

Realizing Auditor Independence in China: Insights from the Local Context

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ABSTRACT

This study contributes to context-based auditing research by providing insights into the realization of auditor independence in China's politico-economic and cultural context. Given the increasing legitimizing power and wide diffusion of Western corporate governance and accountability, it is crucial to examine the practice of imported concepts in countries such as China, where the development of accounting profession has taken a different path and been shaped by contextual influences different from those of Anglo-American countries. Twenty-one semi-structured interviews were used to obtain insights into auditor independence. The findings suggest a discrepancy between the imported construct of auditor independence and China's institutional context. China's politico-economic and social contexts have narrowed construction of auditor independence to its economic dimension. Given the pervasiveness of *guanxi*, low legal risk, and intense competition in the audit services market, Chinese auditors are under pressure to lower audit fees, avoid issuing qualified opinions, and provide additional advice and assistance on financial reporting. We argue that when auditor independence, as developed in Western economies, is implemented in transitional economies, there is a need to take into account its ability to adapt.

Keywords: Auditing, Auditor Independence, China, Local Context

INTRODUCTION

Auditor independence has long been recognized as the cornerstone of the value of audits. However, its operationalization in developing and emerging economies is still subject to debate. Auditor independence is rooted in auditing practices in Anglo-American countries (MacLulich & Sucher, 2005; Kosmala, 2007). The construct of auditor independence and its conceptual framework have been enshrined in the professional codes of those countries and by leading international accounting organizations (see the Professional Code of Conduct in the United States, the Members' Handbook in the United Kingdom, the Code of Ethics for Professional Accountants in Australia, and the Code of Ethics for Professional Accountants issued by the International Federation of Accountants, or IFAC). IFAC (2012), for example, prescribes that auditors must maintain both independence of mind and independence in appearance. In particular, auditors are required to invoke the conceptual framework to identify threats to independence, evaluate their significance, and apply safeguards to eliminate or reduce them. This conceptual framework for auditor independence, claimed as "high-quality ethical standards,"¹ along with the Anglo-American practice of external auditing has been embraced by many transitional and emerging economies such as China, countries in Central and Eastern Europe, and Saudi Arabia.

This paper addresses issues associated with the realization of the Anglo-American construct of auditor independence in China, the world's largest transitional economy. Given the increasing legitimizing power and wide diffusion of Western corporate governance and accountability, it is crucial to examine the application of imported concepts in countries such as China, where the development of accounting profession has taken a different path and been shaped by contextual influences different from those of Anglo-American countries. In the context of international convergence, understanding these influences is particularly important because auditor independence is essentially a cognitive and cultural concept in addition to its technical aspects (Wolnizer, 1987). We argue that auditor independence is *historically and locally constructed*, and thus cannot be understood in isolation from the local institutional context and historical development of the accounting profession. Without the recognition of differences in local cultures and accounting traditions, it is unlikely to realize auditor independence even though "internationally appropriate" procedures are being followed.

¹ IFAC (2014) states, "The International Ethics Standards Board for Accountants (IESBA) develops and issues in the public interest high-quality ethical standards and other pronouncements for professional accountants for use around the world."

Much of the prior research on auditor independence has explored the impact of the threats to independence prescribed by internationally acceptable professional codes of ethics on interested parties' perceptions of auditor independence (independence in appearance) and/or on auditors' behavior and audit quality (independence of mind). For example, the impact of non-audit services and auditor tenure has been extensively examined. (For the impact of non-audit services, see Ashbaugh, LaFond & Mayhew 2003, Felix, Gramling & Maletta 2005, Dee, Lulseged & Nowlin 2006, Hay, Knechel & Li 2006, Basioudis, Papakonstantinou & Geiger 2008, and Davis & Hollie 2008. For the impact of auditor tenure, see Carecillo & Nagy 2004, Carey & Simnett 2006, Gul, Jaggi & Krishnan 2007, Kealey, Lee & Stein 2007, Boone Khurana & Raman 2008, Chen, Lin & Lin 2008, and Manry, Mock & Turner 2008). Although the results of such studies provide insights into auditor independence, these insights are limited, particularly in complex global contexts.

These studies rely on quantitative methodologies by using proxies, such as discretionary accruals, audit opinion issues, or restatement of financial data to measure auditor independence and examine its association with various factors. However, the meaning and operation of auditor independence cannot be fully ascertained only by using quantified measurements and statistical relationships, particularly for countries where the construction of auditor independence may have been shaped by contextual influences different from those of Anglo-American countries. In addition, these quantitative studies have produced mixed results. For example, some researchers document a negative impact of non-audit services on the quality of accruals (Dee et al., 2006) and on perceived auditor independence (Hay et al., 2006; Davis & Hollie, 2008), whereas others find no evidence that such services undermine auditor independence (e.g., Ashbaugh et al., 2003; Iyer & Rama, 2004; Ruddock, Taylor & Taylor, 2006). Such results suggest no automatic association between the mechanisms stipulated by professional codes and auditor independence. Richer insights are required to understand the complex issues related to independence by drawing on a contextual analysis of a country's politico-economic and social institutions.

