A nighttime city skyline with a financial line chart overlay. The chart is a glowing orange line that fluctuates across the frame, superimposed on a blurred background of city lights and buildings. The chart starts on the left, rises to a peak, falls, rises again to a higher peak, and then fluctuates as it moves towards the right. The background is a dark, out-of-focus cityscape with various lights and building silhouettes.

# How listed companies should enhance quality and efficiency against the backdrop of the new 'Nine National Guidelines'

4 June 2024



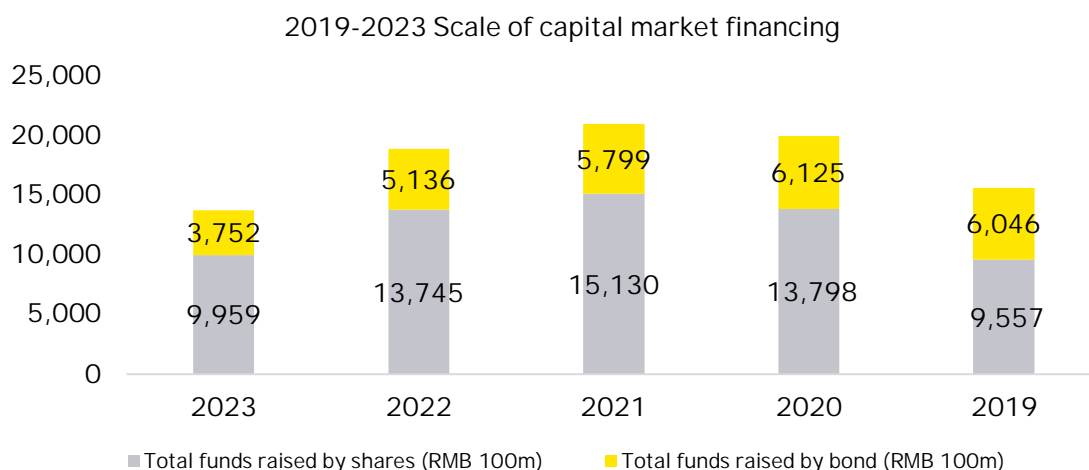
On 12 April 2024, the State Council issued "Several Opinions on Strengthening Supervision, Preventing Risks and Promoting High-Quality Development of the Capital Market" (hereinafter referred to as the new 'Nine National Guidelines'). This is the third time that the State Council has issued a guideline document on the capital market, following the first 'Nine National Guidelines' in 2004, which initiated the split-share structure reform, and the second 'Nine National Guidelines' in 2014, which released the reform dividend and encouraged innovation and development. The new 'Nine National Guidelines' focuses on strengthening regulation, preventing risks and pushing forward high-quality development to fully harness the functions and roles of the capital market, promoting the building of a country with a strong financial sector and serve the goal of advancing Chinese modernization.

The new 'Nine National Guidelines' aims to implement a comprehensive, closed-loop supervision of listed companies and continued efforts in three aspects: Strict regulation on the entry into the capital market, rigorous sustained oversight of listed firms and strengthening regulation on delisting. At the same time, the China Securities Regulatory Commission (CSRC), Shanghai, Shenzhen and Beijing Stock Exchange intensively introduced a package of supporting policies and rules to strengthen the supervision of listed companies, improve the quality of listed companies, and the full implementation of the reform of the registration system for the issuance of shares in line with the focus of the reform.

## The current landscape of capital market

### 1. Strict regulation on the entry into the capital market

According to Dealogic, WIND, and EY\* statistics, global initial public offering (IPO) activities continued to slow in 2023, with 1,347 companies going public globally and raising a total of US\$126.1 billion for the year. Compared to the whole year of 2022, the number of IPOs and the proceeds fell by 5% and 32% respectively. The Chinese mainland is an important region for global IPO activities, with A-share IPO proceeds in 2023 accounting for 40% of the global proceeds. The A-share capital market has been developing rapidly, and the cumulative equity and debt financing in the A-share capital market amounted to RMB8,904.7 billion during 2019-2023, which is now showing a trend of decline, with the details of the financing scale in each year as follows:

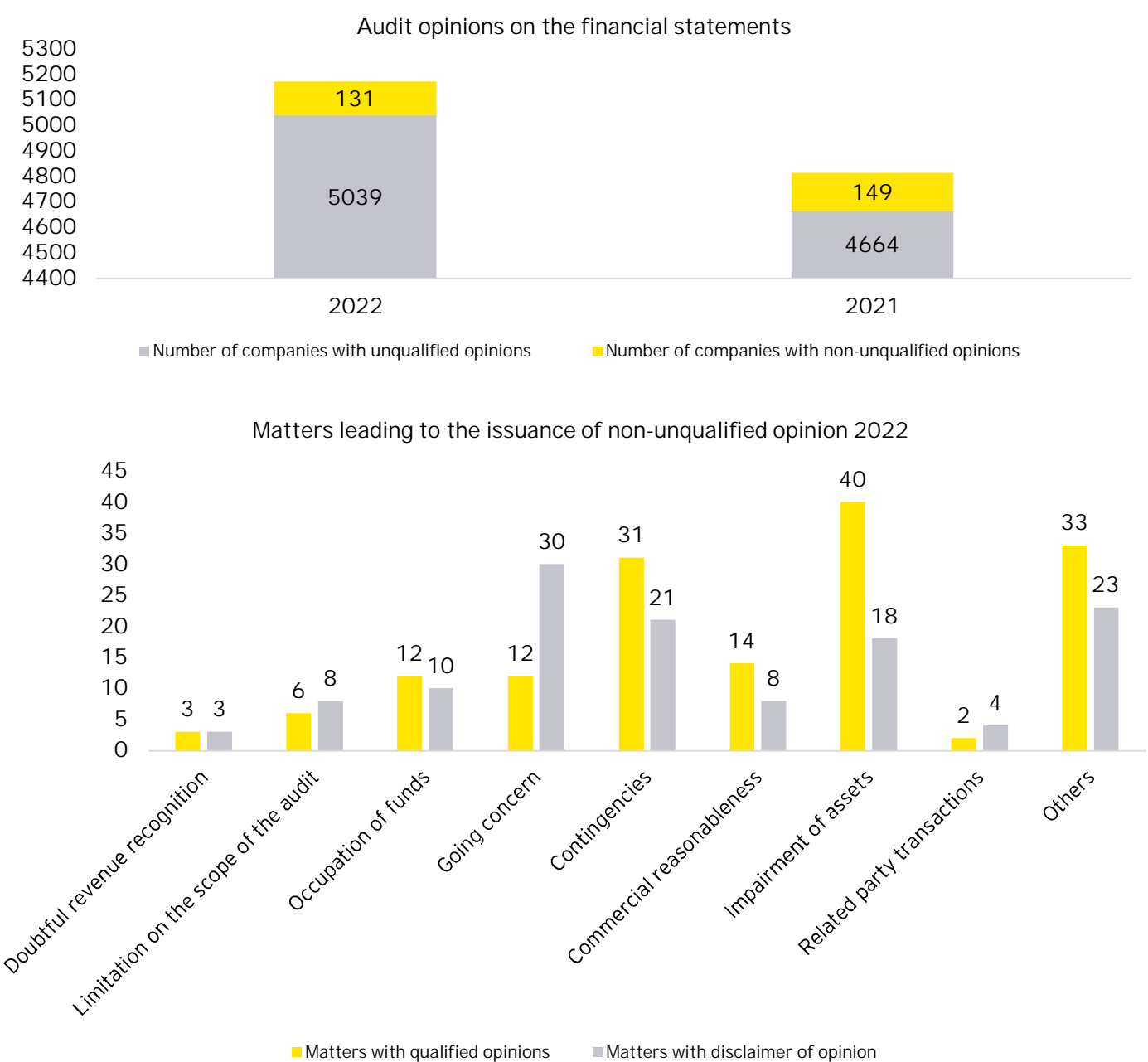


Source: iFinD, EY

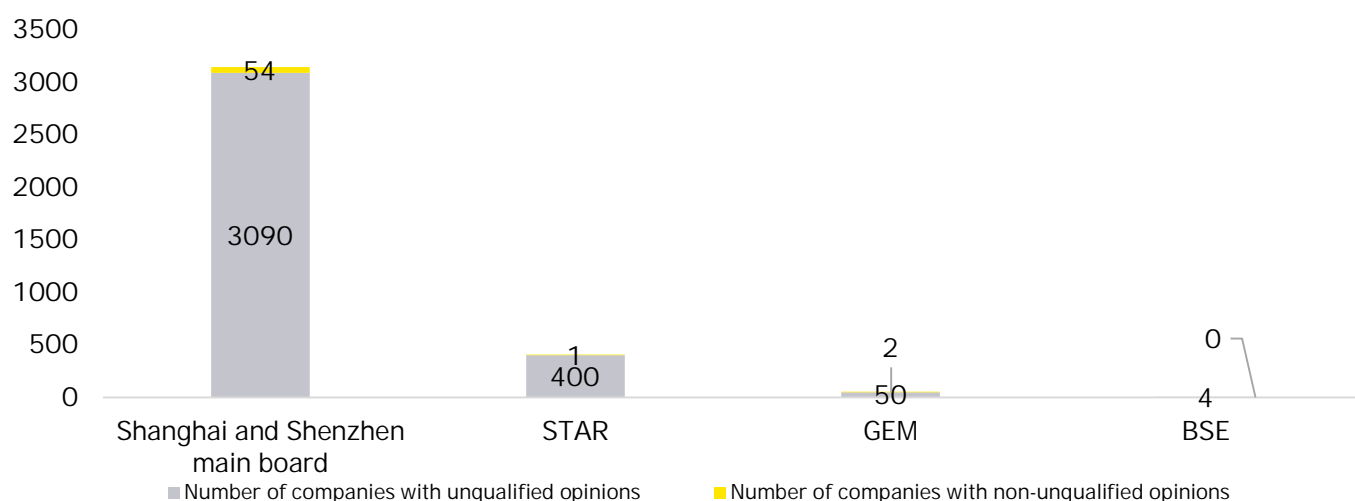
According to WIND and EY statistics, in 2023, a total of 245 companies to be listed in the A-share market terminated their listing applications (including withdrawals and rejections); as of 11 May 2024, a total of 568 companies have terminated their listing applications, an increase of more than 132% over the same period last year. The growing list of companies to withdraw listing applications reflects that the regulators set "strict" as the priority, strengthen the regulations for listing, keep a close eye on market entry and quality, and promote rational pricing of the value of listed companies, which is necessary to improve the registration system. In the long term, this will help improve the overall quality of listed companies and reinforce agencies to serve as a good "gatekeeper" for capital market, take their responsibilities, and consolidate the foundation of the healthy and stable development of the capital market.

## 2. Rigorous sustained oversight of listed firms

According to the Chinese Institute of Certified Public Accountants (CICPA) statistics, the annual financial statement audit of listed companies in 2022 shows that, a total of 131 issued non-unqualified opinions, and the matters leading to the non-unqualified opinions mainly included doubtful revenue recognition, limitation on the scope of the audit, occupation of funds, going concern, contingencies, commercial reasonableness, impairment of asset, related party transactions and others; in the internal control audit of listed companies in 2022, a total of 57 issued non-unqualified opinions, and the percentage of non-unqualified opinions that found internal control ineffective reached 88%. The details in the audit opinion on the financial statements of listed companies and the conclusion of the internal control evaluation report is as below:



