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Accounting Horizons
Vol. 14 No. 1
March 2000
pp. 69-89

The Making of Independent Auditing Standards in China

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SYNOPSIS: Chinese independent auditing standards (CIAS) have been promulgated since 1995. This paper contextualizes the various Chinese attempts at setting auditing standards, especially the making of the CIAS, by identifying factors that motivated these efforts. It finds that, prior to the CIAS, some auditing standards and procedures were issued on a voluntary basis in order to educate auditors and auditees, to improve audit quality, and to help auditors survive the competition between various consultancy firms. However, these standards failed to achieve their objectives and could not prevent auditors from being involved in a number of well-publicized major financial scandals. Amid crises of public confidence, the *CPA Law* was stipulated and the Chinese regulators began to formulate the CIAS to strengthen the legal system that regulates the audit profession and to harmonize Sino-foreign auditing. The paper also illuminates some major features of the Chinese audit market, such as the lack of audit independence, the shortage of well-qualified auditors, an environment of extensive corruption, and the existence of many misconceptions about the audit. These conditions will significantly hinder the further development of the audit profession in China. In particular, they will severely impair the effectiveness of the CIAS and recently developed accounting standards. Consequently, investments in Chinese companies will still involve considerable risks despite the existence of the CIAS.

Data Availability: Data used in this paper are publicly available.

We thank Roy Chandler, Eugene A. Imhoff, Michael John Jones, Barry Morse, Maurice Pendlebury, Anne Rich, Ira Solomon, Stuart Turley, and two referees of the journal for their helpful comments on earlier versions of the paper. We are most grateful for the provision of some data by Huaxiong Li, Guliang Tang, and Yunwei Tang.

Submitted: January 1998

Accepted: September 1999

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INTRODUCTION

China is one of the largest and fastest growing economies. By 1996, its gross national product (GNP) was seventh in global terms with an annual growth rate of 11 percent during 1990–1996 (World Bank 1998). This makes China particularly attractive to foreign investors and researchers.

China's economic achievement has been facilitated by economic reforms aimed to move a centralized economy to a market-based one. Among other economic reforms, China has promulgated "independent auditing standards" (CIAS) since 1995. These are sometimes regarded as China's first auditing standards (Ding 1996a, 1996b). However, prior to the CIAS, a number of voluntary auditing standards were issued. Indeed, even before 1949, there were attempts to set auditing standards. This paper identifies the factors that motivated these various attempts. These factors contextualize Chinese auditing standard setting and explain some important features of the CIAS. In particular, they provide further evidence to suggest that China, both currently and in the near future, lacks professional/independent auditing (Xiang 1998) and, as a result, investments in Chinese companies involve considerable risks.

From an audit perspective, the paper provides an insight into the evolution of institutional arrangements in China over a period of rapid social and economic change. The paper also brings to light the issues and problems involved in auditing standard setting in a developing country. These institutional changes, issues, and problems in China are relatively unfamiliar to researchers, regulators, and investors outside China. A clear understanding of them is essential for an adequate assessment of the effectiveness of the foreign standard-based CIAS, the difficulties involved in international harmonization of audit, and the conditions of the Chinese audit environment.

The paper provides insights into the origins of the Chinese interest in auditing standards and will enable researchers and standard setters to judge whether the Chinese standard setting approach differs from those adopted in other countries. Historically, professional accounting bodies elsewhere (e.g., in the U.K.) have either been reluctant to develop auditing standards (Chandler 1997a) or adopted a crisis management approach (Carey 1969, 1970; Baker 1993).

Data were basically obtained from Chinese journals and newspapers, with other materials emanating from official documents produced by the Ministry of Finance (MoF), the State Audit Administration (SAA), the Chinese Institute of Certified Public Accountants (CICPA), and the Chinese Association of Certified Public Auditors (CACPA). Ten interviews (interviewees A–J) were also undertaken with Chinese auditing standard setters and other officials in 1997 and 1998 (see Table 1).

The paper proceeds as follows. The next section provides the historical and institutional context within which Chinese auditing standards have been developed. The third section traces various Chinese attempts at setting auditing standards. The fourth section presents the factors that motivated auditing standard setting. The final section provides a summary and conclusions.

HISTORICAL AND INSTITUTIONAL BACKGROUND

Professional public accountants appeared in China as early as 1918 in response to a relatively strong growth of state-owned and private business enterprises (Zhang 1987). Although their numbers did not greatly increase,¹ a legal system governing the audit

¹ By the end of 1947, only 3,356 people had obtained the qualification of certified accountants (Xu 1995).

