Auditing Standards in China—A Comparative Analysis with Relevant International Standards and Guidelines

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Key Words: Chinese auditing standards; International Standards on Auditing; Chinese professional ethics; International Federation of Accountants; Code of Ethics for Professional Accountants; Chinese accounting industry

Abstract: The continuing and deepening economic reforms in China have brought many changes both socially and economically to the society. The primary function of auditing in China has begun to shift away from the traditional tax compliance assessment towards the credibility lending to financial statements. The economic reforms and the development of the Accounting Standards for Business Enterprises have necessitated the parallel development of auditing standards in China. While some significant differences exist, the new Chinese auditing standards are, in a number of important aspects, similar to the professional standards promulgated by the International Federation of Accountants. The development of a comprehensive body of standards, auditor independence, the role of certain auditing techniques, and certified public accountant (CPA) population are the major areas that China needs to improve. Opening up the Chinese accounting industry will trigger significant advances in the implementation of Chinese standards and the development of the Chinese accounting profession.

Over the last decade, China (the People’s Republic of China, or PRC) has experienced tremendous social and economic changes. The development of socialist market economy, privatization, and large inflows of foreign investment demand the innovation of a Chinese accounting system in harmony with international practice. As a result, China released a set of Accounting Standards for Business Enterprises (ASBE) in 1993. To reinforce the confidence of investors, to regulate the performance of audits, and to harmonize with international practices, China began to issue independent auditing standards with the first batch being effective from January 1, 1996. The issuance of the Chinese auditing standards marks an important milestone in the development of the Chinese accounting profession. The standards also represent a commitment on the part of China to improve the quality and standard of certified public accountants (CPAs) with a view to harmonize China’s professional standards with international practice.
Compared with research on international accounting standards, there has been limited study on international auditing standards (Needles, 1989, 1997). It is not surprising that research into Chinese auditing standards is rare. Xiao et al. (2000) identify various factors that motivated auditing standards setting. Their study, however, did not directly compare the new Chinese auditing standards with international standards on auditing. In contrast, there have been numerous studies on Chinese accounting standards (e.g., Fang and Tang, 1991; Winkle et al., 1994; Chen and Tran, 1995; Davidson et al., 1996; Xiao and Pan, 1997). Motivated by the relative lack of attention to Chinese auditing standards, this article analyzes the motivations for the recent development of auditing standards in China and describes the framework of the standards. A comparison is made of the Chinese standards and the technical pronouncements issued by the International Federation of Accountants (IFAC) focusing on five broad areas: the auditor and attest function, independence, ethical principles and enforcement, audit evidence, and audit report. These five broad areas were identified because they are fundamental to the confidence and credibility that can be placed on an auditor’s opinion (Stamp and Moonitz, 1978; Needles, 1985).

THE ACCOUNTING PROFESSION IN CHINA

The accounting profession in China is much younger and inexperienced compared to most Western countries. The Chinese Institute of Certified Public Accountants (CICPA) was founded in November 1988. This is the first professional accounting body founded in China since the establishment of the PRC in 1949. In most western countries, accounting firms and auditing firms are alike and their associated professional bodies are independent, private, and self-governed organizations not affiliated with the state. The situation in China is quite different. Accounting firms and auditing firms are treated separately. This is evident by the parallel coexistence of the CICPA and the Chinese Association of Certified Public Auditors (CACPA) established in 1991. Although CICPA and CACPA are technically private organizations, they are governed and regulated, respectively, by the Ministry of Finance (MOF) and the State Audit Administration (SAA) and their day-to-day functions are directly influenced by substantial government involvement (Chow et al., 1995; Macve and Liu, 1995; Graham, 1996). 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 body. The parallel coexistence of both accounting and auditing firms has led to many problems in the Chinese public accounting profession such as abnormal competition and duplicate audits (Li, 1991; Li and Lin, 1991). Following a notification issued by the MOF in June 1995, the two professional bodies emerged to form a new professional body by the name of CICPA, under the direct control of the MOF. This change has resulted in the unification of name, institution and regulations. While the work of the SAA after the merger focuses on governmental audits and audits of state-owned enterprises in compliance with economic laws, the performance of the attest function is restricted to the CPAs.

In China, only foreign investment enterprises and listed companies are required to have a legal audit by CPAs. There is generally no statutory requirement as to other types of businesses that must receive financial statement auditing. The choice of auditor is a matter of management’s discretion. However, in order to audit listed companies’ and foreign
investment enterprises’ financial statements, CPA firms must first be approved by the state. There are 107 CPA firms qualified to do securities-related business by the end of 1998 (The Hong Kong Accountant, May 2000). The Law of the People’s Republic of China on Certified Public Accountants (CPAs Law) requires auditors to perform the following services: to audit the enterprise’s financial statements, to verify the enterprise’s capital contribution, to engage in the audit work of the enterprise’s merger, dismerger and liquidation, and to provide professional services specified by the law and regulations.