## 2022 Conclusion of the internal control evaluation report



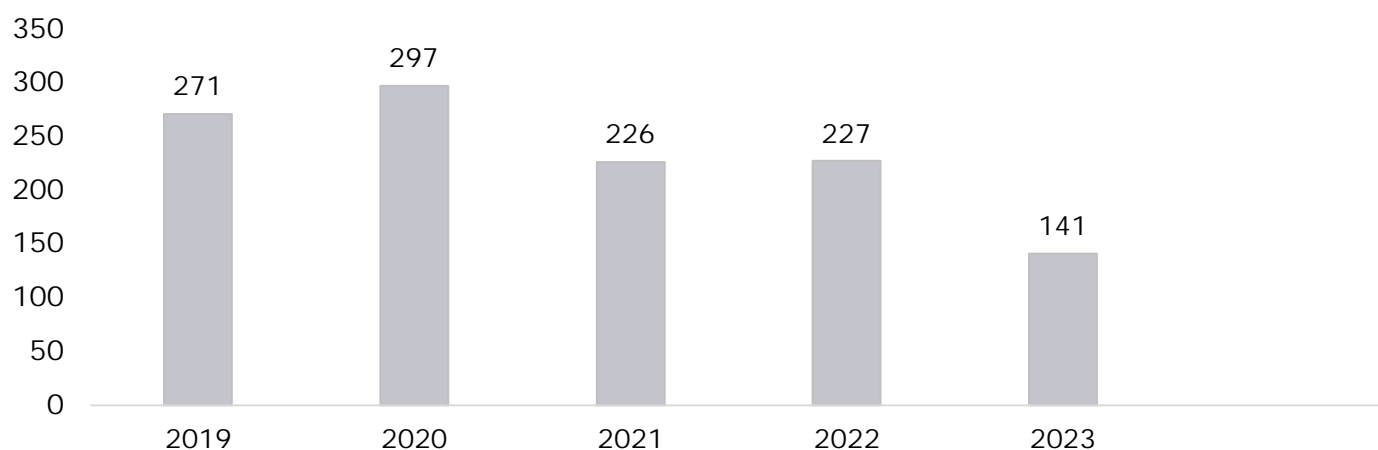
Source: CICPA, EY

The new 'Nine National Guidelines' outlines a range of core tasks aimed at bolstering capital market oversight and preventing financial misconduct. These include strengthening information disclosure and corporate governance supervision, building a comprehensive punishment and prevention system to prevent and eliminate counterfeiting in the capital market, addressing financial counterfeiting, occupation of funds and other key areas of illegal behavior, supervising listed companies to improve the internal control system, and leveraging the role of independent directors to reinforce the safeguarding and supervision of the core tasks.

According to data analyzed by Wind, for the whole year of 2023, the total amount of financing and the total amount of dividends paid by A-share listed companies were RMB1,134.4 billion and RMB1,763.8 billion, respectively; and for the whole year of 2023, 398 listed companies on the A-share stock market have been paying dividends and raising financing simultaneously. Additionally, according to Wind data, during 2019-2023, the annual average dividend of A-share listed companies was RMB1,498.8 billion, which is lower than average dividend of U.S. listed companies, which was US\$967.2 billion.

According to Wind statistics, during 2019-2023, the average number of proposed reductions in the maximum number of changes in the ratio of total share capital (more than 5%) by listed A-share companies was 234. A perfect management method and regulatory system for listed companies to reduce their holdings and cash dividends will promote stability, continuity and predictability of investment returns, better protect the interests of investors and promote the high-quality development of the capital market. Therefore, it is imperative to comprehensively improve the system and rules on share reduction and strengthen the regulation of cash dividends of listed companies.

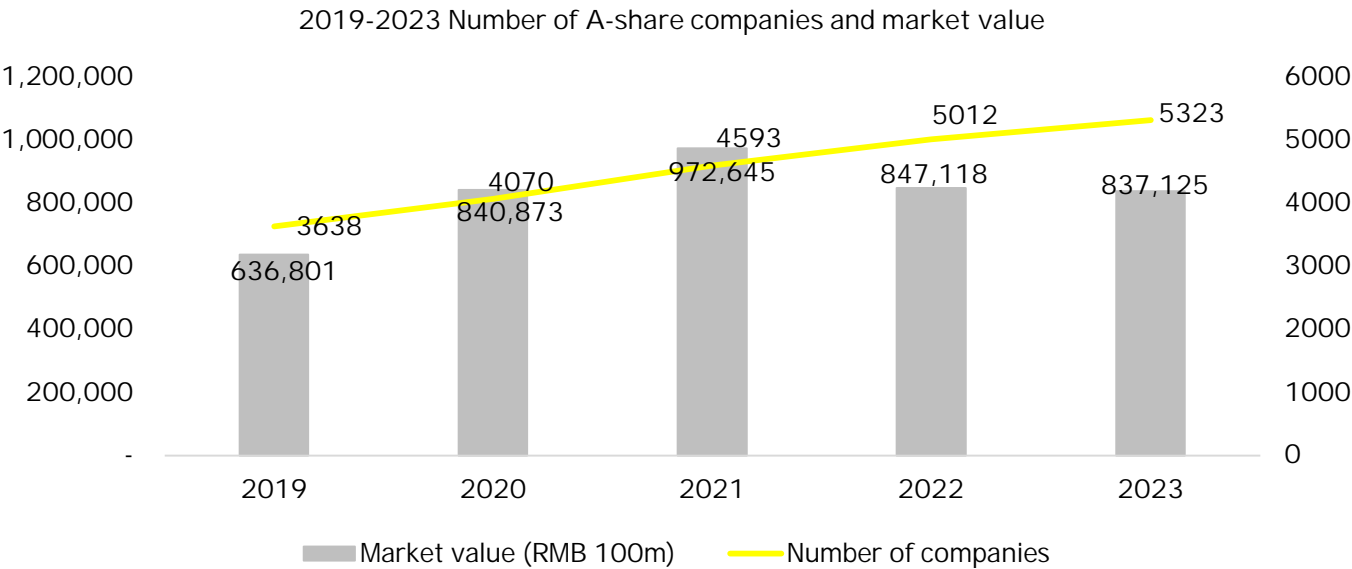
## 2019-2023 Number of shareholding reductions by shareholders accounting for more than 5% of A-shares



