audits are related to higher audit fees. These findings are consistent with an increased demand for higher quality auditing by ACs and by firms that make greater use of internal audits. Chen and Zhou (2009) find that firms with effective ACs are associated with less earnings management and less audit fees, and are less likely to have modified opinions and delayed filings. In line with the principles of the agency theory, these initiatives mainly aim to improve a board’s monitoring potential by increasing its independence from management (Daily et al., 2003; Finegold et al., 2007; Ramli et al., 2010). Typical measures to improve a board of directors’ independence include increasing the number of outside non-executive directors, separating the roles of the CEO and the chair, limiting the number of board interlocks and establishing oversight board committees. Chien, Mayer, and Sennetti (2010) find that the presence of a committee and the committee’s specific qualities of independence, financial expertise, and increased activity positively correlate with reduced frequencies of internal control problems. Ika and Ghazali (2012) suggest that AC effects are likely to reduce financial reporting lead times. In addition, Iyer, Bamber, and Griffin (2013) find that professional accounting certification and AC experience are valued positively by the BoD when designating an AC member as a financial expert. As a result, board systems appear to evolve and converge around the globe (Bezemer et al., 2007; Chhaochharia and Grinstein, 2007; Valenti, 2008). For future research, Stuart and Zaman (2014) suggest: (1) greater consideration of the organizational and institutional contexts in which audit committees operate; (2) explicit theorization of the processes associated with audit committee operation; (3) complementing extant research methods with field studies; and (4) investigation of unintended as well as expected consequences of audit committees.

SBs. After 2006, the newly amended Chinese Corporate Law significantly enhances the role played by SBs. They find that before the new corporate law became effective, SBs did not affect executive compensation, although their role after that became significant. Ding, Wu, Li, and Jia (2010) explain that China's CG system implements both American and German style mechanisms, but the SB, a typical feature of German style governance, is generally considered dysfunctional. Xiao, Dahya, and Lin (2004) examine how SBs function in Chinese-listed companies. Particular attention is paid to the problems that are faced by the SB and to the likely causes and consequences of these problems. Gorton and Schmid (2004) document that under the German CG system of co-determination; employees are legally allocated control rights over corporate assets through seats on the SB—that is, the board of non-executive directors. Firth, Fung, and Rui (2007) find that the types of the dominant shareholder, the size of the SB, and the percentage of independent directors have an impact on the frequency of modified audit opinions. Qin (2007) examines the relationship between corporate performance and the characteristics of the SB. He suggests that the SB functions effectively in China and that improving SB functions could result in better corporate performance. One specific proposal for improving the SB system advanced in Wei and Jiang (2010) is to create public supervisors and creditor supervisors. Bezemer, Maasen, and Van Halder (2012) suggest that a separate board with the power to influence management through consent, advice and incentives is an effective, pre-emptive form of monitoring. Block and Gerstner (2016, p50) find that the American board has begun to reflect German two-tier model in function if not in form and they remark "The heightened monitoring standards for boards and the rising importance of committees has made the one-tier board in America more akin to a multi-tiered board." Block and Gerstner (2016) stressed that another important monitoring task is the supervision of executive actions, where effectiveness depends on (1) independence from management, (2) information access and (3) overcoming operational challenges.

In summary, the characteristics of independence, expertise, and diligence of the SB and the AC are a prerequisite for the effective exercise of monitoring functions. China has entered a period of unprecedented transformation, within which business operations have become more complex. It is a period of rapid innovation as well as that of trial and error in the evolution of businesses and business processes. The relevant studies of Li and Du and Tang (2006), Li and Chen (2006), Li and Liu (2005), Li (2007), and Chang (2001) all suggest that China must enhance governance mechanisms in its listed companies and the development of the capital market by refining the basic principles of "Corporate Law," "Securities Law," and "Rules for Listed Companies Governance" as well as by learning from the best reform practices of domestic and overseas CG.

## Regulation

AC. It appears that there is no universally accepted definition of an AC to be found in regulations, reports, surveys, and research studies. Instead, different definitions are presented such as those in Section 404 of SOX (2002), Klein (2002a), Collier (1996), and Braiotta (1999). These definitions state that the AC is a sub-committee of the BoD, and they confine the definition primarily to the composition and the key responsibilities of ACs:

*The term "AC" means—a committee (or equivalent body) established by and among the BoD of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer. (U.S. Securities Exchange Act of 1934 #3 (a)(58); SOX Section 404, 2002)*

These definitions state that the AC is a sub-committee of the BoD and confine the definition mainly to the composition and the key responsibilities of ACs. They also discuss the

composition of the AC, particularly with regard to the participation of independent directors with professional abilities to perform the key responsibilities of financial reporting, audit, and internal control. In a nutshell, all the above-quoted definitions of the AC tend to emphasize the two attributes of its composition, namely independence and financial expertise, as well as its responsibility over operations. It is contrasted with the SB with regard to their service scopes, their functional positions and responsibilities, as well as their operations.

