

International Conference «Corporate Governace: A Search for Advanced Standards in the Wake of Crisis»

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**Legal Account Auditing
in the Corporate System
of Chinese Listed
companies Relevance
and Implications**

PURPOSE OF THE RESEARCH

In recent years, the People's Republic of China has enjoyed strong growth that has attracted the attention of the whole world. This has opened China to foreign investment and the gradual liberalization of foreign companies in the Chinese domestic market. The presence of foreign investors and foreign companies in China has increased the demand for higher quality in the standard of auditing and an acceleration of the process of international convergence.

The aim of this research is to investigate the current scenario of the system of statutory audit in the People's Republic of China, the degree of development of auditing system highlighting the differences and peculiarities of the audit through an empirical analysis that involved the companies composing the index CSI 300 the 300 most highly capitalized companies, 95 of which are listed on the Shenzhen Stock Exchange and 205 on the Shanghai Stock Exchange.

THE AUDITING SYSTEM IN ANCIENT TIME

- In the Chinese context the accounting system has been evolving for about 3000 years;
- The earliest evidence of the existence of a formalized system of audit procedures date back to the Zhou Dynasty (1122 BC-770 BC);
- The first rudimentary form of auditing called **Zaifu** consisted in a summary audit on monthly reports and in an auditing in the more comprehensive and analytical accounts of the **Annual Report (Sui-Hui)**. The review of the Annual Report formed the basis for a second review - **the Ta-chi or Great Calculation** - and for the **Triennial Evaluation of the Governative Officers**.
- These procedures were further developed and better regulated during the Tang Dynasty (618 AD -907 AD) with the introduction of the review system Bi-Bu;
- it was during the Song Dynasty (907 AD-1279 AD) that the term audit appears, indicated by the expression **She-Ji (Shen** means "examination" and **Ji** which means "accounting and finance").
- Over the years there were various dynasties (Zhou, Song, Ming) during which the accounting and auditing systems were more and more refined until the advent of the last dynasty, the Qing dynastic empire, this led the empire towards an irreversible crisis in 1911 which lead to the civil war, and finally **in 1912 to the origin of the People's Republic of China.**

THE AUDITING SYSTEM AFTER THE PEOPLE'S REPUBLIC OF CHINA (1912)

- A major step for the development of the audit it was in **1918** with the publication of the **Law of Internal Auditing** and in **1945** the **Law of Accountants**;
- In **1949**, **Mao proclaimed the birth of the People's Republic of China**, and he implemented the Soviet model. In this context, the role of the auditor consisted in the control of the use of state funds allocated to the companies, a kind of "Compliance Tests" to verify if public resources were used properly.
- **At the end of the 80 'with the death of Mao and the adoption of the Open Door Policy** introduced methods of business management and accounting practices in use in the Western world;
In 1983 it was established the **Audit Administration of the People's Republic of China (AAPRC)**, which marked the birth of the **CNAO (China's National Audit Office)**. In 1986 the "Regulations of the People's Republic of China on Certified Public Accountants", was published by the State Council and also Audit for private companies - called **Social Audit** – starts from this moment on.
In 1988 the CICPA (Chinese Institute of Certified Public Accountants), was founded to develop the profession of Certified Public Accountants (CPA) and finally the establishment of the PA (Public Auditors, mainly Audit Firms).

THE CHINESE AUDITING STANDARD

- The Chinese Institute of Certified Public Accountants (**CICPA**) appointed the Commission for the development of Chinese Independent Auditing Standards (**CIASC**);
- The first set of 10 principles were adopted in December 1995. A second set was enforced in January 1996, finally in 1999 a third group of 15 specific standards;
- Recently China has encouraged the project alignment with the international rules until 2008. In that year, it has been published the existing Chinese Auditing Standards Revised and Redrafted, with the aim of aligning with ISA.
- In accordance with the principle of continuous and global convergence, the Chinese Auditing Standards Board (CASB) has completed the review of Chinese Auditing Standards (CSA) and **has reached full convergence with the Clarified ISAs**. The **reviewed CSA** have been officially applicable in **November 2010** and were officially effective for the financial statements auditing starting from **January 2011**;
- From the comparison between the Clarified ISAs and the new CSA is possible to identify a strong similarity with the exception of the CSA 1153 in which communication between the new auditor and the previous one is faced separately.

