

I. Introduction

1. Study Background

The 1997 financial crisis in Asia exposed structural weaknesses in the banking and corporate sectors of affected countries owing largely to poor governance, lack of transparency, and weak supervision and regulation.²

The Asian Development Bank (ADB) has been taking a number of initiatives to assist Developing Member Countries (DMCs) in overcoming these structural problems. The focus on improved governance includes enhancing the effectiveness of public administration and development management at the sector level and in national institutions in the DMCs. Where appropriate, institutional development of the local and provincial agencies and the private sector is also covered. A sound regulatory financial framework and its enforcement, capable institutions, skilled human resources, and effective monitoring and supervision are important prerequisites to an efficient financial structure.

Regional Technical Assistance (RETA) No. 5877 – *Strengthening Financial Management and Governance in Selected DMCs* – was approved by ADB for the purpose of carrying out initial studies to identify gaps and weaknesses in financial management and governance and to recommend courses of action to overcome these problems.

2. Objectives

ADB has demonstrated its stand on the importance of good governance, through effective financial management, for sustained economic development. This RETA involved a diagnostic review of the existing accounting and auditing support and standards available in the selected DMCs. After carrying out this diagnostic review, the study assessed the need for assistance to improve the current situation. Objectives were to:

- (i) assess the capability and capacity within each country to provide efficient and effective accounting and auditing support to meet international standards and best practices and address the issue of training and capacity enhancement

² Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand*. Asian Development Bank: Manila.

- (ii) determine the existing accounting and auditing standards of each country
- (iii) assess the degree of deviation from International Accounting and Auditing Standards (IAAS) while identifying weaknesses and possible corrective options
- (iv) discuss the fieldwork findings and introduce the concepts of the international standards through workshops
- (v) develop reference materials for potential users of the IAAS, and
- (vi) determine the level and type of assistance needed by each country in order to provide acceptable accounting and auditing support to the private and public sectors.

3. Scope

The RETA involved an indepth study of the key issues relating to accounting and auditing support in the selected DMCs, identified gaps and weaknesses that need to be addressed to improve accounting and auditing support, and developed assistance programs in collaboration with other donors to rectify the identified weaknesses. The People's Republic of China (PRC) was one of seven countries that participated in the RETA.

4. Country Case Studies and Workshops

The first part of the study examined the current accounting and auditing structure and systems adopted in the PRC. It also: (i) analyzed the political, institutional, and regulatory and legal framework on accounting and auditing practice and the level of enforcement of existing laws, rules, and regulations; (ii) identified gaps and weaknesses in accounting and auditing support available and deviations from international standards; and (iii) identified alternative options to remedy the identified weaknesses, with the objective of eventually doing away with these.

The second part of this study disseminated the country-research findings through in-country workshops. Each workshop provided a cross-section of views on the research findings and established ways to move forward to improve financial management and governance in the country. After carrying out the assessment of accounting and auditing support in the PRC, the study findings and recommendations were discussed at a workshop in Beijing on 14 August 2000, and at an international conference at ADB Headquarters in Manila from 16-18

October 2000. This report incorporates feedback from the Workshop and the Conference.

5. The ADB Focus on Financial Governance in the PRC

ADB's Country Operational Strategy for the PRC emphasizes three broad objectives: (i) improvements in economic efficiency, (ii) promotion of growth to reduce poverty in poor inland provinces, and (iii) environmental protection and natural resource management. ADB is supporting broad governance activities through the technical assistance program. Support for the drafting of the *Public Procurement Law*, its Standard Bidding Documents and Implementing Regulations; improved audit standards and procedures; strengthening the inspection function; support for the *Bankruptcy Law* and other key economic laws; and construction industry regulations and registration procedures are a few examples.³

More specifically, ADB is initiating policy dialogue to support the Government in the development of an efficient and commercially-oriented banking sector. To achieve this goal, the Government needs to: (i) establish a sound legal framework, (ii) enhance corporate governance and raise accounting and financial disclosure standards, (iii) improve banking regulatory and supervisory systems and liquidity management, (iv) improve legislation for bankruptcy and loan foreclosures, (v) develop efficient market infrastructures for payments, clearing, and settlements, (vi) deregulate interest rates, (vii) develop an effective strategy for debt resolution of State-owned Enterprises (SOEs), and (viii) ensure general public confidence in the banking system.⁴ This RETA directly contributes to these activities.

6. The People's Republic of China

The PRC covers an area of 9.6 million square kilometers and is the world's third-largest country, after Russia and Canada. Mountains dominate much of the country, but there are also large desert areas, high plateaus, and river basins. The PRC's climate is subtropical in the south, arid in the northwest, and monsoonal in the east. The country is susceptible to floods, droughts, typhoons, and earthquakes.

³ Asian Development Bank. January 2000. *Country Assistance Plan: People's Republic of China* p. 11.

⁴ Ibid. p. 20.

After the end of the Second World War, the Communists fought a civil war against the Kuomintang. The Communists achieved victory in 1949 and, on 1 October of the same year, Mao Zedong proclaimed the People's Republic of China (PRC) to an audience of 500,000 in Tiananmen Square. Beginning in late 1978, the Chinese leadership began to move the economy from a sluggish Soviet-style centrally-planned economy to a more market-oriented economy. To this end, the authorities switched to a system of household responsibility in agriculture in place of the old collectivization, increased the authority of local officials and plant managers in industry, permitted a wide variety of small-scale enterprise in services and light manufacturing, and opened the economy to increased foreign trade and investment.

In the past 50 years, the PRC has made tremendous progress in poverty reduction, particularly over the last two decades. Twenty years ago, the PRC was among the world's poorest countries, with 80 percent of the population living on incomes of less than \$1 a day and only a third of all adults able to read or write. Between the launching of the PRC's economic reform program in 1978-1995, its transition from a command to a market-based economy helped fuel a remarkable average growth in Gross Domestic Product (GDP) of eight percent a year.

Since then, growth has remained relatively strong and incomes have generally continued to rise. Now, only about seven percent of the population between 15 and 25 years old is illiterate, and the PRC's high life expectancy and low infant mortality rates are envied by much richer nations. The PRC has made great strides in improving social welfare. Consumption has more than doubled and the poverty rate has declined, as 200 million Chinese living in absolute poverty have been raised above the minimum poverty line. Prudent macroeconomic policy aided the PRC in adjusting to the Asian crisis. In 1999, growth slowed slightly and prospects are that a rate lower than the trend in the 1990s can be sustained in the medium term. The challenges will be to continue the reform process of opening the economy, improving efficiency in the state sector, addressing unemployment issues, and developing a legal and regulatory framework essential for efficient functioning of a market economy.⁵

There are about 1.26 billion people in the PRC, three-quarters of whom live in the countryside. The population is made up of some 56 ethnic groups who speak many different languages. The largest ethnic

⁵ Asian Development Bank. 2000. *Asian Development Outlook 2000*. p. 61.

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group is the Han, who represent 92 percent of the population. By virtue of its huge population and geographic size, the PRC is one of the world's major producers of grain, cotton, edible oil, meat, eggs, textiles, coal, steel, and cement. It is also a major producer of fertilizer, chemical fibers, hydroelectric power, and crude oil, and has enormous reserves of natural gas.