Source: Wind, EY

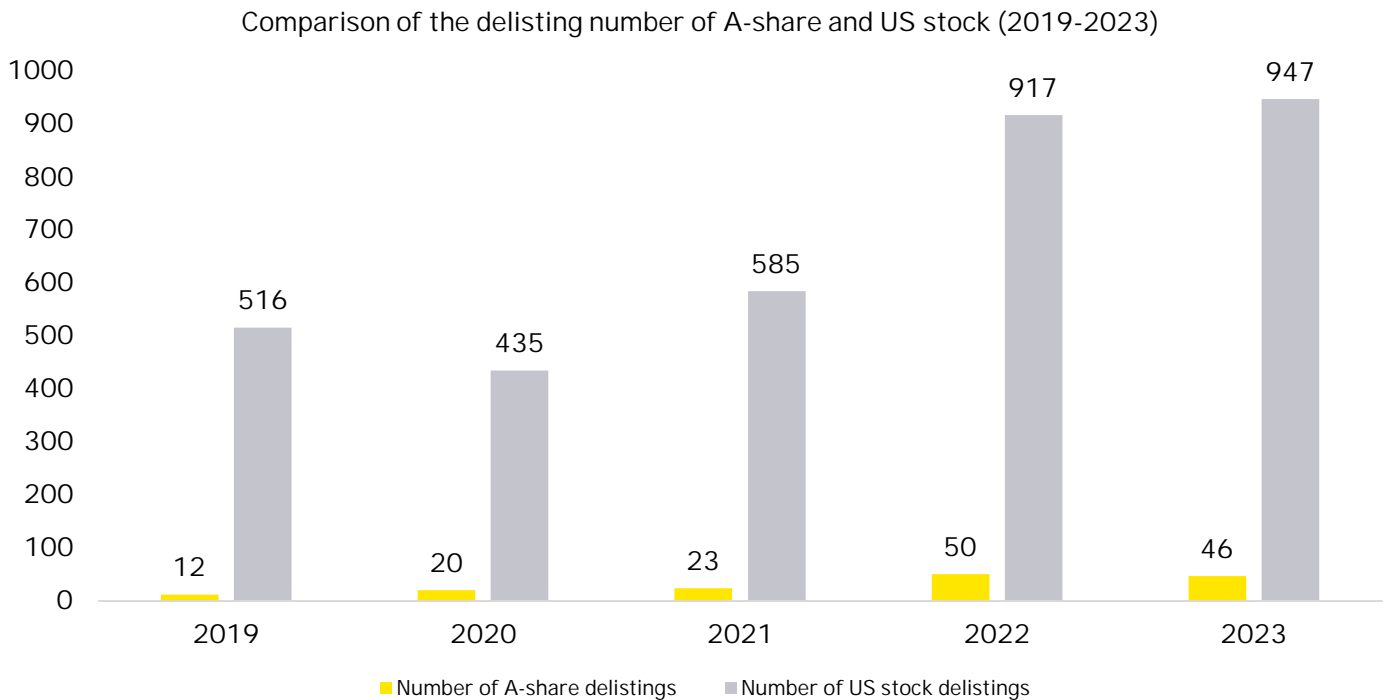


According to Wind statistics, the number of A-share listed companies during 2019-2023 has increased steadily year-on-year, but the market value fluctuated depending on the market state. Arising from the split-share structure reform, the market value management guidance, which was proposed in 2004 and written into the overarching documents in 2014, has now been incorporated into the internal and external assessment and evaluation system of the enterprise under the new ‘Nine National Guidelines’. Actively responding to market value management, cultivating internal power, strengthening oneself and establishing a high-quality corporate image will assist the listed companies to enhance their investment value.



### 3. Strengthening regulation on delisting

In November 2020, the Central Committee for Strengthening Overall Reform approved ‘the Implementation Plan for Improving the Delisting Mechanism for Listed Companies’, establishing a regularized delisting mechanism for listed companies. The number of A-share companies delisting during 2019-2023 totaled 151, with an average delisting rate of less than 1%, which was lower than the 3,400 delistings and the average delisting rate of 6% of the U.S. stock market during the same period.



