Hooking-Up: A Unique Feature of China Public Accounting Firms

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Abstract

With the implementation of a market economy after 1979, the CPA profession in China was revived and the public accounting firm was reestablished as a newly created social organization. However, due to the socio-economic and political factors existing at that time, they could not be established as independent firms. These newly established firms were required to affiliate with existing government or educational institutions. This has given rise to the term "hooking-up," which refers to the affiliated relationship between an auditing firm and its sponsoring organization.

This paper examines the development of this phenomenon and the future outlook of the Chinese auditing profession. Given the complexity of this relationship, several accounting and social issues are examined. In addition, this paper also discusses the factors hindering the movement toward establishing independent accounting firms in China and the removal of the hooking-up relationship.

Introduction

In 1949, with the implementation of a planned economy under the communist political system, accountants in China became government employees. In addition to removing the Law of Accountants promulgated in 1945, the profession of certified public accountants (CPAs) went into extinction with the closing of public accounting firms. Fortunately, with the implementation of a market economy after 1979, the CPA profession was revived and the public accounting firm was reestablished as a newly created social organization. However, due to the socio-economic and political factors existing at that time, public accounting firms could not be established as independent firms. They were required to affiliate with existing government or educational institutions. Though auditing firms have the appearance of independent firms, they are actually subunits or departments of a government agency or an educational institution. This has given rise to the term "hooking-up" ("Gua-Kao": "Gua" means "under someone else's name" and "Kao" means "relying on"), which refers to the affiliated relationship between an auditing firm and its sponsoring organization. In 1993, this requirement was repealed with the issuance of the Certified Public Accountant Law of PRC. The law was issued to promote the development of China's CPA system and specifically allows the use of a partnership structure to establish public accounting firms. However, the law was unclear as to how the new organization structure should be

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established and the motivation behind the change. Consequently, the impact of this law is limited. For example, by the end of 1996, China had 6,700 accounting firms and 124,000 CPAs; among them 58,000 were practicing CPAs and 66,000 worked for enterprises, government agencies, and other units (Yang and Yang, 1997). Out of a total of 75 public accounting firms in the city of Shanghai, only two were of a private partnership nature. Out of a total 965 certified public accountants (hereafter CPAs), only 18 are practicing in these two private firms. The continued existence of the public accounting firms' hooking-up relationship is an interesting and unique phenomenon in China's public accounting arena.

The primary purpose of this paper is to examine the development of this phenomenon and the future outlook of China's auditing profession. Given the complexity of this relationship, several accounting and social issues will be examined. In addition, this paper discusses the factors hindering the movement toward establishing independent accounting firms in China and the removal of the hooking-up relationship.

Historical Background

In 1983, accounting firms were established in response to the needs of foreign investors in China and the forming of joint venture businesses between China's state-run enterprises and foreign investors. For China to protect its benefits in joint ventures, the State Finance Bureau must audit them. For the foreign investors, instead of relying on governmental auditors (under the Finance Department) to perform the audit, they preferred to employ an independent accounting firm. However, the system of independent public accounting firms had been abolished in 1949 and no independent accounting firm existed in the early 1980s. To meet the needs of the foreign investors, "independent" accounting firms were first established by the State or City Finance Departments. For example, the first accounting firm in Shanghai was set up by the Finance Department of Shanghai and was affiliated with the Department.

Due to the underlying social, economic, and political conditions, affiliated ("hooking-up") accounting firms were established in the early 1980s. Three reasons can be offered for establishing affiliated accounting firms. First, persons with some knowledge of foreign accounting and with good command of a foreign language (i.e., English) had to be recruited to establish an accounting firm. Under the Communist system, persons with these qualifications were either working for the government finance offices or teaching in educational institutions that had accounting/finance programs. Instead of resigning from their secured jobs, they were usually "transferred" or worked part time for the newly created subunit, i.e., the accounting firm. For example, the two largest accounting firms in Shanghai were established and affiliated with the Finance Department of Shanghai, the Shanghai University of Finance and Economics, and the Shanghai Academy of Social Sciences.