EMPIRICAL ANALYSIS

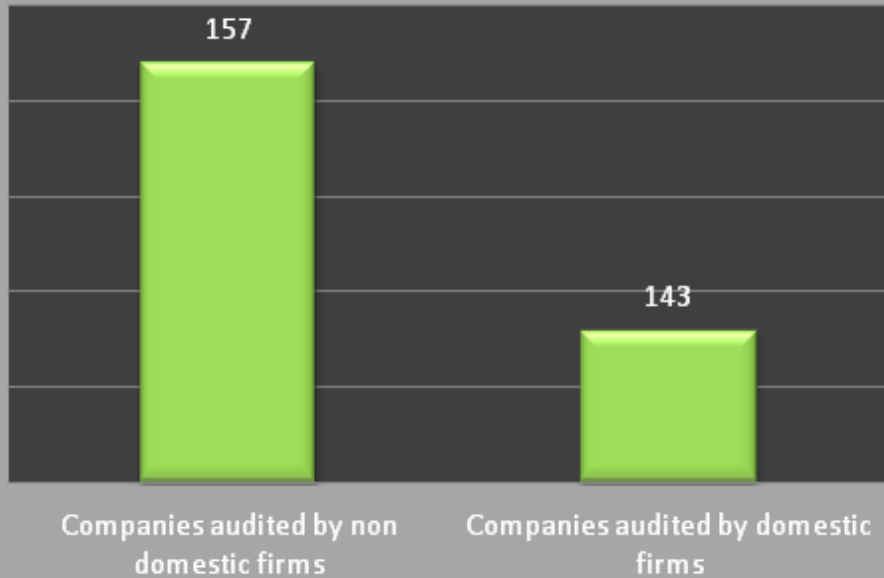
In China, the stock market was born on **November 26, 1990** with the foundation of **the Shanghai Stock Exchange (SSE)**. Almost contextual was the opening of the second Chinese Stock Exchange, **the Shenzhen (SZSE)** which was established **on 1st December 1990**. Shanghai Stock Exchange is one of the main Chinese stock market by number of listed companies, **on January 28, 2012 there are about 925 listed companies and it is the second stock market in the world after the United States.**

For this analysis it is taken into consideration a sample of companies constituent of the CSI 300 index as the most highly capitalized; in particular this index is made up of 95 companies listed on the Shenzhen Stock Exchange Market and 205 companies listed on the Shanghai Stock Exchange Market

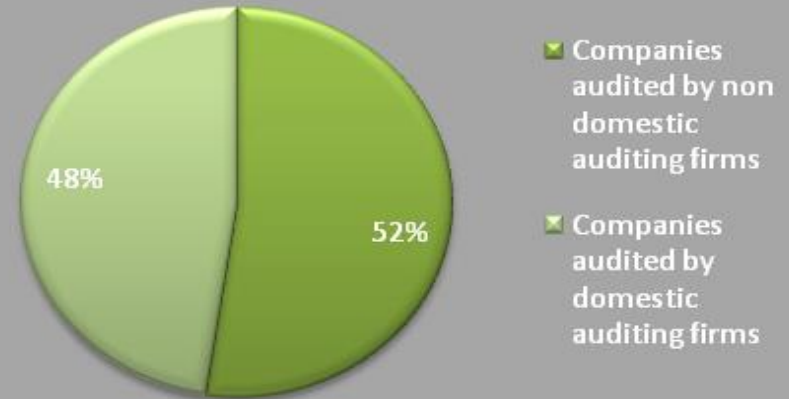
The analysis carried out aims to examine the audit reports prepared for the financial statements of 2012 of the listed companies in the index CSI 300.