Given the importance of obtaining insights into the complexity of auditing issues, context-based studies in auditing are now receiving increased attention. These context-based approaches have been used to examine auditor independence in cultures whose features are considerably different from those of Anglo-American countries. For example, Sucher and Katarzyna (2004) find that in the Czech Republic the understanding and realization of *auditor independence* is shaped by an unstable market and immature legal framework. MacLulich and Sucher (2005) argue that

auditor independence in Poland is influenced by accounting traditions (e.g., accounting's administrative function) under the country's centrally planned economy. Hudaib and Haniffa (2009) indicate that in Saudi Arabia, Islamic teachings have a considerable impact on the meaning of auditor independence. Such studies provide insights into the practice of auditor independence outside of Anglo-American countries.

Our study contributes to context-based auditing research by providing insight into the realization of auditor independence in China. Specifically, drawing from interviews with knowledgeable informants and document analysis, this study suggests that Chinese auditors' use of an economic instead of an ethical perspective to auditor independence is attributable to China's politico-economic and cultural influences and to the country's accounting traditions. We argue that the operationalization of auditor independence, which is derived from the Anglo-American auditing tradition, is likely to encounter problems in emerging economies because of the power of the local institutional context.

The remainder of this paper is organized as follows. In the next section, we present our theoretical framework based on institutional perspective and describe China's institutional context. Then we discuss our research method and the analysis. We offer our conclusions in the final section.

THEORETICAL FOUNDATIONS AND RESEARCH CONTEXT

Accounting and accountability is increasingly viewed as a social and institutional practice shaped by its contextual environment (e.g., Hopwood, 1983; Hopwood & Miller, 1994). The theoretical framework of this paper is based on an institutional perspective because of its strength in adopting a holistic view to examine the context in which accounting operates. The significance of the wider economic and social setting of accounting is often stressed, and calls are often made for studies of accounting in its context (Burchell, Hopwood & Hughes, 1980; Hopwood, 1983, 1987; Hopwood & Miller, 1994). Prior studies suggest that local construction of auditor independence needs to be examined from a historical and cultural perspective (e.g. Sucher & Katarzyna, 2004; MacLulich & Sucher, 2005; Hudaib & Haniffa, 2009). In this paper, we examine how auditor independence in China has been influenced by the country's politico-economic system, legal system, cultural system, and accounting traditions.

Politico-Economic System

It is important to examine the local politico-economic system that shapes relationships among stakeholders of a firm (Roe, 2003). Politico-economic institutions also create incentives that influence the behavior of these stakeholders (Bushman & Piotroski, 2006). Following the establishment of the socialist regime in 1949, the Chinese government focused on the class struggle between the proletariat and the bourgeoisie and tightly controlled economic activities (Yu, 1998). In the centrally planned economy, the government owned and ran all enterprises, which were only considered units for implementing central plans and had little if any autonomy.

In the 1980s, the government turned its attention from the class struggle to economic development and initiated a series of economic reforms. Other forms of ownership, such as foreign investment companies and private companies, have since emerged and become increasingly important in the economy. Even more significant is that the Chinese government diversified ownership of underperforming state-owned enterprises. Small enterprises were sold to private investors. Medium and large enterprises were restructured to resemble companies in Western countries. Some of these restructured state-owned enterprises were listed on the domestic stock exchange with the government as the controlling shareholder (Jiang, Yue & Zhao, 2009; Wang & Chen, 2008). In addition, Chinese listed companies have a heavily concentrated shareholder structure. The five largest shareholders accounted for 58 percent of outstanding shares compared with 25 percent in the United States (Xu & Wang, 1999). This structure gives controlling shareholders, and especially the government, the power to dominate company decisions and benefit themselves at the expense of minority interests (Zou, Wong, Shum, Xiong & Yan, 2008). Thus, the main agency problem in China is the expropriation of minority interests by controlling shareholders within the concentrated ownership structure (Su, Xu & Phan, 2008; Zou et al., 2008).

Legal System

The legal system affects auditing mainly through enforcement of corporate laws and litigation against noncompliant auditors. Although protecting shareholder rights from a legal perspective is important in all economies, numerous scholars find systematic differences among legal origins in the protection of shareholders and especially minority shareholders (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1998; Djankov, McLiesh & Shleifer 2007; Djankov, La Porta, Lopez-de-Silanes & Shleifer, 2008). The strength of legal enforcement affects organizational players' incentives. Choi et al. (2008) find that legal liabilities associated with audit failures are a determinant of auditor effort because when investor protection regimes become stricter, there is a greater possibility that misconduct will be detected

and wrongdoers punished. A strong environment of investor protection and legal enforcement, therefore, is conducive to auditor independence.