It is the duty of the Audit Committee to ascertain that the Company maintains adequate procedures and control systems to manage the financial, operational and risks to which the company are exposed, to prevent fraud and to oversee the integrity of the Company's financial reporting (FRC-UK, 2016). According to Section 52 of the Code of CG for Listed Companies in China, the BoD of a listed company may establish an AC. China's "Rules for Listed Companies Governance" set out five main duties of CG for the AC:

1. Provide suggestions for engaging or changing the external audit firm (CPA);
2. Supervising the Internal Audit system and its implementation;
3. Be responsible for the internal and external auditing communication;
4. Verify and reveal the financial information of the company;
5. Check the internal control system.

SB. According to the German regulations on CG, the SB (Aufsichtsrat) oversees and advises the BoD (Executive Board, Vorstand), and also has control over fundamental and important decisions. According to Paragraph 1 of Article 111 of the German Company Act (Aktiengesetz; AktG), the SB has the right and responsibility to oversee (überwachen) the operations of the company (Chen, 2007, p. 154). The supervisory board reviews the management by inspecting the books<sup>1</sup>, reviewing the annual report<sup>2</sup>, issuing and overseeing the work of an external auditor<sup>3</sup>, analyzing the information provided by the management board<sup>4</sup> and reporting to the general meeting<sup>5</sup>. In addition, the supervisory board also has standing for court actions against the management<sup>6</sup>. The characteristic of the existing German system of CG indicates that the SB plays the role of overseeing the operations and finance of the company. In addition to the appointment and removal of directors, the most important right and responsibility of the SB is to oversee the operations of the directors (Yang, 2004, p. 102). In the Chinese system of CG, there are two institutions participating in the Shareholders Assembly Meeting: the BoD which is responsible for making important day-to-day managerial decisions, the removal of managers, and the execution of day-to-day operations, whereas the SB is responsible for the supervision of the company's finance, the violation of laws, regulations, or company constitution by the directors and managers in their execution of their duties to the company (Yang, 2004). According to Article 126 in China's Corporate Law, the SB in a Chinese company is the internal supervisory unit responsible for supervising the directors and managers' behaviour. Corporate Law also stipulates the system of the SB and guides it on behalf of the shareholders to supervise the organisation of internal power, exercised by the BoD and the layers of management of the company. In both the German and the Chinese systems, it is the right and responsibility of the SB to oversee the conduct of the BoD. In the German system, the SB has a rank position above the BoD, whereas in the Chinese system, the SB has the equal rank position as the BoD. This structural difference might have some impact on the supervisory effectiveness,

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<sup>1</sup> Section 111 para. 2 sent. 1 & 2 AktG.

<sup>2</sup> Section 171 para. 1 sent. 1 AktG.

<sup>3</sup> Sections 111 para. 2 sent. 3, 170 para. 1 & 2, 171 para. 1 AktG, No. 7.2.2 GCGC.

<sup>4</sup> Section 90 para. 1 AktG.

<sup>5</sup> Sections 118 para. 3 sent. 1, 124 para. 3 sent. 1, 171 para. 2 AktG.

<sup>6</sup> Section 112 AktG.

the powers, and roles of the SB in both systems. The duties of SB as stipulated in Corporate Law include:

1. Reviewing the financial affairs of the company;
2. Monitoring the performance of directors and senior officers; removal of directors or senior officers in the case of violation of laws, administrative regulations or articles of association;
3. Requiring rectification from directors or senior officers if they cause harm to company interests;
4. Proposing interim shareholder meetings; convening shareholder meetings when the board of directors does not do so as required by law;
5. Submitting proposals at the shareholders meeting;
6. Filing suit against directors or senior officers if they harm the company while performing their duties in violation of laws, administrative regulations or the articles of association;
7. Exercising other authorities set out in the articles of association.

In addition, supervisors may attend board meetings and may propose issues to be determined by the board of directors. A supervisory board or the supervisors of a company that does not have a committee may conduct investigations upon discovery of any unusual operations of the company. A supervisory board of a wholly state-owned company may exercise the first three powers in the above list as well as other powers set out by the State Council.

First, in 2006, China's National People's Congress (NPC) specified the SB as the special institution for financial inspection and supervision, whereas in 2002 the Chinese Security Regulatory Commission (CSRC) mandated that both the SB and the ACs were responsible for financial supervision, and both have the same financial supervisory function of overseeing the authenticity and reasonableness of the disclosure of the company's accounting information. Second, both are responsible for safeguarding against questionable conduct of the Directors, and related transactions of senior managers. The duties of the AC and the SB as stipulated in Corporate Law and the Code of CG for Listed Companies in China are essentially similar; both try to monitor within the company's functions on the same issue, identified as supervising financial reporting, auditing, internal control and compliance. However, organisationally they are not affiliated to each other, as the AC is under the jurisdiction of the BoD, while the SB is parallel to the BoD. This can cause confusion in their respective responsibilities if there is lack of clarification or co-ordination, and it may appear that many institutions are supervising but no unit actually performing that function. Clarification the defects of performing SBs in China or co-ordination includes defining the duties, functions and position between SBs and ACs in the organisation, but such clarification measures are still outstanding. Therefore, this paper endeavours to investigate on operations and coexistence of two monitoring institutions.

