PIONEER
ACADEMIC PUBLISHING LIMITED

Studies in Law and Justice
ISSN 2958-0382
www.pioneerpublisher.com/slj
Volume 3 Number 4 December 2024

# China's Experience in Corporate Governance: The Role of Supervision Mechanisms in the Company Law

**Tiankun Li**[1]

[1] School of Law, Beijing Normal University, Beijing, China
Correspondence: Tiankun Li, School of Law, Beijing Normal University, Beijing, China.

doi:10.56397/SLJ.2024.12.06

**Abstract**

Improving corporate governance structures is the primary objective of the amendments to China's Company Law, with a central focus on adjusting existing corporate supervision mechanisms. Building upon the current supervisory board system, the amended Company Law introduces the audit committee under the board of directors, representing a significant institutional innovation as it transitions from a dual-tier to a single-tier governance framework. The supervisory board has been redefined from a mandatory to an optional institution, affirming the flexibility and openness in the configuration of supervisory mechanisms. As a functional alternative to the supervisory board, the audit committee shares certain financial oversight responsibilities but differs in its emphasis. In the process of regulatory adjustments, the specific scope of statutory duties should be further clarified, and the proportion of non-executive directors appropriately increased. The ultimate goal of effective corporate governance lies in balancing the interplay between supervision and management. Therefore, the construction of supervisory mechanisms should be tailored to China's corporate governance practices and local conditions.

**Keywords:** corporate governance, supervisory mechanisms, audit committee, China's Company Law

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## 1. Introduction

The corporate governance structure under China's Company Law has consistently adhered to the traditional "three-tier" framework of the shareholders' (general) meeting, the board of directors, and the supervisory board. Although successive amendments to the Company Law have left this fundamental governance structure and its core mechanisms largely unchanged, its seemingly stable framework has not yielded the legislative outcomes anticipated by lawmakers. This shortfall is most pronounced in the supervisory board, which is tasked with corporate oversight functions.

In 2019, the Kangmei Pharmaceutical financial fraud scandal, which shook China's capital market, highlighted these shortcomings. The company failed to disclose the specific performance of its supervisory board in its annual reports, while supervisory board members were long-serving senior management personnel, in blatant violation of the Company Law's prohibitions regarding the qualifications of supervisors. The supervisory board not only failed to fulfill its oversight duties but also became a gateway for financial fraud and misstatements.

To address the supervisory board's failure to perform its oversight role, lawmakers have introduced various measures. For instance, the independent director system was established in listed companies to share oversight responsibilities with the supervisory board, particularly in areas such as financial matters and related-party transactions. However, the independent director system has exhibited functional homogeneity and substitutability with the supervisory board, leaving oversight weaknesses unresolved and persistent in corporate governance.

Another measure concerns the governance structure of wholly state-owned enterprises (SOEs), where supervisory board members are appointed by state-owned assets supervision and administration agencies. While the appointment system mitigates issues associated with electing supervisors through shareholder votes, it presents its own challenges, such as the failure of external supervisory boards to modernize their work content and the ineffectiveness of incentive and employment mechanisms. Consequently, proposals to establish an external director system have been made to address the supervisory board's governance dilemmas.

In response to the regulatory shortcomings of corporate supervisory mechanisms, the legislative body undertook a review of the Company Law and solicited public opinions. The revised Company Law introduced substantial amendments and additions, with over 70 new or modified provisions, including significant adjustments to the supervisory mechanisms within the corporate governance framework. These changes aim to reconstruct the internal and external supervisory systems, reflecting their coupling effects and optimizing the overall corporate governance structure.

Building on this foundation, this article examines the adjustments to the rules governing the establishment of corporate supervisory mechanisms under the Company Law. Specifically, it analyzes the changes in the supervisory board's role, interprets the provisions regarding the composition and proportion of personnel in audit committees, and explores the scope of financial oversight powers. Furthermore, it assesses whether the newly introduced regulatory provisions leave room for further refinement and interpretation.

## 2. The Reconfiguration of Corporate Supervisory Mechanisms

The Company Law introduces innovative adjustments to the supervisory mechanisms within the corporate governance framework, particularly reflected in the evolving role of the supervisory board within the traditional "three-tier" governance structure. Among these adjustments, the optional nature of the supervisory board has become one of the focal points of this round of legislative revisions. Although the supervisory board is no longer a mandatory institution in corporate governance, its legal status and functions remain consistent with the overall provisions of the current Company Law.

