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Operationalizing Audit Committee Functions and Enhancing Internal Audit in Local Commercial Banks under the New PRC Company Law—A Practice-Oriented Analysis in Zhejiang Province

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Abstract: *The 2023 revision of the PRC Company Law establishes a new internal oversight model centered on the audit committee, bringing profound changes to the corporate governance systems of local commercial banks. Using practices of local commercial banks in Zhejiang Province as the sample, this study finds a gradient pattern of development: listed banks have largely completed institutional transition and deepened functional implementation; most non-listed banks are moving from formal compliance toward substantive operation; and county-level rural commercial banks face multiple constraints such as shortages of talent and resources. The study further identifies three key challenges in the current reform: (1) weak linkage among oversight functions and resulting disconnections; (2) inadequate independence and professionalism of audit committees, including the risk of "hollow" organizational arrangements; and (3) an ambiguous positioning of internal audit that leads to weakened functions. Based on Zhejiang's experience, this paper proposes differentiated implementation paths: at the institutional level, develop classification-based guidance; at the mechanism level, innovate a "two-way embedding" operating model; and at the capability level, strengthen empowerment through digital technologies. The study provides actionable solutions for local commercial banks to transform their oversight systems under the new rules, and offers reference value for advancing the modernization of corporate governance in local commercial banks.*

Keywords: *New PRC Company Law; Audit Committee; Internal Audit; Local Commercial Banks; Corporate Governance*

1. Introduction

Effective internal supervision is a cornerstone of a sound modern corporate system. This is especially critical in the financial sector, which is characterized by high leverage and strong risk spillovers; a robust oversight framework is therefore a key line of defense for financial stability. The 2023 revision of the PRC Company Law makes structural adjustments to the board of supervisors regime and expressly encourages companies to replace the board of supervisors with an audit committee established under the board of directors[1], which then assumes the core oversight functions. This reform is a central measure to move corporate governance from "formal completeness" to "substantive effectiveness", and aims to systematically reshape the allocation of oversight powers, responsibilities, and operating effectiveness.

Since the implementation of the transitional arrangements for supporting rules under the new Company Law, market practice has responded actively. Led by listed companies, the pace of abolishing the board of supervisors and transferring oversight functions to the audit committee has accelerated. In addition, multiple large state-owned and joint-stock banks and other financial institutions have reportedly joined this wave of institutional transition and entered the implementation stage.

However, compared with listed entities whose governance foundations are relatively mature, local commercial banks—numerous and heterogeneous—face distinct challenges in this governance transition. As financial hubs rooted in local economies and serving the grassroots, the governance quality and oversight resilience of local commercial banks directly affect regional financial ecology and the vitality of the micro-economy. Although the time pressure for regulatory compliance may be less immediate than for listed companies, features such as ownership structure, business models, and talent reserves mean that the implementation of the audit committee system requires more targeted solutions. [2]

Against this backdrop, this paper examines local commercial banks in Zhejiang Province. Zhejiang

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has a dynamic private economy and an active financial ecosystem, covering a full spectrum of local legal-person banks (including city commercial banks and rural commercial banks) with visible stratification in governance capacity, making it a suitable sample for observing the real effects of this governance reform. The paper addresses three questions: (1) what practical pathways do local commercial banks follow to operationalize audit committee functions under the new rules; (2) what structural difficulties arise in implementation; and (3) how can the oversight effectiveness of the audit committee and the quality of internal audit functions be enhanced simultaneously. The goal is to provide practice-oriented guidance for similar institutions undergoing institutional transition.

2. Reconstructing the Oversight Framework under the New Company Law: the Logic and Path

2.1 Structural Defects and Functional Hollowing-out of the Board of Supervisors

As a representative oversight mechanism in civil-law systems, the board of supervisors has been introduced into China's company law and operated for a long time, yet in practice it often exhibits "hollowed-out oversight." The deeper causes lie in three inherent design defects[3]:

1) Inherent lag in information acquisition: supervisors are institutionally placed outside the core decision-making process. Their oversight over major matters relies mainly on board reports and limited meeting attendance. This ex-post, externalized oversight model makes it difficult to form timely and effective judgments on complex, dynamic decisions and risks, reducing supervision to procedural endorsement.

