China Moves to Repatriate Its Auditing Profession:

A Historical Perspective from the Boxer Uprising to Today

By

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The State of Chinese Auditing

As is true everywhere, the reliability of financial reporting by Chinese companies – and thus the ability to engender investor confidence and prompt a willingness to commit capital resources – is a joint function of not only the quality of accounting standards but also the skill, determination and independence with which those financial statements are examined by autonomous, professional outside auditors. As such, the development of a high-quality auditing profession in China is an important requirement if Chinese companies are to take their rightful places in the wider world of commerce. However, it has been generally perceived – in part because of a profusion of widely-remarked-upon financial reporting aberrations and alleged frauds – that a number of issues in the public accounting profession in China have yet to be resolved, reflecting concerns about professional competence, independence, ethical standards and applications of effective auditing procedures.

Although there had been a respected auditing tradition in pre-1949 China, the post-Maoist accounting profession in China is less sophisticated than that in most Western countries. The Chinese Institute of Certified Public Accountants (CICPA) is still in its infancy, having been founded only in 1988, a hundred years or more after corresponding events in England and other commercially advanced nations. Also, the evolution of the accounting and auditing systems in modern China at first followed courses that differed from those in the West, with Chinese accounting firms being guided by the CICPA, which although nominally private is in fact closely governed and

regulated by China's Ministry of Finance (MOF), while the auditing profession was overseen by an organization established in 1991, the Chinese Association of Certified Public Auditors (CACPA), which in turn was regulated by a separate entity, the State Audit Administration (SAA). The establishment of an accounting firm or an auditing firm and the qualifying procedures for becoming a CPA or a practicing auditor were within the discretion of their respective sponsoring bodies, a situation which had been criticized as contributing to decidedly sub-optimal results.

This unique situation was resolved in 1995, when the two professional bodies merged to form a new organization carrying forward the name CICPA, still under the direct control of the MOF. Thus, today the MOF sets accounting standards and also approves the choice of auditors for foreign investment enterprises and authorizes the establishment of CPA firms.

In China, only foreign investment enterprises and listed companies are legally required to have an audit conducted by CPAs. The choice of auditors is a matter of management's discretion, but in order to audit listed companies' and foreign investment enterprises' financial statements, CPA firms must first be approved by the state. In this regard, there are similarities to the situation in the U.S. post-Sarbanes-Oxley, where auditors of issuers must be registered with the PCAOB and are subject to periodic quality reviews.

China allows non-Chinese citizens to take CPA examinations, and hundreds of foreign nationals have availed themselves of this opportunity. Responding to clients' moves to invest in China (ranging from joint ventures to factory ownership), the major international accounting firms established affiliate operations in China by opening representative offices. These firms were not allowed to do any statutory audit work under Chinese law but were able to offer consulting services, establish joint ventures to perform audits on multinational corporations and Chinese firms listed overseas, accept

Chinese accounting firms as member firms in their international associations of firms, and apply for provisional operation licenses to set up operations in China.

Recent Moves to Repatriate the Auditing Profession in China

In May 2012, the MOF announced that said it would require more auditors practicing in China to take the Chinese CPA exam (which will only be administered in the Chinese language, however), and would impose new limits on the percentage of non-Chinese-certified audit partners at the firms. More specifically, China will require the Big Four firms to have no more than 40% of partners foreign-certified, as part of a phased-in rule that will reduce that figure to 20% by 2017. Currently, as many as 90% of senior positions at major firms are held by non-nationals.

Various theories quickly surfaced regarding the MOF's motivation for imposing this mandate, ranging from rash reaction against the PCAOB's insistence on reviewing working papers of Chinese audit firms (Big Four affiliates included) that certify financial statements of U.S.-listed issuers, to a perceived need to upgrade the quality of practice at those firms, to a simple desire to provide job opportunities for native Chinese at the expense of foreign nationals.

Although Chinese auditing practices have been subject to criticism, particularly (but not exclusively) due to allegations of financial reporting misdeeds by the so-called Chinese RTO companies (those achieving listed status in the U.S. via reverse takeovers of dormant "shell" issuers), more rigorous requirements have been imposed over recent years, and further improvements are in the offing. Furthermore, Chinese firms affiliated with the major international associations of firms (Big Four, second tier, or smaller groups of essentially local firms) often utilize the same audit programs (the so-called "checklists") that U.S. and other member firms employ themselves. For that reason, differences in the quality of work performed is probably due

more to training and supervision variances than to discrepancies in the programs themselves.

