

II. Accounting and Auditing in the PRC

This chapter presents an overview of accounting and auditing arrangements in the PRC. It provides context for the following chapters on professional infrastructure, accounting and auditing standards, accounting and auditing training, and government budgeting and accounting. The chapter comprises ten sections, in two parts, as follows:

Part One: Accounting

- 1 – Introduction – describes the historical factors that have influenced accounting arrangements in the past 50 years.
- 2 – Issues and Responses since 1979 – discusses the issues that faced the PRC in 1979 when the economic reform and open-door policy was initiated. It also summarizes the actions that were taken in response to these issues.
- 3 – The ‘Chinese Accounting System’ – describes accounting arrangements. These include governing laws and regulations, accounting bases, asset management and internal-control systems, and accounting information systems.
- 4 – Financial Reporting – describes financial reporting requirements.

Part Two: Auditing

- 5 – Introduction – describes the development of auditing in the PRC.
- 6 – Governing Laws and Regulations – describes the laws that govern PRC auditing practices and audit requirements.
- 7 – Auditor Qualifications – describes auditor qualification requirements.
- 8 – The Chinese National Audit Office (CNAO) – describes the role and functions of the CNAO, which is responsible for leading the auditing profession.
- 9 – Chinese Institute of Internal Auditing (CIIA) – describes the internal auditing ‘profession’ and the functions and capacity of the CIIA.
- 10 – Public Accounting and Auditing Firms – describes the presence of major domestic and international accounting firms in the PRC. The section also discusses four major initiatives to improve the quality of accounting and audit services within the PRC.

Part One. Accounting

1. Introduction

Central planning was introduced to the PRC after the end of the civil war in 1949. Before this, the PRC had public accounting firms and an accountancy profession. In the 1950s, the PRC adopted the Soviet accounting system that catered to the needs of central planning. The system provided statistical information, including financial information. It emphasized standardization and uniformity so that information could be compared across sectors and industries. Detailed instructions replaced professional judgment in the accounts-preparation process. Consequently, public accounting firms and the accountancy profession were disestablished.

The PRC's 1979 decision to align accounting practices with the needs of a mixed-market economy posed a number of challenges. However, the Soviet accounting system created a sound basis on which to build. First, the system used many concepts of modern accounting including accrual measurement and double-entry bookkeeping. Second, large numbers of bookkeepers were trained in these concepts and became proficient in their application.

2. Issues and Responses since 1979

The PRC's continuing accounting reforms have three objectives: (i) to standardize and rationalize financial reporting – this is expected to gradually improve the efficiency of business enterprises through associated improvements to financial management and control systems; (ii) to transit from the Soviet accounting model to the western accounting model – foreign investors encountered tremendous difficulties in understanding and preparing financial reports based on the Soviet model – the adoption of the western accounting model is expected to facilitate foreign direct investment in the PRC; and (iii) to gradually give business enterprises more discretion to design their own internal accounting and financial systems.⁶

In the two decades since 1979, the PRC has made enormous strides in terms of developing an accounting infrastructure suitable to the needs of a market economy. The magnitude of these accomplishments is best viewed by examining the 1979 situation. First, bookkeepers numbered

⁶ Liu, Kin Cheung and Wei Guo Zhang. 1996. *Contemporary Accounting Issues in China: An Analytical Approach*. Prentice Hall: Singapore. pp. 21-22.

in the tens of millions but there were no qualified Certified Public Accountants (CPAs) let alone a professional accounting body. Second, financial information on the performance and position of organizations was not publicly available. In any case, this information did not meet international standards nor did it cater to the needs of investors or lenders. Third, the users of financial information (investors and creditors) were unfamiliar with what they should demand from organizations. Fourth, financial information was not independently verified (audited) to international standards and could not be relied upon. Fifth, the entire legal framework was geared to central planning and specified exactly what information should be produced, how it should be produced, and to whom it should be provided. Finally, the regulatory entities that generally exist in market economies to oversee financial disclosure practices, such as securities exchange commissions, did not exist.

Table 1 summarizes developments in accounting arrangements in the PRC over the past two decades.

Table 1: The Development of the PRC's Accounting Infrastructure

1979	Economic reform and open-door policy initiated.
1981	First public accounting firm established in Shanghai. To promote the rapid development of the public accountancy profession, the Government allows organizations (including government ministries and businesses) to establish accounting firms as subsidiary units.
1985	<i>Accounting Law</i> enacted. It sets out accounting responsibilities, accounting procedures and legal responsibilities for state-owned enterprises.
1988	Chinese Institute of Certified Public Accountants (CICPA) is established as a subsidiary unit of the Ministry of Finance (MOF). By the year 2000, CICPA will be one of the world's largest professional accounting bodies with around 135,000 members.
1992	MOF promulgates first accounting standard – the Basic Accounting Standard. It provides a conceptual accounting framework, sets out accounting principles, and is based upon International Accounting Standards (IAS).

MOF promulgates revised uniform accounting system regulations. The 'uniform accounting systems' prescribe charts of account, reporting formats and detailed accounting instructions. They replace the Soviet-based regulations and represent a fundamental update to accounting practices – largely in line with the Basic Accounting Standard and western accounting practice.