2) Insufficient institutional safeguards for independence: although the law emphasizes independence, in practice nomination, remuneration, and career paths are often closely linked to the board or management. This "supervisee selects the supervisor" mechanism creates real conflicts of interest when supervisors attempt to exercise core duties such as inquiry or veto, weakening accountability.

3) Structural mismatch between expertise and oversight needs: effective oversight—especially in financial firms—requires interdisciplinary expertise in finance, accounting, law, and risk management. In many organizations, particularly non-listed ones, supervisory roles are treated as honorary positions or transitional arrangements, and the knowledge base is inadequate for increasingly complex operations and financial innovation, preventing supervision from reaching substantive issues.

2.2 Strengthening Audit Committee Functions through System Reconfiguration and Functional Integration

By establishing the audit committee as the core oversight body, the new Company Law promotes a systemic shift from "coexisting institutions" to "integrated functions."

Organizational integration: upgrading governance structure from "coexistence" to "integration." The law permits a joint-stock company, as provided in its articles of association, to establish an audit committee composed of directors within the board of directors to exercise the statutory powers of the board of supervisors, and accordingly not establish a separate board of supervisors or supervisors. This organizational choice addresses long-standing problems of fragmented oversight powers and overlapping institutions, and signals a shift from formal dual or hybrid governance structures toward a function-oriented, integrated model. Under this new paradigm, oversight functions are embedded within the decision-making center of the company—the board of directors—creating an organizational foundation for more effective supervision.

Reconfiguration of powers: strengthening independence and effectiveness through statutory authorization. To ensure authority and effectiveness, the new law grants the audit committee a set of key powers designed to remedy the board of supervisors' traditional weaknesses such as limited authority and poor information access:

(1) Proactive information access: consistent with the audit committee's positioning and the board's general powers, the audit committee may require management to report work and provide necessary information, shifting away from passive receipt of reports.

(2) Independent investigation and verification: the audit committee is authorized to engage external professionals (e.g., accounting firms and law firms) to support investigations, enabling it to penetrate complex operations and verify critical matters—an essential safeguard for independence and professionalism.

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(3) Ex-ante review of key decisions: for major related-party transactions and annual financial reports, while the law may not enumerate every item, granting the committee supervisory powers in substance requires that such matters be reviewed by the audit committee before submission to the board for deliberation, moving the oversight checkpoint forward.

2.3 Internal Audit as an Inevitable Mechanism for Effective Oversight

Although the new law does not explicitly define the status of internal audit, strengthening audit committee functions logically requires internal audit to become a key mechanism supporting the committee's performance of duties.

(1) Deepened oversight responsibilities with a missing execution vehicle: the law assigns the audit committee broad oversight over financial and business activities. Yet the audit committee is a meeting-based body, often including external members, and cannot conduct continuous, day-to-day supervision. This creates a gap between "oversight responsibilities" and a standing internal execution capacity.

(2) Internal audit as a necessary lever for the audit committee: due to its permanence, proximity to operations, and professional skills, the internal audit function becomes an indispensable extension of the audit committee's statutory oversight. Supporting rules (e.g., measures on independent directors of listed companies) provide institutional basis. In practice, the audit committee's "supervision and evaluation" over internal audit is reflected in approving annual audit plans, reviewing key findings, and evaluating the head of internal audit. This embedded cooperation turns internal audit from a management-facing service into an institutionalized "agile sensor" that supports the committee's continuous oversight.

(3) Reshaping reporting lines and realizing collaborative effectiveness: these arrangements establish a direct functional reporting line from internal audit to the audit committee, enhancing independence and authority and enabling objective disclosure of risks without undue management influence. Operationally, internal audit's real-time insights provide the committee with a dynamic and precise "governance dashboard," extending supervision from periodic meetings to an ongoing process and enabling timely risk warnings and more accurate decision guidance.