## RESEARCH METHODOLOGY

### Design

This article aims to answer the research question by a case study of interviewing the AC and the SB chairmen of a listed company in Hanchou, China and referring to the work of Gendron, Be ´dard, Turley and Zaman, Spira, and others. As these researchers performed only limited research on internal processes, they have called for more research to be carried out. Thus, the interviews with the AC and the SB chairman will help identify the operation process of the monitoring institutions for the realization of effective supervision, rooted in their practical experiences, in response to calls by the relevant researchers to unravel the black box of the monitoring system, as this cannot be achieved through quantitative methods. Generally, the qualitative method will analyze the responses from the interviewees of one listed company to

identify operational processes on the understanding of the supervisory institutions' concrete practices of implementation by revealing the contexts of supervisory functions in the sampled interviewees.

### **Sample Target**

The sampled company of engineering machinery Co., Ltd. listed in the Shanghai Stock Exchange (SSE) with three interviewees, one General Secretary of BoD; one AC chairman and one SB Chairman were interviewed. The interviews were conducted after the introduction of the General Secretary of the BoD, as he is in charge and the co-ordinator of the BoD and the SB, including ACs and its related parties. Three interviewees were questioned about the process of typical supervisory functions, and the extent to which the company's SB and AC fulfilled its mandate in practice in China, to make data collection more systematic for each interviewee, it was intended to keep the interview fairly conversational and situational. The data were then analyzed and consolidated to generate conclusions. Face to face in-depth interviews with three interviewees:

*Mr. XX1: Secretary of the BoD of the Hangcha Engineering Machinery Co., Ltd., Hangzhou. Mr. XX2: Chair of the SB and Legal Advisor of the sampled Engineering Machinery Co., Ltd., accompanied by Mr. XX1, Secretary of the BoD. Hangzhou. Mr. XX3: Chair of the AC and Chief Financial Officer of the sampled Engineering Machinery Co., Ltd., accompanied by Mr. XX1, Secretary of the BoD. Hangzhou. [Video recording in possession of author]ll*

### **Techniques**

Prior to fieldwork, investigations were specified through understanding a background of the sampled company and the SB and AC features of the sampled company in the sampled corporation as tables 1-2 based on the research objective, literature review and experience of themes related to key functions of SBs and ACs; while being flexible enough to explore new approaches during the interview. Semi-structured interviews were used to allow the interviewees to express their points of views for mutual understanding relating to the SB's operations related to effectiveness and dynamic relationships with related parties (Rubin & Rubin, 1995). The interview transcripts were analyzed through qualitative procedures (Miles & Huberman, 1994). Therefore, semi-structured questions were designed for in-depth interview for the sample company, to arrive at the general understanding of the practice of the SB and the AC. Questions were prepared in order to understand the monitoring functions and the questions were made known to each category of interviewees before the fieldwork commenced. "The analysis has selected feelings, problems, and so on according to some explicit decision rules and has clustered discrete but similar items" (Miles & Huberman, 1994, p. 178). This study clarified similar variables along with three interviewed SB and AC members to summarize the findings.

## **EMPIRICAL RESULTS**

### **Background of the sampled company**

The table 1 contains the background of the sampled company. This case is growing bears book value of total assets 3.06(2014); 3.14(2015); 4.58(2016) billion Yuan according to their return on equity over the past three years with good performance 25.33%(2014); 19.9% (2015); 19.95% (2016). State-owned equity percentage occupies 20.10% though her majority shares were owned by the state before being merged in 2000 in the process of transitioning from being state owned companies to the employee and the public. This case bears 2 shareholders possess more than 10% of the company's voting shares. One is 44.72% owned by a private holding company limited; another is state owned 20.10%. In the Shanghai Stock Exchange

officially listed in the year end (2016). The independence of this case is questionable, for the CEO is also President of the BoD.

### **SB/AC Features of the sampled company**

The table 2 is based on the data provided by the sampled company and financial statements. (A) Composition: (1) Independence: All 3 AC members are in the case are external directors, two are not officers or employees of the corporation or any of its affiliates. This case has none of the members of the SB is independent, i.e. the SB comprises zero outside and unrelated members. (2) Expertise: This case has 1 member in the SB; 1 director in AC with financial expertise. One outside director on AC in this case has experience serving on other AC as an outside director.

(B)Functions: this case's SB is responsible for financial reporting; internal control and corporate performance without involvement the internal and external auditing functions. This case's AC is responsible for financial reporting; internal control and the internal and external auditing without involvement corporate performance. The function overlaps between the SB and the AC in this case including two aspects of financial reporting and internal control.

(C)Resources: (1) Both of the SB and the AC in this case have no right to remove any directors or any members of the company; (2) Only the AC but not the SB of this case can use the resources of the internal and external auditors. Only the SB but not the AC of this case can direct access to legal advice.