The MOF starts restructuring accounting firms with two objectives; to separate them from their parent organizations, and to encourage mergers. By the end of 1998, all accounting firms involved in the securities sector have been separated. By the end of 1999, the restructuring is largely complete.

1993 *Certified Public Accountants (CPA) Law* enacted. The Law provides legal backing to CICPA, lays down clear rules and regulations for CICPA's administration system and organizational structure, and sets out CPA qualification procedures.

Accounting Law 1985 amended. The amendment broadens the Law's scope from state-owned enterprises to all registered enterprises.

1995 CICPA promulgates first set of Independent Auditing Standards.

1997 CICPA joins the Confederation of Asian and Pacific Accountants (CAPA) and the International Federation of Accountants (IFAC).

A review of professional practices and ethics leads the MOF to start a clean-up (Rectification) campaign of CPA firms – by the end of the Rectification campaign in 1999, 12,700 individual CPAs and 580 CPA firms will have been forced from the profession.

1998 Chinese Accounting Standards Committee (CASC) formed. The CASC comprises seven members and provides advice to the MOF on accounting standards issues.

1999 *Accounting Law 1985* amended. The amendments make organization managers responsible for accounting arrangements and financial reporting.

3. The 'Chinese Accounting System'

Governing Laws and Regulations

The recently amended *Accounting Law 1985*, the provisions of which came into force on 1 July 2000, governs the 'Chinese accounting system'.⁷ The original accounting law, which was promulgated in 1985, set out accounting arrangements, responsibilities and procedures for State-owned enterprises. The 1993 amendment widened the Law's scope to include all business and government organizations. The *Accounting Law* serves as the 'constitution' for the school of accounting regulations, and defines the accounting and reporting practices for all public and private sector organizations.

The 1999 amendment of the *Accounting Law 1985* clarified the respective roles and responsibilities of the State, organization managers, and accountants for accounting procedures and accounting information. First, the revised law makes the person in charge of a corporation legally responsible for the truthfulness of accounting information. The more precise statement of responsibility is expected to strongly motivate enterprise leaders to work harder on internal management in pursuit of a good image. Second, accountants were previously responsible for monitoring financial operations on behalf of the State and organization owners. In addition to assigning responsibility to organization managers, the revised law personalizes the activities of accountants, who are now responsible for themselves rather than acting on behalf of the State. Finally, the revised law reinforced role clarity by introducing a range of financial penalties for contraventions.

Box 1: An Example of a New Statement of Responsibility⁸

The Board of Directors of Anhui Gujing Distillery Company Limited hereby confirms that there are no important omissions, fictitious statements or serious misleading information in this report, and shall take all responsibility, individual and/or joint, for the reality, accuracy and completion of the whole contents.

⁷ The amendment of the *Accounting Law 1985* was adopted at the 12th meeting of the Standing Committee of the Ninth People's Congress on 31 October 1999 (Appendix 5 refers).

⁸ Anhui Gujing Distillery Company Limited. 2000. *Annual Report for the Year ended 31 December 1999*.

The key laws and regulations that govern PRC accounting arrangements are as follows:

Title	Description	Listed Cos.	Unlisted Cos. ⁹	Not-for-Profit Bodies ¹⁰
<i>Accounting Law 1985</i>	The latest revision took effect on 1 July 2000, and covers general accounting principles, accounting rules, corporate-accounting rules, supervision of accountants, accounting firms and accountants, and their legal responsibilities.	✓	✓	✓
<i>Companies Law 1993</i>	Chapter 6 of this law requires companies to prepare annual financial statements that include a balance sheet, a cash flow statement and an income statement.	✓	✓	
<i>Securities Law 1998</i>	This law took effect from 1 July 1999 and governs the issuance and trading of securities. The Law requires that organizations and individuals that prepare documents, such as audit reports for the issuance or listing of securities or for securities trading activities, must check and verify the truthfulness, accuracy and completeness of these reports and shall bear joint and several liability for the parts of such reports for which they are responsible.	✓		

⁹ These include state-owned enterprises.

¹⁰ These include government units, schools, hospitals, etc.

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Title	Description	Listed Cos.	Unlisted Cos. ⁹	Not-for-Profit Bodies ¹⁰
<i>Basic Accounting Standard for Business Enterprises 1992</i>	In 1988, the MOF began work on establishing Accounting Standards. These were to be divided into a Basic Accounting Standard (that provided a framework), and specific standards (that provided guidance on specific issues – such as the treatment of contingent liabilities). The draft <i>Basic Accounting Standard</i> was prepared in November 1991 – it was formally promulgated at the end of 1992 and became effective from 1 July 1993. The <i>Basic Accounting Standard</i> provides the conceptual accounting framework, sets out accounting principles, and is based upon International Accounting Standards.	✓	✓	
<i>Revised Uniform Accounting Systems Regulations 1992</i>	The <i>Uniform Accounting Systems</i> prescribe detailed sectoral accounting procedures and guidelines (e.g. for government units and for business enterprises). They provide charts of account, reporting formats, and detailed accounting instructions. This is where the requirements of the ‘Soviet accounting system’ were set out.	✓	✓	✓