TABLE 1
Background Information about the Interviewees

<u>Interviewee</u>	<u>Qualification</u>	<u>Company</u>	<u>Position</u>	<u>CIASC^a Member</u>	<u>Domestic Advisory Group^b</u>
A	B.A., CPA	University	Full Professor	No	Yes
B	Ph.D., CPA	MoF	Full Professor	Yes	No
C	Ph.D., CPA	University, CPA firm	Associate Professor, firm division head	Yes	No
D	Ph.D., CPA	CICPA	Deputy division head	Yes	No
E	Ph.D., CPA	CICPA	Staff member	Yes	No
F	B.Econ., CPA	SAA, CACPA	Sub-division head	No	No
G	M.Econ.	CICPA	Staff member	No	No
H	M.Econ.	CICPA	Staff member	No	No
I	B.Econ.	CICPA	Staff member	No	No
J	B.Econ.	CACPA and CICPA	Staff member	No	No

^a CIASC = China Independent Auditing Standards Commission. An explanation of other acronyms can be found in Figure 1.

^b Domestic Advisory Group = A group of domestic experts appointed by the MoF to advise the CIASC.

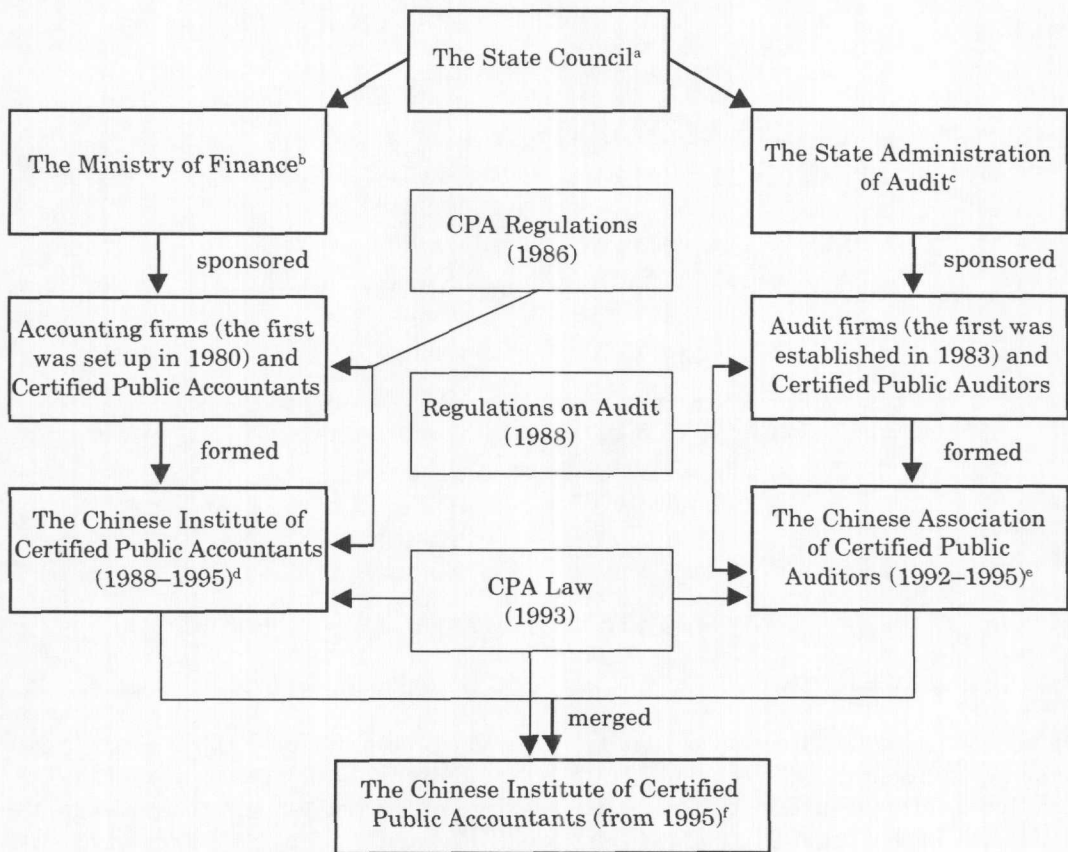
profession gradually developed. Landmarks in this process included the "Tentative Provisions on Accountants" issued in 1918, the first audit regulation in China, and the *Law on Accountants* issued in 1945. The legal system prescribed, among other things, the qualifications of certified public accountants (CPA) and the scope of their services, responsibilities, and ethics (Xu 1997).