(D) Diligence: (1) 3 directors serve in the AC and 3 supervisors in the SB of this case. (2) Over two meeting times per year by the SB and 4 times per year by the AC of this case. Apart from formal meetings each year, two private meetings occur in the SB and zero in the AC.

### **Interview of the sampled company**

The general secretary of the BoD arranged the interview between author and interviewees. Before conducting the interviews with the supervisors and the members of the AC, Mr. XX1 was interviewed as follows:

#### ***Please describe the AC of your company.***

It works under the BoD. According to the constitutions of the company, it audits the operations of the whole company and the performance of the higher management. Its goal on financial audit is the same as that of the SB.

#### ***Since the goals of the AC and the SB are the same, is there overlap between their functions? Has there been any consideration on the cost of supervision? How do they share the workload of supervision?***

The SB publishes its supervisory report biannually, and is mainly retrospective supervision; so theoretically, there is a need to increase progressive and concurrent supervisions. As there is the additional supervisory institution, I suppose the scope of supervision can be widened. Our company has not yet looked into the issue of the cost of supervision, probably because the supervisory function of the AC has not yet been fully realised, and there is no monetary cost for the SB. Currently, there are two stakeholders' SB members, who are paid nothing other than their salaries for their respective roles in the company. The stockholder SB member is appointed by the government, who receives his own salary from his own organisation. The company does not need to pay these members for their supervisory work. The company only needs to pay the independent directors. It is a fixed sum determined by the General Assembly Meeting. The independent directors mainly attend the meetings of the BoD, and they tend to take the viewpoints of the minor and medium stockholders in their advice during the decision making process of the meetings of the BoD. On the other hand, the SB tends to take the

viewpoints of the major stockholders in their retrospective supervision on the operations of the company. The functions of the two institutions are different.

***How does the SB operate?***

Its operation is simple. It does not operate much since its formation. Currently, it only reviews the financial and audit reports before the meetings, and discuss in their own meetings if there is any major problem. Apart from these, it does not perform any day-to-day supervision. Its focus is not the same as the internal audit department. The SB supervises mainly by reviewing reports, followed by oral enquiries if necessary.

***Which documents are provided for the members of the SB?***

Essentially, it is the same data available for the BoD before their meetings, such as the audit report, the BoD report, financial report, and the assessment of the performance of the higher management.

***Is there specific meeting agenda for the SB? Is there clear specification as to which documents should be reviewed by the members of the SB? Do its members meet before the meetings of the BoD?***

Yes, there is. I will give you a copy of the regulations on the meetings of the SB for your reference. This is compiled according to the responsibilities and procedures specified in the Company Act. The meetings of SB are held after the meetings of the BoD rather than before, but copies of relevant documents will be delivered by the Secretary of the BoD to the Directors and SB members ten days before the meeting of the BoD.

***Are there areas for improvement in the current supervisory system?***

There are three areas (concerning the SB) for improvement. First, it is not a dedicated role. Improvement is needed to improve the level of participation. Secondly, there is need to enhance professional competence, especially for the stakeholder members, who might not be able to understand financial reports. Thirdly, its membership should be a dedicated position. Currently, it is overseen by stakeholders, and it is difficult to realise its supervisory function. There is justifiable consideration behind having stakeholder members elected by the union, but there is the issue of independence. On the other hand, there is specific requirement on the professional level of the AC, and it consists of independent directors, so it is expected to be able to compensate the weakness of the SB.

***There are both the SB and the AC in Chinese system. How should these be organised in the organisational structure?***

The Chinese system has been through the history of the Three Old Institutions and the Three New Institutions. Combining with the global trends in the supervisory mechanisms, the special context of the Chinese system is formed. The Three Old Institutions (in state owned enterprises) are the Stakeholders' Representatives' Committee, the Management and Party Officers' Committee. Our company was a Party-owned enterprise. The political atmosphere was a bit strong then. Now under the system of market economy, the economic tone is stronger. Currently, it is a semi-state-owned-and-semi-private enterprise. These characteristics need to be further integrated to suit the specific culture of China.

***How should the supervisory function be enhanced in practice in the future?***

First the professional competence of the members needs to be improved. Then the supervisory culture of the enterprise needs to be improved, and an environment conducive to proper supervision needs to be formed. The fundamental issue of independence need to be resolved, otherwise it is difficult to realise the supervisory function.



***Are there informal meetings between the SB and the AC?***

No.

***How long is a meeting by either the SB or the AC?***

A meeting of the SB is usually about half an hour, and it never lasts longer than an hour. It usually checks if there is any problem and then follow the motion of the specified agenda and procedures rather than investigating deeply into any problem.