The Historical Perspective on Chinese Accounting and Auditing

Students of history may recall learning that China had been, during the late colonial era, a weak state that was unable to resist various incursions by foreign nations, a number of which had imposed so-called “unequal treaties” granting them concessions regarding trade arrangements and long-term leases to certain territories such as Hong Kong (Britain) and Macao (Portugal). Deeply shamed by these overt signs of foreign domination by upstart nations (none of which could boast of China’s thousands of years of continuous history), by yet further intrusions by Germany and other nations, and by the Qing Dynasty’s lack of will and/or might to resist these developments, groups of peasants in northern China began to band together into a secret society known as I-ho ch'üan ("Righteous and Harmonious Fists") around 1899. These groups, later dubbed “Boxers” by the Western press, were opposed to the ruling dynasty, but more importantly were determined to rid China of foreign influences and the territorial incursions of foreign (mainly European) powers.

After several years that witnessed considerable violence and the arrival of foreign expeditionary forces sent to rescue the nationals of the impacted countries (the Boxer Rebellion or Boxer Uprising), Chinese imperial and Boxer rebel forces were defeated and a peace treaty was signed. The vulnerabilities thus exposed led indirectly to the overthrow of the imperial government in 1911 and the establishment of the Chinese Republic under Dr. Sun Yat-sen.

Turn the clock forward to the post-Mao era in China, when under the enlightened leadership of supreme leader Deng Xiao-peng China began to make major strides to develop its economy (and, more gradually, to relax dictatorial Communist Party control), which has now become the second largest in the world, after that of the U.S. As in other formerly Communist nations, where all enterprises had been state-owned and concepts such as profitability reporting were unknown or held in contempt as

being artifacts of capitalism, China faced the need for a modern score-keeping system that would facilitate the development of private enterprise, a modern banking system, and ultimately private investor activities.

Recognizing the need for foreign investment to jump-start an economy that had been decimated by rigid Maoist control and policy mistakes for over 25 years, China promulgated the Joint Venture Law in 1979, which led to the imposition of a new set of *accounting rules and regulations*, which were formulated to govern the preparation of financial statements by these joint ventures and other enterprises into which foreign companies had invested. After another decade had passed, yet a further set of accounting guidelines was formulated, intended specifically for the joint stock companies (i.e., corporations), into which the formerly state-owned enterprises were then being restructured in anticipation of public offerings. These were further revised in 1998 by the issuance of what were commonly referred to as PRC GAAP. This coincided with the rapid near-universal acceptance of International Financial Reporting Standards (IFRS, which at the time were known as International Accounting Standards, IAS), although PRC GAAP differed substantially from IAS and left many matters normally subject to specific financial reporting guidance unaddressed.

These omissions were largely dealt with in 2006, when the MOF announced the issuance of Accounting Standards for Business Enterprises (ASBEs), which are substantially aligned with IFRS, albeit with modifications reflecting China's peculiar economic circumstances – a situation not unique to China, however, inasmuch as the European Union's 2005 adoption of IFRS for public company reporting also contained several so-called "carve-outs." ASBE are now mandatory for all listed Chinese companies and are gradually being phased in for all other enterprises.

A somewhat parallel process has been undertaken in modernizing Chinese *auditing standards*. Evolving, as had Chinese accounting rules, from earlier government practices, by the mid-1990s China's independent auditing mandates were being promulgated, incorporating the General Independent Auditing Standard, specific

auditing standards and various practice pronouncements. The standards have been largely modeled on the International Standards on Auditing (ISA), which are published by a body of the International Federation of Accountants, but they too reflected China's unique and piecemeal transition to a market economy. Thus, both accounting and auditing practices are rapidly evolving and conforming to world norms in China, and should, if faithfully implemented, offer investors the same level of comfort as those in other developed nations.

Conclusion

In the author's view, China's current move to "repatriate" its auditing profession can more accurately be seen as an expression of national pride and desire for self-determination, which is a sentiment that is arguably even more justified today, for the world's second-most-dominant economic power, than was the century-earlier antipathy over "unequal treaties" and foreign concessions that led to the Boxer Uprising. As a manifestation of its own sovereignty, and coupled with the presumptive clearly-understood desire to foster further growth, employment and capital investment, this peacefully pursued "box-checkers rebellion" should not be a cause for undue concern.

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