In light of the need for independent audit services, China has undertaken various measures to establish an independent audit profession. The set up of accounting body in 1988 and the promulgation of the CPAs Law in 1993 are examples of various measures (National People’s Congress, 1993). In addition, China allows non-Chinese citizens to write CPA examinations. So far, more than 220 expatriates have passed the exams and obtained non-practicing membership of CICPA (Tang, 1999). Sooner they will enjoy the same practicing rights as Chinese CPAs after they have worked at least 2 years for a CPA firm in China. The establishment of accounting firms must be approved by the MOF to be able to provide statutory services. CPAs may form an accounting firm on a partnership basis, providing that the registered capital of the firm is not less than 300,000 RMB yuan (approximately US$36,000) and that the firm has at least five registered CPAs (CPAs Law, art. 24). By the end of 1997, there were 62,460 practicing CPAs and 6,900 accounting and auditing firms in the country (Tang, 1999). The CICPA expects that the country needs 100,000 CPAs by 2000 and 300,000 by 2050 (Zhang, 1995).

Over the last decade, there is a tremendous growth of foreign direct investment in China. Since 1993, China has been for five consecutive years the second largest recipient of foreign direct investment, after the United States. Foreign direct investment amounted to US$45 billion in 1998 (Beijing Review, 1999). More than 200 of the world’s top 500 companies have invested in the country. Driven by their clients’ move, over the past few years, leading international accounting firms have moved into the country by opening representative offices. However, they are not allowed to do any statutory audit work under the law. They can, however, establish their presence in China through: a) opening representative office to offer consulting services, b) establishing joint ventures to perform audits on multinational corporations and Chinese firms listed overseas, c) accepting Chinese accounting firms as their member firms, and d) applying for provisional operation licences to set up operations in China (Hong Kong Trade Development Council, 1999). At present, there are 22 representative offices, 11 joint ventures and seven member firms of international CPA firms (The Hong Kong Accountant, August 2000). The Big 5 takes up about 15 percent of the total market share in China (Tang, 1999).

As a part of a big overhaul of its state-run economy, China is in the midst of privatizing thousands of state enterprises and listing many on overseas exchanges, which typically requires the skills and reputation of international accounting firms. China has responded to this by gradually freeing up its accounting industry. Furthermore, in the effort to gain membership in the World Trade Organization, China has eased its restrictions on the establishment of branches by joint venture firms and overseas firms. The deadline to transform joint ventures in China into member firms has been extended from 2001 to 2010 (Xindeco Business Information, 1998). The restriction on the maximum ownership of 33 percent equity by overseas firms in joint ventures has also been lifted.
THE NEED FOR AUDITING STANDARDS IN CHINA

Prior to the open-door policy in 1979, auditing played a very limited role in China. The government was the single source of financing for state enterprises and there had virtually been no foreign investment. Under such a situation, auditing had been no more than a mean of compliance tests to see if government funds were properly utilized. Prior to 1979, business operations were fully controlled by the government. As a result of the economic reform in 1979, which relaxed the relationship between state-owned enterprises and the central government, enterprises were given more power and control over their operations and retained profit. Auditing began to play the role of evaluating the effectiveness of business operations. In the early 1980s, state auditing was viewed as the most important part of China’s auditing activities. State-owned enterprises and organizations of major economic importance are subject to audit by the SAA. One of the most important purposes of state auditing is to help safeguard the state against misconduct, such as fraud and corruption. By June 1988, state auditing institutions discovered misconduct amounting to over 40 billion RMB yuan (US$11 billion) (Skousen et al., 1990). As the majority of Chinese government’s revenues came from taxes from state-owned enterprises, auditing in China primarily served the function of tax compliance checks. With the deepening economic reforms in 1993, this function has gradually shifted away towards lending credibility to financial statements. The shift of emphasis is attributable to the following events.

Although state-owned enterprises are still the dominant part of the Chinese economy, as a result of the economic reforms, collective and private enterprises and foreign investment enterprises coexist and compete with state-owned enterprises. There are over 300,000 private enterprises and 320,000 foreign investment enterprises in operation in China by the end of October 1998 (Beijing Review, 1998). Recent estimates indicate that about 73 percent of industrial output was generated outside the state sector in 1999 (National Bureau of Statistics, 2000). The movement in China toward private ownership that is almost totally divorced from management requires an independent audit on the financial reports made by management. This audit is essential for the success of the economic reforms. As private ownership is separated from management, the flow of investor funds to corporations has become dependent to a large extent upon reports by management. If investors are to have confidence in the veracity of the financial representations of management, it is necessary to provide an independent opinion on the truthfulness and fairness of the reports.