**SUMMARY**

This sampled company established the AC only within one year of the interview day. It is in the process of completing the operation of ACs. Mr. XX1 admitted that “its operation does not fully comply with the requirement.” Its co-ordination with the SB is also under construction. He identified the functions of the two institutions as being different, and differentiated them in terms of the AC tending to take the viewpoints of the minor and medium stockholders into account during the decision making process of the meetings of the BoD, whereas the SB tends to focus on the viewpoints of the major stockholders in their retrospective supervisions.

Mr. XX1 said the operation of SB is simple, and does not operate much since its formation. A meeting of the SB is usually about half an hour when not investigating deeply into any problem. Currently the SB supervises mainly by reviewing reports of the same data available for the BoD before their meetings: such as the audit report, the BoD report, financial report, and the assessment of the performance of higher management, followed by verbal enquiries if necessary. Then the meetings of SB are held after the meetings of the BoD rather than before. Mr. XX1 identified the areas for improvement in the current supervisory system as follows:

1. It does not have dedicated supervisors. Improvement is needed to improve the level of participation. Its membership should be a dedicated position. Currently, it is overseen by stakeholders, and it is difficult to realise its supervisory function.
2. There is a need to enhance professional competence, especially among stakeholder members, who might not be able to understand financial reports.
3. There is justifiable consideration for having stakeholder members elected by the union, but this leads to issues of independence.
4. Then the supervisory culture of the enterprise needs to be improved, and an environment conducive to proper supervision formed.

Mr. XX1 expects the installation of the AC to enhance levels of professionalism and independence, compensating for the weakness of the SB. He also mentioned that his company has been transformed from fully state owned to a semi-state-owned-and-semi-private enterprise, and he recognises it is now part of a system of market economy, so highlights the necessity of introducing the AC to fit into international practice, while simultaneously suiting the specific culture of China with the SB.

In order to understand more about the operations of SB, the XX2, Chair of the SB, was introduced by Mr. XX1 for interview by the author as follows:

***There are both the SB and the AC in the Chinese system. What is your view on the functions and operations of these two institutions?***

I have not been the Chair of the SB for long, but I have been involved in the process of company transition. Currently, both institutions have been formed in our company. This is to comply with the requirement of the Company Act, and concerns the legitimacy of the conduct of both the company and the higher management according to the constitution of the company. In my opinion, the AC is a more microscopic viewpoint. As to me, I am Chairs of both the SB and the committee of the Union, so the conduct of both the company and the higher management

should be reviewed for their legitimacy and rationality. The consideration of rationality is from the angle of the Union, but this should not conflict with legitimacy.

***Is it your recommendation to have two stakeholders' representatives on the SB?***

Yes.

***Having both the SB and the AC, there is the possibility that their functions may overlap.***

***What is your opinion on this issue?***

In my opinion, there is not much overlap. The independent directors mainly participate in the operations of the BoD. The SB is parallel to the BoD. It is an independent institution; whereas the AC observes the operations of the company from a microscopic angle.

***What are the focal points when you call for the meetings of the SB?***

First, it is the level of execution of the resolutions by the BoD after the General Assembly Meeting. Secondly, it is the supervision of the taking of major decisions by the BoD according to the Company Act, Stock Exchange Regulations and the constitutions of the company. Thirdly, it is the level of legitimacy of the conducts of the BoD and the higher management, supervised by the members of the SB.

***In your opinion, what is the level of professional competence of the SB regarding the auditing of the financial report?***

I myself am definitely not an expert. There are accounting professionals in the SB. As the SB needs to oversee financial reporting, this is mainly done by the member with expertise in accounting. If he raises any questions, other members will assist accordingly.

***Has the SB performed any supervision or interpretation about the assessments, including the internal auditing?***

The BoD is more mature in its operations in this regard. Since this term of service of mine (which is my first term), there have not been many questions raised. This is because the SB mainly supervises the BoD, and the BoD is the main decision making institution.

***How frequently does the SB interact with the management under the BoD?***

Not frequently, but I attend every meeting of the BoD.

***Your job description is the permanent supervisor. Do you hold any other post in the company?***

I am also the Chair of the union and the internal legal advisor. The latter is for the conveniences of internal operations even though the company has also appointed external legal advisors.

***In your opinion, what are the strengths and weaknesses of the current operations of the SB?***

Our company has gone through certain historic transitions. It transformed from a wholly state owned organisation to a semi-state-owned one by releasing its stocks to its stakeholders, so the strength of the SB is that it is more democratic, having a good people foundation. A strength and weakness is its members are both stakeholders and stockholders. There are members elected by the stockholders as well as by stakeholders, so the relationship with the BoD is not the simple relationship between the supervised and the supervisor. Hence, there are interactions before problems reach the explicit process of supervision in which a common ground is reached and problems solved or hidden. As to the weakness of the SB, the professional level of the members of the SB, including I myself, need to be improved to the international standard. This applies to both financial and management professions.

***Are there areas in the mechanism and interaction between the two institutions where improvements are needed?***

The interaction between the two institutions should collect more regularly the operational information of the company. The BoD does respect the SB, and does notify the SB in advance about new policies and resolutions. Improvements are needed in the understanding of day-to-day operations. Enhancement in this understanding can further pinpoint the source of problems. I personally do not understand much of the operations of the AC, and I suppose they have the same problem towards us. For instance, upon the call for meetings, the independent directors might not be able to grasp the day-to-day operations of the company, and there are considerations on the qualities of their members.