FINANCIAL MANAGEMENT AND GOVERNANCE ISSUES IN THE PRC

Title	Description	Listed Cos.	Unlisted Cos. ⁹	Not-for-Profit Bodies ¹⁰
	With the release of the <i>Basic Accounting Standard</i> , the MOF published a series of new uniform accounting systems for the major economic sectors. The new systems were broadly in line with western accounting and reporting practices. At the procedural level, they mirrored changes made in the <i>Basic Accounting Standard</i> .			
<i>Specific Accounting Standards for Business Enterprises 1998 (onwards)</i>	The MOF has promulgated ten <i>Specific Accounting Standards</i> since May 1997. They are based on International Accounting Standards (IAS) and provide specific accounting instructions on issues such as Cash Flow Statements and Construction Contracts. Further standards will be issued in the next few years.	✓	✓	

Accounting Bases

With the exception of government organizations, all organizations use double-entry bookkeeping and all transactions are recorded on the accrual basis. Not-for-profit organizations, such as health and education bodies, have recently moved to modified accrual accounting. Core government organizations use modified cash accounting. All organizations prepare balance sheets and record accrual (non-cash) adjustments – such as depreciation and provisions for bad debts. The basis on which these accrual adjustments are calculated however, varies between sectors and does not necessarily accord with international

practice. The *Accounting Law 1985* requires all entities to disclose contingencies in financial and accounting reports.¹¹

Asset Management and Internal-Control Systems

The *Accounting Law 1985* requires all organizations to maintain asset registers and to perform regular verifications of these assets. The uniform accounting system regulations prescribe procedures for bank reconciliations, bank account operations, asset verifications, and stocktaking. All organizations must establish accounting procedures and associated internal controls in line with the *Accounting Law 1985* and associated regulations.¹²

Accounting Information Systems

The accounting information systems of government organizations are described in chapter VI. The Government actively encourages computerization – therefore most accounting information systems are computerized. The *Accounting Law 1985* requires that, where a computerized accounting information system is used, the system must be able to meet the requirements of the *Accounting Law 1985* and associated regulations.

4. Financial Reporting Requirements

Introduction

Government financial reporting is described in chapter VI. Under the state-planned economic system, government agencies strictly controlled most business enterprises and financial reports were not disclosed to the public. With the development of the securities market, listed companies are now required to publicly disclose certain financial and non-financial information. In the past 15 years, various regulations on the public disclosure of information by listed companies have been prepared and promulgated. The increased demand for better information disclosure has closely followed the development of the securities market (Table 2 refers).

¹¹ Article 19.

¹² Article 27.

Table 2: Development of the PRC's Securities Markets

1979	Economic reform and open-door policy started.
1981	First public issue of treasury bills.
1984	First public issue of shares.
1986	Securities trading in the over-the-counter market allowed.
1990	Shanghai securities exchange established.
1991	Shenzen securities exchange established.
1992	B shares issued to foreigners. China Securities Regulatory Commission (CSRC) formed. <i>Opinions on Companies Limited by Shares</i> published.
1993	Shares of State-owned companies listed in Hong Kong. Provisional Regulations concerning the Issuance and Trading of Shares published. <i>Company Law</i> enacted. Implementation Measures on Disclosure of Information promulgated. Standards of Contents and Format of Public Disclosure by Listed Companies published.
1995	Law relating to the <i>Punishment of Crime for Financial Disorder</i> passed.
1998	<i>Securities Law</i> enacted to govern the issuance and trading of shares.
1999	CSRC promulgates <i>Detailed Rules on Information Disclosures for Listed Companies</i> . CSRC issues <i>Notice on Enhancing the Quality of Financial Information Disclosure of Listed Companies</i> . The notice limits options for altering accounting treatments and accounting policies, and strengthens auditor rights.

Reporting Requirements

Private sector reporting requirements are set out in the *Accounting Standards*, *Accounting Law 1985*, *Rule of Business Financial Reporting*, *Companies Law 1993* and the *Securities Law 1998*. Business enterprises, including SOEs, are required to prepare; a balance sheet, an income statement, a cash flow statement, and associated notes to the financial statements.

The China Securities Regulatory Commission (CSRC) has published a series of regulations relating to the public disclosure of information by listed companies. For example: the *Contents and Format of Prospectuses*, and the *Contents and Format of Annual Reports*. On 8 December 1999, the CSRC promulgated *Detailed Rules on Information Disclosures for Listed Companies* under the *Securities Law 1998*. The regulation sets a number of requirements for annual reports. In particular, it requires listed companies to: disclose the full text of their annual reports on the Internet, present a summary in a designated newspaper, simplify the contents of annual reports, and provide more information about restructuring activities and on their parent companies.

As of July 2000, the CSRC was drafting improved guidelines on financial reporting (*Interim guidelines on listed financial institutions' required information disclosures*) which are likely to include the following: financial institutions must provide full information on asset quality, including the ways in which delinquent assets are managed; financial institutions must publish information on key business risks; and these financial institutions must be audited by approved CPA firms. In this respect, the CSRC is considering only allowing international CPA firms to conduct audits of financial institutions.