The development of stock markets in China, as a result of the establishment of the share capital system in 1992, has had a profound influence on the development of auditing. So far, some Chinese companies have successfully issued and listed bonds, A-shares, B-shares, H-shares, and N-shares to raise capital from domestic and foreign stock markets. Companies that offer B-, H-, and N-shares must provide understandable financial statements comparable to international standards. However, the traditional Chinese financial reporting system has many deficiencies compared to internationally accepted practice. As a result of the demand for revision in the accounting system, China formulated the ASBE, which became effective on July 1, 1993. This has brought Chinese accounting practice in harmonization with internationally accepted accounting principles. China’s new accounting framework is based on many common aspects on Western accounting frameworks (Davidson et al., 1996). However, this does not necessarily mean that financial
position and operating results provided by the Chinese system represent the true and fair view. Although the financial statements prepared under the new accounting framework are comparable to those of Western financial reports, the overall credibility of the information contained in the Chinese financial statements depends to a critical extent upon the quality of the opinion of the auditor. If the auditor’s primary function is to lend credibility to the financial statements, it follows that auditors themselves must be credible (Stamp and Moonitz, 1978). Sound auditing standards can lend credibility to auditing itself. The continuing economic reforms, as well as the development of accounting standards in China, necessitate a corresponding development of a set of auditing standard in harmony with international practices. The coexistence of the two standards are mutually reinforcing in establishing investor confidence that the financial statements prepared in a country other than their own can be relied upon.

Furthermore, the development of auditing standards in China is a necessity for enhancing the quality of audit work, services, and practices. Chinese accounting profession has developed rapidly over the last 10 years. However, a large number of CPAs at the early stage were qualified through an evaluation process based on working experience before a nationwide CPA examination was introduced in October 1991. Furthermore, there is a lack of continuing professional education for CPAs. A relatively low degree of professionalism is anticipated in China, as many CPAs did not receive systematic academic education and possess experience with market economy transactions and international accounting practice (Graham, 1996). It is therefore particularly necessary to provide a set of uniform professional standards that is clearly accepted and enforced by all members of the profession.

FRAMEWORK OF CHINESE AUDITING STANDARDS

Empowered by the CPAs Law, an Auditing Standards Task Force of 15 headed by the Secretary General of the CICPA, was formed in October 1994 to draft the auditing standards. Exposure drafts on the first 10 independent auditing standards were completed and released in January 1995 to all Chinese CPA firms and then in July 1995 to all finance bureaus in provinces and cities for consultation. Two separate teams of Chinese and international experts were formed in July and October of 1995 to help finalized the exposure drafts. However, there was no public exposure in the sense that not everyone in the general public was invited to comment on the exposure drafts and there was no public hearing. This practice of soliciting comments is another difference between Chinese and international auditing standards. On December 25, 1995, the MOF approved and issued the first set of 10 independent auditing standards, which became effective from January 1, 1996 (Ministry Of Finance, 1995). The issuance of auditing standards has been described by Zhang Youcai, Chinese Vice Minister of Finance, as “a landmark of the development of the Chinese CPA profession,” and its development is “a necessity for the legalization, standardization, and internationalization of the Chinese CPA profession.” The second and third batches of seventeen standards, five practice pronouncements and three related general standards on professional ethics, quality control and continuing professional education became effective from January 1, 1997, and July 1, 1999, respectively. As such, the regulatory framework of professional standards for CPAs in China has been basically established.
Figure 1. Regulatory Framework of Auditing and Independent Auditing Standards.
The independent auditing standards are comprised of three categories of statements of different levels of authority. Fig. 1 depicts the regulatory framework of the standards in relation to other laws.

The general auditing standard acts as the overall framework and provides a basis for the development of other categories of statements. The second category consists of two types of statements: (a) specific auditing standards are detailed standardization of an ordinary audit engagement and audit reports, and (b) practice pronouncements are detailed standardization of audits relating to specific purposes audits and specialized industries. These two categories of statements must be approved and issued by the MOF and compliance is mandatory. Implementation guidelines are statements issued by the CICPA as practical guidance on applying the specific standards and practice pronouncements. Their implementations are within the auditor’s own discretion. The independent auditing standards apply to any audit with a view to expressing an opinion on the truthfulness and fairness of the financial statements prepared by business management.

A COMPARATIVE ANALYSIS WITH RELEVANT INTERNATIONAL STANDARDS AND GUIDELINES

The following subsections focus on comparisons in five broad issues that are fundamental to the confidence and credibility that can be placed on an auditor’s opinion (Stamp and Moonitz, 1978; Needles, 1985). The comparison is made to the *International Standards on Auditing (ISA)* (for subsections 1, 4, and 5) and the *Code of Professional Ethics for Professional Accountants* (for subsections 2 and 3) promulgated by the IFAC (International Federation of Accountants, 1994, 1996, 1998a,b,c). Verification of capital contribution, a statutory audit unique to China, is also described. A summary comparison of the Chinese auditing standards to the ISA is given in the Appendix.

The Auditor and the Attest Function

The Chinese *CPAs Law* defines CPA, the business name of the auditor, as a professional who possesses a CPA designation and works in the auditing and accounting fields. The auditor should possess professional knowledge and experience, undergo appropriate professional training, and possess sufficient analytical capability and judgment. *ISA* refers the auditor to be the person with final responsibility for the audit.