Second, it is difficult to form an independent CPA firm privately due to a lack of capital. In addition, there were a limited number of foreign investment firms or joint ventures available in the early 1980s and revenues generated were insufficient to cover the operating costs; thus substantial subsidies were needed to maintain the accounting firm. The thought of being unemployed overshadowed the opportunity to be independent. Moreover, it was significantly important to be "employed" or "attached" to a state agency or government organization as there were various fringe benefits such as housing, employment opportunity for children, and pensions. Consequently, it was impossible to recruit accountants if the accounting firm was not affiliated with a state agency or educational institution.

Third, prior to 1993, no uniform CPA examination system existed; a subjective approach was used to certify accountants (Yang and Yang, 1997). In order to obtain CPA certification, the candidate's department would provide information directly to the Ministry of Finance on the candidate's qualifications, political background, and quality of job performance. In addition, the candidate had to work at or above the level of a "bureau" under the provincial government. In other words, only those agencies and universities at the city or provincial level could recommend their accountants for certification. As a result, accounting firms had to be established within these governmental agencies and universities where qualified accountants were available.

Based on these three factors, hooking up was the only route to establishing accounting firms in the 1980s. Without the affiliated relationship with a government agency, accounting firms could not recruit qualified accountants, obtain financial support, or reduce the risk of being unemployed.

Current Situation (since 1990)

Generally an accounting firm can be affiliated with either of two types of organization: (1) the governmental departments, e.g., finance, taxation, and office of foreign investment; and (2) the accounting department of universities or commerce colleges. By the end of 1996 (Yang and Yang), a total of about 6,700 accounting firms had been established in China. Unfortunately, only a handful were of a private partnership nature. This number would be much smaller if based on the number of practicing CPAs. According to the 1996 report of the Finance Department of Shanghai,[1] out of a total of 75 accounting firms in Shanghai, only two (about 3%) were private, independent partnership firms employing about 1.5% of the total practicing CPAs. Table 1 presents Shanghai's seven largest accounting firms, their size, and their affiliations. These seven firms have main offices in Shanghai and branch offices in the suburban area of Shanghai, some of which were established through partnership with local firms. As the great majority of these public accounting firms are affiliated, this

Table 1
Shanghai's Largest Public Accounting Firms

Accounting Firm	Number of CPAs	Affiliated with
Shanghai CPAs	35	Finance Bureau of Shanghai
Zhonghua SASS CPAs	34	Ministry of Finance and Shanghai Academy of Social Sciences (SASS)
Dahua CPAs	58	Shanghai University of Finance and Economics
Li-hsing CPAs	35	Li-hsing Accounting College
Shanghai Shangrui CPAs	33	Taxation Bureau of Shanghai
Shanghai Datong CPAs	20	Metallurgical Industry Bureau of Shanghai
Shanghai Zhongchuang CPAs	23	Office of Finance and Trade, Communist Party Committee of Shanghai

means that almost every governmental agency has established an accounting firm. The two changes made since 1990 are examined below.

1993 CPA Law Supports De-affiliation

The affiliated status of existing public accounting firms is not consistent with the expectation of the 1993 Certified Public Accountant Law of PRC. The law specifically permits and encourages the forming of private, independent accounting firms. Two types of organizational structure can be used to establish an accounting firm: partnership accounting firms and limited liability accounting firms (Yang and Yang, 1997).

Partnership Accounting Firms

Using the partnership structure, two or more CPAs can set up a firm with unlimited joint liabilities. However, every partner must meet the following requirements:

a) must be a citizen of the People's Republic of China;

b) must hold a valid CPA certificate of the People's Republic of China;

c) must have more than five years experience in auditing and have good ethical records;

d) cannot work for other governmental units for salary; and

e) must have resided continuously in the location of registration for more than one year before the date of application.

The establishment of a independent partnership accounting firm must be approved by the Finance Bureau. In addition, the firm must reserve a risk fund or buy a professional liability policy from an insurance company. For the risk fund, the firm must contribute at least 10 percent of its annual operating revenues. Finally, an accounting firm cannot audit listed companies if the total of its paid-in capital, risk fund, and collective fund is less than one million Renminbi, even though it is otherwise qualified.