For instance, the revised Company Law explicitly reiterates that the supervisory board serves as the company's supervisory body and introduces a new provision allowing the supervisory board to require directors and senior management to submit reports on the performance of their duties. These measures reaffirm and strengthen the supervisory board's functions. Additionally, the decision-making threshold for supervisory board resolutions has been adjusted. Resolutions now require approval by a majority of all supervisory board members, rather than merely a majority of those present. This minor adjustment aligns the resolution requirements of the supervisory board with those of the shareholders' meeting and the board of directors, thereby preserving the integrity of the corporate governance structure. The raised threshold also enhances the credibility and authority of supervisory board resolutions.

Thus, it is evident that the revised Company Law maintains a positive stance toward the role of the supervisory board in the corporate governance framework rather than abandoning it entirely.

The establishment of the supervisory board has become an optional component in the corporate governance structure, with the alternative being the creation of a specialized internal body within the board of directors—namely, the audit committee, which exercises financial and accounting oversight functions. The Company Law reflects a shift from the traditional dual-tier structure toward a single-tier model, where only a board of directors is established, without a supervisory board, and several specialized committees are integrated into the board.

The single-tier model, represented by the United States, relies on specialized committees and independent directors to achieve internal oversight of the board of directors. In contrast, the dual-tier structure, inspired by the constitutional principle of "separation of powers," divides corporate governance into deliberative, executive, and supervisory bodies, with Germany as its archetype. This transition from dual-tier to single-tier governance is increasingly evident in comparative legal practices. For instance, during reforms of Japan's Company Law, a series of modernizations in corporate governance structures were introduced, including the adoption of a system allowing companies to choose between triangular (dual-tier) and single-tier models (Zhu, Daming, 2022). The single-tier model itself underwent further refinement, evolving from multiple specialized committees into a unified supervisory committee, thereby enhancing the supervisory mechanisms available in corporate governance frameworks.

These developments underscore a broader trend toward diversifying governance structures to optimize oversight functions within corporations.

The Company Law establishes an opt-out mechanism for supervisory boards tailored to different types of companies. In limited liability companies, the board of directors is required to establish an audit committee composed of directors. For joint-stock companies, additional restrictions apply: a majority of the audit committee members must be non-executive directors, and they are prohibited from concurrently serving as the company's general manager or chief financial officer.

A comparison reveals that joint-stock companies impose more stringent requirements on the composition and roles of audit committee members. However, the scope of authority for audit committees remains consistent across both types of companies. The law stipulates that audit committees are responsible for supervising the company's financial and accounting matters, as well as exercising other powers as prescribed in the articles of association.

Thus, the statutory authority of the audit committee encompasses broad auditing functions, including oversight of the company's financial operations and accounting records. Additionally, a catch-all provision allows the articles of association to confer further responsibilities on the committee, ensuring flexibility in its functional scope.

In summary, the Company Law introduces two major approaches to reforming corporate supervisory mechanisms. First, the supervisory board system is retained, but its status shifts from a mandatory to an optional component. This transition reinforces the legal status and authority of the supervisory board, mitigating the impact of its optionality on the traditional corporate governance structure and facilitating the gradual implementation of the new provisions. Second, the law adopts a single-tier board of directors system by establishing the audit committee as a substitute for the supervisory board. The audit committee's oversight functions, particularly in financial and accounting matters, are emphasized, reflecting greater flexibility and openness in the corporate governance structure.

## 3. Rethinking the Supervisory Board: Challenges and Reforms

The supervisory board, while positioned as one of the core institutions within the "three-tier" governance framework, has been criticized for its ineffectiveness in practice. Its independence has been subject to persistent doubts and challenges. Under the current Company Law, the supervisory board lacks independent authority over financial resources, and its members are constrained by the "capital majority rule," whereby they are typically appointed by shareholders, effectively rendering the board a "spokesperson" for controlling shareholders. Furthermore, employee supervisors constitute a minority and are often dependent on the enterprise due to their employment relationship (Shi, Tiantao, 2020).

Whether the supervisory board should continue to exist within the corporate governance framework remains a contentious issue. A review of perspectives within China's corporate law scholarship reveals robust arguments on both sides, with proponents for either retaining or abolishing the supervisory board presenting compelling cases.

### *3.1 At a Crossroads: Evaluating the Future of the Supervisory Board*

The current revision of the Company Law retains the supervisory board but redefines its status from a mandatory to an optional institution. Whether this shift reflects a response to the longstanding debate over the supervisory board's existence is a question worthy of exploration. As previously discussed, the supervisory board remains designated as the corporate supervisory body under the Company Law and does not exist in a mutually exclusive relationship with the newly introduced audit committee within the board of directors. From a regulatory configuration perspective, both can coexist within the corporate governance structure.

Although the supervisory board system has been preserved, its transition to an optional institution marks a significant departure from its prior mandatory status. While lawmakers have stopped short of entirely removing the supervisory board from the corporate governance framework, the debate over its continued relevance remains unresolved and has not been alleviated by the new provisions.