However, after 1949, the days of certified accountants were numbered. The socialist government took measures to establish a single public ownership economy and began to centralize the management of businesses and control of all economic resources. By 1956, all private companies had been transformed into state or collective ownership. The private audit profession, together with government audit, was replaced by a system of "specialist supervision and internal accounting control."²

² That system consisted of three elements: (1) establishing internal accounting controls within a company or government department; (2) monitoring the accounts of subordinate organizations by supervising ministries and their local branches; and (3) providing "specialist supervision" by the MoF, the taxation authorities, state banks, and their local offices in conjunction with their transactions with various organizations. These types of control, however, suffered from a lack of independence, and hence were not truly effective.

In the early 1980s, a nongovernment audit profession re-emerged as a result of the mushrooming Sino-foreign joint ventures brought about by China's open-door policy. Figure 1 outlines its development since 1980. The laws on Sino-foreign joint ventures

FIGURE 1
Institutional Arrangements and Development of the
Private Audit Profession in China Since 1980



^a The State Council = The administrative organ of the central government in China.

^b The Ministry of Finance (MoF) = A department under the State Council empowered to manage accounting and finance affairs.

^c The State Administration of Audit (SAA) = A department under the State Council to undertake government audits.

^d The Chinese Institute of Certified Public Accountants (CICPA) (1988-1995) = A professional organization supervising and serving accounting firms and certified public accountants, sponsored by the MoF.

^e The Chinese Association of Certified Public Accountants (CACPA) (1992-1995) = A professional body supervising and serving audit firms and certified public auditors, sponsored by the SAA.

^f The Chinese Institute of Certified Public Accountants (CICPA) (from 1995) = The name of the united profession following the 1995 merger of the CICPA (1988-1995) and the CACPA (1992-1995), jointly supervised by the MoF and the SAA.

required the audit of annual financial statements and income tax returns and the verification of capital contributions by registered Chinese certified accountants.³ Consequently, the first “accounting firms” emerged in 1980 and were allowed to carry out attestation and consultancy services. Their position was reinforced by the *Accounting Law* issued in 1985 and the “CPA Regulations” in 1986. The latter, promulgated by the State Council, prescribed the scope of CPA practice and some working and ethical rules. It also led to the formation of the CICPA in 1988.

Economic reforms stimulated the growth of the CPA profession. The reforms aimed to develop a socialist market economy on the assumption that an audit profession helps the market work in an orderly and efficient manner. Increasingly, economic reforms relied on CPA services. This can be seen from the numerous government regulations that require the involvement of independent auditors in implementing economic reform measures (Tang et al. 1992).⁴

The private audit sector, however, developed along a dual track. Apart from accounting firms, “audit firms” started to emerge in 1983. They offered types of services similar to those provided by accounting firms, although for many years they mainly audited domestic companies whereas accounting firms focused on companies using foreign investments (Wang 1989). While accounting firms were sponsored by the MoF, audit firms were backed by the SAA which conceived “social audits”⁵ as a supplement to government audits (Wang 1988). In 1987, the SAA published “Issues Related to Further Development of Social Audit” to govern the work of audit firms. In 1988, the State Council promulgated the “Regulations on Audit” which, although mainly for government auditing, defined the nature and working scope of social audits. Audit firms gained momentum from these regulations. To compete with the CICPA, the SAA issued in 1991 “Tentative Rules on Certified Public Auditors” to regulate auditors employed in audit firms. In 1992, audit firms formed the CACPA under the auspices of the SAA.

Although competition contributed to the rapid growth of both accounting and audit firms (see Table 2), this duality caused many problems. Apart from competitive bidding and repeated audits that resulted in excessive burdens on clients,⁶ the profession’s growth in quantity was not matched with an equal improvement in quality (CICPA 1989). The fight for power between government ministries that sponsored various firms also had negative effects. The chief accountant of a major international accounting firm complained that they were confused by the different rules issued by different government departments (*CPA Newsletter* 1995).

These problems led to the merger of the CICPA and CACPA. In 1993, the “CPA Regulations” were upgraded to become the *CPA Law*.⁷ As a result, the MoF gained the power to manage both accounting and audit firms. An intention to merge was signaled in 1993 by Zhang (1994), then Deputy Minister of Finance. The merger was announced in 1995 and “CICPA” became the name of the united body. However, a quarter of the two institutes’ provincial branches did not merge until 1998 (Ding 1998).

