Impact of institutions and culture on auditor independence and corporate governance in China: three case studies of issues arising from China's economic reforms

Wenqi Han

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Impact of institutions and culture on auditor independence and corporate governance in China: three case studies of issues arising from China’s economic reforms

Wenqi Han

"This thesis is presented as part of the requirements for the award of the Degree of Doctor of Philosophy of the University of Wollongong"

March 2017
ABSTRACT

The “Open Door” policies of China have brought many changes to Chinese society and its economy, such as foreign investment, and an influx of and an exponential growth in the mobility of skilled professionals. China’s cultural history is long, broad and profound. Confucian culture is deeply embedded in Chinese culture, in which guanxi is an important component. When culture changed, the meaning of guanxi also changed, especially through the transformation and restructuring of societies and politics. This thesis explains the ensuing impact of the political and cultural changes on auditor independence and corporate governance after the implementation of Chinese economic reforms.

After the implementation of Chinese economic reforms, China adopted and transplanted many international regulations and policies that were devoted to technical performance and also to conforming with established institutional practices. Auditors and companies embed institutional practices, interactions and responses to external disturbances in their cultural environment. This thesis focuses on how Chinese auditors and companies respond to institutional changes under cultural pressures by observing three case studies.

This thesis will make a unique contribution particularly to the existing literature in the areas of the neo-Durkheimian theory, and auditor independence and corporate governance in context of Chinese culture. This thesis also provides an opportunity to understand auditor and corporate practices in Chinese institutional and cultural environments, and also improves the understanding of potential risks existing in the process of adopting new international regulations in China.
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Professor Andrew always provided freedom to develop my own research interest area and supported me. He gave me some brilliant ideas which made me so excited when I was in my research predicament. In addition, he was very patient to listen to my presentation every meeting. Even though he had tremendous administrative workload including faculty meetings, he always patiently provided me with feedback.

Meanwhile, I also appreciate Dr Rudkin’s unwavering confidence in my ability, guidance toward the right direction and in providing me with opportunities to explore my potential. I could not have become efficient in my work without her quick responses and close supervision. I am therefore greatly indebted to my supervisors who have helped me grow up towards becoming an independent accounting researcher.

I would like to sincerely thank Ms Alison Haynes for her English language support. I also thank the staff at University of Wollongong for their advice and assistance with this research.
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CHAPTER 1 INTRODUCTION

The accounting profession is struggling to regain public trust after high profile corporate scandals, such as Toshiba in 2015 and Enron in 2001 accounting scandals, which indicate problems with the quality of accounting financial reporting on a global scale. In China, there are also continuing instances of unexpected corporate failures and scandals, such as Yin Guang Xia and Green Land. This leads to the disrepute of and consequent loss of faith in the accounting profession. In 2001, former Chinese Premier Zhu Rongji gave three national accounting institutes in Beijing, Shanghai, and Xiamen personally inscribed plaques with the motto: to keep good faith and integrity, abide by the code of professional ethics, adhere to accounting standards, and to never falsify an account.

China, a country with the world’s largest population and the second largest economy, has undergone rapid changes and reforms since the late 1970s. With the implementation of the Open Door policy and the process of transforming planned economies to be more market oriented, there has been a rapid growth in the number of multinational corporations establishing subsidiary companies in China. Australia signed a free trade agreement with China on 17 November 2014. China is Australia’s largest trading partner. This China-Australia free trade agreement will unlock significant opportunities for Australia. Auditing is relied upon in such relationships, because it is important for assurance of financial reporting integrity, being an activity of verification and evaluation of financial statements.

This thesis explains the ensuing impact of the political and cultural change on auditor independence and corporate governance after the implementation of Chinese
economic reforms. Thus, the research problem of the thesis is the international auditing practices and transplanted corporate governance systems in China. This problem has two aspects, referring to the functioning in the Chinese context, and the risks identified in the case studies.

In this introductory chapter, section one will discuss the research site. Section two will introduce the three selected cases. Section three will introduce the theoretical framework, followed by a discussion of the contribution of this study in section four. The organization of the thesis will be detailed in section five.

1.1 The research site

Three case studies were selected from China because of the unique development and institutional environment of that country. With the process of transforming planned economies to be more market oriented and China entering the World Trade Organisation (WTO), there has been an exponential growth in the number of multinational corporations establishing subsidiary companies in China. Comparing the economic development of Chinese coastal and interior provinces, the policy of Chinese transition to a market-based economy was initially implemented in the coastal provinces (Demurger, 2001). As a result, both large amounts of foreign investment, and western culture entered China together.

Chinese culture is not only deeply rooted, but has also significantly influenced East Asian countries, such as Japan, Korea, Malaysia, and Singapore. However, with the implementation of the open-door policy and a dramatic growth of international trade,
Chinese traditional culture has been shaken. This study can improve the understanding of individual behavioural changes in this unique environment.

1.2 The theoretical framework

Auditing is recognized as involving both social and cultural activities. It is important to investigate behaviours in the context of culture because culture can shape the way people think. While culture is attributed to socially constructed processes, government policies and political practices influence the social construction.

New institutional theory suggests that for organizations to succeed in society they must achieve and maintain legitimacy in their environment (Chiang and Northcott, 2012). Organizations maintain legitimacy in order to seek a position in the society. During the process of economic reform in China, the auditing profession increased their institutional legitimacy. New institutional theory assumes that institutional isomorphism is forced by three institutional pressures, namely coercive, mimetic, and normative isomorphism (DiMaggio and Powell, 1983; Scott, 1995). However, because the policy of transition to a market-based economy was initially implemented in the coastal provinces of China, particularly in Special Economic Zones, regions opened up to the world gradually from coastal to interior regions. So, the auditing profession in different regions seeks their institutional legitimacy. In this process, culture may impact individuals’ behaviours and thoughts in different ways when individuals adopt similar policies and practices in different regions.

Anthropologist Mary Douglas firstly proposed the grid-group method in 1970 to explain such a social and cultural phenomenon. The grid-group dimensions
categorise cultures into four different social environments and is based on two dimensions: the grid dimension and the group dimension. The grid dimension refers to the degree of social regulation that individuals are subject to in selecting social roles, while the group dimension concerns the degree of loyalty that an individual has to other group members (Linsley et al., 2015, p. 4). Individuals and organizations interpret their social context based on their own values and beliefs because culture exerts a strong impact over cognition. Although political events and institutions significantly influence individuals’ behaviours, individuals interpret and accept these institutional constraints as a process. Institutions enact rules and regulations and ask individuals to follow them, which cultivate individuals’ thought style. This is culture in this group of people. When people in a group share the same attitudes, customs, and beliefs, individuals tend to act in ways that reinforce those institutions. However, if individuals’ thought style has been changed, institutions may become disorganized. And also if institutions have been changed, the new institutions may cultivate new thought styles.

Due to globalization of the world economy and the proliferation of multinational corporations, national economies have become increasingly interdependent. An increasing number of countries such as China are converging to internationally acceptable auditing practices. Neo-Durkheimian theory emphasizes the impact of informal institutions of culture which limits individuals’ opinions and cognition to adapt institutional changes (6, 2015).

Confucian society does not encourage individuals to be outstanding or to be straightforward in expressing their own opinions against others’, because these
behaviours are seen as stealing the limelight and showing off. Individuals in Confucian societies prefer to avoid conflict, a trait which is attributed to the influences of the Confucian value of harmony. Harmony enhancement focuses on building and promoting relationships, and while conflict avoidance maintains the relationship, at the same time it limits independence. Independence is concerned with autonomy and the capability to exercise control. However, people live in a community and are heavily influenced by their social and cultural environment. This thesis uses neo-Durkheimian theory through the *grid-group* approach to analyse cultural aspects of international auditing convergence and the adoption of corporate governance practices, with particular reference to how they function in the context of Chinese auditing and corporations.

1.3 The three selected cases

The Chinese Securities Regulatory Commission commenced implementation of the regulation of the *Public Condemnation System* (公开谴责制度) in 1999. The number of listed A share companies conducting fraud was first disclosed in 2000 with 146 company frauds. This number rose sharply after 2006 (see Table 1 and Figure 1).
Table 1: The number of Chinese listed companies conducting frauds (Lu and Chang, 2017)

<table>
<thead>
<tr>
<th>Year</th>
<th>The number of listed companies conducting frauds</th>
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<tr>
<td>2000</td>
<td>146</td>
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<td>2001</td>
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<td>2011</td>
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<td>2012</td>
<td>538</td>
</tr>
</tbody>
</table>

Figure 1: The number of Chinese A share listed companies conducting fraud (Lu and Chang, 2017)
The introduction of international accounting and auditing standards from 2006 coincides with a marked increase in detected fraud. The three cases occur during this period, and are selected to find potential reasons of listed companies continuously conducting fraud after the Chinese institutional environment changed. All cases received wide publicity, and are a matter of public record.

1.3.1 Yin Guang Xia
Guang Xia (Yinchuan) Industry Co., Ltd. limited by shares (Yin Guang Xia) was listed on the Shenzhen Stock Exchange on 17th June 1994. It was the first publicly listed company in the Ningxia (Hui) Autonomous Region, in which the major industries are plant cultivation, daily chemical products, and wine production and sales. The scandal of Yin Guang Xia occurred during the period between 1999 and 2000. In 1999, China completed its enterprise reform \(^1\). Before the corporate reformation, Yin Guang Xia was a well-known and important state-owned enterprise. After corporate restructuring, Yin Guang Xia became a company limited by shares. It had a board of directors, a board of supervisors, and managers. In addition, this restructuring occurred when Chinese CPA firms started to disaffiliate from their government sponsoring body in 1997.

1.3.2 Green Land
Yunnan Green Land Biological Technology Co., Ltd. by shares (Green Land) (云南绿大地生物科技股份有限公司) became the first listed company in the horticultural industry in 2007 and its stock traded on the Shenzhen Stock Exchange. Yunnan Hekou Green Land Industry Co., Ltd. with limited liability (云南河口绿大地实业有

\(^1\) Chinese enterprise reform in May 1984 was initiated to expand SOE’s autonomy in production planning and profit retention (Kang and Kim, 2012).
was founded in 1996, and was the predecessor of Green Land. Green Land conducted fraudulent accounting operations for the initial public offering (IPO) process and after it was listed, from 2004 to March 2010, when the China Security Regulatory Commission (CSRC) started to investigate fraud operations in Green Land.

In 2006, the *Chinese CPA Implementation Standards (CCIS)* (中国注册会计师执业准则) were issued by the Chinese Institute of Certified Public Accountants (CICPA) and approved by the Ministry of Finance (MOF) and executed in 1st January 2007.

1.3.3 Amoi Electronics

The profit fraud in Amoi Electronics Co., Ltd. limited by shares (Amoi Electronics) happened in the period between 2006 and 2007. Amoi Electronics, a renowned mobile phone company, was approved by the China Securities Regulatory Commission for public offering on April 24, 1997. On 4th June 1997, the company’s stock traded on the Shanghai Stock Exchange. It is likely that Amoi Electronics conducted accounting fraud to avoid the risk of being delisted.

1.4 Contributions of this thesis

With the gradual process of Chinese economic reforms, institutional environments have been changed and individuals and organizations have to adjust and adapt for their long-term survival and sustainability. In the process of adaption, the way individuals and organizations interpret and accept institutional change is limited by
cultural impacts. The contribution of this thesis is to develop an understanding of China’s auditor independence through the lens of neo-Durkheimian theory. Neo-Durkheimian theory guides analyses of the political and cultural influences on auditing and corporate governance. This thesis uses case study methodology to research auditing and corporate governance to enable a contextual understanding of Chinese regulatory environments.

Neo-Durkheimian theory emphasizes the impact of informal institutions of culture (Tansey, 2004, p.18). It classifies culture into four different solidarities, to understand individuals’ problems, options, and choices within their experienced institutional changes. Institutions enact rules and regulations they ask individuals to follow. This cultivates individuals’ thought style, which relates to the culture of this group of people. People share the same attitudes, customs, and beliefs in the group, which lead individuals to act in ways that reinforce the institutions (6, 2015). However, if individuals’ thought style has been changed, institutions may become disorganized. If institutions have been changed, the new institutions may cultivate a new thought style (6, 2015).

1.5 Organization of this thesis

This thesis comprises eleven chapters. This section outlines the remaining nine chapters. Chapter two provides an overview of auditor independence in the context of Chinese corporate culture. Chapter three discusses the philosophical meaning of independence and different views of accountability in the context of different cultures, and introduces neo-Durkheimian institutional theory. Chapter four introduces institutional theory, and the background to guanxi in regional cultural
contexts. Chapter five develops the neo-Durkheimian theory and analyses individuals’ behaviours in context of Chinese culture. Chapter six provides an overview of the Chinese auditing system, and a discussion of the challenges it brings to auditor independence and audit culture. Chapters seven to nine explore consecutively the three case studies, namely, Yin Guang Xia (chapter 7), Green Land (chapter 8), and Amoi Electronics (chapter 9), to specifically analyse how auditors and companies interpreted and adapted to the Chinese institutional changes with the limitation of cultural impacts. Chapter ten describes the development of Chinese auditing standards and discusses the external supervision system of Chinese listed companies. Chapter eleven, building upon the previous chapters, concludes the thesis.

After the implementation of Chinese economic reforms, China adopted and transplanted many international regulations and policies regarding technical aspects, to ensure their performance conformed with established international institutional practices. Auditors and companies embed institutional practices, interactions and responses to external disturbances in their cultural environment. This thesis focuses on how Chinese auditors and companies responded to institutional changes under cultural pressures by observing three selected case studies. Thus, the research problem of the thesis is the international auditing practices and transplanted corporate governance systems in China. This problem has two aspects, referring to the functioning in the Chinese context, and the risks identified in the case studies.

This thesis will make a unique contribution to the existing literature in the areas of neo-Durkheimian theory, and auditor independence and corporate governance in
context of Chinese culture. This thesis also provides an opportunity to understand auditor and corporate practices in Chinese institutional and cultural environments, and also improve the understanding of potential risks existing from the process of adopting international accounting regulations.
CHAPTER 2 LITERATURE REVIEW

2.1 Introduction

Auditor independence has been viewed as necessary for an effective capital market as it has the capacity to improve the integrity of the financial statements and increase the overall quality of the information available to the market. Auditors are expected to play an important role in adding credibility to financial statements. However, in the recent past, a string of financial scandals and high profile corporate frauds has shocked the public and tarnished the reputation of the auditing profession.

The development of corporate governance in China lags behind the west because it is a new issue in China and it has taken many years to develop in other cultural settings. Issues and deficiencies in corporate governance have prompted regulatory reform in China, such as Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies in 2001 and Code for Governance of Securities in 2002. However, internal control in Chinese corporations is still a serious problem, which has been a factor in a number of frauds (Sun and Ren, 2017; Cao et al, 2015; Song, 2011).

In the absence of efficient legal environments and corporate governance regimes, auditors serve an important function. This thesis draws upon past research papers on auditor independence and Chinese corporate culture to support the research.

2.2 Auditor independence

Auditor independence has been researched for many years. Brooker and Statuton (1966) stated that auditors represented a person or a group of people which had some
interest in the matter to be accounted for (p.173). They considered two situations in which auditors might lose their independence, which was whether auditors had been a participator in a transaction or had an interest in the result of a transaction as an indirect party, and whether auditors had been influenced by considerations such as losing audit clients and incurring financial loss.

The quality of audit service is defined by DeAngelo (1981) as the probability that (1) the auditor will uncover a breach and (2) report the breach. “The conditional probability of reporting a discovered breach is a measure of an auditor’s independence from a given client” (DeAngelo, 1981, p. 186).

There are four main threats to auditor independence that are client importance (financial bonding to the client), non-audit services, auditor tenure, and a client’s affiliation with CPA firms.

2.2.1 Client importance

DeAngelo (1981) suggested that clients’ importance created auditors’ incentives to compromise their independence.

Li (2009) investigated the effect of client importance on auditor independence. Client importance was measured as the client’s proportion of audit fees and non-audit fees, and auditor independence was measured as the auditor’s propensity to issue a going-concern opinion (unqualified audit opinion). The result showed that more important clients were more likely to receive a going-concern opinion in the post-Sarbanes-
Oxley Act period, which suggests that auditor independence was compromised for significant clients.

2.2.2 Non-audit service

During the twentieth century, auditors in public accounting firms extended the range of their services into areas such as taxation, IT consultancies and management consulting services, which gave auditors more possibilities to develop interests in audited companies and perhaps become more dependent. Greenwood et al. (2002) used case studies to examine the role of professional associations (the Canadian Institute of Chartered Accountants and the Institute of Chartered Accountants of Alberta) when public accounting firms changed their primary accountancy services to multidisciplinary services, such as financial advisory, management consulting, and legal services. As Greenwood stated, from 1977 to 1997, public accounting firms expanded their primary accounting services to incorporate more extensive business advisory services. For example, the 1997 business card of KPMG indicated that the KPMG firm defined itself as a business advisory company rather than an accounting firm (Greenwood et al., 2002, p.65).

“The growing array of non-audit services offered by some independent public accountants and the growing importance of management advisory services to the revenues, profits and competitive position of accounting firms are a cause for legitimate concern as to the impact of these activities on auditor independence, objectivity, and professionalism.”

After the release of ASR No. 264, diversification of services in public accounting firms continued to expand. However, the Public Oversight Board (Zeff, 2003) concluded that “at this time no rules should be imposed to prohibit specific services on the grounds that they are or may be incompatible with the profession of public accounting, might impair the image of the profession, or do not involve accounting or auditing related skills” (p. 205).

Wyatt (2004) also observed the accounting profession’s evolution over the past 50 years. Consulting services started at the beginning of the 1960s and increased exponentially in the 1980s and 1990s, including services to improve client companies’ internal controls and even extended to devising business strategies. The growing consulting services had become an important part of revenue in public accounting firms. Accounting firm partners increased the firm revenue in order to enjoy the profit increases. According to Wyatt’s perspective (2004, p.49), “it is easy to see the greed factor at work. At the time, however, the changing focus on revenue and profit growth was viewed as merely adapting to the changing times. The focus on professionalism diminished, and the focus on revenue growth and increased profitability sharpened.” Wyatt (2004) also claimed that the growth of consulting services had significantly influenced the internal culture of accounting firms.
Gendron et al. (2006) investigated the relationship between changes in the condition of work and professional ethics. That is because public accounting firms in Canada are becoming increasingly large and multidisciplinary (Gendron et al., 2006). Specifically it was argued “advisory services have become an increasingly prominent activity within public accounting firms, thereby strengthening the influence of commercialisation in these organizations” (Zeff, 2003 as cited in Gendron et al., 2006). To study the influence of the expansion of multidisciplinary services, Gendron et al. used an online survey to explore whether the work context would influence the independence commitment. More than 7000 questionnaires were sent to Chartered Accountants (CAs) in four provinces in Canada. The results showed that accountants who had worked outside large public accounting firms had a higher independence commitment than accountants who worked in large public accounting firms. This phenomenon is even more significant in Big 4 accounting firms. The researchers concluded that changes in the level of multidisciplinary services had influenced professional independence among accountants.

Extending the range of services in public accounting firms may cause high competition in the audit services market. In this highly competitive market, auditors may compromise independence to keep audit clients.

2.2.3 Auditor tenure

Gul et al (2007) found that the association between non-audit fees and auditor independence depended on auditor tenure, and that high non-audit fees negatively impacted auditor independence when audit tenure was short and client firm size was small.
Firth et al (2012) examined the effect of auditor rotation on auditor quality in China’s different institutional conditions. The results showed that firms with mandatory auditor partner rotations are associated with a significantly higher likelihood of a modified audit opinion in less developed regions. However, the significance level of voluntary audit firm rotation is much weaker than mandatory partner rotation.

Law et al (2013) investigated the impacts of guanxi between auditors and CFOs on auditor independence in Hong Kong. The results showed that independence was severely influenced by guanxi, especially when the duration of guanxi with audited clients reached five years or more.

2.2.4 Client’s affiliation with CPA firms

Yang et al (2003) examined independent audit services in China after the commencement of the open market policy. They found in many cases audited clients committed illegal acts such as the forgery of accounts to mask true financial positions, evade tax, embezzle state revenue, and appropriate state assets. The auditors involved in these cases were found to have intentionally helped clients to falsify accounts, or provide false certificates of capital contribution verification and unqualified audit reports. The reason that auditors intentionally helped clients to conduct frauds was argued to be guanxi between managers and auditors.

Liu et al (2011) examined the influence of guanxi on audit quality. The study classified two types of guanxi which appeared to have a link to auditor independence in China, namely, firm-level connections derived from state ownership, and personal
connections developed through management’s affiliations with auditors. The results showed that state-ownership and management connections with auditors increased the probability of receiving unqualified audit opinions, and firm-level and personal connections with auditors were more important to non-state-owned enterprises than to SOEs.

Fan et al (2012) investigated the effect of guanxi on the judgement of Chinese auditors. The study classified guanxi with two dimensions, namely, favour-seeking guanxi and rent-seeking guanxi, based on Su and Littlefield’s (2003) classification of guanxi orientations. Favour-seeking guanxi is “culturally rooted, signifying social contracts and interpersonal exchanges of resources in a collectivistic society” (Su et al, 2003, p.310), in which exchanges and reciprocal relations facilitate harmonious relationships in societies. In contrast, rent-seeking guanxi is recognised as “institutional norms signifying social collusion based on power exchanges in a hybrid Chinese socialist market economy” (Su et al, 2003, p. 310). Fan et al (2012) found Chinese auditors’ favour-seeking guanxi was positively associated with ethical judgments but the rent-seeking guanxi negatively influenced ethical judgments.

Du et al (2015) investigated Chinese auditors’ awareness of earnings management induced by the delisting rule and whether guanxi between managers and auditors could influence auditors’ opinion. The results showed that guanxi undermined auditors’ ability to correct earnings management. Especially, when auditors had close guanxi with managers, auditors might be less likely to recommend adjustments.
2.3 Chinese corporate culture

Xin and Pearce (1996) interviewed Chinese executives to examine whether *guanxi* (connections) was an important element in the development of companies. The results showed that *guanxi* was considered by private-company executives as reparation for the lack of official government support. Moreover, private-company executives made more extensive use of gift giving to build trust relationships with government officials to improve their *guanxi* and gain favours.

Park and Luo (2001) investigated the effect of *guanxi* on organizational performance in China. They used a survey instrument to examine 128 firms in China. The results showed that *guanxi* impacted organisational performance, as evidenced by sales growth. The results indicated that non-state-owned firms perform much better than state-owned firms. The results were consistent with earlier findings of Xin and Pearce (1996) that private-company executives relied more on *guanxi* than executives in state-owned or collective-hybrid companies.

2.4 Discussion

Although these previous studies have found the effect of *guanxi* on auditor independence, they did not give reasons for a lack of independence in the Chinese audit profession. With the convergence to the international auditing standards and the adoption of corporate governance, Chinese auditing and corporate governance operate in a very different environment from those experienced in western countries. Auditing is increasingly viewed as a social science, which is shaped by institutional contexts. Institutional theorists view economic activity as a social phenomenon related to social institutions (Wu and Patel, 2013). Institutional theory suggested that
organizations succeed in society, which must conform to ensure their legitimacy in the environment (Al-Twaijry et al., 2003; Maingot, 2006). The key category of the institutional theory is legitimacy. Chiang and Northcott (2012) generalised legitimacy is that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions (p.345).

However, institutionalism has been criticized because it does not give much attention to the micro processes of institutionalization (Zucker, 1991; Meyerson, 1994; Scott, 1995; Roberts and Greenwood, 1997). Zucker (1991) argued that there were variable organization’s interpretations of and responses to a similar institutional environment. Thus, she claimed that there is a need to consider “clever strategic responses to external constraints” (p. 105) when using institutional theory versus resource dependence. Irvine (1999) believed that “macroeconomic behaviour depends on the behaviour of the underlying micro units which make up the economy” (p. 95). Meyerson (1994) stated that individuals’ behaviours and interpretations are embedded in institutional systems (p. 650). Scott (1995) called for scholars to pay attention to the micro processes of institutionalization within an institutional context, which is a dynamic process of adapting new institutional environments, rather than a static adoption.

Auditor independence has been viewed as a moral-ethical issue in the 20th century, and is recognized as one of the central values of auditors (Gendron et al., 2006). Auditors’ ethical values are increasingly viewed as being influenced of institutional contexts. In reality, a person is a social person whose behaviours are shaped by their institutional context. That is why people accept similar ethical standards but they
make different decisions when they in different contexts. Many empirical studies have found the interrelation between an auditor’s ethics and factors or characteristics, such as culture, education, job level, and organizational characteristics. The interrelation partly explains the significance of the topic in this study.

In addition, culture plays an important part in identifying ethical standards. Schein (1989) states that culture defines a group of people with the same basic subconscious beliefs. Cohen et al. (1992) explain that understanding cultural differences can improve the understanding of differences in ethical values, because culture shapes a group of people’s general values and norms of behaviours. For example, guanxi is recognised as connections and relationships among people. In China, guanxi as informal relationships is a personal asset and also liability because one may request favours and also repay favours (Hwang et al., 2008). However, compared to similar western relationships, the main difference with guanxi is the notion of obligation, as western countries generally operate a code which could be described as ‘enlightened self-interest’ which carries less fixed notions of favours being returned than does the idea of obligation under guanxi.

Thus, this thesis argues that a process of individuals’ adapting new institutional environments is a dynamic process rather than a static adoption, and culture may influence this process.

2.5 Summary

According to previous studies, the Chinese audit services market has become a highly competitive market as the range of services in public accounting firms has
expanded. *Guanxi* as an important component of Chinese culture exists in Chinese business activities, which positively impacts organisational performance and negatively influences auditor independence.

However, with the opening of the Chinese economy and the range of new regulations promulgated under the new economic order, this thesis examines some cases of how Chinese auditors adapt to the new institutional environment as they cope with cultural impacts. This thesis observes Chinese auditor independence and corporate fraud activities in three cases by using Mary Douglas’s *grid-group* approach to explore potential risks in Chinese auditor independence and corporate governance.
CHAPTER 3 THEORETICAL FRAMEWORK

3.1 What is independence?
A dictionary definition of independence refers to “the freedom from outside control, the absence of influence by others, and the capability of thinking and acting for oneself” (Padoa-Schioppa, 2000, p.26).

Independence can be viewed in different ways. For example, Angrawal (1975) explained independence from a broad ethical point of view that “a man can be held to be independent only when his higher or rational self, or his ideal personality, determines his actions” (p. 110, cited from Reiter and Williams, 2005, p. 9). However, Coffee (2014) said independence is “synonymous with freedom understood as the absence of arbitrary power, whereas dependence indicates slavery” (p. 908).

In this study, independence refers to individual behaviour. Willis (1965) defined independent behaviour as:

“Pure independent behaviour occurs whenever the individual perceives relevant normative expectations, but gives zero weight to these perceived expectations in formulating his decision. This does not mean that he does not ‘weight’ the expectations in the sense of evaluating their importance and appropriateness, but rather that the outcome of this process of evaluation leads him to reject them as guides to his behaviour. The independent person is one capable of resisting social pressures, rather than one who is unaware of them or who merely ignores them. He ‘sticks to his guns’, so to speak.” (p. 379)

Independence is concerned with “autonomy and being able to exercise control” (Northway, 2015, p. 203). Northway (2015) explained that individuals may need support to perform tasks, but they are able to maintain independence through
exerting control over such provided support. Thus, the concept of ‘autonomy’ is important for independent behaviour.

3.2 Where does the concept of ‘autonomy’ come from?
The concept of autonomy rests on the treatment of the subject by philosophers, particularly by ancient Greek philosophers (Gelderen and Jansen, 2006; Olsen, 2009). Autonomy is derived from the two words: “self (autos) and rule or law (nomos)” (Gelderen and Jansen, 2006, p. 25). In the eighteenth century, autonomy was an important theme for political philosophers, and referred to the relationship between the state and the individual (Gelderen and Jansen, 2006). Gelderen and Jansen (2006) stated that “according to the large majority of (western) political philosophers, the state should not interfere with the autonomy of the individual (providing ‘negative freedom’), and, according to some, the state should even enlarge the autonomy of the individual (providing ‘positive freedom’, for example by providing education and jobs)” (p. 25). Although there are differences in the understanding of autonomy in the details, autonomy is generally understood as “the ability to direct one’s own life and to make one’s own decisions” (MacDonald, 2002, cited from Varjus et al., 2011, p. 201).

3.3 What is the philosophical meaning of ‘autonomy’?
Garnett (2014) proposed a theory that rejected the dominant understanding of autonomy as rule by the self (Weimer, 2014), instead understanding it as resistance to rule by others. Garnett (2014) claimed that “autonomy is resistance to subjection to foreign wills” (p. 145). Garnett (2014) emphasized resistance of rule by others including two conditions:
“A reasonable resistance condition, according to which I am not subject to your will if I can be reasonably expected to resist your influence;

A conformity of wills condition, according to which I am not subject to your will if I would endorse your intention to influence me were I to know of it” (Garnett, 2015, p. 156)

However, the conformity of wills condition has been criticised by Weimer (2014). Garnett (2015) defended the basic idea of the conformity of wills condition as “if you intend to get me to do something, then (other things equal) your intention is foreign to me, but your intention can be rendered relevantly non-foreign to me by virtue of its conformity or alignment with my own will” (p. 156). Garnett (2015) gave an example that Betty hid Jane’s car keys because Jane was drunk. Although Betty’s will was relevantly foreign to Jane at that time, Jane was not an autonomous agent.

The conformity of wills requirement can be read as:

“attitudes that are literally and shallowly yours are relevantly foreign to me, unless they conform with attitudes that are literally and shallowly mine. Their conformity with anything else – anything external to me (in the shallow sense of ‘me’) – does not render them non-foreign to me (again, in the shallow sense of ‘me’)” (Garnett, 2015, p. 157).

Autonomous agents need be more rational than non-autonomous agents, which is the virtue of autonomous agents (Garnett, 2015). If a person is irrational or insane, how could this person be autonomous? The rule of an irrational person is by irrational rules. Autonomy should be seen as a virtue. Therefore, Garnett (2014) provided the two conditions (a reasonable resistance condition and a conformity of wills condition) to explain resistance of rule by others as reasonable.
3.4 Interpretation of ‘autonomy’ in the context of culture

Garnett (2014) gave two conditions (a reasonable resistance condition and a conformity of wills condition) to consider reasonable resistance to foreign wills. However, this reasonable resistance may have different interpretations in how much is reasonable in different cultures.

Many underlying themes of Confucian philosophy, characterised in popular sayings, discourage autonomy. In Confucian philosophy, there is an old saying that ‘two heads are always better than one’ (in Chinese: 三人行必有我师). A modest manner is seen as a virtue. People should be modest in listening to other people’s opinions. This does not mean that we must take another’s ideas nor does it encourage people to express their own opinions. That is because ‘the bird out of the group will be shot’ (in Chinese: 枪打出头鸟). Confucian society does not encourage individuals to be outstanding or to be straightforward in expressing their own opinions against others’, because these behaviours are seen as taking the limelight and showing off. Confucian philosophy emphasises the doctrine of the mean. Therefore, in Confucian societies, individuals may take on more of others’ perspectives in order to avoid conflicts.

Individuals in Confucian societies prefer conflict avoidance and this is attributed to the influences of the Confucian value of harmony. Leung (1997) proposed that harmony has two distinct motives: disintegration avoidance and harmony enhancement (cited in Lim, 2009, p. 403):

“Disintegration avoidance refers to avoiding actions that will strain a relationship and lead to its weakening and dissolving.

Harmony enhancement refers to engaging in behaviours presumed to strengthen the relationships among the interactants.”
Harmony enhancement focuses on building and promoting relationships, while disintegration avoidance is to maintain relationships. Both motives are trying to build a harmonious environment. Hwang (2012) stated that the Confucian focus is on “relationalism as a societal status hierarchy, where the role relationships between people provide the behavioural rules by which individuals are expected to abide” (cited in Lee, 2015, p. 6). Therefore, no matter what relationships between superior and inferior or peers are, individuals are trying to keep them harmonious.

In other words, harmonious relationships limit independence. Lim (2009) stated that “Confucianism emphasizes the value of harmony. When one is conflicting with someone else within his or her social network, the first thing one has to learn is ‘forbearance’… (this leads to) giving up one’s personal goal for a prior consideration of maintaining a harmonious relationship” (p. 403). When a person makes an independent decision which may conflict with other foreign wills, in a Confucian society the person may avoid the conflict or at least, try to avoid the conflict in order to keep a harmonious relationship and reduce the likelihood of revenge. Thus, a person may not resist foreign wills to maintain their independence.

The Confucian culture was in a dominant position in Chinese culture. However, since the ‘new’ China was founded in 1949, this position has significantly changed. During the Maoist period (1949 – 1976), traditional cultures, such as Confucianism, were abandoned. Confucian ethics were denounced as feudalistic and decaying. “From 1949 to 1976 the practice of Maoist socialism relied on the socialist state’s monopoly of political power via the Leninist Chinese Communist Party and the Communist ideology on the one hand and its monopoly of economic power through
the planned economy and its collective redistributive system on the other” (Yan, 2010, p. 491). The two dominant forces eliminated the market-based economy and all individual benefits were supposed to be sacrificed in order to satisfy the State’s benefits. During this period, China was a highly collectivist society and also a ‘harmonious’ society, but the harmony differed to that of Confucianism.

Firstly, individuals try to build and maintain Confucian style harmonious relationships in order to gain reciprocal benefits, while in the Maoist period, a new relationship, called comradeship, was created to guide the relations between individuals. This comradeship was derived from the Chinese Communist Party in the Second World War. The idea of comradeship was to create another ‘harmonious’ relationship in which individuals felt equal. For example, everyone calls each other comrade, no matter who is superior or inferior.

Secondly, Maoist morality emphasised not only comradeship (between individuals), but also the relationship between individuals and the state. It specified that individuals should be self-sacrificing in order to achieve a ‘harmonious’ state or even a higher level, named a Communist utopia (Yan, 2010). Thus, “the individual almost entirely had lost her/his freedom and autonomy as she/he could not even choose where to work or to reside, much less to which social or political group she/he would belong” (Yan, 2010, p. 492). Therefore, although both Confucian culture and Maoist morality were aiming to create harmonious relationships, they were different in how they built relationships and gained benefits from relationships. During the Maoist period, the relationship was created by institutional and political power. Individuals
Many current western scholars knew of China as a collectivist society, partly from Hofstede’s study in 1980. The data collected by Hofstede was derived from the 1960s and 1970s. Indeed, during that period, China was Maoist and highly collectivist. However, after Chairman Mao died, from the late 1970s, China started to open its door to the world and transformed its planned economy to be more market oriented. Subsequently, a number of multinational corporations have established subsidiaries in China. With more western companies entering China, western cultures have been brought into China. However, western cultures came into coastal regions earlier because of the open door policy. In 1980, Shenzhen, Zhuhai, Shantou, and Xiamen were set up as special economic zones. In 1988, Hainan province was set up as a special economic zone. During the period between 1990 and 1992, many other cities were set up as special economic zones, such as Shanghai, Tianjin, Beihai, Zhanjiang, Guangzhou, Fuzhou, Ningbo, Nantong, Lianyungang, Qingdao, Weihai, Yantai, Dalian, and Qinhuangdao (Leong, 2013).

Due to opening the cities at different times, Chinese cultures tended to mix with western cultures firstly from south to north and from coastal to interior regions. Thus, individuals adapted western cultural attributes, such as individualism, in different Chinese regions at different times.

The idea of the ‘self’ is described differently in Western and East Asian cultures. The narrative of the self in Western culture is of the autonomous individual (Fishbane,
Fishbane (2001) stated that “the mature autonomous self is characterized by independence and separation individuation” (p. 273). However, in psychology, the ‘self’ has two constructions: “an independent self, which perceives itself as separate from others, and an interdependent self, which sees itself as connected with others” (Littlewood, 1999, p. 79). Littlewood (1999) gave detailed features of two selves, as shown in Table 2. According to Littlewood, views of the self can be different according to cultures. Hence there are different understandings of autonomous self in the context of different cultures.
Table 2: Independent and interdependent conceptions of the self
(Based on Markus and Kitayama, 1991, cited in Littlewood, 1999, p. 80)

<table>
<thead>
<tr>
<th>The independent self</th>
<th>The interdependent self</th>
</tr>
</thead>
<tbody>
<tr>
<td>The <em>independent</em> self is more likely to:</td>
<td>The <em>interdependent</em> self is more likely to:</td>
</tr>
<tr>
<td>* Be disposed to express individual, unpredictable views</td>
<td>* Pay attention to the group when forming opinions and attitudes</td>
</tr>
<tr>
<td>* Prefer horizontal, equal relationships</td>
<td>* Feel comfortable in vertical, unequal relationships</td>
</tr>
<tr>
<td>* Be willing to enter into confrontation and competition</td>
<td>* Emphasize harmony and cooperation in the group</td>
</tr>
<tr>
<td>* Be willing to express open criticism</td>
<td>* Attach importance to preserving ‘face’ (their own and others”)</td>
</tr>
<tr>
<td>* Attach importance to individual goals and ‘self-actualization’</td>
<td>* Attach importance to supporting group goals and expectations</td>
</tr>
</tbody>
</table>

*Western cultures* support this conception more than *East Asian cultures*

*East Asian cultures* support this conception more than *Western cultures*
To sum up, China should not be regarded as simply a Confucian society. China should be thought as a country which is rooted in the Confucian culture, because its culture has been also developed by the influence of its institutional and political power. In addition, culture is viewed as “the ‘social glue’ holding people together through their identification with one particular social group over another, and where its members obey a prescribed set of acceptable behavioural codes” (Lee, 2015, p. 1). So individuals’ interpretations of independence might differ across China’s different regional cultures.

3.5 Issues concerning the development of institution and culture

Legitimacy and institutions arising from rules made by government can be easily changed, while culture as a prescribed set of acceptable behavioural codes, cannot be changed easily. If culture changes but institutions lag behind, people start to reform and change the institutions. For example, in the early years of Chinese economic reform, people accepted many western democratic beliefs, but the Chinese government did not immediately change the collective institutions. In the student strikes of 1989, students sought democracy but finally the government used political power to put a stop to this mind change. Thus, culture in this case had to adapt to the institutions of government.

If the culture lags behind institutions, new policies and institutions may not be ‘perfectly’ implemented. An example is when an independent director is introduced into a Chinese company after Chinese economic reform. In 2001, the Chinese Securities Regulatory Commission (CSRC) issued the *Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* to provide
practical rules for independent directors (Zhou, 2011). This institution of corporate governance was borrowed from the US and the UK, where the dispersed ownership of shares of large corporations created an agency problem for the managerial board (Zhou, 2011) and society. However, this new institution firstly appeared in China in the 1990s. Before the enterprise reforms in the early 1980s, most Chinese companies were state-owned enterprises (SOEs) that were administered by either the central government or local governments. Even in the early stage of Chinese enterprise reform in the 1990s, the government still held the majority shareholdings in SOEs (Yang et al., 2001; Yang et al., 2003). People in China did not even understand the meaning of an independent director. The board of directors in Chinese listed companies is strongly controlled by majority shareholders (Zhou, 2011). In fact, independent directors in China are also called ‘vase directors’ because they have lost their genuine function as ‘monitors’ of the board (Zhou, 2011). In another example, Nie et al. (2013) observed the difficulty of determining fair value in China because “many assets did not exist in a ‘vibrant’ market” (p.286). They also argued that “the technical complexities involved in valuation in an emerging market economy could increase the difficulty of determining fair value and the lack of research and practice regarding fair value in China was an impediment to Chinese accountants in the implementation of fair value” (Nie et al., 2013, p.286).

Therefore, although foreign cultures and the institutional models can be transplanted to China, the Chinese economy has developed so quickly since the economic reform. Ideas from new institutions may not have filtered through to local culture. Hence, ideas of legitimacy that guide behaviour that would ensure the institutions are properly implemented may not be in place yet. In addition, the way that open door
policy was introduced meant people came in contact with foreign cultures and beliefs in a different way in different regions and that is limiting the development of regional cultures\(^2\), and also means that many new institutional models are implemented in different ways in different regions.

### 3.6 Neo-Durkheimian institutional theory

Anthropologist Mary Douglas first proposed the famous *grid-group* method in her research work *Natural Symbols* in 1970 to explain social and cultural phenomena. The grid-group dimensions split cultures into four different social environments. The grid dimension refers to the degree of social regulation that individuals are subject to when selecting social roles, while the group dimension concerns the degree of loyalty that an individual has to other group members (Linsley et al., 2015, p. 4). The four social environments are shown in Figure 2.

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\(^2\) Here the limitation of the development of regional cultures refers to the fact that individuals’ interpretations of independence might be different.
Figure 2: Grid-group Diagram
(Douglas, 2003, p. 1354)
Linsley et al (2015) introduced the four solidarities in detail. The individualistic solidarity is described as a weak grid-weak group form of society. Individuals are at liberty to collaborate with other individuals in the society. Their own interests are more important than the group’s interests. The second form of society is hierarchical solidarity which is a strong grid-strong group form. In this form of society it is important that rules are adhered to and that tradition and authority are respected. Social rules are demarcated and statutes are clearly defined within internal boundaries, while the external boundary defines who is inside and who is outside the group. Egalitarian solidarity is a weak grid-strong group form of society which shares features with individualistic and hierarchical solidarities. There are no internal boundaries as social rules, while the external boundaries even more important than in the hierarchical solidarity. The last form of society is isolate solidarity which is the strong grid-weak group from. This implies little leeway in choosing one’s social role and this places restriction on isolates. The weak group aspect means individuals do not feel they belong to any group.

Linsley et al. (2015) also acknowledged that all four solidarities could be present in any society and no society would comprise only one. Linsley et al. (2015) argued that “within any society cultural dialogues will continually occur as the different solidarities promote their world view and look to win new recruits. The interaction that the four solidarities have with one another, and the incessant debates they have, are also important as they reconfirm to the members of each solidarity what it stands for” (p. 6).
However, although Linsley et al. (2015) acknowledged that the four solidarities could be present in the same society and continually re-structure within that society, they did not describe how the four solidarities are changed by institutions or political power in the society. This study takes Linsley et al’s (2015) framework further, explaining how the four solidarities and institutional powers interact in social transactions. These can be described by vivid metaphor. The institutional powers or political power can be likened to a piece of dye and local culture as a bathtub full of water. Individual people are molecules or basic constituents of the ‘water’. The interaction of local culture and institutions is like when the dye drops into the water. The dye will change the colour of the water immediately surrounding the droplet of the dye and then disperse into other areas of the bathtub. However, the direction and degree of the colour change will depend on the direction and speed of the water flow.

For example, traditional Chinese cultures such as Confucian culture appeared in the Shandong province. However, from 1891 until 1914 Qingdao (a city in Shandong province) had been a German colony. During this period, Qingdao, also known as Tsingtao, was starting to take shape with the completion of a series of projects such as wharves, the Tsingtao-Jinan Railway line, the Tsingtao Railway Station and locomotive work. German culture had been forcibly embedded in Qingdao local culture by political power. In addition, following the implementation of the Open door policy, Qingdao was set up as a special economic zone between 1990 and 1992. As a result, the development of commerce and trade was emphasised much earlier in Qingdao than in Jinan, which is a city belonging to the same province of Shandong. The political power and institutional power changed the Qingdao local culture. Qingdao companies are more likely to be private companies while Jinan has more
state-owned enterprises. Haier Group of Qingdao is world famous for consumer electronics and home appliances. Tsingtao Brewery Co., Ltd is another famous company in Qingdao. Neither of them are state-owned enterprises. In contrast, people may only know Shandong Luneng Group Co., Ltd in Jinan, which focuses on energy and minerals business and operates as a subsidiary of State Grid Corporation of China, a large state-owned enterprise. Moreover, due to population mobility around Qingdao, the whole Jiaodong Peninsula economy has been more quickly developed after the implementation of the open door policy than interior cities in Shandong province. Dezhou and Zaozhuang (interior cities in the Shandong province) are still undeveloped and keep a more traditional culture, compared to cities in Jiaodong Peninsula.

Therefore, China should not be regarded as a solely traditional Confucian society. Chinese culture can be described as comprising the four solidarities of the grid-group method. These are evident in different regions, with differing institutional powers. In addition, Chinese culture should be viewed as being in a dynamic state rather than a static state. The direction of institutional policy and population mobility alters regional cultures. Thus, individuals’ interpretations of professional independence in different regions are changing as regional cultures also change.

3.7 ‘Autonomy’ in professions

The interpretation of ‘autonomy’ varies in the context of different cultures. However, in different countries with different cultures, when independence is described as an attribute of profession, such as medicine, law, and auditing; autonomy is always emphasised.
“Professionals are distinguished from other occupational workers by the control they wield over the technical and formal content of their work” (Timmermans, 2005, p. 493). Professionalism can be defined as “possessing professional status, methods, character, and standards (Morris, 1981)” (cited from Bell, 1990). Professional process involves competence in one’s field and attaining certain recognition from people within the particular field a person has entered (Bell, 1990). Standards are the heart of true professionalism, which involve legal and ethical restraints, and originate from the laws of the land and stated codes of professional societies (Bell, 1990).

“Certain situations may arise during the practice of a business that would pass the tests of legality, and possibly even written ethical standards, but might still tend to make one feel uneasy. This type of situation tests whether a person is truly a professional in the highest sense because an appeal is made to the individual in which basically all external judgements would approve of the action in question” (Bell, 1990, p. 189).

Professionals are held to “a higher level of public trust than basic laws require” (Bell, 1990, p. 189). Thus, it is important for professionals to behave in an ethical manner and apply their judgment independently.