The supervisory board system originates from Germany, where the German Company Law adopts a dual-board structure, dividing the board of directors into the management board (which oversees the comprehensive management of the company) and the supervisory board. The primary function of the supervisory board is to supervise and control the management board. A key foundation of the supervisory board's authority in Germany lies in its significant power to appoint, dismiss, and determine the remuneration of management board members (Hopt, K. J., 2016). However, such authority is absent in other jurisdictions that have adopted the dual-board system, including China, leading to fundamental differences from the German legal framework.

When drafting its Company Law, China drew upon the German legislative model to establish the supervisory board system. However, a direct transplantation of Germany's "dual leadership model" would have disrupted China's existing governance framework under the Company Law, increased unnecessary institutional costs, and potentially caused corporate instability (Ma, Gengxin, 2021).

Moreover, the economic and social contexts in which the Company Law was initially promulgated have undergone significant changes. Whether the supervisory board can evolve with the times and continue to shoulder its supervisory responsibilities remains a matter of doubt.

In corporate governance practice, the supervisory board has shown a weakened position. Some argue that the fundamental flaw in China's corporate governance lies in the establishment of the supervisory board. Numerous provisions within the Company Law have failed to resolve the issue of the supervisory board's nominal existence. Not only has the supervisory board fallen short of fulfilling its intended function, but its presence has also increased corporate governance costs (Zhao, Xudong, 2020).

Corporate governance oversight cannot be achieved through a single mechanism. The diverse forms of oversight mechanisms in contemporary corporate governance practices indirectly confirm this point (Cai, Wei, 2018). Consequently, the supervisory board system has been criticized for its inability to deliver effective oversight. Empirically, the supervisory board system has also failed to support sound corporate governance. For example, financial fraud in corporate accounting may bring short-term benefits to employees, leaving worker representatives on the supervisory board insufficiently motivated to perform their supervisory duties. As a result, the supervisory board's oversight often becomes superficial, rendering the board itself a mere ornament (Xie, Deren, 2006).

Beyond its intrinsic weaknesses, the supervisory board system is significantly influenced by external factors. In particular, many Chinese companies originated from the restructuring of state-owned enterprises (SOEs), which are plagued by problems such as unbalanced ownership structures. The dominance of a single controlling shareholder ("one share dominates all") represents the greatest obstacle to effective corporate governance. Consequently, the supervisory board becomes a symbolic presence, lacking the inherent conditions for internal constraints, and market-based oversight mechanisms remain underdeveloped (Shi, Tiantao, 2020).

Thus, the existing supervisory board system in China suffers from inherent flaws. Without adequately considering the realities of corporate governance practices in China, the adoption of a single model risks the supervisory board system becoming ill-suited to local conditions. The supervisory board often serves as a superficial component of the corporate governance structure, and terms such as "ornament" or "empty framework" are frequently used in scholarly critiques to describe its role.

As a traditional component of corporate governance under the Company Law, the supervisory board has objectively facilitated the corporate restructuring of China's state-owned enterprises (SOEs) and provided an institutional foundation for the country's economic achievements from the 1990s to the present. Beyond its supervisory functions, the supervisory board's existence as a key element of the governance structure symbolically underscores the completeness of governance frameworks across various types of companies in China, securing its place in the globalized economy. Therefore, abolishing or replacing the supervisory board without first addressing critical issues such as its authority and legal status could have adverse effects on corporate governance. Similar concerns are reflected in arguments supporting the retention of the supervisory board system. For example, without a comprehensive reform aligning the supervisory board with the independent director system, any abrupt organizational restructuring may result in substantive flaws in the allocation of authority under the Company Law (Liu, Bin, 2021).

Supporting the supervisory board system does not equate to ignoring its existing problems; rather, solutions should focus on addressing the issues directly rather than seeking alternative paths. Although the supervisory board has struggled to fulfill its oversight role, it must remain a mandatory institution, provided that its statutory powers and rights necessary for performing its duties are clarified and strengthened (Yang, Dake, 2022).

The supervisory body remains a critical player in the corporate governance structure. Strengthening and refining the supervisory functions of the supervisory board can be achieved through targeted reforms to its specific mechanisms. Compared to radical abolition, moderate and gradual improvements are better suited to the continued development of the supervisory board system within the framework of China's Company Law.

*3.2 Preservation and Evolution: Reforming the Supervisory Board Framework*

The Company Law continues to define the supervisory board as the corporate supervisory body and grants it the authority to require directors and senior management to submit reports on the performance of their duties. Beyond these provisions, the supervisory board's overall rules remain largely unchanged, reflecting a consistent legislative approach. The supervisory board's authority and status were not diminished in this revision; its role in corporate governance is still governed by the relevant rules of the Company Law, and the legislature has not entirely abandoned the supervisory board system. In fact, certain provisions suggest an intention to moderately expand its powers.