At present, some of the A-share listed companies that should have been eliminated are trying to retain their listing status by all means, failing to achieve survival of the fittest, getting in and out, and withdrawal of the fittest. The new ‘Nine National Guidelines’ will promote the capital market to optimize the function of resource allocation, accelerate survival of the fittest and improve the overall quality of the listed companies. Nowadays, the A-share market still has the situation of “speculation in small, poor and new stocks”, with more strict supervision on delisting, “small and poor” companies will be marginalized, the “shell premium” will also be gradually disappeared. The A-share market will further show the trend of giant, indexing, institutionalization and specialization, during this process, companies need to take into account the internal and external governance to enhance and support giant development.

### Suggestions:

The new ‘Nine National Guidelines’ makes efforts from three aspects: Further improve the issuance and listing system, strengthen the issuance and listing of the whole chain of responsibility, and increase the issuance of underwriting supervision. In the future complete market cycle and regulatory closed-loop test, the market participants will gradually optimize and adapt to the final formation of an effective market constraints. Under the new situation, what is the best way to cope with the governance and regulatory requirements of A-share proposed and listed companies, and continuously improve enterprise value and profitability?

### How can companies do corporate governance well in this new context?

Corporate governance regulation involves all parties, including the company itself, regulators and intermediaries. However, in the game of interests in the capital market, under the severe regulation and rising penalties, fraud incidents are still repeated, which poses new challenges to listed companies, regulators and intermediaries. The new ‘Nine National Guidelines’ once again emphasizes that “financial fraud, funds occupation and other key areas of illegal behavior should be seriously rectified, listed companies should be urged to improve their internal control system, and the role of independent directors to monitor should be played effectively”. All parties in the market should take part together to improve the internal control system of companies and shoulder the responsibility of independent directors as the starting point, and jointly prevent the risk of violations of laws and regulations in key areas from both inside and outside.

#### 1. Improve internal control system

Good internal control can hinder fraud from its root. It has been more than 15 years since the implementation of the ministry control norms issued by five ministries and commissions in China in 2006. From the actual implementation, listed companies and regulators pay more and more attention to the construction of internal control, and the improvement of internal control requirements is an important cycle of the supervision of corporate governance.

Regarding the company’s own governance supervision, listed companies should focus on the major and key issues of the company’s internal control, and start from the five elements of internal control environment, risk assessment, control activities, information communication and supervision, and effectively build up the three lines of defense of the enterprise’s internal control of operation and management, compliance and internal control, and internal audit:

	First line of defense	Second line of defense	Third line of defense
Functional department	Business Operation Manager	Risk management and compliance department	Internal audit
Responsibility	Person responsible for the management of risk	Risk control and compliance control	Risk recognition
Independence	Not independent	Incomplete independence	Stronger independence
The relation of reporting	Report to executives	Report to executives	Report to corporate governance bodies

From the perspective of regulatory requirements of external organizations, in December 2023, Finance and Accounting [2023] No. 30 "Circular on Strengthening the Internal Control Construction of Proposed and Listed Companies and Promoting the Evaluation and Audit of Internal Controls", jointly issued by the Ministry of Finance and the CSRC, explicitly stated that since the disclosure of the 2024 annual report, all listed companies and IPO filers would be required to provide internal control audit reports. As early as 2022, the Ministry of Finance and CSRC jointly issued the Circular on Further Enhancing the Effectiveness of Internal Controls over Financial Reporting of Listed Companies, which focuses on the risk of making false records, misleading statements or material omissions in financial reporting information with motives such as misappropriation of assets, violation of guarantees, insider trading and manipulation of the market:

- ▶ Strengthen the assessment and control of risks of fraud in the management of funds and assets. Pay attention to the authenticity of fund and asset transactions, the consistency of relations of different accounts, accounts and documents, and accounts and facts, make sure the related internal control processes and control measures are effective.
- ▶ Enhance the assessment and control of the reasonableness of revenue recognition policy, sales management process and revenue fraud risk. Pay attention to the effectiveness of internal control processes and control measures such as revenue recognition accounting policy change procedures, customer management, sales management, pricing management, contract management, current account management, bad debt accruals and write-offs.
- ▶ Enhance risk assessment and control related to costs and expenses. Pay attention to the effectiveness of internal control processes and control measures in research and development management, procurement management, fund management, asset management, contract management and accounting.
- ▶ Enhance risk assessment and control of fraudulent investment activities. Pay attention to the risk of financial statement fraud in the name of investment activities and other risks affecting the authenticity of transactions and the fairness of prices for the purpose of fulfilling performance bets, performance commitments, meeting the conditions for the exercise of equity incentives, and meeting the expected performance in the market. Focus on the effectiveness of internal control processes and control measures over the authenticity of transaction targets, fairness of transaction prices, and truthfulness and completeness of transaction information disclosure.
- ▶ Enhance the assessment of the risk of fraudulent connected transactions and the assessment and control of the risk of the presentation of connected transactions. Pay attention to the effectiveness of internal control processes and control measures such as the authenticity of the business background of transactions, the authenticity of capital and asset transactions, the reasonableness and fairness of the sales model, and the compliance with the maximum number of connected transactions.
- ▶ Enhance risk assessment and control of significant risky business. Strengthen the construction and implement early warning and emergency response mechanisms for significant risk factors and events.
- ▶ Strengthen the risk assessment of the financial reporting process and the risk assessment and control of the information system related to the preparation of financial reports. Focus on the risk of material misstatement of financial reports caused by fraud of "key few" and establish an effective anti-fraud mechanism.

## 2. Independent directors to play the role of supervision

At this stage, the lack of integrity in the company's operation and the doubtful truthfulness of its financial status have triggered a great deal of attention from investors and regulators in the securities market. With the external auditor yet to issue an audit report and the anonymous tip-off triggering inquiries from regulators, the function of independent directors is of paramount importance. In September 2023, the "Measures for the Management of Independent Directors of Listed Companies" further clarified the duties of independent directors and strengthened the supervision and management of the performance of their duties:

- ▶ Clarify the qualifications and procedures for the appointment and removal of independent directors. Listed companies shall make specific provisions on the professional knowledge, work experience and good character that should be possessed by independent directors. The appointment and removal of independent directors shall be optimized in the whole chain from nomination, qualification examination, election, continuous management, termination, etc., with the establishment of nomination avoidance mechanism and qualification recognition system for independent directors. In principle, independent directors shall serve as independent directors in a maximum of three domestic listed companies.
- ▶ Clarify the responsibilities of independent directors and the manner in which they perform their duties. Independent directors shall perform three duties: Participating in the decision-making of the board of directors, supervising matters of potential major conflicts of interest and providing professional advice on the operation and development of the company, as well as exercising special powers, such as independently engaging intermediaries, when there are signs of irregularities or malpractices. In response to the situation that independent directors do not actually fulfill their liabilities while on duty, independent directors are required to work on-site at the listed company for no less than fifteen days per year and have relevant work records.
- ▶ Clarify the guarantee for performing duties. The listed company shall provide the necessary working conditions and personnel support for independent directors to perform their duties. To improve the relief mechanism for independent directors to perform their duties, if independent directors encounter obstacles in the performance of their duties, they may explain the situation to the board of directors and request the directors and senior management to cooperate with them, and if the obstacles cannot be overcome, they may report the situation to CSRC and the stock exchange.

The importance of independent directors' performance of duties is stressed, which also means that the responsibility for them is heavier. "The Measures for the Management of Independent Directors of Listed Companies" adds a special chapter on "Supervision Management and Legal Liability", which states that if a company, its independent directors and related subjects violate the provisions of the Measures, the CSRC may take such supervisory measures as ordering corrections, supervisory conversations, warning letters, public explanations and periodic reports. If administrative penalties should be imposed in accordance with the law, the CSRC will penalize them based on the relevant provisions. Shanghai Stock Exchange listed companies to penalize case statistics, since the provisions of the landing, has been a total of independent directors to implement disciplinary and supervisory measures for more than 10 people, mainly related to independent directors in the performance forecast violations, financial forgery and other violations, focus on solving the "sole director is not independent," "eye candy independent director" and other prominent problems, in order to effectively protect the independent director fulfill supervision function, to protect the legitimate rights and interests of listed companies and their small and medium-sized shareholders has played an important role.



## How can businesses deliver greater value in this new context?

Nowadays, how can listed domestic companies improve their profitability to adapt to new regulations and requirements in a more complex economic and market environment? How can they achieve high-quality development in an increasingly challenging macroeconomic and market environment?

### 1. Core of the “costs and efficiency optimization” and key to success

The core for companies to reduce cost and improve efficiency is to increase productivity rather than just considering cut cost. Cutting cost in a simple or inappropriate manner will not necessarily lead to improved efficiency but undermine employee motivation as well as cash flow and supply chain stability.