In the context of globalisation, an increasing number of emerging economies, such as China, India, Bangladesh, and South Africa, are moving towards internationally acceptable professional ethical standards in industries such as medicine and auditing. These professional ethical standards mainly emphasize professional autonomy and independence. However, there could be different interpretations of the concepts of professional autonomy or independence in the standards, in the context of different cultures.
Weiss-Gal and Welbourne (2008) defined professional autonomy as “the right of workers to make work-related decisions on the basis of their professional knowledge and values, without being subject to the directives of those outside the profession or to constraints that are inconsistent with that knowledge and those values” (p. 284). They found that the degree of professional autonomy depended upon the field of practice, the worker’s position and skills, and the sector within which they were employed (Weiss-Gal and Welbourne, 2008). For example:

“In India, most social workers have little professional autonomy, but those in medical and psychiatric settings may be able to negotiate greater professional autonomy for themselves. In the UK, social workers employed in the voluntary sector often enjoy greater professional autonomy than those employed in the government sector. In South Africa, where there are government-created systems to establish professional status in social work and related professions, greater autonomy is enjoyed by social workers in areas where they are viewed as experts, such as in social welfare issues.” (Weiss-Gal and Welbourne, 2008, p. 285)

3.8 The relationship between independence and accountability

However, despite the fact that independence emphasises individuals’ attitudes it can never be absolute independence, because human beings are also social human beings who are heavily influenced by their social and cultural environment. Professions, such as auditing and medicine, are recognized as a social entity which involves both social and cultural activities. Therefore, it is difficult to avoid other influences and keep objective opinions. In fact, an absolutely objective opinion does not exist. When an opinion is expressed, it is already mixed with personal opinion.

Moreover, “‘too much’ accountability – at least in some forms – may reduce independence. ‘Too much’ independence – at least in some forms – may reduce accountability” (Barr, 2015, p. 119). That is because the accountable self is mediated
by a set of social norms, which depend on being accountable to ‘whom’. Being too accountable for one’s interests could reduce objective expression. In contrast, providing too much independence may give individuals or organizations too much power and may result in them exercising their own preferred decisions in the end. Therefore, it is important to find the equilibrium between independence and accountability.

3.9 What is accountability?

Accountability can be generally defined as “the duty to give account for one’s actions to some other person or body” (Scott, 2000). Normanton gave a more expansive definition:

“a liability to reveal, to explain, and to justify what one does; how one discharges responsibilities, financial or other, whose several origins may be political, constitutional, hierarchical or contractual.” (Scott, 2000, p. 40)

Traditionally, the concept of accountability was narrowly used in regard to public lawyers and political situations (Scott, 2000). After the Second World War, forms of accountability have been changed (Scott, 2000) and more public agencies are required to be accountable.

To understand accountability in any one situation it is helpful to ask two questions: to whom is a person accountable; and for what? Scott (2000) found three broad classes within each category.

“Accountability may be rendered to a higher authority (‘upwards accountability’), to a broadly parallel institution (‘horizontal accountability’), or to lower level institutions and groups (such as consumers) (‘downwards accountability’). The range of values for which accountability is rendered can be placed in three categories: economic values (including financial probity and value for money); social and procedural value (such as fairness, equality, and legality);
continuity/security values (such as social cohesion, universal service, and safety).” (Scott, 2000, p. 42)

Scott (2000) outlined nine correlations between accountability and values (Table 3), which clearly described the performance of different levels of accountability considering different perspectives of value.
Table 3: Examples of linkages between values and accountability
Scott (2000, p.43)

<table>
<thead>
<tr>
<th>For what?</th>
<th>To whom?</th>
<th>Economic values</th>
<th>Social/procedural values</th>
<th>Continuity/security values</th>
</tr>
</thead>
<tbody>
<tr>
<td>‘Upwards’ accountability</td>
<td>Of departments to treasury for expenditure</td>
<td>Of administrative decision-makers to courts/tribunals</td>
<td>Of utility companies to regulators</td>
<td></td>
</tr>
<tr>
<td>‘Horizontal’ accountability</td>
<td>Of public bodies to external and internal audit for probity and value for money</td>
<td>Review of decisions by grievance-handlers</td>
<td>Third-party accreditation of safety standards</td>
<td></td>
</tr>
<tr>
<td>‘Downwards’ accountability</td>
<td>Of utility companies to financial markets</td>
<td>Of public/privatized service providers to users</td>
<td>Consultation requirements are: universal service requirements</td>
<td></td>
</tr>
</tbody>
</table>
Messner (2009) explained “accountability is a morally significant practice, since to demand an account from someone is to ask this person to enact discursively the responsibility for her behaviour” (p.920). Financial audit plays an important role in serving the public interest by reinforcing trust and confidence in financial reports and increasing the accountability of managers. Auditing becomes an important component of most modernist conceptions of accountability since it legitimates the information on which formal, financial accountability rests (Power, 1997, cited Gendron et al., 2001). Messner (2009) suggested that it should be important to consider both the content and the practice of accountability when it comes to understanding the ethical dimension of accountability, because ethical questions may not “emerge with respect to the ‘what’ of accountability, but also with regards to the ‘how’” (p. 920).

Auditor independence is recognized as one of the core values of modern auditors. Carey and Doherty (1966) defined the meaning of auditor independence:

“First, in the sense of not being subordinate, it means honesty, integrity, objectivity and responsibility. Second, in the narrow sense in which it is used in connection with auditing and expression of opinions on financial statements, independence means avoidance of any relationship which would be likely, even subconsciously, to impair the CPA’s objectivity as auditor. Third, it means avoidance of relationships which to a reasonable observer would suggest a conflict of interest.” (cited from Vanasco, 1996, p.4).

According to the above definition, the accountability of auditors requires “honesty, integrity, objectivity and responsibility”, and this accountability is kept by avoiding

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3 Audit can be divided into two parts which are internal audit and external audit including government audit and financial audit.
any relationship which would be likely, even subconsciously, to impair the auditors’ objectivity.

However, Messner (2009) suggested that “the demands for accountability may become so great as to be ethically problematic for the person or organization that is expected to give an account”, because “strong and emotive expression refers to a form of accountability that, in the name of ethics, forces the accountable self to account for something which is very difficult or even impossible to justify and which, in this respect, does ‘violence’ to the accountable self” (p. 918). Therefore, auditor independence demands auditors’ accountability which may also result in ethical problems. This is because a person is a social person. If only legislations force auditors to account for independence, auditors will trade off their benefits and the risk of penalization in context of social and cultural environments which may result in ethical issues.

In addition, Messner (2009) proposed that “the accountable self is mediated by a set of social norms that structure the scene of the address” (p. 933), which means “if the accountable self has several alternatives of how to give an account, then the act of accountability will clearly be less ethically demanding than in the case of there being only one available regime of truth” (p. 931). For example, public auditors not only need to be accountable to survive but also need to conform to legitimate demands (auditing standards) to take accountability to the public. As such, if these two groups of accountabilities have to be met at the same time, auditors need to balance or trade them off while also considering their costs and risks. More specifically, if the auditor observes that a client’s company does not engage in financial fraud, the best choice
for the auditor is to not work with the client’s company to engage in any type of fraud. However, if the auditor recognizes that a client’s company engages in financial fraud, the auditor can comply with the client’s demands to accept possibly inappropriate accounting practices and risk penalties from the auditor authority if financial fraud is discovered. The alternative choice is to refuse to accept these practices and risk losing the client. Therefore, which action is taken depends on the trade-off of benefits.

This study agrees that “too much accountability can become an ethically problematic burden for the accountable self” (Messner, 2009, p. 919). Auditor independence is recognized as auditors’ accountability as an ethical practice. Even though auditor independence has been regulated through standards promulgated in codes of ethics and/ or government regulation, such as the Code of Ethics for Professional Accountants in the International Federation of Accountants, a question arises as to why instances of auditor independence failure are continuing. Moreover, with the growth number of countries adopting or converging to the international auditing standards⁴, further questions arise as to why instances of auditor independence failure appear to be different in different countries, whether the adopted auditing standards take a role as expected, and whether auditors indeed follow auditing standards. Auditing may not be as we believe it to be.

⁴ There are 106 countries using the clarified the International Standards on Auditing (ISA), or committed to using them until 2015 (IFAC, 2015).
3.10 Different views of accountability in context of different cultures

From an individual perspective, according to a particular role’s social requirements, people need to be accountable for their conduct in that role, and no one is isolated from their community. Ames (2011) stated that:

“We are all born and reared in a specific cultural community, each with its language, values, religious orientation, customs, traditions, and concomitant ideas of what it is to be a human being. Each of us has specific, hopes, fears, joys, sorrows, values, and views which are inextricably linked to our definitions of who and what we are, and these definitions have been overwhelmingly influenced by the cultural community of which we are part” (p. xv, cited from Bell, 2012, p. 604)

In our community, we need to play a role which means “either a persona, such as a character in a novel or play, or a type of person acting out a certain set of behaviours consistently, either actively or passively as the context requires” (Wen, 2012, p. 627). Thus, “living or playing one’s role means living up to the role’s social requirements” (Wen, 2012, p. 627).

To account for one’s actions is also viewed as the core sense of accountability (Mulgan, 2000). Mulgan (2000) explained that

“the account is given to some other person or body outside the person or body being held accountable; it involves social interaction and exchange, in that one side, that calling for the account, seeks answers and rectification while the other side, that being held accountable, responds and accepts sanctions; it implies rights of authority, in that those calling for an account are asserting rights of superior authority over those who are accountable, including the rights to demand answers and to impose sanctions” (p. 555).
Messner (2009) explained that “the accountable self is limited in its accountability, in so far as the scene of the address is mediated by a set of norms that are not of the self’s own making” (p. 930).

“The accountable self is mediated by a set of social norms that structure the scene of the address. The subject becomes an accountable subject only when submitting to a regime of truth that cannot be questioned if one wants to give an account. Extending accountability into different regimes of truth can result in an ethical burden for the subject if several of these accountabilities have to be met at the same time, without knowing how they should be balanced or trade-off.” (Messner, 2009, p. 933)

Different cultures may deal with conflicts between various demands in different ways. In other words, when multiple demands for accountability occur at the same time, the attitudes of compromising the primary accountability at the cost of others may be different in different cultures.

In Chinese traditional culture, harmony (in Chinese: 和) is a defining or core value. According to Davies (2012), “harmony is the right ordering of things according to originary principles of relation” (p. 576). A Chinese old saying is: ‘reconciliation benefits both and leads to harmony; harmony is most precious’. It can see that Chinese traditional culture encourages people to compromise with others in order to maintain harmony when conflicts of interest occur.

However, modern Chinese society has become more commercialised. The pursuit of self-interest may become the dominating force in relationships with others. For example, a company should consider its accountability to shareholders and in regard
to social and environmental sustainability. However, companies compromising with the accountability of social and environmental sustainability are rarely found.

Companies as well as individuals are well aware of the risk of penalization because rules of man have dominated China’s long history. ‘The law is no more important than human being itself’ states a Chinese saying. In other words, anything can be negotiated, depending on your relationships.

From another perspective, in Chinese society, people have the sense of ‘face-giving’ and ‘face-saving’. When a company is found to lack accountability of social and environmental sustainability and to be facing penalization, it will use its relationship with higher offices and ask them to give ‘face’. If the offices give ‘face’ to the company; then the company must repay this favour and sometimes increase the value of this favour. Guanxi is strengthened or maintained via this exchange of favours.

Therefore, in summary, the accountable self is limited by the complexity of relationships in China.

3.11 Discussion

To sum up, independence is concerned with autonomy and the capability to exercise control. In other words, there is no such thing as pure independence, because people live in a community and are heavily influenced by their social and cultural environment. Garnett (2014) proposed an understanding of autonomy as resistance of rule by others, this study supposes the interpretation of reasonable resistance of rule by others may vary according to culture.
People living in a community need be accountable for their conduct. However, when multiple demands for accountability occur at the same time, the attitudes of compromising the primary accountability to others are different in different cultures. In other words, the accountable self has different degrees of limitation in different cultures. For example, the accountable self is limited by the complexity of relationships in China.

Therefore, people seek equilibrium between independence and accountability. In the same country or the same institution but different culture, people’s attitude to the equilibrium between independence and accountability may be different. That is because compulsion is the attribute of law and regulation in the institution that is a visible hand, while culture is not mandatory but also shapes people’s behaviour, and is an invisible hand.

In the context of culture and institutions, a question is how to balance the equilibrium between independence and accountability? To what degree do people understand the concepts of independence and accountability regarding standards – substantially or superficially? The process of understanding independence and accountability in regard to standards and regulations is a process that requires finding equilibrium between cultural understanding and global understanding. Specifically, this study examines how Chinese auditors interpret independence from the Chinese auditing standards and their local cultural life, against the backdrop of a transition from a planned economy to a market economy and the convergence with global markets.
CHAPTER 4 INSTITUTIONAL BACKGROUND

4.1 Introduction
Due to globalization of the world economy and multinational corporations proliferating, national economies have become increasingly interdependent. An increasing number of countries, such as China, are converging to internationally acceptable auditing regulations. This study describes whether international auditing practices can function properly to improve Chinese auditing quality. The purpose of this study is to set out a framework that can be used in understanding the process and outcome of converging to international audit practices from an institutional perspective.

Moreover, because the implementation of the ‘open’ door policy started in Special Economic Zones and then diffused across the nation, the embeddedness of the old structure may create different levels of resistance in adopting international auditing practice in different regions.

This chapter is organized as follows. Section two discusses influences on institutions. Section three describes the Chinese culture pressures. Section four examines individuals’ different practices under both institutional and culture pressures by loose coupling theory. The final section presents a conclusion.

4.2 Institutional theory consideration
Institutional theory suggests that for organizations to succeed in society they must achieve and maintain legitimacy in the environment (Chiang and Northcott, 2012). The key aspect of the institutional theory is legitimacy. Suchman (1995) generalised
“legitimacy is that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (cited in Chiang and Northcott, 2012, p.345).

Organizations maintain legitimacy in order to seek a position in the society. Not only do local professional auditing entities look for legitimacy from national professional auditing bodies, but national professional auditing bodies also seek legitimacy from international auditing bodies.

As such, Chinese auditing practices increasingly adopt international standards after Chinese economic reform. The Chinese Certified Public Accountant (CPA) Law was established in 1993 (Yang et al., 2001) and the Chinese Independent Auditing Standards (CIASs) (中国独立审计准则) came into effect in 1996. Until 2003, the CIASs comprised one basic standard, 28 specific standards, 10 practice pronouncements, and five other standards. In 2006, the Chinese CPA Implementation Standards (CCISs) (中国注册会计师执业准则) were issued by the Chinese Institute of Certified Public Accountant (CICPA) and approved by the Ministry of Finance (MOF), which were based on revised content of the CIASs, in order to converge with the International Standards on Auditing (ISA), which were effected in 2007. The CCISs were also called the ‘new’ Chinese Auditing Standards which contained 48 standards. In 2010, the CICPA proposed to revise the CCISs and issued the Chinese Auditing Standards (CAS) (中国注册会计师审计准则) in order to further accommodate the ISA. The new CAS came into effect in 2012, and contained 38 standards.
During the process of economic reform, the auditing profession increased their institutional legitimacy. New institutional theory refers to ‘institutional isomorphism’ and assumes it is forced by three institutional pressures, namely, coercive, mimetic, and normative isomorphism (DiMaggio and Powell, 1983; Scott, 1995). However, due to variations in the implementation of Chinese ‘open’ door policy, regions became open to the world gradually from the coast to the interior. Thus, the auditing profession in interior regions seeks their institutional legitimacy, in which organizations are motivated to adopt similar policies and practices.

4.2.1 Coercive isomorphism

Coercive isomorphism is when external pressures force organizations to adopt structures, techniques or behaviours, moving towards homogeneity with other organizations. For example, direct political influence on organizations is exercised through legislation and regulation. The auditing standards setting and implementation is a political process in China (Lin and Chan, 2000; Yang et al., 2001). For example, as mentioned before, the Law of the People’s Republic of China for Certified Public Accountants was assigned by the Ministry of Finance (MOF). One of functions of MOF is being responsible for supervising national accounting practices, formulating accounting regulations, and guiding and supervising the business of accounting firms (Ministry of Finance, 2017).

Another example is where Chinese CPAs Law requires auditors to perform the following services:

“to audit enterprise’s financial statements, to verify the enterprise’s capital contribution, to engage in the audit work of the enterprise’ merger, demerger and liquidation, and to provide professional services specified by the law and regulations” (Lin and Chan, 2000, p. 561).
However, the State Administration for Industry and Commerce of People’s Republic of China (SAIC) announced the reform program of the registration system – the registered capital on 19th February 2014, which officially changed the rules of corporate annual financial report auditing and capital verification auditing services from 1st March 2014 (The State Administration for Industry and Commerce of People’s Republic of China, 2014). According to SAIC, this regulation changed companies’ annual financial auditing system to an annual reporting system in which industrial and commercial annual audits are not enforceable, nor are capital verification auditing services. The coercion effectively makes organizations accept the need for legitimacy, but may not make every organization operate efficiently. This leads to the symbolic but not instrumental acceptance of legitimacy.

4.2.2 Normative isomorphism

Normative isomorphism is associated with the professions. It means “the collective struggle of members of an occupation to define the conditions and methods of their work had led to a similarity with their counterparts in other organizations, which occur through university courses, professional networks, and by the development of a pool of people with a similar orientation” (Irvine, 1999, p. 78).

From a global viewpoint, the international institutions and organizations, such as World Trade Organization (WTO), the International Accounting Standards Board (IASB), the International Auditing and Assurance Standards Board (IAASB), the Institute of Internal Auditors (IIA), and international public accounting firms,

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5 The reform program of the registration system – the registered capital (注册资本登记制度改革方案)
facilitates the diffusion of new practices and information exchange across the nations. For example, the IAASB is responsible for the development of the International Standards on Auditing (IASs) which are helpful to formulate a common body of knowledge for the global auditing profession. There are 106 countries either using the clarified International Standards on Auditing (ISA), or committed to using them in 2015 (IFAC, 2015).

From a Chinese domestic viewpoint, universities facilitate the diffusion of new accountancy knowledge across the nation. In Chinese accounting reform, accountancy education lags behind. In 1977, China resumed the college entrance examination and since the late 1970s Chinese economic reforms have created high demand for accounting workers (Chen et al., 1997).

“By the mid-1980s, most tertiary education institutions offered professional accounting courses. In 1993, there were 421 universities and colleges offering professional accounting courses with 41,400 new students enrolled each year. Adult professional accounting training courses which offer part-time accounting students were also offered by 459 tertiary institutions with 140,000 students enrolled each year. About 1,000 colleges at the secondary level offered accounting courses to 127,800 students each year.” (Chen et al., 1997, p. 149).

Due to the rapid expansion of higher education from 1999, by 2009 the number of accountants was over one percent of the national population (Sheng and Zhai, 2009). However, the quality of the accounting professionals is low. In 1995, less than 10% of accountants had received accounting education at the tertiary level; 70% of them had never received any formal accounting training (Lu, 1995; cited in Chen et al., 1997, p.149). According to Sheng and Zhai (2009), in 2005 less than 10% accountants had the qualities required of accounting positions in foreign companies. Chen et al. (1997) stated that
“too much emphasis has been placed on financial accounting, and course design is still largely based on rules-based accounting system. Also, in the rush to offer accounting courses, some education institutions have enrolled many more students than their faculties can properly accommodate, resulting in marked variations in the quality of accounting education across the country” (p. 150).

Chinese accounting education also has been substantially changed in recent decades. “Under a centrally controlled planned economy, the primary objective of accounting education was to train a massive number of accounting personnel who could perform simple bookkeeping functions according to the highly restrictive accounting regulations or rules formulated by the government authorities” (Lin et al., 2005, p.152). Accounting students were taught in a very rigid process according to the national uniform chart of accounts and prescribed forms of accounting statements (Lin et al., 2005, p. 151). According to Tang (1997), Chinese accounting standards adopted the rule-based accounting approach and most accounting textbooks were outdated. According to Benston et al. (2006),

“Rules-based standards often provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of the standards. This can result in financial reporting that is not representationally faithful to the underlying economic substance of transactions and events. In a rules-based system, financial reporting may well come to be seen as an act of compliance rather than an act of communications” (p.169).

As a result, Chinese accounting education fell behind western accounting education. Lin et al. (2005) stated that many Chinese accountants did not receive regular accounting training in that time. Most people believe that anyone can be an accountant because they think accountants are just responsible for recording
numerical data. Thus, for a long time, Chinese accounting education was very narrow with no professional skills development (Tang, 1997).


“Principles-based standards refer to fundamental understandings that inform transactions and economic events. Principles-based systems issue generic accounting standards. As opposed to rules-based systems, accounting standards of the principles persuasion do not address every controversial issue at hand but keep considerable ambiguity about such major processes as record keeping and measurement” (p.456).

A principles-based approach means that understanding the rationale behind accounting principles and the exercise of professional judgment by accountants are central to the practice of principles-based accounting standards (Patel et al., 2010). “As China moves to principles-based accounting standards, Chinese academics assert that the practitioners must improve their professional ability to apply judgment in the implementation of the new standards” (Nie et al., 2013, p. 287). Currently the accounting courses in most Chinese universities are similar: Fundamental Accounting, Intermediate Accounting, Advanced Accounting, Analysis of Financial
Statements, Accounting Theory, and Auditing Theory (Nie et al., 2013). However, teaching materials and teaching abilities differ across universities. Some top ranked universities choose bilingual education and teaching materials, selecting foreign language teaching materials from foreign universities. For example, Tsinghua University has cooperative relationships with foreign publishers and develops the syllabus with reference to original foreign accounting teaching materials. Such a bilingual accounting education can produce accounting personnel with the ability of international thinking and foreign language communication skills which may be useful given the acceleration of global economic integration and the realization of international convergence of accounting and auditing standards. Moreover, “many universities have established cooperative relationships with international professional bodies and new majors in international accounting and professional CPA programs have been developed, including the integration of ACCA⁶ and CGA⁷ exam courses into Chinese university accounting curricula” (Zhang et al., 2014, pp. 837-838). For example, in 2007, the Nanjing Audit University became the first university in China to cooperate with the Institute of Internal Auditors (IIA), an international professional association.

4.2.2.1 Normative isomorphism in different regions: education aspect

In China, most accounting education is carried out at universities that facilitate the diffusion of accountancy knowledge. However, one of the disparities in higher education in China is the distribution of higher education institutions (HEIs), which is affected by factors relating to politics, history, economics and geography. High school students in regions with a higher number of HEIs have better opportunities to

⁶ ACCA: the UK’s Association of Chartered Certified Accountants
⁷ CGA: the Certified General Accountants Association of Canada
receive higher education, because local students do not need as high scores in the College Entrance Exam. When the People’s Republic of China was first established in 1949, the majority of the HEIs were in the Eastern regions of China. The Chinese government has tried to address regional imbalance through reforms such as ‘Plan for counterpart support to higher education in the western area’ in 2001, and also establishing more HEIs in the middle and western parts of China (Zhu and Luo, 2011). However, according to Chinese university rankings in 2015, three out of the top10 Chinese universities are located in Beijing, and 20 out of the top 100 universities are located in Beijing. This may be due to the central government locating in the north. Moreover, Tsinghua University’s alumni are given high prestige in the Chinese political arena. For example, Chairman Xi, ex-Chairman Hu, and ex-prime minister Zhu all graduated from Tsinghua University, as well as Politburo members such as Wu Bangguo, Wu Guanzhang, and Huang Ju. There are more numerous heads of central ministries and local governments from Tsinghua University.

China started to expand its higher education system from the latter part of 1978, but the real surge in higher education happened after 1999 (Gu, 2012). “In 1998, there were only 3.14 million students enrolled by China’s higher education. However, the students’ enrolment increased to 20.21 million in 2008” (Gu, 2012, p. 514). Although the rapid expansion of higher education occurred in China after the implementation of the education reform policy of 1978, there is significant disparity in higher educational resources between different regions. Wei (2012) investigated the disparity of higher education in China in the allocation of higher educational resources. The author found that in Zhejiang, Guangdong, Jiangsu, and Tianjin the
per-capita fiscal expenditures are above average and the levels of per-student expenditure in these regions are higher than average. In Fujian, Shanxi, and Hubei the per-capita fiscal expenditures are below average, but their per-student expenditures are higher than average, which reflects the input into higher education in these regions. In several regions in China’s southwest, namely Yunnan, Gansu, Sichuan, Henan, and Guizhou, both per-capita fiscal input and per-student expenditure are below average, which indicates that local finances to a certain extent have inhibited input into higher education in these regions. In Xinjiang, Inner Mongolia, and Ningxia, all ethnic minority autonomous regions, the per-capita fiscal expenditures are above average but their per-student expenditures lag behind, which shows that there is a certain amount of room for fiscal extension in terms of input into higher education in these regions (Wei, 2012, pp. 34-36). Socio-economic conditions vary greatly in China’s regions, leading to the disparity of higher educational resources across different regions.

Shah et al. (2005) posit that differences in education investment are another important determinant for the disparities in education between regions of China. The economic performance of an area is a crucial determinant of the level of education investment. For instance, when the economic growth in an area is healthy and steady, people are more likely to make educational investments as the perceived future return on their investment is greater (Shah et al., 2005). Also, people in poorer regions are more likely to be constrained by their financial situation and therefore are limited in their ability to make investments in human capital including expenditures on education. In China, the rural-urban income gap is large. Costs associated with education can be increasingly burdensome for families to bear, especially as young
people progress onto secondary and tertiary level education. Furthermore, the economic growth rate of the region can also influence the level of demand in a regional labour market. When the conditions of the labour market are poor and also the demand for human resources is low, people are likely to be discouraged from education and the acquisition of skills.

In addition, Yang and Li (2007) investigated education inequality in 31 provinces in China from 1996 to 2004. They found that people in Beijing, Shanghai, and Tianjin were generally more educated while people with lower educational level were from Tibet, Qinghai, and Gansu. The reasons of education inequality are inequality of economic development and geographical environments. The 10 western provinces of China feature highlands, deserts, climate variability, and soil erosion. People in these areas are scattered and commuting is inconvenient, so it is difficult to promote education here.

Moreover, Lu (2007) stated that since Chinese economic reform in the late 1970s, the population mobility from rural to urban has been a social phenomenon in China. However, “in 1958, the Chinese government had already officially adopted the family register system, ‘Hukou’ (户口), to control the movement of people among different residential locations, especially between urban and rural areas” (Li et al., 2013, p. 239). Early children’s education relies on Hukou, because it is a requirement of school. Otherwise, migrant children must pay extra and higher fees compared to local children. Migrant children in coastal regions were more likely to be delayed for schooling. This also resulted in the increased establishment of schools for children of temporary migrant workers’ in many coastal cities. However, the education facilities
in the schools for temporary migrant workers’ children are generally poor, compared with local schools. According to the report of Guangzhou Daily in 14th January 2009 (Gu, 2012), in the 1980s, “college students coming from rural areas still accounted for 30% or more, while the current ratios of urban and rural students are 82.3% and 17.7%, respectively” (p. 515).

In summary, there exists disparity of access to education across regions in China, with implications for accounting knowledge and skills that may influence professional judgments required in the new Chinese accounting and auditing standards. Moreover, due to both old and new generations of accountants currently existing in China, the disparity of accounting education may cause more obvious differences in accounting and auditing professional judgments across regions.

4.2.3 Mimetic isomorphism
Mimetic isomorphism is when an organization faces uncertainty models itself after other organizations that are perceived to be more legitimate and successful (DiMaggio and Powell, 1983, cited in Irvine 1999, p.77). In other words, an organization may adopt structures and processes used by similar organizations, even if it may be not what is best to do.

Irvine (1999) argued that there is a strong sense of identity and culture when an organization responds to mimetic pressures. However, Irvine did not acknowledge the effect of culture, because culture is a complementary element which may facilitate or impede mimetic isomorphism. Thus, the study argued that mimetic
isomorphism might be influenced by peer pressure which encourages individuals or organizations to change their attitudes, values or behaviours to conform to groups.

To sum up so far, the institutional theory offers a lens to understand how norms and practices of organizations and professions are shaped by three institutional elements which can increase homogeneity among organizations. When an increasing number of organizations adopt similar policies or procedures, these policies and procedures become norms that can be seen as legitimate (Scott, 1995, cited in Chiang and Northcott, 2012). The central idea of institutional theory is that organizations seek legitimacy when adopting institutional practices, so the norms are reinforced.

4.3 Culture pressure

Culture may facilitate institutional isomorphism or may negatively influence the process of isomorphism. For example, China is a relationship society where social network success determines the success of individuals. People use guanxi as an expression of relationships. Confucian culture is deeply embedded in Chinese culture with a history of more than 5000 years. Guanxi is an important component in Confucian culture. Chinese society has been built around family clans (Hwang and Staley, 2005). Guanxi builds on the concept of the clan by widening the circle of influence to include distant relatives, friends and finally unrelated individuals (Hwang et al., 2008). Informal relationships and exchange of favours dominate all business and social activities in China and are strongly influenced by the Chinese culture. Guanxi can help people to reap benefits (Hwang and Staley, 2005). However, guanxi is contrary to the spirit of auditor independence, which can be defined as “the individual auditor considers auditor independence as a key attribute
of the profession, and believes that regulatory standards of auditor independence (issued by the profession and/or external regulatory agencies) should be rigorously binding and enforced in the auditing domain” (Gendron et al., 2006, p. 170). Moreover, Chinese culture varies from regions to regions. Thus, the effect of culture on the process of isomorphism also varies.

4.3.1 Dialects with Guanxi

Whorf (1950) suggested that “each language embodies and perpetuates a particular world view” (cited in Brown and Lenneberg, 1954, p.454). It is argued that “the speakers of a language are partners to an agreement to see and think of the world in a certain way” (Brown and Lenneberg, 1954, p. 454). Language can be used to describe various aspects of culture or it can mirror a culture.

Confucian culture puts great emphasis on family clans. In the Chinese language, there are more words to express the relationship between relatives, compared to the English language. These words are much more clear and easier for Chinese people to use in their lives. For example, ‘uncle’ has several words expressing the relationship of relatives in the Chinese language, such as ‘叔’ (father’s younger brother), ‘伯’ (father’s older brother), ‘舅’ (mother’s brother), ‘姨父’ (mother sister’s husband), and ‘姑父’ (father sister’s husband). Although these Chinese words can be expressed by the English language, obviously, they are much more easily expressed in the Chinese language. This is because the notion of kinship is more important to Chinese people. People use more simple expressions to make information easier to communicate and strengthen this notion.
Language is a tool for the exchange of ideas. It also can reflect and shape the way of thinking. There is an interaction between language and thinking. Every dialect has its own specific characteristic which is closely related to the local culture and people’s thinking. In China, the first emperor of the Qin Dynasty unified the country and the Chinese language, but dialects were passed down through history.

In China, there are seven major Han (汉) dialects – Guanhua (Mandarin, or Putonghua), Wu (spoken around Shanghai), Xiang (Hunan), Gan (Jiangxi), Kejia (Hakka), Yue, and Min (Fujian and Taiwan), and additionally ethnic minority languages such as Zhuang, Tibetan, and Uygur (Wong and Xiao, 2010). Each Han dialect embodies a set of sub-dialects. For example, Cantonese is part of Yue dialect in the Guangdong area. The Shandong dialect is part of Mandarin and Jinan and Qingdao dialects are sub-dialects of Shandong dialect. Even though Han dialects share a unified writing form, there are still many differences grammatically, lexically, phonologically, and phonetically (Ma et al., 2010). Even people from two adjacent cities may use different dialects and may have difficulties in speaking to each other.

Mandarin Chinese was officially adopted as the common speech at the beginning of 1956 (China, 1996, cited in Guo, 2004, p.45), and defined as having “Beijing speech as its pronunciation, the northern Chinese dialect as its base dialect, and modern Chinese literary classics written in vernacular Chinese as its grammatical norm” (China, 1996, cited Guo, 2004, p.46). Mandarin is the officially recognized standard Chinese language, which is used in education, media, and formal settings. It facilitates communication between different dialect regions of China. However,
dialects have not been weakened by the emergence of Mandarin as the national language (Erbaugh, 1995). People in Shanghai and Guangdong still use their local dialects as their first languages (Miao and Li, 2006). Although central government popularized Mandarin across China, the government has shown a benign attitude toward local dialects, for example, local TV programmes may be broadcast in dialects (Gong et al., 2011).

Erbaugh (1995) argued that “many Chinese take pride in speaking more than one dialect, viewing it as a sign of intelligence” (p. 82). In fact, local dialects may become a great channel to build guanxi. For example, in Foshan, a major city in Guangdong province, most people are locals or from Guangdong who speak Yue dialect and therefore Mandarin-speaking outsiders are marginalized. However, Shenzhen is another city in the same province where most people are Mandarin speaking immigrants from different regions of China and it may be much easier to build guanxi here than in Foshan. Another example is Hong Kong, where most people are from Guangdong and speak Cantonese. Customers who speak Cantonese usually receive superior service than those who speak Mandarin.

Tong et al. (1999) examined the relationship between social identity and intergroup relations in Hong Kong. Due to the process of the handover of Hong Kong to the People’s Republic of China in 1997, there are growing numbers of immigrants and visitors from mainland China to Hong Kong. “The language differences together with many other differences in the sociocultural background and life-style between Hong Kong people and Mainland Chinese have increased the salience of the group boundary between Hong Kong people and Mainland Chinese” (Tong et al., 1999, p.
That is because in the Hong Kong context, new Chinese immigrants and visitors bring mainland Chinese culture into Hong Kong. Hong Kong people speak Cantonese and English, while new immigrants and visitors speak Mandarin. The communication accommodation theory posits that “in intercultural contacts, individuals may seek to promote social approval and intergroup communication efficiency or increase the distinctiveness of their own group” (Tong et al., 1999, p. 282). Tong et al. (1999) found that as reflected in both assessments of intergroup attitudes and attitudes toward language learning, Hong Kong people were less inclined to accept mainland people. Hong Kong people preferred to use Cantonese (the in-group language) to communicate with mainland Chinese. This may be because “people expect in-group members to maintain a distinctive group identity by maintaining the use of in-group language in intergroup communication” (Tong et al., 1999, p. 293).

Armstrong and Yee (2001) stated that “the popularity of the Chinese dialects can be demonstrated through their heavy and almost indispensable usage in both business and informal conversations among many Chinese businesspeople. This is especially the case with reference to older Chinese businesspeople, who may be more proficient and comfortable in using their own Chinese dialects.” (p. 69). The same dialect would strike a chord for people with the same culture. Sharing the same language would also influence the level of trust (Armstrong and Yee, 2001). Ma et al. (2010) claimed that “even outside their native dialect regions, people from the same dialect region always like to speak their own dialect to each other to show the special close relationship between them” (p. 351). Gong et al. (2011) also identified dialect as a basis for establishing personal relationships. People’s frequency of speaking in their
local dialect could influence their decision to stay with their organization. Xie (2011) stated that “local people use the dialect not only to communicate among themselves but also to proclaim their identity as natives of the city, distinguishing themselves from the growing number of migrant workers” (p. 20).

4.3.2 Historical activities influence regional culture
Chinese business behaviour characteristics have been observed to have strong differences between the various regions of the mainland. One of the most important themes is the striking contrast between the North and the South (Schlevogt, 2001). “Several centuries ago, Marco Polo mentioned these differences, comparing Cathay (North) to Manzi (South, especially, Canton), which were two almost separate worlds” (Schlevogt, 2001, p.520). Traditional Chinese culture such as Confucian culture appears in the North (Shandong province), and emphasizes respect for seniority, politeness, loyalty, collective orientation and trust, reinforcing centralizing tendencies (Schlevogt, 2001).

Schlevogt (2001) argued that “the north lacks a well-developed and sophisticated commercial history” (p. 524). However, Shanxi Merchants (Chinese: 晋商 Jin Shang, in the North) very famous in Chinese history, were prominent businessmen from the Song to the Qing dynasty. The Shanxi Merchants built a close relationship with the government and were responsible for creating the first banking institutions in China.

“Due to their shrewdness and abilities in handing financial matters, they became successful in business and, down through generations, exchange shops they started had moved into dozens of cities all over the country. Usually, one such shop owned a dozen to 100 branches and some of these even had branches in Japan, Europe and South-eastern Asia. So it is said that China’s
financial industry in modern time was started by these Shanxi Merchants. These exchange shops had controlled the financial market for more than 200 years during the Qing Dynasty and even Emperor Dowager Cixi once borrowed money from them” (i-Leica, 2013).

Schlevogt (2001) claimed that in the north, business closely links with government and companies are heavily controlled by the government. Commercial activities are considered political activities. Hechuan Zhang, who was the president of Guangdong Midea Group Co., Ltd, stated that compared to the South, in the North a high proportion of enterprises are either state-owned or the state holds most shares (Jinhengzixun, 2006). That is why the first special economic zone was Guangdong far away from northern political centre of Beijing. With less political control, there is a higher prevalence of commercial activities in the market in Guangdong.

Compared with the North, the South has a more developed commercial tradition (Schlevogt, 2001). There are excellent river connections such as the deltas of the Yangtze River and Chu Chiang, and many sea access points, by which merchants are able to engage in more domestic and international trade than in the North. Schlevogt (2001) argued that traditional culture is less emphasized in the South, perhaps because of history and international influence. However, this study does not agree with this opinion, because it can also observe that traditional culture was highly emphasized in the South. For example, Hui Merchants (Chinese: 徽商) were one of the most famous merchant groups with a very strong cultural foundation in China’s history during the Ming and Qing dynasties (1368-1911). “Hui Merchants were deeply influenced by Confucianism. Guided by Confucian philosophy, they valued honesty and morality in their business dealings. They made profits based on the Yi rules (Yi in Confucianism means duty or righteous behaviour), and paid strict
attention to learning new things and accumulating experience” (China today, 2010).

Hui Merchants were also closely attached to bureaucracy.

“The history of Hui Merchants covers about 600 years, but for 300 years they dominated the region. They occupy a significant place in the history of Chinese commerce. In the Southern Song Dynasty, as the capital was moved from Kaifeng to Lin’an (now Hangzhou in Zhejiang province), the political and economic centre shifted to the south. This stimulated the economy of neighbouring areas to develop, and then the Central Plains culture was introduced to the South. Huizhou was situated in an important place between Jiangsu and Zhejiang provinces. It was significant to the economy of south-eastern China as a communication hub between the south and the north. As a result of Huizhou’s particular geographical condition and the need of economic development, landowners began to take up business” (Huangshan tour, 2008).

In the ‘new’ China, since the late 1970s Chinese open door reform, with the process of transforming planned economies to be more market oriented and transforming state-owned enterprises into stock companies, a number of multinational corporations have established subsidiaries in China. This phenomenon has facilitated population mobility from rural to urban regions as more people look for a job in the city. Due to the unequal development of the economy, China is divided into coastal and interior regions. The coastal regions, partially south-eastern coastal regions, have been seen as more modernised than interior regions because that is where Chinese reform started. Chinese modernisation is associated with industrialisation, advanced technology, higher standards of living, and the influx of western management ideas and techniques (Redfern and Crawford, 2010).

However, simply dividing China into coastal and interior regions as a means to define a particular area’s level of economic development may be not adequate because of the impact of history. For example, “there is no disagreement about
overall trends in the Qing economy, in which a generally prosperous eighteenth century gave way to a period of growing economic difficulty after 1800, during which China was slow to grasp new opportunities radiating from the British industrial revolution” (Brandt et al., 2014, p. 61). China had become a laggard by the nineteenth century (Brandt et al., 2014). After the Opium War (1839-1842), “British arms forced the Qing to accept the Treaty of Nanking (1842), which ceded Hong Kong to the British, forced the Qing to accept a regime of virtual free trade, and initiated the ‘treaty port’ system by opening five Chinese ports to British merchants (Brandt et al., 2014, p. 81)”, which included Guangzhou, Fuzhou, Xiamen, Ningbo, and Shanghai ports. Subsequently, similar forced agreements expanded to include dozens of treaty ports where foreign residents were protected by extraterritoriality at the expense of Chinese sovereignty (Brandt et al., 2014, p. 81). Although this is a humiliating modern Chinese history, western cultures were able to deeply influence Chinese regional culture. For example, Qingdao was a German colony from 1891 until 1914. During this period, Tsingtao (Qingdao) was starting to take shape with the completion of a series of projects such as wharves, the Tsingtao-Jinan Railway line, Tsingtao Railway Station and locomotive works. “In the year of 1910, the Germans drew up for the second time the city planning of Tsingtao. As a result, the former urban area was extended for four times highlighted by the emphasis on the development of commerce and trade” (Qingdao, 2015). Haier Group of Qingdao is a famous worldwide business for consumer electronics and home appliances. Tsingtao Brewery co., Ltd is another famous company in Qingdao. Neither are state-owned enterprises. In contrast, people may know only Shandong Luneng Group Co., Ltd in Jinan, which focuses on energy and minerals businesses and operates as a subsidiary of the State Grid Corporation of China, which is a large state-owned enterprise.
Therefore, no matter how China is divided, whether it is into the North and the South or the coastal and interior regions, the reason for different regional culture is the process of historical activities which includes the interactions of foreign cultures and political activities. Apparently, since the open door policy, there is a new division between the coastal and interior regions. This is because they were opened up at different times\(^8\) and historically experienced the influence of foreign cultures in different ways. Most economic zones were set up in coastal regions. Therefore, it is not accurate to simply divide into the coastal and interior regions for comparison. This study believes a more accurate way to divide Chinese regions through the definition of special economic cities and non-special economic cities.

4.3.3 Culture influences the education in different regions

China with a cultural history steeped in Confucianism has a long history of preference for sons (Wang et al., 2013). “Confucian principles underpinned a highly patriarchal society. Women’s status was symbolized by the appalling practice of foot-binding…girls married early and had very limited educational opportunity” (Wang et al., 2013, p. 87). According to China Daily (2014), in 2014, Chinese families have a preference for sons and sons would often have better educational opportunities; according to the 2005 census, the ratio of boys to girls was 1.21 males to one female. In the 2013 census showed that the sex ratio at birth had improved, but “the narrowing of the gap does not necessarily mean that girls are valued more highly” (China Daily, 2014).

\(^8\) In 1980, Shenzhen, Zhuhai, Shantou, and Xiamen were set up as special economic zones. In 1988, Hainan province was set up as a special economic zone. During the period between 1990 and 1992, many other cities were set up as special economic zones, such as Shanghai, Tianjin, Beihai, Zhanjiang, Guangzhou, Fuzhou, Ningbo, Nantong, Lianyungang, Qingdao, Weihai, Yantai, Dalian, and Qinhuangdao (Leong, 2013).
Lu (2007) argued that there were no gender differences in migrant children’s education, but the author might have neglected the effect of the Chinese one-child policy. Lee (2012) investigated the effect of the one-child policy on gender equality in education in China. The study found that “no difference in years of schooling between only child boys and only child girls, where the gap between boys and girls inside multiple-child households remained significant” (p.41). For example, a migrant child must pay ‘educational endorsement fees’ if they want to enrol at local schools (Lu, 2007). However, these fees are a heavy burden for low-income migrant families (Meng and Zhang, 2001). If they have two children and one is a boy, the boy always gets the first chance of an education unless he does not want to go to school.

Moreover, according to the Chinese Ministry of Finance, in 2005 China’s 12 million professional accountants included 6.7 million women (Keeffe, 2010). Females accounted for 56% of the total number of all accounting personnel. However, most female accountants work in basic accounting jobs such as bookkeepers and cashiers.

In the Chinese labour market, although the government encourages gender equality, Chinese women still have a lower status (Huang, 2001). “Women are considered inferior to men in the patriarchal family” (Huang, 2001, p. 258). Therefore, women are less educated than men, especially in rural areas (Huang, 2001). This is because of the Confucian norm that women should not have too much education (nvzhi wucia bianshi de, in Chinese: 女子无才便是德) (Huang, 2001).

“Most Chinese parents, especially those in the rural areas, consider it unwise to invest in the education of their daughters because they will marry out and join their husbands’ families. With limited resources, sons, the main supporters of aging parents, are more likely to have
opportunities for higher education whereas daughters often have to quit school to help family production (Huang, 2001, pp. 258-259)"

In summary, Chinese culture may negatively influence institutional isomorphism. It does not mean that the effect of culture prevents the process of isomorphism. This study argues that the impact of culture may divert isomorphism from expected end points. Thus, culture should be classified within the same level as institutions. In social transformation, there is an interaction between culture and institutions.

4.4 Loose coupling

Under the two pressures from culture and institutions, individuals may practice in a variety of ways while maintaining the standards and legitimate structures. Ortan and Weick (1990) refer to this phenomenon as ‘loose coupling’, and explains it is “a divergence of legitimacy-seeking activities and technical activities” (cited in Chiang and Northcott, 2012, p. 347).

In the process of Chinese auditing standards’ convergence with international auditing standards, there is a question of whether the new Chinese Auditing Standards are implemented as expected, and exactly how auditors interpret and implement these new standards. Loose coupling is a concept that is helpful to understand the practices of auditors in this process, and situate responses of accepting, resisting, or adapting the new standards in China. Wu and Patel (2013) acknowledge that loose coupling encompasses both resistance and adaptability to institutional change and the latter accommodation of the change. “The organizational implications of the new values and meanings may be imperfectly understood or deliberately misinterpreted, which allow diversions to occur from expected goals” (Wu and Patel, 2013, p.207). This
change could start as superficial change and then become more and more significant over time. For example, Chinese CPA firms started to reform when they were affiliated firms to the government and then later became independent firms.

The Chinese financial auditing service was really started in early 1983. At that time, CPA firms included accounting firms and auditing firms that were established and sponsored by government bodies or government controlled institution (Yang et al., 2001). In June 1995, the two professional bodies, the Chinese Institute of Certified Public Accountants (CICPA) and the Chinese Association of Certified Public Auditors (CACAP), emerged as a new professional body named CICPA, under the direct control of the MOF (Lin and Chan, 2000).