China's legal system is still underdeveloped and enforcement is ineffective. Indeed, China's legal institutions are much younger and less developed than its counterparts in the west (Allen, Qian & Qian, 2005; Hua, Miesing & Li, 2006; Cai, 2007). Laws and regulations related to accounting, including the Accounting Law, the Law of Certified Public Accountants, and the Securities Law, were only developed following the economic reforms in the 1980s. It has been pointed out that China's legal system offers little protection to investors and even less to minority shareholders (Wang & Chen, 2008; Zou et al., 2008). For example, the Supreme People's Court is cautious toward civil securities claims. It was not until 2003 that the Supreme People's Court allowed lower courts to accept private securities litigation relating to misrepresentation in Provisions on Hearing Civil Compensation cases. Furthermore, the Supreme People's Court stipulates that plaintiffs must base their civil compensation claims on a China Securities Regulatory Commission (CSRC) administrative sanction or criminal conviction. Given that CSRC actions and court enforcement are not effective (Cai, 2007; Liebman & Milhaupt, 2008), the ability of defrauded investors to seek civil remedy is largely restricted by the current legal system.

Cultural System

A culture is a system of societal or collectively held values (Gray, 1988) that have a significant impact on human behavior. Perera (1989, p. 43) contends that accounting is not culture free; instead, "accounting is a socio-technical activity involving human and non-human resources or techniques as well as the interaction between the two." Culture affects auditing by influencing auditors' behavior and judgment. Auditing is a complex cultural phenomenon. For example, researchers have documented that when auditor independence and its Anglo-American perspective are imported to other cultures, its construction and realization are shaped by those cultures (Sucher & Katarzyna, 2004; MacLulich & Sucher, 2005; Hudaib & Haniffa, 2009).

Confucian philosophy plays the most important role in Chinese cultures (Lin & Ho, 2009). Confucianism stresses interdependent and harmonious relationships. These Confucian values are largely reflected by the pervasiveness of China's unique cultural construct, *guanxi*, which is formally translated as relationships or connections (Liu, Wang & Wu, 2011). China is a relation-oriented society, in which an individual's *guanxi* with others is an important consideration (Hwang, 1987; Leung, Chan & Wong, 2005). Developing and maintaining *guanxi* is a social norm which dominates

all business and social activities in China (Lovett, Simmon & Kali, 1999; Leung et al., 2005; Wong, 2010). In the culture model of Hofstede (2001), China's rankings in cultural dimensions are significantly different from those of the United States, the United Kingdom, and Australia.² For example, on the dimension of individualism, the United States, Australia, and the United Kingdom have the highest scores (91, 90, and 89, respectively), whereas China has a low score of 20. The difference suggests that the ties between individuals in the US, Australia and the UK tend to be weaker than those in China. This cultural difference is likely to have considerable implications for auditor independence, which explicitly emphasizes the value of independence.

The Development of the Profession and the Audit Services Market

The development of the accounting profession and the audit services market in China has been closely related to the country's politico-economic transformations. Before the 1980s there was no independent accounting profession because China had a centrally planned economy dominated by state-owned enterprises (Adhikari & Wang, 1995). The economic reforms that started in the 1980s revived the Chinese accounting profession and drove the growth of the audit services market. Throughout the process, the Chinese government has maintained tight control over the accounting profession and the audit services market.

Unlike in Anglo-American countries, where the accounting profession tends to be self-regulated, the accounting profession in China is regulated by the government. Most accounting firms in China have traditionally been affiliated with government agencies (Lin, 1998; Xiao, Zhang & Xie, 2000; DeFond, Wong, & Li, 2000). It was not until 2000 that the Ministry of Finance (MOF) launched a disaffiliation program. Since then, formal investment or payroll relationships between accounting firms and government agencies have ended (Gul, Sami, & Zhou, 2009). However, the Chinese government still wields administrative influence over the licensing of accounting firms, qualifying exams, and firms' day-to-day operations through agencies such as the MOF and the Chinese Institute of Certified Professional Accountants (CICPA).

CICPA was established as a subsidiary unit of the MOF, and its personnel and financial budget is administered by the MOF (Liu et al., 2011). The MOF delegates to CICPA administrative responsibility for the registration of certified public accountants (CPAs) and certified public accounting firms, the conducting of professional examinations, and the management of training programs. CICPA is also responsible

² In Hofstede's (2001) culture model, the United States, the United Kingdom, and Australia have similar rankings in all five dimensions (Individualism/Collectivism, Power Distance, Masculinity/Femininity, Uncertainty Avoidance, and Long-term Orientation).

for formulating and implementing codes of CPA ethics and developing auditing standards. Upon approval by the MOF, these codes and standards become authoritative documents that are binding on all CPAs. Thus, CICPA essentially acts as an agent of the government rather than as a self-regulated professional association.

In addition, there are concerns about the shortage of qualified CPAs given the size of the Chinese economy (Winkle, Huss & Chen, 1994; Xiang, 1998; Lin & Chan, 2000). Despite the dramatic growth of the Chinese CPAs, compared to its counterparts in Anglo-American countries, China has few qualified CPAs. To date the total number of CPAs is around 200,000, 98,000 of whom are in public practice (CICPA, 2014). This is still a small number in light of the growing demand for independent audit services. Table 1 compares the number of professional accountants in China and two Western countries.