Differences in the qualifications and training of auditors may cause variations in the quality of audits. There are differences between China and IFAC with regard to how auditor’s professional competence should be examined. Before October 1991, there were two routes to become a registered accountant in China: through the written examination and through the evaluation process. China’s national uniform examination of professional competence started in October 1991. Like IFAC, China also requires the equivalent of a university degree and the completion of a qualifying examination. The similarity is somewhat misleading, however, because the nature and contents of the examination vary. IFAC Education Committee suggests the knowledge that individuals must gain prior to qualification. This knowledge falls into four categories: general knowledge, organizational and business knowledge, information technology knowledge, and accounting and
accounting-related knowledge (International Federation of Accountants, 1996). The syllabus of the Chinese CPA uniform examination is more limited in scope since it relates only to accounting and accounting-related knowledge (accounting, financial management, auditing, economic laws, and taxation).

Article 4 of the Chinese General Standard states that the objective of an independent audit is “to express an audit opinion on the legitimacy and fairness of the entity’s financial statements and the consistency of the accounting treatments.” Legitimacy refers to whether the financial statements are prepared in conformity with the ASBE and other related financial accounting regulations. Fairness refers to whether the financial statements present fairly, in all material aspects, the financial position, operating results, and changes in cash flow. Consistency refers to whether the accounting policies adopted follow the consistency principle. ISA 200 describes the objective of an audit of financial statements as being enabled the auditor “to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.” Thus, it appears that Chinese standards are more specific about the objective of an audit. ISA 200 does not address whether the examination seeks to determine whether the financial statements are prepared according to legal requirements prescribed by law, or whether the financial statements present fairly in accordance with a set of accounting standards.

Independence

It is of the essence of the auditor’s function that the auditor shall be independent in his or her relationships with the client if he or she is to be objective, and be perceived to be objective in expressing his or her opinions. Article 5 of the Chinese General Standard on Professional Ethics requires the auditor to remain independent in form and in substance. An accounting firm or a CPA must not accept the engagement for an audit or other attestation function if vested interest with the client exists.5

IFAC addresses the independence issue in the Code of Ethics for Professional Accountants (International Federation of Accountants, 1998b). It stresses the importance of both the appearance and the substance of independence and identifies many ways that would impair the independence of the auditor. These include: financial involvement with clients, appointments in companies, provision of other services to the clients, personal and family relationships, audit fees and ownership of the capital.

Despite similar definition, the practical situation in China raises question marks over the independence of CPA firms. Due mainly to insufficient assets to bear the full responsibilities and legal liabilities that go with an accounting practice, most of the accounting firms established in the early 1980s were shielded, funded, and managed by different government agencies. Furthermore, all CPA affairs are supervised by the MOF in the name of a seemingly autonomous body, CICPA.6 Substantial government involvement in the accounting profession in China has resulted in a strong statutory control and influence over accounting activities (Zhong, 1998). To enhance audit independence, since 1997, China has started the institutional restructuring of CPA firms, aiming to sever the CPA firms’ financial links with related government agencies. The delinking of CPA firms from their sponsoring organizations in terms of four main areas—personnel, finance, business strategy and name, has been rigidly enforced. So far, there are about 1,000 CPA firms being restructured into
partnerships with limited liability. The delinking of CPA firms in Shenzhen, Hainan and Beijing for CPA firms qualified to conduct securities-related business has been completed (The Hong Kong Accountant, February 2000). In 1998, the government decided to turn all joint venture CPA firms into independent partnership by the year 2010 (Xindeco Business Information, 1998). After the restructuring, Chinese CPA firms will be more independent and free from government interference. DeFond et al. (2000) find that the new Chinese auditing standards have resulted in increased auditor independence since 1996. However, the social and cultural constraints (centralization, conservatism, and uncertainty avoidance) on the development of a more flexible self-regulatory accounting body in China will continue for the foreseeable future (Chow et al., 1995).

**Ethical Standards and Enforcement**

Ethical standards are to ensure the public that the profession will maintain a high quality performance. Similar to ISA 220, China has issued the *General Standard on Quality Control* to ensure that all audits are conducted in accordance with relevant laws and regulations. China addresses the professional ethics in the *General Standard on Professional Ethics*. The term “professional ethics” in the standard refers to the CPA’s professional integrity, discipline, competence, and responsibility. It further requires that during the period of professional engagement, the CPA must maintain objectivity, confidentiality, professional conservatism, and competence and observe professional standards.

ISA 200 requires the auditor to follow the ethical principles addressed in the *Code of Ethics for Professional Accountants* issued by IFAC (International Federation of Accountants, 1998b). Ethical principles governing the auditor’s responsibilities include independence, integrity, objectivity, professional competence, and due care, confidentiality, professional behavior, and technical standards.

The Ethics Committee of IFAC has proposed that the power for disciplinary action may be provided by legislation or by the constitution of the professional body. China sets and enforces ethical standards through a process that involves both a legal basis in law (e.g., *CPAs Law*) and a code of ethics adopted by the CICPA (e.g., *General Standard on Professional Ethics*). The MOF enforces ethical standards. The authority to revoke a license rests with the MOF. However, it is the CICPA that actually conducts the disciplinary investigations (*CPAs Law*, art. 37). The lack of adequate adherence to the ethical standard by Chinese CPAs has been serious. The practice review of CPA firms in 1998 has resulted in 344 CPA firms being closed down, 1,509 firms being penalized by temporary suspension of licenses, fines, forfeiture of illegal gains, and compulsory restructuring, and 1,441 branch offices being shut down. The certificates of 352 CPAs were cancelled and other actions such as suspensions or warnings were given to 2,396 CPAs (Tang, 1999). It appears that it will take a long time to improve the ethical standard of the Chinese accounting industry.