From 1997, Chinese accounting firms started to disaffiliate from their sponsoring bodies in order to converge to the global auditing system. However, the CICPA is still essentially governed and regulated by the MOF, because it allows dual appointment of senior directors in the CICPA who also have government positions. In addition, many leaders in the CICPA and provincial institutes of Certified Public Accountants had governmental working experience due to historical reasons. Due to the effect of Chinese culture, guanxi may still exist between leaders and government. Therefore, it is difficult to maintain auditing independence under the influence of the government. Another example of the influence of government on public accounting firms is that the establishment of a public accounting firm must be reported and approved by the provincial department of finance, but not the provincial institute of Certified Public Accountants (Ministry of Finance of the People’s Republic of China, 2015a). As such, the institute of Certified Public Accountants seems to help the
government supervise public accounting firms, because many important decisions are made by the government.

Secondly, internal audit was established and developed later in China, compared to the financial audit. The China Institute of Internal Audit (CIIA) joined the Institute of Internal Auditors (IIA) in 1987. The Chinese Internal Auditing Standards (CIASs) was established in 2003 and implemented from 1st June 2003. The CIASs were revised in 2013 and implemented from 1st January 2014.

In fact, the independence of internal audit is not designed as a monitoring operation to prevent frauds and control financial and operational risks. Some private corporate directors consider the corporate money is their own money, so they can use it in whichever way they want (Wang, 2014). The internal audit restricts their self-business rights (Song, 2011). In the state-owned enterprises (SOEs), some directors think that internal audits weaken their authority. Therefore, “they either do not set up an internal audit department, or deprive its rights even if it exists. The staffs in internal audit departments are even excluded and isolated, and cannot play their roles as expected” (Song, 2011, p.191). Internal auditors are guided and authorized by directors, which significantly influences the independence of internal audit. The directors control the economic funds of internal auditors and exercise their personal control. In most Chinese corporations, there is a real separation of ownership and management. The directors usually participate in corporate management. Therefore, the internal audit cannot play an independent internal control role.
In summary, although the Chinese auditing system converges to the international auditing system in order to maintain legitimacy, loose coupling reflects the contradiction between institutional and culture pressures in the institutional context.

4.5 Conclusion

To sum up, with the process of institutional isomorphism, the Chinese auditing profession has adopted international auditing standards in order to seek legitimacy in the global market. However, the differences of regional culture may result in Chinese auditors imperfectly interpreting the new Chinese Auditing Standards or deliberately misinterpreting them. In other words, whenever legitimation is sought, ‘loose coupling’ may result. But superficial changes could become more significant over time. Therefore, the framework of this study is described as Figure 3.
Figure 3 Framework for understanding the Chinese auditor independence commitment

Cultural pressure

Institutional pressure

Loose Coupling
CHAPTER 5 AN ANALYSIS OF CHINESE CONTEXT

5.1 Introduction

With the process of transforming planned economies to be more market oriented and China entering the World Trade Organisation, there has been an exponential growth in the number of multinational corporations establishing subsidiary companies in China. The Chinese auditing practices and corporate governance are converging to internationally acceptable practices. This chapter uses neo-Durkheimian theory to analyse cultural aspects of international auditing convergence, with particular reference to how they function in the Chinese auditing context.

Most institutional theories of organizations use cost, ideational or regulatory factors to explain adoption and diffusion of empirical forms of formal institutions (6, 2015, p.771). By contrast, neo-Durkheimian theory argues that “informal institutions are causally key, that generic elementary forms are more significant than empirical ones, and that quite rapid informal institutional change is common … each elementary institutional form of social organisation cultivates a distinct thought style, meaning the manner in which people frame decisions – measured, for example, by their stance towards anomalies in classification, past and future, issue linkage, risk, fallback options in strategy, issue linkages” (6, 2015, p.771). Simply speaking, other institutional theories use institutional change to explain how individuals and organisations adapt to either gradual or catastrophic change. However, neo-Durkheimian theory emphasizes the impact of informal institutions of culture. The impact of culture limits individuals’ opinions and cognition to adapt to institutional changes. Although some research using institutional theories also investigates cultural influence (Wu and Patel, 2015), they view culture as simply part of the
context of an institution. However, neo-Durkheimian theory classifies culture into four different solidarities, to understand individuals’ problems, options, and choices within their experienced institutional changes.

The purpose of this chapter is to set out the framework of neo-Durkheimian institutional theory to be used in understanding the process and outcome of converging to international audit practices in China.

This chapter is organized as follows. Section two discusses neo-Durkheimian theory. Section three describes Chinese culture. Section four examines individuals’ practices as classified under the grid-group framework of the neo-Durkheimian institutional theory. The final section presents a conclusion.

5.2 The development of Neo-Durkheimian institutional theory

Neo-Durkheimian institutional theory describes four solidarities. The individualistic solidarity is described as a weak grid – weak group form of society. Their own interests are more important than the group’s interests. When individuals gather wealth and resources they can be at liberty to collaborate with others, but they always put their own interests first. Thus, these kinds of relationships are easy to break. As such, no-one in this society expects other people’s help or assistance. To reduce the possibility of failure, individuals need to be self-insured. Therefore, there is no trust between individuals’ cooperative actions.

The second form of society is hierarchical solidarity which is a strong grid – strong group form. In this form of society it is important that rules are adhered to, and that
tradition and authority are respected. Social rules are demarcated and statutes are clearly defined within internal boundaries, while the external boundary defines who is inside and who is outside the group. It can be described by a vivid movie example. In times of war, whether or not the war is of benefit depends on which perspective you take. From the individual’s point of view it could be harmful, but from the country’s point of view it could be beneficial. The soldier is in the army, which is a hierarchical solidarity with a strong grid-strong group form. The soldier has to participate in the war in spite of her or his own personal views or desires, because there are strict rules in the army and he is also accountable to the country.

Egalitarian solidarity is a weak grid – strong group form of society which shares features with the individualistic and hierarchical solidarities. There are no internal boundaries in the form of social rules, but the external boundaries are even more important than in hierarchical solidarity. There is a good metaphor in China from the 1950s, which is the saying ‘eating from the same big pot’ (吃大锅饭). This is a vivid metaphor of the egalitarian practice of everyone taking food from the same big pot. You could say that companies ate food from the country’s big pot and no matter whether there was profit or loss, wages were still paid, and within companies, regardless of whether labourers worked hard, it did not impact the distribution of their individual wages. These ideas explain why betraying socialism was the worst act, because it threatened the group boundary.

The last form of society is the isolate solidarity which is a strong grid – weak group form. This implies there is little leeway in choosing one’s social role and belong to any group.
Individuals or individual organizations interpret their social context based on their own values and beliefs because culture exerts a strong impact over cognition (Tansey, 2004, p.18). Durkheim’s approach suggests that “society is the individual mind writ large” (Tansey, 2004, p. 19). Although political events and institutions significantly influence individuals’ behaviours, individuals interpret and accept these institutional constraints as a process. In this process, “individuals negotiating their way through the organizational constraints of actively interpreting, challenging, accepting, and recreating their social environment are limited to a style of discourse consistent with the constitutive premises of that environment” (Rayner, 1992, p. 90, cited from Tansey, 2004, p. 19).

6 (2015) also stated that “institutions amplify biases, leading people to think of their world as being only as integrated and regulated as they themselves are socially integrated and regulated by their institutions. Neo-Durkheimian theory proposes a feedback loop, in which each elementary form of informal social organization cultivates thought styles, which then leads people to act in ways that reinforce that form” (p. 771) (Figure 4).
Figure 4: The structure of explanation in neo-Durkheimian institutional theory (6, 2015, p.772)

First, foundational phase

Mechanism: Quotidian ritual interaction order

Social organisation, specified by mix of elementary forms of institutions

First, foundational phase

enacts

cultivates

reinforces, even to the point of disorganisation

Secondary phase

Thought style

Note: A two-phase feedback loop
Simply speaking, institutions enact rules and regulations they ask individuals to follow. This cultivates individuals’ thought style, which relates to the culture of this group of people. People share the same attitudes, customs, and beliefs in the group, which lead individuals to act in ways that reinforce the institutions. However, if individuals’ thought style has been changed, institutions may become disorganized. Also if institutions have been changed, the new institutions may cultivate a new thought style.

Moreover, Linsley et al. (2015) acknowledged that all four solidarities could be present in a society and no society would comprise only one of the solidarities. Linsley et al. (2015) argued that “within any society cultural dialogues will continually occur as the different solidarities promote their worldview and look to win new recruits. The interactions the four solidarities have with one another, and the incessant debates they have, are also important as they re-confirm to the members of each solidarity what it stands for” (p. 6). However, in reality, it may be difficult to observe these four typical solidarities. In contrast, more ‘moderate’ solidarities may be present because of social ties between individuals of different connections and strengths. For example, social culture is located conceptually within the hierarchical culture, while individuals who live in this social culture may work in a workplace with individualist solidarity. When individuals make decisions in their work place, their situation may shift to a moderate solidarity somewhere between the hierarchical culture and the individualist culture, where they trade off benefits and punishments and may also change their accountability. To expand on this, section three first describes the Chinese culture, then analyses how individuals’ behaviours change because their accountability changes in the mixed moderate solidarities.
5.3 The description of Chinese cultures

Confucian culture is deeply embedded in Chinese culture. Confucianism constructed the “san gang wu chang” 三纲五常 which are the three cardinal guides: the ruler guides his subjects, the father guides his son, and the husband guides his wife. Confucianism identifies five constant virtues: ren 仁 (relational virtuosity/consummate conduct), yi 义 (commitment), li 礼 (propriety in roles and relations), zhi 智 (wisdom), and xin 信 (credibility). As well as the guides, there were strictly hierarchical rules. In addition, China is a relationship-based society where people use guanxi as an expression of a relationship. Guanxi is an important component of Confucian culture especially since Chinese society has been built around family clans (Hwang and Staley, 2005). Guanxi builds on the concept of the clan by widening the circle of influence to include distant relatives, friends and finally unrelated individuals (Hwang et al., 2008). Thus, in China’s feudal society, the hierarchical solidarity (strong grid – strong group) was present at an extended scale.

However, during the period from 1840 to the present, China experienced distinct cultural transitions because of wars, significant political and institutional changes, and the globalisation of economic development, Chinese culture still predominately identifies with a hierarchical solidarity, in which there may be different levels between grid and group.
5.3.1 Fading Glory (1840-1919)

Since the Opium War in 1840, “British arms forced the Qing to accept the Treaty of Nanking (1842), which ceded Hong Kong to the British, forced the Qing to accept a regime of virtual free trade, and initiated the ‘treaty port’ system by opening five Chinese ports to British merchants” (Brandt et al., 2014, p. 81). These ports included the Guangzhou, Fuzhou, Xiamen, Ningbo, and Shanghai ports. Subsequently, similar forced agreements included dozens of treaty ports where foreign residents were protected extraterritoriality at the expense of Chinese sovereignty (Brandt et al., 2014, p. 81). Since 1840, Chinese traditional cultural beliefs have been totally questioned by Chinese elites (Wu, 2007). Reformists such as Zheng Guanyin realized that the influence of West resulted from the fact that “‘China being an agrarian country’ versus ‘foreign countries being a commercial one’ ” (Wu, 2007, p. 141). Zheng Guanyin had immortal words in his life “欲攘外，亟须自强；欲自强，必先致富；欲致富，必首在振工商；欲振工商，必先讲求学校、速立宪法、尊重道德、改良政治” (in English: The country needs to be strong and self-reliance if it wants to resist foreign aggression; if it wants to be self-reliant, it must first become rich; if it wants to be rich, it should conduct industry and commerce; if it wants to revive industry and commerce, it must firstly force education, set up legislature and respect for moral and political institutional reform). Wei Yuan proposed “to learn from foreign countries and then tame them” (Wu, 2007, p. 141). Moreover, Li Hongzhang adopted Western military beliefs and set up the Chinese North Marine Navy.
In 1888, the North Marine Navy was formally established and also promulgated the “North Marine Navy Statutes” (Baike, 2016; Wikipedia, 2016). Almost 70% of captains had studied or trained in the UK, France, Germany, or other countries (Baike, 2016; Wikipedia, 2016). Li Hongzhang also hired William Metcalfe Lang as a supervisor to train the navy (Sina, 2014).

Li Hongzhang adopted Western military beliefs and implemented the Chinese North Marine Navy; these cultivated a new thought style. However, new institutions were only implemented in the army. As such, the new thought style was limited in its impact on the dominant Chinese culture.

Confucian culture was legitimated in the ancient China and dominated in the economy and society (Wu, 2007). However, during this time, Chinese culture was questioned but it was not shaken. Wu (2007) stated that “it is impossible to shake the potent collective beliefs deep-rooted in the society merely by self-reflection or denouncement. Society will abandon its ancient beliefs only if it is assured of finding others” (p.141).

During this period (1840-1919), western countries used military force to open China’s door, and in doing so they were able to deeply influence Chinese culture. Chinese people saw and interpreted their environmental changes, which challenged their old institutions. Throughout this period, the hierarchical solidarity (strong grid – strong group) remained.
5.3.2 Transitional Trauma (1919-1949)

Until the May 4th Movement (also called the New Cultural Movement), China started to embrace more Western beliefs, especially Chinese students and youth. The May 4th Movement also indicated a radical break with the Confucian ethical and political system (Wu, 2007). The May 4th movement was the first major student movement in modern China (Zhao, 2000, p.1599):

“Since 1917, China’s new intellectuals and students initiated a vast modernization drive that aimed to strengthen the country through science and democracy. This modernization drive to a great extent paved the ways to the rise of the movement. The movement, however, was named after the May 4th incident in 1919: on that day, over 3000 Beijing students marched in the streets in an anti-Japanese demonstration protesting the Shandong Resolution of the Versailles peace conference. Joined by merchants, workers, and other urban residents, anti-Japanese protested soon spread to many other Chinese cities. Eventually, the government of Northern China had to dismiss three pro-Japanese officers and to refuse to sign the Versailles peace treaty. Politically, it contributed to the rise of the Chinese Communist Party (CCP) and the reorganization of the Nationalist Party (Guomindang). Culturally, it facilitated the rise and dominance of vernacular literature and mass education and the decline of Confucianism and traditional ethics.” (Zhao, 2000, p.1599)

During this period, many critical events happened in China, such as military conflicts between warlords from 1927, anti-Japanese warfare from 1937 to 1945, and the civil war from 1946 to 1949. Chinese people wanted to learn Western science and beliefs in order to find a way out and save the nation. Many young people, such as Deng Xiaoping and Zhou Wenlai even went to Europe for study. Wu (2007) claimed that “science is not merely regarded as a discipline of knowledge, but as the panacea to solve all the problems existing in nature, society, life, politics and ethics” (p. 143). This transformation occurred in a troublesome period: the national institutions could
not be effectively implemented, and at the same time the transformation shook the domination of Confucian culture.

Moreover, although the government published a series of laws to restrict people’s rights to free speech, association, and the press between 1912 and 1914, such laws could not extend to cities controlled by southern revolutionaries, and foreign concessions, where publication and association were not regulated by Chinese law (Zhao, 2000, p.1609). Even within the Northern political sphere, some organizations such as commercial organizations, worker unions, and other nongovernmental organizations were also out of its control, especially after Yuan Shikai’s failure to restore a monarchy and his death in 1916 (Zhao, 2000, p.1609).

During this period, people started to challenge the ‘old’ political system because it did not suit the ‘new’ conditions or the pursuit of democracy. They were trying to establish republicanism, which is a political ideology in contrast to monarchy and dictatorship. Social organization had been re-established in order to create a new interaction order, which cultivated a republicanist thought style. The revolution reinforced the new thought style to buttress the new institutions.

Hierarchical solidarity (strong grid – strong group) was gradually moved to a ‘moderate egalitarian’ solidarity. The strong grid moved to a relatively weak grid. Due to the resistance of foreign aggression in the whole country, in China, the strong group was still present. In a ‘moderate egalitarian’ solidarity, the typical situation is a lack of control. Individuals were trying to negotiate on all points and change institutional ordering, but the old hierarchical cultural power was a countervailing
pressure that limited the continuing movement of the grid. As such, social regulations were questioned and a ‘moderate egalitarian’ solidarity emerged.

5.3.3 Cultural Redefinition (1949-1978)

When the People’s Republic of China was founded in 1949, China became a socialist society (Wu, 2007), following the socialist Soviet Union, positioning itself within the socialist camp and therefore rejecting capitalist ideology, (such as was present in European countries and America). During this period, Mao Zedong launched the ‘Great Cultural Revolution’ criticising the then dominant Confucian culture, which he claimed represented decadent beliefs. In the end, there was no individualism, no self-assurance, and no aseity in the whole country (Wu, 2007). Wu (2007) stated that “highly unified under the ideological governance, all social activities and living experiences are manifested as political. Science and democracy has been literally discarded. All members of society are dreaming of joining in the Communist party and are proud of being Poor Peasants (Pinnong) in class origin. And the material beliefs of the pursuit of gains will be severely inhibited and even punished.” (p.144).

In other words, Chinese people were ‘brain washed’ during such a short time under such strong political power.

New institutions were established to dominate social interaction order by strong political power, which cultivated a new thought style. With the new thought style, individuals reinforced the new social organisation.

During this period, people emerged from the pain of war and established a new country, in which people blindly admired the leaders. Meanwhile, the Chinese
Communist Party (CCP) established strict regulations to ensure their highest leadership in the whole nation. Therefore, the weak grid moved back to a strong grid. Hierarchical solidarity (strong grid-strong group) was again present under strong political power.

5.3.4 Chinese Consensus (1978-present)

Since 1978, China has introduced dramatic economic reforms. With the process of economic reform, the Chinese economy and society have been significantly restructured. This period is also called the post Maoist period. When Deng Xiaoping became the paramount Chinese leader in 1978 (Wu, 2007), he started the reforms and began to open up the country. Deng Xiaoping had one aphorism: “it does not matter whether the cat is white or black, so long as it catches mice” (Wu, 2007, p. 145). China came to put economic construction at its centre, rather than its political movement. With the implementation of the open-door policy in 1978, China started to transform its planned economy to be more market oriented. Subsequently, a number of multinational corporations have established subsidiaries in China. With more and more western companies entering China, western cultures have also been brought into China. For example, in Beijing, 70% of buildings are foreign-named and the gymnasiuems and main sports facilities of the 2008 Chinese Olympic venue were totally designed by foreigners (Wu, 2007, p.145). The Chinese economy has been dramatically developed, and in 2015 its GDP ranking had bounced up to be the second in the world (Knoema, 2015).

Although China continues to be a one party dictatorship of the Chinese Communist Party, albeit with some economic freedom, Chinese individuals have considerable
freedom to self-select. For example, Chinese individuals are no longer confining
themselves to the revolutionary movies. Instead, they have started to explore the
outside world from television, films, and the internet. In particular, the internet gives
Chinese individuals more freedom to speak. For example, Zhou Jiugeng, an official
of the Nanjing government of Jiangsu province, suddenly became famous because a
netizen posted his very expensive brand watch and luxury car on the website in 2008
(Ma, 2012). Such freedom could never have happened in China at any other time.
However, the freedom is relative. For example, Facebook and YouTube cannot be
logged into in China because videos such as those documenting student strikes in
1989 can be viewed on these websites. For another example, the famous compere, Bi
Fujian, was suspended when a video emerged on a website in which, at a private
banquet, he was joking about Chairman Mao. Compared to the Maoist period, the
strong grid has been gradually moved to a relatively weak grid because of the
influence of institutional changes during the economic reform.

In addition, guanxi is still deeply embedded in Chinese culture. Guanxi can help
people to reap benefits. Guanxi success determines the success of individuals since
informal relationships and exchange of favours dominate all business and social
activities in China. However, with the transformation of planned economies to be
more market oriented, freedom of competition is encouraged, such as the enterprise
reform since 1980s and the accession to the World Trade Organization (WTO). As
such, the strong group has also been gradually moved to the relatively weak group
form with the transformation of the planned economy to be more market oriented.
Thus, hierarchical solidarity has moved to a ‘moderate hierarchical culture’.
5.3.5 Understanding *guanxi* in Chinese societies

China is a relationship-oriented society. In the Chinese language, people use *guanxi* as an expression of relationship. *Guanxi* generally refers to networks of informal relationships and exchanges of favours that dominate all business and social activities (Qin, 2011). However, *guanxi* is derived from Confucianism. Confucianism divided social relationships into five categories called “Wulun” (五伦), whereby “Wulun” generalised the relationship between monarch and his subjects (Jun chen 君臣), the relationship between father and son (fu zi 父子), the relationship between younger and older brother (xiong di 兄弟), the relationship between wife and husband (fu fu 夫妇), and the relationship between friends (peng you 朋友).

Mencius⁹ believed that people should deal with these five relationships by following Zhong 忠 (loyalty), xiao 孝 (filial piety), ti 恂 (doing one’s duty as a younger brother), ren 忍 (endurance), and shan 善 (kindness). In other words, subjects should be loyal to their monarch; a son should be filial to his father because of hierarchical orders; in brotherhood, the younger brother should do his duty as a younger brother because of blood-relations; husband’s and wife’s loves are different, and they should put up with each other; friends should be honest to each other, and should be kind and caring to each other. Confucianism used family relationships to explain social relationships. As such, monarchs were called ‘monarch father’ (君父) and officials were called ‘parent governors’ (父母官). The relationship between a monarch and his subjects was similar to the relationship between father and son. If a monarch does not do his duties properly, he does not expect his subjects to be loyal nor to respect him, as with the relationship between father and son. In marriage, a husband should

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⁹ Mencius was a Chinese philosopher of Confucianism.
be the leader in the family and make decisions for the family, while a wife should obey her husband’s decisions. Friendship should not only be based on reciprocation but also honesty. Moreover, Confucianism advocated that “四海之内，皆兄弟也” that means within the world people are all brothers and society is like ‘a big family’.

In the Han dynasty, Confucianism constructed the “san gang” (三纲) that are the three cardinal guides: the monarch guides his subjects, the father guides his son, and the husband guides his wife. To deal with these three relations, Confucianism identifies five constant virtues: ren 仁 (relational virtuosity/consummate conduct), yi 义 (commitment), li 礼 (propriety in roles and relations), zhi 智 (wisdom), and xin 信 (credibility). People normally refer to these virtues together as “san gang wu chang” (三纲五常) in a way that politicized Confucianism in order to maintain political order. “San gang wu chang” advocated that children should obey their father; a wife should obey her husband; if the husband died, a family should obey the eldest son. In fact, this was not the real doctrine of Confucius and Mencius, but a politicized version. This is because Confucius never said that ‘if a monarch asked his subjects to die, the subjects must die; if a father asked the same requirement, the son must obey this order’ (in Chinese: 君要臣死，臣不得不死；父要子亡，子不得不亡). In contrast, Confucius advocated that the ‘monarch should respect his subjects when he orders his subjects and his subjects should be loyal to his monarch when they do their duties’ (in Chinese: 君使臣以礼，臣事君以忠). Mencius also stated that ‘if a monarch treats his subjects as hands and feet, his subjects would treat their monarch as their heart; if a monarch treats his subjects as dogs and horses, his subjects would treat their monarch as a normal person; if a monarch treats his subjects as grass and
mud, his subjects would treat their monarch as the enemy’ (in Chinese: 君之视臣如手足，则臣视君如腹心；君之视臣如犬马，则臣视君如国人；君之视臣如土芥，则臣视君如寇仇). In fact, in the Han dynasty, Confucianism became the main culture used by politicians in China.

Confucian philosophy played a dominant role in Chinese ancient societies to structure social relationships. However, as culture changed, the meaning of guanxi also changed, especially through the transformation and restructurization of societies and politics. In the early twentieth century, with the collapse of the Qing dynasty and expansion of western colonization in China, the Confucian culture was shaken from its dominant position.

The May 4th Movement indicated a radical break with the Confucian ethical and political system. The May 4th Movement specifically criticized the “san gang wu chang” which organized Chinese feudal social relationships. The relationship between husband and wife, as the key point in Confucian relationships was among the aspects criticized. The Confucian ethical system required that a wife should be ‘physically loyal’ to her husband in whatever situations, saying ‘starving to death is a small matter, while disloyalty is a big deal’ (in Chinese: 饿死事小，失节事大). For example, when the husband died, the wife could not remarry. If a wife was raped, she had to commit suicide because she brought shame and disgrace on her husband and family. Indeed, Confucianism promoted the male position in the family and supported the authority of patriarchy, rather than gender equality.
Moreover, after the People’s Republic of China’s foundation in 1949, Mao Zedong launched the ‘Great Cultural Revolution’ criticising Confucian culture, which he claimed represented decadent beliefs. The Chinese Communist Party (CCP) promotes gender equality as a basic policy of China and required banning arranged marriage, foot binding, and concubinage, as well as giving females the same opportunities in education and work.

However, both the May 4th Movement and the ‘Great Cultural Revolution’ only criticized Confucian hierarchical relationships called “san gang wu chang” which is not the original doctrine of Confucius and Mencius. Although “Wulun” in the original doctrine of Confucius and Mencius included hierarchical relationships, friendship in “wu lun” was an equal relationship. “San gang wu chang” was used by feudal rulers to structure and sustain social relationships. Confucianism was criticized and abandoned in order to overthrow feudal institutions and establish new institutions. However, because only Confucian hierarchical relationships were criticized, Confucian ideas of friendship were still maintained, and called guanxi, in an expanded meaning of guanxi. This ‘friendship in Confucianism’, guanxi, is different from normal friendship, because in a friendship the exchange of favours is not expected, but in guanxi, people expect exchanges of favours. Also guanxi can be divided into an organizational level and an individual level. Kosmala and Xian (2011) stated that guanxi at the organizational level “informs the construction and enactment of identity, as it guides daily business running, supervisor-subordinate relations, and by the cultivation of a network of the ‘right people who help the business’, enables survival of the firms” (p. 203), while guanxi at the individual level
refers to more informal personal relationships which are established with a trust-based commitment.

Moreover, ironically, although the CCP in the Maoist era abolished Confucianism, organizations and individuals still sought *guanxi* to gain benefits. For example, some empirical studies found that *guanxi* benefited companies’ competitive positions and enabled companies to survive, especially when resources are scarce (Park and Luo, 2001; Qin, 2011). Tian (2000) argued that state-owned enterprises (SOEs), which had government *guanxi* in China were in a privileged position for successful production when resources were scarce after the war, because SOEs depending on *guanxi* ties to governments could gain more resources compared to private companies. Moreover, before Chinese economic reforms, at the individual level, all the family was proud of and depended on a family member who worked in a SOE, because jobs in SOEs were called the ‘Iron Rice Bowl’. If a parent worked in a SOE, his son or daughter could get a position in the SOE when the parent retired, by an arrangement called ‘ding ti’ (顶替 take over). In addition, when China implemented the planned economy, people bought food using *Liang Piao* (粮票 ration tickets). If *Liang Piao* ran out, the family would starve. However, if a family member or a close friend worked in a food supply centre which was an SOE, family and friends would get the benefits of more food. Moreover, girls wanted to marry men who worked in SOEs rather than men with their own businesses, the SOE employee had a stable income. This kind view of marriage changed after the enterprise reforms. But in any case, both organizations and individuals still went underground and looked for *guanxi* to get own benefits in the Maoist era. People underground looked for *guanxi*
because of the limitation of political factors. People called seeking *guanxi* as ‘*zou hou men*’ (走后门 getting in by the back door), which was dishonourable behaviour.

However, since the implementation of Chinese economic reforms in the late 1970s, looking for *guanxi* among people and organizations is no longer underground. The state looks at the rapid economic recovery and individuals look at earning more and enjoying more benefits. Consequently, successfully looking for *guanxi* determines the success of individuals in the current society, because people still remember that *guanxi* brought extra benefits in the Maoist era and was called “*zou hou men*” (走后门 getting in by the back door). However, the difference is that today people do not feel that seeking *guanxi* is dishonourable behaviour, and they gloss over seeking *guanxi* as seeking ‘*ren mai*’ (in Chinese: 人脉).

### 5.3.6 Unique *guanxi* environment in China

*Guanxi* is one of the most important aspects of Chinese culture and is embedded in social and business activities. However, *guanxi* is different to social networking in the western world. To understand *guanxi* requires understanding of conceptions of the world and the cognitive processes. According to Nisbett and Masuda (2003), the ancient Chinese saw matter as interpenetrating substances. As a Chinese old saying states, “万物有因，世事有果” (where there is reek, there is heat), which means all occurrences must have reasons and everything is related. In addition, Nisbett and Masuda (2003) stated that the ancient Chinese attended to relationships among objects. For example, in China, when people see a child they normally ask her or him who her or his father is. People judge the child’s character according to the father’s
character. Similarly, if the child does something wrong, people usually blame his parents for not disciplining and educating the child well. Chinese people’s belief that everything is related might be due to the social system, that China is a relationship-oriented society. Nisbett and Masuda (2003) stated that in Chinese society, people “were engaged in multiple, complex role relations with other individuals, with the extended family, the village, and the representatives of the state” (p. 11163).

Guanxi also organizes social activities. To build guanxi, Berger et al (2015) argued that guanxi includes three constructs: Gangqing, Renqing, and Xinren. Firstly, gangqing refers to feelings of loyalty and harmony. In China, there is a common practice whereby many things are resolved in restaurants that supply private informal environments to promote and establish gangqing. When Chinese people have a meeting for work-related matters they do not directly start to talk about work and working payments. In contrast, they talk about irrelevant things, common acquaintances, hometown, and personal interests. This kind of small talk builds up both sides’ common topics and interests. It can be reflected in a Chinese old saying: “酒逢知己千杯少，话不投机半句多” (A thousand cups seem still less when friends drink together, but even a word is redundant when conversation is not congenial.).

Moreover, the Chinese people do not directly negotiate working payments, because there is another old saying: “谈钱伤感情” (Talking about money hurts feelings). It does not mean that they do not care about payments. In contrast, they believe when gangqing is ripe, payments are assured. Gangqing is built up in a harmonious environment. Chinese culture encourages individuals to compromise with others in order to maintain harmony, particularly when conflicts of interests occur. Maintaining harmony not only keeps good guanxi, but also gives others face.
Payments refer to one side losing money while the other side gains money, which is a sensitive topic in China. However, if both sides build up good ganqing, when one side gives an offer, the other side finds it difficult to say ‘no’. That is because they need to maintain a harmonious relationship. This is also called giving face (gei mianzi). Of course, in China, there are people who do not give face to others. They break up the harmony of relationships, and will find it difficult to ‘survive’ in Chinese social activities. These kinds of people are seen as lacking sophistication.

In addition, to build up a good ganqing, people are likely to call each other brothers and sisters when they are not actual relatives because this makes individuals feel close and loyal. This feeling may derive from the ancient Chinese societies that were constructed on the basis of familiar collectivism. However, in contemporary Chinese society, real familial relations cannot satisfy all people’s social activities, while this kind of fake familial terms may expand people’s relationships. For example, when an employee calls a manager or supervisor ‘older brother/sister’ or ‘teacher’, this kind of emotional bond makes both of them feel close and means the manager or supervisor is respected in a hierarchical relationship. From other employees’ point of view, this employee has a good ganqing with the manager or supervisor. As such, Chinese people attach great importance to ganqing in the process of building guanxi. In other words, building up good ganqing is a good start to building up guanxi.

Secondly, renqing means to create commitment through beneficial and reciprocal exchanges. Beneficial exchanges maintain guanxi in contemporary Chinese society, and guanxi is subtly different to friendship. The meaning of guanxi between friends in original Confucianism has changed in contemporary Chinese society. The original
Confucian philosophy required friendship to be built on emotional honesty rather than beneficial exchanges, as in: “君子之交淡如水，小人之交甘若醴” (The friendship between men of virtue is light like water, yet affectionate; the friendship between men without virtue is sweet like wine, yet easily broken). However, in the contemporary context of China, people normally build up guanxi because they aim to get beneficial exchanges, especially in working environments. As a foreigner, it may be difficult to understand sometimes a person gives a gift of greater value than a favour merits. That is because in China people like others to owe them favours as personal assets that can be received in the future. As such, renqing is not just a one off favour exchange. Guanxi is a long term relationship. In other words, maintaining guanxi relies on continuing beneficial exchanges.

Thirdly, xinren means trust and is a foundation of guanxi. As guanxi is a long term relationship, favour exchanges need trust. If there is no trust in guanxi, guanxi is easy to break. Trust is also derived from the Chinese social system. In Chinese society, people “were engaged in multiple, complex role relations with other individuals, with the extended family, the village, and the representatives of the state” (Nisbett and Masuda, 2003, p.11163). Chinese societies are constructed on the basis of familial collectivism. The family is considered to be the core unit of society. As it is built on family relations, interpersonal trust is beyond any other trust. As such, in the ancient business environment, most business operated as small family businesses. In fact, the trust in familial relations still has great emphasis in Chinese modern societies. For example, in Chinese private companies, many accountants have familial relations with the boss. That is because the accountant controls the money of the company and means the accountant holds the wallet of the boss. In such a situation, the boss needs
to find a person who can be sufficiently trusted to be the accountant. The trust in familial relations is normally prioritised, because the concept of family is important for Chinese people. There is an old saying: “打断骨头连着筋” (Brothers are by flesh even if our bones are broken). That means conflicts among family members are smaller matters than conflicts outside the family.

In addition, the treatment of princelings of Chinese private equity also reflects that the trust within family is beyond any other trust. Princelings are “children of former high-ranking officials of the CCP” (the Chinese Communist Party) (Bo, 2008, p.342). For example, Jiang Zemin was China’s chairman from 1993 to 2003, and his son, Jiang Mianheng, is CEO of Shanghai government investment vehicle Shanghai Alliance Investment (Aldred and Liu, 2014, p.2), which is one of Shanghai’s largest state-owned enterprises. Jiang Zemin’s grandson, Alvin Jiang, is a founding partner at Hong Kong-based Boyu Capital which is one of the famous firms in China (Aldred and Liu, 2014, p.2). Liu Lefei is CEO and president of CITIC Private Equity Funds Management, who is the son of politburo member Liu Yunshan (Aldred and Liu, 2014, p.3). He Guoqiang’s Son, He Jintao, is co-founder of Nepoch Capital (Aldred and Liu, 2014, p.3). Li Xiaolin is CEO of China Electricity, and his father is former Premier Li Peng. This kind of family relations reflects China’s unique guanxi, including ‘blood is thicker than water’.

In fact, trusting family members above all others reflects Chinese people’s lack of security. Although people use the appellation of fake family relations to promote ganqing in order to gain trust from others, in modern Chinese society, guanxi is based on favour exchanges that may cause one side to obtain more benefits than the
other side if one side does not give any favours. *Guanxi* is an informal relationship which is not the same as contracts that are protected by laws. However, in modern Chinese society, only family relationships do not satisfy people’s social activities. Therefore, people need to not only keep commitments for favour exchanges but also maintain a harmonious environment and provide face-giving in order to maintain a healthy *guanxi*.

5.4 An analysis of individuals’ behaviours changing in the mixed moderate solidarities

Although individuals are in the same social environment, they may be located in different positions in the grid-group frame because of their different cognition styles. 6 (2005) stated that “at least some and perhaps many individuals in almost any society are likely to be located in different solidarities in different contexts. Few people can expect to live lives of total consistency between all the contexts of home, work, leisure, local community of residence, religious and political affiliations, etc…cognition styles will differ between contexts for many individuals” (p. 102). For example, institutional activities, such as Chinese enterprise reform, have different impacts on individuals and organizations, such as laid-off workers and auditors. Different individuals under the impact of institutional changes may locate themselves in different places of the grid-group frame in the same social environment.

5.4.1 Laid-off workers

The enterprise reform was almost completed by 2004, but the influence of this reform is still being felt in China (Gomersall and Wang, 2013). Although this reform made Chinese SOEs improve their management and become more efficient in a
global marketplace, laid-off workers were the sacrifice of this reform, because few or none of the benefits or security was provided for workers that the previous state system had provided (Gomersall and Wang, 2013). Workers were protected by their SOEs before the enterprise reform, and their jobs were guaranteed by a system of job allocation across the workforce (Dong and Bowles, 2002; Guiheux, 2007, cited from Gomersall and Wang, 2013). Such benefits from SOEs were known as the ‘Iron Rice Bowl’ since workers at a SOE would never lose their job.

However, with the enterprise reform accelerating the transition to a market economy, the ‘Iron Rice Bowl’ has gone, and thousands of workers have lost their jobs (Gomersall and Wang, 2013). “To restructure its SOE sector, the Chinese central government institutionalized the policy of: ‘nurturing the big, while letting go of the small’” (Gomersall and Wang, 2013, p. 221). The concept of being ‘laid-off’ first happened in Guangdong. In 1993, the Guangzhou state-owned radio factory laid off 1000 workers, to avoid bankruptcy (Guoqi, 2013; Wu, 2008). During the period between 1996 and 2001, approximately 40% of SOEs were lost. The increasing number of laid-off workers was concentrated in the wholesale and retail-trading sectors, the manufacturing industry and mineral mining, which were predominantly in north-east China where there is a high concentration of SOEs (Gomersall and Wang, 2013). In south coastal regions, laid-off workers generally could accept this reform, because in this region people already had the opportunity for a ‘second career’. The laid-off compensation could become their start-up capital for a small business. However, in the north, especially in the region with a high concentration of SOEs, people have become accustomed to bundling their lives with the enterprises. With the collapse of the SOEs, people suffered low compensation.
Hurst (2004) found different views and acceptance of laid-off workers in four main regions of SOEs: the Northeast (Liaoning, Jilin, and Heilongjiang), North-Central China (the provinces of Henan, Shanxi, and Shaanxi, plus the cities of Baotou and Lanzhou), the Central Coast (Tianjin, Shandong, Jiangsu, and Shanghai), and the Upper Changjiang (Hubei, Hunan, Chongqing, and Sichuan) (see Figure 5). The Northeast has been the Chinese industrial base since the Japanese occupation during the Second World War, with the principle sectors of steel, railroad equipment, mining, and petroleum (Hurst, 2004). Although Chinese economic reforms were implemented in the late 1970s, the Northeast old industrial base lost out at every stage of Chinese transition to a market-based economy (Hurst, 2004).

Compared with the Northeast, the Central Coast started to industrialize rapidly in the 1950s. With a massive influx of foreign investment, the Central Coast became one of China’s richest regions, with the largest centres of trade and commerce, and the majority of ports of entry (Hurst, 2004).

Coal mining is a pillar industry in the North-Central economy, as well as manufacture of agricultural machinery and light industrial goods. The economy of the North-Central had a tentative transition, since economic reform did not fail as in the Northeast (Hurst, 2004).
Figure 5: Chinese map – four main regions with SOEs

Note: the red color on the map represents the Northeast. The orange color represents the North-Central China. The blue color represents the Central Coast. The Green color represents the Upper Changjiang (Hurst, 2004).
Upper Changjiang also has a political economy of tentative transition. Industries in the Upper Changjiang are mainly related to textile, mining, steel, machine building, and some light manufacture (Hurst, 2004).

Hurst (2004) stated that since the implementation of economic reform, the Central Coast had rapidly developed into a booming market; both the North-Central and Upper Changjiang regions had stayed in a tentative transition; the Northeast, instead of pressing forward, had drawn back in political economic collapse (or near collapse) (see Table 4).

Due to regional differences in the results of economic reforms, there are different views of workers laid-off by enterprise reform, according to interviews by Hurst (2004). The interviewees who were laid-off in the Northeast complained that:

“Reform has brought nothing but problems. Political reforms have taken away rights from the people and undermined the revolution’s victories…Even the Japanese managed things in the Northeast better than today’s government. Managers and officials are all corrupt nowadays and they get away with everything… The Northeast is dying and the Communist Party does not care about socialism anymore. During the planned economy we were all poor. But we were poor together. We were all proletarians. We all ate the food from the common pot. Now, the rich people get richer while we all get poorer. The special characteristic of Chinese socialism is that it is especially unfair!” (Hurst, 2004, pp. 103-104)
<table>
<thead>
<tr>
<th>Regional political economy</th>
<th>Primary type of grievances</th>
<th>Primary type of claims</th>
<th>Political dominant frame</th>
<th>Opportunity structure</th>
<th>Overt target</th>
<th>Hidden target</th>
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<tr>
<td>Stalinist Rustbelt (Northeast)</td>
<td>Subsistence</td>
<td>General, Subsistence, Restorative Maoist moral economy</td>
<td>Relatively open/ sympathetic</td>
<td>Local government</td>
<td>Central state</td>
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<tr>
<td>Tentative transitional</td>
<td>Opportunity</td>
<td>Specific, Opportunity, Regulatory Head down &amp; muddle through</td>
<td>Relatively closed</td>
<td>Local government</td>
<td>Local state, corrupt officials</td>
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<tr>
<td>(Upper Changjiang and North-Central)</td>
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<tr>
<td>Booming market (Central Coast)</td>
<td>Contractual</td>
<td>Specific, Legalistic enforcement Market hegemony Malleable</td>
<td>Firms or local government Firms</td>
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In contrast, in the Central Coast, laid-off workers blamed individual mismanagement (an inability to adapt to new conditions) and corruption only in particular firms. One of the laid-off workers in Shanghai claimed that since economic reform, her family had a television, refrigerator, and air conditioner, which were impossible luxuries in the 1970s. She also said that “protesting would not be worth the trouble and that her problems were probably unique to her experience (or at least to her work unit)” (Hurst, 2004, pp. 104-105).

Although the North-Central and Upper Changjiang regions belong to a middle category of tentative transition between the Northeast and the Central Coast, laid-off workers in the these two regions generally keep quiet as long as they can find temporary work because of the benefits of working combined with threats of repression and lost income (Hurst, 2004). One of the laid-off workers in Chongqing said:

“Protest is of no use for us laid-off workers. No one ever gets anything from stirring up trouble and people like me can’t stop working and go protest. We have to feed our children” (Hurst, 2004, p.105)

Another laid-off worker in Datong in Shanxi province had a similar view:

“I am afraid of what would happen if I were caught protesting. Some of my co-workers from the mine have protested violently and have been arrested. I am able to find enough work around town to feed my family, but I have no health insurance or pension. If I get in trouble, I don’t know what would happen” (Hurst, 2004, p.105)

To sum up, due to regional differences among Chinese political policies, there are different views on Chinese economic reform. Laid-off workers in different regions
lost their ‘Iron Rice Bowl’ and never felt their national ‘host’ position, compared to the Maoist period. As such, the strong group moved to the relatively weak group from laid-off workers’ perspective.

However, the grid dimension has different degrees among Chinese regions. Since the implementation of Chinese economic reform, the Central Coast has been the frontline border, where the market encourages individuals to have more freedom of competition and choice. Thus, there is more individualism in the Central Coast. Laid-off workers in the Central Coast blamed themselves for mismanagement and positively look for a second career. In contrast, the Northeast lost out at every stage of China’s transition to a market-based economy and has maintained a highly regulated system. Thus, there is more a culture of isolates in the Northeast. Laid-off workers in the Northeast felt frustrated and did not feel part of a community. They blamed institutional changes but also accepted their fate. The North-Central and Upper Changjiang regions have stayed in a tentative transition, where there is a moderate solidarity between the Central Coast and the Northeast cultures. Laid-off workers in these two regions had less complaint about institutions but looked for working opportunities and felt their lives were under pressure.

Moreover, the Central Coast is the frontline border of the implementation of Chinese economic reform. Here rules of the market-oriented economy were established at the beginning of China’s economic reform, and a more individualism thought style has been cultivated. As such, under this kind of thought style, laid-off workers positively reinforced the new form of institutions.
In contrast, the Northeast lost out at every stage of Chinese transition to a market-based economy. The old hierarchical culture (the old thought style) still remained in this region. However, a new institution (the enterprise reform) enacted a new interaction order (workers getting laid off) which cultivated a new thought style (market-oriented economic thought). The new thought style conflicts with the old thought style. It was difficult for laid-off workers to reinforce the new institution in the Northeast. As such, there were a lot of complaints in the Northeast.

The North-Central and Upper Changjiang regions have stayed in a tentative transition in that the new institution was cultivating a new thought style, but the old thought style was also maintained. Thus, in these regions, the new thought style reinforced the institution, while the old thought style was undermining the offsetting of the institution. Laid-off workers had complaints about the new institution, but also looked for job opportunities.

5.4.2 Chinese supervisors and independent directors in the Chinese State-owned enterprises

Before the enterprise reform of the early 1980s, most Chinese companies were state-owned enterprises (SOEs) that were administered by either the central government or local governments. During that time, China’s market implemented a planned economy and the central government allocated national resources. The SOEs were placed in a hierarchical culture (strong grid-strong group).

Chinese enterprise reform was initiated in May 1984 to expand SOEs’ autonomy in production planning and profit retention (Kang and Kim, 2012). In July 1992, SOEs
were allowed to set their own prices and wages, hire and fire employees, and invest fixed capital (Kang and Kim, 2012). The completion of the first enterprise reform saw the adoption of the Company Law in December 1993, which provided a legal framework for SOEs to clarify property rights. This was a landmark for Chinese enterprise reform, seeing the separation of ownership from management in SOEs.

SOEs became less related to government which means becoming more independent, compared to before enterprise reform. In SOEs, the hierarchical culture (strong grid-strong group) moved to the culture of ‘moderate individualists’. Why did SOEs move to a culture of ‘moderate individualists’ rather than a culture of ‘individualists’? Because Party organizations are set up in Chinese enterprises to strengthen the Chinese Communist Party’s (CCP) position of highest leadership in the country.

Chinese SOEs are operated under the dual leadership of the state and the CCP. On the state side, the State-owned Assets Supervision and Administration Commission (SASAC) play a role as ultimate owner (Yu, 2013). On the party side, the Organization Department “selects and appoints firms’ top executives, evaluates their performance, gives them incentives, and oversees their work” (Yu, 2013, p. 384). This kind of corporate structure is to ensure SOEs respond to policy signals from the CCP.

The leadership of Chinese SOEs has been controlled by the Chinese Communist Party (CCP) since the founding of the People’s Republic of China. Since the enterprise reforms in the early 1980s the leadership has made ongoing efforts to
transfer SOEs’ decision making power from local party committees and the state bureaucrats to the company itself. However, transforming SOEs still allowed the interference of the party and state institutions in the corporate governance (Yu, 2013). Enterprise reform has not been able to disentangle party management from corporate governance (Yu, 2013).