Table 1 The Number of Professional Accountants in China and Two Western Countries

Country	Population	Number of Professional Accountants ³	Proportion of Professional Accountants per Million Population
China	1,356 million (1)	200,000 (2)	147
United States	319 million (1)	394,000 (3)	1,235
Australia	22.5 million (1)	CPA Australia 150,000 (4) + Institute of Chartered Accountants in Australia 70,000 (3) = 220,000	9,778

Source:

- (1) <http://www.census.gov/population/international/data/countryrank/rank.php>
- (2) http://www.cicpa.org.cn/news/201408/t20140804_45617.html
- (3) <http://www.globalaccountingalliance.com/globalaccountingalliance/Alliance-Members>
- (4) <http://www.cpaaustralia.com.au/about-us>

The audit services market has grown in parallel with China's economic development, and the Chinese government has been deeply involved in the process of the growth of the audit services market. For example, the government has adopted an incremental approach to opening up the auditing services market to international accounting firms to protect China's fledgling certified public accounting profession

³ Professional accountants refer to members of professional accounting bodies.

from competition with foreign accountancy giants. The audit services market in China is still small but highly competitive. Listed companies are the main targets of accounting firms, but these listed companies are small in both number and size. At the end of 2006, there were only 1,400 listed companies in China and 73 accounting firms were qualified to audit them, suggesting fewer than 20 listed clients on average for one qualified firm (Chen, Su & Wu, 2007). China ranks 32nd in the world in terms of the average size of listed companies (Liebman & Milhaupt, 2008). Furthermore, unlike in Anglo-American economies, in which Big 4 firms audit the majority of listed companies, there is no such concentration in the Chinese audit market. A report issued by the U.S. Government Accountability Office (2008) shows that the market for public company audits in 2006 was monopolized by Big 4 firms, who controlled a 94 percent share of the market. In comparison, the market share of Big 4 firms in the Chinese audit market of listed companies was only 19 percent in 2005 (Wang, O. & Claiborne, 2008). In 2001, the concentration ratios for the top 4 and top 8 auditors were 30.32 and 44.70 percent, respectively (Xia & Lin, 2003). Low concentration increases competition in the audit market, weakening the bargaining power of auditors and raising questions about auditor independence.

RESEARCH METHOD

This study adopts an interpretive research methodology. This methodology has its strengths in focusing on the research context, interactive processes and meanings that are not measurable by statistical data (Denzin & Lincoln, 1994; Robson, 2002). Interpretive researchers deploy a wide range of interconnected methods such as case study, personal experience, and interview to provide rich descriptions of the social world, particularly the meanings attached to actions and events in the language of the principal actors (Covaleski & Dirsmith, 1990; Gendron, 2009). An interpretive research methodology is considered appropriate for this study as it enables the researchers to obtain a rich understanding of the institutional context and the dynamic processes associated with auditor independence in China.

Semi-structured interviews were the main method of data collection. All participants answered the same questions and the interviewer had the latitude to explore any new insights that emerged (Fontana & Frey, 2003). Data triangulation was achieved by using survey of public documents including regulations, reports issued by government agencies, and CICPA websites. In addition, an examination of the literature that investigates auditing issues in China also generated a better understanding of China's auditing practices and environment.

The construction of the interview guide was informed by the institutional perspective and the literature on auditor independence to ensure that the interview questions focused on relevant issues and elicited useful information. Questions were designed to gain insights into how auditor independence has been shaped by China's politico-economic, legal, and cultural influences in addition to local accounting traditions. Furthermore, the interview guide incorporated some broad, open-ended questions to engage interviewees in a loosely guided conversation and thus elicit rich, in-depth insights (Taylor & Bogdan, 1998; Smith, 2003). As the interviews would be conducted in Chinese, we translated the English version of questionnaire into Chinese. Both versions were reviewed by an experienced translator with considerable knowledge in business and accounting fields (the interview guide is provided in Appendix A). A pilot study with four participants was undertaken before the field study to assess the appropriateness of the interview questions, as suggested by Robson (2002).

Potential participants were identified based on their auditing knowledge and expertise. All participants were required to have more than five years' experience in the field and hold senior positions. In accordance with the selection criteria, 40 interviewees were initially identified by searching the websites of 28 listed companies, nine universities, and the regional offices of MOF, CICPA and CSRC in Guangdong Province, where the interviews were conducted. As one of the most developed regions of China,⁴ Guangdong has a more advanced institutional infrastructure than less developed regions. Issues associated with auditor independence in Guangdong are also likely to occur in other regions, which makes it an appropriate research field.

After contacting the potential participants by phone or by email, we arranged interviews with 21 participants. There were four categories of interviewees: seven company managers (CM), five independent directors (ID), five auditors (AU), and four academics (AC). Interviewing several groups of participants provided both a comprehensive picture of the phenomenon under examination and a variety of perspectives on that phenomenon (McKinnon, 1988). More details on profile of the interviewees are given in Table 2. It was important for us to seek out views of government agencies, as the development of the accounting profession has been driven by the government. However, because of difficulties in gaining access to government officials, we failed to obtain insights from this perspective. All interviewees were formally assured of the confidentiality of the interview content. The interviews were conducted in China by one of the researchers and ranged from 40

⁴ Guangdong is the first province which experimented on reform and open-door policy in China. It has the largest GDP among all provinces in China since 1989.

minutes to two hours.⁵ Fifteen interviews were tape-recorded with the participant's permission, and notes were taken on the remaining six. Chinese versions of the transcripts were mailed to the interviewees for verification, and any ambiguities were clarified. All Chinese transcripts were translated into English by the same translator. In addition, we thoroughly reviewed the translator's work.