***How do you expect the two institutions to interact and cooperate?***

The AC consists of independent directors and it is expected that they will sing a different tune. In some respect, it is good to have different voices. Having everyone singing in accord is not necessary a good thing. It is also expected that the independent directors can bring in the benefits of external links. This is because what they have experienced and encountered is different from those of our internal staff. They should be allowed to utilise their advantages to bring positive assistance to the company. To sum up, it is expected that they will bring in new ideas and links to the external environment, utilising their resources to enhance the company.

***What is the standard of supervision?***

For instance, the financial reports are audited according to the earnings conditions, following the GAAP/IFRS, from structural items to practical items.

***Are you involved in appointing external auditors?***

No. It is determined by the BoD.

***In your opinion, what improvements are needed to realise the supervisory mechanism of corporate governance?***

To further enhance or perfect supervisory effectiveness and function, first the quality of the members needs to be improved. Secondly, more attention is needed on the understanding of the process of the operations of the SB. Thirdly, the viewpoint of the SB is somewhat macroscopic; efforts might be needed to deepen and refine its view to be able to identify problems in advance and act as a problem prevention mechanism.

**SUMMARY**

Mr. XX2 is the Chair of both the SB and committee of the Union, as well as the internal legal advisor. He has a legal professional background. The other supervisors were recommended by Mr. XX2; and it may be assumed that, as its Chair, he has absolute power in implementing its supervisory functions in this sampled Corporation.

Mr. XX2 believes there is not much overlapping in these two institutions' functions for they are located in different organisations. He stresses that the AC has a more microscopic viewpoint and the SB a more macroscopic one. He also highlights key functions of the SB, namely: (1) Resolutions by the BoD after the General Assembly Meeting; (2) Supervising the major decisions by the BoD; (3) Supervising the compliance level of legitimacy of the conduct of the BoD and higher management. Mr. XX2 is also aware that the SB needs to oversee financial reporting, which he admitted he has no expertise in. Accordingly, this is mainly carried out by the member with accounting expertise. The SB does not interact with or use the resource of internal auditing, nor frequently interact with the management: the SB merely supervises the

BoD, and the latter is the main decision making institution. Thus he attends every meeting of the BoD.

Mr. XX2 asserts that a strength and weakness of the SB pertains to its membership being both stakeholders and stockholders. As members are elected by stockholders and stakeholders, its relationship with the BoD is not merely that between supervised and supervisor. Hence, one clear weakness of the SB lies in the interactions in which common ground is reached and problems solved or buried occur before an explicit process of supervision becomes necessary. Moreover, it is urgent for it to have more members from a financial or managerial background to conform to international standards.

Mr. XX2 highlights two areas in which the co-ordination of the two institutions when implementing supervisory functions needs to be improved:

- (1) The interaction between the two institutions should collate more regularly the operational information of the company.
- (2) Improvements are needed in the understanding of day-to-day operations. Enhancement in this understanding can further pinpoint sources of problems.

He also expects to utilise the independent directors, bringing in new ideas and external links to enhance the company.

Mr. XX2 summarises his comments as follows: first, membership quality needs to be improved. Second, more attention is needed on understanding the processes of the SB. Third, the perspective of the SB is somewhat macroscopic; efforts might be needed to deepen and refine its view, in order to identify problems in advance and act as a problem prevention mechanism.

To understand the process behind the implementation of the AC, XX3, the AC's Chair was introduced to the author by Mr. XX1, General Secretary of the BoD. The resulting interview with Mr. XX3 was as follows:

***Your company has just installed the AC. In your opinion, what is the reason behind its installation?***

I don't think there is conflict between the SB and the AC. I think that the SBs in China's enterprises have not yet attained the standard it should have been in theory. Perhaps it is because of this, or because of the different operations in different countries, that we have observed some differences between our operations and the French companies that we came in touch with. Their SB operates at a different level than ours. The BoD has to report to the SB, and does not execute their plans without the approval of the latter. Whereas in our system, both the BoD and the SB report to the General Assembly Meeting. The BoD does not require the prior approval of the SB for its operations. Such a difference in corporate structure may have affected the effectiveness of the CG functions.

***Now that you have both the SB and the AC, how should these two departments share their supervisory roles?***

Theoretically, there must be some point in introducing the AC from the Anglo-American model. There are several reasons why the SB has not functioned as expected. First, in the Chinese context, many things are just formalities. There is no actual cultural backing for supervision. The members of the SB might be wary that they would be shunned by the management and the colleagues if they try too hard. Without the backing of the proper cultural environment, they are powerless in supervision. Secondly, the members of the SB mostly take on the role on a part-time basis, so they are reluctant in involving in the actual processes of supervision, so they probably do not really understand the onus of supervision, and ended up reviewing the final

reports only. The main reason, basically, is that they don't really want to supervise. Therefore, work should be done on changing the culture. The management should value the supervisory functions, and provide the members of the SB with necessary data and documents, rather than preventing the latter's involvement in the operations.