At the same time, the optional nature of the supervisory board adds flexibility to the traditional corporate governance framework. Even without a supervisory board, governance structures that comply with the law are deemed reasonable and legitimate. As a private law framework, the Company Law should primarily support corporate autonomy. The shift in the rules governing supervisory board establishment—from mandatory to advisory—embodies a legislative philosophy that favors company self-governance (Liu, Junhai, 2021).

Some have argued that the debate over the supervisory board's existence and its optional status contradicts the general provisions of the Civil Code regarding for-profit legal persons. The Civil Code, particularly in its General Provisions, requires for-profit legal persons to establish independent supervisory bodies, with "independence" understood to mean independence from management. Based on this interpretation, the supervisory board is viewed as a mandatory institution for for-profit legal persons, making the Company Law's provisions inconsistent with the Civil Code.

This interpretation, however, appears somewhat misplaced. Under the General Provisions of the Civil Code, the requirement for for-profit legal persons to establish institutions does not necessarily include supervisory bodies. This conclusion arises from the Civil Code's provisions, which explicitly require for-profit legal persons to have decision-making and executive bodies but do not impose a similar requirement for supervisory bodies. The General Provisions only stipulate the functions and powers supervisory bodies must exercise if established. Furthermore, supervisory bodies for for-profit legal persons are not limited to supervisory boards or supervisors; the term "etc." used in the Civil Code aligns with the Company Law, which permits audit committees under the board of directors as substitutes for supervisory boards.

In other words, the supervisory board is not inherently mandatory as a corporate supervisory body. The Company Law's provisions allowing for the optional establishment of supervisory boards are, in fact, consistent with the General Provisions of the Civil Code.

Whether the supervisory board system should be retained or abolished in the Company Law fundamentally reflects the question of how corporate governance oversight should contribute to achieving the overarching goal of maximizing corporate efficiency. If reforming or eliminating the supervisory board could achieve effective governance, such disputes would naturally be resolved.

At the same time, the supervision needs of companies and enterprises in mature economic markets vary depending on their forms and sizes. For long-established industry leaders, which must exercise caution in operational decision-making due to low tolerance for trial-and-error costs, rigorous supervisory mechanisms are essential safeguards. In contrast, for startups and small-to-medium-sized enterprises (SMEs), the primary focus is on scaling operations and pursuing profitability. These companies inevitably incur and accumulate trial-and-error costs as part of their growth process. Imposing equally stringent oversight requirements on such enterprises may hinder their development.

Thus, the rules governing the establishment of corporate supervisory mechanisms should move beyond a fixation on the supervisory board. Whether a supervisory board is established, or whether a company opts to create other types of supervisory bodies based on its specific circumstances, both approaches should be considered viable. The decision to introduce the audit committee as a substitute for the supervisory board in this round of revisions to the Company Law reflects a design that balances legislative continuity with corporate autonomy. This pragmatic and flexible approach to governance should be affirmed.

## 4. The Audit Committee System: Innovations and Critical Reflections

The Company Law grants companies greater autonomy in determining their governance structures, allowing the audit committee under the board of directors to serve as a substitute or optional mechanism for the supervisory board. This flexible and inclusive legislative approach to allocating governance powers across limited liability companies, joint-stock companies, and wholly state-owned enterprises represents a significant institutional innovation in recent revisions of the Company Law.

The prevailing view holds that China's current Company Law is primarily centered on shareholder dominance, where the shareholders' meeting elects directors and supervisors (excluding employee representatives), and the board of directors executes the resolutions of the shareholders' meeting. Examining the interplay between the supervisory board and the audit committee in this revision, the focus appears to lie on inheriting and strengthening financial oversight powers. However, the underlying issue is the exploration of a single-tier governance model within the framework of the Company Law, reflecting a shift toward a director-centric governance mechanism in future legislation.

This trend aligns with governance practices in most mature capital markets, where board-centric models prevail, and the board of directors plays the most authoritative role in corporate governance (Deng, Feng, 2013). By incorporating oversight functions into the board through the audit committee, this approach theoretically reduces governance costs and enhances corporate competitiveness. However, whether this theoretical advantage can be realized in corporate governance practice depends on the strengthening of the audit committee's supervisory capacity through concrete regulatory measures.