Table 2 Profile of The Interviewees

Interviewee	Education/Qualification	Years of Work Experience	Position
CM1	Master's	20	Board secretary in a large non-state-owned listed company
CM2	Bachelor's	20	Board secretary in a large state-owned listed company
CM3	Master's	20	CFO in a medium non-state-owned listed company
CM4	Bachelor's	20	CFO in a large state-owned listed company
CM5	Master's	20	Board secretary in a large state-owned listed company
CM6	Master's, CPA	15	Company senior manager in a large non-state-owned listed company
CM7	Bachelor's	20	Company senior manager in a large state-owned listed company
ID1	PhD, CPA, Professor	25	Audit committee chair and/or member in a number of listed companies
ID2	PhD, CPA Professor	25	Audit committee chair and/or member in a number of listed companies
ID3	PhD, CPA Professor	25	Audit committee chair and/or member in a number of listed companies
ID4	PhD, CPA Professor	25	Audit committee chair and/or member in a number of listed companies
ID5	PhD Professor	20	Audit committee chair and/or member in a number of listed companies

⁵ This paper is part of a larger research project examining the adoption of Anglo-American models of corporate governance and financial reporting in China.

Table 2 Profile of The Interviewees (continued)

Interviewee	Education/Qualification	Years of Work Experience	Position
AU1	Bachelor's, CPA	10	Senior manager in one of Big 4 international accounting firms
AU2	Master's, CPA	15	Partner in one of the top 10 local accounting firms
AU3	Master's, CPA	10	Senior manager in one of Big 4 international accounting firms
AU4	Master's, CPA	10	Senior manager in one large local accounting firm
AU5	Master's, CPA	10	Senior manager in one large local accounting firm
AC1	PhD, Professor	30	MBA director in a university
AC2	PhD	5	Associate director of master's program in a university
AC3	Master's	10	Head of accounting department in a university
AC4	Master's	10	Associate head of accounting department in a university

Note 1: Enterprises are classified based on "The Classification of Large, Medium and Small Enterprises in Statistics (Provisional)" issued in 2003 by the National Bureau of Statistics of China. 《统计上大中型企业划分办法（暂行）》 <http://www.stats.gov.cn/>

FINDINGS

We organize our findings around the major themes of our investigation. Our analysis is based on the interviewees' narratives and a review of public documents and academic journals.

Government Influence

The government can influence the appointment of an auditor, although the traditional association between the government and auditors was officially severed before 2000. This intervention takes different forms, including administrative rules and recommendations over the selection of an accounting firm.

For state-owned enterprises, the State-owned Assets Supervisions and Administration Commission (SASAC) requires listed state-owned companies to engage the auditor who has been engaged by the controlling shareholder (i.e., parent company), that is, to use the same accounting firm for the entire group. (ID4)

Government departments make recommendations. Sometimes if the government believes a particular firm provides good-quality service, or because there is a long-term relationship between the government and a particular accounting firm, that firm could be recommended to other companies. (AU1)

The government's influence over the appointment of auditors is also documented in the literature. For example, Lin and Fraser (2008) find that, in addition to normal factors such as changes in management or operations, influences from government agencies have made it difficult to assess risk in an audit engagement in China.

In addition, China's unique tax practices also affect auditor independence. Each year, local tax offices need to complete a certain amount of tax collection that has been pre-specified by provincial and national offices. To collect those taxes, tax offices tend to influence the timing and amount of tax liability recognition, which essentially reflects the outcome of the negotiation between tax officers and enterprise management. One common way to manipulate tax liability is to control the issuance of sales invoices.

They [tax officers] will tighten it up if they can't complete the assigned tax collection task...They will relax it if they have already gotten their job done. Every year tax offices are given a heavy collection task load [by the higher-level authorities]. It increases each year. Where does it come from? Enterprises....They negotiate with the enterprise managers over how much tax they have to pay. (CM3)

Listed companies are under pressure from the government. There are several situations...one situation is about tax offices. All tax offices have a certain task each year. If the task for the whole year has been accomplished early, say, in November, they [tax officers] tell companies not to issue invoices,⁶ because if the actual tax collection in that year exceeds the prescribed amount, the task for next year will increase. This apparently affects the listed companies, which are not allowed to issue invoices. This means that the company can't recognize sales revenue. Thus, the reported profit is lower than it actually should be. (CM1)

These statements illustrate how taxation affects financial accounting in China. One could argue that these unique tax practices lead companies to breach accounting

⁶ In China, a company needs to pay value-added tax for all sales transactions. When a company makes a sales transaction, a tax invoice is issued to the customer and sales information is simultaneously transmitted to the local tax office via computer. In this way tax offices are able to monitor a company's sales and associated tax liability at all times.

standards regarding the recognition of revenue. However, the practices are so prevalent that they have been taken for granted. When auditors see this, they are likely to look the other way. A company director commented that "...every company faces these situations. That is not caused by company themselves. Auditors fully understand this..." (CM1).