Limited Liability Accounting Firms

Limited liability accounting firms can be established by initiation of a certain institution. The majority of accounting firms in China use this form of organization. However, to avoid conflict of interest, the following institutions cannot established limited liability accounting firms:

a) an institution that itself is affiliated with another organization;

b) Party or governmental organizations at or above the county level, including the people's congress; judicial departments; procuratorial departments; and government organizations engaged in public security, supervisory, judicature, auditing, taxation, industrial and commercial administration, land administration, customs, technical supervision, commodity inspection; and other government organizations and offices that cannot organize any economic entities as regulated by the government.

An accounting firm established by initiation must have at least 10 full-time practitioners, at least five of whom must be CPAs. Its registered capital must be at least 300,000 yuan. The establishment of such an accounting firm must be approved by the Finance Bureau or a finance department at the provincial level.

A Change In Socio-economic Environment

In addition to the change in the audit regulation, there are also tremendous changes in the socio-economic environmental conditions in the past 10 years. The environmental conditions affecting the development of accounting firms are: (1) the tremendous increase in foreign investments, which have caused a high demand for accounting services and have transformed public accounting jobs into a lucrative, high-salaried occupation; (2) the implementation of the uniform CPA examination, which provides an objective way to obtain CPA certification; and (3) the change from a compulsory job assignment system to self-select employment option, which creates an opportunity for university graduates to work for private accounting firms instead of governmental agencies. Due to the attractive salary packages, most graduates prefer to work for private accounting firms. This provides an opportunity for the accounting firms to recruit top accounting and business graduates. However, these are necessary but insufficient conditions for establishing independent accounting firms. Though these favorable conditions have been developed, the basic "hooking-up" environment has not been affected or modified substantially. The following section examines three factors causing the slow movement toward establishing de-affiliated independent accounting firms.

Factors Hindering The Removal Of Hooking-up Relationships

Objectives Of Auditing

On the surface, the scope and objectives of the auditing practice are very similar to that in the West. Certification of financial statements is usually the primary business of most CPA firms. In addition, services such as capital verification, audit of reports for business mergers, and business/management consulting are provided. However, due to China's unique business environment, the question of whether the accounting firm (i.e., the auditor) is independent is not a major concern.

Three types of enterprises required CPA certification: foreign invested enterprises, publicly traded enterprises, and village enterprises. However, only 20 percent of the stock of publicly traded enterprises is issued to the public, and it is owned by a relatively small number of individual investors. Thus, protection of shareholders' interests is not the prime reason for having the financial statement certified. As for the village enterprises, due to their small operation and inability to pay for the auditing fees, most of these enterprises financial reports are not certified. The primary purpose for certifying the financial reports of most foreign invested and joint venture businesses (about 120,000 firms in 1996) is for filing of tax returns and other business reports for governmental agencies. To them, meeting the specific governmental requirements and expediting approval of their filed reports by respective government agencies are the major considerations in engaging certain accounting firms. Whether the accounting firms they engage are independent or affiliated is not an important issue. In fact, if an accounting firm is affiliated with the appropriate governmental bureau/department reviewing the returns/forms filed, it could work to the clients' advantage.[2]

Because of the nature of auditing and the motivation of clients in engaging CPA firms with substantial governmental relationships, many governmental agencies (e.g., the tax bureaus, the Department of Commerce and Industry Administration, and the Foreign Trade and Economic Department) have set up accounting firms affiliated with their operating units. As businesses in these affiliated accounting firms have been booming, it makes it more difficult to sever the affiliated relationships that apparently benefit both parties mutually.

Incremental Income

Over the years, most governmental agencies have grown substantially. As downsizing is not possible under a planned economy, human resource expenditures have increased while budget subsidies from the central government have decreased. These agencies are pressured to explore additional sources of revenue to meet the enlarged expenditures. With the implementation of a market economy, the demand for services of public accounting firms has increased tremendously. Given the high profitability of accounting firms, most government agencies (at the provincial and city levels) have been prompted to set up accounting firms to increase their revenues. In addition, establishing an accounting firm creates an opportunity for some accounting personnel, including those who have retired to earn additional income, to subsidize their low guaranteed income from the government. In other words, the economic motivation of establishing an accounting firm as a subunit benefits both the employees and the organization as a whole. For example, many accounting departments of major universities have created accounting firms within their departments. Retired and existing faculty members serve as partners of these firms. In addition to making additional revenue for the accounting faculty members and the accounting departments, these firms provide training grounds for their students. The university as a whole also receives its share of the income generated by the accounting firm.