³ At that time, however, no certified accountants existed in China.

⁴ A total of 21 government regulations or laws were published in the *CPA Newsletter* between 1980 and 1996 that required auditors’ involvement in, for example, selling small state-owned companies, introducing the contract responsibility system, corporatizing state-owned enterprises, and developing stock exchanges.

⁵ In China, an audit carried out by an audit or accounting firm is called a “social audit” (Tang et al. 1992).

⁶ A company might be audited several times by accounting firms and/or audit firms or by different government departments themselves such as the audit bureau, taxation authority, and finance department.

⁷ In China, laws are stipulated by the National People’s Congress, whereas regulations are promulgated as administrative rules by the State Council. Thus, laws have a higher legal status than regulations.

TABLE 2
Growth of Accounting and Audit Firms

Year	Number of Accounting Firms	Number of Certified Public Accountants or Equivalent	Number of Audit Firms	Number of Certified Public Auditors or Equivalent
1988	> 200	>2,000	1,415	2,533
1989	> 300	>3,000	2,148	5,263
1990	1,422	4,979	2,321	7,273
1991	1,240	6,722	2,502	7,924
1992	> 1,500	7,000	2,812	10,606
1993	> 2,500	15,000	3,375	16,845
1994	> 3,300	48,000	NA	NA
1995	2,400	54,000	3,828	58,000

Sources: B. Lu (1993, 1995), CICPA (1988), Ding (1996b, 1998), MoF (1992), Shao (1994), Wang (1996), Yang (1990), and Zhang (1989, 1994).

Clearly, the government played a crucial role in the development of the private audit profession. Most accounting and audit firms were initially attached to a government department (CICPA 1989). This dependence has remained a major problem,⁸ although the government has launched a number of campaigns since 1993 to detach the firms from their sponsors, including a 1998 national "detachment" conference (Zhang 1998). The detached firms are required to adopt the form of either a limited liability company or a partnership.

Foreign accounting firms also helped the development of the Chinese audit profession. By the end of 1997, they had acquired 10 percent of the Chinese audit market (Ding 1997). They have established representative offices, joint firms, associate firms, or member firms in China.⁹ These firms contributed to the implementation of the open-door policy by providing services to foreign investors as early as 1983. They also assisted the development of the Chinese capital market by, for example, undertaking financial audits of Chinese companies that offer shares to overseas investors and/or that wish to obtain or have obtained a foreign listing. In addition, they have helped train Chinese auditors¹⁰ and set auditing standards as described in the next section.

Foreign accounting professional bodies also played a role. The U.K.-based Chartered Association of Certified Accountants (ACCA) and the Certified General Accountants'

⁸ Detachment was not as easy as expected because it also involved ownership and other difficulties.

⁹ By 1993, 23 representative offices had been set up by foreign accounting firms (Ding 1993). Three Sino-foreign joint firms were established in 1991-1992 (MoF 1992). By 1996, 14 foreign accounting firms had opened 27 offices, three member firms, two associate firms, and nine joint firms in China (Qin 1997).

¹⁰ By June 1997, the then Big 6 accounting firms had employed about 2,000 Chinese accountants (Shi 1997). In 1994, their joint firms ran six training courses for 252 Chinese auditors (CICPA 1994).

Association of Canada (CGA), for example, have been training Chinese accountants to obtain their qualifications.¹¹ The Hong Kong Society of Accountants (HKSA), which has remained independent since Hong Kong reverted to China, has undertaken a wide range of activities. These include running training courses for Chinese auditors, providing placement opportunities in Hong Kong, supporting the CICPA's international activities, and helping standard setting in China (Wang and Zhang 1997).

THE ROAD TO "INDEPENDENT AUDITING STANDARDS"

Depending on how auditing standards are defined,¹² there have been a number of Chinese attempts to set auditing standards both before and after 1949.

The Forgotten Efforts Made Before 1949

Before 1949, there were no authoritative or unified auditing standards. The National Association of Accountants (established in 1946) failed to introduce any auditing standards because of the disruption caused by the Civil War (1946–1949). Some regional associations of accountants such as the Shanghai Society of Accountants did stipulate some auditing standards and rules (Xu 1997). However, several of our interviewees (e.g., A, B, and C) confirmed that the laws, regulations, and standards developed before 1949 failed to influence the setting of more recent standards including the CIAS.

Voluntary Auditing Standard Setting by the CICPA

Apart from the requirements contained in various government regulations, no authoritative auditing standards emerged before the CICPA was established in 1988. Some relatively large accounting firms, however, did try to establish in-house auditing procedures and standards. The Zhonghua Accounting Firm (1992), for example, had developed a comprehensive set of auditing procedures and standards by 1992.