THE RESULTS (1)

Auditing Firms: domestic and non domestic

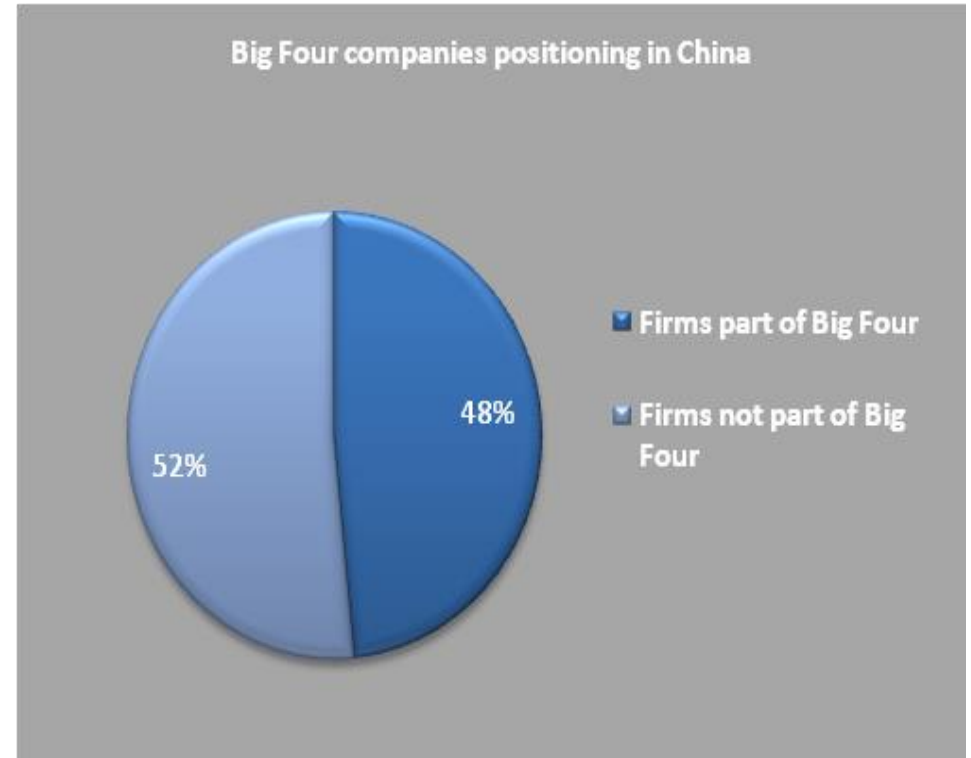
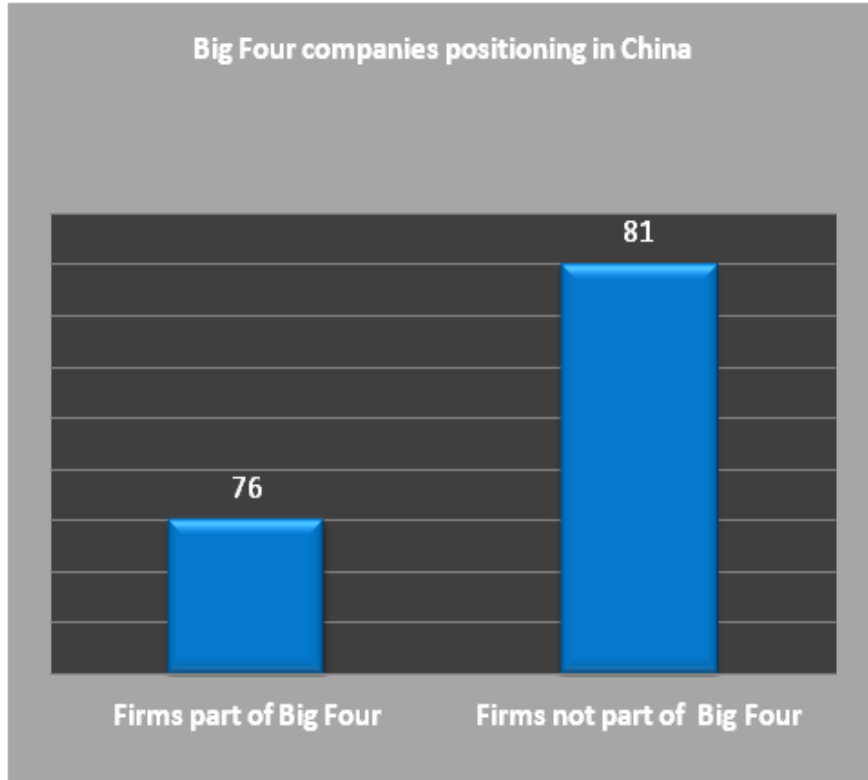


