

Understanding China

Xianzhi Zhang

Standards for Enterprise Management Control

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Preface

With continuous academic efforts in the theory and methods of enterprise management control, a growing number of organizations are applying such principles in their operations. We publish this book, *Standards for Enterprise Management Control*, in order to facilitate the proliferation of management control for commercial practitioners. This English edition is distributed globally to accommodate international audiences with interests in management control as it applies to Chinese enterprises and cross-border organizations.

Standards for Enterprise Management Control is organized in four parts:

- **Part I** provides the necessary background and framework for a discussion on enterprise management control standards. It addresses a number of topics around the subject such as its history, purpose, practical value, and structure.
- **Part II** introduces a basic standard for enterprise management control. This part consists of seven sections including general provisions, elements, contents, procedures, modes, monitoring and assessment, and supplementary provisions.
- **Part III** introduces application guidelines for enterprise management control standards. This consists of application guidelines around regulation control system, budget control system, evaluation control system, and incentive control system.
- **Part IV** provides case studies on the application of enterprise management control standards. It discusses the subject from the perspective of four enterprises each with a unique approach to management control.

Standards for Enterprise Management Control is the companion volume of *Enterprise Management Control System in China* by the same author. This English edition allows international scholars and practitioners to better understand the evolution of management control standards after China's economic reform. Furthermore, this book aims to promote further international academic collaboration on the theoretical research and practical application of enterprise management control.

Dalian, China

Xianzhi Zhang

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10/26/2014, Dalian

Prof. Dr. Xianzhi Zhang

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Part I
Value and Integral Design
of Standards for Enterprise
Management Control

Chapter 1

Value and Integral Design of Standards for Enterprise Management Control

1.1 The Background of Formulating the *Standards for Enterprise Management Control*

With economic globalization going further, enterprise risk issues are increasing. Many countries in the world emphasize on enterprise internal control, and a series of regulations and standards are being formulated and implemented by organizations, such as the famous COSO frameworks. In China, enterprise internal control and risk management are also attached great importance and *Standards for Enterprise Internal Control* has been established. Generally, management control is the process by which managers influence other members of the organization to implement the organization's strategies (Anthony and Govindarajan 1998). Management control is linked closely with internal control. They are interrelated a lot, but not the same. The emergence and development of the management control is determined by the demand and supply of management control theory and practice. The demand and supply of management control should be matched. All these provide a background of formulating a system of *Standards for Enterprise Management Control*, especially in China.

1.1.1 The Formulation and Development of COSO Frameworks

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) was organized in October 1985. It was sponsored jointly by five major professional associations headquartered in the United States.¹ The COSO's mission is to provide

¹the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors

thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence, which are designed to improve organizational performance and governance and to reduce the extent of fraud in organizations (COSO website: <http://www.coso.org/aboutus.htm>).

Regarding internal control, in September 1992, the four volume report entitled *Internal Control—Integrated Framework* was released by COSO and later republished with minor amendments in July 1994. This report presented a common definition of internal control and provided a framework against which internal control systems may be assessed and improved. This report is one kind of standard that U.S. companies use to evaluate their compliance. According to a poll by CFO magazine released in 2006, 82 % of respondents were claimed to use COSO's framework for internal controls (CFO website: <http://ww2.cfo.com/accounting-tax/2006/03/the-trouble-with-coso/>). In order to increase the relevance of *Internal Control—Integrated Framework* in rapidly changing and complex global business environment the COSO revised the framework in May 2013.

The COSO framework defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of specified objectives, i.e., effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations, and safeguarding of assets. The COSO internal control framework consists of five interrelated components derived from the way management runs a business, i.e., control environment, risk assessment, control activities, information and communication, and monitoring. According to COSO, these components provide an effective framework for describing and analyzing the internal control system implemented in an organization as required by financial regulations, and it improves the information environment for decision making and keeping risk within acceptable range.

High-profile business scandals and failures (e.g. Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom) led to calls for enhanced corporate governance and risk management. As a result the Sarbanes-Oxley Act of 2002 (SOX) was enacted. This law extends the long-standing requirement for public companies to maintain systems of internal control, requiring management to certify and the independent auditor to attest to the effectiveness of those systems. The *Internal Control—Integrated Framework* continues to serve as the broadly accepted standard for satisfying those reporting requirements; however, in September 2004 COSO published *Enterprise Risk Management—Integrated Framework*. COSO believes this framework to expand on internal control, providing a more robust and extensive focus on the broader subject of enterprise risk management.

This enterprise risk management framework is still geared to achieving an entity's objectives; however, the framework now includes four categories, including (1) Strategic: high-level goals, aligned with and supporting its mission; (2) Operations:

(IIA), and the National Association of Accountants (now the Institute of Management Accountants [IMA]).