The drafting of national auditing standards began as part of the preparation for the establishment of the CICPA. This made it possible for the opening conference of the CICPA to discuss two draft standards: "Audit of Financial Statements" and "Management of Audit Fees" (CICPA 1988). The conference also set plans to develop other standards. By 1993 nine tentative auditing standards had been issued.¹³ These standards, however, had limited effect as they never became formal standards. This trial status was responsible for many problems, which will be discussed later.

Voluntary Standard Setting by the CACPA

Parallel developments existed in audit firms. Before the formation of the CACPA, some audit firms and/or research institutions took initiatives in standard setting. For

¹¹ For example, the ACCA is running courses leading to a professional qualification and a diploma course jointly in a number of major universities. The latter is also being broadcast via Shanghai TV.

¹² According to Stamp and Moonitz (1979), auditing standards are related to auditing procedures in the same way that accounting objectives and conceptual frameworks are related to accounting standards. For Hicks (1974), however, the real-world auditing standards are more specific than the generally accepted auditing standards.

¹³ These are "Financial Statement Audit" (1989), "Inspection of Accounting Firms" (1991), "Verification of Capital Contributions" (1991), "Audit Working Papers" (1991), "Audit Planning" (1992), "Audit Reports" (1992), "Management Letters" (1992), "Educational Requirements and Training System" (1992), and "Professional Ethics" (1992).

example, the Beijing Institute for Auditing Research, the Beijing Audit Firm, and about 20 other audit firms in Beijing developed "Social Auditing Standards and Procedures" in 1988. These standards and procedures were also adopted by audit firms outside Beijing (Chao 1990).

Perhaps more importantly, the SAA issued a document entitled "Standards and Procedures for Social Audit" in 1990. Although it lacked a sound conceptual foundation, the document provided guidance on audit engagements, audit organization, audit planning, evidential matters, working papers, and the audit report. It was used by audit firms throughout the country with reportedly positive effects on audit quality, and was highly regarded by local audit firms (Chao 1990). However, the document was too general. Thus, the CACPA started to develop detailed standards upon its formation in 1993, and issued six tentative standards between 1993 and 1995.¹⁴ As with the standards issued by the CICPA, these never became formal standards.

Our interview data suggest that the standards issued by the CACPA were confined to audit firms, whereas those issued by the CICPA were intended only for and used by accounting firms. These voluntary standards seemed to have a limited effect on the CIAS, although the interviewees could not agree on the extent of this influence. Interviewee C said, "They were not even referred to in the development of the first batch of the CIAS," whereas Interviewee J said, "Yes, they had a limited influence," and added that a recently issued standard was identical to a standard set by the CACPA. Interviewee D also acknowledged that, of the four people involved in the CICPA's voluntary standard setting, three participated in drafting the first CIAS.

The Birth of the CIAS

The *CPA Law*, promulgated in 1993, made auditing standard setting a statutory requirement. It also empowered the CICPA to draft standards and the MoF to approve the CICPA's drafts. The CICPA formed the China Independent Auditing Standards Commission (CIASC) to draft standards in October 1994, with members from the CICPA, higher education, research institutes, and accounting firms. Two consultative expert groups, the Domestic Advisory Group and the Foreign Advisory Group, were also established in 1995, with members appointed by the MoF. The former consists of leading Chinese accounting academics and practitioners while the latter comprises representatives from international accounting firms active in China.

Initially, the CIAS consisted of a general standard, specific standards, practice pronouncements, and auditing guidelines. This framework was later expanded to include ethical rules, quality control standards, and continuing education requirements. The general standard prescribes the overall requirements concerning CPAs' professional competence and practicing behavior. It is the basis on which specific standards, practice pronouncements, and guidelines are formulated. Specific standards deal with common auditing and reporting issues, whereas practice pronouncements involve auditing and reporting in special industries or for special purposes. Auditing guidelines describe operational procedures relevant to specific standards and practice pronouncements. The general standard, specific standards, and practice pronouncements, representing statutory requirements, are drafted by the CICPA and approved and

¹⁴ These are "Code of Professional Ethics" (1993), "Verification of Capital Contributions" (1994), "Financial Revenues and Expenditures Audit" (1994), "Audit Working Papers" (1994), "Audit Documentation and Management" (1995), and "Audit of Capital Construction Budgeting and Final Accounts" (1995).

issued by the MoF. Auditing guidelines are drafted and issued by the CICPA and have a reference status.