Therefore, SOEs just moved to the culture of ‘moderate individualists’. In the culture of ‘moderate individualists’, internal control systems in companies need to balance their authorities and rights, which may cause their dysfunction.

During the process of Chinese enterprise reform, Chinese enterprises firstly adopted a structure of corporate governance in the 1990s which was based on the German model, including a board of directors, a board of supervisors, and managers. In Germany “supervisors are empowered to appoint and dismiss members of a managing board, as well as to represent the company in its dealings with members of the management board” (Zhou, 2011, p. 276). According to Chinese Company Law, supervisors are one part of the internal governance structure of the company, and their positions are in parallel with the board of directors. Supervisors are responsible to shareholders and perform overseeing functions, such as examining a company’s financial affairs and overseeing the conduct of directors and managers. However, supervisors’ positions and functions differ significantly between the definition in Company law and the real situation in transforming SOEs. In reality, a board of supervisors belonging to an outside agency of the State Council or provincial government, is responsible for the State Council or provincial government and supervises the status of state-owned assets. According to Company Law, supervisors
should be elected within the company’s shareholders and employees. However, in reality, supervisors are appointed by the State Council, provincial governments, autonomous regional governments, or municipal governments.

In 2001, the *Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* (the Guidelines) was announced by the China Securities Regulatory Commission, which provides the main practical rules for regulating independent directors (Zhou, 2011). In the US, UK, and under the Australian corporate governance system, independent directors provide such supervision functions. Under the independent directors, an audit committee is established. In 2002, the Code of Corporate Governance for Listed Companies introduced audit committees into Chinese listed companies (Wu and Patel, 2015). The audit committee is led by an independent director. The function of an audit committee is “recommending the engagement of the external auditor, overseeing the interaction between the internal auditor and external auditor, inspecting the company’s financial reports, and monitoring the company’s internal control system” (CSRC, 2002, cited from Wu and Patel, 2015, p. 34).

Within the corporate governance structure of Chinese listed companies, you would think that the identity and specified duties of supervisors and independent directors would prevent tunneling\(^{10}\) and earnings management fraud in order to maintain the quality of financial reporting. However, China adopted two western models, resulting in a Chinese crossing tiers corporate structure. In reality, China only adopted the names of the models. The board of directors in Chinese companies is strongly

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\(^{10}\)Tunneling is the transfer of assets and profits out of firms for the benefit of those who control them (Huang, 2016).
controlled by majority shareholders, so the companies retain a traditionally hierarchical management. Chen et al. (2009) reviewed prior studies and claimed that the average shareholding of controlling owners was 45.13% in 1088 Chinese listed companies at the end of 2000, and in state-owned holding companies controlling shareholders dominated the board of directors and the executive management team and almost 100% of the senior executives were appointed by the controlling shareholders from 1993 to 2000. From the observation of corporate governance, although China transplanted corporate governance systems from western countries, they implemented them in the Chinese way.

Moreover, the supervisors and independent directors are strongly controlled by majority shareholders, meaning internal auditors are not independent resulting in their dysfunction. A board of supervisors belongs to an outside agency of the State Council or provincial governments (majority shareholders), as well as independent directors, where the strong group form is present. Moreover, majority shareholders have the authority to appoint supervisors and independent directors. Thus, supervisors and independent directors shift their accountability from the company and all shareholders to majority shareholders, causing their dysfunction.

5.4.3 Chinese Certified Public Accountants
The Chinese financial auditing service is derived from the principal-agent relationship arising from the separation of ownership and management that occurred with enterprise reform. The Chinese CPAs Law was established in 1993 (Yang et al., 2001) and the Chinese Independent Auditing standards (中国独立审计准则) took effect in 1994 and was terminated in 2003. In 2006, the Chinese CPA
Implementation Standards (CCIS) (中国注册会计师执业准则) were issued by the CICPA (Chinese Institute of Certified Public Accountants) and approved by the MOF (Ministry of Finance). They were based on the revised content of the Chinese Independent Auditing Standards, with the aim of converging to the International Standards on Auditing (ISA). CPAs have much freedom to choose their auditing procedures. Public accounting firms in China readily provide unqualified audit reports so that they keep the engagement. Thus public accounting firms maintain the status quo of ‘only issue the audit report but do not do audit inspection’. Many auditing scandals such as in Yin Guang Xia, Amoi, and Green Land cases demonstrate the prevalence of this attitude. As such, Chinese CPAs are located in the moderately weak grid.

In the beginning, CPA firms which include accounting firms and auditing firms were established and sponsored by government bodies or government controlled institutions (Yang et al., 2001). The auditing firms were sponsored by regional audit offices, while accounting firms were controlled by the Ministry of Finance. In June 1995, the two professional bodies merged to form a new professional body named CICPA, under the direct control of the MOF (Lin and Chan, 2000). To converge to the global auditing system, from 1997, Chinese CPA firms started to disaffiliate from their sponsoring body.

Since the disaffiliation program, the Chinese CPA body has become a highly competitive industry. In 1981, the first Chinese public accounting firms was registered in Shanghai (Chong, 2008). With rapid economic growth, there has been the establishment of a number of public accounting firms. At the end of 2014, there
were 8295 public accounting firms and 99045 CPAs (Ministry of Finance of the People’s Republic of China, 2015b).

However, Chinese CPAs are located in the moderate individualist culture. This is because it is still essentially governed and regulated by the MOF. The government impacts the operation of CICPA in various ways, for example, by allowing the appointment of senior directors in CICPA who also have government positions. Sun Baohou (孙宝厚) who is vice-chairman of the Chinese Institute of Certified Public Accountants also works in the National Audit Office (CICPA, 2012a). This situation also happens at regional level institutes. For example, Zhang Shunjian (张顺建), the vice-secretary general of Anhui Institute of Certified Public Accountants, also works in the Anhui Provincial Department of Finance (The Anhui Institute of Certified Public Accountants, 2013). Many leaders in the CICPA and provincial institutes of Certified Public Accountants have governmental working experience.

Chinese CPAs are located in the moderate culture of individualist. In a highly competitive industry CPAs shift their accountability from public interests (stakeholders) to majority shareholders in order to keep the loyalty of customers. In addition, due to the effect of Chinese culture, guanxi exists between leaders in public accounting firms and government. According to interviews by Wu and Patel (2015), one of interviewees stated that:

“I should say basically the link between government and auditing firms has been cut off. It was a successful restructure. There is no longer business relationship. However, due to the
historical factor, many firm managers have some government connection, which gives them an advantage in obtaining business” (Wu and Patel, 2015, p. 187).

Moreover, according to interviews by Wu and Patel (2015), *guanxi* is important for accounting firms to obtain an audit engagement, especially in state-owned holding companies. One interviewee claimed that:

“…one large central government controlled company wanted four audit firms. They invited bidders on a 3:1 basis (three bidders compete for one project or one client) … auditors who were not familiar with the company, or with State-owned Assets Supervision and Administration Commission, had no chance of being invited… on that day we saw other auditor firms who came to bid as well. Because we were in the same circle, we knew each other. We found they already knew the evaluation criteria, which had not been disclosed in the invitation letter of bidding, because of their *guanxi* with the government authority. Also the assessment is very subjective… Now we won’t go for any bid invited by centrally controlled enterprises. We know we cannot win such a bid. Other competitors have better relationship with government authorities… Currently in the auditing industry there are lots of complaints about bidding, particularly bids invited by State-owned Assets Supervision and Administration Commission. This (unfair) situation also arises in bids organized by local State-owned Assets Supervision and Administration Commission” (Wu and Patel, 2015, p. 188).

As such, Chinese CPAs are located in the moderate culture of individualist, while also having strong group cognition with government in order to obtain audit engagements. Thus, auditors may present dysfunctional behaviour that leads to a compromise of their integrity and professionalism and a decrease of auditing quality.
5.5 Conclusion

In the context of Chinese social culture, the Chinese auditing profession adopts the international auditing standards in order to seek legitimacy in the global market. The study uses the grid-group approach to map Chinese social cultures. Due to the impact of Chinese social cultures and institutional changes, the auditors’ position shifted to a ‘moderate’ culture of the individualist position. Meanwhile, Chinese auditors’ accountability was also moved, leading them to misinterpret auditing standards in order to obtain more benefits.
CHAPTER 6 CHINESE AUDITING SYSTEM

6.1 Introduction

The auditing profession is struggling to regain public trust after high profile corporate scandals, such as Toshiba and Enron accounting scandals, which indicates problems with the quality of auditing reports on a global scale. In China, continuing instances of unexpected corporate failures and scandals where subsequent investigation shows the financial reports were misleading leads not only to disrepute of the entire audit industry, but also to a loss of faith in the profession.

There is increasing realization that auditing socially constructed since it is not only shaped by institutions but also impacted by culture. Investigating auditor independence is important to understand the contextual nature of auditing. Burchell el al. (1985) suggested that:

“Little is known of how the technical practices of accounting are tethered to the social, of how wider social forces can impinge upon and change accounting, and of how accounting itself functions in the realm of the social, influencing as well as merely reacting to it.” (Patel and Psaros, 2000, p. 314)

Therefore, this study describes the context of external auditing, including government and financial auditing. Specifically, this study examines how Chinese auditor independence has developed with the transition from a planned economy to a market economy and convergence with the global market. Firstly, this chapter discusses the establishment of Chinese auditor independence. General issues caused by culture are examined in section two. Sections three and four describe the development of government audit and explore issues of government auditor independence, respectively. Sections five and six describe the development of
financial audit and explore issues of financial auditor independence, respectively. The final section presents a conclusion.

6.2 The establishment of Chinese auditor independence and general issues caused by culture

Chinese auditing practices have existed for more than 3000 years, but during that time auditing practice was used to ensure accuracy and accountability of all the items and inventories that belonged to the emperors (Chong, 1999, cited in Chong, 2008). Since the ‘new’ China was founded in 1949, during the Mao regime (1941-1967), some scholars argued that auditing practices were suspended because of incompatibility with the socialist planned economy (Xia, 1992, cited Chong, 2008). In fact, Chinese auditing practices did exist between 1952 and 1982 with a different name, ‘fiscal supervision’ (in Chinese: 财政监察), although auditing practices were suspended twice during that period (Hu, 2011). ‘Fiscal supervision’ was first suspended between 1958 and 1961 (Hu, 2011), the period that is also called the ‘Great Leap Forward’. From 1962 ‘fiscal supervision’ institutions started to reappear across the country (Hu, 2011). ‘Fiscal supervision’ was suspended for a second time during ‘the Great Proletarian Cultural Revolution’ (1966-1976). From then until 1979 the State Council asked that ‘fiscal supervision’ institutions should reappear again (Hu, 2011). During this time, the role of ‘fiscal supervision’ institutions was similar to government auditing, that is, to maintain the financial health of the government.

In the late 1970s, with the implementation of the ‘Open’ door policy and the transition from a planned economy to a market-based economy, Chinese corporations
underwent significant changes, especially with regard to a massive influx of foreign investment (Warner, 1996) and Chinese auditing systems also changed in order to adapt to this new environment.

Before the enterprise reforms in the early 1980s, most Chinese companies were state-owned enterprises (SOEs) that were administered by either the central government or local governments. According to Kang and Kim (2012), Chinese enterprise reform was initiated to expand SOEs’ autonomy in production planning and profits retention in May 1984. In July 1992, SOEs were allowed to set their own prices and wages, hire and fire employees, and invest fixed capital (Kang and Kim, 2012). The first enterprise reform was completed by the adoption of the Company Law in December 1993, which was a landmark for Chinese enterprise reform with the separation of ownership from management in SOEs.

However, in the early stages of Chinese enterprise reform in the 1990s, the government still held the majority of shareholdings in SOEs (Yang et al., 2001; Yang et al., 2003), where “the managers of such firms were given considerable decision-making autonomy, as well as financial incentives” (Yang et al., 2003, p.57). Accounting information is often used to measure a company’s performance. Therefore, when the state-owned enterprises started to separate ownership and control, independent auditing was seen to have an important role in these agency problems\textsuperscript{11}. “The Chinese Constitution (1982) recognizes the need for independent auditing in the specific context of economic reform, and such an auditing approach

\textsuperscript{11} An agency relationship is defined as “one in which one or more persons (the principal(s)) engages another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent” (Hill and Jones, 1992).
was established under the Chinese Constitution” (Article 91 of the Constitution cited from Yang et al., 2003, p.57). Article 91 of the Chinese Constitution describes the status of auditing and supervision in China:

“The State Council shall establish an auditing body to supervise through auditing the revenue and expenditure of all departments under the State Council and of the local governments at various levels, and the revenue and expenditure of all financial and monetary organizations, enterprises and institutions of the state. Under the direction of the Premier of the State Council, the auditing body independently exercises its power of supervision through auditing in accordance with the law, subject to no interference by any other administrative organ or any public organization or individual.” (The National Audit Office of the People’s Republic of China, 2015a).

The idea of Chinese independent audit is seen as the result of Chinese economic reforms.

Due to enterprise reform and the separation of ownership, auditing has become an essential element in maintaining healthy economic development. However, continuing instances of a lack of auditor independence have drawn more and more attention from the public. Although Chinese auditing standards are continuing to be revised and converged with international auditing standards, failures in auditor independence have still occurred in recent years. Chinese auditor independence may be negatively influenced by culture and by the high competition in the auditing profession that has occurred with the transition from a planned to a market economy.

Confucian culture, deeply embedded in Chinese culture, also influences Chinese business ethics (Hwang et al., 2008). Guanxi, one of the most important factors in Confucian culture, is a medium to develop business networking between families,
friends, colleagues, and other people (Hwang and Staley, 2005; Hwang et al., 2008).

“The philosophy of Confucius stresses that individuals are not isolated entities but are a part of a large system of interdependent relationships. As such, building and managing effective relationships have been innate in the cultures of China” (Hill et al., 2002, p.358). Hwang et al. (2008) stated that “guanxi is a personal asset because one may request and receive favours; it is also a personal liability because one must repay favours” (p. 238). In a relationship-based society, social network success determines the success of the individual: “it refers to the networks of informal relationships and exchange of favours that dominate all business and social activities that occur throughout China and are strongly influenced by Chinese culture” (Hwang et al., 2008, p. 507). Why is guanxi important to Chinese people? It is because guanxi can help people reap benefits. Although similar relationships also exist in most western countries, such as ‘the old school tie’ or club affiliations or family or gentlemen’s agreement, the main difference with guanxi is the notion of obligation. Western countries generally operate a code which could described as ‘enlightened self-interest’ which carries a less fixed notion of favours being returned than does the idea of obligation under guanxi.

Guanxi is cultivated by the exchange of personalized favours (Lee et al., 2001; Pederson and Wu, 2006), while mutually beneficial and reciprocal exchange is its core (So and Walker, 2006, citied Hwang et al., 2008). Hwang and Staley (2005) stated that “such gifts strike an ethical nerve in a western society and are contrary to
at least the spirit of Sarbanes-Oxley Act\textsuperscript{12} in the U.S.” (cited Hwang et al., 2008, p. 237). \textit{Guanxi} is also contrary to the spirit of auditor independence in \textit{Chinese CPA Professional Ethical Standards}, which requires that auditors should retain independence both in form and substance.

Pederson and Wu (2006) argued that officials using their \textit{guanxi} connections practice the exchange of favours, which leads to a great deal of bureaucratic corruption. Many researchers perceived that \textit{guanxi} is associated with corruption and bribery (Lee et al., 2001; Norton, 2006; Hwang et al., 2008; Yang, 2011). In the \textit{guanxi} environment auditors seeking to keep clients may be more likely to behave in an unethical manner, which may also reduce auditor independence.

This study focuses on discussing independent auditing both in terms of government audit and financial audit. Simply, to identify differences between the government audit and financial audit are who the auditors are and who the auditees are. In government auditing, the government audit offices implement audit practices, while financial auditing is carried out by public accounting firms. Government audit offices have the responsibility to audit government invested companies and departments, and monitor the effectiveness, efficiency, and legality of state-owned enterprises and government departments (Taplin et al., 2014). Public accounting firms provide corporate auditing services to all listed companies, and non-listed companies.

\textsuperscript{12} The Sarbanes-Oxley Act is legislation passed by the U.S. Congress on July 25, 2002 (Coates IV, 2007). The Sarbanes-Oxley legislation was designed to fix auditing of U.S. public companies after a series of high-profile financial scandals that occurred in the early 2000s including Enron, Worldcom, Tyco, and others. The Sarbanes-Oxley created the Public Company Accounting Oversight Board, which is to enlist auditors to enforce existing laws against theft and fraud by corporate officers (Coates IV, 2007). The new rules were “concerning the auditor-firm relationship, auditor rotation, auditor provision of non-audit services, and corporate whistle-blowers” (Coates IV, 2007, p. 91).
6.3 The development of Chinese government audit

Although the practice of auditing has been identified as existing in China for 3000 years (Li, 1998), the present advanced government auditing system was not established until the 1980s (Yarong and Xin, 2011). The present government auditing practices are regulated through a range of auditing standards. In 1994, the Audit Law of the People’s Republic of China was established, which was enacted in 1995 (Li, 1998) and revised in 2006. And the Implementation of the Audit Law of the People’s Republic of China was promulgated in 1997 (Gong, 2009). The law and provisions provide the legal framework for government auditing in China.

6.3.1 Chinese government auditing system

The Chinese auditing system functions at both national and regional levels. The National Audit Office of the People’s Republic of China (NAO) was established in 1983 as a department of the State Council (Yang et al., 2008) and is directly under the leadership of the Premier, who organizes and administers auditing work of the whole country, and reports its work to the State Council (The National Audit Office of the People’s Republic of China, 2015b). Regional audit offices were set up at the provincial, municipal, and county levels, and are supervised under both the next higher level of audit offices and the corresponding level governments (Yang et al., 2008). For example, the municipal audit office is under the joint leadership of the provincial audit office and the municipal government. Under this joint leadership, the provincial audit office provides auditing regulatory guidance and supervision for the municipal audit offices, while the municipal government provides the operational funds and exercises personnel control. Moreover, regional audit offices execute audits on implementation budgets at the corresponding levels as well as other
government revenues and expenditures, and submit audit reports to the government at the corresponding levels and the next higher level of audit offices (The National Audit Office of the People’s Republic of China, 2015c). In 2015, there were 32 provincial audit offices, 442 municipal and 2687 county audit offices (The National Audit Office of the People’s Republic of China, 2015b). The NAO has also set up audit offices in Hong Kong and Macau.

In addition, the NAO has set up a network of resident offices in certain large cities under the direct leadership of the NAO in order to audit provincial governments, State Administration of Taxation and the Central State Treasury, branches of state monetary institutions, branches of Customs, state-owned enterprises, and key state construction projects. These undertakings are directly subordinate to departments of the State Council but are not located in Beijing (The National Audit Office of the People’s Republic of China, 2015d). For example, the principal office of the Bank of Communications in China, which is a state monetary institution, is located in Shanghai, but is subject to the central government. The regional audit office is not allowed to audit it, but the resident audit office can. The 18 resident audit offices are located in Ha’erbin, Changchun, Shenyang, Tianjin, Jinan, Zhengzhou, Wuhan, Nanjing, Changsha, Shanghai, Guangzhou, Shenzhen, Kunming, Chengdu, Xi’an, Lanzhou, Taiyuan, and Chongqing (The National Audit Office of the People’s Republic of China, 2015d). Each resident office is responsible for two or three provinces or municipalities. For example, the resident office in Nanjing is
responsible for Jiangsu and Anhui provinces. The resident office in Shanghai is responsible for Shanghai city, Zhejiang province, and Ningbo city\textsuperscript{13} (Chen, 2013).

Moreover, the NAO has also established 20 dispatched audit offices which are responsible for auditing revenues and expenditures of ministries and agencies of the State Council (The National Audit Office of the People’s Republic of China, 2015d). The details of the government auditing system are displayed in Figure 6 and Figure 7.

\textsuperscript{13} Shanghai is a municipality directly under the central government which is provincial level, while Ningbo is a city specifically designated in the state plan which means that in terms of the politics, it is a vice-provincial position governed by affiliated provincial government, while in terms of economics, it is a provincial position directly controlled by central government. In China, there are five cities specifically designated in the state plan, namely Dalian, Qingdao, Ningbo, Xiamen, and Shenzhen.
Figure 6: The political hierarchy and government audit system in China
(Yang et al., 2008, p.120)
Figure 7: The government auditing system in China (The National Audit Office of the People’s Republic of China, 2015d)

Note: There are 18 resident offices of the National Audit Office, which are located in Ha'erbin, Changchun, Shenyang, Tianjin, Jinan, Zhengzhou, Wuhan, Nanjing, Changsha, Shanghai, Guangzhou, Shenzhen, Kunming, Chengdu, Xi’an, Lanzhou, Taiyuan, and Chongqing. The resident offices are under the leadership of the NAO only.
6.3.2 Chinese government audit procedures

The procedures for government audits usually include four steps: audit planning, audit preparation, audit implementation, and conclusion of audit.

Firstly, the audit planning step requires an audit office to specify certain periods of time for auditing projects in order to ascertain objectives, missions, priorities and implementation measures (The National Audit Office of the People’s Republic of China, 2015e).

Secondly, audit offices need to form an audit team and send an audit notification to the auditee three days before audit implementation (The National Audit Office of the People’s Republic of China, 2015e). The audit notification includes the name of the audited unit, the scope and content of the audit, the time and requirements of the audited unit in order to cooperate with the audit team, and a list of names of the team leader and team members. In some special circumstances, the audit team can directly execute the audit on the strength of an audit notification with approval of the corresponding level of government (The National Audit Office of the People’s Republic of China, 2015e). According to the Implementation of the Audit Law in 2010, the special circumstances can be understood as emergency audit matters, finding that audited units were suspected of serious illegal conduct, and other situations in which it is not suitable to serve the audit notification three days before (Shenzhen Audit Office, 2010).

Thirdly, during audit implementation, auditors should collect auditing evidence through “examining accounting documents, account books, financial statements,
consulting documents and data relating to the audit matters, checking cash material objects and negotiable securities, and conducting fact-finding among the units and individuals concerned” (The National Audit Office of the People’s Republic of China, 2015e). Auditors also need to compile audit logs and audit working papers (The National Audit Office of the People’s Republic of China, 2015e).

After executing an audit, the audit team needs to solicit the auditee’s opinions before submitting their audit report to the audit office. The audit office produces the final audit report after analysing the audit team’s report and auditee’s comments (The National Audit Office of the People’s Republic of China, 2015e).

6.3.3 The content of government audit

According to the Audit Law in 2006 and the Implementation of the Audit Law in 2010, the audit institutions should carry out audit on the following objects:

“1. Budget implementation and other government revenues and expenditures at the corresponding levels;
2. Budget implementation, final accounts and other government revenues and expenditures of the departments (including the units directly subordinate to them) at the corresponding levels and of the people's governments at lower levels;
3. Financial revenues and expenditures of the State institutions as well as other public institutions using government funds;
4. Financial revenues and expenditures of the Central Bank;
5. Assets, liabilities, profits and losses of the State-owned monetary institutions and the monetary institutions where State-owned capital dominates or predominates;
6. Assets, liabilities, profits and losses of the State-owned enterprises and the enterprises with State-owned capital controlling their shares or playing a leading role;
7. Budget implementation and final accounts in respect of the construction projects fully or mainly financed by government investment;
8. Financial revenues and expenditures involving social security funds, public donations and other related funds and capital which are managed by government departments and other units authorized by the government;

9. Financial revenues and expenditures in connection with the projects for which aid or loans are provided by international organizations or governments of other countries;

10. The performance of accountabilities of the principal leading persons of local Party committees, governments, judicial organs and procuratorate organs, the principal leading persons of central and local Party and governmental departments, public institutions and people’s organizations, and the heads of state-owned enterprises.” (The National Audit Office of the People’s Republic of China, 2015c)

6.4 Issues of government audit independence

Government financial accountability is closely related to the implementation of fiscal power and the use of public economic resources. Gong (2009) stated that “at the most basic level, financial accountability in public governance denotes the obligation of financial power holders to make their policies and actions justifiable in terms of the public interest and to be held responsible for any failure to do so” (p. S7).

Financial accountability is critically important for the Chinese government because China has suffered from financial irregularities and corruption since the 1980s (Gong, 2009). For example, during the period from 1982 to 1992, the total loss in state assets reached more than ¥500 billion (Fang and Zhang, 2005; cited from Gong, 2009). Gong (2009) stated that the loss in state assets related to corruption was still drastically increasing. The Central Commission for Discipline Inspection of the Communist Party of China (2015) stated that violations and corruption were detected in 680 government offices in 2014 and 368 government offices had been investigated from 1st January to 1st August, 2015.
Government audit plays an important role in monitoring, ensuring, and appraising the accountability of government (Liu and Lin, 2012). According to Liu and Lin (2012), government audit should be the ‘immune system’ with emphasis not only on detecting irregularities and violations, but also on preventing all risks hidden in economics. In 2003, the NAO for the first time disclosed government auditing results to the public, in a campaign named ‘audit storm’, which made government auditing widely known to the public in China and around the world (Yang, et al., 2008; Liu and Lin, 2012). It not only strengthened the role of government audit, but it also promoted government transparency and accountability.

However, although ‘audit storm’ drew the public’s attention, the question is whether this government audit reform was an instrumental or symbolic adoption of the Western developed countries’ government auditing report system. If it was instrumental, why is corruption still the No.1 problem in China?

The Chinese government’s auditing system is different to that of developed Western countries, such as Australia and America. The Australian National Audit Office (ANAO) is an independent agency providing auditing services to the Parliament and public sector entities (Auditor-General Act, 1997). The American Government Accountability Office is also an independent, nonpartisan agency (U.S. Government Accountability Office, 2015).
The Chinese Government’s auditing system not only exercises auditing of
government performance and state assets\textsuperscript{14}, but it is also a part of the executive
branch of the state (Liu and Lin, 2012). This means auditors and auditees are not
completely independent, and this can be observed from two aspects: one is the
government’s auditing operation system; the other is the government’s auditing
report system.

Firstly, regional audit offices are supervised by both the next higher level of audit
office, and the corresponding level government. Under this dual leadership, the next
higher level of audit office provides regulatory guidance and supervision while the
corresponding level government provides the operational funds and exercises control
over local audit offices. In the meantime, regional audit offices execute audits on the
budget’s implementation at the corresponding levels as well as other government
revenues and expenditures. It means that local government acts not only as the
supervisee, but also as the supervisor. Moreover, the head of the local audit office is
assigned by local government and builds the relationship between local government
and local audit offices. Therefore, Chinese relationship-based culture significantly
reduces local government auditor independence.

Secondly, according to Audit Law, regional audit offices execute audit within the
budget implemented at the corresponding level as well as other government revenues
and expenditures, and submits audit reports to the government at the corresponding
levels and the next higher level of audit offices. Local government is not only the

\textsuperscript{14} At the beginning of the government audit system established in the 1980s and 1990s, auditing
activities were mainly targeted at financial problems in state-owned enterprises (Gong, 2009). However, since the late 1990s, the auditing objects have been expanded to all government offices and administrative units (Gong, 2009).
auditee but also reviews the audit report. According to government audit procedures, the audit team needs to solicit an auditee’s opinions before submitting their audit report to the audit office. The local government may significantly impact the auditing reports and bring about favourable results. Moreover, in fact any local government-owned enterprise having a good financial performance reflects favourably on the political achievements of its local government. Local government may influence the government auditing results by using the relationship between the government and the audit office, in order to show favourable political achievements, which leads to government failure on their functions (Lin and Liu, 2012). Therefore, Chinese government audit plays a more limited role than might be expected.

6.5 The development of Chinese financial audit

The Chinese auditing system in the People’s Republic of China has undergone many changes since Chinese economic reform, especially regarding the financial auditing system. In early 1983, the financial auditing service was really started in the People’s Republic of China. At the beginning CPA firms, which included accounting firms and auditing firms, had been established and sponsored by government bodies or government controlled institutions (Yang et al., 2001). The auditing firms were sponsored by regional audit offices, while accounting firms were controlled by the Ministry of Finance. For example, the Shanghai Da Hua CPA Firm was sponsored by Shanghai University of Finance and Economic which is controlled by the Ministry of Finance (Yang et al., 2001). The CICPA was founded in November 1988 (Lin and Chan, 2000, p.560) and was the first professional association established in China since 1949. In 1991, the Chinese Association of Certified Public Auditors (CACPA) was established (Lin and Chan, 2000). In June 1995, the two professional bodies
merged to form a new professional body named CICPA, under the direct control of the MOF (Lin and Chan, 2000). Yang et al. (2001) stated that “the association between accounting firms and their sponsors typically meant that the sponsoring body owned the firm, and staffs were included in the personnel of the government unit. Firm operating policy could be influenced or even controlled by the government” (p. 178).

Compared to Chinese accounting firms, “in most western countries, accounting firms and auditing firms are alike and their associated professional bodies are independent, private, and self-governed organizations not affiliated with the state” (Lin and Chan, 2000, p. 560). To converge with the global auditing system Chinese CPA firms started to disaffiliate from their sponsoring body from 1997. The CICPA is deemed as a private organization, but it is essentially governed and regulated by the MOF. The government is still able to heavily influence public accounting firms. Many leaders in the CICPA and provincial institutes of Certified Public Accountants have governmental working experience. Due to the effect of Chinese culture, guanxi may still exist between leaders and government. Therefore, it is difficult to maintain auditing independence under the influence of government. Another example of the influence of government on public accounting firms is that the establishment of a public accounting firm must be reported and approved by the provincial department of finance, but not the provincial institute of Certified Public Accountants (Ministry of Finance of the People’s Republic of China, 2015a). As such, the institute of Certified Public Accountants seems to help the government supervise public accounting firms, because many important decisions are made by the government.
In addition, although Chinese central government has allowed foreign accounting firms to operate in China since 1996, the government still has the right to supervise and govern these firms. Taplin et al. (2014) cited that

“Article 44 of the Law allows foreigners’ participation and registration in the Chinese accounting system under the principle of reciprocity: the establishment of representative office of a foreign accounting firm in China must be reported to and approved by the Finance Department of the State Council. The application for the establishment of a Sino-foreign joint venture accounting firm jointly run by a foreign accounting firm and a Chinese accounting firm must be examined and agreed upon by the department in charge of foreign economic relations and trade of the State Council or the departments as authorized by the State Council and the governments at provincial level before being reported to and approved by the Finance Department of the State Council.” (p. 315)

According to ‘The provision for the administration of representative offices of foreign accounting firms’ (“境外会计师事务所常驻代表机构管理暂行办法”) (Ministry of Finance of the People’s Republic of China, 1996) announced by the Ministry of Finance, a foreign accounting firm cannot apply to establish a representative office in China as a subsidiary of an international accounting firm. Therefore, the big-4 accounting firms operating in China are named Ernst & Young with Hua Ming, KPMG with Hua Zhen, Deloitte with Hua Yong, and PWC with Zhong Tian (Taplin et al., 2014). Although the Chinese government allows foreign accounting firms to establish representative offices providing auditing services which increase competition in the Chinese CPA industry and improve independent auditing, government regulations and supervision decreases the independence of foreign accounting firms.

15 Foreign accounting firms include Hong Kong, Macau, and Taiwan’s firms.
6.6 Issues of financial auditor independence

The Chinese CPA industry is a highly competitive industry. In 1981, the first Chinese public accounting firm was registered in Shanghai (Chong, 2008). Rapid economic growth has been accompanied by the establishment of a number of public accounting firms. Up until the end of 2014, there were 8295 public account firms and 99045 CPAs (Ministry of Finance of the People’s Republic of China, 2015b). If some public accounting firms improve the quality of service and others still maintain the status quo of “only issue the audit report but do not do audit inspection”, the market of auditing services will be greatly inclined to the latter. As long as this continues, there will be no change in the quality of audits. However, if all auditors improve the quality of their audit, companies will have no choice but to engage auditing services of ethical audit firms leading to an overall improvement of the quality of financial reports.

Retaining the loyalty of existing customers as well as attracting new customers is the anchor of a public accounting firm’s survival and growth. Public accounting firms are often threatened with dismissal by their client companies. That is because some companies will move to other firms, if the current audit firm does not satisfy the requirements of management. Therefore, public accounting firms will make compromises with their client companies in order to maintain customers. Notwithstanding, Chinese Company Law requires listed companies to issue an announcement not only when they engage the services of public accounting firms but also when they dismiss the public accounting firms. If there is no proper reason to dismiss the public accounting firms, the public accounting firms have the right to report to the Chinese Stock Supervisory Committee. This right is designed to ensure
auditor independence. However, company managers may choose to default on payment of auditing fees and to not coordinate with auditors to create difficulties in order to pressure public accounting firms to compromise with them. Thus, auditor independence may suffer different degrees of damage.

In addition, the law of the People’s Republic of China on Certified Public Accounting (CPAs Law) requires auditors to perform the following service:

“to audit the enterprise’s financial statements, to verify the enterprise’s capital contribution, to engage in the audit work of the enterprise’ merger, demerger and liquidation, and to provide professional services specified by the law and regulations” (Lin and Chan, 2000, p. 561).

However, the State Administration for Industry and Commerce of P.R. China (SAIC) announced *The reform program of the registration system – the registered capital*\(^\text{16}\) on 19\(^\text{th}\) February 2014, which officially stopped corporate annual financial report auditing\(^\text{17}\) to take effect from 1\(^\text{st}\) March 2014. The main purpose of annual financial report audits was to review whether the company had a legally registered business and whether it has an ability to continue operations. According to the State Administration for Industry and Commerce of People’s Republic of China, this regulation changed companies’ from an annual financial auditing system to an annual reporting system, with the effect that industrial and commercial annual audits are not enforceable, nor is the capital verification auditing service. The new announcement gave the initiative to companies, but it cut out much of the business of public

\(^\text{16}\) *The reform program of the registration system – the registered capital (注册资本登记制度改革方案)*

\(^\text{17}\) The following companies need annual financial audits: 1. One person limited liability companies; 2. Listed companies; 3. Finance, securities, and futures companies; 4. Engaged in the insurance, venture capital, capital verification, assessment, guarantees, real estate brokers, immigration agency, labor service intermediary companies; 5. The companies’ registered capital paid by installments have not been paid in full; 6. The companies have false registered capital, false investment, capital flight, and problems found by SAIC within 3 years.
accounting firms, especially in medium and small public accounting firms. In some small public accounting firms, there were only two or three staff, and the annual revenues were almost a hundred thousand yuan. After the implementation of this regulation, small public accounting firms nearly lost most businesses (Accounting society of China, 2014). According to deputy secretary-general of the CICPA in Zhejiang province, Wenjun Jiang, 2012 revenues of Zhejiang accounting firms were 3.8 billion yuan of which income from capital verification business was more than 200-million-yuan and accounted for approximately 5.2%. After this business was cancelled, small accounting firms that relied on income from capital verification business would face transformation or merger into other accounting firms (Accounting society of China, 2014).

According to research by Zhang (2013), there were 7780 public accounting firms in 2011. As shown in Table 4, most public accounting firms are concentrated in east and middle regions, while less accounting firms are located in the west region. In addition, most of the top 100 Chinese public accounting firms are concentrated in Beijing, Shanghai, Guangzhou, Fujian province, Zhejiang province, and Jiangsu province (Zhang, 2013). In more economically developed regions competition is more intense. When the reform program of the registration system – the registered capital was announced in 2014, competition was more intense among medium and small accounting firms due to less auditing business. These accounting firms which need to survive and develop may focus on providing non-auditing services or using personal relationships to gain auditing projects and this in turn may increase the number of potential professional ethical issues.
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</tbody>
</table>
Moreover, according to the *Chinese CPA Professional Ethical Standards – Professional Ethical Basic Standards* (中国注册会计师职业道德守则第 1 号——职业道德基本原则) (2010), No 10 in Article 3 only requires that CPAs need to keep auditor independence both in form and substance, when they provide auditing and non-auditing services, such as in verifying and consultant services (The Chinese Institute of Certified Public Accountants, 2012b). The standards do not clarify whether or not public accounting firms could provide auditing and non-auditing services to the same client. Although the purpose of providing accounting consultation is to use the CPA’s extensive management experience, accounting knowledge and resources to help customers standardize the accounting process and improve management, they also need to monitor the customers to whom they have provided non-auditing services. It is possible that the public accounting firms encourage financial report misstatement. In many Western developed countries, legislation prohibits the provision of both audit and management consulting services to the same customers. The Enron bankruptcy in the United States demonstrates this point. In 2000 Arthur Andersen received audit fees of $ 25 million from Enron, and management consulting fees of $ 27 million (Healy and Palepu, 2003). The Arthur Andersen audit team had found serious financial problems in Enron, but these issues were not disclosed in the auditing report (Fernando, 2010), because Arthur Andersen did not want to lose the client in order to earn more auditing and accounting consulting fees. In China, the revenue of public accounting firms, especially to medium and small public accounting firms is not only from auditing services but also from non-auditing services, such as verifying capital services and accounting consulting services. Therefore, it is often observed that public accounting firms
providing auditing and non-auditing services to the same client. This conflict was not only obvious in Chinese public accounting firms, but it also had potential to influence auditor independence.

6.7 Conclusion

The establishment of Chinese auditor independence followed Chinese economic reforms. Although Chinese auditing plays an important role in Chinese economic development, there exist many auditor independence issues.

The purpose of government audit is to maintain the financial health of the government and prevent all risks of irregularities and violations. However, the government auditors’ independence is significantly reduced by the government auditing political structural position and procedures. Therefore, it could be argued that the Chinese government auditing system converges with western developed countries’ auditing system, but it is largely a symbolic acceptance.

Financial auditor independence is also significantly reduced because of the heavy influence of government. In addition, the high level of competition between public accounting firms, means it is not easy to retain auditors’ independence, particularly in a social environment that emphasizes guanxi.
CHAPTER 7 CASE STUDY 1 – YIN GUANG XIA

7.1 Introduction

Guang Xia (Yinchuan) Industry Co., Ltd., referred to as ST Guang Xia securities, is listed on the Shenzhen Stock Exchange, stock code 000557. The case of Yin Guang Xia occurred between 1999 and 2000. This chapter uses Yin Guang Xia to observe whether Chinese corporate governance and public accounting firms were functioning as intended after the Chinese enterprise reform and the disaffiliation program of accounting firms.

Yin Guang Xia is the first publicly listed company in the Ningxia (Hui) Autonomous Region. Before the corporate reformation, Yin Guang Xia was a well-known and important state-owned enterprise. After corporate restructuring, Yin Guang Xia became a company limited by shares. It has a board of directors, a board of supervisors, and managers. Yin Guang Xia issued 74,000,000 shares to the public on the 26th November in 1993 when approved by the Ningxia (Hui) Autonomous Region Economic Restructuring Committee, the Chinese Ministry of Foreign Trade and Economic Cooperation and the Chinese Securities Regulatory Commission. On 28th January 1994, Yin Guang Xia was officially established. On 17th June 1994, the company’s stocks traded on the Shenzhen Stock Exchange. The company’s business scope included high-tech products development, production and sales; natural products development, processing and sales; animal breeding and plant cultivation, processing and sales; food, daily chemical products, development of wine production and sales; real estate development. Their main productions were grape planting, wine making, and wine sales.
7.2 The case story

The case story is based upon the information provided by the China Securities Regulatory Commission (2002) and Lanzhou University (2015). According to the Punishment Decision of China Securities Regulatory Commission (2002), during the period from 1998 to 2001, Yin Guang Xia conducted the cumulatively fraudulent revenues that totalled in value 1,049.626 million yuan (equal to AU$ 202.55 million), resulting in inflated profits of 771.567 million yuan (equal to AU$ 148.89 million). In 1998, Yin Guang Xia inflated the profit of 17.761 million yuan. Due to the loss of financial information of Tianjin Guang Xia\textsuperscript{18} in 1998 and previous years, the actual profit of Yin Guang Xia in 1998 could not be determined. In 1999, Yin Guang Xia inflated profit of 177.819 million yuan, where in fact they made a loss of 500.320 million yuan. In 2000, Yin Gunag Xia declared inflated profit of 567.047 million yuan, but in fact made a loss of 149.401 million yuan. During the first half year of 2001, Yin Guang Xia inflated the profit of 8.94 million yuan, but made a loss of 25.571 million yuan (China Securities Regulatory Commission, 2002).

\textsuperscript{18} Tianjin Guang Xia was a subsidiary of Yin Guang Xia.
Table 6: The fraudulent profits and the actual loss of Yin Guang Xia from 1998 to 2001 (China Securities Regulatory Commission, 2002)

<table>
<thead>
<tr>
<th>Year</th>
<th>Inflated profits (million Yuan)</th>
<th>Actual profits (million Yuan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>17.761</td>
<td>N/A</td>
</tr>
<tr>
<td>1999</td>
<td>177.819</td>
<td>500.320</td>
</tr>
<tr>
<td>2000</td>
<td>567.047</td>
<td>149.401</td>
</tr>
<tr>
<td>2001 (1~6 months)</td>
<td>8.94</td>
<td>25.571</td>
</tr>
<tr>
<td>Total</td>
<td>771.567</td>
<td>675.292</td>
</tr>
</tbody>
</table>
On November 1999, Ding Gongmin, the CFO and the secretary of the board of directors, called Dong Bo requesting him to increase the profit of each share of Tianjin Guang Xia to ¥0.8. Dong Bo was the chairman of the board of directors and CFO in Tianjin Guang Xia Company, the subsidiary company of Yin Guang Xia (Yin Guang Xia held 75% stake of Tianjin Guang Xia). Based on this requested profit benchmark, Dong Bo commenced financial fraud through raw materials purchase in 1999. Dong Bo fabricated nonexistent companies that included Beijing Rui Jie Company, Beijing Jing Tong Shang Company, Beijing Dong Feng Technical Institute, and other companies. Dong Bo contrived a story that Tianjin Guang Xia Company purchased raw material, such as ginger and cinnamon from those nonexistent companies. Dong Bo then forged the invoices of raw materials from the nonexistent companies and cheques sent these companies based on invoices, remittance slip, cheques and other financial documents obtained from the black market. In this manner, Dong Bo forged sales transactions that totalled in value of more than 199 million. To improve the fraud operation, Dong Bo asked Yan Jindai, the Chief Executive Officer (CEO) and vice chairman of the board of directors in Tianjin Guang Xia Company, to forge production records. Yan Jindai obeyed Dong Bo’s command to forge material receipts, production records, and products delivery notes and so on. Finally, Dong Bo forged the revenue, a total value of 238.986 million. In 1999, Tianjin Guang Xia used forged invoices, fake sale contracts, and forged bank cheques to inflate the profit, resulting in Yin Guang Xia’s inflated profit of 159.819 million yuan (China Securities Regulatory Commission, 2002).

In 2000, the financial fraud continued, except there was no false raw material purchase. In accordance with Ding Gongmin’s request, Dong Bo forged a false sales
contract, remittance slip, sales invoices, export declarations, and cheques from a German company. As a result, in 2000, the total reported export revenue of Tianjin Guang Xia Company was 724 million yuan. The financial report in 2000 was audited by the Shenzhen Zhong Tian Qin public accounting firm. Liu Jiarong and Xu Lingwen, the Chinese CPAs, signed an unqualified opinion report. Yin Guang Xia published the false net profit which was 417.646430 million yuan.