### *4.1 Unpacking the Roles: Non-Executive, Independent, and External Directors*

The term "non-executive director" was introduced as a new concept during the latest revisions to the Company Law, distinguishing members of the board of directors in joint-stock companies into executive and non-executive directors. The revised law further requires that a majority of audit committee members on the board be non-executive directors. A similar concept appears in the provisions for the boards of directors of wholly state-owned enterprises, which stipulate that a majority of board members must be external directors. If an audit committee is established in these enterprises, its members must also consist of a majority of external directors.

The terms "non-executive director" and "external director" are already well-known in other disciplines but appear in the Company Law revisions for the first time. Alongside the pre-existing concept of "independent director," all three terms now coexist in the revised law. However, their respective definitions, distinctions, and interrelations remain unclear. The interpretation of these terms within the legal framework calls for further clarification and analysis in the field of legal scholarship.

The term "non-executive director" corresponds to "executive director," with the distinction being whether the director holds any other position within the company beyond serving as a director. If a director does not simultaneously assume an executive role within the company where they serve as a board member, they are classified as a non-executive director. Such individuals are typically drawn from senior personnel of other companies, experts from various fields, or institutional investors (Cao, Fengqi & Yang, Jun, 2004). They are recruited to the board for their specialized skills or social connections, granting them the authority to participate in board discussions and decisions without taking on operational responsibilities.

The concept of non-executive directors originates from the United Kingdom and has been adopted under various terminologies in different jurisdictions. For instance, in Japan and South Korea, they are referred to as "outside directors"; in Canada, they are termed "unrelated directors." In some countries, such as the United States, the concept overlaps with that of "independent directors." Compared to the terminology used in China's recent Company Law revisions, the lack of a precise definition has led to situations where these terms are used interchangeably, creating overlaps and even conceptual redundancy.

It is generally recognized that the non-executive director system is characterized by three key aspects: independence, knowledge and skill level, and economic incentives. Among these, the vast majority of relevant regulations emphasize that non-executive directors must possess independence, with their capabilities and incentives serving as supplementary factors for ensuring the system's effectiveness (Zattoni, A. & Cuomo, F., 2010). This strong emphasis on independence aligns closely with the concept of independent directors. Independent directors are defined as directors who do not hold any other position within the company and are free from relationships with the listed company or its major shareholders that might impair their ability to make independent and objective judgments.

Based on this, this article argues that "non-executive directors" and "independent directors" are conceptually equivalent regarding independence and objectivity. The primary distinction lies in the criteria for determining qualifications. For instance, the pool of candidates for non-executive directors is broader than that for independent directors, while independent directors are subject to stricter requirements regarding their knowledge and competencies. However, these differences do not result in fundamental conceptual divergence. The breadth or narrowness of candidate selection, as well as the depth or generality of required expertise, ultimately hinge on the core principles of independence and objectivity.

Although the two concepts are essentially similar, distinguishing between them still has a legislative purpose. Independent directors are part of the special regulatory framework for listed companies. For non-listed companies establishing audit committees, the concept of independent directors cannot be directly applied, making "non-executive directors" a suitable conceptual alternative. However, unlike the well-established practice of the independent director system in China's listed company governance, the non-executive director system remains an imported concept in China's corporate legal framework. While it can be practically applied by analogy to the independent director system, this approach is not sustainable in the long term. It is necessary to either formulate detailed regulations for the non-executive director system or merge the two concepts into a unified framework.

The external director system is a unique arrangement in the development of board governance within China's state-owned enterprises (SOEs). "External directors" are specifically designated as members of the board of directors and audit committees in wholly state-owned companies. In some jurisdictions, the concept of external directors is considered equivalent to "non-executive directors" or "independent directors" within their governance frameworks.

This article argues that, given the predominance of external directors in the regulatory framework for wholly state-owned companies, the concept of external directors should be interpreted in accordance with the Chinese context. Such an approach ensures a more accurate understanding of the term as it pertains to China's specific corporate governance environment.

In response to the reform of the boards of directors in China's state-owned enterprises (SOEs), the external director system was introduced to strengthen internal checks within the board, provide diverse perspectives on governance decisions, and facilitate independent and objective decision-making conducive to corporate development. For instance, in 2004, the State-Owned Assets Supervision and Administration Commission (SASAC) initiated a pilot program for establishing boards of directors in certain central SOEs. One of the program's foundational principles was to establish an external director system, enabling the board to make decisions independently of the management team while diversifying human resources and gradually increasing the proportion of external directors on the board.

Regarding the definition of "independent director," SASAC defines such directors as external personnel who are not employees of the company and do not hold any position within the company other than that of director or roles related to specialized board committees. However, unlike the appointment processes for independent or non-executive directors, the selection of external directors in SOEs is primarily controlled by the capital-contributing representative body, particularly in the nomination and appointment stages. For example, external directors of wholly state-owned companies are nominated by the capital-contributing representative body in consultation with relevant departments, while those for wholly-owned subsidiaries are recommended by the controlling shareholder in consultation with other shareholders.