3. Demand, Status, and Challenges of Oversight Reform in Local Commercial Banks

3.1 Rationale for Reform

The oversight reform in local commercial banks is driven by their distinctive risk profile and the new legal requirements. By the end of the third quarter of 2025, commercial banks accounted for 86.4% of total banking-sector assets; city commercial banks and rural commercial banks together exceeded 26%, making them important pillars of regional economies. However, asset-quality pressures are significant: the non-performing loan ratios of city commercial banks and rural commercial banks were 1.84% and 2.82%, respectively—both higher than the industry average of 1.52%.[3] This "large scale, higher risk" profile makes strengthening internal oversight a core requirement for sustainable development. From the legal perspective, the new Company Law provides a direct institutional driver and a compliance requirement for transforming the oversight model. Replacing the board of supervisors with an audit committee under the board of directors aims to embed professional oversight into the decision-making core to address hollow oversight. For local banks, this is not only mandatory compliance but also a strategic opportunity to use legal force to upgrade governance architecture and convert external compliance pressure into internal risk-control capability.

The implementation of the new Company Law provides a direct impetus for this transition. Allowing an audit committee under the board to replace the board of supervisors is intended to embed professional oversight in the decision core. For local banks, this is more than a compliance task: it is an opportunity to leverage legal enforceability to upgrade governance and transform external pressure into internal control capability. Practice also indicates urgency: among corporate-governance penalties issued to local banks by regulators during 2020–2022, cases involving inadequate performance of the board of supervisors accounted for 42%, highlighting the limitations of the traditional model. By optimizing oversight mechanisms, the audit committee system is directly linked to banks' risk-management capacity and long-term sound development.

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3.2 Current Implementation Status

Across the banking sector, oversight reform shows clear differentiation. According to a survey by the China Banking Association, as of June 2024, 78% of local commercial banks with assets above RMB 500 billion had completed the institutional setup of audit committees, while the figure was only 35% for banks with assets below RMB 200 billion. Some leading institutions (e.g., Bank of Beijing and Bank of Shanghai) [4][5]have established relatively mature operating mechanisms, with audit committees convening on average 6–8 meetings per year and reviewing core matters such as risk management and internal control. By contrast, many regional banks have set up audit committees in form, but meeting frequency and agenda depth remain insufficient. Overall, the reform is still at a critical stage of moving from “form” to “substance.”

3.3 Challenges

The rollout of the audit committee system under the new Company Law faces several common challenges in practice. First, functional handoffs may leave gaps: process-oriented and non-financial oversight functions previously undertaken by the board of supervisors—such as supervision of directors’ and senior executives’ performance and protection of employees’ rights—may fall into a vacuum when oversight shifts to an audit-committee model centered on financial reporting and internal control. Second, audit committees often face dual weaknesses in independence and professionalism due to imperfect selection mechanisms and shortages of multidisciplinary talent who understand both financial business and corporate governance, limiting the depth of supervision. Third, internal audit departments may encounter role conflicts under a “dual reporting” relationship: they must remain independent to the audit committee while relying on management for resources, and also need to upgrade capabilities from compliance-oriented auditing to risk-based auditing.

4. Zhejiang Province: Implementation Status and Policy Recommendations

4.1 Practical Landscape and Core Issues

Based on field research and annual report analysis of multiple local commercial banks in Zhejiang, the reform exhibits a clear gradient pattern. Significant differences are observed in abolishing the board of supervisors, enhancing audit committee functions, and transforming internal audit. The effectiveness of oversight transition is shaped by the interaction of three dimensions: institutional foundations, resource endowments, and governance structure.

Institutional foundations determine the pace of transition. Listed banks such as Bank of Hangzhou and Bank of Ningbo [6][7]have long been required by securities regulators to establish audit committees; therefore, this reform is largely a continuation and deepening of existing arrangements. They recently made last minute revisions of their articles of association, formally adopted the audit committee model, and further expanded and refined its functions.

Regional banks such as Bank of Jinhua, Bank of Jiaxing and Bank of Shaoxing [8-10] are at a critical stage of moving from “formal compliance” to “substantive operation.” They often consider abolishing the board of supervisors but have not fully implemented it; their involvement in substantive risks remains limited. They also face a dual dilemma: on the one hand, the selection of independent directors is constrained by regional talent pools, with a notable shortage of professionals with fintech or big-data risk-control backgrounds; on the other hand, traditional “block-style” management structures may conflict with the “line-style” supervision required by audit committees. For example, when an audit committee becomes involved in credit approval, unclear boundaries with the existing credit approval committee can dilute oversight effectiveness.