Benchmarks, Ratios, and Covenants

Shareholding companies are required to include a range of ratios in their financial reports (for instance, the current ratio, and the stock-turnover ratio). In 1999, the Central Government issued detailed rules, which required State-owned enterprises to report specified financial indicators (These include ratios such as Return on Equity and the Current Ratio).¹³

¹³ The requirements are set out in the *Standard for Enterprise Performance Evaluation 1999* and the *Standard for State-Owned Capital Performance Evaluation 1999*.

Part Two. Auditing

5. Introduction

A rudimentary form of auditing emerged in China as early as the Western Zhou Dynasty – 3,000 years ago. A royal court was set up in the Song Dynasty in 992 AD. From then on, every dynasty established specific institutions or offices in charge of monitoring state finances. The PRC's government-driven audit process is very different from the prevailing system found in western countries. The auditing profession comprises three major segments: government auditing, internal auditing, and social auditing (the equivalent of western public auditing).

6. Governing Laws and Regulations

In August 1994, the *Audit Law* was promulgated to strengthen state supervision through auditing, maintain the economic and financial order, promote the development of clean government, and ensure the healthy development of the national economy. The *Audit Law 1994* defines the basic principles for government auditing supervision, government audit institutions and auditors, the responsibilities and powers of audit institutions, audit procedures, and the legal liability of auditors.

Table 3: Audit Requirements

Organization Type	Audit	Auditor	Requirements
People's Bank of China	✓	CNAO	Article 39 of <i>Law on the People's Bank of China 1995</i> .
Securities and Futures Organizations	✓	Approved CPA Firms	Approved CPA firms must audit financial institutions. As of July 2000, the CSRC was drafting improved guidelines on financial reporting (<i>Interim guidelines on listed financial institutions' required information disclosures</i>). In this respect, the CSRC is considering only allowing international CPA firms to conduct audits of financial institutions.

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Organization Type	Audit	Auditor	Requirements
Commercial Banks	✓	Approved CPA Firms	Article 56 of <i>Commercial Banking Law 1995</i> .
Limited Liability Companies	✓	CPA Firms	Chapter VI of the <i>Company Law 1993</i> .
Not-for-Profit Organizations ¹⁴	✓	CNAO	<i>Budget Law 1994</i> .

7. Auditor Qualifications

Auditors within CPA firms must be practising members of CICPA (i.e. CPAs) – CPA membership criteria are described in chapter III.

A further qualification – *License of CPA and CPA Firms for Securities Related Practice* – is required to audit securities-related businesses. In 1992, with the establishment and subsequent expansion of the Shanghai and Shenzhen stock exchanges, only a few CPAs had qualified through the national uniform CPA examination. Most CPAs had received their certificates through subjective evaluation, which raised questions as to their technical competence. As a result, the MOF and the CSRC granted special licenses to those who sat and passed a special examination relating to accounting and auditing, and to the securities law. The special license enabled CPAs to audit securities businesses. Only around 100 CPA firms have this license and, in 1999, of the 4,988 candidates who sat for this qualification, only 467 (14 percent) passed. The examination is administered by the MOF and the CSRC and is organized by the National CPA Examination committee of the MOF. The MOF and the CSRC agree that the separate examination will be terminated in the near future when most CPAs will have qualified through the national uniform CPA examination.

8. The Chinese National Audit Office (CNAO)

Introduction

The PRC had no independent audit institutions from 1949 as internal supervisory bodies of the MOF controlled State finances. In December 1982, the National People's Congress (NPC) adopted a resolution to establish an auditing system in the PRC, which was included in the

¹⁴ These include government units, schools, hospitals, etc.

amended *Constitution*. Because of this resolution, the CNAO was established in September 1983. Provincial, municipal and county governments then set up local audit institutions. The Auditor General heads the CNAO.

The CNAO audits public sector organizations (including many state-owned enterprises). It is also responsible for leading, developing and supervising the auditing profession. In reality, its private-sector supervisory activities are largely undertaken by CICPA (for instance, CICPA certifies auditors and audit firms, conducts practice reviews, promotes the development of the CPA profession, and coordinates and delivers professional training and education).