Auditing firms: domestic and non domestic



The first result as shown in table points out that the most part of the companies' financial statements is audited by international audit firms in particular 157, while 143 companies are audited by domestic auditing firms. The expectations are partially fulfilled because it is verified that the international audit firms are present in China but it is also evident the importance of domestic audit firms.

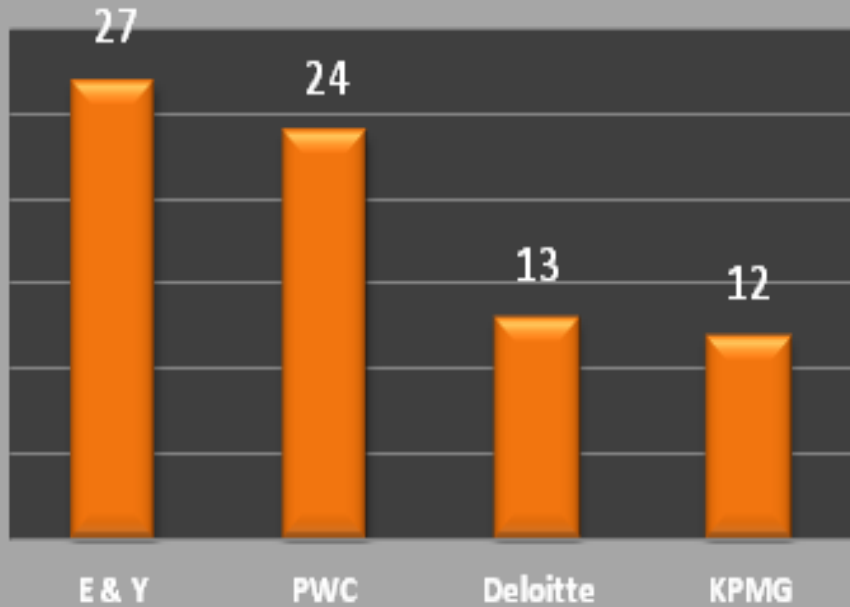
THE RESULTS (2)



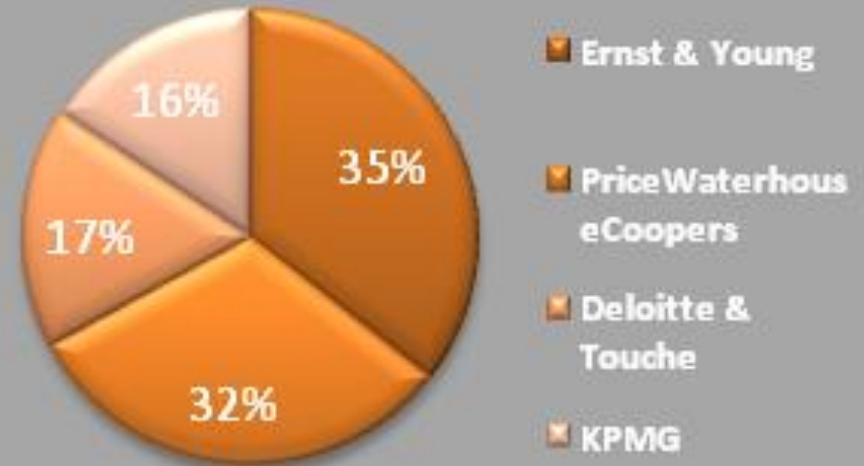
Data of Tab show that the international audit firms the so-called Big Four as (Ernst&Young, Price waterhouse Coopers, Deloitte & Touche and KPMG) are equally presented, they don't have a predominant role in the Chinese audit system. On the contrary of other countries as for example in Italy the companies listed on Milan Stock Exchange are audited mainly by auditors part of the Big Four.