Most county-level rural commercial banks face even more severe challenges, commonly described as “three difficulties”: difficulty attracting professional talent, as high-quality independent director resources concentrate in listed banks; difficulty obtaining information, due to insufficient initiative and completeness in management reporting; and difficulty securing resources, as internal audit staffing ratios are generally low and auditors often bear heavy compliance workloads.[11]

4.2 Systemic Optimization Path and Implementation Strategies

1) Building a differentiated implementation framework. A tiered and classified guidance system is

recommended: for listed banks, prioritize extending oversight toward strategic risks and innovative businesses; for regional banks, focus on resolving structural barriers to implementation; and for county-level rural commercial banks, adopt a two-year transition period to ensure the smooth operation of basic oversight functions. Establishing a repository of audit committee “best-practice templates” can provide concrete references for different types of banks.

2) Innovating talent safeguard mechanisms. To address insufficient professional capacity of independent directors, establish a system of qualification certification and a regional talent pool. With unified professional standards, implement a selection process of “demand submission – candidate recommendation – two-way matching.” At the same time, link 40% of independent directors’ remuneration to performance evaluation results to form a performance-oriented incentive mechanism.

3) Advancing technology-enabled oversight. Build a provincial audit-oversight data platform to unify standards for off-site audit data, risk monitoring indicators, and remediation tracking. Require local banks to raise digital-audit investment to 0.15% of operating revenue by 2026, and lower adoption barriers for smaller banks through standardized risk-monitoring modules.

4.3 Regulatory Innovation and Effectiveness Safeguards

1) Improving oversight effectiveness evaluation. Establish a quantitative evaluation system and break down audit committee operating quality into 12 specific indicators, incorporating them into supervisory rating. Implement “green–yellow–red” differentiated supervision, and apply corresponding measures to institutions that persistently fail to meet standards.

2) Strengthening accountability mechanisms. Establish an accountability tracing mechanism under which major risk events caused by oversight failure are subject to lifelong accountability. Clarify responsibility boundaries among audit committee members, internal auditors, and relevant managers, and link oversight effectiveness to executives’ remuneration.

3) Innovating supervisory methods. Promote the shift from compliance-focused supervision to effectiveness-focused supervision by developing a data-driven dynamic assessment model. For institutions with genuine difficulties, allow explanations and improvement plans, reflecting flexibility and targeted supervision.

Through these systemic measures, Zhejiang’s local commercial banks can build an oversight system that matches their development stages and business complexity, providing a replicable and scalable practice model for peer institutions nationwide.

5. Conclusion

The reform of the board of supervisors regime under the new Company Law offers a valuable institutional opportunity for Zhejiang’s local commercial banks—and similar institutions nationwide—to improve corporate governance and enhance oversight effectiveness. Based on Zhejiang practice, the transition from the “board of supervisors” to the “audit committee” is not a simple organizational merger or cancellation; rather, it is a profound reform involving power reallocation, functional handoffs, and capability upgrading. The reform has entered a challenging phase, and success hinges on whether gaps in functional linkage can be bridged, whether weaknesses in independence and professionalism can be addressed, and whether internal audit can achieve a step-change in role positioning and capability.[12]

Looking ahead, local commercial banks should seize the historic opportunity brought by this legal revision. With the functional operationalization of the audit committee as the core and the strategic enhancement of internal audit as a lever, banks should build a new internal oversight system that is clear in rights and responsibilities, strongly coordinated, and efficient in operation through systematic institutional design and solid practice. This is not mere compliance with legal requirements, but an internal necessity for strengthening risk defenses and achieving high-quality development. Zhejiang’s experience reflects the real-world contexts of implementing the new rules across different foundations and tiers of local commercial banks, serving as a microcosm of the nationwide transformation. It underscores that operationalizing audit committee functions and strategically upgrading internal audit are key pathways to constructing a new oversight system and improving the effectiveness of corporate governance.

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