Some have argued that, under the existing two-tier delegated management system, personnel appointments are heavily influenced by government agencies. These agencies utilize their appointment authority to bypass the practical needs of enterprises, imposing qualifications for external directors as a means of preemptive control, effectively turning external directors into agents of the capital-contributing representative body (Wang, Huaiyong & Wang, Hexiang, 2021).

As a result, the external director system represents a core component of China's board reform initiatives in SOE governance, evolving from regulations and administrative rules to being enshrined at the legal level. By embedding this system within the Company Law, it supports the broader reform goal of separating government functions from enterprise operations. However, in the unique Chinese context, external directors essentially act as representatives of the capital-contributing body, lacking the key characteristic of independence that is integral to non-executive or independent directors.

*4.2 Expanding Financial Oversight: Lessons from the Supervisory Board*

The latest revision of the Company Law makes minor enhancements to the powers of the supervisory board but does not introduce fundamental changes. As a substitute for the supervisory board, the audit committee's authority to "oversee the company's financial and accounting matters" aligns closely with the supervisory board's function of "examining the company's financial affairs."

If these two bodies are treated as an "either-or" choice for corporate oversight, no formal conflict arises. However, if both are established concurrently, questions remain about how their respective roles and powers should be delineated. Whether financial oversight authority manifests differently between the two institutions requires further in-depth examination.

The financial oversight authority of the supervisory board primarily involves reviewing and examining the company's financial and accounting reports, as well as other financial and accounting materials (Song, Yanni & Zhao, Xudong (Eds.), 2018). Supervisors are tasked with verifying and scrutinizing these materials to ensure their compliance with laws and the company's articles of association. Under the current Company Law, financial oversight is stipulated as the supervisory board's foremost authority and represents its primary supervisory function.

In contrast, the audit committee is limited to overseeing financial and accounting matters, making its authority noticeably narrower than that of the supervisory board. In other words, the audit committee's powers under the Company Law can only inherit the financial oversight authority of the supervisory board, while other supervisory functions are not explicitly provided for and may only be assigned by the articles of association.

The financial oversight authority of the supervisory board lacks detailed provisions in the Company Law regarding the specific content and methods of examination, leaving it without the institutional support necessary for practical application. Similarly, the audit committee's authority does not clearly define the scope of financial and accounting oversight, resulting in a parallel to the limitations of the supervisory board's financial oversight provisions (Li, Dongfang & Yang, Qin, 2008). Both share an ambiguity in their statutory scope of financial supervision.

The audit committee has become a standard feature in the governance practices of Chinese listed companies. The Code of Corporate Governance for Listed Companies (hereinafter referred to as the "Governance Code"), first issued in 2002 and revised in 2018, specifies the duties of audit committees. According to the Governance Code, the responsibilities of audit committees primarily include four areas:

1) Oversight of internal and external auditing processes;

2) Review and disclosure of financial information;

3) Supervision and evaluation of the effectiveness of internal controls;

4) Other matters authorized by laws, the articles of association, and the board of directors.

Compared to the audit committee's statutory authority under the Company Law, the responsibilities outlined in the Governance Code are broader in scope. While there is overlap in financial responsibilities, matters such as internal and external auditing and internal control supervision are not covered under the Company Law provisions.

Some scholars argue that the audit committee's focus on financial and accounting oversight does not represent a legislative gap but rather reflects a deliberate decision by lawmakers to rationally define the scope of the committee's supervisory functions. This deliberate focus positions the audit committee's oversight within a narrower yet more effective framework.

Moreover, the other powers of the supervisory board, such as the right to propose dismissals, the right to correct corporate actions, and the right to make suggestions, are not expressly included in the statutory authority of the audit committee. However, these functions are not insignificant and may be assigned through the articles of association. This flexibility aligns with the legislative intent of ensuring adaptability in corporate governance mechanisms, particularly in the allocation of supervisory functions.

The essence of a corporation lies in its aggregation of capital, with corporate assets forming the foundation for its operations and transactions. Consequently, the oversight of a company's financial and accounting activities is inherently tied to its business and transactional activities. Within the "three-tier" structure of corporate governance, the board of directors typically exercises authority over the company's business operations and affairs, while the supervisory board serves as the supervisory body overseeing management and operational activities, with clear distinctions between the two.