THE RESULTS (3)

Big Four firms presence in China

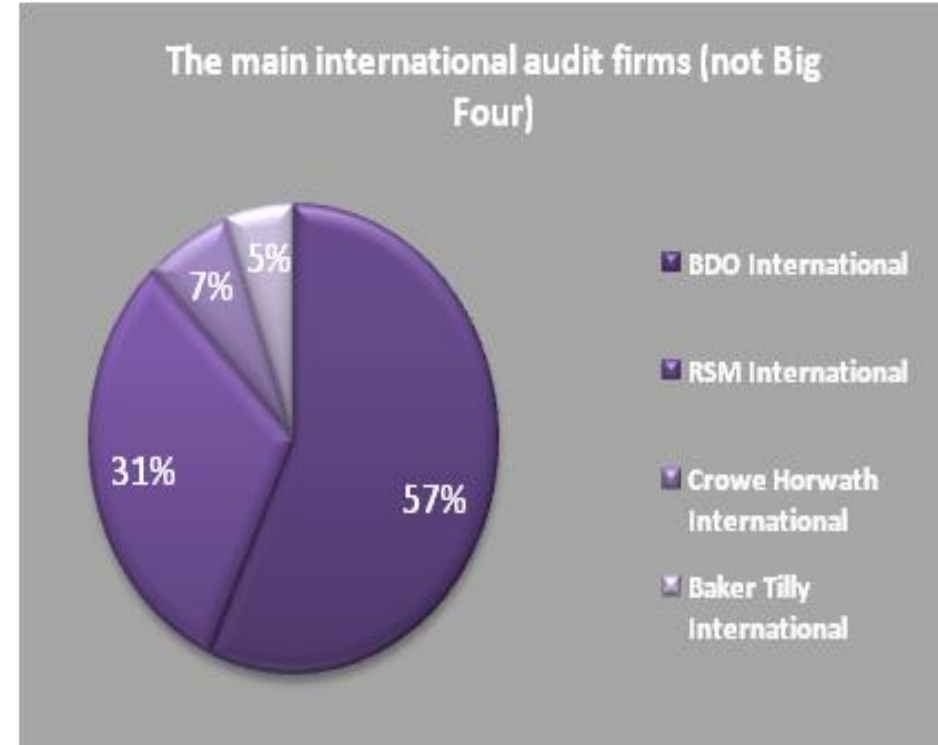
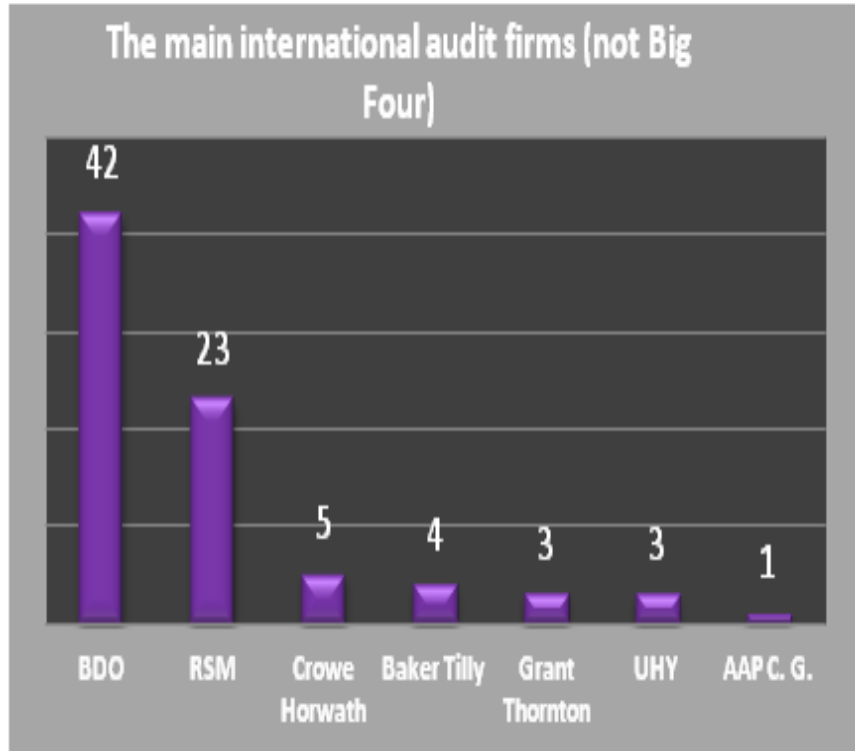


