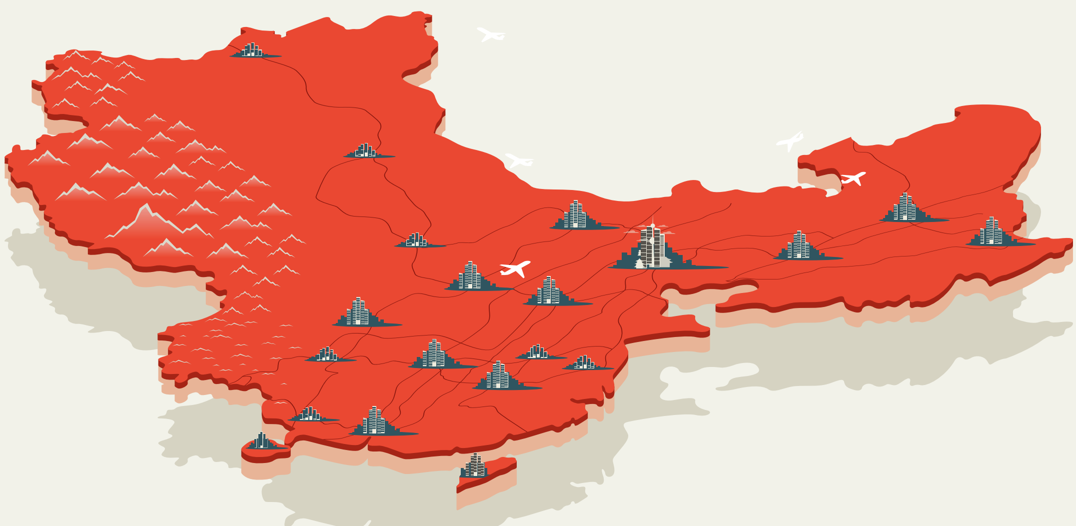
Auditing in China – yesterday, today and tomorrow

Len Jui and **Jessie Wong** look back at the recent history of the Chinese auditing profession and discuss the challenges ahead



China opened its doors to foreign investment in the 1980s under the leadership of Deng Xiaoping. Key events that influenced the evolution of China's auditing profession during that time shaped many aspects of the profession we observe today. An awareness of these events help lay the foundation for a deeper and more thorough understanding of the auditing profession that we see in China at the present time.

Today China's auditing profession is well headed down the path of achieving convergence with international professional standards. The Chinese leadership has begun to speak about China having more influence on the global stage in the auditing arena. However the devil is in the details as the profession comes to grips with applying the requirements in international standards in China's dynamic and diverse environment. China's audit oversight bodies are independent and structurally free from any connections to the profession; a signpost of good audit regulatory practice recognized by international audit regulatory communities. However, there remains much work to be done to address the complexities associated with such a structure, so as to deliver the efficiency and effectiveness of auditor oversight that China authorities has set out to achieve.

A look back in time

When China opened its doors to foreign investment in the 1980s, companies from Hong Kong and Taiwan reacted quickly to seize potential commercial opportunities. These companies made their way into China and quickly became major players largely by forming joint ventures with local affiliates, setting up factories and entering into commercial arrangements to export Chinese-made goods overseas. Rapid market growth and increase of commercial activities generated a demand for accounting and auditing services locally. This led to a restoration of a focus on building a national auditing profession. Prior to this time, development of China's auditing profession in the country had largely been stagnant.

Chinese authorities needed a quick solution to meet the demand in the capital market for audit know-how — particularly demand generated by foreign companies that have new ventures in China. The Chinese government's intermediate response was to look to the global accounting network firms to fill this skills gap. The Chinese government permitted the Big Four global accounting network firms to operate in China cooperatively with China's Ministry of Finance affiliated firms. In most cases, the Chinese affiliates of these global accounting networks were set up by the networks' Hong Kong affiliates. These arrangements were referred to as sino-foreign cooperative accounting firms. The Chinese authorities set an operational period of 20 years for these arrangements at that time. It was felt that these joint venture firms would be ready to become local Chinese accounting firms by that time.

As a result of these events, the relationships formed between the Chinese authorities and the Hong Kong affiliates of the global accounting network firms went beyond that of business partners. Not only did the Hong Kong auditing profession help fill the auditing skills shortage in China, they also provided auditing knowledge and technical expertise which China needed to develop its own auditing profession. Access to such know-how spurred the growth of the Chinese auditing profession locally. Among other things Chinese standards-setters and regulators were introduced to international standards used by accounting professions across the globe. By responding to the auditing skills shortage in China at that time, the Hong Kong auditing profession contributed significantly to shaping the auditing landscape in China that we see today.

Ethnic Chinese audit professionals from foreign jurisdictions also picked up on the demand for their skills in China. Being ethnic Chinese, these individuals were fluent in the Chinese language, and had the competitive advantage of being able to communicate effectively with their Mainland counterparts. They were also in sync with the local cultures. To a large extent foreign ethnic Chinese audit professionals also contributed to the physical growth of the auditing profession in Mainland.