The Company Law positions the audit committee as an opt-out alternative to the supervisory board, retaining the supervisory board's most critical authority—financial oversight—as the statutory duty of the audit committee. As such, the audit committee's authority to oversee corporate financial and accounting matters is derived from the supervisory board's financial oversight powers. In practice, these two bodies perform similar functions in corporate governance oversight. For instance, both conduct regular reviews of interim and annual financial reports. Whether exercised by the supervisory board or the audit committee, the methods of supervision in practice exhibit little difference in form.

Although the financial and accounting oversight powers of the two bodies—supervisory boards and audit committees—appear highly similar, treating them as entirely equivalent fails to capture the distinct role of the newly established audit committee under the recent Company Law revisions. Positioned under the board of directors, audit committee members simultaneously serve as directors, granting them a dual role in both financial oversight and corporate governance. Since the board of directors is responsible for making business management decisions and executing corporate operations, the audit committee inevitably participates in business and management decision-making while overseeing financial and accounting matters.

In essence, this type of oversight can be characterized as proactive, with objectives extending beyond the regulation of corporate financial operations to ensuring compliance in business decision-making. This aligns closely with the goals of the independent director system. By contrast, the supervisory board does not directly engage in the company's operational activities, focusing solely on specific supervisory tasks. Its oversight is more passive and retrospective. Reforms such as introducing independent or external supervisors and improving the mechanism for appointing supervisory board members aim to address conflicts of interest between the board members and the company, thereby enhancing the effectiveness of supervision through external involvement.

The distinction between the financial oversight functions of audit committees and supervisory boards can also be framed in terms of reasonableness versus legality. The supervisory board's oversight is primarily concerned with legality—ensuring compliance with laws and regulations—while the audit committee extends its supervisory depth to include the reasonableness of business decisions, incorporating both legal and commercial considerations (Liu, Bin, 2022).

### *4.3 Evaluating Reform Strategies: Improving the Existing Framework*

The Company Law expands the audit committee system beyond listed companies to encompass various types of companies, enriching the institutional framework for supervisory functions in corporate governance and breaking away from the traditional dual-tier governance structure. By incorporating the audit committee at the statutory level, the law moves beyond its previous role as a governance mechanism exclusive to listed companies, reflecting a legislative intent to align corporate governance more closely with the practical needs of companies' development.

However, an examination of the specific rules governing audit committees reveals areas that warrant further improvement and optimization. For instance, how should the statutory duties of audit committees be defined in the articles of association? Should the requirement for a majority of non-executive directors on the audit committees of joint-stock companies be revisited or adjusted? These questions highlight the need for more nuanced regulatory refinements to enhance the practical effectiveness of audit committees in diverse corporate contexts.

In the enumeration of the specific powers of the audit committee, financial and accounting oversight is established as a statutory duty, while other powers are regulated by the company's articles of association. This approach aligns with the broader trend in the Company Law revisions to shift from a detailed itemization of board powers to more abstract, principle-based provisions, reflecting a legislative inclination toward rational corporate autonomy.

However, unlike the comprehensive enumeration of the supervisory board's powers, the audit committee is entrusted solely with the authority to oversee the company's financial affairs, leaving the arrangement of other supervisory board functions unaddressed. These additional powers are instead covered through a catch-all provision, allowing them to be specified in the company's articles of association. This distinction underscores the shift in legislative design, prioritizing flexibility and adaptability in governance mechanisms.

The formulation of the articles of association is a critical process in optimizing the various structures, mechanisms, and strategies within a corporate governance framework. Assigning powers through the articles of association constitutes a pivotal element in corporate governance. In this context, the default provisions of the Company Law, serving as standardized clauses or model texts, often become the basis and reference for drafting. In general, companies tend to incorporate the default provisions of the Company Law into their articles of association (Zhao, Xudong, 2022). Thus, it remains necessary to clarify and define the powers of the audit committee as stipulated in the articles.

In the latest revision of the Company Law, the supervisory board's powers have undergone minimal adjustment. For companies opting to establish an audit committee in lieu of a supervisory board, the articles of association could theoretically assign the supervisory board's powers to the audit committee. However, the rules governing such power allocation and conversion are not explicitly specified. Comparative examples from foreign corporate laws provide useful references. For instance, under the Korean Commercial Act, the audit committee (referred to as the supervisory committee in this context) inherits the supervisory board's authority to oversee the directors' business execution. This includes full authority to monitor all aspects of business operations, including accounting oversight. Similarly, in Taiwan's Securities and Exchange Act and Company Act, it is stipulated that the provisions applicable to supervisors (i.e., the supervisory board) also apply mutatis mutandis to the audit committee when established.