In 2001, in order to further improve the fraud operation, Dong Bo purchased 500 value-added tax (VAT) invoices from Tianjin Beichen State Tax Bureau via false revenue declaration. Apart from normal sales, Dong Bo sent 290 VAT invoices to Tianjin He Yuan Company which was the Tianjin Guang Xia production distribution company. These VAT invoices referred to the total value of 221.456594 million yuan, including 37.647619 million yuan tax. The company then reported that the sales largely become account receivable and eventually only paid 5 million yuan in tax. In May 2001, in order to be able to distribute interim dividends, Li Youqiang (the vice chairman of the board of directors and CEO in Yin Guang Xia Company) borrowed 150 million yuan from Shanghai Jin Er Dun Investment Company, on the false excuse of an equipment purchase for Tianjin He Yuan Company. So 150 million yuan was sent to Tianjin He Yuan’s bank account. And then Tianjin He Yuan Company sent 150 million back to Tianjin Guang Xia Company as paid account payable. After that, Tianjin Guang Xia Company transferred 125 million yuan to Yin Guang Xia Company as the subsidiary company’s profit. According to Dong Bo statements, in the fraud operation, the company seal was forged by the computer. The relationship of key players can be seen in the Figure 8. The information of fraudulent profits of Yin Guang Xia and its subsidiaries can be seen in Table 7. As
shown Table 6, Tianjin Guang Xia made false profits from 1998 to 2001, resulting in Yin Guang Xia’s inflated profit of 682.723 million yuan, and occupied 88.5% of Yin Guang Xia inflated profits.
Figure 8: The relationship of the key players in the Yin Guang Xia case
<table>
<thead>
<tr>
<th>Year</th>
<th>The information of fraudulent profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>1. Wuhan Shi Mao company, which was a subsidiary of Yin Guang Xia, cancelled a contract of selling building with Wuhan Commercial Development company in 1999, but the contract was signed in 1998. Wuhan Shi Mao did not reduce sales revenue, resulting in inflated profits of 26.904 million yuan, which inflated the profit of Yin Guang Xia accounted for 13.721 million yuan.&lt;br&gt;2. Yin Guang Xia also used allotment funds (30 million yuan) to invest Guang Xia Yinchuan Natural Products Company to receive interests in allotment funds and offset financial expenses, resulting in Yin Guang Xia inflated profits of 4.04 million yuan.</td>
</tr>
<tr>
<td>1999</td>
<td>1. Tianjin Guang Xia used forged the invoices, fake sale contracts, and forged bank notes to inflate the profit of Yin Guang Xia, amounting to 159.819 million yuan.&lt;br&gt;2. Yin Guang Xia also used allotment funds to invest Guang Xia Yinchuan Natural Products Company and He Lan Mountain Wine Company to receive interests in allotment funds and reduce financial expenses, resulting in Yin Guang Xia inflated profit of 17.64 million yuan.&lt;br&gt;3. Wuhu Guang Xia, which was another subsidiary of Yin Guang Xia, reduced costs of glass products (2.68 million yuan), cuted down interests 334,400 yuan, and increased depreciation 1.30 million yuan and other expenses 880,200 yuan, resulting in Yin Guang Xia inflated profit of 350, 980 yuan.</td>
</tr>
<tr>
<td>2000</td>
<td>1. Tianjin Guang Xia forged sales contracts, invoices, bank notes, and export declarations, resulting in Yin Guang Xia inflated profits of 522.874 million yuan.&lt;br&gt;2. Wuhu Guang Xia intentionally decreased costs of goods sold, management expenses, and operating expenses, resulting in Yin Guang Xia inflated profits of 2.774 million yuan.&lt;br&gt;3. Hai Yun cultural company, which was a subsidiary of Yin Guang Xia, forged advertising revenue of 30 million yuan, resulting in Yin Guang Xia inflated profit of 26.70 million yuan.&lt;br&gt;4. Yin Guang Xia used 104.55 million yuan of allotment funds to increase its investment into the He Lan Mountain Wine company to receive interests and offset financial expenses, resulting Yin Guang Xia inflated profit of 14.70 million yuan.</td>
</tr>
<tr>
<td>2001</td>
<td>Yin Guang Xia received the interest of allotment funds from He Lan Mountain Wine company, valued of 8.94 million yuan, and used the interest to offset financial expenses, resulting in Yin Guang Xia inflated profit of 8.94 million yuan.</td>
</tr>
<tr>
<td>(1~6 months)</td>
<td></td>
</tr>
</tbody>
</table>
7.3 An analysis of auditing failure

In 1999 and 2000, Liu Jiarong and Xu Lingwen, the CPAs in the Shenzhen Zhong Tian Qin public accounting firm, signed unqualified opinion reports. The information on auditing failure is described according to Zheng and Zhou (2004, pp.197-203) (Table 8).
Table 8: The auditing failure in Yin Guang Xia (Zheng and Zhou, 2004, pp.197-203)

<table>
<thead>
<tr>
<th>The auditing failure 1</th>
<th>When Yin Guang Xia prepared the consolidated financial statements, the associated transactions between subsidiaries were not offset, which inflated huge assets and profits values. The auditors did not discover and report the prominent fraudulence issues which violated the requirements of Chinese Independent Audit Practice Bulletin No. 5 - audited consolidated financial statements of special consideration.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The auditing failure 2</td>
<td>CPAs did not effectively implement account receivable confirmations procedures. During the audit of Tianjin Guang Xia, all the confirmation letters were sent by Tianjin Guang Xia, but the debtors were not requested to send reply mail back directly to the public accounting firm. In 2000, 14 letters had been sent by Tianjin Guang Xia, but none had been replied to. Due to the account receivable confirmations that were not verified, the auditors used alternative procedures but failed to obtain relevant external evidence such as customs report, delivery notice and notice of receipt which violated the Independent Auditing Standard No. 5 - auditing evidence and the Independent Auditing Standard No. 27 - confirmation.</td>
</tr>
<tr>
<td>The auditing failure 3</td>
<td>CPAs did not effectively implement analytical testing procedures. For example, in 2000, Yin Guang Xia’s main business revenue had substantial growth, while its electricity expenses had reduced. This unusual phenomenon were not found and reported by CPAs. In addition, the input-output ratio of lecithin production dropped significantly in 2000, compared with the ratio in 1999. The CPAs did not examine nor consult expert opinions. Instead, they chose to believe the statement of Yin Guang Xia which was that the ‘production (process) became matured’. The auditors’ behaviour violated the Independent Auditing Standard No. 11 - analytical review and the Independent Auditing Standard No. 12 - the use of expert work.</td>
</tr>
<tr>
<td>The auditing failure 4</td>
<td>The auditors did not pay serious attention to value added tax (VAT) and income tax policy disclosure which did not comply with the national tax law. The auditors did not give serious attention after collecting two different customs declarations (for example, CPA reviewed several declarations and found the ‘export number’ of each commodity was blank, which violate the basic requirement of declaration to fill overseas sales). The auditors did not collect and review important legal documents, which violate the Independent Auditing Standard No. 21 - Know audited entity’s situation, the Independent Auditing Standard No. 5 - Audit evidence, the Independent Auditing Standard No. 3 – Audit Plan, the Independent Audit Standard No. 6 - Audit Working Papers.</td>
</tr>
</tbody>
</table>

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19 Chinese Independent Audit Practice Bulletin No. 5 - audited consolidated financial statements of special consideration in Chinese is 独立审计实务公告第 5 号——合并会计报表审计的特殊考虑. This case study occurred between 1999 and 2000. During this period, the Independent Auditing Standard (独立审计准则) and Chinese Independent Audit Practice Bulletin (独立审计实务公告) were the practical guidance of CPAs.
To sum up, the auditing processes of Yin Guang Xia and Tianjin Guang Xia failed to follow the guidance of the *Independent Auditing Standard*. In reality, these kinds of phenomena are continuing to occur, but the reasons are various. For example, in order to maintain customers or to gain lucrative personal benefits, auditors may compromise with audited companies. However, sometimes it is hard for auditors to follow auditing standards. For example, according to the *Chinese CPA Implementation Standard – audit working paper* (中国注册会计师执业准则—— 审计工作底稿), an audit working paper needs to be reviewed or checked by the Chief Accountant, department managers, and project managers (called three stages review). The first stage is a detailed review. In the first stage, the project manager is responsible for making sure all audit working papers following the guidelines of regulatory requirements and for identifying problems to be amended. In the second stage, the general review, department managers are responsible for reviewing the audit procedures of material accounting accounts in audit working papers, audit adjusting events, and audit results. The second stage review is to check important matters in audit working papers, based on auditing standards and guidelines. The third review is implemented by the Chief Accountant, and is based on the result of general review. The purpose of third stage is to review the whole auditing plan, schedule, implementation, and auditing results to make sure that the auditing quality meets the requirements of auditing standards. However, in reality, the three-stage review is rarely achieved, especially in small public accounting firms. To establish partnership public accounting firms only requires two partners or more. Two partners are also only two CPAs in public accounting firms. In small public accounting firms like these, the three-stage review cannot be implemented. Thus, sometimes this kind of review system is more symbolical than real.
Moreover, according to the *Chinese CPA Implementation Standard – the communication between former and successor CPAs* (中国注册会计师执业准则——前任注册会计师和后任注册会计师的沟通), the communication with former CPAs should be started by successor CPAs, but also needs the consent of the audited company. Even though an audited company may consent to this communication, the former CPAs can still decide whether the successor could review audit working papers. Thus, in reality, in most cases this kind of communication between former and successor CPAs does not happen.

### 7.4 Institutional background and critical analysis

The case of Yin Guang Xia was disclosed in 2000. In 1999, China completed the enterprise reform and the disaffiliation program of public accounting firms. In the process of these reforms, many new concepts of corporate governance and auditing were transplanted into China. If business culture has not changed that would mean the cognition of these new concepts also remain unchanged, it would mean the transplanted law would be ineffectively enforced.

This section analyses potential issues within the enterprise reform and disaffiliation program of public accounting firms.

#### 7.4.1 The enterprise reform

Before the enterprise reforms of the early 1980s, most Chinese companies were state-owned enterprises (SOEs) that were administered by either the central government or local governments. According to Kang and Kim (2012), Chinese enterprise reform in
May 1984 was initiated to expand SOE’s autonomy in production planning and profit retention. In July 1992, SOEs were allowed to set their own prices and wages, hire and fire employees, and invest in fixed capital (Kang and Kim, 2012). The completion of the first enterprise reform saw the adoption of the Company Law in December 1993, which provided a legal framework for SOEs to clarify property rights. This was a landmark for Chinese enterprise reform, seeing the separation of ownership from management in SOEs.

However, in the early stages of Chinese enterprise reform in the 1990s, the government still held the majority of shareholdings in SOEs (Yang et al., 2001; Yang et al., 2003). For example, the Party organizations are set up in Chinese enterprises in order to strengthen the Chinese Communist Party’s (CCP) highest leadership in the whole country.

7.4.1.1 The Chinese Communist Party Structure

The Chinese Communist Party (CCP) is the party in power in China and has both central and local organizations. The Central Committee is elected by the National Party Congress for a term of five years, and leads all the work of the CCP, also representing it outside the Party (China.org.cn, 2003). The Political Bureau of the CCP Central Committee, the Standing Committee of the Political Bureau, and the General Secretary of the CCP are all elected by the Central Committee plenary. The Political Bureau and its Standing Committee exercise the functions and powers of the Central Committee (China.org.cn, 2003). The Secretariat of the Central Committee is the administrative body of the Political Bureau and its
Standing Committee (China.org.cn, 2003). The General Secretary is responsible for calling sessions of both the Political Bureau and its Standing Committee, and is in charge of the work of the Secretariat of the Central Committee (China.org.cn, 2003).

Local organizations of the CCP include congresses of various provinces, autonomous regions, municipalities directly under the Central Government, cities with districts, autonomous prefectures, counties, autonomous counties, and cities without districts as well as districts of cities which are held once every five years (China.org.cn, 2003). Grassroots organizations of the Party, where there are more than three full members of the Party, are set up in enterprises, rural villages, organizations, schools, research institutes, neighbourhoods, the People’s Liberation Army companies and other basic units (China.org.cn, 2003). (See Figure 9)
Figure 9: Party structure in China (China.org.cn, 2003)

Note: Local organizations of the CCP include congresses of various provinces, autonomous regions, municipalities directly under the Central Government, cities with districts, autonomous prefectures, counties, autonomous counties, and cities without districts as well as districts of cities (China.org.cn, 2003).

Grassroots organizations of the Party, where there are more than three full members of the Party, are set up in enterprises, rural villages, organizations, schools, research institutes, neighbourhoods, the People’s Liberation Army companies and other basic units (China.org.cn, 2003).
7.4.1.2 Party secretaries in China’s corporate governance structure

Chinese SOEs are operated under the dual leadership of the state and the CCP. On the state side, the State-owned Assets Supervision and Administration Commission (SASAC) plays a role as ultimate owner (Yu, 2013). On the party side, the Organization Department “selects and appoints firms’ top executives, evaluates their performance, gives them incentives, and oversees their work” (Yu, 2013, p. 384). This kind of corporate structure is to ensure SOEs respond to policy signals from the CCP.

Although China’s SOEs have adopted western corporate governance structures formally, in reality they create their own structure that establishes the primary organizations of the party. All types of organisations are required to establish the primary organisations of the party if they have three party members (Yu, 2013, p. 385). Over time, increasing numbers of private enterprises have established primary organizations of the party, in which a CCP member (中共党员) is selected as a party secretary (党组书记). The primary organizations of the party established are not based on the type of company (eg. SOEs or non-SOEs), but depend on whether there are at least three party members in an organization. According to statistics of the Organizing Department of the Central Committee of the CCP, by the end of 2014, there were 87.793 million CCP members in China (CPC news, 2015). By the end of 2014, there were 236,000 government branches establishing the primary organizations of the party, accounting for 99.6% of 237,000 government branches (CPC news, 2015). Out of 546,000 public institutions, 506,000 had established the

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20 Public institutions in China are invested by government and mainly perform social services such as education, science and technology, culture and health. Compared to companies, public institutions do not pursue profit and government financial investment is not for economic benefits in return.
primary organizations of the party (CPC news, 2015). In enterprises, there were 194,000 out of 213,000 SOEs and 157,900 out of 297,300 non-SOEs which had established the primary organizations of the party.

Although the purpose of establishing the primary organizations of the party is to strengthen the CCP’s highest leadership in the whole nation, the effort of the primary organizations of the party is different in SOEs and non-SOEs. In SOEs, a party secretary is powerful, because he or she serves concurrently as a chairman of the board or CEO. For example, in this case, Zhang Jisheng (张吉生) was not only the chairman of the board, but also the party secretary. As such, it is easy for the party secretary to exercise party control in a SOE. However, in non-SOEs, a party secretary normally is symbolic, since they do not interfere with the company’s operational and strategic decisions but disseminate the CCP’s principles or carry out governmental policies.

7.4.1.3 Yin Guang Xia

Guang Xia (Yinchuan) Industry Co. Ltd., formerly a SOE, issued 74,000,000 shares to Chinese society on the 26th November in 1993 after approval by the Ningxia Hui Autonomous Region Economic Restructuring Committee, the Chinese Ministry of Foreign Trade, and the Economic Cooperation and Chinese Securities Regulatory Commission. On the 28th January 1994, Yin Guang Xia was officially established and became the first publicly listed company in the Ningxia (Hui) Autonomous Region. On the 17th June 1994, the company’s stock traded on the Shenzhen Stock Exchange.
Although Chinese Company Law was announced in December 1993, providing a legal framework for SOEs to clarify property rights, the government continued to heavily relate to top directors and managers throughout the 1990s. For example, many members of the board in Yin Guang Xia were working for the government or had worked in the government. Zhang Jisheng (张吉生) was not only the Chairman of the board, but also the director of Ningxia Science and Technology Department and party secretary (宁夏科技厅厅长、党组书记). Kong Xiangping (孔祥平) was a member of the board, the head of development office, and vice CEO in Yin Guang Xia, who was also the director of the Enterprise Reform Committee of the Ningxia Autonomous Region, managing the application of the listed companies in this region. Du Yu (杜裕), the chairman of the board of supervisor, was also the head of Yinchuan Health Bureau and party secretary (银川市卫生局局长、党委书记). As such, Yin Guang Xia was heavily related to the government. Although Company Law provided the legal framework for SOEs to clarify property rights, Yin Guang Xia was still controlled by the government. Yin Guang Xia could not independently make decision because of the government’s influence.

In addition, although the enterprise reform occurred in 1990s, the adoption of the new corporate governance system was immature in China. In the view of the internal system of Yin Guang Xia, there was a board of directors, a board of supervisors, and managers (See Table 8). This structure of corporate governance in 1990s was based on the German model. In Germany, “supervisors are empowered to appoint and dismiss members of a managing board, as well as to represent the company in its dealings with members of the management board” (Zhou, 2011, p. 276). This system had never occurred in China before. People were not familiar with concepts of the
new corporate governance system. Moreover, in 2001, the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (the Guidelines) was announced by the China Securities Regulatory Commission, and provides the main practical rules for regulating independent directors (Zhou, 2011). In the US, UK, and under the Australian corporate governance system, independent directors undertake these supervision functions. According to Chinese Company Law, supervisors are one part of the internal governance structure of the company, whose positions are in parallel with the board of directors. Supervisors are responsible to shareholders and perform overseeing function, such as examining company’s financial affairs and the conduct of directors and managers. However, supervisors’ positions and functions are significantly different in the definition in Company law and in the real world in transforming SOEs. In reality, a board of supervisors belongs to an outside agency of the State Council or provincial government, who are responsible for the State Council or provincial government and supervise the status of state-owned assets. According to Company Law, supervisors should be elected within the company’s shareholders and employees. However, in reality, supervisors are appointed by the State Council, provincial governments, autonomous regional governments, or municipal governments. For example, in this case, Du Yu (杜裕), the chairman of the board of supervisor, was also the head of Yinchuan Health Bureau and party secretary (银川市卫生局局长、党委书记).

In addition, Company Law does not provide substantial right to ensure supervisors’ effective supervision. For example, compared to German company laws, Chinese Company Law does not provide supervisors with the right to dismiss members of a managing board; only a shareholders’ general meeting is given the power to elect and
dismiss members of a managing board (Zhou, 2011). Indeed, supervisors in China have often been referred to as ‘vase supervisors’ meaning they have no substantial power in companies but are more like displayed furniture. However, in Germany, “supervisors are empowered to appoint and dismiss members of a managing board, as well as to represent the company in its dealings with members of the management board” (Zhou, 2011, p. 276).
<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Government relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zhang Jisheng</td>
<td>The chairman of the board of directors</td>
<td>The director of Ningxia Science and Technology Department and party secretary</td>
</tr>
<tr>
<td>Kong Xiangping</td>
<td>A member of the board of directors, the head of development office, and the vice CEO</td>
<td>The director of the Enterprise Reform Committee of the Ningxia Autonomous Region</td>
</tr>
<tr>
<td>Wei Deyuan</td>
<td>A member of the board of directors, and the director of the secretariat</td>
<td>A member of standing committee of Ningxia Zhongning (country) and vice secretary, the prefectural governor of Long De (country) and secretary in Ningxia</td>
</tr>
<tr>
<td>Zhao Yinsheng</td>
<td>A member of the board of directors</td>
<td>The vice director of Industrial office in Ningxia Science and Technology Department, and the vice prefectural governor of Xi Ji (country) in Ningxia</td>
</tr>
<tr>
<td>Li Wei</td>
<td>A member of the board of directors</td>
<td>The General manager of the Ningxia Securities Investment Banking</td>
</tr>
<tr>
<td>Du Yu</td>
<td>The chairman of the board of supervisors</td>
<td>The head of Yinchuan Health Bureau and party secretary</td>
</tr>
<tr>
<td>Du Naiwen</td>
<td>A member of the board of supervisors</td>
<td>The head of Yinchuan Health Bureau and party secretary, and the vice director of Yinchuan Arbitration Commission</td>
</tr>
</tbody>
</table>
Moreover, supervisors’ and independent directors’ functions cross over. In other
countries’ corporate governance system, the Anglo-American model of corporate
governance is the model in which there is no a board of supervisors but independent
directors, while the German model is the model in which there is a board of supervisors in parallel with a board of directors. In the US, UK, and under the
Australian corporate governance system, independent directors take up their supervision functions. Under the independent directors, an audit committee is established. In 2002, the Code of Corporate Governance for Listed Companies introduced audit committees into Chinese listed companies (Wu and Patel, 2015). The audit committee is charged by an independent director. The function of audit committee is “recommending the engagement of the external auditor, overseeing the interaction between the internal auditor and external auditor, inspecting the company’s financial reports, and monitoring the company’s internal control system (CSRC, 2002, cited from Wu and Patel, 2015, p. 34)”. However, China adopted both two western models, resulting in a crossing tiers corporate structure. Chinese listed corporate structure can be seen in the Figure 10. Really, China only adopted the names of these institutions, and the board of directors in Chinese companies is strongly controlled by majority shareholders, so that it remains with the traditionally hierarchical management.

\footnote{In 2001, the China Securities Regulatory Commission issued the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (Zhou, 2011), which marks formally introducing the concept of independent director to China.}
Figure 10: Listed corporate structure in China

General meeting of shareholders

Board of directors

Independent director

Secretary of board

Board of directors of the company office

Managers

Vice general managers

Chief financial officer
In the 1990s, Chinese listed companies still used the traditional hierarchical management, although under a different name. That is why the government still had control of listed companies that had transformed from SOEs, such as Yin Guang Xia. In the process of the corporatization of traditional state-managed SOEs, the state still holds shares of companies, but the state is an abstract entity, not a real person. China was trying to materialise the state shareholders to appoint a legal person as the state shareholder, which resulted in a complicated relationship between the government and companies. Zhou (2011) stated that “the supervisory state and party organs at the top as ‘outsiders’ are primary in charge of appointing managers, while they lack effective check-and-balance mechanisms, such as ‘well-functioning capital markets or active monitoring by banks’, to ensure managers’ good performance” (p.276). In short, during this period, there were still existing hierarchical layers of supervision and governance in the transforming SOEs. For example, in this case, Ding Gongming was the ex-CFO and secretary of the board of directors in the parent company, Yin Guang Xia. Dong Bo was the board chairman of Tianjin Guang Xia Company which was a subsidiary company of Yin Guang Xia. The whole fraud operation was made by Ding Gongming’s request and carried out by Dong Bo. In Tianjin Guang Xia Company, Dong Bo could control the ex-CEO, Yan Jindai. Thus, in the 1990s, the adoption of a corporate governance system appears to be more symbolic than real.

This is another issue of the phenomenon of excessive insider control by self-interested managers in the early stage of enterprise reform. The aim of enterprise reform is to separate the state from the management and leave the state as just a controlling
shareholder of the enterprise in order to promote higher efficiency, enhance the profit-making capability of the company, and increase competitiveness among companies by decreasing the ability of the bureaucracy to interfere in the lawful activities of corporations (Zhou, 2011). The board of directors is like the ‘brain’ of a corporation; managers are like the ‘heart’, while the board of supervisors is like the ‘immune system’ of corporations. These changes gave managers more autonomy of daily management and the control of strategic decisions. However, these changes also made several agency problems, such as the control of the firm and the ability of majority shareholders to expropriate minority shareholders’ interests (Huang, 2016). This type of expropriation is referred to as ‘Tunneling’ (Huang, 2016). Tunneling is prevalent among Chinese listed companies because of “its relatively underdeveloped legal environment, absence of effective corporate governance, high concentration of corporate ownership, and high level of government intervention” (Huang, 2016, p.858).

7.4.1.4 The analysis of Chinese corporate governance by the Grid-Group approach

Before the enterprise reform of the early 1980s, most Chinese companies were SOEs that were administered by either the central government or local governments. During that time, China’s implemented the planned economy market. The central government allocated national resources. The SOEs were placed in the hierarchical culture as strong grid – strong group.

Chinese enterprise reform in May 1984 was initiated to expand SOE’s autonomy in production planning and profit retention (Kang and Kim, 2012). In July 1992, SOEs were allowed to set their own prices and wages, hire and fire employees, and invest in
fixed capital (Kang and Kim, 2012). The completion of the first enterprise reform saw the adoption of the Company Law in December 1993, providing a legal framework for SOEs to clarify property rights. This was a landmark for Chinese enterprise reform, seeing the separation of ownership from management in SOEs.

SOEs became less related to government which means becoming more independent, compared with the previous time of the enterprise reform. In SOEs, the hierarchical culture (strong grid-strong group) moved to the culture of ‘moderate individualists’. Why did SOEs move to the culture of ‘moderate individualists’ rather than the culture of ‘individualists’? That is because the Party organizations are set up in Chinese enterprises in order to strengthen the Chinese Communist Party’s (CCP) highest leadership in the whole country. The leadership of Chinese SOEs have been controlled by the Chinese Communist Party (CCP) since the founding of the People’s Republic of China. Since the enterprise reforms in the early 1980s the leadership has started ongoing efforts to transfer SOEs’ decision making power from local party committees and the state bureaucrats to the company itself. However, the transforming SOEs still allowed the interference of the party and state institutions in the corporate governance to continue (Yu, 2013). The enterprise reform has not been able to disentangle party management from corporate governance (Yu, 2013).

Although Chinese enterprises adopted the structure of corporate governance during the process of the enterprise reform, such as a board of supervisors and independent directors, Chinese enterprises, in fact, adopted these names, and the board of directors is strongly controlled by majority shareholders. Chen et al. (2009) reviewed prior studies
and claimed that the average shareholding of controlling owners was 45.13% in 1088 Chinese listed companies in the end of 2000, and in the state-owned holding companies controlling shareholders dominated the board of directors and the executive management team, in which almost 100% of the senior executives were appointed by the controlling shareholders from 1993 to 2000. From the observation of corporate governance, although China transplanted corporate governance systems from western countries, this system might be implemented in a Chinese way.

The reason for the superficial adoption of western corporate governance rather than substantial acceptance of it might be because of the limitations of informal institutions – i.e. Chinese culture. China’s hierarchical culture dominated Chinese societies for a long time. As mentioned in Chapter 5, China is a relationship-oriented society, and Confucianism divided social relationships into five categories called “Wulun” (五伦). However, in the Han dynasty, these five categories of social relationships have been reconstructed as the “san gang” (三纲) that are the three cardinal guides: the monarch guides his subjects, the father guides his son, and the husband guides his wife – a form of politicized Confucianism to maintain political order. This politicized “san gang” proposed strictly hierarchical relationship in ancient Chinese societies, meaning that ‘if the monarch asked his subjects to die, the subjects must die; if a father asked the same requirement, the son must obey this order’ (in Chinese: 君要臣死，臣不得不死；父要子亡，子不得不亡). This sense of obedience continues to impact modern society. In

22 “Wulun” generalised the relationship between monarch and his subjects (Jun chen 君臣), the relationship between father and son (fu zi 父子), the relationship between younger and older brother (xiong di 兄弟), the relationship between wife and husband (fu fu 夫妇), and the relationship between friends (peng you 朋友).
context of the hierarchical culture, it is important that rules are adhered to, and that tradition and authority is respected. However, the sense of independence in independent directors and boards of supervisors is contrary to the sense of obedience. To break the old culture and accept a new institution, a new thought style needs to be cultivated. It is as Chan et al (2014) stated:

“(corporate governance) these rules were developed by the courts in the UK dating back to the eighteenth century, containing elements of both trusteeship and agency-like legal obligations. If laws are culturally neutral, and since directors’ duties have worked well in the UK in terms of receptiveness of the regulated and the effectiveness of the laws, then it should perform equally well in other jurisdictions, like China. If not, this would suggest that what the law prescribes and the manner by which cultural values guide behaviour are different.” (p.184)

As such, western regulations were introduced into China, while the Chinese government still kept a one-party dictatorship, whereby the party structure was still embedded in Chinese companies in order to keep the Chinese Communist Party’s position of highest leadership in the whole country. Although Chinese individuals have considerable freedom in terms of economic and social transformation in this kind of institutional environment the hierarchical culture could only move to a ‘moderate’ hierarchical culture. Thus, a new thought style was cultivated which might not properly reinforce the new institutional changes. In metaphorical terms, it is like drawing a tiger with a cat as a model, meaning that you would draw it catching its spirit. The substance is that it is informal institutions of culture that limit individuals’ opinions and cognition to adopt institutional changes. From the observations of the case study, it appears that the higher level officers required the lower lever officers to conduct fraud, while the lower level officers did not oppose this, which means that the sense of obedience dominated in Yin
Guang Xia. Thus, there is no expectation that a board of supervisors which could be functional.

7.4.2 The disaffiliation program of public accounting firms

Accounting information is often used to measure a company’s performance. Therefore, when state-owned enterprises started to separate ownership and control, independent auditing was seen to have an important role in solving agency problems\(^{23}\). Due to enterprise reform and the separation of ownership, auditing has become an essential part of healthy economic development. However, continuing instances of auditor independence failure has drawn more and more attention from the public. Financial auditing service began in the People’s Republic of China in early 1983. In the beginning, CPA firms, including accounting and auditing firms were established and were sponsored by government bodies or government controlled institutions (Yang et al., 2001). The auditing firms were sponsored by regional audit offices, while accounting firms were controlled by the Ministry of Finance. In June 1995, the two professional bodies merged into a new professional body named CICPA, under the direct control of the MOF (Lin and Chan, 2000).

From 1997, to converge with the global auditing system, Chinese CPA firms started to disaffiliate from their sponsoring bodies. This was because continuing instances of affiliated CPA firms’ scandals, such as Qiong Min Yuan (琼民源事件) and Hong Guang (红光事件), which led to the disrepute of the entire CPA industry. The aim of the

\(^{23}\) An agency relationship is defined as “one in which one or more persons (the principal(s)) engages another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent” (Hill and Jones, 1992).
disaffiliation program was to make the CPA firms’ financially and operationally independent (Yang et al., 2001) in order to improve the auditing quality.

The CICPA is deemed to be a private organization, but it is essentially governed and regulated by the MOF. The CICPA is required to a private organization in order to guarantee its capabilities of professional status, integrity, objectivity, and independence. However, the Chinese government is still able to heavily influence public accounting firms. For example, the government impacts the operation of CICPA in various ways such as allowing the appointment of senior directors in CICPA who also have government positions (dual appointments). Sun Baohou (孙宝厚) vice-chairman in the Chinese Institute of Certified Public Accountants also works in the National Audit Office (The Chinese Institute of Certified Public Accountants, 2012a). This situation also happens at the regional level. For example, Zhang Shunjian (张顺建), vice-secretary general of Anhui Institute of Certified Public Accountants, also works in the Anhui Provincial Department of Finance (The Anhui Institute of Certified Public Accountants, 2013). Moreover, many leaders in the CICPA and provincial institutes of Certified Public Accountants have government working experience. Although the government is still able to heavily influence public accounting firms, since the disaffiliation programme Chinese public accounting firms started to disaffiliate from their sponsoring bodies. Public accounting firms have also changed from the strong grid-strong group form to the weak grid-strong group form.
7.4.2.1 The Shenzhen Zhong Tian Qin public accounting firm

In this case, auditors did not effectively implement accounts receivable confirmation procedures. During the audit of Tianjin Guang Xia, all confirmation letters were sent by the company, but the debtors were not requested to reply by mail directly to the public accounting firm but instead they were requested to reply by mail to Tianjin Guang Xia who then handed reply mail to the CPAs. This process significantly reduced the reliability of confirmation letters. Moreover, the auditing leaders of Tianjian Guang Xia were not registered public accountants. They lacked knowledge of foreign trade and were not professionally competent, which seriously violated the *Independent Auditing Basic Standard* and the *Independent Audit Guideline No. 3 – Audit plan*\(^{24}\). In fact, in China, in the highly competitive CPA’s industry, public accounting firms encourage their employees to use their *guanxi* to find auditing projects. Whoever finds an auditing project, will be in charge of it, which means even people without qualifications are in charge of auditing projects and also become leaders of an auditing team. This is because whoever is in charge of the auditing project will get more bonuses. Due to the way auditing projects involve close relationships between auditors and auditees, the auditing process has become more symbolical than real.

\(^{24}\) For example, Article 5 in Chapter 2 of *Independent Auditing Basic Standard* states: an independent CPA should have specialized knowledge and experience, be professionally trained and have enough analysis and judgment competence. Article 7 in Chapter 2 of *Independent Audit Guideline No. 3 – Audit plan* points out that during the preparation of the audit plan, the CPA should consider the following factors: the auditing competence of the members in the audit team, audit experience, and the level of familiarity with audited entity. Article 17 in Chapter 4 the review of audit plan requires: the audit plan should be reviewed and approved by the person who is in charge of the public accounting firm. Article 18 points out: the audit plan should be reviewed as to whether the members of audit team were selected appropriately.
One may wonder why Yin Guang Xia which was a listed company in Yinchuan (in the interior region), asked the Shenzhen Zhong Tian Qin public accounting firm in Shenzhen (in the coastal region) to audit its financial reports. In China, to audit listed companies, public accounting firms must have securities and futures business qualifications. In China, there are only 40 qualified public accounting firms as of 2015. According to the Ministry of Finance of the People’s Republic of China (2015), these 40 public accounting firms are required to supply auditing services to more than 2500 listed companies. Although these public accounting firms have sub-offices in different cities some public accounting firms were amalgamated into one, the situation that whoever is in charge of auditing projects gets more bonuses creates difficulties in the management of public accounting firms. In this case, the Shenzhen Zhong Tian Qin public accounting firm was amalgamated from the Shenzhen Zhong Tian public accounting firm and the Shenzhen Tian Qin public accounting firm, but the two public accounting firms worked separately in two different places. In this case, the Shenzhen Zhong Tian public accounting firm audited Yin Guang Xia Company, but the partners of the Shenzhen Tian Qin public accounting firm even did not know the details of the auditing procedure when the Yin Guang Xia scandal was disclosed by the media.

On the other hand, the supervision of the Shenzhen Chartered Accountants Association is suspect. The Shenzhen CPA Association is supposed to supervise and inspect auditing activities of Shenzhen public accounting firms. However, the main revenue of local CPA Association depends on membership fees which are calculated from the revenue of member public accounting firms. Between 1999 and 2000, the revenue of membership fees in the Shenzhen CPA Association was around 5 million yuan, while the
membership fees of the Shenzhen Zhong Tian Qin was more than 800 thousand yuan (Jin, 2001). If the media had not disclosed the Yin Guang Xia fraud, the question is whether the Shenzhen CPA Association would have initiative inspected the auditing activities of the Shenzhen Zhong Tian Qin public accounting firm. The Shenzhen CPAs Association’s behaviour was consistent with the value of harmony which Confucianism emphasises. When one is in conflict with someone else within their social network, the first thing they have to learn is ‘forbearance’ (Lim, 2009, p. 403). The Shenzhen CPA Association gave up its professional goal that is inspection of Shenzhen public accounting firms’ auditing activities, for the prior consideration of maintaining a harmonious relationship, ultimately for its own interests.

7.4.2.2 The analysis of Chinese auditor independence using the Grid-Group approach

Public accounting firms started to disaffiliate from government sponsors and the Chinese Independent Auditing standards commenced to act in concert with enterprise reforms, although governments still heavily influenced public accounting firms. Did Chinese culture also limit the concept of auditor independence in the auditing industry? As mentioned before, Chinese CPA firms were sponsored by government bodies or government controlled institutions before the disaffiliation program. The affiliation system had played a positive influence at the beginning of the development of China’s financial auditing system, including providing office space and equipment and a guarantee of credibility by governments. However, the affiliation system also caused disruption in the CPA market. First, the establishment of affiliated CPA firms was to create extra revenues for sponsoring government agencies as the agencies would introduce auditing business to sponsored CPA firms. Second, government agencies
might directly interfere with the auditing process and the final audit opinion, because the
government agencies sponsored CPA firms in the context of Chinese culture (for
example, the sense of obedience). Therefore, before the disaffiliation program, Chinese
CPA firms were controlled by sponsoring government agencies, and most auditing
business was introduced by sponsors, presenting a strong grid and strong group form.

After the disaffiliation program, Chinese accounting firms disaffiliated from sponsoring
government bodies and the CICPA was deemed a private organisation. Now at least,
Chinese accounting firms and the CICPA are nominally independent, because they are
still governed and regulated by the MOF. In the context of Chinese culture, guanxi is
important for accounting firms to obtain audit engagements, especially in state-owned
holding companies. According to one of Wu and Patel’s interviewees (2015):

“I should say basically the link between government and auditing firms has been cut off. It was a
successful restructure. There is no longer business relationship. However, due to the historical
factor, many firm managers have some government connection, which gives them an advantage in
obtaining business” (Wu and Patel, 2015, p. 187).

Another interviewee claimed that

“…one large central government controlled company wanted four audit firms. They invited bidders
on a 3:1 basis (three bidders compete for one project or one client) … auditors who were not
familiar with the company, or with State-owned Assets Supervision and Administration
Commission, had no chance of being invited… on that day we saw other auditor firms who came to
bid as well. Because we were in the same circle, we knew each other. We found they already knew
the evaluation criteria, which had not been disclosed in the invitation letter of bidding, because of
their guanxi with the government authority. Also the assessment is very subjective… Now we
won’t go for any bid invited by centrally controlled enterprises. We know we cannot win such a bid. Other competitors have better relationship with government authorities… Currently in the auditing industry there are lots of complaints about bidding, particularly bids invited by State-owned Assets Supervision and Administration Commission. This (unfair) situation also arises in bids organized by local State-owned Assets Supervision and Administration Commission” (Wu and Patel, 2015, p. 188).

Thus, Chinese CPAs are located in the ‘moderate’ culture of individualist, while also having strong group cognition with government in order to obtain audit engagements.

Another question is whether Chinese auditors understand why the independence is important for them. In China, the demand for auditing service does not come from shareholders, but is due to the requirements of government supervision and management, such as capital verification of enterprises, annual inspection of SOEs, auditing financial statements of foreign-invested enterprises, and annual inspection of foreign exchange. Audited companies would draw more attention to whether satisfy the requirement of governmental regulations, while is not due to the principal-agent relationship arising from the separation of ownership and management. As it is, auditors are more concerned with whether they can obtain auditing business.

Therefore, although the disaffiliation program has been implemented, Chinese auditors may not cultivate the notion of independence. In addition, Chinese culture, especially guanxi and a sense of obedience, also impacts on auditor independence. Although Chinese CPAs are located in the ‘moderate’ culture of individualist, the strong group
resists the cultivation of the notion of independence. This means the disaffiliation program may not substantially improve the auditor independence.

7.5 The motivation of investigating Yin Guang Xia

The case of Yin Guang Xia occurred between 1999 and 2000, when China completed its enterprise reform and its disaffiliation program of public accounting firms. Chinese accounting and auditing standards and regulations have been continuing to converge and adapt to the international standards. For example, as will be covered in Chapter 9, the MOF announced the Chinese Accounting Standards in 2006, which were the adoption of principles-based accounting standards, by the publication of converged to the International Financial Reporting Standards (IFRSs). With the increasingly convergence to the International Standards on Auditing (ISA), the Chinese Auditing Standards has revised and developed 3 times, which were the Chinese Independent Auditing Standards (CIASs) (中国独立审计准则) (effected in 1996), the Chinese CPA Implementation Standards (CCISs) (中国注册会计师执业准则) (effected in 2007), and the Chinese Auditing Standards (CAS) (中国注册会计师审计准则) (effected in 2012).

As covered in Chapter 8 mentioned that the CSRC and MOF jointly issued a regulation of mandatory audit partner rotation. Therefore, Chinese regulators continuously issued regulations in order to improve auditor independence and the quality of accounting financial reports. However, despite the improvement of legislation in China, there are continuing instances of unexpected corporate failures and scandals, such as Amoi Electronics and Green Land, which emerged after the scandal of Yin Guang Xia was disclosed in 2000. Some may argue that professionals need to cultivate their cognitions
of new introduced institutions, which needs a period of time to adapt to the new institutions. From the observation of Chapter 8, Green Land conducted fraud from 2004 to 2010, which indicated that guanxi might still impact auditor independence. Thus, regulators were trying to improve legislation to correct for problems that occurred, while business culture, including guanxi, still resisted changes to professionals’ cognition. The cases demonstrate that Chinese culture, especially guanxi and the sense of obedience, remained unchanged and continued to impact the cultivation of the sense of independence through time. The government’s practice of continuously issuing new regulations as problems occurred may be a facile solution to this problem.

In addition, according to the Punishment Decision of China Securities Regulatory Commission (2002), Yin Guang Xia was imposed a fine of 600,000 yuan. However, 10 years later, another corporate scandal Jinlin Zixin Pharmaceutical (002118) resulted in a fine of 400,000 yuan (China Securities Regulatory Commission, 2014). Compared to the degree of damage caused by these two corporate scandals, the punishment was symbolic. As such, even after the reform had been experienced for more than three decades, the attitude to corporate scandals seems not to have changed, because although regulations and standards were formally adopted in China, culture resisted behaviour changes.

7.6 Conclusion

This chapter uses the case of Yin Guang Xia to observe whether Chinese corporate governance and public accounting firms were functioning as intended after the Chinese enterprise reform and the disaffiliation program of accounting firms. The observations
from the case study found that the transplanted western corporate structures might not be functioning as expected because China adopted two western models of corporate governance systems (the German model and the Anglo-American model), resulting in Chinese crossing tiers in the corporate structure. It might reflect the fact that China adopted only the naming protocol of these structures, such as supervisors and independent directors, leaving a company strongly controlled by majority shareholders, and remaining in traditional hierarchical management. In addition, party secretaries are embedded in Chinese corporate structures, which means that companies (especially SOEs) might not really clarify the relationship with the government after the Chinese enterprise reform. In context of Chinese culture, guanxi and hierarchical management might cause the transplanted corporate governance to be superficial.

In addition, although Chinese accounting firms disaffiliated from their sponsoring body (the government), they are still governed by the MOF, arising from the dual appointment of senior directors in the CICPA and the party secretaries. In fact, the government, as a majority shareholder in some SOEs, also governs and monitors the CICPA operations, which may risk decreasing auditor independence, because of Chinese culture. In this case, the government is both regulator and participant, and may use guanxi to gain its favourite benefits. Meanwhile, CPAs who are impacted by the government may also change their accountability to the government rather than the public interest.

Therefore, although China has adopted the international auditing standards and other regulations, it also needs to consider the Chinese cultural and institutional environments. Otherwise, these adopted regulations might not be effective.
CHAPTER 8 CASE STUDY 2 – GREEN LAND

8.1 Introduction

This is a case study of accounting fraud in Yunnan Green Land Biological Technology Co., Ltd. by shares (Green Land) (云南绿大地生物科技股份有限公司). The predecessor of Green Land, Yunnan Hekou Green Land Industry Co., Ltd. (云南河口绿大地实业有限公司), was founded in 1996. On the basis of literal interpretation, the difference between Green Land and Yunnan Hekou Green Land Industry Co., Ltd is a company limited by shares and a company with limited liability. The Companies Law of the People’s Republic of China, Article 2 states that “the term company refers to a company with limited liability or a company limited by shares incorporated within the territory of the People’s Republic of China in accordance with this law” and Article 3 states that “shareholders of a company with limited liability shall assume liability towards the company to the extent of the capital contributions subscribed respectively by them; and the shareholders of a company limited by shares shall assume liability towards the company to the extent of the shares subscribed respectively by them” (Companies Law of the People’s Republic of China, 2006, pp. 2-3). These two kinds of companies have several differences under the Chinese company law. Firstly, the number of shareholders differs. According to Article 24, “a company with limited liability shall be jointly invested in and incorporated by not more than 50 shareholders” (Companies Law of the People’s Republic of China, 2006, p.6). And also Article 59 requires that “A natural person may only make investment for the incorporation of one-person company with limited liability. Such a company may not make investment for the incorporation of a new one-person company with limited liability” (Companies Law of the People’s
Republic of China, 2006, p.14). However, Article 79 in the Chinese companies law requires “to incorporate a company limited by shares, there shall be not less than 2 but not more than 200 promoters, more than half of whom shall have their domiciles with the territory of the People’s Republic of China” (Companies Law of the People’s Republic of China, 2006, p.18). After a company has been established, the number of shareholders is no longer limited.

Secondly, according to Chinese company law, there are no requirements of registered capital for a company with limited liability. However, in the case of a company limited by shares, according to Article 90, “after payment in full of the subscription money for the shares issued, such money shall be subject to verification by the capital verification authority established according to law, which shall produce a capital verification certificate” (Companies Law of the People’s Republic of China, 2006, p.20).

Thirdly, the capital contribution certificates in the two kinds of companies are different. According to Article 32, in a company with limited liability, “after a company with limited liability is incorporated, it shall issue investment certificates to its shareholders” (Companies Law of the People’s Republic of China, 2006, p.8). However, according to Article 126, “the capital of a company limited by shares shall be divided into shares of equal value; the shares of the company shall take the form of share certificates, which are vouchers issued by the company to certify the shares held by its shareholders” (Companies Law of the People’s Republic of China, 2006, p.27).
In addition, the way of establishing the company is different. In a company with limited liability, the amount of capital contributions can only be subscribed by its shareholders. According to Article 26, “the registered capital of a company with limited liability shall be the amount of capital contributions subscribed for by all of its shareholders, as is registered with the company registration authority” (Companies Law of the People’s Republic of China, 2006, p.7). However, for companies limited by shares, according to Article 78 and Article 85,

“companies limited by shares may be incorporated by means of promotion or by means of share offer. A company incorporated by means of promotion is one incorporated by the promoters subscribing for all the shares to be issued by the company. A company incorporated by means of share offer is one incorporated by the promoters subscribing for a portion of the shares to be issued by the company, with the rest offered to the general public or to specific quarter … where a company limited by share is incorporated by means of share offer, the shares subscribed for by the promoters shall be not less than 35 percent of the total number of the shares issued by the company” (Companies Law of the People’s Republic of China, 2006, pp.18-19).

Moreover, there are differences in the publication of financial reports. According to Article 166, “a company with limited liability shall send its financial report to each of its shareholders within the time limit stipulated”, while “a company limited by shares shall, 20 days prior to the convening of the annual meeting of the shareholders general assembly, make the financial report available at the company for examination by its shareholders; and a company limited by shares that publicly issues its shares shall publicize its financial report” ” (Companies Law of the People’s Republic of China, 2006, p.34).
Figure 11: The relationship between Green Land and subsidiaries in 2007

Yunnan Hekou Green Land Industry Co., Ltd.

Yunnan Green Land Biological Technology Co. Ltd. by shares

- 90%
- 90%
- 3.03%

Chengdu Green Land Gardening Co., Ltd.
(Holding subsidiary)
Legal Representative: Yunkui Xu

Shenzhen Green Land Gardening Technology Development Co. Ltd.
(Holding subsidiary)
Legal Representative: Kaixi Jiang

Yunnan Flowers World Logistics Co. Ltd.
(Share subsidiary)
Legal Representative: Qin Duan

Kaixi Jiang: a director and CFO in Green Land (2.26% stock control)

Yunkui Xu: The secretary of the board (0% stock control)
Figure 12: The relationship of key players in Green Land case

Xuekui He: the chairman of the board of directors; in 2008, the general manager and the chairman of the board of directors

Mingxing Pang: the financial consultant of Green Land; the partner of the Sichaun Hua Yuan public accounting firm

Feng Liang: one of the 9th Issuance Examination Committee Members; the partner of the Shenzhen Peng Cheng Public accounting firm

Yunnan Hekou Green Land Industry Co., Ltd.

Xuekui He

28.63% stock control

Yunnan Green Land Biological Technology Co. Ltd. by shares

The predecessor

The partner

Sichuan Hua Yuan Public accounting firm


Xuekui He: the chairman of the board of directors; in 2008, the general manager and the chairman of the board of directors

Mingxing Pang: the financial consultant of Green Land; the partner of the Sichaun Hua Yuan public accounting firm

Feng Liang: one of the 9th Issuance Examination Committee Members; the partner of the Shenzhen Peng Cheng Public accounting firm

Zhong He Zheng Xin public accounting firm – 2008
Zhong Shen Ya Tai public accounting firm – 2009
Zhong Zhun Public accounting firm - 2010

Good working relationship

Auditing relationship
Green Land completed the shareholding reform to become a company limited by shares, and was the first registration at Yunnan Administration Bureau for Industry and Commerce on 28\textsuperscript{th} March 2001 (The report and plan of strengthened corporate governance and self-examination in Green Land, 2008, p14). Section 2 of this chapter not only discloses Green Land’s fraud accounting operations before listing, but also analyses issues in the initial public offering (IPO) process. Section 3 describes continuing fraud operations in Green Land after listing and also analyses some reasons for auditor independence failure due to the impact of Chinese guanxi. Section 4 argues that guanxi is in conflict with auditor independence and introduces Chinese mandatory audit partner rotation. Section 5 discusses the relationship between Chinese CPAs and governments in which there may be potential risks of decreasing auditor independence, and also compares the inspection system of Chinese CPAs with American ones. Section 6 analyses local governments protectionism in Green Land. Section 7 discusses the accountability of CPAs in the context of Chinese culture while Section 8 concludes the analysis of Green Land case.