CNAO Legal and Regulatory Framework

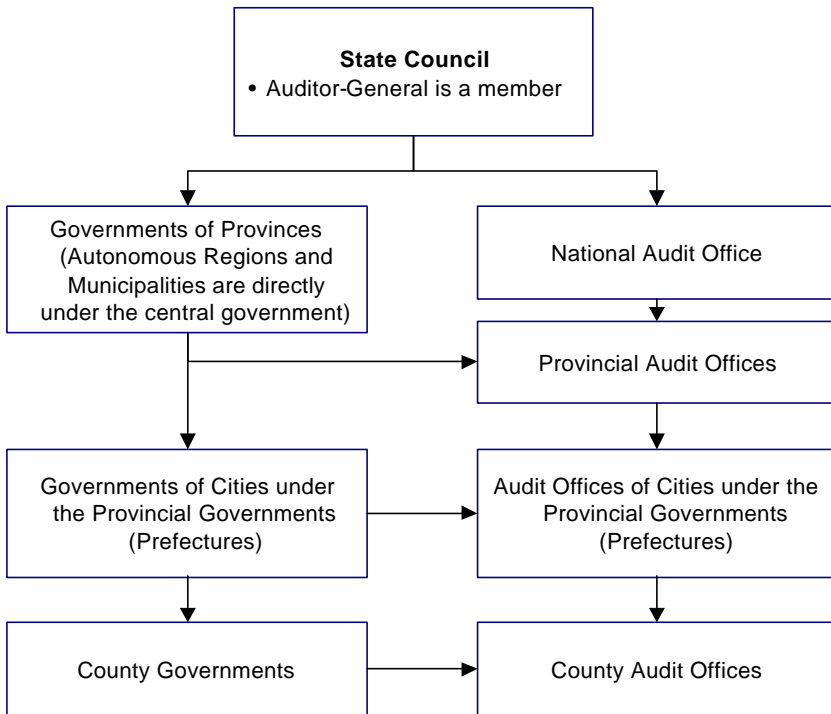
The *Audit Law 1994* stipulates that “the State Council shall establish an audit institution (the CNAO) that will audit the public revenues and expenditures of: departments of the State Council, departments of local governments, state banking institutions, and state enterprises.” The *Constitution* also stipulates that the Auditor General shall be a member of the State Council and that the Auditor General should be nominated by the Premier and, subject to the approval of the NPC or the NPC Standing Committee, shall be appointed or removed by the President.

According to the *Constitution* and the *Audit Law 1994*, the duties and responsibilities of the audit institutions are auditing: (i) the budget implementation, final accounts, management and use of off-budget departmental funds at the corresponding levels, and governments of lower levels; (ii) the assets, liabilities, profits and losses of State-owned monetary organizations and state-owned enterprises; (iii) the revenues and expenditures of state non-profit undertakings; (iv) the budget implementation and final accounts of state construction projects; (v) the revenues and expenditures of projects where assistance or loans have been provided by international organizations or foreign governments; (vi) state-owned enterprises that are vital to the national economy, receive large government subsidies or suffer substantial losses, as well as other state-owned enterprises designated by the State Council or corresponding local people’s governments; and (vii) special funds such as social security funds and agricultural funds.

CNAO Organizational Structure

Public sector audit activities are uniformly managed – the audit institutions at each level report to the next higher level audit institution (Figure 1 refers). While the higher-level audit body directs the audit work of local institutions, local audit institutions report both to the higher-level body and to the local government.

Figure 1: Structure of the PRC's Government Auditing System¹⁵



Each year, audit institutions at various levels present reports on audit activities to the corresponding level of government. The Audit Institutions at each level also provide professional guidance and supervision to internal audit units, and conduct quality checks of public audit firms.

¹⁵ China National Audit Office. 2000. *An Overview of Government Auditing in China* p. 3.

The CNAO has 12 departments as follows:

- General office
- Foreign affairs department
- Personnel and education department
- Law department
- Public finance audit department
- Monetary audit department
- Non-profit government agencies audit department
- Trade and economic audit department
- Agriculture, resources, and environmental protection audit department
- Social security audit department
- Fixed assets investment audit department
- Foreign funds application audit department

The CNAO has branches based in Government departments and agencies (dispatched audit offices). In addition to conducting audit fieldwork, the personnel of these offices attend management and other meetings held by the audited bodies as formal participants or observers. The CNAO also has resident offices in the PRC's 16 largest cities. Table 4 presents a breakdown of staff numbers as at June 1998.

Table 4: Staffing Levels of Nationwide Audit Institutions¹⁶

Type of institution	Actual	Allowed	Staffing Level (%)
CNAO (including staff in dispatched offices)	1,934	3,360	58%
Provincial audit institutions	7,436	9,239	80%
Municipal audit institutions	23,619	26,114	90%
County audit institutions	53,624	51,398	104%
Total	86,613	90,111	96%

CNAO Staff Retention

In June 1998, only 58 percent of CNAO positions were filled (Table 4 refers). The staff-retention problem faced by CNAO is a common one for Supreme Audit Institutions. Two factors drive the problem. First, in view of its importance, the CNAO receives significant training assistance from multilateral and bilateral donors. This training,

¹⁶ Source: China National Audit Office. 2000. *An Overview of Government Auditing in China* p. 13.

combined with good on-the-job experience, makes its personnel attractive to the private sector and to other government organizations. Second, there is a significant gap between CNAO salaries and private-sector salaries. A CNAO director earns about \$200 per month while their private counterparts earn upwards of \$1,500 per month.

Independence, Financing, and Powers

The CNAO can freely access the financial records of all government organizations – with the exception of military bodies – and defines its annual audit program without external direction or interference. The CNAO's budget is approved by the NPC on recommendation from the State Council. The military, as a separate part of the state apparatus, has its own audit function. Audit institutions have the power to: (i) require audited bodies to provide budgets, financial plans, statements about budget implementation, final accounts, financial reports, and other relevant information; (ii) review accounting information and assets of the audited bodies; (iii) investigate relevant issues and individuals about issues related to audit assignments and obtain evidence where necessary; (iv) suspend funding or freeze access to resources when auditees are in violation of state laws and regulations; and (v) report audit findings to relevant government departments and publish audit findings to the public.