Although the Company Law does not enumerate additional powers of the audit committee, adopting a similar approach by applying the supervisory board's powers mutatis mutandis could be an effective way to enhance the audit committee's authority. Beyond inheriting the supervisory board's enumerated powers, the audit committee could also be granted supplementary responsibilities. Examples include the authority to demand corrections or cessation of actions by directors or senior executives that harm the company's interests, or the right to solicit votes to protect the interests of minority shareholders (Li, Jianwei, 2004). These additions could serve as valuable supplements to the audit committee's powers as defined in the articles of association.

The articles of association allow for significant flexibility and openness in assigning specific powers to the audit committee, aligning with the principle of rational corporate autonomy. However, under the majority-rule principle governing shareholder resolutions, questions arise as to what powers an audit committee might be granted under articles of association dominated by controlling shareholders and whether such arrangements could unduly harm the interests of minority shareholders. Therefore, while promoting rational corporate autonomy, it is equally important to delineate the boundaries of the audit committee's powers through the permissive provisions of the Company Law to prevent potential abuses and ensure equitable governance.

In the rules governing the composition of audit committees, joint-stock companies are required to have a majority of non-executive directors on the committee, whereas no such requirement applies to limited liability companies. As previously mentioned, the audit committee originates from governance models used in listed companies. According to the Independent Director Rules issued by the China Securities Regulatory Commission (CSRC), independent directors must constitute the majority of audit committee members and serve as the convener. The Code of Corporate Governance for Listed Companies (Governance Code) contains similar provisions.

An examination of foreign corporate laws regarding the composition requirements of audit committees reveals consistency in requiring a "majority" of certain members, though the specific proportion varies. The audit committee, as a specialized committee under the board of directors, originated in U.S. corporate governance practice. The Sarbanes-Oxley Act, enacted by the U.S. Congress in 2002, mandates that publicly traded companies establish audit committees composed entirely of independent directors [1]. Similarly, in Taiwan, the audit committee system stipulates that the committee must consist entirely of independent directors.

In South Korea, the Commercial Act provides that companies establishing an audit committee composed of at least two-thirds external directors (i.e., independent directors) are not required to have a supervisory board. In Singapore, the Companies Act requires that independent directors constitute the majority of the audit committee[2]. This is further detailed in the Singapore Guide to Audit Committees for Listed Companies, which recommends that the audit committee consist of at least three non-executive directors, with more than half (including the chair) being independent directors [3]. Similarly, Japanese corporate law requires that independent directors make up the majority of the audit committee (Wu, Jianbin (Ed. & Trans.), 2017).

1 See The Sarbanes-Oxley Act, Title III Section 301(3) Independence.

2 See Companies Act 1967, 201B(2).

3 See Singapore Guide to Audit Committees for Listed Companies, Section 1.1.7.

Drawing from these comparative frameworks, this article argues that while the Company Law requirement for non-executive directors to constitute a majority of the audit committee aligns with the general understanding of "majority," this threshold may be insufficient to enable the audit committee to fully perform its supervisory functions or to reinforce its independence, particularly given the traditionally weaker state of corporate governance in China. Raising the threshold for the proportion of non-executive directors on the audit committee is necessary to strengthen the institution's effectiveness.

Furthermore, given the varying sizes and developmental stages of different types of companies in China, differentiated composition requirements should be established for listed companies, unlisted joint-stock companies, and limited liability companies (ACGA, 2021). The current uniform provision applying only to joint-stock companies lacks the flexibility needed to accommodate the diverse realities of corporate governance in China.

**5. Conclusion**

In corporate governance mechanisms, the interplay between supervisory powers and managerial powers represents a critical factor in improving and enhancing governance systems. This interplay highlights the inherent tension between objectivity and proximity in supervisory roles. Objectivity requires supervisors to maintain an appropriate distance from managers, enabling them to make independent decisions. However, this distance can lead to delays in decision-making corrections, increasing transaction costs. Proximity, on the other hand, necessitates closer connections between supervisors and managers to facilitate timely access to information and early intervention, but it risks supervisors being assimilated by those they are meant to oversee (Boot, A. W. A. & Macey, J. R., 2003).

This theoretical tradeoff between different supervisory models is reflected in the revised Company Law's approach to governance oversight mechanisms. The retention of the supervisory board underscores the requirement for supervisors to make independent and objective judgments, affirming the supervisory board's legal status within the corporate governance structure. The introduction of the audit committee, meanwhile, promotes the integration of supervisory powers with board-level management to enable more effective business decision-making. Yet, the choice of governance and oversight models is left open by the Company Law, allowing companies to decide based on their circumstances.

China's Company Law began its development relatively late and still lags behind foreign legislative and governance practices in some respects. Therefore, while building upon its existing regulatory framework, it is essential to explore governance and supervisory mechanisms tailored to China's specific corporate governance practices. A flexible and pragmatic approach to designing supervisory institutions will better align with the needs of China's evolving corporate landscape.

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