8.2 An analysis of IPO process in Green Land

8.2.1 Requirements for listing

In 2007, Green Land’s stock traded on the Shenzhen Stock Exchange and it became the first listed company in the horticultural industry, and also the first listed private company in Yunnan province. Where were the requirements that needed to be met for the company’s listing? According to listing requirements of the Shenzhen Stock Exchange, a company seeking to launch an IPO and listing on the Main Board and SME
Board (a small and medium-sized enterprise) needs particular finance and accounting requirements as stated:

“(1) Its net profit has been positive for the last three financial years, with the aggregate amount exceeding RMB 30 million, and net profits shall have been calculated as the lower of the amounts before and after deducting non-recurring losses and profits;

(2) Its cumulative net cash flows from business activities for the last three financial years exceed RMB 50 million; or cumulative business income for the last three years exceeds RMB 300 million;

(3) Its total stock capital before issuance is no less than RMB 30 million;

(4) Its intangible assets (excluding land use rights, marine cultivation rights and mining rights, etc.) do not exceed 20% of net assets at the end of the latest period; and

(5) No loss has not been made up for in the latest period.” (Shenzhen Stock Exchange, 2006).

According to the IPO prospectus of Green Land in 2007, the net profits in the last three consecutive years from 2004 to 2006 were 33.421 million yuan, 37.236 million yuan, and 47.070 million yuan, respectively, which is more than 30 million yuan. In addition, the revenues from 2004 to 2006 were 146.736 million, 157.792 million, and 190.545 million, respectively, in which the accumulated revenue in these three years was 495.073 million, more than 300 million. Moreover, the net operating cash flows from 2004 to 2006 were 19.937 million, 3.349 million, and 47.517 million, respectively, in which the accumulative net operating cash flows were 70.803 million, more than 50 million. And also the intangible assets in 30th June 2007 were 84.032 million, which accounted for 18.75% of total assets (The IPO prospectus of Green Land, 2007, p.13, p.175) (See Table 10).
Table 10: selected data from Green Land’s financial reports from 2004 to the first half year of 2006 (The IPO prospectus of Green Land, 2007, p.13, p.175) (Unit: Yuan)

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<th>2004</th>
<th>2005</th>
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<td>Net profit</td>
<td>33.421 million</td>
<td>37.236 million</td>
<td>47.070 million</td>
<td>117.727 million</td>
</tr>
<tr>
<td>Revenue</td>
<td>146.736 million</td>
<td>157.792 million</td>
<td>190.545 million</td>
<td>495.073 million</td>
</tr>
<tr>
<td>Net operating cash flow</td>
<td>19.937 million</td>
<td>3.349 million</td>
<td>47.517 million</td>
<td>70.803 million</td>
</tr>
</tbody>
</table>
It appears that all requirements were met. However, in 2006, Green Land applied for a share listing, but failed. This raises the question: why did Green Land fail in 2006, yet one year later it was able to pass the IPO application? According to News.cn (2012), the reason it failed the application of listing in 2006 was that not only that the application forms were poorly filled out, but it also failed to answer questions on market research operations, market prospects, and raising funds for investment and operations. After the first application of the IPO, the applicant, Xuekui He, trained for one year, and Green Land finally succeeded in the share listing in 2007. The 2006 application failure may not have been because of a lack of professionalism. In fact, Xuekui He did not even hesitate to release some original shares to Kaixi Jiang in 2001 when asking him to be the Chief Financial Officer (CFO) and the director of Green Land (finance.ifeng.com). Kaixi Jiang had worked in the Guizhou Institute of Finance between 1985 and 1987, and also worked for the Department of Yunnan Audit between 1987 and 1996 (Green Land 2007 annual report, 2008, p.12). The record of his experience shows, Kaixi Jiang to be an expert in accounting and finance. In 2003, Kaixi Jiang introduced Xuekui He another auditing expert, Mingxing Pang. With their help, although Green Land made fraud accounting operations for listing, the different results for listing in 2006 and 2007 might be because of failure of Guanxi system in the 2006 application, which is analysed in section 8.2.3.

8.2.2 Fraud accounting operations for listing

To become a listed company Green Land committed several accounting frauds. According to the audit report of Green Land in 2011 by Shandong Zhengyuan Hexin public accounting firm (2012), there were many errors in the financial reports of Green
Land between 2004 and 2007, mainly regarding inflating assets though false contracts
(The audit report of Green Land in 2011, 2012, pp.35-36) (See Table 11).
Table 11: Selected frauds in the financial reports of Green Land between 2004 and 2007  
(The audit report of Green Land in 2011, 2012, pp.35-36)

<table>
<thead>
<tr>
<th>Fraud 1:</th>
<th>Green Land made false contracts to inflate the price of 3500 acres of land in Maming town of Malong county(^{25}) (马龙县马鸣乡), which was recorded as 31,900,000.00 yuan. However, the real cost of land was 1,700,000.00 yuan.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraud 2:</td>
<td>Green Land made false contracts to inflate the cost of land reclamation of the 3500 acres of land in Maming town of Malong county (马龙县马鸣乡), accounted for 21,240,000.00 yuan. However, the real cost of land reclamation was 4,051,272.00 yuan.</td>
</tr>
<tr>
<td>Fraud 3:</td>
<td>Green Land used false contracts to inflate the cost of irrigation system in Maming town of Malong county (马龙县马鸣乡), accounted for 7,972,000.00 yuan. However, the real cost incurred was only 7,510,820.00 yuan.</td>
</tr>
<tr>
<td>Fraud 4:</td>
<td>Green Land used false contracts to inflate the cost of a 960 acres land purchase in Jiuxian village of Malong county (马龙县旧县村), accounting for 9,002,000.00 yuan. However, the real cost of land purchase was 550,000.00 yuan.</td>
</tr>
</tbody>
</table>

\(^{25}\) Counties, townships, and villages are at different levels in the Chinese administration frame.
Evidence suggests that Green Land forged accounting records so as become a listed company. After Green Land successfully became a listed company, it issued 21 million shares of one yuan par value stock at a price of 16.49 yuan a share on 6th December 2007, which raised a total capital of 34.629 million yuan (The IPO prospectus of Green Land, 2007, p.1, p. 13). In fact, a company listed by shares needs to engage in complex processes in order to list. So how did Green Land make things look alright during the listing processes? And why did not the failed case just a year before draw the IPO review committee’s attention to Green Land’s application?

8.2.3 Listing processes

According to the listing processes provided by the Shenzhen Stock Exchange, a company limited by shares needs to engage in a complex process to be listed, which can be summarized by the following points. First, the company needs to employ intermediaries such as securities companies, public accounting firms, asset agencies, and law firms to inspect their development history, operation condition, and financial situation. Then the company and intermediaries prepare and submit the application documents to the China Security Regulatory Commission (CSRC). The CSRC will conduct a preliminary review. After the preliminary review, the application will be submitted and reviewed by the Initial Public Offering (IPO) Review Committee which consists of seven committee members from both CSRC professionals and non-CSRC experts. After reviewing the application, the committee members vote. With five or more consent votes, the application will pass the IPO review and the CSRC will grant approval to the company. Before the IPO, the company needs to disclose and publish its
summary prospectus and make an IPO announcement in the newspapers designated by the CSRC (Shenzhen Stock Exchange, 2016). The full listing processes can be seen in Appendix 8.2.

In the listing process, seven issuance examination committee members votes determine whether the issuance company can pass the IPO review, which is the key part of the listing process. The Measures of China Securities Regulatory Commission for the Issuance Examination Committee, which had been “deliberated and adopted at the 179th chairman’s meeting of China Securities Regulatory Commission on 8th May 2006, was hereby promulgated and shall come into force on 9th May 2006” (China Securities Regulatory Commission, 2006). Article 6 states: “the issuance examination committee members comprises of both CSRC professionals and non-CSRC experts, who should be appointed by the CSRC. The total of members are 25 people, including 5 CSRC professionals and 20 non-CSRC experts” (China Securities Regulatory Commission, 2006).

On 9th May 2007, the China Securities Regulatory Commission held the meeting of the establishment of the 9th Issuance Examination Committee. The 25 committee members’ names were published in the website of China Securities Regulatory Commission (China Securities Regulatory Commission, 2007a). The names can be seen in Table 12.
Table 12: The names of the 9th Issuance Examination Committee members

<table>
<thead>
<tr>
<th>Names</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The 9th Issuance Examination Committee members</strong></td>
</tr>
<tr>
<td>王志雄 Zhixiong Wang，白彦春 Yanchun Bai，白维 Wei Bai，吕苏阳 Suyang Lv，孙勇 Yong Sun，张圣怀 Shenghuai Zhang，陆军 Jun Lu，郑建彪 Jianbiao Zheng，金黎明 Liming Jin，徐珊 Shan Xu，郭洪俊 Hongjun Guo，高忻 Xin Gao，梁烽 Feng Liang，傅炳辉 Binghui Fu，温京辉 Jinghui Wen，韩厚军 Houjun Han，魏先锋 Xianfeng Wei，白英姿 Yingzi Bai，吴晓求 Xiaoqiu Wu，李旭利 Xuli Li，陈飞 Fei Chen，陈洪 Hong Chen，胡宝剑 Baojian Hu，徐林 Lin Xu，郭旭东 Xudong Guo.</td>
</tr>
</tbody>
</table>
Interestingly, among these 25 committee member, Feng Liang (梁烽) worked in Shenzhen Peng Cheng public accounting firm (Finance.sina, 2007) and since 1999, was a partner in Shenzhen Peng Cheng public accounting firm. However, prior to 2008, the Shenzhen Peng Cheng public accounting firm conducted auditing services for Green Land for seven years. The Shenzhen Peng Cheng public accounting firm was founded in 1992, which is qualified to conduct security and future-related business. In the Shenzhen Peng Cheng public accounting firm, there were 500 staff members, and of these 200 were CPAs and 50 CPAs were qualified to conduct security and future-related business.

There is a question as to whether Feng Liang (梁峰) played an important role in the listing process of Green Land.

According to the announcement of the 157th issuance examination committee working meeting in 2007, the issuance examination committee members who attended Green Land’s IPO review were Yanchun Bai (白彦春), Yong Sun (孙勇), Jun Lu (陆军), Liming Jin (金黎明), Shan Xu (徐珊), Binghui Fu (傅炳辉), and Baojian Hu (胡宝剑) (China Securities Regulatory Commission, 2007b) (see Table 13).
Table 13: issuance examination committee members who attended Green Land’s IPO review

<table>
<thead>
<tr>
<th>Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yanchun Bai (白彦春), Yong Sun (孙勇), Jun Lu (陆军), Liming Jin (金黎明), Shan Xu (徐珊), Binghui Fu (傅炳辉), and Baojian Hu (胡宝剑)</td>
</tr>
</tbody>
</table>
Feng Liang (梁峰) was not one of Green Land’s IPO examination committee members. The reason is according to No. 3 of Article 15 in *The Measures of China Securities Regulatory Commission for the Issuance Examination Committee* (China Securities Regulatory Commission, 2006), if issuance examination committee members or their working units have, in the past two years, provided sponsorship, underwriting, audit, evaluation, law, consulting, and other services to an issuance company that could interfere with their impartial performance, they should request CSRC for permission to avoid attending issuance examination committee meetings for the issuance company (China Securities Regulatory Commission, 2006). Apparently, Feng Liang complied with the rules.

However, do not forget *guanxi* in the Chinese cultural context. Du et al. (2013) found that the relation between issuance companies and issuance examination committee members (or a member’s firm) could significantly increase possibilities of passing an IPO review. In a similar vein, this study finds involvement of issuance examination committee members’ public accounting firms from the 6th to 9th Issuance Examination Committee (See Table 14).
Table 14: List and tenure of the involved public accounting firms where issuance examination committee members worked from the 6th to 9th Issuance Examination Committee (Tan et al., 2013, p.192)

<table>
<thead>
<tr>
<th>Main Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>7th</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>8th</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>9th</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>
According to records (Table 13), Shenzhen Peng Cheng public accounting firm was not formally involved in the issuance examination committee until 2007. This evidence alone cannot guarantee that Feng Liang did not play an important role in Green Land’s listing process, or that the involvement of the Shenzhen public accounting firm increased the possibility of Green Land passing its listing review.

In fact, between Green Land and the Shenzhen Peng Cheng public accounting firm, there was a complex relationship. Prior to 2008, the Shenzhen Peng Cheng public accounting firm conducted auditing services for Green Land for seven years. The Shenzhen Peng Cheng public accounting firm reported unqualified opinions on Green Land’s financial reports in 2004, 2005, 2006, and the first half year in 2007 (Green Land’s audit report, 2007, p.3). One note is that according to the sentence of the Kunming Intermediate People’s Court in 2013 (Haitong, 2013), Pang Mingxing (庞明星) as the financial consultant of Green Land was sentenced to five years imprisonment and made to pay a fine of ¥300,000 yuan (about AU$ 60,000). In addition, Pang Mingxing was a partner of the Sichuan Hua Yuan public accounting firm which was established in December 2005. However, the Sichuan Hua Yuan public accounting firm was not qualified to conduct security and future-related business, while the Shenzhen Peng Cheng public accounting firm was. Pang Mingxing had working experience in the Shenzhen Peng Cheng public accounting firm, and the two public accounting firms had a good working relationship. Between 2005 and 2007, Pang Mingxing helped Green Land falsify annual financial reports in order to list. The relationship between Green Land and public accounting firms is illustrated in Figure 13.

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Figure 13: The relationship between Green Land and public accounting firms

Green Land

He Xuekui
(The Chairman of the board)

The Shenzhen Peng Cheng public accounting firm

The Sichuan Hua Yuan public accounting firm

Pang Mingxing
(The partner)

Collusion

Cooperative partners

Working in the Shenzhen Peng Cheng before 2005

IPO Audit
Even if Pang Mingxing was not signing auditing reports in 2007 (Green Land’s audit report, 2007, p.2), according to the sentence of the Kunming Intermediate People’s Court in 2013 (Haitong, 2013) Green Land’s audit engagement was associated with a personal relationship. Thus, according to the complex relationships within the Green Land case, it might be assumed that Feng Liang used guanxi to impact the result of Green Land’s listing review, even if he did not attend the IPO review meetings for Green Land.

Moreover, the issuance examination committee members should have disaffiliated from their original firms and companies, but no laws and regulations clearly state that these firms and companies cannot provide services to issuance companies (Du et al., 2013). In this case, although Feng Liang was pro forma independent to Green Land and did not attend its issuance examination committee meetings, the question remains as to whether Feng Liang was in fact independent. Feng Liang disaffiliated his partner position in the Shenzhen Peng Cheng public accounting firm, meaning he sacrificed a higher salary to become a committee member (Du et al., 2013). That Feng Liang could get extra money after helping Green Land to list could be a possibility, especially in the context of Chinese guanxi, because guanxi is a long term relationship. Maintaining guanxi in the long term relies on continuing beneficial exchanges.

**8.3 An analysis of fraud operations after listing**

After becoming a listed company, Green Land continued to commit fraudulent accounting operations. Some fraudulent operations are listed in Table 15.
| **Fraud 1** | Green Land inflated the value of the 9000 acres of land at Maomaodong village in Yuewang town of Malong county (马龙县月
| | 望乡猫猫洞村), accounting for 83,700,000.00 yuan. In 2009, Green Land recorded allowances for assets impairment for this
| | land, accounting for 42,852,400.00 yuan. However, the real purchase cost of this land was 0.00 yuan. Green Land used false
| | contracts to inflate the cost of the irrigation system of this land, accounting for 34,380,150.00 yuan between 2007 and 2009. However, the real cost that occurred was only 8,319,850.00 yuan. |
| **Fraud 2** | Green Land inflated the purchase cost of 12,830 acres of land in Wenshan Zhou Guangnan county (文山州广南县), accounting for 104,070,550.00 yuan. However, the real cost was 6,039,950.00 yuan. |
| **Fraud 3** | At the beginning balance of 2010, the account receivable balance for Kunming Qianke Flower Company (昆明千可花卉有限公司) was 15,971,970.00 yuan and the account receivable balance for Kunming Xiaolin Gardening Company (昆明晓林园艺工程有限公司) was 10,500,000.00 yuan. Account payables for these two companies totalled 25,369,412.90 yuan at the beginning balance of 2010. All these transactions were forged by Green Land. |
| **Fraud 4** | In addition, the account payables beginning balance of 2010 comprised balances for Kunming Free Space Gardening Company (昆明自由空间园艺有限公司) 20,814.20 yuan, Kunming Dian Wen Hui Company (昆明滇文卉有限公司) 1,297,173.24 yuan, Kunming Yong Hong Gardening Company (昆明永红园艺有限公司) 2,467,987.80 yuan, Kunming Kai Jun Material Company (昆明凯珺建筑材料有限公司) 5,693,257.92 yuan, Kunming Run Lin Gardening Company (昆明润林园艺有限公司) 251,354.40 yuan, which were all forged by Green Land. |
| **Fraud 5** | On 25th August 2010, Green Land received a bank remittance from Yunnan Xiang Yang Gardening Technical Company (云南向阳园林科技有限公司) (account no.: 2035301110010000126471), accounted for 1,076,800.00 yuan. Actually, this account was opened by Green Land and this transaction did not exist at all |
There were many other accounting errors between 2007 and 2010, including inventories, raw materials, accrued payroll, and other accounting subjects. This raises another question: from 2004 to 2010, Green Land committed fraud, while it received five unqualified audit reports within 7 years. Did auditors not find any issue within the first 5 years or other reasons to impact audit opinions?
<table>
<thead>
<tr>
<th>Year</th>
<th>Name of public accounting firms</th>
<th>Auditing fees</th>
<th>Auditing opinion</th>
<th>Reasons of changing public accounting firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>Zhong He Zheng Xin</td>
<td>¥300,000</td>
<td>Unqualified opinion</td>
<td>Working arrangement of the Peng Cheng public accounting firm</td>
</tr>
<tr>
<td>2009</td>
<td>Zhong Shen Ya Tai</td>
<td>¥500,000</td>
<td>Qualified opinion</td>
<td>The Zhong He public accounting firm merged with the Tian Jian Guang Hua public accounting firm</td>
</tr>
<tr>
<td>2010</td>
<td>Zhong Zhun</td>
<td>¥500,000</td>
<td>Disclaimer Opinion</td>
<td>Working arrangement of the Zhong Shen Ya Tai public accounting firm</td>
</tr>
</tbody>
</table>
After listing, Green Land changed its public accounting firms three times in three years and each time these happened on the eve of the disclosure date of the annual report. The audit fees nearly doubled in cost after changing public accounting firms, thereby raising suspicion that Green Land may have ‘bought’ the audit opinions (Table 16).

According to the sentence of the Kunming Intermediate People’s Court in 2013 (Haitong, 2013), punishment for the Shenzhen Peng Cheng public accounting firm was to revoke the license of its securities services business, but this did not have a great impact on the partners, because the Shenzhen Peng Cheng public accounting firm had already merged into the Guofu Haohua public accounting firm in 2012. However, three other public accounting firms listed in Table 16 did not receive any punishment. This begs the question: what are the responsibilities of auditors?

According to the regulation of the Audit Engagement Letter, the company’s responsibilities are:

1. According to Accounting Law of The People's Republic of China and Regulations on Financial Reporting of Enterprises, the Company and the Company's management are responsible for the authenticity and integrality of the accounting records. Therefore, the Company's management is responsible for properly maintaining the accounting records and providing us the financial information (but not limited to accounting vouchers, books and records and other accounting information). Such records should reflect a true and fair view of the Company's financial position, operating result and cash flow.

2. It is the Company's management responsibilities to prepare the financial statements in accordance with Accounting System for Business Enterprises. Such responsibilities also include, (1) the design, establishment and maintenance of a proper internal-control system that to avoid the financial statements contain material misstatements because of frauds or mistakes;
(2) to decide and to use appropriate accounting policies; (3) to make reasonable accounting estimates. (The Chinese Institute of Certified Public Accountants, 2006)

The public accounting firm’s duties:

1. Our duties are to express our opinions to the Company’s financial statements. We will perform our audit based on the Auditing Standards of People’s Republic of China (referred hereinafter as the “PRC Auditing Standards”). The PRC Auditing Standards require us to follow the professional ethics requirements, to plan and to perform our audit, so as to obtain the necessary assurance that the financial statements are free of material misstatement.

2. Our audit comprises of performance of our audit procedures so as to obtain audit evidence in relation to the amounts on the financial statements and the related disclosures. We shall select the necessary audit procedures using our professional judgments. The audit procedures include the evaluation of the material misstatements resulting from fraud and other mistakes. When we are evaluating the inherent audit risks, we also consider internal controls relating to the compilation of financial statements, in order to decide the appropriate audit procedures. The purpose of the risk assessment is not to provide any opinion to the effectiveness of the internal controls. The audit procedures also include the evaluation on appropriateness of the adoption of the accounting policies, reasonability of accounting estimates and the evaluation of the overall financial statements presentation which are decided by the Company’s management.

3. We need to perform a reasonable audit plan and carry out our audit works which ensure us to obtain sufficient and appropriate audit evidence to have the assurance for the Company’s financial statements do not contain any material misstatement.

4. We have the responsibility to state in the auditors' report for any Company’s activities that do not follow the <Accounting System for Business Enterprises> where the Company do not adjust their financial statements in accordance with our suggestions.

5. Because of the nature and the inherent limitation of our audit tests and the inherent limitation of the internal controls, the risk of the probabilities of the existence of material misstatement after our audit still exists.

6. During our audit, if any material weakness in the internal control is noted, we might provide management suggestion letter to the Company. In our management suggestion letter, it does
not provide all probable weaknesses in the internal control or all possible remedies to the weaknesses found. The Company should evaluate the effectiveness before implementing our suggested remedies. The Company cannot disclose the management suggestion letter to any other parties without our written consent.

7. Our audit does not reduce the responsibilities of the Company and the responsibilities of the management of the Company. (The Chinese Institute of Certified Public Accountants, 2006)

Therefore, the public accounting firm’s responsibilities are based on the authenticity and integrity of the accounting records provided by the company, while the public accounting firm’s duties are placed on auditors who should comply with professional ethics requirements (including independence) properly. In addition, the *China Standard on Auditing No. 1141 – The auditor’s responsibility to consider fraud in an audit of financial statements* clearly divides responsibilities of auditors and company governance and management tiers. Article 13 states that preventing and detecting fraud is the responsibility of company governance and management layers. Article 16 requires auditors to implement auditing processes based on the *China Standard on Auditing* and to reasonably assure that there are no material misstatements in financial statements, regardless of whether the misstatement is due to fraud or errors. In fact, Article 16 does not conflict with Point 5 of the public accounting firm’s duties, because Article 16 requires auditors to *reasonably* assure there are no material misstatements, so it considers the nature and the inherent limitation of audit tests and the inherent limitation of the internal controls. Although the inherent limitation of the internal controls may limit auditors’ judgments, the process of auditing risk assessment may help auditors find risks of material misstatements. The auditing risk assessment is a process that occurs before implementing the audit. If there are material risks after completing the risk assessment, the auditor should refuse to
continue auditing. If auditors do not implement the risk assessment properly, they may not find existing miss-statements through collecting their auditing evidence. Evaluating internal controls is the auditor’s responsibility.

In the Green Land case, this raises another question: whether there were no issues within Green Land corporate governance or whether auditors had difficulty in finding potential risks within Green Land’s internal control. In fact, there were some suspect issues in Green Land corporate governance. For example, according to financial reports before 2010, independent directors did not point out any issues in the company. In March 2010, CSRC started to investigate fraud operations in Green Land and the 22nd meeting of the 4th board of directors in March 2011 decided to dismiss Xuekui He of the position of chair of the board. Yaguang Zheng replaced her position as the chairman of directors and the secretary of the board until the restricting of Green Land. In this way, according to the 2010 annual report of Green Land published in April 2011, independent directors gave suggestions on the internal control of the company.

In addition, from 2007 to 2010, there was a rapid movement across positions in Green Land. For example in this period Yunkui Xu took several positions, first as the secretary of the board, then deputy general manager, followed by general manager, and finally the deputy general manager. Zhiming Mao was the general manager in 2007. Xuekui He held two positions in 2008 chairman of the board the general manager. In 2010, Guangzhong Wang was the general manager and also the director. The position of general manager was frequently changed, which might be because this position did not have real authority while the chairman of the board, Xuekui He,
was in control. Xuekui He had a bachelor degree, was a graduate from the School of Commerce in Yunnan University of Finance and Economics, and had the qualification as senior economist. From 1990 to 1993, she was an accountant in Lu Da company affiliated to Yunnan Provincial Science and Technology Department. From 1993 to 1995, she was project manager in Sheng Long company affiliated to the Health and Family Planning Commission of Yunnan Province. From 1995 to 1996, she was the chairman of the board in Yunnan He Kou Yong An company. From 1996, she ran Yunnan Hekou Green Land Industry Co., Ltd. (云南河口绿大地实业有限公司) (The 2010 financial report of Green Land, 2011, p.11). After listing, in 2007, Green Land raised 346 million yuan. Xuekui He was the largest shareholder in Green Land from 2007 to 2010, and had a 28.63% shareholding. As such, she ranked among the 2009 Hurun List which reports the richest people in China.
Table 17: Selective positions in Green Land from 2007 to 2010

<table>
<thead>
<tr>
<th>Position</th>
<th>Name list</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td></td>
</tr>
<tr>
<td>The chairman of the board of directors</td>
<td>Xuekui He</td>
</tr>
<tr>
<td>The secretary of the board</td>
<td>Yunkui Xu</td>
</tr>
<tr>
<td>The general manager</td>
<td>Zhiming Mao</td>
</tr>
<tr>
<td>The deputy general manager</td>
<td>Desheng Chen</td>
</tr>
<tr>
<td>The Chief Financial Officer</td>
<td>Kaixi Jiang</td>
</tr>
<tr>
<td>2008</td>
<td></td>
</tr>
<tr>
<td>The chairman of the board of directors</td>
<td>Xuekui He</td>
</tr>
<tr>
<td>The secretary of the board</td>
<td>Linming Tang</td>
</tr>
<tr>
<td>The general manager</td>
<td>Xuekui He</td>
</tr>
<tr>
<td>The deputy general manager</td>
<td>Linming Tang; Desheng Chen; Yunkui Xu; Menglong Li</td>
</tr>
<tr>
<td>The Chief Financial Officer</td>
<td>Kaixi Jiang</td>
</tr>
<tr>
<td>2009</td>
<td></td>
</tr>
<tr>
<td>The chairman of the board of directors</td>
<td>Xuekui He</td>
</tr>
<tr>
<td>The secretary of the board</td>
<td>Linming Tang</td>
</tr>
<tr>
<td>The general manager</td>
<td>Yunkui Xu</td>
</tr>
<tr>
<td>The deputy general manager</td>
<td>Linming Tang; Desheng Chen; Menglong Li</td>
</tr>
<tr>
<td>The Chief Financial Officer</td>
<td>Kaixi Jiang</td>
</tr>
<tr>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>The chairman of the board of directors</td>
<td>Xuekui He</td>
</tr>
<tr>
<td>The secretary of the board</td>
<td>Xuekui He</td>
</tr>
<tr>
<td>The general manager</td>
<td>Linming Tang</td>
</tr>
<tr>
<td>The deputy general manager</td>
<td>Yunkui Xu; Desheng Chen; Menglong Li</td>
</tr>
<tr>
<td>The Chief Financial Officer</td>
<td>Peng Li</td>
</tr>
</tbody>
</table>
In addition, in 2010, Guangzhong Wang was general manager, which might be because Green Land wanted to make use of Guangzhong Wang’s political background to facilitate financing and get protection from the inspection of CSRC. According to the news from XZBU website, in the construction of green seedling production base, there was a 550-million-yuan shortfall in 2009. Green Land faced huge financial pressure; Guangzhong Wang might have been used to help in financing. Guangzhong Wang was party secretary of the Kunming foreign trade and economic relations commission from 2001 to 2004. And also from 2004 to 2010 he was placed as deputy director, director, and party secretary of the Kunming Bureau of Commerce (The 2010 financial report of Green Land, 2011, p.12).

It is insightful to compare details from the annual reports of 2007 and 2010. In 2007, there were 6 directors on the board (Xuekui He, Guoquan Zhao, Hong Hu, Kaixi Jiang, Gang Li, and Jiafu Zhong), while in 2010 there were only three directors on the board (Xuekui He, Hong Hu, and Guangzhong Wang). Only two original directors remained. If Green Land’s performance was good, why did so many directors leave their position? Could it be that they have realised that Green Land was going to collapse, so they left?

Therefore, facing such chaos within Green Land corporate governance, auditors did not detect fraud operations and reported unqualified opinions in the first 5 years (from 2004 to 2008). Auditors might have used fraudulent financial information provided by the audited company to explain and reduce their responsibilities in Green Land case, but CSRC needed to consider whether it was true or whether auditors did not keep to their professional ethics or even not implement auditing risk
assessment, especially under the effect of Chinese culture and high competition in the CPA industry. China’s audit services market has been in rapid growth since the 1980s. By 2016, the Chinese CPA had become a highly competitive industry. According to the Overview of the Accountancy Profession in China (The Chinese Institute of Certified Public Accountants, 2016), “CICPA has 8,374 accounting firms as group members (accounting firms), 40 of them are qualified to conduct security and future-related business and 11 firms are authorized to conduct H-share audit” (p. 2). In the end of 2015, there were approximately 2,800 listed companies (The Chinese Institute of Certified Public Accountants, 2016), while only 40 public accounting firms were qualified to audit them, averaging 70 clients per audit firm. According to Bandyopadhyay et al. (2014) and Huang et al. (2016), during the period from 1999 to 2007, the Big 4 audit firms accounted for only 17% of market share in China. Within the Chinese audit market, the Big 4 audit firms accounted for 61% of American market share, 71% of Australian market share, and 74% of Taiwan market share during the period from 1999 to 2007 (Bandyopadhyay et al., 2014, p.21). In 2014, the revenue of the Chinese accountancy profession reached 60.357 billion yuan (The Chinese Institute of Certified Public Accountants, 2016, p.2), while the revenue of the ‘Big 4’ in China was approximately 10 billion yuan which only accounted for 16% (The Chinese Institute of Certified Public Accountants, 2016) (Figure 14). This shows the low concentration of the Chinese audit market and this is likely to have increased competition which in turn might have weakened the bargaining power of auditors and interfered with auditor independence. The following example describes how auditors might not have defended their rights in Green Land due to the effect of Chinese culture in the context of high competition within the CPA industry.
Figure 14: Revenue of Top 100 Accounting firms of China from 2006 to 2014 (The Chinese Institute of Certified Public Accountants, 2016, p.8)
According to the *Notice of listed companies to hire and replace public accounting firms* (Chinese Securities Regulatory Commission, 1996), if a listed company replaces a public accounting firm, it should inform the public accounting firm and give reasons. If the public accounting firm is not satisfied with the reasons, it can report the listed company to the China Security Regulatory Commission and the Chinese Institute of Certified Public Accountants. Moreover, the new auditors should communicate with their predecessors as to why they were replaced. If the new auditors know of any unreasonable reasons for replacement, they should not provide auditing services to the listed company.

From this case, it is difficult to identify whether the new auditors communicated with the former auditors. However, when all four public accounting firms were replaced, none of them reported to the China Security Regulatory Commission and the Chinese Institute of Certified Public Accountants for the reason of replacement. The replaced accounting firms did not report against being sacked by Green Land. The reasons may be as follows. Firstly, the reporting process can be time-consuming. Even if the China Security Regulatory Commission and the Chinese Institute of Certified Public Accountants support a report, they only provide suggestions to the general meeting of shareholders to reconsider the replacement. Secondly, due to Chinese culture, people save *face* for others and keep good *guanxi* with others, so determining the success of an individual. If the public accounting firms had reported to Green Land about the replacement, they would have completely damaged their relationship with the company. Moreover, if Green Land had spread information about the reporting among listed companies, other listed companies might not want to hire these public accounting firms either because someone who did not give *face* to another must be a
difficult person. Nobody wants to cooperate with a difficult person. Thirdly, the reason might be from the public accounting firms’ point of view. They might have known Green Land’s real financial situation because all of them were big accounting firms qualified to conduct security and future-related business. However, they might have only issued audit reports and not reported real facts, especially those who issued unqualified opinions.

In addition, from Green Land’s point of view, frequently changing public accounting firms from 2008 to 2010 might have been because Green Land was not in a harmonious situation during that time, although reasons given for changing public accounting firms by Green Land were not convincing. In contrast, changing to the Zhong He Zheng Xin public accounting firm in 2008 might have been because a person such as Pang Mingxing was introduced to Green Land by using guanxi. Thus, although the 2008 auditing report issued an unqualified opinion, it appears that such harmonious guanxi might have been broken after 2008. That is because the audit fees nearly doubled in cost after hiring the Zhong Shen Ya Tai public accounting firm. Green Land might have ‘bought’ the audit opinion. However, the Zhong Shen Ya Tai public accounting firm might not have had a deep relationship with Green Land. Thus, Zhong Shen Ya Tai issued a qualified opinion in the 2009 auditing report and Green Land did not have its wishes fulfilled. Thus, Green Land continued to change public accounting firms and hired the Zhong Zhun public accounting firm for its 2010 annual financial report audit. This was also because Zhong Shen Ya Tai had issued a qualified opinion in the 2009 auditing report released in 2010. In the same year, the China Securities Regulatory Commission started to investigate Green Land’s suspected financial information disclosure. Therefore, one likely reason for
Green Land’s scandal being exposed was that Green Land had not kept harmonious relationships. With *guanxi* harmony it might not only be difficult to discover corporate scandals, but also possible to induce a lack of auditor independence.

Moreover, in reality, public accounting firms will have signed an auditing contract with audited companies or even issued audit reports. However, due to audit reports not satisfying their requirements, audited companies scrapped the contract. Public accounting firms normally did not sue audited companies because they wanted to keep a harmonious relationship with them, especially in small public accounting firms. Keeping a harmonious relationship is not just to obtain future business with the audited company, but also to show that the public accounting firm has a harmonious relationship and gives face to potential clients. In China, there is an old saying: “和气生财” (Do business with a smile and you'll make a pile; Harmony breeds wealth.).

### 8.4 Guanxi conflict with auditor independence

However, in the context of harmony and face-giving situations, *guanxi* is contrary to the spirit of auditor independence. Auditor independence is recognized as one of the core values of modern auditors. Independence has been of concern and a topic of debate in the auditing profession for a long time. Carey and Doherty (1966) defined the meaning of auditor independence:

“First, in the sense of not being subordinate, it means honesty, integrity, objectivity and responsibility. Second, in the narrow sense in which it is used in connection with auditing and expression of opinions on financial statements, independence means avoidance of any relationship which would be likely, even subconsciously, to impair the CPA’s objectivity as
auditor. Third, it means avoidance of relationships which to a reasonable observer would suggest a conflict of interest.” (Vanasco, 1996, p.4).

Bartlett (1991) stated that “independence is a term used every day by CPAs. It is a common English word which has assumed a special significance in the linguistic structure of the accounting profession” (p. 11). Bartlett (1991) defined independence, as a characteristic of individuals, is “a mental state of being unbiased with regard to a particular client” (p. 11), and as a set of constraints, is “adherence to rules which are designed to create the appearance that the CPA is disinterested in the outcome of the audit process” (p. 11). Bartlett’s definition of independence also emphasised self-determination and no other influences.

Guenin-Paracini et al. (2015) distinguished two senses of independence: organizational and operational senses, based on Power’s (1999) study. The organizational dimension of independence is primarily regarded to “design an incentive [organizational] structure together with a range of escalatory possibilities such that auditors…will not be deterred from using the available enforcement options when necessary” (Power, 1999, p. 132, cited from Guenin-Paracini et al., 2015, p. 202). That means auditors would not change auditing opinions when reporting errors found during an audit, which is consistent with Bartlett’s individual independence. Guenin-Paracini et al. (2015) focused on operational independence. Operational independence is more concerned with the audit process itself and is linked to the notion of competence as the “ability [of auditors] to detect material misstatements” (Humphrey et al., 2007, p. 151, cited from Guenin-Paracini et al., 2015, p. 202). However, auditors’ capability to work with diligence and efficacy depends on information supplied by the auditee. Ultimately, Guenin-Paracini et al. (2015) found
that the reality of operational independence could not design as Bartlett’s (1991) definition as “adherence to rules which are designed to create the appearance that the CPA is disinterested in the outcome of the audit process” (p. 11), because official arrangement designed to guarantee operational independence are unlikely to be effective and independence is a personal state of mind which drives action.

As mentioned before, no matter which dimension of independence was defined, all emphasised there being no relationship and no other influence. However, guanxi is cultivated by the exchange of personalized favours. Mutually beneficial and reciprocal exchange is the core of guanxi. Hwang and Staley (2005) state, “such gifts strike an ethical nerve in a western society and are contrary to at least the spirit of Sarbanes-Oxley Act in the U.S.” (Cited Hwang et al., 2008, p. 237). Guanxi is contrary to the spirit of auditor independence in Chinese CPA Professional Ethical Standards that require an auditor to be independent in both in form and substance.

8.4.1 Chinese mandatory audit partner rotation

In 2002, Section 203 of the Sarbanes-Oxley Act of 2002 implemented mandatory audit partner rotation. Its purpose was to keep auditor independence and reduce auditors collaborating with audited companies to do accounting fraud after the scandal of Enron and Arthur Andersen was exposed. This section states that:

26 The Sarbanes-Oxley Act is legislation passed by the U.S. Congress on July 25, 2002 (Coates IV, 2007). The Sarbanes-Oxley legislation was designed to fix auditing of U.S. public companies after a series of high-profile financial scandals that occurred in the early 2000s including Enron, WorldCom, Tyco, and others. The Sarbanes-Oxley created the Public Company Accounting Oversight Board, which is to enlist auditors to enforce existing laws against theft and fraud by corporate officers (Coates IV, 2007). The new rules were “concerning the auditor-firm relationship, auditor rotation, auditor provision of non-audit service, and corporate whistle-blowers” (Coates IV, 2007, p. 91).
“it shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer” (Sec.gov, 2002, p.773).

Chinese regulators considered that Chinese *guanxi* could heavily influence auditor independence, so in 2003 the China Security Regulatory Commission and Ministry of Finance jointly issued a policy which requires that auditors who sign the audit report of a listed company should be rotated off after five years (The China Securities Regulatory Commission, 2003; Firth et al., 2012, p.115). The key requirements of mandatory audit partner rotation are summarized in Table 18.
Table 18: The key requirements of mandatory audit partner rotation (Firth et al., 2012, p.116)

<table>
<thead>
<tr>
<th>No. of article</th>
<th>Article contents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 3</td>
<td>Signing auditors must not provide audit services for the same entity for more than five consecutive years, except under the circumstances specified in Article 7.</td>
</tr>
<tr>
<td>Article 5</td>
<td>Signing auditors must not provide audit services for the same initial public offering (IPO) entity for more than two consecutive years after the IPO.</td>
</tr>
<tr>
<td>Article 7</td>
<td>If both of the signing auditors have provided audit services for the same entity for five consecutive years during the same period, one of them is allowed to extend to a maximum of one more year their position as a signing auditor of the entity concerned.</td>
</tr>
<tr>
<td>Article 8</td>
<td>After a signing auditor is rotated off due to having provided audit services for the same entity for five consecutive years, he should not provide audit services for this entity within two years.</td>
</tr>
<tr>
<td>Article 13</td>
<td>This regulation takes effect on January 1, 2004.</td>
</tr>
</tbody>
</table>
Although the policy of mandatory audit partner rotation was issued in 2003, it did not reduce the impact of *guanxi* in the Green Land case in 2007. This is because Pang Mingxing used another way for the policy to lose effectiveness, because he was not one of the signing auditors of auditing reports. In China’s highly competitive CPA industry, public accounting firms are also happy to use personal *guanxi* to gain an audit engagement in order to increase business revenue, while auditors such as Pang Mingxing could also earn personal benefits from referral fees. Therefore, expecting the policy of audit partner rotation to be effective is a big risk because of the influence of Chinese culture - *guanxi*.

8.5 The impact of government
The analysis above discusses the effect of personal *guanxi* on auditor independence. However, according to Chinese auditing development history and enterprise reform, as described in the previous chapter, the government as a regulator and also participant may also risk damaging Chinese auditor independence in the context of *guanxi*.

8.5.1 Government influence
As mentioned in the previous chapter concerning Chinese auditing development history, financial auditing services really started in the People’s Republic of China in early 1983. CPA firms were established and sponsored by government bodies or government controlled institutions (Yang et al., 2001) until 1996. After the initiation of a program to disaffiliate CPA firms from their sponsoring bodies in 1997, the disaffiliated CPA firms needed to take higher market risks than affiliated firms, and therefore needed to act more independently. However, although after the
disaffiliation program the Chinese Institute of Certified Public Accountant (CICPA) was seen as a private organization, it was essentially governed and regulated by the Ministry of Finance. Moreover, the government impacts the operation of the CICPA by allowing dual appointment of senior directors in the CICPA who also have a government position. Therefore, the government may still control the CICPA.

8.5.2 The relationship with government
As mentioned above, Chinese financial audits are impacted by the government and enterprise reform was derived from government influence. The enterprise reforms were completed in the 1990s and the adoption of the Company Law in December 1993 provided a legal framework for SOEs to clarify property rights. Although a large number of listed companies on the Shanghai and Shenzhen stock exchanges were carved out from SOEs, the state and parent SOEs still hold sufficient shares to control the dominant portion of listed companies (Kang and Kim, 2012, pp. 473-474). By the end of 2013, in China’s 2460 listed companies, state-owned listed companies (including local state-controlled listed companies and the central state-controlled listed companies) accounted for 83% of total net assets, and their market value accounted for 69.8% of A-share market value (ifeng, 2014; sohu, 2013).

Due to historical reasons the relationship between public accounting firms and the government and the relationship between listed companies and the government, as well as the relationship between listed companies and public accounting firms are complex. Whether or not the government mediated between auditor and audited companies when financial issues disclosed could a potentially decrease auditor independence. Empirical findings from existing studies are mixed. Gul et al. (2009)
found that after the disaffiliation program, qualified audit opinions for listed companies in China significantly increased, and Chinese government improved auditor independence, especially in small public accounting firms. However, Lin and Fraser (2008) found that Chinese government agencies impacted on the difficulty of assessing risk in an audit engagement. In addition, Wu and Patel (2015) showed that the government could have influence over the appointment of an auditor.

This study considers that the relationship with government has the potential to decrease auditor independence. In the process of corporatization of traditional state-managed SOEs, the state still holds shares of companies, but the state is an abstract entity, not a natural person. China was trying to materialise the state shareholders to appoint a legal person as the state shareholder, which resulted in a complicated relationship between the government and companies. In addition, according to differences in affiliation, SOEs or state-holding shares companies can be divided into SOEs by supervision of the central state assets management bureau, SOEs by supervision of local state assets management bureau, and SOEs by supervision of the MOF (central administrative institutions owned enterprises, financial companies such as banks, and companies having financial relations with MOF). MOF also supervises and governs CICPA as mentioned before. Although legal persons in the SOEs, persons who supervise state assets in SOEs, and persons who supervise CICPA are not the same person, all of them work for government. The government is both regulator and participant. The present government has been a one-party dictatorship of the Chinese Communist Party (CCP) since the founding of the People’s Republic of China in 1949. The CCP is the highest leadership in the whole country. Therefore, there could be a potential risk of the government impacting CPAs’ opinions on
financial reports of SOEs. They might wish to do this in order to protect state-owned benefits, which might be protecting the value of state-owned assets against loss, or guaranteeing tax collection to accomplish political goals. Moreover, from the global view, with more and more foreign companies entering China, whether or not the government decreases auditor independence is a potentially big risk for foreign investors, because the government is both regulator and participant.

8.5.3 Comparing the inspection system of CPA in China with the United States

However, some Chinese scholars argued that self-regulation in Western countries, such as America, may be not a good choice for China. Liu and Chen (2004) compared the Chinese system with the American accounting inspection system. They stated that the Public Oversight Board (POB) was the self-regulatory system that oversaw the accounting profession in the United States. The POB was created by the American Institute of Certified Public Accountants (AICPA) in 1977 as an independent private sector body charged with overseeing and reporting on the programs of the Securities and Exchange Commission Practice Section (POB, 2003). However, due to high profile corporate scandals, such as Enron, the POB lost public trust. The POB was terminated by Section IX of the Charter in 2002 (POB, 2003). In the same year, the Public Company Accounting Oversight Board (PCAOB) was established by the Sarbanes-Oxley Act of 2002 which required that auditors of American public companies be subject to external and independent oversight (PCAOB, 2016). Liu and Chen (2004) argued that the American inspection system for CPAs changed from self-regulation to external oversight.
In contrast, the Chinese supervision system of CPA can be divided into government supervision (the external inspection) and self-supervision. Chinese public accounting firms have been supervised and governed by government institutions and CICPA (See Figure 15). The MOF is the main government institution that supervises public accounting firms. Its duties are mainly to develop CPA regulations and registrations, the approval of the establishment of public accounting firms and penalising of accounting violations. In addition, the National Audit Office also acts as a supervisor of government institutions, but it only governs public accounting firms that are qualified to conduct security and future-related business.
Figure 15: The Chinese supervision system of public accounting firms

Government supervision

CSRC

NAO

MOF

Self-supervision

CICPA

Public accounting firms qualified to conduct security and future-related business

All public accounting firms

Note: CSRC is Chinese Securities Regulatory Commission; NAO is the National Auditor Office; MOF is Ministry of Finance; CICPA is the Chinese Institute of Certified Public Accountants.
However, the National Audit Office has no authority to revoke a CPA’s registration and deregister a public accounting firm’s qualification, but it does have the right to refer violation cases to the MOF. Another government supervision institution is the Chinese Securities Regulatory Commission (CSRC). It inspects listed companies’ audited financial reports. If CPAs commit violations leading to a misleading financial report, CSRC has the authority to suspend the qualification of conduct of listed companies audits and fine accounting firms. As mentioned before, after the disaffiliation in 1997, the CICPA was deemed a private organization, but it is essentially governed and regulated by the MOF. The government influences the operation of CICPA in various ways such as allowing dual appointment of senior directors in CICPA who also have government positions. As mentioned before, the government is both regulator and also participant; it is also an inspector of CPAs. This is very different to the situation with the PCAOB which is an external and independent inspective organization. Considering, in China, the present government is a one-party dictatorship of the Chinese Communist Party (CCP) which is the highest leadership in the whole country. Thus, in China’s relationship-oriented society, there is a high risk of decreasing auditor independence and the government oversight may contribute to this risk.