As such low-cost set ups benefit many parties, it would not be worthwhile to discontinue the affiliated relationship between accounting firms and their supporting organizations. Furthermore, if an accounting firm becomes independent, it may face survival problems due to the lack of reputation and support of the affiliated organization (i.e., universities and government agencies).

Responsibility and Liability of Independent Accounting Firms

Under the affiliated set up, the affiliated organization bears all the economic obligations, legal liabilities, and any other risks relating to accounting practices. It is responsible for matters relating to accounting personnel and is directly liable to its clients for the accounting services performed. In other words, the affiliated accounting firm is not involved in maintaining personnel records or monitoring the political ideology of its employees[3]. It is relieved from handling these human resource responsibilities. Furthermore, the legal liability of an accounting firm is borne by the affiliated organization, so the individual CPA is not legally liable and personal assets cannot be used to pay off the firm's legal liabilities.

On the other hand, the independent accounting firm has to bear tremendous responsibility for its personnel as well as liability for the accounting services performed. An independent CPA is personally liable if the firm is negligent in performing accounting services. The Certified Public Accountants Law specifically states that "the liability of an accounting firm, which is a partnership structure, should be borne individually by the partners either in proportion to their capital contributions or based on partnership agreement requiring the use of personal assets to discharge the firm's liability." It also specifies that "for an accounting firm meeting the requirements (stated in previous sections), its liability is limited to an amount not exceeding US$38,000 (equivalent to 300,000 yuan)." Given that most CPAs in China have relatively low salaries[4] and limited personal assets, the amount of US$38,000 is significant and far beyond their normal ability to pay. Consequently, to avoid responsibility and liability, CPAs prefer to work for an affiliated accounting firm. Only a handful of risk-taking CPAs will set up independent accounting firms using a partnership structure.

Problems Resulting from the "Hooking-Up" Structure

Create Unfair Competition for Accounting Services

Under the hooking-up structure, the accounting firms often obtain their clients based on the power and reputation of their affiliated organizations. They do not have to compete for clients based on their professional technical capabilities and quality of services. Due to the relationships between these organizations and their clients, they can basically dictate that their clients use the accounting services provided by their internal accounting firms. By dividing the sales territories among themselves, they control the market for accounting services and gain additional income. Consequently, independent firms are unable to compete fairly. For example, Hubei Da-Sin accounting firm (1996), an independent firm with no affiliation,[5] described the problems it encountered in recruiting and retaining clients due to the unfair competitive environment. They had to move into the market indirectly and to adopt a differentiation strategy to compete for clients. In the beginning, they established their reputation and relationships with corporations and state enterprises by teaching training courses. By providing high-quality services and assuring customer satisfaction, they were subsequently able to establish their market share of accounting services and to retain clients.

Providing Low Quality of Services and Lacking Professional Independence

In most situations, clients select a certain accounting firm primarily based on their relationships with the parent (sponsoring) organization. The reputation of the accounting firm plays an insignificant role compared to the reputation of the parent. In addition, due to economic incentives underlying the establishment of an accounting firm within the organization, retired accountants or untrained accounting employees from other departments were usually transferred into the newly created accounting unit rather than hiring qualified professional accountants. Since these hooking-up accounting firms rely on their parent organizations' reputations and power in competing for clients, professional competence and quality of services are not essential features to pursue. Furthermore, under the protection of the parent organization, the hooking-up accounting firms bear limited responsibilities and liabilities. This structure creates no incentive for an accounting firm to provide quality service. As long as the hooking-up accounting firms provide satisfactory income for their parent organizations, their survival is not threatened. This brings in the issue of audit independence. Some of the clients served by hooking-up accounting firms are directly or indirectly related to the parent organizations due to ownership and control. The question of performing independent and objective audits of these clients has often been raised. Unless the audit regulation stipulates that such practices are unacceptable, the existing arrangement will continue.