Making progress

In October 1993 the Law of the People's Republic of China for Certified Public Accountants was passed – a monumental piece of legislation enshrining the accounting profession's role in fostering the growth of companies and ensuring stability of the capital market in China. The roles of Chinese CPAs were also stipulated in numerous other pieces of legislation such as the China's Company Law, Securities Law, Law on State-Owned Enterprises and Commercial Bank Law.

China's auditing profession has made notable progress as Chinese regulators continue to focus on building the profession's capabilities and competencies. Year 2012 saw the expiration of the sino-foreign cooperative arrangements. Under the directive of the MoF, these joint venture firms converted into special general partnerships. This new legal form has been formulated by the MoF specifically for the Big Four sino-foreign cooperative accounting firms in recognition of their unique historical development and circumstances specific to these firms.

To take on the special general partnerships structure, the firms are required to meet specific requirements relating to the proportion of partners who are Chinese-qualified public accountants and partners who are foreign-qualified public accountants. Contrary to what had been portrayed in the news, such a requirement is targeted at regulating the qualifications and licensing *not* the nationality of public accountants. Similar requirements are also common in many other jurisdictions around the world. Commenced in August 2012, the conversion process for the firms is now complete.

Despite this, the effects of the evolution of China's accountancy profession are still felt today. Beginning in 2006, the Chinese Institute of Certified Public Accountants has held the Cross-straits, Hong Kong and Macau Accounting Profession Conference annually, together with the Federation of CPA Associations of Chinese Taiwan, the Hong Kong Institute of Certified Public Accountants and the Union of Associations of Professional Accountants of Macau. This is a key event aimed at providing the platform for dialogue for accounting professionals in Mainland, Hong Kong, Macau and Taiwan. The conference is well attended by leaders of the various accountancy profession bodies and it has ambitious aims to:

- Enhance the economic cooperation of the four cross-straits jurisdictions through deepening exchanges and cooperation of the local accounting professions. The jurisdictions will cooperate and actively work towards achieving convergence with international professional standards.
- Promote the convergence and mutual recognition of professional standards of the four cross-straits jurisdictions with the larger objective of enhancing collective economic competitiveness.
- Strengthen dialogue and coordination between the four cross-straits jurisdictions with the larger objective of building the foundation for participating and influencing the formulation of international standards at the global level.

Down the path of international convergence

With China's growing importance on the world's stage, Chinese standard-setters and regulators saw the merits of adopting international standards. Chinese authorities moved swiftly to accomplish this, effectively achieving convergence with the International Financial Reporting Standards in 2006. Efforts to achieve convergence with International Standards on Auditing began in 2005 and reached fruition in 2010. Convergence with the International Code of Ethics for Professional Accountants was completed in 2009. Prior to these, China became members of the International Federation of Accountants and Confederation of Asian and Pacific Accountants in the late 1990s. China currently has representation on key international regulatory and standard setting bodies including the International Organization of Securities Commissions, International Accounting Standards Board, International Auditing and Assurance Standards Board, International Public Sector Accounting Standards Board, International Organization of Supreme Audit Institutions, IFAC Board and committees and International Valuation Standards Committee.

Having taken these steps, the challenge that lies ahead is putting in place a structure for on-going monitoring and improvement of the standards as China gains a better understanding of how the standards are used in practice. Audit practitioners grapple with understanding and complying with accounting and auditing requirements. This is made more challenging by having to concurrently juggle China's business environment and local cultures. Consequently the profession demands for more detailed interpretation and guidance. China has historically been a rule-based society. As such, professionals, businesses and the society at large are much dependent on direct guidance and interpretations from relevant governmental authorities. This extends to China's regulatory framework.

Alongside adoption of international professional standards, Chinese authorities have also encouraged local accounting firms to step up on the growth and development of their practices. This policy direction for the profession is often referred by Chinese authorities through the use of the slogan "to become bigger and stronger." In its strategic plan for 2011-2015, the CICPA indicated that facilitating the internationalization of local accounting firms is one of its strategic objectives for the five-year period. In working to achieve this objective, the CICPA is encouraging local accounting firms to join global accounting networks. Mergers between local accounting firms to form bigger-sized firms have also taken place. While the Chinese policymakers' and regulators' objective of creating bigger local accounting firms has begun to take shape, policies and regulations now need to be targeted at going beyond achieving "growth" in the structural form. The challenge ahead is on ensuring the simultaneous improvement of the quality of these larger firms in substance.

Audit licensing

Audit firms in Mainland are required to be licensed by the MoF and the relevant provincial governmental finance departments. Firms that undertake audits of listed entities are further required to be licensed by the Chinese Securities Regulatory Commission. Registration requirements for firms include criteria relating to registered capital investment, number of CPAs and scope of business operations. Licenses for individual auditors are issued by provincial CPA institutes. CPA licensing requirements include CPA qualifying examinations and work experience requirements. The CPA qualifying examination is held nationally and is centrally administered by the CICPA.