8.6 Local government’s protectionism

When a company becomes a listed company, beneficiaries are not only the company and agencies, but also local governments, especially in underdeveloped regions. For example, in this case, another interesting issue is in the first quarter financial report of Green Land in 2010 (2010, p.6), Green Land’s sale revenue was 161,120,638.27 yuan and cash flow from sales of goods and rendering of services was 537,281.28
yuan, while cash paid for various taxes was 302,041,225.95 yuan (The first quarter financial report of Green Land in 2010, 2010, p.8). However, according to the supplements and correction notice for the first quarter financial report of Green Land in 2010 (2010, pp.5-6), after the adjustment and correction, cash flow from sales of goods and rendering of services was 59,893,483.44 yuan and cash paid for various taxes was 1,009,021.68 yuan. Green Land paid so much in tax to governments. This could explain why local governments encourage local companies to list, i.e. it can greatly increase taxes and increasing tax is a political achievement for local government. As such, local governments not only wish local companies to list but also help companies cover up certain issues so they can gain more benefits from local listed companies. When the Green Land scandal was exposed, Yunnan local government interceded with the CSRC for Green Land, and obstructed the execution of the arrest of Xuekui He several times. According to news from Chinese economic observation (Huang, 2011), in December 2010, Green Land contacted the Yunnan Finance Office and China Securities Regulatory Commission Yunnan Authority in order to get help with the investigation by CSRC which had started to investigate fraud operations in Green Land in March 2010. To protect Green Land, the vice governor of Yunnan province who was in charge of this case went to Beijing twice, and the provincial deputy secretary-general went to Beijing at least 10 times. Both of them were trying to negotiate with CSRC on behalf of Green Land. Thus, this kind of regional protectionism may encourage deliberate fraud to some degree, at least in the Green Land case. Of course, local governments also get benefits from local companies.
8.7 Accountability of Chinese CPAs

As discussed above, although auditor independence is a core value for auditors, there is no such thing as pure independence because human beings are also social beings who are heavily influenced by their cultural environment. This is especially true in China because it is a relationship-oriented society that values guanxi. Auditing is recognized as a social activity that involves both social and cultural activities. Therefore, it is difficult to avoid other influences and keep 'objective' opinions. In fact, when an opinion is expressed, it is already mixed with personal opinion. Therefore, this section discusses Chinese auditors’ expected accountability – to whom, and for what, and whether this conflicts with the spirit of auditor independence.

The process of inspections should iron out irregularities and errors. According to Article 33 of the Accounting Law of the People’s Republic of China, financial bureaus, government auditing bureaus, tax bureaus, the People’s Bank, securities regulatory bureaus and insurance supervision departments should be in accordance with relevant laws and administrative regulations duties when they supervise and inspect companies’ accounting information. After supervision and inspection, inspection conclusions should be issued. However, if supervision and inspection results have been made by prior supervision departments to meet posterior supervision departments in performing their duties required, posterior supervision departments should use the supervision results made by prior supervision departments in order to avoid repeated audit (Ministry of Finance of the People’s Republic of China, 2000). This raises the question as to whether the accounting information audited by CPAs is accurate enough to meet the requirements of other
supervision departments. If it meets other supervision departments’ requirements, these departments do not need to repeatedly audit this information. As such, the functions of different supervision departments may be overlapping or not carried out.

In the listing process of Green Land, if CSRC carried out its duty, it would have found false accounting entries, and Green Land would not have passed its listing application. Moreover, after becoming a listed company, Green Land was continuing to conduct fraud accounting operations, and the auditing reports for the 2007 and 2008 financial reports were issued with unqualified opinions. If any of the supervision institutions for CPA had met their responsibilities, Green Land’s financial scandal would have been exposed earlier. Therefore, Chinese CPAs may lack supervision and regulations because of the impact of Chinese culture in which everyone would like to keep a harmonious guanxi.

CPA’s accountability is expected to protect the public interests. However, due to high competition in the industry and a low degree of regulation, the accountability may shift to majority shareholders in order to keep the loyalty of customers.

Moreover, after more than three decades of Chinese economic reforms, relative laws and regulations, such as the Chinese auditing standards and the Chinese company laws, have been established and converged to corresponding international laws and regulations. However, according to the case of Green Land, these laws and regulations did not achieve expected effectiveness because people attach more importance to guanxi. Actually, in ancient Chinese society, people were regulated by governors and it was not until the modern era that Sun Yat-sen, the first president of
the Republic of China, generated the concept of governing the state by laws. As mentioned before, people referred to governors as ‘parent governors’ and societies were constructed by relationships. When an issue occurred between two people, the first response was to find someone who could solve the issue, rather than find relative laws to defend themselves. Thus, it is often observed in China that bureaucrats shield one another. Although in ancient Chinese society governors proposed that ‘all men are equal in the eyes of the law; even the king must be subject to the law’ (in Chinese: 王子犯法与庶民同罪), there was never a king or emperor who was punished. In fact, the saying that all men were equal was ideological only. In reality, as another old saying expresses it, ‘punishments are not for nobles; ceremony is not for the common people’ (刑不上大夫, 礼不下庶人), which reflects the fact that there was a strict hierarchy in ancient Chinese societies.

However, for the historical reasons, in current Chinese society, although governing the state by laws is a fundamental policy, people still attach importance to guanxi. For example, there was a famous scandal in China referred to as ‘My Dad is Gang Li’. On 16th April 2010, there was a traffic accident causing one death and one injury in Hebei University. The driver, Qiming Li, was driving drunk and after the accident, he continued to drive. When he was arrested, he called out “my dad is Gang Li; I don’t care if you sue me”. His father (Gang Li) was the deputy chief in Baoding Bureau of Public Security in Hebei province. After this scandal was exposed by the media, “my dad is Gang Li” become Chinese catchwords. This scandal shows that in current society some people who have guanxi with important people have relatively little sense of laws.
Therefore, in the Green Land case, it can be understand why Pang Mingxing (庞明星), as the financial consultant of Green Land, was sentenced, while the Shenzhen Peng Cheng public accounting firm which had reported unqualified opinion to Green Land’s financial report in 2004, 2005, 2006, and 2007 was not punished, according to the sentence of the Kunming Intermediate People’s Court in 2013 (Haitong, 2013). This might be because the Shenzhen Peng Cheng public accounting firm had a better guanxi than Pang Mingxing and so could avoid punishments. This kind of dependence on guanxi as more important than laws could significantly damage auditor independence. Although the Chinese legal system environment has been much improved, the strong group form of society still impacts auditors as they try to reach inside a group to get more benefits. As such, auditor independence would be damaged because auditors’ accountabilities shift to the inside group rather than outside the group.

8.8 Conclusion
This chapter uses the Green Land case to analyse what factors might cause problems for Chinese auditor independence. It provides insights into how Chinese culture (especially guanxi) and the government impact auditor independence, causing auditors’ accountability to change. After analysing this case, it appears that the current supervision system of CPA does not take effect as expected. The reason may be that Chinese culture, such as guanxi, significantly impacts the supervision function. In addition, Chinese culture may also decrease auditor independence, and induce auditors to use guanxi to keep the loyalty of customers in a highly competitive CPA industry.
Although the Chinese government transplanted the International auditing standards and other regulations such as the policy of mandatory audit partner rotation, it can be noted that in the Green Land case these regulations did not take effect as expected. Due to the effect of Chinese culture and a low degree of regulation, Chinese auditors may account to majority shareholders for their own benefits.

Therefore, although the motivation behind the convergence to the International auditing standards and other regulations is to assist in adapting to the global market, it is also necessary to consider the unique Chinese context, arising from Chinese culture. Otherwise, it may mean the transplanted regulations are superficial and lack substance to impact on auditors.
CHAPTER 9 CASE STUDY 3 – AMOI ELECTRONIC

9.1 Introduction

This is a case study of accounting fraud in Amoi Electronics Co., Ltd., a company limited by shares (stock code: 600057, hereinafter referred to as Amoi Electronics), and a nationally renowned mobile phone company. Amoi Electronics committed the profit frauds between 2006 and 2007. The case provides insights into how a listed company conducted accounting fraud, and examines the reasons that motivated the listed company to forge accounting information.

Amoi Electronics was engaged in the production of televisions when the company first started. In 1993, Amoi Electronics also entered the booming video cassette recorder market and subsequently entered the mobile phone market in 2000. In 2002 Amoi Electronics achieved a net profit of 610 million Chinese yuan. Since then, Amoi Electronics started to diversify its production. It had invested heavily in research and development of 3G mobile phones. The company also manufactured LCD televisions, laptop computers and other products. However, after 2004, the financial performance of Amoi Electronics began to decline. By the end of 2006, Amoi Electronics was forced to withdraw from the computer laptop market and also the LCD television market. With the failure of its diversified development, in 2005 Amoi Electronics suffered a loss of 658 million yuan (Zhu, 2012).

Amoi Electronics was established by public offering on the 24th April, 1997 after approval by the China Securities Regulatory Commission and on the 4th June 1997, the company’s stock traded on the Shanghai Stock Exchange (The financial report of Amoi Electronics, 2006). Amoi Electronics’ parent company was Amoi Electronics
Co., Ltd. with limit by liability which held a 43.09% share in Amoi Electronics (The financial report of Amoi Electronics, 2006). China Electronics Corporation (CEC) was the biggest shareholder in Amoi Electronics’ parent company, and held 51% of shares in the parent company, as well as indirectly holding a 21.98% share of Amoi Electronics (The financial report of Amoi Electronics, 2006). As such, Amoi Electronics was predominantly controlled by CEC, a company, which was established in May 1989 (The relationship can be seen in Figure 16) (The financial report of Amoi Electronics, 2006). CEC is a State-owned Enterprise (SOE), directly managed by central government and has remained China’s largest state-owned information technology (IT) corporation since its establishment. CEC has nearly 23 member companies, of which 15 companies are listed companies (China Electronics Corporation, 2016).
Figure 16: The relationship between the Amoi Electronics and the predominant controlling companies (The financial report of Amoi Electronics, 2006, p.9)

The China Electronics Corporation

51%

Amoi Electronics Co., Ltd. limited by liability

43.09%

Amoi Electronics Co., Ltd. limited by shares

Indirectly held 21.98%
As mentioned above, Amoi Electronics Co., Ltd. limited by liability was the parent company of Amoi Electronics Co., Ltd. limited by shares. According to *Companies Law of the People’s Republic of China*, Article 3 “shareholders of a company with limited liability shall assume liability towards the company to the extent of the capital contributions subscribed respectively by them; and the shareholders of a company limited by shares shall assume liability towards the company to the extent of the shares subscribed respectively by them” (*Companies Law of the People’s Republic of China, 2006*, pp. 2-3). The differences between the two kinds of companies have been discussed in Chapter 6. In this case, the parent company and the subsidiary company had similar names, but the difference was “limited by liability” and “limited by shares”. According to Article 24, “a company with limited liability shall be jointly invested in and incorporated by not more than 50 shareholders” (*Companies Law of the People’s Republic of China, 2006*, p.6). However, Article 79 requires “to incorporate a company limited by shares, there shall be not less than 2 but not more than 200 promoters, more than half of whom shall have their domiciles with the territory of the People’s Republic of China” (*Companies Law of the People’s Republic of China, 2006*, p.18). After the company is established, the number of shareholders is not limited.

In addition, establishment is different between the two kinds of companies. In a company with limited liability, the amount of capital contributions can only be subscribed by its initial shareholders. According to Article 26, “the registered capital of a company with limited liability shall be the amount of capital contributions subscribed for by all of its shareholders, as is registered with the company
registration authority” (Companies Law of the People’s Republic of China, 2006, p.7). However, according to Article 78 and Article 85:

“a company limited by shares may be incorporated by means of promotion or by means of share offer. A company incorporated by means of promotion is one incorporated by the promoters subscribing for all the shares to be issued by the company. A company incorporated by means of share offer is one incorporated by the promoters subscribing for a portion of the shares to be issued by the company, with the rest offered to the general public or to specific quarter … where a company limited by share is incorporated by means of share offer, the shares subscribed for by the promoters shall be not less than 35 percent of the total number of the shares issued by the company” (Companies Law of the People’s Republic of China, 2006, pp.18-19).

Another important difference is that only a company limited by shares can be listed on a stock market in China.

These two kinds of companies in China are similar to proprietary companies limited by shares and public companies limited by shares in Australia. According to the Corporation Act 2001 – SECT 112, within both proprietary companies and public companies, there are companies limited by shares, but the difference is as follows. A proprietary company needs at least one member and up to a maximum of 50 non-employee shareholders. Conversely, a public company must have a minimum of one member and has no maximum limit. Secondly, proprietary companies are defined as unlisted, as they are not allowed to raise capital by selling shares to the public. However, public companies can be listed or unlisted, and allow raising capital from the public. The shares are listed on the Australian Stock Exchange. Due to the nature of their revenue raising capacity, public companies are also obliged to disclose
This chapter analyses how Amoi Electronics conducted fraudulent accounting operations, and in section two how the auditing process failed. Section three dissects the financial reports of Amoi Electronics to detect financial issues. Section four describes the development of Chinese auditing standards. Section five discusses some possible reasons for the fraud, such as tunneling and delisting risk, that motivate listed companies to conduct fraudulent accounting operations. Section six contains comments on the Chinese accounting standards and accounting rules. Section seven covers the external supervision system of Chinese listed companies as discussed above. Section eight concludes this chapter.

9.2 The fraud accounting operations and auditing failure

9.2.1 The fraud accounting operations


According to the penalty decision received from the China Securities Regulatory Commission on the 16th November 2009 (Shanghai Stock Exchange, 2009), the main
fraudulent accounting operations conducted by Amoi Electronics are outlined in the following table.
Table 19: the main fraud accounting operations (Shanghai Stock Exchange, 2009)

<table>
<thead>
<tr>
<th>Fraud 1</th>
<th>Amoi Electronics disclosed that its bankers’ acceptances were 699,833,498.04 Yuan and bill receivable was 10,682,440.00 Yuan, which totalled approximately 710,515,938.04 Yuan on the 31st December, 2006. With the exception of the above bill receivable being disclosed, there were also 280,878,100 yuan bill receivables that were issued in bankers’ acceptances at the 31st December, 2006.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraud 2</td>
<td>Amoi Electronics did not adjust their balance sheet based on events after the balance sheet data. Amoi did not use returns of products in 2006 and the first quarter in 2007 to offset the 2006 revenue and cost of sales which were 31,424,138.89 and 18,212,444.77 yuan, respectively, resulting in an inflated profit of 13,211,694.12 yuan in 2006.</td>
</tr>
<tr>
<td>Fraud 3</td>
<td>In the 2006 financial report, except for the accrued discount and price guarantee, there was still the amount of 27,561,924.77 yuan of discount and price guarantee which had been confirmed with customers, but such amount of discount and price guarantee were not accrued, resulting in an inflation of profit by 276,124.77 yuan.</td>
</tr>
</tbody>
</table>

27 The definition of banker’s acceptance: “a short-term instrument issued by a firm that is guaranteed by a commercial bank. Banker’s acceptances are issued by firms as part of a commercial transaction” (Investopedia, 2016).
28 “A bill receivable is a document that the customer formally agrees to pay at some future date. The bill receivable document effectively replaces, for the related amount, the open debt exchanged for the bill. Bill receivables are often remitted for collection and used to secure short term funding” (Oracle receivables user guide, 2016).
29 Price by discounts is a strategy of sale that manufacturers (wholesalers) give some percentage of sales of profit to wholesalers (retailers) in order to stimulate their sales. The price by discounts should be recorded into the account of cost of sales. Price guarantees given means that there is a contract between manufacturers and wholesalers, in which during a period of time manufacturers would make up loss to wholesalers when the price of productions goes down. The price guarantees given is also recorded into the account of cost of sales.
9.2.2 Auditing failure


There are significant differences between banker’s acceptances and bill receivables in the level of credit risk and receivable risk. A bill receivable is pledged by other companies except for banks, while banker’s acceptances are pledged by banks. Thus, banker’s acceptances have less receivable risk than bills receivable. As such, if a bill receivable was disclosed as a bankers’ acceptance, Amoi Electronics would have a lower risk profile and so a more favourable prospect of obtaining financing in the future. Moreover, in 2006, the beginning balance of accounts receivable was 445 million yuan and the closing balance of accounts receivable was 738 million yuan, an
increase of 65.52%. According to Amoi Electronics’ financial report, the reason for the increase in accounts receivable was an increase of sales. Sales in 2005 were 480 million yuan while in 2006 they were 550 million yuan, an increase of 15%. The increase in accounts receivable was much higher than the increase in sales. Amoi Electronics took high levels of risk with their uncollectible accounts receivable, in order to expand their sales. Thus, an improper disclosure by Amoi Electronics of the classification of bills receivable might mislead in the assessment of financial information users. Financial information users might potentially underestimate the company’s operational risk.

In addition, there was another motivation for the improperly disclosed classification of bills receivable. When the bills receivable were due, the company could directly convert them into accounts receivable. In contrast, bankers’ acceptances are pledged by banks, and so there is a greater possibility of receiving money. Thus, normally, the possibility of fraud in bankers’ acceptances is much less than in bills receivable. Thus, Amoi Electronics could forge sales and deliberately disclose them as bankers’ acceptances to reduce the appearance of risk and also conceal their fraud, because bankers’ acceptances would draw less attention from auditors compared to bills receivable.

In 2006, Amoi Electronics improperly disclosed bills receivable as bankers’ acceptances, which were valued as 280 million yuan, accounting for 40% of the total bills receivable (Zhu, 2012). Also when the due dates of these acceptances came, all of them were converted into accounts receivable (Zhu, 2012). When Tianjian public accounting firm was carrying out the auditing observing and confirmation procedure,
it only randomly selected and checked three bankers’ acceptances, which were valued as 50 million yuan, 40 million yuan, and 20 million yuan, respectively, but these three bankers’ acceptances were actually bills receivable (Zhu, 2012). As such, Tianjian public accounting firm did not exhibit competence in this aspect of the audit, resulting in Amoi Electronics’ misleading bills receivable where they appeared as banker’s acceptances.

Tianjian public accounting firm did not conduct proper auditing procedures in Amoi Electronics’ sales returns. Firstly, Tianjian public accounting firm only conducted auditing procedures for sales return from January to February 2007 belonging to Amoi Electronics’ subsidiaries. As such, the audited sales returns were only a part of the entire sales return (Zhu, 2012). Thus, the auditing procedures were not adequate to discover the issue of sales returns. Secondly, the confirmation letters of account receivable did not specifically note the date of the account receivable that should be checked. Customers normally respond to the closing balance of accounts payable on the 31st December in 2006 (Zhu, 2012). Therefore, Tianjian public accounting firm could not use such confirmation letters as auditing evidence to find sales returns issues after the balance sheet date.

Looking at changes in sales in 2005 and 2006 (Table 2) it is easy to see that Amoi Electronics’ sales in the fourth quarter appeared abnormal. The sales in the fourth quarter of 2005 had increased by 40.74%, compared to sales in the third quarter. And sales in the fourth quarter in 2006 were further increased by 55.28%, compared to sales in the third quarter. Amoi Electronics’ explanation seemed reasonable because of the seasonal characteristic of mobile phone sales, especially during the period
between New Year’s Day and Chinese Spring Festival (Zhu, 2012). However, this period always occurs in the first quarter of each year. Thus, annual reports showed sales typically peaking in the first quarter. Interestingly though, in 2007 sales significantly declined in the first quarter, compared to sales in the fourth quarter of the previous year (Table 20). This strange phenomenon should have drawn auditors’ attention to the possibility that Amoi Electronics might have forged sales at the end of year and conducted sales returns in the following year in order to cover up its loss.
Table 20: Changes in sales between 2005 and 2007 in Amoi Electronics (Zhu, 2012)

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Sales (Yuan)</th>
<th>Increasing rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The first quarter in 2005</td>
<td>1,211,302,729.53</td>
<td></td>
</tr>
<tr>
<td>The second quarter in 2005</td>
<td>1,107,781,761.51</td>
<td>-8.55</td>
</tr>
<tr>
<td>The third quarter in 2005</td>
<td>1,034,390,335.82</td>
<td>-6.63</td>
</tr>
<tr>
<td>The fourth quarter in 2005</td>
<td>1,455,808,587.20</td>
<td>40.74</td>
</tr>
<tr>
<td>The first quarter in 2006</td>
<td>1,446,545,160.40</td>
<td>-0.64</td>
</tr>
<tr>
<td>The second quarter in 2006</td>
<td>1,184,190,457.81</td>
<td>-18.14</td>
</tr>
<tr>
<td>The third quarter in 2006</td>
<td>1,129,080,008.19</td>
<td>-4.65</td>
</tr>
<tr>
<td>The fourth quarter in 2006</td>
<td>1,753,197,370.91</td>
<td>55.28</td>
</tr>
<tr>
<td>The first quarter in 2007</td>
<td>892,474,413.57</td>
<td>-49.09</td>
</tr>
</tbody>
</table>
Thirdly, Tianjian public accounting firm only performed auditing procedures and confirmations on the Amoi Electronics’ discount and price guarantee before the 31st December 2006, according to Amoi Electronics’ accounting system. However, the amount of 20.43 million yuan of discount and price guarantees which was attributed to 2006 had not been confirmed by auditors, because it was later recorded in the accounting system between January and March in 2007 (Zhu, 2012). Thus, Tianjian public accounting firm could hardly have found this undisclosed discount and price guarantee by using the confirmation auditing procedures.

Moreover, according to audit working papers and auditing evidence, Tianjian public accounting firm did not mark the index number corresponding to the label content, while simplifying the statement of audit working paper in rebate and price guarantees (Zhu, 2012). This auditing behaviour violated the requirement of the Article 22 of Chinese CPA Implementation Standards (CCIS) (中国注册会计师职业准则) No. 1101 – auditing objectives and general principles: CPAs should obtain sufficient auditing evidence and also need to assess levels of reliable evidences in order to reduce auditing risk. In addition, CPAs should publish audit opinions, based on the assessment of auditing evidence.

9.3 A dissection of financial reports of Amoi Electronics

The financial report consists of three financial statements including the balance sheet, the income statement, and the statement of cash flows. However, the three statements reflect different financial information. The balance sheet reports the financial position at a specific point in time, which is reflected by the assets, liabilities, and the equity of the company. However, the income statement and the
statement of cash flows report the financial performance for a series of flows over a specific time period. The income statement reports the result of the company’s financial performance, such as profit and loss, while the statement of cash flow reports financial information about the changes to a company’s cash and cash equivalents during a particular period of time. Thus, these three statements provide different financial information to interested users for making economic decisions.

Cash flow is important for a company because it is related to the payment of dividends and the ability to repay debts, and it is also related to the company’s survival and development. A company’s cash flow could present as different types when it is in different life stages. According to Hribar and Yehuda (2015), the life-cycle concept identifies four critical stages in a company’s life: start-up, growth, maturity, and decline (Quinn and Cameron, 1983; Smith et al., 1985; cited from Hribar and Yehuda, 2015). At the start-up stage of a company, earnings are low and cash flows from operating activities are normally negative or low. In addition, due to the company investment in production, cash flows from investing activities are negative at this stage. At this stage, cash mostly comes from financing activities (positive). During the growth stage, cash flows from operating activities are normally positive because revenues grow rapidly. Meanwhile, to continue to extend its market share, the company needs to continue to invest in production. Thus, cash flows from investing activities are negative. However, the cash from operating activities may not satisfy the company’s demand. Therefore, cash flows from financing activities may be positive. When the company moves through to the maturity stage, the company’s products begin to saturate the market; thus investment opportunities diminish. Cash flows from operating and investing activities are positive. However, cash may be
used to pay debts, so cash flows from financing activities may become negative. After entering the stage of decline, a company experiences market shrinkage and falling sales, and cash flows from operating activities is negative. In addition, the company largely collects from its investments to repay debts. As such, cash flows from investing activities may be positive, while cash flows from financing activities may be negative (Hribar and Yehuda, 2015).

According to financial reports of Amoi Electronics from 2002 to 2006 (see Table 20), cash flows from operating activities from 2002 to 2003 were positive. In 2002, cash flows from investing activities were negative due to the launch of two new types of mobile phones, the A8 and A6, which significantly improved sales revenue. According to the income statement of 2002, Amoi Electronics achieved a net profit of 606,938,466.53 yuan (See Table 22). Compared to the net loss of 2001 which was 78,249,478.53, the profit turnaround was remarkable in 2002. In addition, in 2002, due to the transformation of the main business to mobile phones, Amoi Electronics invested in mobile phone research to establish the ‘Shanghai Xiaxin Mobile Communication Technology Co., Ltd.’ (上海厦新移动通信技术有限公司) in Shanghai. To improve mobile phone research, cash flows from investing activities were negative. In 2002, Amoi Electronics did not finance any money and repaid debts occurring in prior financial years. As such, cash flows from financing activities were negative.
Table 21: Select figures from Amoi Electronics’ cash flow statement from 2002 to 2006

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows from operating activities</td>
<td>972,159,531.84</td>
<td>500,968,163.14</td>
<td>-660,344,359.45</td>
<td>154,837,425.25</td>
<td>165,709,220.89</td>
</tr>
<tr>
<td>Cash flows from investing activities</td>
<td>-87,240,224.80</td>
<td>-299,579,621.26</td>
<td>-291,415,095.30</td>
<td>-155,337,059.22</td>
<td>20,701,872.46</td>
</tr>
<tr>
<td>Cash flows from financing activities</td>
<td>-537,294,116.48</td>
<td>253,899,630.06</td>
<td>364,151,729.33</td>
<td>67,146,690.78</td>
<td>-173,843,113.31</td>
</tr>
<tr>
<td>The impact of exchange rate on cash</td>
<td>-260,243.18</td>
<td>-2,820,237.70</td>
<td>-1,722,171.21</td>
<td>-904,317.00</td>
<td>248,026.36</td>
</tr>
<tr>
<td>Net increase in cash &amp; cash equivalents</td>
<td>347,364,947.38</td>
<td>452,467,934.24</td>
<td>-589,329,896.63</td>
<td>65,742,739.81</td>
<td>12,816,006.40</td>
</tr>
</tbody>
</table>
Select figures from Amoi Electronics’ cash flow statement from 2002 to 2006

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash flows from operating activities</th>
<th>Cash flows from investing activities</th>
<th>Cash flows from financing activities</th>
<th>The impact of exchange rate on cash</th>
<th>Net increase in cash &amp; cash equivalents</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>972,159,531.84</td>
<td>-87,240,224.80</td>
<td>-537,294,116.48</td>
<td>-260,243.18</td>
<td>347,364,947.38</td>
</tr>
<tr>
<td>2003</td>
<td>500,968,163.14</td>
<td>-299,579,621.26</td>
<td>253,899,630.06</td>
<td>-2,820,237.70</td>
<td>452,467,934.24</td>
</tr>
<tr>
<td>2005</td>
<td>154,837,425.25</td>
<td>-155,337,059.22</td>
<td>67,146,690.78</td>
<td>-904,317.00</td>
<td>65,742,739.81</td>
</tr>
<tr>
<td>2006</td>
<td>165,709,220.89</td>
<td>20,701,872.46</td>
<td>-173,843,113.31</td>
<td>248,026.36</td>
<td>12,816,006.40</td>
</tr>
</tbody>
</table>
### Table 22: Net profit of Amoi Electronics from 2002 to 2006

<table>
<thead>
<tr>
<th>Year</th>
<th>The net profit (yuan)</th>
<th>Increase amount (yuan)</th>
<th>Increase percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>606,938,466.53</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>590,412,476.20</td>
<td>-16,525,990.33</td>
<td>-2.72%</td>
</tr>
<tr>
<td>2004</td>
<td>15,854,315.52</td>
<td>-574,558,160.68</td>
<td>-97.31%</td>
</tr>
<tr>
<td>2005</td>
<td>-658,050,491.18</td>
<td>-673,904,806.70</td>
<td>-4250.61%</td>
</tr>
<tr>
<td>2006</td>
<td>24,212,631.18</td>
<td>682,263,122.36</td>
<td>103.68%</td>
</tr>
</tbody>
</table>

### The net profit of Amoi Electronics from 2002 to 2006

![Graph showing the net profit of Amoi Electronics from 2002 to 2006](image-url)
In 2003, the reason for the decline in cash flows from operating activities was that a large number of revenues were recorded by bankers’ acceptances that did not result in increased cash. However, Amoi Electronics paid for materials purchased by cash, causing the decrease in cash. In addition, Amoi Electronics in 2003 continued to extend technical research and buy capital assets, which further decreased cash flows from investing activities. Moreover, Amoi Electronics used bank financing to increase cash flows from financing activities.

Amoi Electronics began to decline in 2004. Compared to the net profit in 2003 which was 590,412,476.20 yuan, the net profit in 2004 was only 15,854,315.52 yuan, which represented a drastic decrease of 97.31%, because of high competition in the mobile phone market, clean-up inventory, and continued decrease in mobile phone prices (Table 2). The reason for declining cash flows from operating activities was not only due to the decrease in profitability but also the decrease in receivables turnover. In 2004, Amoi Electronics also used bank financing to increase cash flows from financing activities.

In 2005, Amoi Electronics suffered a loss of 658,050,491.18 yuan. Compared to the net profit of 2004, horizontal change of the net profit during 2005 was the amount of 673,904,806.70 yuan, which represented a decrease of 4250.61% (Table 2). The reason given was the same as for 2004: high competition in the mobile phone market causing a decrease in profitability. However, cash flows from operating activities were positive, because of the clean-up of inventory and the extension of accounts payable. Although cash flows from operating activities were positive, these cash flows were not entirely due to the growth of revenues. Cash flows from investing
activities were negative, because of continuing to invest in technical research. Moreover, in 2004, Amoi Electronics used bank financing to increase cash flows from financing activities (The financial report of Amoi Electronics, 2004).

In 2006, the net profit turnaround was significant, an amount of 24,212,631.18 yuan, an increase of 103.68%. From 2002 to 2005, financial performance had presented a declining trend, but this significant profit turnaround did not attract the attention of the auditors. Amoi Electronics attributed the rapid growth of sales to lower sales price in the competitive mobile phone market. However, according to the statement of cash flow, Amoi Electronics did not make any investment outside the company while collecting earnings from prior investments. And also the company was not financing to increase cash flows from financing activities. As such, the profit in 2006 was mostly from sales revenue. However, Amoi Electronics suddenly became profitable after a previous large loss and that should have signalled caution to the auditors because the company had not significantly changed its products nor made other changes.

The income statement combined with the statement of cash flow can help detect financial issues. For example, the operations index ratio compares the company’s profit with cash flows from operating activities, which provides an index of the cash-generating productivity of the company’s operations. The higher this ratio is, the better the company’s performance, since it means the company has a strong capability of receivables from operating and low pressure of a company’s finance. The operations index is calculated as in Formulae 1.
As shown in Table 23, the operations index of Amoi Electronics from 2002 to 2005 indicated a fall from 1.60 in 2002 to -0.24 in 2005. Moreover, in 2004, the operations index fell as low as -41.65, which means that producing 1 (yuan) profit would cause 41.65 (yuan) cash flowing out. Amoi Electronics explained that high competition in the market caused the decline in revenue from mobile phones. However, after Amoi Electronics suffered this decline, it made a miraculous turnaround in 2006. In 2006, the operations index was 6.84. A question raised is whether the mobile phone market fluctuation was consistent with Amoi Electronics’ explanations. This study compares Amoi Electronics with another company, Ningbo Bird Co., Ltd, which is another Chinese nationally renowned mobile phone company. The operations index in Ningbo Bird from 2002 to 2006 were all positive and tended to be stable from 2004 to 2006, being 0.26, 0.84, and 0.50, respectively. However, the operations index of Amoi Electronics exhibits strong fluctuations from 2004 to 2006 (Figure 17). Although the operation index in both companies went down in 2004, the operation index in Amoi Electronics dramatically declined. Auditors should have paid much more attention to whether Amoi Electronics presented a false income statement.
Table 23: The operations index of Amoi Electronics and Ningbo Bird from 2002 to 2006

The table of operations index of Amoi Electronics

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash flows from operating activities (yuan)</td>
<td>972,159,531.84</td>
<td>500,968,163.14</td>
<td>-660,344,359.45</td>
<td>154,837,425.25</td>
</tr>
<tr>
<td></td>
<td>The net profit (yuan)</td>
<td>606,938,466.53</td>
<td>590,412,476.20</td>
<td>15,854,315.52</td>
<td>-658,050,491.18</td>
</tr>
<tr>
<td></td>
<td>The operations index</td>
<td>1.60</td>
<td>0.85</td>
<td>-41.65</td>
<td>-0.24</td>
</tr>
</tbody>
</table>

The table of operations index of Ningbo Bird

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash flows from operating activities (yuan)</td>
<td>594,365,720.05</td>
<td>855,935,710.84</td>
<td>54,185,322.19</td>
<td>-396,583,409.33</td>
</tr>
<tr>
<td></td>
<td>The net profit (yuan)</td>
<td>251,816,972.98</td>
<td>245,023,581.50</td>
<td>207,459,814.58</td>
<td>-471,202,679.59</td>
</tr>
<tr>
<td></td>
<td>The operations index</td>
<td>2.36</td>
<td>3.49</td>
<td>0.26</td>
<td>0.84</td>
</tr>
</tbody>
</table>
Figure 17: The operations index of Amoi Electronics and Ningbo Bird from 2002 to 2006
To sum up, it is helpful and efficient to detect questionable issues by using information from the statement of cash flows in combination with other financial statements. However, the Tianjian public accounting firm issued unqualified reports in 2005 and 2006. Without reference to the influence of culture, did auditors pay attention to the information from the cash flow statement but not find any issue, or did they not even attach any importance to the cash flow statement?

It may be that in China, statements of cash flow are not taken notice of, partly because the statement of cash flow was developed quite late, compared to international accounting standards. The International Accounting Standards Committee reissued the International Accounting Standards No.7 (IAS 7) – Cash Flow Statements in 1992 and it came into effect in 1994, replacing the IAS 7 – Statement of Changes in Financial Position in 1977 (Deloitte, 2016) (The history of IAS 7 can be seen in Table 24). However, in the Chinese Accounting Standards – the statement of cash flow was issued in 1998. In 2001, the revised Chinese Accounting Standards – the statement of cash flow started to be used for all companies, although this does not mean every company prepared statements of cash flow in 2001. In 2006, Ministry of Finance revised and issued the Chinese Accounting Standards No. 31 – the statement of cash flow, which converged to IAS 7 and required all listed companies to prepare a statement of cash flow. Although it converged to IAS 7, there were still some differences. Firstly, IAS 7 defines that “bank overdrafts are included as a component of cash and cash equivalents” (IAS 7, 2010, p.2), while bank overdrafts are not included as a component of cash and cash equivalents in China.
Table 24: History of IAS 7 (Deloitte, 2016)

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1976</td>
<td>Exposure Draft E 7 Statement of Source and Application of Funds</td>
</tr>
<tr>
<td>October 1977</td>
<td>IAS 7 Statement of Changes in Financial Position</td>
</tr>
<tr>
<td>July 1991</td>
<td>Exposure Draft E36 Cash Flow Statements</td>
</tr>
<tr>
<td>1 January 1994</td>
<td>Effective date of IAS 7 (1992)</td>
</tr>
<tr>
<td>6 September 2007</td>
<td>Retitled from Cash Flow Statements to Statement of Cash Flows as a consequential amendment resulting from revisions to IAS 1</td>
</tr>
<tr>
<td>16 April 2009</td>
<td>IAS 7 Amended by Annual Improvements to IFRSs 2009 with respect to expenditures that do not result in a recognized asset</td>
</tr>
<tr>
<td>1 July 2009</td>
<td>Effective date for amendments from IAS 27 (2008) relating to changes in ownership of a subsidiary</td>
</tr>
<tr>
<td>1 January 2010</td>
<td>Effective date of the April 2009 revisions to IAS 7</td>
</tr>
<tr>
<td>29 January 2016</td>
<td>Amended by Disclosure Initiative (Amendments to IAS 7)</td>
</tr>
<tr>
<td>1 January 2017</td>
<td>Effective date of the January 2016 revisions to IAS 7</td>
</tr>
</tbody>
</table>
Secondly, IAS 7 allows companies to report the statement of cash flow using either the direct method\textsuperscript{30} or the indirect method\textsuperscript{31}, but encourages companies to report the statement of cash flow using the direct method (IAS 7, 2010). However, according to Chinese Accounting Standards No. 31 – the statement of cash flow, companies preparing a statement of cash flow are required to use the direct method, and meanwhile disclose cash flow information using the indirect method in financial notes.

Thirdly, IAS 7 requires “cash flows arising from taxes on income” to “be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities” (IAS 7, 2010). However, the Chinese Accounting Standards require that cash flows arising from taxes on income shall be all disclosed in cash flow from operating activities (Chinese Accounting Standards, 2006).

Fourthly, Article 6 in the Chinese Accounting Standards No. 31 – the statement of cash flow requires that losses from natural disasters, insurance claims and other special items should be, depending on their nature, integrated into cash flows from operating activities, investing activities, and financing activities, respectively. However, in IAS 7, there is not this requirement (Chinese Accounting Standards, 2006).

\textsuperscript{30} The direct method is preparing a statement of cash flow whereby “major classes of gross cash receipts and gross cash payments are disclosed” (IAS 7, 2010, p. 4).

\textsuperscript{31} The indirect method is preparing the statement of cash flow whereby “profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows” (IAS 7, 2010, p. 4).
Moreover, IAS 7 requires that disclosing cash flows from interest received and paid shall be classified as cash flows from operating activities, investing activities, and financing activities, depending on their nature. However, in China, interest paid shall be classified as financing cash flow, while interest received shall be classified as three different activities cash flows depending on their nature.

In reality, there is a problem for Chinese accountant to prepare the statement of cash flow. Financial statements are recorded on an accrual basis and then adjusted. However, the statement of cash flow is prepared on a cash basis, which reflects the information of cash inflows and outflows. When using the direct method to prepare the cash flow statement, Chinese accountants use an adjustment method by the working paper and the T-type accounts to transform financial statement balances from the accrual basis to the cash basis. However, the cash flow statement is prepared at the end of the accounting period. The adjustment of entries is very comprehensive, because the relationship between accounts is complex. As such, the process of adjustment is difficult, and there is a large possibility of making errors. In addition, in a company, the accountants’ division of functions are clear, and each accountant has their own details of the accounts. For example, account payable accountants provide processing of vendor invoices, check requests, and expense reports, including monthly credit card expenses. However, payroll accountants may need to evaluate payroll data, income statement accounts, and analyse payroll affiliated balance sheets. As such, the adjustment of the cash flow statement entries involves the accounting information from different accountants. Thus, the adjustment creates a lack of coherence between daily processing and period end processing, and makes it difficult to ensure the accuracy of the data.
In theory, if financial statements are recorded by the cash basis, the cash flow statement is not difficult to prepare. However, in reality accountants translate the cash flow statement after using the accrual basis for the other financial statements, which needs a complex adjustment and is difficult to understand, and may also mean the cash flow statement does not function as expected.

9.4 Conclusion

This chapter used the Amoi Electronics case to analyse how a listed company made a series of accounting frauds. It provides insights into how to analyse financial reports to detect financial issues. Due to the balance sheet and the income statement being prepared on an accrual basis while the statement of cash flow is prepared on a cash basis, reviewing three statements may be more helpful to detect companies’ financial issues. However, in China, the statement of cash flow was developed quite late, compared to international accounting standards. The adjustment of transactions recording from the accrual basis to cash basis is much more complicated for the preparation of cash flow statements because of the need to adjust the accrual-based number in the other financial statements. This may explain why in reality auditors do not pay more attention to the statement of cash flow.

According to the analysis of financial reports of Amoi Electronics, this chapter provides some examples of how companies make accounting frauds, and finds that the motivation for a listed company to forge accounting information is to avoid delisting risk.
From these three case studies, some potential risks in the Chinese auditing industry and corporate governance in China can be perceived. In the case of Yin Guang Xia, after the enterprise reform, China transplanted western corporate structures, but China only adopted the naming protocol of these structures, leaving a company strongly controlled by majority shareholders, and remaining in traditional hierarchical management. Moreover, SOEs did not clarify the relationship with the government after the enterprise reform because of the embedded party secretaries in corporate structures. In the context of Chinese culture, guanxi and hierarchical management might cause the transplanted corporate governance to be not effective. In addition, after the program of disaffiliation, the MOF continues to govern the CICPA. The government, as a majority shareholder in some SOEs, also governs the CICPA operations, which may risk decreasing auditor independence, because the government is both regulator and participant which may use guanxi to gain its favourite benefits.

The case of Green Land also provided insights into how Chinese culture (especially guanxi) and the government impact auditor independence. Although the Chinese government transplanted the international auditing standards and other regulations, these regulations did not take effect as expected, because of the influence of Chinese culture and a low degree of regulation.

The case of Amoi Electronics explained how professionals interpreted and challenged new institutions within the limitation of cultural and social environments. Listed companies used connected transactions, inflated income, and intentionally
decreased costs to make fraudulent profit, and conduct false operations of cash flow in order to become a listed company, conduct tunnelling and prevent delisting.

Therefore, from the three case studies, although China is converging to the international auditing standards and other regulations to assist in adapting to the global market, these regulations may not take effect as expected, because of the effect of Chinese culture.
CHAPTER 10 THE DEVELOPMENT OF CHINESE AUDITING STANDARDS AND THE EXTERNAL SUPERVISION SYSTEM OF LISTED COMPANIES

In the Chinese Auditing Standards, there is no specific standard to guide the auditing of the cash flow statement, and this can be seen in the development of Chinese auditing standards. Chinese auditing standards experienced four stages up to 2012.

The first stage (from 1991 to 1993) was developing and designing Chinese CPA’s implementation guidance. In this period, the CICPA was continuing to issue 7 implementation guides, which was important to promote CPA to become professional and legalised.

The second stage (from 1994 to 2003) was establishing Chinese auditing standards. On 31th October 1993, the Chinese CPA’s Law (中国注册会计师法) was passed in the fourth meeting of the Standing Committee of the Eighth National People’s Congress. After approval by the MOF, the CICPA started to draft the Chinese Independent Auditing Standards (中国独立审计准则) from May 1994. By the middle of 2003, the CICPA had developed a preamble to the standards, a general standard, 28 independent auditing standards, 10 independent audit announcements, 5 practical guides, and 3 relevant standards (which include the professional ethical standards, the auditing quality control standards, and the further education standards) (Figure 18), to a total of 48 standards.
Figure 18: The system of Chinese Independent Auditing Standards in 2003

A preamble of the standards

A general standard

28 independent auditing standards

10 independent audit announcements

5 practical guidance

3 relevant standards: the professional ethical standards, the auditing quality control standards, and the further education standards
The third stage (from 2004 to 2006) was improving and developing Chinese auditing standards. The global trend of convergence in the international auditing standards has gained increasing momentum in the past decades. For example, Hong Kong totally adopted the international auditing standards, India and Singapore partly adopted the international auditing standards and England and Australia developed their new national auditing standards based on the international auditing standards and their existing standards. By the end of 2003, the International Auditing and Assurance Standards Board (IAASB) issued 4 auditing standards that related to auditing risk testing: the International Standards on Auditing (ISA) No. 200 – overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing, the ISA No. 315 – identifying and assessing the risks of material misstatement through understanding the entity and its environment, the ISA 330 – the auditor’s responses to assessed risks, and the ISA 500 – audit evidence. These four international auditing standards are used to guide CPAs to identify, assess and respond to the risks of material misstatement in financial reports, and they are also called audit risk standards. In order to converge to the international auditing standards, Chinese financial auditing standards also need to be revised and improved. At the end of 2004, there were significant differences between Chinese auditing standards and the international auditing standards. For 24 auditing standards in the international auditing standards there were no significant differences in Chinese auditing standards but 9 auditing standards did have significant differences. Thirteen auditing standards in the international auditing standards did not exist in Chinese auditing standards. Moreover, there were 3 auditing standards still in use in Chinese auditing standards that were abolished in the international standards. There were 4 auditing standards which were peculiar to Chinese, with no corresponding equivalent
in the international auditing standards. The reasons for these differences are mainly as follows: first, in the development of standards, some standards were transplanted from American auditing standards, resulting in a mismatch with the international auditing standards system. Second, the revision of Chinese auditing standards lags behind ISAs. Third, the development of Chinese auditing standards started late. Some standards had not even been developed yet. Fourth, some international auditing standards were not suitable for the Chinese auditing situation.

By the end of 2005, CICPA had developed and issued 17 new auditing standards and 5 exposure drafts, as well as revised 26 published standards. In 2006, CICPA formally published 5 auditing standards which were drafted in 2005. By the end of 2006, there were 48 Chinese auditing standards (including 2 Chinese peculiar standards), that corresponded to 46 international auditing standards (Table 25).