**Evidence**

The key element in any audit is the marshalling and evaluation of evidence. Chinese specific auditing standard No. 5, *Auditing Evidence*, requires the auditor to obtain sufficient
appropriate evidence necessary for the expression of an opinion and issuance of an audit report. The auditor should exercise his professional judgment to decide whether evidence is adequate and appropriate, based on the factors such as audit risk, materiality, misstatement, or irregularity, and types and sources of evidence. Sufficient appropriate audit evidence may be obtained by such means as inspection, vouching, observation, inquiry and confirmation, computation, and analytical procedures. When obtaining evidence through compliance tests, the auditor should consider such factors as the existence and effectiveness of the client’s internal control system. When obtaining evidence from substantive tests, the auditor should consider such factors as the existence or occurrence, rights and obligations, completeness, measurement, valuation, and matching of income and expense.

This section closely resembles that of ISA in terms of determination of sufficient appropriate evidence and procedures for obtaining evidence. Audit evidence can be obtained from compliance tests and substantive tests, such as analytical procedures. Chinese specific standard No. 11 deals with analytical procedures. However, the role of analytical procedures in the evidence collection process in China has generally not been recognized to the same extent as in the West. The efficiency and effectiveness of the use of analytical procedures in audits has been well recognized by the western accounting firms for decades. The primary advantage of using analytical procedures is their apparent abilities of reducing time-consuming detailed testing and of signaling a large proportion of financial misstatements (Hylas and Ashton, 1982; Wright and Ashton, 1989). American SAS 56 (American Institute of Certified Public Accountants, 1988) and British SAS 410 (Auditing Practices Board, 1995) have made analytical procedures mandatory in the planning and review stages of the audit and strongly recommend their use directly as substantive procedures. However, the decision to use analytical procedures at any stage of the audit in China is a matter of auditor discretion. The general lack of the attention on analytical procedures may be due to insufficient competitive pressure among Chinese CPA firms for cost savings.

In most Western countries, professionalism is relatively high where accountants are encouraged to adopt independent attitudes and to exercise their individual judgments to a great extent. Solomon (1995), on the basis of a review of American auditing standards, concludes that judgment pervades virtually every aspect of contemporary financial statement audits. In general, compared with the West, professional judgment has not really been emphasized in accounting education in China, which has been based on an over-specialized and industry-oriented accounting curriculum (Tang et al., 1994). As judgment involves a certain degree of “freedom” and “uncertainty,” it is understandable that a society of strong uncertainty avoidance that has long been accustomed to detailed rules and guidelines may adopt a conservative approach to deal with this issue (Gray, 1988; Chow et al., 1995).

**Audit Report**

The content and structure of the Chinese audit report are generally similar to international standards. With regard to the scope paragraph, specific auditing standard No. 7 (art. 15) requires that audit report specify the following matters: the name of the financial statements audited including the date of and period covered by the financial statements, the accounting responsibility and the audit responsibility, the basis of the audit (i.e., China’s Independent Auditing Standards of CPAs), and the major audit
procedures performed. Moreover, it requires that the auditor’s opinion paragraph convey three messages. Firstly, whether the financial statements conform with the ASBE and other relevant financial accounting regulations. Secondly, whether the financial statements present fairly, in all material respects, the financial position, results of operations, and changes in cash flow. Finally, whether the accounting policies adopted follow the consistency principle. The auditor may issue an unqualified, qualified, adverse, or disclaimed report. An unqualified opinion is expressed when the entity’s financial statements prepared comply with the three matters specified in the opinion paragraph and no material matters requiring adjustments have not been made by the entity. A qualified opinion is expressed when the entity refuses to make a material adjustment, or audit evidence cannot be obtained as required due to a significant limitation on the audit scope on certain aspects, or the application of individual material accounting treatment is not consistent. An adverse opinion is expressed when the application of the accounting treatments by the entity seriously violates the requirements of the ASBE or the financial statements prepared seriously distort the financial position, operating results, and changes in cash flow, and the entity refuses to make adjustments. A disclaimer of opinion is expressed when the CPA cannot obtain the necessary audit evidence due to a severely limited audit scope imposed by the client, the entity, or other circumstances. The impact of such a limitation is so material that the CPA is unable to express an audit opinion on the financial statements as a whole. In the case of the last three types of audit report, the auditor shall provide adequate explanations and quantify the extent of its possible effect on the financial statements.