Guanxi

Many interviewers cited *guanxi* as an important factor in a company's selection of an auditor. Moreover, *guanxi* is often intertwined with government intervention.

Guanxi must be involved in obtaining an audit engagement...In addition to *guanxi*, the quality and reputation of an accounting firm will also be taken into account. (ID2)

...SASAC issued a document requiring a five-year rotation (within state-owned enterprises)...several central state-owned companies took advantage of this opportunity to remove us (to engage other auditors who had much closer guanxi with them)...depends on who has a connection with the government. (AU2)

I should say that basically the formal link between the government and accounting firms has been cut off. It was a successful reform. However, due to the historical factor,⁷ many firm managers have some connections with the government, which gives them an advantage in obtaining business. (CM4)

Numerous interviewees pointed out that tenders are gaining popularity in state-owned companies. However, even when a listed company does invite bids, *guanxi* still plays a significant role in the process. First, *guanxi* is important for ensuring that an accounting firm receives an invitation to bid. Furthermore, *guanxi* is critical in determining final outcomes. One interviewee elaborated:

...one large central government-controlled company wanted four accounting 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 SASAC, had no chance of being invited...on that day we saw other auditor firms who came

⁷ Many managers of accounting firms are former government officials or have extensive connections with the government because these firms are former government entities.

to bid as well. Because we were in the same circle, we knew each other. We found that they already knew the evaluation criteria, which had not been disclosed in the invitation letter to bid, because of their guanxi with the government authority. Also the assessment is very subjective...Now we won't participate in any bidding to which we are invited by a central government-controlled enterprise. We know we cannot win such a bid. Other competitors have better relationships with central government authorities. (AU3)

According to these statements, the government still intervenes in the audit services market and guanxi plays an important role in selecting auditors. Auditors who have good connections with government officials, controlling shareholders, and managers are likely to have an advantage in the audit services market.

Low Legal Risk

When discussing an auditor's legal liabilities, interviewees suggested a low legal risk of being sued, particularly by investors:

The possibility of being sued by investors is low. In the past there was no such kind of legal liability, which mainly relies on actions taken by CSRC...what needs to be addressed in the legal system is how to protect investors' interest. (ID1)

If anything goes wrong with the financial report of the company, it is even impossible to sue managers and directors, not to mention auditors. (AC4)

Although China has made good progress in developing and revising economic laws, enforcement is still weak...in many situations, a court won't even accept a case. Rarely, a case may be accepted, but the legal process will be too lengthy. (ID4)

Given the need for strong legal support to realize auditor independence, the minimal legal risk is unlikely to deter auditors from misconduct.

The Competitive Audit Services Market

Although providing non-audit services raises concerns in Anglo-American countries due to its negative impact on audit quality (Dee et al., 2006; Hay et al., 2006; Davis & Hollie, 2008), it does not seem to be a serious problem in China. One interviewee pointed out that "in China, there is not much non-audit service" (ID1). His view is confirmed by the CICPA 2010 Top 100 Accounting Firms Evaluation Report.

The report reveals that non-audit service fees accounted for only 18 percent of the total revenue of the top 100 accounting firms in 2009 (CICPA, 2010).⁸

Nevertheless, the majority of interviewees confirmed that the audit services market in China is highly competitive and admitted that fierce competition is the major factor threatening auditor survival and independence. As one interviewee explained:

China's economy has been growing fast. But the competition in the audit market is becoming more severe. Previously, local firms were protected by the government. Now more and more international firms are coming...Definitely, competition affects auditors' abilities to do their job properly. (AC4)

Issues of Independence in the Audit Process

We identified numerous issues related to auditor independence in China. Such issues are shaped by local institutional forces and the local context.

Lowering Audit Fees and Avoiding The Issuance of Qualified Opinions

This analysis has found that Chinese auditors tend to avoid issuing qualified opinions to retain clients and to reduce audit fees to compete for clients. Numerous interviewees called attention to this point:

Strong competition in China may threaten auditor independence. They have to reduce the audit fee, or are likely to compromise when negotiating with clients. (AC4)

If an auditor frequently gave a qualified opinion (i.e., acting independently), other companies would be scared off (and keep away from the auditor). (ID4)

These findings are consistent with the literature. For example, Chen *et al.* (2007) argue that the buyer's market in China is likely to impose pressure on auditors to compromise their independence and to accord clients more bargaining power. In highly competitive environments, Chinese auditors are more likely than their UK counterparts to accede to their clients when there is disagreement (Lin & Fraser, 2008).

⁸ The total revenue is RMB 20.61 billion (approximately USD 3.17 billion). The total revenue from audit services is RMB 16.99 billion (approximately USD 2.61 billion).