The fourth stage (from 2007 to 2012) was the continuing convergence to the International Standards on Auditing (ISA). Chinese auditing standards (CSA) (中国注册会计师审计准则) were officially issued in November 2010, including 38 standards, and were effective from 1st January 2012 (The Chinese Institute of Certified Public Accountants, 2010). Since the new CSA were effective, the Chinese CPA Implementation Standards (中国注册会计师执业准则) (CCIS) issued in 2006 were abolished. The new CSA are more converged to the International Standards on Auditing (ISA). Compared to the CCIS, there are 21 redrafted standards, 16 revised standards, and 1 added standard (Table 26) (Riva and Provasi, 2014). The added standard is the CSA 1152 – Communicating deficiencies in internal control to those charged with governance and management, which aims to design a suitable auditing
procedure rather than disclose an effective opinion for the internal control, when auditors engage in risk assessment. Compared to CSA 1152, CSA 1211 and CSA 1231\textsuperscript{32} which require auditors to know audited companies’ internal control and implement auditing risk testing.

\textsuperscript{32} CSA 1211 is identifying and assessing the risks of material misstatement through understanding the entity and its environment. CSA 1231 is the auditor’s responses to assessed risks.
Table 25-1: The comparison of auditing standards between the *Chinese CPA Implementation Standards* (CCIS) and the *International Standards on Auditing* (ISA) in 2006 (Wang and Liu, 2005)

<table>
<thead>
<tr>
<th>Chinese CPA Implementation Standards (CCIS) in 2006</th>
<th>Corresponding to the ISAs</th>
<th>Continuing effectively published standards</th>
<th>Revised auditing standards</th>
<th>Added auditing standards</th>
</tr>
</thead>
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<td>Yes</td>
<td>No</td>
<td>Released time</td>
<td>Released time</td>
</tr>
<tr>
<td>CCIS 1101 - overall objectives of the independent auditor and the conduct of an audit in accordance with Chinese standards on auditing</td>
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<td>CCIS 1111 – agreeing the terms of audit engagements</td>
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<td>CCIS 1121 – quality control for an audit of financial statements</td>
<td>√</td>
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<td>CCIS 1131 – audit documentation</td>
<td>√</td>
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<tr>
<td>CCIS 1141 – the auditor’s responsibilities relating to fraud in an audit of financial statements</td>
<td>√</td>
<td></td>
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</tr>
<tr>
<td>CCIS 1142 – consideration of laws and regulations in an audit of financial statements</td>
<td>√</td>
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<tr>
<td>CCIS 1151 – communication with those charged with governance</td>
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<tr>
<td>CCIS 1152 – communications between the auditor and his/her predecessor</td>
<td>√</td>
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<tr>
<td>CCIS 1201 – planning and audit of financial statements</td>
<td>√</td>
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<td></td>
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</tr>
<tr>
<td>CCIS 1211 – identifying and assessing the risks of material misstatement through understanding the entity and its environment</td>
<td>√</td>
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<tr>
<td>CCIS 1212 – audit considerations relating to an entity using a service organization</td>
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Table 25-2: The comparison of auditing standards between the *Chinese CPA Implementation Standards* (CCIS) and the *International Standards on Auditing* (ISA) in 2006 (Wang and Liu, 2005)

<table>
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<tr>
<th>Chinese CPA Implementation Standards (CCIS) in 2006</th>
<th>Corresponding to the ISAs</th>
<th>Continuing effectively published standards</th>
<th>Revised auditing standards</th>
<th>Added auditing standards</th>
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<tr>
<td></td>
<td>Yes</td>
<td>No</td>
<td>Released time</td>
<td>Released time</td>
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<td>CCIS 1231 – the auditor’s responses to assessed risks</td>
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<tr>
<td>CCIS 1301 – audit evidence</td>
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<tr>
<td>CCIS 1311 - the goods in stock scrutinizing stocktaking</td>
<td>✓</td>
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<tr>
<td>CCIS 1312 – external confirmations</td>
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<td>CCIS 1313 – analytical procedures</td>
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<td>CCIS 1314 – audit sampling</td>
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<td>CCIS 1321 – audit accounting estimates</td>
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<td>CCIS 1322 – audit fair value accounting estimate and related disclosures</td>
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<td>CCIS 1323 – related parties</td>
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<td>CCIS 1324 – going concern</td>
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<td>CCIS 1331 – initial audit engagements – opening balances</td>
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<td>CCIS 1332 – subsequent events</td>
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Table 25-3: The comparison of auditing standards between the *Chinese CPA Implementation Standards* (CCIS) and the *International Standards on Auditing* (ISA) in 2006 (Wang and Liu, 2005)

<table>
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<tr>
<th>Chinese CPA Implementation Standards (CCIS) in 2006</th>
<th>Corresponding to the ISAs</th>
<th>Continuing effectively published standards</th>
<th>Revised auditing standards</th>
<th>Added auditing standards</th>
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<td></td>
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<td>CCIS 1341 – written representations</td>
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<td>CCIS 1401 – using the work of other CPAs</td>
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<td>CCIS 1411 – considering the work of internal auditors</td>
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<td>CCIS 1421 – using the work of an auditor’s expert</td>
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<td>CCIS 1501 – forming on opinion and reporting on financial statements</td>
<td>√</td>
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<tr>
<td>CCIS 1511 – comparative information</td>
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<td>CCIS 1521 – the auditor’s responsibilities relating other information in documents containing audited financial statements</td>
<td>√</td>
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<tr>
<td>CCIS 1601 – auditing report for specific elements, accounts or items</td>
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<td>CCIS 1602 – capital verification</td>
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<td>CCIS 1611 – audit of commercial bank’s financial statement</td>
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<td>CCIS 1612 - external confirmations during the audit of commercial bank’s financial statement</td>
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<td>CCIS 1613 – the relationship between bank supervision departments</td>
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Table 25-4: The comparison of auditing standards between the *Chinese CPA Implementation Standards* (CCIS) and the *International Standards on Auditing* (ISA) in 2006 (Wang and Liu, 2005)

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<th>Chinese CPA Implementation Standards (CCIS) in 2006</th>
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<th>Continuing effectively published standards</th>
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<td>CCIS 1631 – special considerations – audit of environmental events or items in financial statements</td>
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<td>CCIS 2101 – review the financial statements</td>
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<td>CCIS 3101 – audit or review historical financial information or other certified information</td>
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<td>CCIS 4101 – the implementation of the agreed procedure to financial information</td>
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<td>CCIS 5101 – quality controls for firms that perform audits and reviews of financial statements and other assurance and related services engagements</td>
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### Table 1. Clarified ISA and CSA

<table>
<thead>
<tr>
<th>ISA</th>
<th>n. CSA</th>
<th>CSA (Chinese Auditing Standards)</th>
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<th>RD</th>
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<td>ISA 200</td>
<td>CSA 1101</td>
<td>Overall Objectives of the Independent Auditor and the Conduct of an Auditor Accordance with Chinese Standards on Auditing</td>
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<td>ISA 210</td>
<td>CSA 1111</td>
<td>Agreeing the Terms of Audit Engagements</td>
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<td>ISA 220</td>
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<td>Quality Control for an Audit of Financial Statements</td>
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<td>CSA 1131</td>
<td>Audit Documentation</td>
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<td>ISA 240</td>
<td>CSA 1141</td>
<td>The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements</td>
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<td>Communications with those charged with governance</td>
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<td>ISA 265</td>
<td>CSA 1152</td>
<td>Communicating Deficiencies in Internal Control to those Charged with Governance and Management</td>
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<td>ISA 300</td>
<td>CSA 1201</td>
<td>Planning and Audit of Financial Statements</td>
<td>x</td>
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<td>ISA 315</td>
<td>CSA 1211</td>
<td>Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment</td>
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<td>ISA 320</td>
<td>CSA 1221</td>
<td>Materiality in Planning and Performing an Audit</td>
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<td>ISA 330</td>
<td>CSA 1231</td>
<td>The Auditor’s Responses to Assessed Risks</td>
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<td>ISA 402</td>
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<td>Audit Considerations Relating to an Entity Using a Service Organization</td>
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<td>Audit Evidence-Specific Considerations for selected items</td>
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<td>External Confirmations</td>
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<td>ISA 510</td>
<td>CSA 1331</td>
<td>Initial Audit Engagements-Opening Balances</td>
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<td>Analytical Procedures</td>
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<td>ISA 530</td>
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<td>Audit Sampling</td>
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<tr>
<td>ISA 540</td>
<td>CSA 1321</td>
<td>Audit Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures</td>
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10.1 The motivation of listed companies conducting fraud and some common examples of false accounting operations

In China, there are continuing instances of unexpected corporate failures and scandals, but what is the motivation for listed companies to make false accounting operations alongside the problems of company failure? The reasons are various and include becoming a listed company (as shown in Chapter 8 – Green Land). The section introduces other techniques, such as tunneling and prevention of delisting, and also shows some common examples of false accounting operations.

In the gradual process of Chinese enterprise reform, China has adopted corporate governance systems, such as independent directors and supervisors, from the USA and other western capitalist nations. The aim of enterprise reform was to separate the state from the management and limit the state to the role of controlling shareholder of the enterprise. This was in order to promote higher efficiency, enhance the profit-making capability of companies, increase competitiveness and decrease the ability of bureaucracy to interfere in the lawful activities of corporations (Zhou, 2011). These changes gave managers more autonomy in daily management and control of strategic decisions. However, these changes also created several agency problems, such as control of the firm and majority shareholders expropriating minority shareholders’ interests (Huang, 2015) which is referred to as ‘tunneling’ (Huang, 2015).

Tunneling is the transfer of assets and profits out of firms for the benefit of those who control them, and has drawn the attention of recent corporate finance scholars (Chen, et al., 2006; Liu and Lu, 2007; Chen, et al., 2009; Peng, et al., 2011; Wang and Xiao; 2011; Huang, 2015). Tunneling is prevalent among Chinese listed
companies because of “its relatively underdeveloped legal environment, absence of effective corporate governance, high concentration of corporate ownership, and high level of government intervention” (Huang, forthcoming, 2015). But the concept is not generally known in other developed countries. Previous studies have empirically investigated various forms of tunneling among Chinese listed companies. For example, Chen et al. (2006) examined the effect of ownership structure and boardroom characteristics on tunneling. Liu and Lu (2007) introduced tunneling to examine the relation between earnings management and corporate governance. Chen et al. (2009) reported that dividends might be used by controlling shareholders to engage in tunneling. Peng et al. (2011) developed Friedman et al.'s model to test Chinese listed companies. They found that when a company was in good financial condition controlling shareholders were more likely to use connected transactions to engage in tunneling, while in financial distress, they were more likely to use connected transactions to prop up the listed company. Wang and Xiao (2011) showed that controlling shareholders who engaged in tunneling for private benefits had a lower sensitivity to the relationship between executive pay and companies’ performance. Huang (2015) investigated the balance of outstanding related-party loan guarantees (RPLG) of Chinese listed companies to illustrate that both the intensity and the propensity of tunneling though RPLG had increased after the 2008 enterprise income tax reform.

Although prior studies have documented various forms of tunneling in Chinese listed companies, here a question is raised when companies continue tunneling, how do listed companies inflate profit to avoid delisting and keep their right to issue new
shares? Answering this question may help auditors to detect tunneling in future auditing work to protect minority shareholders’ interests.

According to *Rules Governing the Listing of Stocks on Shanghai Stock Exchange*, if “the company has been in the red in the most recent two consecutive years (based on the audited net profits disclosed in the latest two annual reports)” (Shanghai Stock Exchange, 2012, p. 860), the Exchange will issue a delisting risk warning on the stocks of the listed company. If the company continues to make losses in the third year, it will be issued as a particular transfer company which means suspension of trading (Peng et al., 2011). That is one of the reasons that listed companies may engage in creative accounting after losses so that they suddenly become profitable in order to keep their listing.

In order to keep their listing, companies make false profits in the following ways. Firstly, listed companies use connected transactions to inflate profit. In China, to become a listed company is not easy. Normally, companies need to have at least 30 million yuan in share capital and no record of accounting fraud in the last three consecutive years, according to Chinese Company Law. Some companies start to conduct fraud before becoming listed companies. For example, Company B would separate its assets and liabilities; it would invest good assets in Company A, while Company B retains the liabilities. To avoid stock supervisory committee inspections of parent company B, company B would also establish another non-listed company C. Company B would separate all bad assets and liabilities to the company C. After these operations, company A becomes a ‘fresh and healthy’ company. After company A becomes a listed company, it would start to help the parent company B.
That is one of the reasons why after becoming a listed company, controlling shareholders start to divert funds.

After becoming a listed company, company A can issue new shares for financing as long as its return on equity is not less than 10% over three consecutive years before issuing new shares (Peng et al., 2011). To meet this requirement, the listed company A also can use connected transactions to inflate profit. For example, if the related company C purchases products from company A, with a market value of 10 million yuan, but company A sells these products for 20 million yuan that inflates the revenue by 10 million yuan. However, this kind of connected transaction was too easily recognized by the stock supervisory committee. For this reason the Ministry of Finance and the Chinese Securities Regulatory Committee issued several rules about connected transactions. For example, “the connected transactions of a total value of greater than 30 million or 5% of net assets, which is higher, the transaction price must be appraised or audited by professionals and approved in the general meeting of shareholders” (Peng et al., 2011, p. 310). Thus, this kind of connected transaction is improved. For example, in the situation above, a non-related company D could be asked to purchase products from the company A at 20 million yuan, when their market value was 10 million yuan, and then company C could purchase these products from company D. In this example, the market value of products is easy to identify. However, sometimes, this kind of connected transaction presents as consulting services and in these cases it is difficult to recognize the real value of services.
Secondly, a listed company may also make false income statements by inflating income and apparently decreasing costs. Inflating income can be illustrated in the following ways. A listed company creates a fictitious customer to inflate income. For example, the listed company A sells products to the fictitious customer F, taking the normal procedures to simulate the operation, including fake orders, fake sales contracts, falsified shipping documents, and real sales invoices approved by the tax department.

Listed companies inflate income in real transactions. For example, a listed company A sells products to company G, in a real sales transaction. However, when company A records this transaction, company A intentionally expands the amount of products in order to inflate the income. In some cases, the company forges this kind of transaction with many customer companies. It is difficult for auditors to detect this kind of fraud.

Listed companies can also intentionally record accounts received in advance as revenue in this accounting period in order to adjust profits.

In addition, a listed company can use accounts receivable to adjust income. For example, the listed company A falsifies a transaction which is valued at 10 million yuan recorded in the accounts receivable. When this transaction is over 1 year, the company A transfers this record to long-term accounts receivable or other receivable.

Moreover, listed companies use deficits to counteract invoices and inflate income. For example, at the end of the financial year, listed company A falsely writes out a
huge invoice to the buyer company H in order to inflate revenues. Early the next year, company A uses the RED number (reverse transaction) to write down the inflated number in accounts receivable.

Apparently decreasing costs or expenses to inflate net income is normally through provisions. Provisions are used to prevent a future company’s value change risk, but the provision can be recorded in various ways which provide the opportunity for the company to inflate income. For example, the company may intentionally decrease allowance for doubtful debts and impairment for assets or may not record the decrease in order to intentionally decrease expenses. Deferred and prepaid expenses could be treated in the same way as above. Moreover, the company may also intentionally transfer administrative expenses and financial expenses to deferred assets, construction in progress, and assets awaiting a deal loss or income (unsettled assets profit and loss) in order to not only decrease expenses but also inflate assets.

To sum up, listed companies can create false profits through transfer payments with connected transactions and entities, inflating income, and intentionally decreasing costs. These kinds of adjustments are according to accrual based accounting assumptions or fraud. However, the statement of cash flow is assumed to be prepared on the cash basis. The statement of cash flow is supposed to prevent the company inflating profit and help auditors detect false profits. However, in reality, listed companies also produce false cash flow statements.

Listed companies use Accounts Receivable to inflate profit and to inflate cash flow. Listed companies directly give cash to customers, and then ask customers to use this
cash to purchase its products, which inflates income and cash flow. In the accounting general journal, it may present as the following entries:

1. Dr: Construction in Progress (prepaid for purchase or other receivable)
   Cr: Cash in banks
2. Dr: Cash in banks
   Cr: Sales
   Taxes payable – output tax
3. Dr: Cost of goods sold
   Cr: Inventories

In addition, a listed company may also adjust the payment period of accounts payable in order to reduce cash flow out. A listed company may also intentionally record cash flow from investing activities into cash flow from operating activities. For example, listed company A invests some cash in securities. When company A needs cash, it then sells these securities, and the cash flow should be recorded as investing activities. However, listed company A may change customer contracts, or forge customers’ seals and fake contracts in order to forge sale transactions. Finally, company A engages in false sales transactions by using cash flow from investing activities in order to increase the cash flow from operating activities.

10.2 Comments on the Chinese accounting standards and accounting rules

As discussed above, listed companies may use connected transactions, inflate income, and intentionally decrease costs to make fraudulent profits, and also conduct false operations in the cash flow statement in order to make fraud more difficult to find.

According to Mary Douglas’ grid-group analysis, individuals’ cognition might not be cultivated to cope with new and rapid institutional changes. However, it is
important to remember that Chinese accounting standards are still in transition. Before Chinese economic reforms, China’s enterprises had a single form of ownership and existed in a highly centralized planned economic system. Accounting standard systems were unchanged for years. After economic reform, the Chinese accounting standard system was changed. The development of Chinese accounting standards can be divided into four stages: introducing international accounting standards, studying international accounting standards, improving Chinese accounting standards, and converging to the international accounting standards, in which all was done in a very short time compared to that taken in Western countries.

Firstly, between 1979 and 1992, China introduced the international accounting standards. The initiation of Chinese accounting standards development is the Regulations on Financial Issues of Sino-foreign Equity Joint Ventures (关于中外合资工业企业财务会计问题的若干规定) promulgated in 1979. In addition, the Enterprise Accounting Standards (企业会计准则) and the Enterprise Financial Standards (企业财务通则) were promulgated in November 1992, as well as 13 industry accounting rules (in Chinese: 行业会计制度) and 10 industries financial rules (行业财务制度) (referred to as ‘two standards’ and ‘two rules’). The main features of this stage were the Regulations on Financial Issues of Sino-foreign Equity Joint Ventures in 1979 and the Accounting Rules for Sino-foreign Equity Joint Ventures (中外合资企业会计制度) in 1985 for the first time with reference to international practices.
Secondly, between 1993 and 2000, the ‘two standards’ and ‘two rules’ became effective on the 1st July 1993, and in December 2000 the MOF promulgated the *Enterprise Accounting Rules (企业会计制度)*. In this stage, China began to learn the international accounting standards, and also implemented the ‘two standards’ and ‘two rules’ according to national conditions. During this period, following Chinese financial scandals, the first specific accounting standard, the *Enterprise Accounting Standards – Disclosure of connected transactions (企业会计准则 – 关联方关系及交易的披露)* was issued in 1997 and took effect in 1998. By the end of 2001, China had promulgated 16 accounting standards, which indicated that China had quickly established a Chinese accounting system with reference to international accounting practices.

Thirdly, on the 1st January 2001, the *Enterprise Accounting Rules (企业会计制度)* took effect. To improve the Chinese accounting standard system, the *Accounting Rules for Financial Enterprises (金融企业会计制度)* was promulgated in 2001, as well as the *Small Business Accounting Rules (小企业会计制度)* in 2003 and the *Nongovernmental Nonprofit Organization Accounting Rules (民间非营利组织会计制度)* in 2004.

Fourthly, on the 15th Feb 2006, the Ministry of Finance announced the *Chinese Accounting Standards (中国会计准则)* which became effective on the 1st January 2007, and included 39 new accounting standards. The most prominent feature of the new *Chinese Accounting standards* was the adoption of principles based accounting
standards, which are converged to the *International Financial Reporting Standards* (IFRSs).

As described above, China has both accounting rules and accounting standards: *Enterprise Accounting Rules* (企业会计制度) in 2001 is the rules-based accounting approach, while the *Chinese Accounting Standards* (中国会计准则) in 2006 is the principles-based accounting approach. Both accounting regulations were issued by the MOF. The *Enterprise Accounting Rules* were first implemented in joint stock companies. In 2002, all foreign invested companies started to use the *Enterprise Accounting Rules*, and meanwhile SOEs were also encouraged to use them. At the end of 2005, all central SOEs under the control of the State-owned Assets Supervision and Administration Commission started to use the *Enterprise Accounting Rules*. The accounting rules include the *Enterprise Accounting Rules*, the *Accounting Rules for Financial Enterprises*, and the *Small Business Accounting Rules*, which provide respective operations of the set of accounting subjects, the specific accounting operations, and financial reports preparation for general business, financial and insurance companies, and small business.

However, since the new *Chinese Accounting Standards* were implemented on the 1st January 2007, all listed companies have changed to use the *Chinese Accounting Standards*. Other non-listed companies can choose either the *Chinese Accounting Standards* or the *Enterprise Accounting Rules*, but companies have been encouraged to use the *Chinese Accounting Standards* in order to converge to international accounting standards. The *Small Business Accounting Rules* (小企业会计制度) of 2003 were repealed on the 1st January 2013, and meanwhile the *Small Business*
Accounting Standards were implemented. Since the new Chinese Accounting Standards were issued, the guidance and explanation for the standards continue to be promulgated.

Although China gradually accepted the international accounting practice that took a principles-based accounting approach, accounting rules and accounting standards still coexist in China. This means that both principles-based and rules-based accounting approaches are taken in China. The Chinese unique accounting system may confuse accounting professionals and this may have potential risks when professionals conduct accounting practices. Firstly, most tertiary education institutions offer professional accounting courses, but the question is which accounting approach should be chosen. Some top ranked universities choose original foreign accounting teaching materials, such as Tsinghua University, in order to understand the principles-based international accounting standards. Moreover, “many universities have established cooperative relationships with international professional bodies and new majors in international accounting and professional CPA programs have been developed, including the integration of ACCA\textsuperscript{33} and CGA\textsuperscript{34} exam courses into Chinese university accounting curricula” (Zhang et al., 2014, pp. 837-838). This means Chinese accounting education pays more attention to the principles-based accounting standards. If this is true, why are rules-based accounting rules still used by the Chinese accounting industry, rather than completely using the principles based accounting standards? If only principles-based accounting standards are taught, how will students implement the accounting rules when they work in companies using the Enterprise Accounting Rules?

\textsuperscript{33} ACCA: the UK’s Association of Chartered Certified Accountants  
\textsuperscript{34} CGA: the Certified General Accountants Association of Canada
The situation of both the principles-based and the rules-based accounting approaches coexisting in China create difficulties in accounting education, and also in professional accounting practices. Although the MOF has issued the Announcement of the abolishment of several accounting rules (关于公布若干废止和失效的会计准则制度类规范性文件目录的通知) (Ministry of Finance, 2015c) in 2015 to repeal the ‘two’ standards and ‘two’ rules (1993), the Accounting Rules for Financial Enterprises (金融企业会计制度) (2001), and the Small Business Accounting Rules (小企业会计制度) (2003), the Enterprise Accounting Rules effected in 2001 were not on the list. This raises the question: when a parent company uses the Enterprise Accounting Rules and their subsidiaries use the Chinese Accounting Standards, how does the parent company consolidate financial statements? For example, in this case, the parent company was Amoi Electronics Co., Ltd. limited by liability, while the Amoi Electronics Co., Ltd. limited by shares was the subsidiary company which had been listed. If the parent company and the subsidiary used different accounting policies, how did Amoi Electronics’ parent company consolidate the financial statements? Before the Chinese Accounting Standards were implemented in 2007, the Enterprise Accounting Rules was implemented in 2001 in joint stock companies, while after the Chinese Accounting Standards took effect in 2007, all listed companies switched to the Chinese Accounting Standards. That means after 2007, Amoi Electronics started to use the Chinese Accounting Standards, but whether the parent company also switched to the new accounting standards and whether accounting professionals had been educated for them might present a potential risk to the effective implementation of the new accounting standards.
Although several policies can show that the MOF was trying to popularize the principles-based accounting standards to converge to the international accounting standards, why does it still keep the Enterprise Accounting Rules? With both the principle-based and the rules-based accounting approaches coexisting in China, Chinese accounting professionals could be confused and find it difficult to cultivate a new cognition for the principles-based accounting standards, especially since the new accounting standards were announced with explanations and guidance, which may limit and frame the exercise of professional judgment. Accounting professionals may still not understand the rationale behind accounting principles. For example, one of the features in the new *Chinese Accounting Standards* is how to calculate fair value. However, Nie et al. (2013) observed the difficulty of determining fair value in China was because “many assets did not exist in a ‘vibrant’ market” (p.286). They also argued that “the technical complexities involved in valuation in an emerging market economy could increase the difficulty of determining fair value and the lack of research and practice regarding fair value in China was an impediment to Chinese accountants in the implementation of fair value” (Nie et al., 2013, p.286). As such, Chinese accountants might only superficially accept the new accounting standards, while be deeply impacted by the guidance and explanations that provide more rules for accounting practices. Thus, some accounting frauds occur because accountants have just made the accounting equation equilibrium while they rarely cared about the substance of business transactions. The reason might be that accountants did not understand the rationale behind accounting principles or intentionally committed fraud under the cloak of principles-based accounting standards that required professional judgments.
10.3 The external supervision system of Chinese listed companies

Another question is, as the last line of defence in ensuring accurate accounting information of listed companies, did the external supervision system play their roles as intended?

The Chinese Securities Regulatory Commission (CSRC) is a ministerial level public institution directly under the State Council (Chinese Securities Regulatory Commission, 2016). Its function is to supervise and govern China’s securities and futures market and maintain the market’s order to ensure legal operation of the capital market.

CSRC is located in Beijing, and has 21 functional departments, one inspection division, and three centres (Chinese Securities Regulatory Commission, 2016). CSRC has set up a public offering review committee and a punishment administrative committee (Chinese Securities Regulatory Commission, 2016). CSRC has also established 36 securities regulatory bureaus in different provinces, autonomous regions, municipalities, and cities specifically designated in the state plan, which fall directly under the Central Government (Chinese Securities Regulatory Commission, 2016). Moreover, CSRC has established the Shanghai Commissioner Office in Shanghai and the Shenzhen Commissioner Office in Shenzhen (Chinese Securities Regulatory Commission, 2016). The CSRC institutional system can be seen in Figure 19. In this case, Xiamen securities regulatory bureau is one of the subsidiary bureaus of CSRC in the city specifically
designated in the state plan\textsuperscript{35}. The main responsibilities of Xiamen securities regulatory bureau is to “supervise the securities and futures activities of listed companies in this region, securities and futures operational institutions, securities investment consulting institutions, and the intermediaries dealing with securities business such as law firms, accounting firms, and assets appraisal institutions authorized by CSRC; investigate and prosecute violation of laws and rules within its jurisdiction” (Chinese Securities Regulatory Commission, 2008).

\textsuperscript{35} Xiamen is a city specifically designated in the state plan which means that from a political point of view, it is the vice-provincial position governed by the affiliated provincial government, while economically speaking, it is in a provincial position directly controlled by central government. In China, there are 5 cities specifically designated in the state plan that are Dalian, Qingdao, Ningbo, Xiamen, and Shenzhen.
Figure 19: Chinese Securities Regulatory Commission and its system
(Adopted in Chinese Securities Regulatory Commission, 2016)

China Securities Regulatory Commission

- Public Offering Review Committee
- Administrative Sanction Committee
- 21 Functional Departments
- One inspection division & three centres (Enforcement Task Force, Research Centre, IT Service Centre, and Administrative Service Centre)

36 securities regulatory bureaus in provinces, autonomous regions, municipalities, and cities specifically designated in the state plan & Shanghai Commissioner Office & Shenzhen Commissioner Office
The accounting information of listed companies is required to be supplied to different supervision government departments or other accounting institutes in order to disclose true and accurate accounting information to the public. In accordance with Chinese Company Law, listed companies need to submit the first half year financial report to regional securities regulatory bureaus within 60 days of the report being finished, and need to submit the annual report after CPAs’ audit to the regional securities regulatory bureau within 120 days after the end of the financial year (Shanghai Stock Exchange, 2012). Government auditing departments audit the accounting information of listed companies in order to guarantee the state assets inflation-proofing and appreciation. Tax bureaus inspect the accounting information of listed companies in order to make sure companies pay enough taxes. Public accounting firms audit financial reports of listed companies because shareholders engage CPAs to perform auditing services on shareholders’ behalf in order to know the company’s true operational performance. The supervision system of Chinese listed companies can be seen in Figure 20.
Figure 20: The external supervision system of Chinese listed companies
In this case, according to the 2005 financial report of Amoi Electronics, the net profit was in deficit by -658,050,491.18 yuan (The financial report of Amoi Electronics, 2005). However, according to *Rules Governing the Listing of Stocks on Shanghai Stock Exchange*, if “the company has been in the red in the most recent two consecutive years (based on the audited net profits disclosed in the latest two annual reports)” (Shanghai Stock Exchange, 2012, p. 860), the Exchange will issue a delisting risk warning on the stocks of the listed company. This is why Amoi Electronics committed profit fraud in 2006. According to the 2006 financial report of Amoi Electronics, the net profit suddenly went up to 24,212,631.18 yuan.

Moreover, supervision departments, such as financial bureaus, auditing bureaus, tax bureaus, the People’s Bank, securities regulatory bureaus, and insurance supervision departments, are government institutions. Compared to public accounting firms, there is no direct interest relationship between listed companies and supervision departments, because supervision and inspection from supervision departments is compulsory and gratis. However, auditing services from public accounting firms are not free and is also a fiduciary duty to shareholders. As such, keeping the loyalty of customers is the anchor of a public accounting firm’s survival in the highly competitive Chinese CPA industry. In reality, some CPAs do not inspect, and also help audited companies make false accounting information to satisfy other supervision departments’ requirements in order to keep the engagement. Listed companies also use *guanxi* to negotiate with supervision departments in order to ask them not to do a real inspection. This may be another reason why the fraud of corporate scandals seemed obvious, but was not detected immediately.
10.4 Conclusion

The external supervision system of listed companies may not reduce the risk of fraudulent accounting information, but trigger the accounting fraud, because the supervision departments can use results made by prior supervision departments to avoid repeated inspection, according to Article 33 of the Accounting Law of the People’s Republic of China. Thus, the quality of auditing reports is important for other supervision departments. Chinese CPAs are required to improve the quality of financial information and use auditing techniques and auditing methods to promote Chinese auditing standards converging to the international auditing standards.
CHAPTER 11 CONCLUSIONS AND RECOMMENDATIONS

11.1 Conclusion

Understanding of auditor independence in socio-political struggles must be explored within cultural and institutional contexts. China was selected as an area of study because of its unique institutional and cultural environments. In the process of transforming China’s planned economy to be more market oriented, China completed enterprise reforms and a disaffiliation program of public accounting firms from their government sponsoring body in the 1990s. Since then, there has been an exponential growth in the number of multinational corporations establishing subsidiary companies in China. With China entering the World Trade Organization (WTO) in 2001, the Chinese economy was increasingly integrated into the international economy. With the development of information technology and the complexity of economic activities, Chinese CPAs are required to improve the quality of financial information and to deal with auditing market risks to maintain market stability and auditing trust. These requirements ask Chinese CPAs to improve their auditing techniques and auditing methods so that Chinese auditing standards can successfully converge with international auditing standards.

This study selected three Chinese auditing failures and scandals, namely Yin Guang Xia (1999-2000), Green Land (2004-2010), and Amoi Electronics (2006-2007), each contextualized by a different timing in the process of Chinese economic reform.

The case of Yin Guang Xia occurred during the period between 1999 and 2000, when China completed its enterprise reform and its disaffiliation program of public accounting firms. The aim of enterprise reform was to separate the state from the
management to promote corporate independence, decrease bureaucratic interference in corporate activities, and increase Chinese corporate competitiveness. Another aim of the disaffiliation program of public accounting firms from their government sponsoring bodies was also to improve auditor independence.

At the early stage of Chinese economic reform, new concepts of corporate governance, such as supervisors and independent directors, and auditor independence were introduced to China. According to neo-Durheimian theory, when institutions have been changed, individuals need to cultivate new thought style to adapt to the new institutions. In the case of Yin Guang Xia, Chinese professionals need to cultivate the new thought style when they interpret and accept these new institutions, such as supervisors, independent directors, and auditor independence. This is because Chinese SOEs were controlled by either the central government or local governments before the enterprise reform and Chinese public accounting firms were sponsored by government and government controlled institutions before the disaffiliation program. However, in the process of cultivating individuals’ new thought style, culture as an informal institution limits individuals’ opinions and cognitions to adapt to institutional changes, especially guanxi and a sense of obedience may obstruct the adjustment process. Chinese economic reforms were trying to change hierarchical culture which was a strong grid – strong group form, but party secretaries are embedded in China’s corporate governance structure where they retain a strong group form, as well as the Ministry of Finance which continues to govern the CICPA. Thus, in the case of Yin Guang Xia, the cognition of these new concepts remained unchanged. The reason might be that the process of cultivating new thought style for newly introduced institutions needs a period of time.
However, in the second case study, Green Land conducted fraudulent accounting operations for the initial public offering process and after it was listed from 2004 to 2010, in which auditor independence was significantly impacted by Chinese culture, especially the obligations derived from *guanxi*. Although the new concepts of corporate governance and auditor independence had been introduced in the 1900s, these regulations did not have the expected effect, as indicated by the case of Green Land. Auditor independence is a core value for auditors, but in the highly competitive auditing industry, auditors are trying to find and reach inside the group to get more benefits within a strong group form of society. The public accounting firms were happy to use personal *guanxi* to gain an audit engagement in order to increase business revenue. Therefore, whether the new policies could achieve expected effectiveness in the long run there remained a big risk because of the influence of Chinese culture.

The case of Amoi Electronics examined how professionals interpreted and challenged new institutions within the limitation of cultural and social environments. In this case, it provides insights into how a listed company conducted accounting fraud, and investigated the reasons that motivated this company to forge accounting information. The reason for fraud was found to be driven by avoiding the risk of being delisted. In order to keep their listing, listed companies create false profits through connected transactions, inflating income, and intentionally decreasing cost. In this case, we see that a listed company may be prepared to produce a false cash flow statement to make a false profit seem reasonable.
Moreover, the accounting information of listed companies is required to be supplied to different government supervising departments or other accounting institutes as part of their obligation to disclose true and accurate accounting information to the public. However, the fact of an external supervision system for listed companies may not reduce the risk of inaccurate accounting information, and in a sense its diversity enabled this accounting fraud, because the supervision department can use results made by prior supervision departments to avoid repeated inspection if the results meet the posterior supervision department needs in performing its required duties, according to Article 33 of the Accounting Law of the People’s Republic of China. Therefore, the external supervision system for listed companies may not reduce the risk of inaccurate accounting information because of its complexity. However, in context of the Chinese CPA industry, auditors may help companies to create false accounting information to satisfy supervision departments’ requirements in order to keep the engagement. Companies may also use guanxi to negotiate with supervision departments in order to avoid a real inspection. That may be a reason why the fraud in this corporate scandal which seems so obvious but was not disclosed immediately.

The risks of auditor independence from the three case studies have explained the results of Liu et al (2011) that state-ownership and management connections with auditors increased the probability of receiving unqualified audit opinions, and firm-level and personal connections with auditors were more important to non-state-owned enterprises than to SOEs. That is, in the context of the low degree of Chinese external supervision and a low risk of punishment (a weak grid form), the strong group form of society in which individuals use guanxi to conduct their business
activities may significantly impact auditor independence, resulting in a reduction in the quality of auditing reports.

11.2 Recommendations

From these three case studies, some potential risks in the Chinese auditing industry can be perceived. According to the context of the Chinese relationship-oriented society, the observations show that some senior directors in CICPA also have government positions, while the government also holds shares in SOEs. There may be a potential risk of damage to auditor independence, because of the government being both regulator and the participant. It is possible to reduce this kind of risk by making a clearly separate relationship between the government and public accounting firms, which would mean cancelling dual appointment of senior directors in CICPA who also have government positions and not allowing someone to take a senior director position in CICPA if they had government working experience immediately before they took up their position on the CICPA. In addition, to reduce the risk of public accounting firms compromising their independence with audited companies in order to maintain their customers, one possible solution may be to set up credit files for CPAs to record their dishonesty and keep a history of penalties. Moreover, public accounting firms may also be classified by ranks that are evaluated by CICPA through credit files of CPAs. This suggestion may also make it easier to punish public accounting firms who merge with other public accounting firms after their qualifications are revoked.

Furthermore, the government auditing system should make clear its relationship with the government, and take actions such as cancelling the joint leadership. For
example, local governments should not provide operational funds and exercise their control over local audit offices, which may reduce the impact of culture and keep government auditors independent. Audit committees in companies should also operate independently using their own funds and personal control. Otherwise, the function of the audit committee would not be as expected in the context of Chinese culture (the strong group form).

Although Chinese corporate governance introduced some ideas from western corporate governance, people in companies might not know much about the nature of newly introduced roles such as independent directors and audit committee members. According to observations in the Green Land case, the chairman of directors also held the position of secretary of the board, which indicates that functions and responsibilities of newly introduced positions might be not fully understood or accepted within Chinese corporate governance, possibly because of Chinese hierarchical culture.

Therefore, although international auditing standards and the western corporate governance system were transplanted to China, the resistance of culture may mean that auditors do not function as they were intended to. In other words, the effectiveness of the adoption of international standards or regulations is determined by the institutional environment and also the cultural environment. The institutional pressures forced on people and organizations to adopt new concepts and standards seems, in metaphorical terms, to be like installing parts from different factories into a machine, while culture determines whether these parts can work properly.
The identified risks in these case studies have implications for policy makers, professional practitioners, investors, and researchers. Firstly, these observations suggest that Chinese corporate governance, its external supervision system, and auditing standards may not be functioning as intended, because of China’s unique cultural and institutional environment. It will be essential for foreign investors to assess Chinese corporate governance and consider the quality of Chinese auditing reports in any investment decision.

Secondly, policy makers and regulators may consider the Chinese cultural environment, especially guanxi, when making effective regulations and standards. In a relationship-oriented society, it is difficult to make policy to cut off relationships. This is especially true in China, seeing that guanxi is a significant part of the culture. The imposition of high-risk penalties, such as permanent disqualification, criminal charges and jail, may be an option to increase the independence of auditors by making it very costly to compromise the auditing standards required to express an authoritative opinion on the quality of the financial statements. In the balance of costs and risks, if the price of fraud is high, this may draw more attention to the risk of committing it.

Furthermore, external supervision departments should also review auditing reports carefully and use all three financial statements to analyse potential accounting frauds. With respect to the process of listing, the relations among companies, auditors, and issuance examination committee members should receive close attention because of the Chinese cultural context.
11.3 Limitations and suggestions for future research

The limitations of this study relate to limited sources of data available. As a set of case studies, while general themes are drawn, the specific findings are not generalizable beyond each case’s locations and periods investigated. This study was only able to observe cases spanning the short period of the introduction of new institutions and their regulations. Future studies could provide interviews and other research approaches to enhance the understanding of corporate governance and auditor independence in the Chinese context. The findings of this study reveal that while new policies could achieve expected effectiveness in the long run, there remains a risk to auditor independence and good corporate governance because of the influence of Chinese culture. Future research could investigate whether or not new Chinese institutions do successfully embed independent auditor practices over time.

This study adopted of Neo-Durkheimian theory by using grid – group method to contextualize the situation in China and provide an understanding of how auditing and corporate governance has evolved in China after the economic reforms. Future research could also use this theoretical framework to examine corporate governance evolutions and auditing practices in other developing and emerging economies.

This study found the culture as an informal institution limited individuals’ cognitions to interpret new institutions when institutions changed. Future research could test whether the culture limits other professionals’ cognition to interpret new institutions. With the opening up of the Chinese market after the economic reforms, there is a
large amount of foreign investment flowing into China, but most foreign investment is injected into coastal provinces. For example, “over 40 of the World’s largest multinationals have invested in Shanghai, and a total of $35 billion in direct foreign investment has been made in the area” (Deshpande and Farley, 2008). Thus, due to the inequality of economic development in varying geographical environments as mentioned in Chapter 4, coastal regions interact more frequently compared to interior regions. Future research could compare whether there are differences of the effect of culture on individuals’ cognition to interpret new institutions in different regions in large-sample empirical studies. Moreover, this study only observed financial auditing practice from the three case studies in China. Future research could also investigate the influence of culture on internal and government audit.
ABBREVIATIONS

1. ACCA: the UK’s Association of Chartered Certified Accountants
2. AICPA: American Institute of Certified Public Accountants
3. Amoi Electronics: Amoi Electronics Co., Ltd. limited by shares
4. ANAO: Australian National Audit Office
5. CACPA: Chinese Association of Certified Public Auditors
6. CAS: Chinese Auditing Standards
7. CCISs: Chinese CPA Implementation Standards
8. CCP: Chinese Communist Party
9. CEC: China Electronics Corporation
10. CEO: Chief Executive Officer
11. CFO: Chief Financial Officer
12. CGA: the Certified General Accountants Association of Canada
13. CIASs: Chinese Independent Auditing Standards
14. CICPA: Chinese Institute of Certified Public Accountants
15. CPA: Certified Public Accountant
16. CSRC: China Security Regulatory Commission
17. Green Land: Yunnan Green Land Biological Technology Co., Ltd. by shares
18. Guidelines: Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies
19. HEIs: Higher education institutions
20. IAA: Institute of Internal Auditors
21. IAASB: International Auditing and Assurance Standards Board
22. IAS: International Accounting Standards
23. IASB: International Accounting Standards Board
24. IFRSs: International Financial Reporting Standards
25. IIA: Institute of Internal Auditors
26. IPO: Initial public offering
27. ISA: International Standards on Auditing
28. MOF: Ministry of Finance
29. NAO: National Audit Office of the People’s Republic of China
30. PCAOB: Public Company Accounting Oversight Board
31. POB: Public Oversight Board
32. RPLG: Related-party loan guarantees
33. SAIC: State Administration for Industry and Commerce of P.R. China
34. SME: a small and medium-sized enterprise
35. SOEs: State-owned enterprises
36. VAT: Value-added tax
37. WTO: World Trade Organisation
38. Yin Guang Xia: Guang Xia (Yinchuan) Industry Co., Ltd. limited by shares
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APPENDIX 8.2: LISTING PROCESSES (SHENZHEN STOCK EXCHANGE, 2016)

(1) Restructuring and establishment: Drafting the restructuring plan; employing intermediaries such as sponsors (securities companies), accounting firms, asset appraisal agencies and law firms to study the feasibility of the plan, audit and appraise the assets of the enterprise to be restructured, sign the sponsors’ agreement and draft the articles of association and other corporate documents; setting up internal organizational structure; and establishing the company limited by shares by means of promotion. Unless there are specific provisions in laws and regulations, the approval of the provincial government is canceled.

(2) Due diligence: companies should invite sponsorship institutions (securities companies), accounting firms, law firms and other intermediaries to undertake due diligence inspections concerning the development history, operation condition and financial situations. The intermediaries mentioned above should also make a diagnosis of existing problems.

(3) Pre-listing Tutoring and Tutoring Records: Sponsors and other intermediaries offer professional training and business guidance for the company, familiarize the company with the necessary knowledge for being a listed company, improve the organizational structure and internal management, standardize corporate conduct, define its business objectives and the purpose of the proceeds, rectify deficiencies according to listing requirements, prepare IPO application documents, and need to pass the inspection organized by local regulatory authority on their coaching activities.

(4) Submission acceptance of application: Enterprises and intermediaries prepare application documents according to the CSRC’s requirements. Sponsors conduct internal review and make recommendations to the CSRC. The CSRC will accept the application if it meets relevant conditions.

(5) Preliminary review of application documents: After acceptance of the application, the CSRC will conduct a preliminary review. It will also consult with the provincial governments, the National Development and Reform Commission (for listing on the ChiNext36, there is no need for such consultation and the CSRC will only need to communicate with the province-level government on the share offer) and minister of commerce (for Sino-foreign joint ventures and foreign enterprises). Then the CSRC will provide its opinion to sponsors which will make arrangement for the issuer and intermediaries to respond to the opinion or remedy any deficiencies. Then pre-disclosure will be made and the application documents will finally be submitted for review to the CSRC public offer review committee.

(6) Review by the IPO Review Committee: After the preliminary review, the application documents will be submitted to the IPO Review Committee. The IPO Review Committee comprises of both CSRC professionals and non-CSRC experts. 7

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36 ChiNext was launched in October 2009. The market primarily targets innovative growth enterprises with profitability. ChiNext reflects innovative efforts in both technology and business models in China’s enterprises (Shenzhen Stock Exchange, 2016).
committee members will be present for each IPO review meeting. They will conduct queries, issue review opinions and take a vote on the application documents. Companies with 5 or more consent votes will pass the IPO review.

(7) Approval Granting: After the application documents pass the IPO Review, the company and relevant intermediaries will implement relevant issues raised by the review committee. Then they will reclassify the application documents and keep them in archives for future reference. After the documents are sealed and internal procedures are fulfilled, the CSRC will grant approval to the company for IPO.

(8) Road show: Before the IPO, the company must perform the required disclosure obligations. Main Board listing candidates should publish the summary prospectus and IPO announcement in the newspapers designated by the CSRC. They should also publish the full prospectus and relevant documents on the websites designated by the CSRC. ChiNext listing candidates should publish the full prospectus and IPO announcement on the websites designated by the CSRC as well as on their corporate websites. Moreover, they should publish an IPO and ChiNext listing announcement in the newspapers designated by the CSRC, informing investors of such websites and how to access the relevant documents. Then the lead underwriters (securities firms) and issuers will conduct road show, promotion and book-building and determine the issue price based on book-building results.

(9) Listing: The issuer will launch its IPO according to the method prescribed by the CSRC. Then it will apply to the stock exchange for listing, complete custody and registration procedures at the registration and settlement company, and get listed. After listing, the sponsor will be responsible for continuous supervision and guidance.

The time that an enterprise takes from restructuring to listing varies depending on circumstances is around one year. Normally, the time for various stages is roughly as follows: approximately six months from corporate restructuring to the establishment of a company limited by shares; approximately three to six months for sponsors and other intermediaries to conduct due diligence and prepare applications; approximately six to nine months from the CSRC review to public offering.