Only very occasionally does the CNAO contract public accounting firms to conduct audits. Although the CNAO has contracting powers, it does not exercise these for two reasons. First, the CNAO has its own experts in specialist audit areas, such as financial institutions. Second, the CNAO's limited financial resources restrict its ability to pay private sector fees. In the rare occasions that the CNAO does contract public accounting firms to conduct audits, these firms have to comply with the CNAO's procedures and standards.

CNAO Auditor Qualifications

Many CNAO staff have CPA non-practising certificates. The CNAO has established an internal exam system for auditor qualifications.

International Relations

The CNAO has joined various international organizations, the main ones being the International Organization of Supreme Audit Institutions

(INTOSAI) in 1982, and the Asian Organization of Supreme Audit Institutions (ASOSAI) in 1984.

Audit Certification and Reporting

Audit institutions have the power to report audit findings to relevant government departments and publish audit findings to the public. The CNAO also provides annual audit reports to the State Council, and then to the NPC. If approved, the reports are then available to the public. Audit opinions are issued at the conclusion of audits, as are management-letter type reports.

External Assistance to the CNAO

A number of countries and organizations have assisted the CNAO over the past decade. In many cases, this assistance has involved short-term training. Chapter VII provides details of the assistance – in summary:

- The Canadian International Development Agency (CIDA) provided training support in the late 1980s
- ADB provided technical assistance from 1991 to 1995 that supported: the development of government auditing standards and audit procedures (including an audit manual), the design and implementation of a training program in relation to those standards, and the preparation of recommendations for office automation.¹⁷
- The Australian Agency for International Development (AusAID) is currently providing extended in-Australia training for around 10 middle-ranking managers focusing on SOE auditing, and computerized audit approaches. It also is supporting the development of an audit-training manual for SOEs and the development of multimedia training materials.
- ADB is currently providing technical assistance to: reformulate the auditing standards, and design and implement an audit-training program to promote full and consistent adherence to the auditing standards.¹⁸
- The German Technical Assistance Agency (GTZ) has provided equipment (information technology, office equipment, and training

¹⁷ TA. No. 1483-PRC: *Audit Administration of the PRC*. \$600,000. Approved 21 Feb 1991.

¹⁸ TA No. 3103-PRC: *Strengthening the Government Audit System*. \$700,000. Approved 26 November 1998.

equipment), and is providing ongoing support to the CNAO, in particular, to the Continuing Education Centers.

- The World Bank is currently providing technical assistance to support: the establishment of a training program for auditors, the development of reference and training materials, and the development of management information systems.

9. Chinese Institute of Internal Auditing (CIIA)

The PRC has 92,500 Internal Audit units nationwide with around 243,000 professional staff. A recent survey of internal auditors found that their average experience was 9.1 years.¹⁹ This indicates that, in comparison to their more transient western counterparts, Chinese professionals tend to be career internal auditors. Over 90 percent of the survey respondents had college or higher-level training (survey respondents were from Chongqing, Guangzhou, Jinan, and Wuhan).

In most organizations, the size of the internal audit department is too small to operate as a fully functional strategic unit. This is compounded by the absence of audit committees, or their equivalent, in the Chinese environment. Moreover, the heavy emphasis on accounting matters lessens the emphasis in perceived value-added activities such as management or operational audits. As such, when the 50 percent organization-wide headcount reduction in all national agencies was mandated by the central government in 1998 (as part of the public-sector reform reforms), some internal auditing departments were eliminated.

The Chinese Institute of Internal Auditing (CIIA) is a government organization. Until recently, the CIIA did not have any members – it focused on research and training activities. These activities have included the translation of the International Certified Internal Auditor (CIA) exam into Chinese – around 1,000 candidates participated in the exams first offering in November 1998 in Guangzhou. In 1987, the CIIA joined the International Institute of Internal Auditors (IIA).

In 2000, the CIIA will be officially categorized as a professional member organization and will establish a membership base of internal auditors. It is expected that a significant portion of new members will come from private industries and joint ventures. The CIIA will also

¹⁹ Chang, Stanley and Ronald Davidson. 2000. The Current State of Internal / Management Auditing in the People's Republic of China. *Pakistan Accountant*. January/February. pp. 36-39.

regulate professional activities, establish standards, and become more independent from the government. A new monthly professional journal will be launched with the inauguration of the new organization with an expected circulation of 80,000 per issue. The CIIA is also planning an aggressive national training program, including the establishment of specialized curricula at leading educational institutions.

10. Public Accounting and Auditing Firms

Introduction

After a 30-year hiatus, the first public accounting firm was established in the PRC in 1981. Much has happened in the ensuing 20 years – the PRC now has a thriving CPA profession. In the past two years, domestic accounting firm mergers have been actively encouraged – firms were previously legally allowed to only cover a single specific region.

The Big Five international accounting firms: Arthur Andersen, Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PriceWaterhouseCoopers are all established in the PRC. The Big Five firms employ 5,000 people in the PRC, over 90 percent of whom are Chinese nationals. They have seen a rapid increase in market share over the past several years. In 1992, their business turnover in the PRC was Y1.5 million (\$186,000), which represented only 0.05 percent of the accounting profession's total market volume. By 1997, turnover grew to Y510 million (\$62 million), representing 17.5 percent of the total revenue of all accounting firms in the PRC. Such market growth is the main impetus behind the merger trend among the PRC's domestic accounting firms.