***What do you think the main focus of the financial supervision of the AC would be?***

It would be to abide by relevant laws and regulations. Their evaluation and selection of external auditors should be based on the latter's reputation and track record.

***How do you think should the AC function?***

Currently, there are three members of the AC. Two of these are independent directors, and I am the only internal member. The operation of the AC should be led by the two independent directors to ensure the independence of the AC. I myself am the Chief Financial Officer overseeing financial reporting. I don't think there is any regulatory concern over this, but if the independent directors think otherwise, we should follow their opinion, which account for two thirds of the AC. Also, current regulation dictates that more than half of the members of the AC should be independent directors, but I think it would be more in line with the consideration on the independence of the AC if all members would be independent directors.

***How should the AC operate?***

There is an internal constitution for the AC, so the AC should operate accordingly. The independent director should call for meetings. The members of the AC meet once a season, but there isn't much communication amongst them otherwise.

Secretary XX1: We have just formed our AC and its operation and promotion is still wanting. The convener is experienced (in auditing and supervision), and we expect him to direct us in the operations of the AC. We have focused on complying with the relevant regulations for the sake of being a listed company.

***Please elaborate on the relations between the AC and the internal audit in your company.***

Initially, the internal audit was under the direct control of the Managing Director. Now it is promoted to be directly under the BoD. Though both the AC and internal audit have the functions of auditing, each has its own emphasis. The internal audit focuses on the details such as the supervision of internal control, whereas the AC takes a more macroscopic view. In the future, the internal audit unit should be installed under the AC so as to facilitate their co-operations. My primary role is the Chief Financial Officer, which is supposed to be supervised (by the internal audit), yet I am also a member of the AC (which is above the internal audit), and this is somewhat unusual. There are only three employees in the internal audit. I think it is necessary to enhance its function. Now the regulation for this is in place, we should focus on its installation. This should start with the formation of a culture and mindset conducive to its proper operation to distil the sense of importance in the auditing functions and willingness of the colleagues in cooperating with auditing departments in enabling their proper operations.

***What are the problems facing supervision?***

As the AC has just been installed, it is still not fully functioning as specified by the regulations and expectations, so it is difficult to say if there would be any further problem in its operation.

***Is there any area in its three main functions of the AC, i.e., financial reporting, auditing and internal control, in which improvement is needed?***

The crucial point, theoretically, is to instil the mindset throughout the organisation of the importance of supervision and to improve the quality of the auditing staff. The operation of the

SB and the AC should focus on the levels specified by the regulations so as to identify problems. In the current operation, the SB mainly oversees the results rather than the processes, and the members do not really strive to perform properly as this is not their main roles in the company. It is lacking in the level of supervision of the processes and the level of support the company gives to supervision.

***Does the members of the AC meet before the meetings of the BoD to review the reports? How does it overcome the neglects in supervising the processes?***

This is not done at the moment.

***Will it be done in the future?***

The Chief Financial Officer stresses the importance of financial data, and the effect of internal control is shown in the data. The supervision of processes should have been done on a daily basis rather than waiting for the AC to evaluate it before the Board of Director meetings. (The Chief Financial Officer went to answer a phone call)

Secretary XX1: Because of his unique position in the company, Mr. XX3 needs to know the financial condition because of his main role as the Chief Financial Officer, and since he is also the Chair of the AC, it is not necessary for the AC to meet before the BoD' meetings to know the situation of internal control. Actually, the financial unit itself provides certain level of daily control.

#### **SUMMARY**

Mr. XX3 is a member of the AC and also the Chief Financial Officer overseeing financial reporting. He said: "My primary role is the Chief Financial Officer, which is supposed to be supervised (by the internal audit), yet I am also a member of the AC (which is above the internal audit), and this is somewhat unusual." Yet he thinks that the supervision of processes should be done on a daily basis, rather than wait for the AC to evaluate it before Board of Director meetings. Secretary XX1 added that because of his unique position in the company as Chief Financial Officer, and since he is also the Chair of the AC, it is not necessary for the AC to meet before BoD meetings in order to know the situation of internal control. Mr. XX1 points out that the financial unit itself provides certain levels of daily control. Regarding the composition of the AC, its current status still meets with Chinese regulations, in that over half the members are independent directors. Mr. XuX3 concluded: "I think it would be more in line with the consideration on the independence of the AC if all members would be independent directors."

The other two members of the AC are independent directors. Explaining the reasons behind installing the AC, Mr. XX3 stressed that the SB has not functioned as expected:

- (1) Because of different operations in different countries of direct line reporting, in China, the BoD does not require the prior approval of the SB for its operations. He therefore considers such a difference in corporate structure may have affected the effectiveness of CG functions.
- (2) The members of the SB might be wary that they would be shunned by the management and the colleagues if they try too hard. Without the backing of the proper cultural environment, they are rendered powerless.
- (3) The members of the SB mostly take on the role on a part-time basis, so are reluctant to involve themselves in the actual processes of supervision. Consequently, they probably do not truly understand the process of supervision, so end up reviewing the final reports only.