ISA 700 provides guidelines for the content and structure of audit report. It recommends that the report contain the following basic elements: title, addressee, identification of the financial statements audited, a statement of the responsibility of the entity’s management and the responsibility of the auditor, a reference to the auditing standards or practice followed, a description of the work the auditor performed, an expression of opinion on the financial statements, the auditor’s signature and address, and the date of the report. The guideline indicates that the terms used to express the auditor’s opinion are “give a true and fair view” or “present fairly, in all material respects.” Thus, audit reports prepared under Chinese standards and IFAC guidelines are similar in format. However, there are some differences in terminology used (e.g., audit report title) and in the details of the guidelines provided. Unlike ISA 700, which provides guidelines on standardized wording, the language of the Chinese audit report is not standardized. Standardized wording should promote a more consistent understanding of whether or not the auditor has any reservations and should also avoid the confusion, which can result from using different messages to describe essentially similar situations (Hatherly and Skuse, 1991). Moreover, Chinese audit report tends to provide less detail on qualifications reflecting a conservative culture in information disclosure (Chow et al., 1995).

Verification of Capital Contribution

Chinese practice pronouncement No. 1 defines verification of capital contribution as the verification of the truthfulness and legitimacy of the entity’s paid-in capital (share capital) and its relevant assets and liabilities. A CPA certified verification of capital
contribution is a legal requirement when: (1) a new business is set up that requires each party to pay its contribution within the time as fixed in the contract; (2) the change of legal person, merger, or demerger, increases in and assignments of registered capital; and (3) contracting parties wish to change (increase, decrease, or withdraw) their registered capital. For example, equity joint ventures in China are required to have a registered capital to which all parties must contribute. Contribution can be made in cash or in tangible and intangible assets. After all contributions are made by each party, a CPA firm is called upon to verify them and issue a certificate of verification. The scope of verification includes the paid-in capital, the corresponding cash, tangible and intangible assets that make up the paid-in capital, and the relevant liabilities. The guidelines require the auditor to conduct necessary verification procedures and obtain sufficient appropriate evidence for the expression of an opinion and the issuance of a verification report. Among other elements, the verification report should contain two paragraphs: one describing the scope of the verification and one expressing the auditor’s opinion on the verification of capital contribution.

No equivalent ISA was found in this area. Verification of capital contribution is generally not a statutory audit in the developed economies such as Australia, Canada, UK, and USA, although auditors sometimes have to verify capital contributions under various regulatory requirements. Verification of capital contribution is peculiar to and forms an important practice area of the Chinese CPAs. Several economic cases in the early 1990s, all involving fictitious verification reports by the accounting firms, have caused the society serious concerns over the work of auditors. In response to these incidents, the Chinese government has made the verification of capital contribution a statutory audit in various laws and regulations and made it clear that the issuance of an untruthful certificate by the auditor is a criminal offense.

CONCLUSION

While it is impossible to develop a set of faultless auditing standards in one attempt, China has now established a general framework for further development of a comprehensive body of standards. The standards and guidelines issued contain both international and Chinese characteristics. Guidelines on the verification of capital contribution, as a statutory audit, are developed based on China’s unique economic environment. A comparison of the Chinese auditing standards with the IFAC pronouncements suggests that the Chinese standards most closely resemble international standards and guidelines in a number of important dimensions. Many of the similarities occurred because the development of Chinese accounting profession is so recent that many standards and guidelines issued by IFAC and well-established accounting professions were adopted with relatively little change. This is a very efficient way of making the new standards harmonized with international norms. However, differences exist with respect to how auditor’s professional competence is examined, how independence is defined and practiced, how ethical standards are established and enforced, and how certain audit procedures are emphasized and performed.

For example, differences exist with regard to how auditor’s competence should be examined. Chinese CPA examination only started in 1992 and the syllabus of the
uniform CPA examination and the curriculum of higher education are somewhat narrow in scope. Furthermore, there is a lack of post-qualification education. In terms of auditor independence, there are inherent weaknesses in the management system of Chinese CPA firms and in the status and authority of the CICPA. It is expected that cultural constraints on the development of a more flexible self-regulatory accounting body will continue for the foreseeable future. As for ethical standards, the MOF enforces the standards. The CICPA merely acts as an investigator, due to the lack of authority and power. Cultural constraints (conservatism and uncertainty avoidance) and the lack of emphasis on school curriculum and training may explain why professional judgment and analytical procedures are not emphasized in China. Lack of sufficient competitive pressure on audit fees may also explain this lack of emphasis by the Chinese CPAs. Finally, the language of the Chinese audit report is not standardized and the report tends to provide less detail on qualifications, reflecting a conservative culture in information disclosure.

With the number and the comprehensiveness of standards it has developed, China moved closer to ISA. The three batches of 35 statements form the framework for regulating the auditing practices in China. Though it is relatively young and inexperienced compared to Western counterparts, the Chinese accounting profession is developing rapidly. China has the formal structure necessary to support a strong auditing profession. It now has a legislative framework at the national level, a professional organization, a systematic education program, and a uniform CPA examination system operating in close concert with government agencies. The mutual reinforcement between accounting standards and auditing standards will improve the usefulness and enhance the credibility of the financial reports of Chinese companies.