The quality of accounting firms, their staff, and their activities has been mixed. The MOF and CICPA have taken, or are taking, the following steps to improve quality of accounting and audit services provided by public accounting firms:^{20,21}

- The Rectification Campaign (July 1997 – March 1999).
- Structural reform of CPA firms (1992 – 2000).
- Strengthening supervision (ongoing).
- Increasing competition and opening up the market (ongoing).

²⁰ CICPA. RETA 5877-REG Questionnaire Response. July 2000.

²¹ Yong, Li. 1999. The Reform, Regulation and Opening-up of China's Accounting Market. *Contemporary Issues in China Accounting and Finance: Policy and Practice*. Oxford University Press. pp. 278–286.

A Newspaper Article Shows the Extent of Auditing Weakness ...

Random Audit Exposes Accounting Fraud in Most Chinese SOEs

Hua Sheng Bao.²² 12 December 1999. A random state audit of 100 state-owned enterprises (SOEs) in China found that 81 of the companies reported false assets worth Y3.8 billion (US\$459 million) and 89 SOEs reported false profits worth Y2.7 billion (US\$326 million).

The audits, which were under the direction of the Ministry of Finance, are part of a drive to improve China's dismal accounting practices, which prevent investors from assessing the value of listed firms, and make it nearly impossible for banks to tell whether a company is credit-worthy.

If the results of the sample audit are any indication of the accounting practices of the rest of China's 300,000 state-owned firms, then rosy official statistics for state sector profits may be way off the mark.

According to the State Economic and Trade Commission, the agency in charge of state-owned enterprises, SOE profits rose 93% on year to Y48.2 billion (US\$5.82 billion) in the first half of 1999. Companies singled out as having particularly egregious accounting problems were the China Tourism Business and Trade Services, the China

Daily newspaper, Liuzhou Bureau of Railroads, China Grains' Heilongjiang Import and Export Branch, Wuhan Tobacco Group and Wuhan Tobacco Sales.

To make matters worse, previous audits of the 100 SOEs by 82 public auditing firms had found nothing awry with the accounts of 62 of the firms, which seriously undermines government confidence in its public auditors.

As a result, the China Institute of Certified Public Accountants has issued a warning to a number of accounting firms, saying their SOE accounting services will be suspended for one year, that their illegal earnings will be confiscated, and that they will be fined.

Further highlighting the extent of China's accounting problems is a recent China National Audit Office (CNAO) probe of two of the nation's four big commercial banks, Industrial and Commercial Bank of China (ICBC) and the China Construction Bank (CCB), which found that the banks' assets, liabilities and shareholders' equity were over-reported by over Y20 billion (US\$2 billion), according to the December 17 *Zhongguo Jingji Shibao* (China Economic Times).

The Rectification Campaign (1997 – 1999)

From July 1997 to March 1999, a nationwide rectification campaign of the accounting market was conducted. The objective of the campaign was to standardize, and raise the quality of, accounting and auditing practices. The campaign had four stages:

- I. Self-inspection. In the six months to December 1997, around 6,700 accounting firms conducted self-inspections. The self-inspections covered around 50 percent of their 1996–1997 activities. Just under 1.5 million business reports were inspected

²² Overseas Chinese Newspaper.

– of these, 26 percent were considered to be either defective or in need of correction.

- II. Focus Groups and Field Inspections. In January 1998, local CPA Institutes established working groups. In the following six months, these working groups conducted field inspections of 5,800 firms.
- III. Inspection Reviews. From July to the end of October 1998, 192 people selected by CICPA reviewed the inspections conducted in stages I and II. The reviews focused on 405 accounting firms.
- IV. Re-examination. From November 1998 to March 1999, CICPA re-examined the qualifications and status of qualified accountants and accounting firms.

As a consequence of the campaign almost 12,700 individual CPAs were either forced to withdraw from the profession or were disciplined (25 percent of CPAs) – many of these were older members who had not passed the uniform accounting examination, and around 580 accounting firms withdrew from the profession or had their licenses cancelled – warnings and punishments were issued to a further 2,000 accounting firms (43 percent of firms).

CICPA judged the campaign to be a success based on the following evidence.²³ First, during the period of the campaign, 6,300 newly qualified accountants joined the profession. The net effect was to substantially improve the profession's age structure and knowledge. Second, to address problems that were identified in the inspections, 85 percent of accounting firms substantially improved their internal-management practices; improved professional rules; implemented or improved quality-control systems; increased training; and in doing so, effectively eliminated the problems that had been identified. Third, in 1998, the level of "non-clean" audit opinions given on listed companies rose dramatically (to around 12 percent of audit reports) which (arguably) indicated improved professional quality and ethics. Fourth, the credibility of CPAs in the eyes of the public, as measured by a media survey, climbed from 45 percent in 1996, to 81 percent in June 1998.

²³ Yong, Li. 1999. The Reform, Regulation and Opening-up of China's Accounting Market. *Contemporary Issues in China Accounting and Finance: Policy and Practice*. Oxford University Press. p. 282–283.