For non-Mainland accounting firms, a temporary license from MoF is required in order to perform audit work in China. China accounting firms are prohibited from cooperating or sharing working papers and other information with non-Mainland accounting firms that do not have a valid license. The licenses normally have a validity period of six months with the exception of Hong Kong, Macau and Taiwan. Licenses granted to accounting firms from these locations have validity periods of five years (Hong Kong and Macau) and one year (Taiwan). In terms of the scope of the licenses, they only cover the firm's existing audit engagements and do not extend to new audit engagements. Where there are changes in circumstances, these need to be reported to the MoF. The ministry has imposed reporting obligations for license holders and has inspection powers. Licensees are required to comply with China's laws and regulations including state secrets laws:

- Accounting records of Chinese companies are prohibited to be taken outside of China.
- Information obtained may not be shared with third parties outside of the provisions of the temporary license.
- Where MoF has signed regulatory cooperative agreements with foreign audit regulators, matters regarding regulatory procedures and audit working papers access will be dealt with in accordance with the agreements in place.

MoF may impose penalties on licensees for non-compliance including a prohibition from applying for a temporary license for five years.

More recently, MoF issued new requirements, effective 1 July, aimed at regulating cross-border auditing practices conducted by Mainland and foreign CPA firms in connection with overseas listings of Mainland companies. Under the new requirements, foreign accounting firms are required to cooperate with an eligible Mainland CPA firms in the case of such companies. The requirements also impose obligations on the foreign CPA firms to report to the MoF.

Audit oversight frameworks

China has a tripartite audit oversight framework consisting of the MoF, the CSRC and the CICPA. All of these bodies have oversight responsibilities for the auditing profession and the power to inspect accounting firms. The MoF has powers to inspect companies and as deemed necessary for purpose of the inspection, MoF may require auditors to provide audit documentation of the company under inspection. The CSRC has powers to inspect companies listed on Mainland stock exchanges and those accounting firms that perform audits of these listed companies. Unlike in many other jurisdictions, the CICPA, although a professional accounting body, is a government entity that operates under the auspices of the MoF and has inspection powers over Mainland accounting firms. In Taiwan, the independent Financial Supervisory Commission has responsibility for audit oversight and in Macau, the Financial Services Bureau's Committee for the Registry of Auditors and Accountants plays this role. Only Taiwan is currently a member of the International Forum of Independent Audit Regulators.

The above structure is aligned with many other jurisdictions including the United States, United Kingdom, Australia and Japan where the responsibility for audit oversight lies with a body that is independent of the profession. While Mainland, Macau and Taiwan all have audit regulators that are structurally independent from the profession, Hong Kong is in stark contrast. The auditing profession's self-regulatory framework has remained unchanged for a period of time with the HKICPA holding oversight and discipline powers over the audit profession. The independent government agency Financial Reporting Council was established in 2006 and tasked to investigate possible auditing and reporting irregularities in relation to listed entities. However registration, inspection and disciplinary powers over the profession mostly reside with the HKICPA. On the securities market front, the Securities and Futures Commission has regulatory powers over listed companies in Hong Kong. The SFC can command auditors to furnish working papers to assist in its investigation of companies. The Hong Kong government is currently considering changes to its audit regulatory framework to better align with international norms. An information paper was issued by the Financial Services and the Treasury Bureau in October 2013 in this regard with proposals for changes to stimulate public debate. On 26 June, the FSTB issued conclusions of its public consultation on the proposals. Among the comments received, notably, respondents expressed general support for the proposed independent audit oversight model for Hong Kong listed entities. The next step is for FSTB to prepare the draft amendment bill based on the consultation conclusions. It is anticipated that the legislation will likely be finalized in 2017 and become effective in 2018.

Importance of good corporate governance in Chinese companies

High quality audits in China cannot be achieved by focusing solely on developing China's auditing profession. It necessarily goes hand-in-hand with building a foundation of good corporate governance and high quality financial reporting in Chinese companies.

This principle needs to be firmly imprinted in China's blue print for nurturing and promoting its accounting and auditing professions. Importantly companies need to build up the resources necessary to implement and monitor effective corporate governance. Such a structure should be supported by tone from the top that emphasizes high quality financial reporting.

Features should include appropriate segregation of duties between management and those charged with governance, establishing competent audit committees to oversee the financial reporting process and external audit including selection, appointment and termination of the external auditors, and ensuring appropriate risk management and internal controls such as internal audit. At the same time, initiatives are needed to educate the capital markets and investors on the importance for companies in which they invest to focus on good corporate governance.

In order for good corporate governance to be a permanent feature of Chinese companies, the demand for such best practices needs to be market driven. To close the loop, regulators also need to see to it that there are appropriate enforcement of financial frauds and audit failures.

The immediate next step for China's regulatory community is to focus on developing a skilled and competent accounting profession. This is fundamental to ensuring high quality financial reporting in Chinese companies. There is urgency for the regulators to step up on this task as opposed to devoting even more resources on auditing reforms. The sole focus dedicated to oversight and regulation of auditors now need to be directed to financial reporting and corporate governance at the company level. After all, companies are the originators of financial information, not the audit profession.

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