The Provision of Advice and Assistance on Matters of Financial Reporting

Numerous interviewees indicated that Chinese auditors are often under pressure to assist their clients with financial reporting. Such services may threaten auditor independence. Although auditors are allowed to advise clients on matters of financial reporting,⁹ providing certain types of services may create a self-review threat.¹⁰ The most recent Code of Ethics for Chinese CPAs was issued in February 2010. According to Article 112, No. 4 (Independence Requirement for Audit and Review), to assess the existence and extent of a self-review threat, at least three factors should be taken into account: the materiality of valuation to the financial statement, the client's involvement in determining and approving the valuation method and other important judgments, and the subjectivity associated with the valuation. The interviewees suggested that self-review threats are likely to occur because of clients' dependence on their auditors for determining accounting treatments:

In China, an auditor's advice could be very specific in terms of making adjusting entries, impairment tests, fair value determinations, etc. Because of the close relationship between auditors and clients, auditors offer this kind of assistance very often...In China, it is not enough that you just explain accounting standards, you have to give specific advice on how the accounting standard is applied to the client's situation. If we don't give the advice, they don't know how to determine the accounting treatment, and may also consider us unfriendly and unhelpful. (AU5)

I don't argue much with my auditor, because in daily operations I consult with my auditor if I have any problems. We communicate a lot. They have been our auditor for many years. Whenever I face a problem, I ask the auditor for advice on how to deal with it. (CM3)

These situations are closely related to accounting traditions in China. The professionalism of Chinese information preparers is limited, and these preparers are reluctant to make professional judgments (Ding & Su, 2008). When their skills and knowledge of applying new accounting standards are limited, they are likely to

⁹ For example, in Australia, the Accounting Professional and Ethical Standards 110, titled the *Code of Ethics for Professional Accountants*, allows accounting firms to provide technical advice on such matters as accounting principles and financial statement disclosure, the appropriateness of controls, and the methods used in determining stated amounts of assets and liabilities to their audit clients without it being considered a threat to their independence, under normal circumstances (refer to APES 110, paragraph 290.168).

¹⁰ For example, in Australia, the Accounting Professional and Ethical Standards 110 indicates that a self-review threat may be created when an external auditor provides assets valuation services (refer to APES 110, paragraph 290.175-176).

consult their auditor for advice. One possible outcome is that the auditor makes a considerable contribution to determining the accounting treatment, which may amount to a management decision. In addition, the close relationship suggested by these quotes implies that auditors are pressured to provide specific advice to their clients. Their closeness to the client may make it difficult for auditors to evaluate their clients and thus may impair auditor independence. The closeness between auditors and their clients is also common in other parts of the world and departmentalization can be used as a control mechanism. However, in given the limited professionalism of Chinese information preparers, such closeness is more likely to threaten auditor independence.

An Economic Interpretation of Auditor Independence

Numerous interviewees frequently referred to a “transitional stage” when discussing auditor independence. Chinese auditors use China’s status as is a transitional economy to explain their economic interpretation of independence. Auditors take an economic approach, and economic considerations usually outweigh ethics when issues of independence arise.

We are in a transitional economy; auditor independence should also be understood in this context. For us, the major concern is the economic benefit and career risk. Now if an auditor is in a relatively senior position, particularly in a large accounting firm, his (or her) income is much higher than the average wage in the job market (which leads to an unwillingness to risk independence for minor benefit). For example, we charge one million RMB to audit a small company for its IPO [initial public offering] and I personally only share a small portion of that amount. If the risk is high (compared to the gain), it’s not about independence, anyway. I won’t take a risk (for such a minor benefit). I think independence is intangible; I consider safety (instead of independence) to be more important. I think independence is mainly about risk. There is no need to risk my career. (AU1)

In summary, China’s experience of auditor independence is different from that of Anglo-American countries. For example, although non-audit services raise concerns in Anglo-American countries (Dee et al., 2006; Hay et al., 2006; Davis & Hollie, 2008), it seems not to in China. The analysis suggests that auditor independence in China is shaped by government influence, *guanxi*, low legal risk, fierce competition in the audit services market, and auditors’ economic approach to independence. *These findings are consistent with the literature, which indicates that the meaning and operation of auditor independence is influenced by China’s local historical and*

cultural context (e.g. Sucher and Katarzyna, 2004; Hudaib and Haniffa, 2009; MacLulich and Sucher, 2005).

DISCUSSION AND CONCLUSIONS

Drawing from interviews with knowledgeable individuals and document analysis, this paper provides insights into auditor independence in China, the world's largest transitional economy. The construct of auditor independence originated in Western capitalist economies and from there globalization has taken it to emerging or transitional economies. Although patterns of conduct in terms of best practices have been imported to China, our findings reveal that professional ethics is locally constructed and that there are differences in local institutional contexts and accounting traditions across countries.

Our analysis indicates a mismatch between the imported construct of auditor independence and China's institutional context. This study shows that in China the construct of auditor independence is perceived as imported from Western accounting knowledge and is therefore interpreted as alien to the Chinese tradition. China has a different institutional setting from that of Anglo-American countries. Given the discrepancy between the imported idea and the local context, the interpretation and operation of auditor independence in China is likely to have different features. This study shows although formal rules have changed rapidly as a result of decisions made by the Chinese government, informal constraints embedded in customs and traditions are much more persistent.