How can companies achieve the optimal cost savings by identifying the most appropriate target through analyzing potential areas for cost reduction? Cost reduction and increasing productivity are not only the responsibility of the finance department, but also requires cooperation among business, finance and operation functions to address bottlenecks that are undermining profitability. Based on the logic of profit generation, it is not difficult to understand the core of cost reduction and efficiency improvement is to achieve an orderly increase in revenue and a reasonable control and reduction in costs and expenses, which is one of the keys to successful reform.

Cost reduction formula may vary by industry, region, business nature and a company's value position within the industry. Bottlenecks which are undermining profitability can be identified effectively in a certain way with considerations from two dimensions – whether accounting for a high proportion of total costs and carrying a heavy weight. A tailored approach is needed while identifying bottlenecks, integrating industry-specific experience and upstream and downstream value-chain practices rather than making simple conclusions through direct numerical comparison.

### 2. Challenge 1: Focus areas varying significantly across industries

Industry is entitled to a priority consideration for cost reduction. Focus areas may vary significantly across industries or segments, even differ in a single industry. However, businesses within the same industry have commonalities, which we identify based on our experience with the following industries as example.

For traditional manufacturing (discrete manufacturing), the most effective way to cost reduction for improved efficiency is to optimize procurement costs, which account for 70%-95% of total costs among businesses within the industry, although different segments vary significantly. Especially for certain primary processing segments, procurement costs represent more than 95%. As such, optimizing procurement costs is the top priority for improved cost-effectiveness within the industry.

For energy and chemical industry (process manufacturing), the most effective measure to cut costs and increase productivity is to improve overall real equipment effectiveness. Since most businesses within the industry have an immense quantity of large and heavy equipment that is complicated in structure and highly expensive in both procurement and maintenance, the overall equipment effectiveness determines to a great extent their production capacity and output stability and becomes one of the biggest potential constraints on revenue growth.

For consumer products and retail industry, focus areas for cost reduction and efficiency improvement encompass revenue growth, including sales channels (chain retailers, inclusive of outlet performance) and product selection, and cost reduction, including optimizing procurement, outlet and people costs. Please focus on new perspectives of the traditional three elements – goods, venue and people.

### 3. Challenge 2: The scope and methods varying significantly

As the evolution of people and culture differ, the scope, methods and steps of transformation for improving cost-effectiveness vary significantly across businesses which are at different stages of development and featuring diverse nature of business, even among those in similar industry and with similar market position.

The decision on the path toward transformation matters for the team leader, whose experience in industry and transformation, and capability in data analytics and data mining are demanding, with considerations taken of certain factors including piloting in service lines, regions or channels and expanded implementation.

Moreover, the scope and methods of transformation may vary by macroeconomic environment, industry competition and value chain which are likely to differ within an organization amid transformation.

The new 'Nine National Guidelines' poses higher requirements on profitability, dividend policy and operating ability for companies listed and to be listed. Improving cost-effectiveness is an important means to optimize profitability while bringing positive significance to enhanced operation ability and competitiveness. However, due to reliance on various factors including professionalism, difficulty in implementation, experience in transformation and change in concepts, being successful in transformation for optimizing cost-effectiveness is highly challenging.

In this new context, companies to be listed should focus more efforts on their development in the medium and long run to create greater value, improve profitability and increase attention to information disclosure. They should also strengthen governance to achieve higher growth across the board and move toward high-quality economic development, while seizing opportunities amid transformation to grow bigger and stronger through more precise strategic positioning and goal setting, and cooperation to create synergy.

## Conclusion

As economic growth slows down and certain industries suffer from overcapacity, it is essential to make wise investments and avoid ineffective decisions that could lead to financial losses, while taking proactive measures to cut capital expenditure, strengthen delisting, dividend distribution and share repurchase to improve return on invested capital. The new 'Nine National Guidelines' aims to promote the high-quality development of the capital market, stress efforts to provide more effective protection of the legitimate rights and interests of investors, especially small and medium-sized investors, and better serve the high-quality economic and social development, featuring goal orientation and problem orientation. A series of measures will raise expectations of market liquidity, tighten trading regulation and strengthen the inherent stability of capital market to further increase market risk appetite.

Amid ongoing transformation and improvement in the capital market, brokerage firms need to actively cooperate with regulators and stock exchanges, give full play to their advantages to serve businesses and assist them with listing and information disclosure, to help businesses move toward high-quality development.

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