Mr. XX3 commented simply that, "the main reason, basically, is that they (supervisors) don't really want to supervise; therefore, work should be done on changing the culture." Mr. XX3 has

the same viewpoint on the question of implementing supervisory functions, in order to comply with the relevant laws and regulations. Mr. XX1 added that: "We have focused on complying with the relevant regulations for the sake of being a listed company." It seems that complying with the regulations for being a listed company was another reason behind installing the AC.

AC meetings are mainly called by the Chair (as well as once each season by the independent directors), but there is not much communication amongst the members; nor are any meetings held before meetings of the BoD. Mr. XX3 admitted, "it is still not fully functioning as specified by the regulations and expectations, so it is difficult to say if there would be any further problems in its operation." Mr. Xu expects the internal audit reports of the AC to help facilitate better co-operation in the future. Mr. XX3 focused on the formation of a culture and mindset conducive to proper operation of the AC: distilling a sense of importance in the auditing functions and willingness of colleagues to co-operating with auditing departments.

Mr. XX3 identified ways in which to improve the implementation of supervisory functions, by improving the level of supervision of the processes, and the level of support the company gives to supervision. He believes it is important to improve the quality of auditing staff, and remedy the current problem of members not really striving to perform their AC roles properly.

### CONCLUSIONS

In this case the operation of SB is simple, and had not operated much since its formation. Three interviewees point out the problems and difficulties of implementing SBs in China including: (1) it is not a dedicated supervisory role but a "part-timer" so supervisors are reluctant to engage in the actual process of supervision; (2) they are rendered powerless without the backing of the proper cultural environment because of the different operations in different countries of direct line reporting, in China, the BoD does not require the prior approval of the SB which may impact upon the effectiveness of CG functions; (3) the SB's members may lack independence whenever the subject of supervision is the SB member's main department, leading to conflicts of interest and loss of independence. There is justifiable consideration behind having stakeholder members elected by the union, but this leads to problems in terms of independence; the CEO is also the President of the BoD; and two shareholder possesses more than 10% of the company's voting shares; (4) there is a need to enhance professional competence, especially among stakeholder members, who might not be able to understand financial reports. The representation of financial and managerial professions among SB members needs to be improved, bringing it into line with international standards. The chairmen of SB with legal expert stresses the importance of compliance and views compliance as a foundation, by which management can maintain a tight connection between management and supervision. This may explain why Chinese regulations specifically points out the legal requirement for the composition of the SB. (5) A meeting of this case's SB is usually about half an hour, and does not investigate deeply into any problem. It may suggest that this case could be more active in due diligence for the SB meeting usually presents whether investigation deeply into any problem.

This case improves the operations of SBs by resolving to establish ACs. The motivation for establishing AC is to improve the effectiveness of supervisory functions in China. This case recognises the benefits of adopting two institutions simultaneously: (1) This suits the Chinese context and can cater for the spirits of both the Three Old Institutions and the Three New Institutions; (2) The SB can perform its supervisory function being formed by internal staff, more familiar with the functions; (3) The AC's organisational structure can comply with the international supervisory mechanism. This case expects the installation of AC to enhance levels of professionalism and independence, compensating for the weakness of the SB. This company

has been transformed from fully state-owned to a semi-state-owned-and-semi-private enterprise, and recognises it is now under a system of market economy, so highlights the necessity of introducing the AC to fit in with international practice while suiting China's specific culture simultaneously. This case also expects independent directors to bring in new ideas and the benefits of external links, so enhancing the company. In the future how to focus on the formation of a culture and mindset conducive to the proper operation of AC such like distilling a sense of importance regarding auditing functions, and willingness of colleagues to fully co-operate? It seems also a challenge in operations of monitoring institutions in China.

This case expects the establishment of ACs to solve the problems and difficulties in implementing SBs. Yet there may be further problems after adding in AC. This issue should be further explored as the follows: The co-ordination of two institutions in implementing supervisory functions. This case highlights that "improvements are needed in the understanding of day-to-day operations. Enhancement of this understanding can further pinpoint the source of problems." The SB and the AC are supervisory institutions under different CG models. It is suspected that incorporating both into one model will result in functional overlaps and gaps within the two sampled companies. Therefore, this calls for further investigates the day-to-day process of supervisory functions to reveal the overlapping status which may point towards redundant work in one organisation; and the missing outcome which may pose a risk to the organisation by omitting oversight of risky items. The process of implementing supervisory functions between two institutions may exist. This case highlights "it is important to instil the mindset throughout the organisation." Yet there is no vertical reporting line between SBs and ACs. Therefore, this paper also calls for endeavours to understand the co-ordination of the two institutions in the further study.

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