However, at present, the accounting industry in China has not yet fully opened up to the international accounting firms. It is understandable that for self-interest, China will protect its young accounting industry to allow it to grow to some extent before permitting expatriate competitors to enter the market. It is argued, however, that freeing up access to the market for international firms will help the profession implement the accounting and auditing standards as well as transfer the necessary skills and technologies to Chinese nationals and enable the profession to grow as rapidly as the economy demands.

One of the most important areas in which China needs to improve relates to the independence of CPAs. Given the cultural influence, Chinese accounting profession will continue to be characterized by substantial government control over its accounting activities. The relationship between the state, the auditor, and the client clearly should be clarified before the image of the auditor in China can be substantially improved. The recent requirement of establishment of member firms severing CPA firms from sponsoring government agencies is an important step in the right direction.

Now that the new Chinese standards are closer to the ISA, full implementation and adoption by firms become the key in meeting the public expectations. One major concern in the implementation of auditing standards in China is the relative small number of adequately qualified CPAs in practice in light of its economic size. Current shortage of qualified CPAs may become more apparent as more state-owned enterprises are converted to private enterprises. Opening up the accounting industry, allowing more competitors into the market, and granting qualified expatriates the practicing rights in China would trigger significant advances in the implementation of Chinese standards and allow the industry to expand and improve. It is equally important to provide existing...
auditing personnel with adequate training and continuing education to ensure the proper
application of these standards. Although promulgating ethical requirements is partly the
responsibility of the legislative body, Chinese accounting profession body has the
responsibility to promote high standards of professional conduct and to ensure that
ethical requirements are observed. Failure to observe them should be investigated and
appropriate actions taken.

APPENDIX A

Comparison of Chinese Auditing Standards to ISA

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<th>ISA #/Corresponding</th>
<th>ISA title</th>
<th>Chinese standards generally conform to ISA?</th>
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<td>Responsibilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>200/1</td>
<td>Objective and General Principles</td>
<td>Yes. However, ISA highlights persuasive conclusive evidence and absolute and relative audit assurance.</td>
</tr>
<tr>
<td>210/2</td>
<td>Terms of Audit Engagements</td>
<td>Yes. However, ISA also considers recurring audits and provides example of an engagement letter.</td>
</tr>
<tr>
<td>220</td>
<td>Quality Control for Audit Work</td>
<td>Similar to Chinese General Standard on Quality Control</td>
</tr>
<tr>
<td>230/6</td>
<td>Documentation</td>
<td>Yes.</td>
</tr>
<tr>
<td>240/8</td>
<td>Fraud and Error</td>
<td>Yes. However, ISA also considers reporting of fraud and error to regulatory and enforcement authorities.</td>
</tr>
<tr>
<td>250/18</td>
<td>Consideration of Laws and Regulations in an Audit of Financial Statements</td>
<td>Yes. However, ISA also considers reporting of noncompliance with laws and regulations to regulatory &amp; enforcement authorities.</td>
</tr>
<tr>
<td>Planning</td>
<td>Planning</td>
<td>Yes.</td>
</tr>
<tr>
<td>300/3</td>
<td>Knowledge of the Business</td>
<td>Yes.</td>
</tr>
<tr>
<td>320/10</td>
<td>Audit Materiality</td>
<td>Yes.</td>
</tr>
<tr>
<td>Internal control</td>
<td>Risk Assessments and Internal Control</td>
<td>Yes. However, ISA also illustrates the interrelationship of the components of audit risk.</td>
</tr>
<tr>
<td>400/9</td>
<td>Auditing in a Computer Information Systems Environment</td>
<td>Yes.</td>
</tr>
<tr>
<td>401/20</td>
<td>Audit Considerations Relating Entities Using Service Organization</td>
<td>No similar Chinese standard.</td>
</tr>
<tr>
<td>Audit evidence</td>
<td>Audit Evidence</td>
<td>Yes.</td>
</tr>
<tr>
<td>500/5</td>
<td>Audit Evidence—Additional Considerations for Specific Items</td>
<td>No similar Chinese standard.</td>
</tr>
</tbody>
</table>
510/14  Initial Engagements—Opening Balances  Yes.

520/11  Analytical Procedures  Yes. Roles at planning and review stages not specifically emphasized.

530/4  Audit Sampling and other Selective Testing Procedures  Yes.

540  Audit of Accounting Estimates  No similar Chinese standard.

550/16  Related Parties  Yes.

560/15  Subsequent Events  Yes.

570/17  Going Concern  Yes. However, ISA also provides examples of opinion paragraph when highlighting the going concern problem.

580/23  Management Representative  Yes.

Using work of others

600/8  Using the Work of Another Auditor  Yes.

610/22  Considering the Work of Internal Auditing  Yes.

620/12  Using the Work of an Expert  Yes.

Audit conclusions and reporting

700/7  Auditor’s Report on Financial Statements  Yes. However, ISA also suggested wording of the report.

710  Comparatives  No similar Chinese standard.

720/19  Other Information in Documents Containing Audited Financial Statements  Yes.