Big Four presence in China



The following analyses show the companies number audited by each of the Big Four Out of the 74 companies audited by the Big Four, 27 of them are audited by Ernst & Young, which comes out to be the most represented of the Big Four in China. The same survey was carried out for the international audit firms not part of the Big Four.

THE RESULTS (4)



The Tables show that BDO International and RSM International are definitely more present. In particular, the International BDO firm audit a considerable number of companies and comes out to be the outlier.

THE RESULTS (5)

| Auditing Domestic Firm | N° audited | Auditing Domestic Firm | N° audited |
|---------------------------------|------------|-----------------------------------|------------|
| Ascenda CPA | 24 | Jonten CPA | 2 |
| Shinewing CPA | 21 | Shanghai Shanghui CPA | 2 |
| Pan-China CPA | 14 | GP Public Accountants Company Ltd | 2 |
| Reanda CPA Co | 8 | Shandong Zhengyuan Hexin Co | 2 |
| China Audit Asia Pacific CPA | 7 | Sichuan Huaxin Group CPA | 2 |
| Daxin CPA | 7 | Xigema CPA | 1 |
| Shenzen Peng Cheng | 5 | Xin Yong Zhong He Cpa | 1 |
| Beijing Xinghua CPA | 4 | Beijing Zhongzheng Tiantong CPA | 1 |
| Huapu Tianjian Gaoshang | 4 | Zhongzhun CPA | 1 |
| Zhonglei CPA | 3 | Beijing Tianyuanquan CPA | 1 |
| Jiangsu Tianheng | 3 | Wuzhou Songde Union CPA | 1 |
| Fujian Huaxing CPA | 3 | Zhong Qin Wanxin CPA | 1 |
| Zonzun Accounting Office | 3 | Sichuan Hua Xin | 1 |
| Shandong Huide CPA | 3 | Zhongrui Yuehua | 1 |
| Jiangsu Suya Jincheng CPA | 3 | Beijing Yong Tuo CPA | 1 |
| China Auditor International CPA | 3 | Zhong Xing Cai Guang Hua CPA | 1 |
| Tianzhi Guoji CPA | 2 | | |
| Asia Group Accounting Firm | 2 | TOTALE | 143 |

THE RESULTS (5 SEGUE)

- In regards to **the domestic auditing firms** data shows that they **are a large number therefore each of them**, excluding the first three of the list, audit a small number of companies;
- In particular, the data point out that the main domestic auditing firms are the following: Ascenda CPA carry out the auditing of 24 companies; Shinewing CPA audit 21 companies; Pan-China CPA 14 companies;
- The research carried out **highlights how Chinese listed companies prefer mostly domestic auditing firms for their financial statement auditing**. This results are relevant and can be considered critical as in China, due to the recent introduction of the standards the domestic auditing firms have been characterized by a lower quality level than the one provided by international auditing networks;
- They also have been characterized, in the past, by **a less structured and detailed methodological approach, and especially less independent from government authorities and customers**.
- This result confirm the importance of the revolutionary introduction of the auditing standards described in the first paragraphs of this work.

THE RESULTS (6)

| CODE | SECTOR | COMPANIES NB |
|------|-----------------------------------|--------------|
| A | Agriculture | 5 |
| B | Extractive Industry | 34 |
| C0 | Food and beverage | 16 |
| C1 | Textile and clothing | 2 |
| C4 | Petrolchemical | 11 |
| C5 | Electronic | 6 |
| C6 | Metallurgy | 34 |
| C7 | Machinery and industrial supplies | 45 |
| C8 | Pharmaceutical | 24 |
| C9 | Other manufacturing industries | 1 |
| D | Utilities | 11 |
| E | Construction | 11 |
| F | Transportation | 13 |
| G | IT | 13 |
| H | Wholesale and retail trading | 12 |
| I | Financial | 34 |
| J | Real estate | 12 |
| K | Social services | 3 |
| L | Media | 2 |
| M | Conglomerate | 11 |
| | | 300 |