Structural Reform of CPA Firms (1992 – 2000)

When the CPA system was established in the early 1980s, most accounting firms were funded and managed by various government institutions, including the Ministry of Finance. In addition, corporate entities were entitled to start accounting firms. These arrangements supported the rapid establishment and development of the CPA profession but, with the deepening of the reforms, no longer met the needs of the market economy. First, the independence of accounting firms was greatly compromised, thus damaging their public image and social reputation. Second, the sponsoring corporate entities, not the accounting firms, bore the legal obligations, which blunted the positive incentive effects of litigation threats.

The general objectives of the structural reforms were to establish a management system for accounting firms that was commensurate with a mixed-market economy, and to directly expose accounting firms to legal obligations. Specific objectives were to develop accounting firms that were characterized by independent operation, self-assumption of risks, self-discipline and self-development, and to strengthen the risk awareness of CPAs, improve their professional ethics, and ensure quality. The reforms had two aspects:

- Management system reforms. These changes focused on deregulating personnel practices, service charges, salaries and benefits, businesses and financial management. They also focused on de-linking accounting firms from their corporate sponsors in four ways. First, organizational affiliation – accounting firms and their employees were no longer affiliated to the sponsoring entity. Second, financial affairs – the sponsoring entities lost their rights as equity owners. Third, business connections – accounting firms were forbidden to leverage the power and influence of the sponsoring entity. Fourth, names – auditing firms were forbidden to use their sponsoring entity's names.
- Organization structure reforms. These changes focused on restructuring accounting firms into partnerships and limited liability firms (The *CPA Law 1993* allowed two forms of accounting firms: partnership and limited liability. In line with the law, the

establishment of accounting firms as partnerships was strongly encouraged).²⁴

Beginning in 1992, the MOF started restructuring the accounting firms. By the end of 1998, all firms qualifying as securities and futures businesses had been separated from their sponsoring entities and had been transformed into limited liability CPA firms. In April 1999, the MOF issued the *Announcement on CPA Firms De-linking from their Sponsoring Organizations and the Structural Reform*. This required all CPA firms to sever linkages with their sponsoring organizations and to adopt partnership or corporate (limited liability) structures within one year.

By the end of 1999, the structural reform of the accounting firms was pretty much complete – the number of firms had fallen from 6,045 to 4,805 and 1,240 firms had disappeared due to mergers and combinations. CICPA considers the de-linking and structural reforms a success because: (i) practitioners are now more aware of risk and responsibility; (ii) the profession's age profile is younger and practitioners are more technically competent; (iii) the pace at which larger firms are developing has gained momentum; and (iv) the image of CPA firms has improved which has strengthened the confidence of domestic and foreign investors.²⁵

Strengthening Supervision (Planned)

Rectification campaigns can only be effective in the short term. In the long run, CICPA intends to lock in the success of the first two initiatives by improving supervision. Five main actions are planned: (i) strengthening the supervision and control of auditing in key fields (such as financial-institution audits), (ii) establishing a business reporting and recording system for accounting firms, (iii) improving CICPA's monitoring and quality control capacity, (iv) formulating and improving supervisory regulations and introducing peer reviews, and (v) exposing professional failures in the media.

Increasing Competition and Market Opening (Ongoing)

CICPA recognizes that increased competition in the accounting services market will also improve professionalism and service quality. In

²⁴ Yong, Li. 1999. The Reform, Regulation and Opening-up of China's Accounting Market. *Contemporary Issues in China Accounting and Finance: Policy and Practice*. Oxford University Press. pp. 278–286.

²⁵ CICPA. 2000. *Annual Report: For the year ended 31 December 1999*. p. 2.

particular, CICPA believes that the entry of international firms to the domestic market will speed up the improvement of the PRC's accounting profession and support the elevation of the PRC's accounting firms to international standards.²⁶

The Big Five international accounting firms are all present in the accounting market which has been opened up through: (i) international accounting firms establishing permanent representative offices²⁷ in the PRC, (ii) the establishment of joint-venture accounting firms, (iii) the development of Chinese membership in international accounting firms, (iv) the issuance of temporary licenses to foreign firms, (v) the opening of the national CPA examination to non-Chinese citizens, and (vi) the promulgation of the 1998 regulation on *Provisional Methods for Approval of Non-Chinese CPAs*. The PRC's accounting market is now more open than the markets of many other Asian countries. The PRC's pending entry to the World Trade Organization (WTO) has influenced these initiatives, and the Government offered very generous terms for the opening up of the accounting market during WTO-entry negotiations.

CICPA intends to continue these initiatives. Its objectives are to: reinforce the establishment of joint-venture accounting firms; encourage the continuing establishment of respected international firms; encourage training and project cooperation between international and domestic firms; encourage communication between senior professionals from international and domestic firms; and establish the *Foreign Experts' Consulting Committee* which will enable regular or irregular discussions and communications on a range of policy issues.

²⁶ Yong, Li. 1999. The Reform, Regulation and Opening-up of China's Accounting Market. *Contemporary Issues in China Accounting and Finance: Policy and Practice*. Oxford University Press. pp. 284–286.

²⁷ By 1999, thirty-one such offices had been established – these offices had a 45 percent share of total industry revenues.