Increase in Fraud, Misrepresentation, and Under-disclosures

China's Securities and Exchange Supervisory Committee has reported an increasing number of cases of fraud, misrepresentation, and under-disclosure of accounting information. Some have attributed this trend to the hooking-up structure of accounting firms, poor professional ethics, and the low quality of services provided. Zhu (1997) provided examples of companies that were investigated by China's Securities and Exchange Supervisory Committee. For example, the stocks of Shenzen Yuanye Corporation, a real-estate developer, were prevented from trading on the Shenzen Stock exchange because the accounting firm failed to report the amount of paid-in capital contributed and overstated assets. The accounting firm lost its license to certify financial statements, and the corporation ended in bankruptcy due to mismanagement of funds. In another incident in 1996, a hooking-up accounting firm failed to disclose in a timely manner a loss in revenue due to cancellation of a major contract, and it did not report the incorrect treatment of capital contributed as operating revenue. With these certified though false financial statements, Nantong Machine Tool Company was able to raise huge capital funds from the securities market. A vast number of shareholders suffered tremendous loss and sued the company and the accounting firm. The accounting firm, however, could not be held liable because the Audit Regulations are unclear with regard to auditors' liability due to "unintentional negligence" or "intentional misconduct." Furthermore, the accounting firm is under the protection umbrella of its parent organization.

Future Outlook

Recognizing that the existing hooking-up structure is causing significant social and business problems, in 1995 the Ministry of Finance issued an exposure draft on "Certified Public Accountant Practice Rules" to eliminate the hooking-up structure. Rule 25 of the exposure draft specifically states that "effective from the issuance date of the Rules, no affiliated accounting firm can be established. For those affiliated accounting firms established prior to issue of the Rules, these firms should be de-affiliated within the next three years." In other words, there should be no economic ties between accounting firms and parent organizations.

Unfortunately, three years after the issuance of the exposure draft, the Rules have not been formally implemented. The problem lies with the three-year requirement to de-affiliate. There is no recommended procedure to resolve the distribution of the assets, retained earnings, and personnel of the affiliated accounting firm (Ding, 1996). Furthermore, limited guidance was provided on the auditors' liability issue. Consequently, the de-affiliation movement has been extremely slow. In 1995, in order prepare for the de-affiliation requirement, Shenzhen City took the lead by issuing "Shenzhen City Certified Accountant Management Guidelines," which support de-affiliation. Two accounting firms were restructured as independent partnership firms with unlimited liability. The restructuring in Shenzhen is considered to be in the experimental stage, and its success will encourage others to follow. Nevertheless, by the end of 1996 only 11 accounting firms had been de-affiliated and established independently using a partnership structure. Only a handful of affiliated accounting firms have applied for de-affiliation (Ding, 1996). The largest and most well-established firms will take longer to de-affiliate than small, less-established ones. In 1996, Zhonghua, one of Shanghai's seven largest affiliated accounting firms, formally de-affiliated from its parent organizations (the Ministry of Finance and the Shanghai Academy of Social Sciences). This has provided a very strong positive signal to other affiliated firms.

To promote de-affiliation, the following problems identified by Ding (1996) must be solved:

- distribution of assets and retained profits,
- handling of personnel,
- audit liability,
- type of organization structure.

Along with achieving independence, the accounting firms in China must develop their accounting profession so as to perform quality service meeting international standards. Currently, China companies must be certified by internationally recognized firms in order to be listed in foreign exchanges, which excludes most of the China accounting firms, affiliated or independent. Achieving international recognition of China accounting firms should be the next goal.

Endnotes

1. Finance Department of the City of Shanghai, "1996 List of Shanghai Practicing Certified Public Accountants," *Emancipation Daily News*, June 17, 1996, page 12.

2. Though not openly stated, tax returns prepared and certified by those accounting firms hooking-up to the income tax bureau tend not to be audited.

3. In addition to making hiring decision, setting salary structure, and evaluating performance, the employer under the communist system also assumes responsibility for developing employees' political ideology.

4. In Shanghai, university graduates working with Big Six offices average a salary per month (including bonuses) of about 3,000 yuan per CPA. The average salary for local CPA firms is about $1,000 for new graduates. Retired CPAs working in accounting firms get an average of $300 to S500 per month in addition to their pensions. However, Shanghai's salary is an exception.

5. Due to the requirements of 1986 Regulation on Certified Public Accountants, the firm had to "hook-up" with an organization officially for a period of about seven years. But it maintained independence on the actual operation of the firm.

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