Specialized areas (Corresponding to Chinese auditing practice pronouncements)

800/6  Auditor’s Report on Special Purpose Audit Engagements  Yes.

810  Examination of Prospective Financial Information  No similar Chinese standard.

810/1  Verification of capital contribution  No similar ISA.

810/2  Management Letters  Discussed in ISA 580.

810/4  Examination of Profit Forecasts  No similar ISA.

810/5  Considerations for Audit of Consolidated Financial Statements  No similar ISA.

Related services (No similar Chinese standards)

910  Engagements to Review Financial Statements

920  Engagements to Perform Agreed-Upon Procedures Regarding Financial Information

930  Engagements to Compile Financial Information
International auditing practice statements
1000 Inter-Bank Confirmation Procedures
1001 CIS Environments-Stand-Alone Microcomputer
1002 CIS Environment-On-Line Computer Systems
1003 CIS Environment-Database Systems
1004 Relationship between Bank Supervisors and External Auditors
1005 Particular Considers in audit of small Business Similar to Chinese Practice Pronouncement No. 3
1006 Audit of International Commercial Banks
1007 Communications with Management
1008 Risk Assessments and Internal Control
1009 Computer-Assisted Audit Techniques
1010 Consideration of Environmental Matters in the Audit of Financial Statements

NOTES

1. Due to the lack of an unlimited liability concept and of a developed legal environment in which to apply this concept, most CPA firms in China are established with limited liability (Chow et al., 1995; Graham, 1996).

2. The State-Owned Enterprise Income Tax Law, which was introduced in 1983, requires state-owned enterprises to pay income tax on profits rather than handing over surplus to the state government. Under that law, large and medium-sized state-owned enterprises have to pay income tax at the rate of 55 percent and small state-owned enterprises were taxed at progressive rates.

3. A-shares and B-shares are available to Chinese citizens and foreigners, respectively. H-shares and N-shares are respectively listed on the Hong Kong stock exchange and the New York stock exchange.

4. Chinese expert team was headed by the late Yang Jiwan, head of Research Institute of Financial Science, MOF, and consisted of university accounting professors and CPA professionals. Foreign expert team was led by Xiao Weiqiang, partner of KPMG (Beijing) and composed of representatives from the leading international accounting firms.

5. Furthermore, the CPAs Law (art. 22) requires that during the period of a professional engagement, the auditor should not: (1) buy or sell stocks or bonds of the client, (2) accept compensation other than the audit fee specified in the engagement letter, (3) act as a liability collector, (4) allow others to practice on his behalf, (5) work in two or more CPA firms, (6) obtain clients by advertising, and (7) engage in other activities that violate laws and regulations. However, there is no limitation on providing non-audit services, such as bookkeeping, preparation of the financial statements, taxation and management consulting, nor is there any
restriction on the percentage of total fee income deriving from one client. To enhance auditor’s independence, some countries prohibit certain services by the auditor. For example, a firm in Japan and Netherlands cannot perform tax and consultant services for the same client for which it also serves as auditor. In Switzerland, fees from one client cannot exceed 10 percent of total income. In Mexico, an auditor is economically bound to the corporation if more than 40 percent of his income arises from one client for more than 1 year (see Needles, 1985).

6. The CICPA is not a delegated authority to issue accounting regulations or standards. The MOF has the real power on accounting regulations. The chairman of the CICPA is the Vice-Minister of the MOF in charge of accounting affairs. Although CPA firms are financially independent, they must distribute from their profits social payments for risk funds, housing, and development to the state and they may contract with the state to audit state-owned enterprises (Graham, 1996). The MOF approves the choice of auditors for foreign investment enterprises and the establishment of CPA firms. The MOF and its affiliated departments themselves operate several CPA firms (Chow et al., 1995). Some CPAs hold multiple positions including some in government agencies. All these raise a serious question over the independence of auditors in China.

7. For example, the CPAs Law (art. 20) stipulates that the auditor should not issue the report if: (1) the client hinted to the auditor to report untruthfully; (2) the client intentionally did not provide relevant accounting information and documents; (3) the client, because of other unreasonable requests, caused the auditor unable to express an opinion on the material items of the financial statements. On the other hand, the auditor is liable for not reporting the following: (1) the auditor knew that the accounting policies adopted by the client contradict with the regulations laid down by the State; (2) the auditor knew that the result of accounting treatments by the client would directly damage the benefits of the report users; 3) the auditor knew that the result of accounting treatments by the client would mislead the report users; 4) the auditor knew that the client’s financial statements contained materially false items.

8. DeFond et al. (2000) and Chen et al. (2000) observe that since China enacted its first set of auditing standards in 1995, the percentage of listed companies receiving modified audit opinions has risen sharply.

9. The “Shenzhen Yuanyie Incident” in 1992, the “Beijing Great Wall Incident” in 1993, and “Hainan Zhongshui Group Incident” in 1994, all involving illegal fund raisings, have caused substantial financial damages to the investors. The companies concerned and their auditors, because of issuing fictitious audit reports, were sued and sentenced.

REFERENCES