Our findings reveal a particular local realization of auditor independence that is shaped by China's institutional forces. The Chinese government is heavily involved in selecting auditors given its controlling shareholder status and bureaucratic and administrative function. Tax regulations and practices also influence the ways in which accounting and auditing tasks are completed. Intertwined with political influence, *guanxi* (personal connection) is significant in the appointment of auditors, which undermines auditors' objectivity and neutrality. Low legal risk does not give auditors an incentive to assert their independence. Fierce competition in the audit services market further weakens auditors' bargaining power in relationships with their clients. As a result, Chinese practitioners appear to take a largely economic approach to auditor independence. The local realization of this construct appears to be rather separate from auditor independence, as defined in international codes of ethics.

Understanding these broad institutional aspects helps us understand the local realization of an imported concept and its adaptation to local realities. *The issues associated* with the operation of auditor independence are complex and should be

understood in the local context. For example, although the Chinese government has been devoted to improving auditor independence by importing Anglo-American auditing concepts and practices, its status as a large shareholder is also creating barriers to the realization of auditor independence. Given the pervasiveness of *guanxi*, low legal risk, and high competition in the audit services market, Chinese auditors are under pressure to lower audit fees, avoid issuing qualified opinions, and provide additional advice and assistance on matters of financial reporting. In addition, the politico-economic and social situation has reduced the local construction of auditor independence to its economic dimension.

We argue that when the conceptual approach to auditor independence, as developed in Western economies, is applied in transitional economies, there is a need to consider its ability to adapt to the local context. Auditor independence is instrumental in ensuring the value of audits. Although this study has identified numerous issues associated with the operationalization of auditor independence in China's context, our findings do not invalidate the idea of auditor independence. Rather, the issues identified should be accommodated in adapting imported practices to domestic conditions. Further research should be carried out in other transitional economies to enhance the understanding of the adaptability of practices developed in capitalist economies. Focusing on local ways of implementing internationally acceptable practices may improve the quality of dialogue between local practitioners and advocates of global accounting. Furthermore, issues such as excessive government interference and unfair tax practices may not only threaten auditor independence but also give rise to unethical accounting practices. Future studies should examine how government intervention and tax evasion may influence the quality of accounting.

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APPENDIX A

Interview guide (English version)

In accordance with the Code and Guideline, the audit committee should recommend the engagement and replacement of the accounting firm.

- (1) How does a listed firm appoint its auditor?
 - (2) In reality, could any party manipulate the audit committee's recommendation? If yes, how? Also, how would the manipulation affect auditor independence?
 - (3) Normally audit fee, non-audit fee, and a long association between auditor and client are major concerns for auditor independence. In your opinion, do these factors result in auditor independence issues in China? Can you elaborate?
 - (4) In your opinion, how important is *guanxi* in the auditor appointment?
 - (5) How important is *guanxi* in obtaining audit and non-audit services?
 - (6) How does *guanxi* affect auditor independence?
In your professional career, have you ever faced any pressure that threatened your independence? Can you elaborate? How did you deal with it? (for auditors)
 - (7) We know historically accounting firms were affiliated with the government. Is the government still important in the audit and non-audit services market? How does the government affect the market?
 - (8) Is an auditor likely to be sued if he or she is negligent? Why?
 - (9) Overall, do you think Chinese auditors are independent? Why? What are the major issues concerning independence?
 - (10) In your opinion, to what extent is an auditor able to add credibility to financial reporting in China? Can you explain?
 - (11) Can you give some suggestions for enhancing auditor independence?
-

Interview guide (Chinese version)

根据‘准则’和‘意见’，由审计委员会来提议聘请或更换外部审计机构。

- (1) 上市公司是如何聘请审计师的？
 - (2) 在现实中，是否有谁可能操纵审计委员会的提议？如果是，如何操纵？这种操纵会怎样影响审计独立性？
 - (3) 一般来说，审计和非审计业务收费，审计师和客户间长期关系被认为是影响审计独立性的主要原因。你觉得这些因素在中国会引起审计独立性问题吗？能解释一下吗？
 - (4) 你认为关系在审计师任命中有何重要？
 - (5) 关系在获得审计和非审计业务有何重要？
 - (6) 关系如何影响审计独立性？
在你的执业生涯里，你的独立性是否遇到过威胁？你能解释一下吗？你是怎样处理的？(审计师)
 - (7) 我们知道历史上会计师事务所是和政府相关联的。今天在审计和非审计业务市场政府还是很重要吗？政府是如何影响这个市场的？
 - (8) 如果审计师疏忽，被告的可能性高吗？为什么？
 - (9) 总的来说，你觉的中国的审计师独立吗？为什么？关于独立性有哪些主要的问题？
 - (10) 你觉得在多大程度上审计能提高财务报告的可信度？你能解释一下吗？
 - (11) 关于加强审计独立性你能给些建议吗？
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