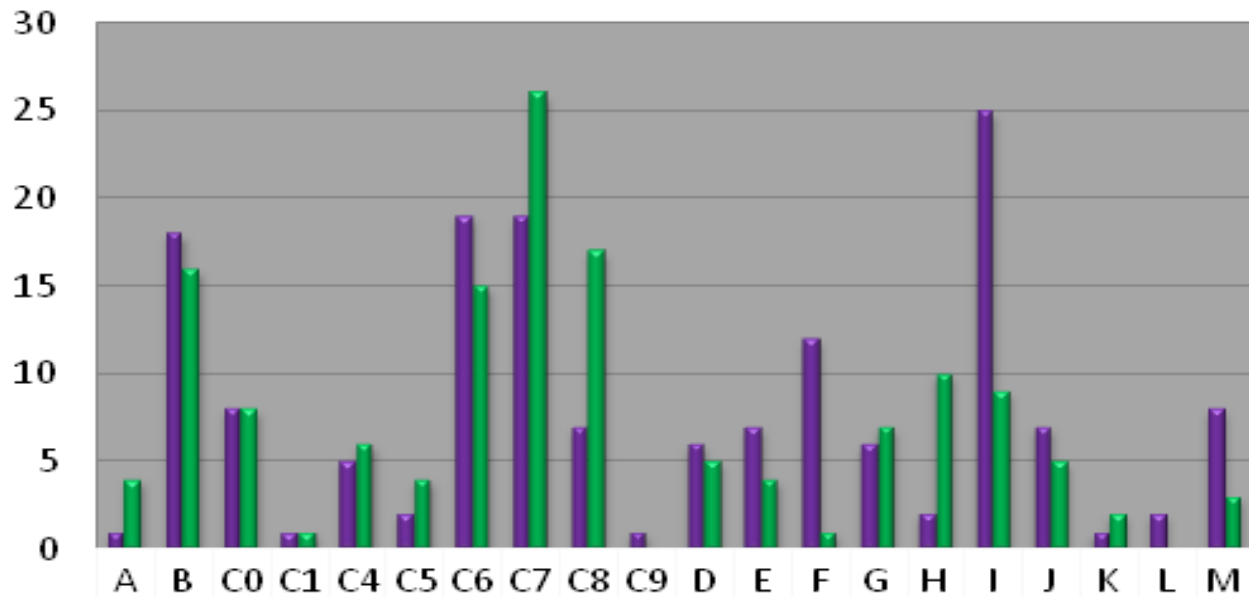
The research examines the belonging sectors of the 300 listed companies in order to define a relation between the auditing firm and audited company sector.

Firstly the belonging sectors of listed companies analyzed are 20.

Most part of the companies belong to; Machinery and industrial supplies, Extractive industry, Metallurgy and Financial.

THE RESULTS (7)

Domestic and non domestic auditing firms in industry sectors



| | | | | | | | | | | | | | | | | | | | | |
|-------------------------------|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ■ Non domestic auditing firms | 1 | 1 | 8 | 1 | 5 | 2 | 1 | 1 | 7 | 1 | 6 | 7 | 1 | 6 | 2 | 7 | 1 | 2 | 8 | |
| ■ Domestic auditing firms | 4 | 1 | 8 | 1 | 6 | 4 | 1 | 2 | 1 | 0 | 5 | 4 | 1 | 7 | 1 | 9 | 5 | 2 | 0 | 3 |

This table shows companies audited allocated by sector. Through this analysis it is possible to identify the sector in which these kind of audit firms operate more in absolute terms. In particular table shows a greater presence of non domestic auditing firms in sectors as Metallurgy (C6) and Financial (I). While there have been a higher presence of the domestic auditing firms in sectors as Machinery and industrial supplies (C7), Pharmaceutical (C8) and Wholesale and retail trading (H).