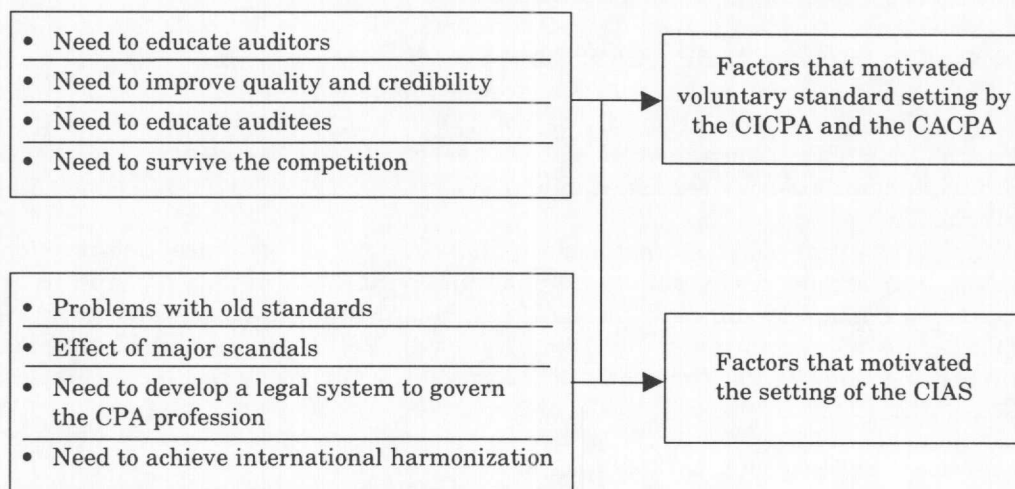
The first ten standards, including the “Preface,” the “General Standard,” and “Financial Statement Audit,” were issued as exposure drafts at the beginning of 1995 and formally adopted by the MoF in December 1995. In January 1996, three auditing guidelines were issued on the audit of annual financial statements, audit working papers, and asset valuation. Fourteen additional specific standards were issued in December 1996, including “Fraud and Error,” “Internal Control and Risk,” “Audit Materiality,” and “Analytical Procedures.” A third batch of 15 specific standards was issued as exposure drafts in 1998. They deal with, among other things, related-party transactions, going concern, the consideration of legality in financial statement audits, computer auditing, and special considerations in the audit of state-owned companies.

The development of the CIAS has exhibited a number of characteristics. First, the government clearly plays an important role as the MoF appoints members of the two advisory groups and approves and issues standards drafted by the CICPA. Second, the CIASC consists of members from nongovernmental organizations and operates under the auspices of the CICPA. This is different from China’s accounting standard-setting body that is part of the MoF, comprising only government officials. Third, unlike the previous voluntary standards, the CIAS are based on a conceptual framework, the “General Standard.” Moreover, the CIAS are largely modeled on foreign standards (Chen 1997; CICPA 1995).

FACTORS THAT MOTIVATED AUDITING STANDARDS SETTING

Figure 2 shows eight main factors that are considered to have motivated auditing standard setting. Whereas all the factors were responsible for the setting of the CIAS, the first four particularly motivated voluntary standard setting by the CICPA and the CACPA.

FIGURE 2
Factors Leading to Auditing Standard Setting in China



The Need to Educate Auditors

Serious personnel problems resulted from the nonexistence of an audit system from the 1950s to the early 1980s, fueled by the suspension of higher education in accounting during the Cultural Revolution. Zhang (1989), then Secretary-General of the CICPA, reported that 80 percent of CPAs were retired accountants. This aging problem was not helped by the fact that, before 1991, CPAs were qualified not by examination but by review and that only associate and full accounting professors and accountants with over 20 years of accounting experience would be eligible for the qualification. The first Chinese CPA qualifying examination was not held until the end of 1991.

A related problem was the lack of systematic professional training and academic education. Consequently, many CPAs misunderstood the very term "audit." For example, some auditors simply considered an audit as a check on whether financial statements were consistent with the ledgers (Wang 1996). Auditors were also ignorant of audit risks and thus, in 1992, the notorious Shichuan Deyang Accounting Firm promised to compensate third parties if the client went bankrupt, merely at the request of a local government department (Li 1998).¹⁵ This lack of training and education was seen as a major cause of poor audit quality and poor management of accounting firms (Liaoning Institute of CPAs 1990).

Similar problems existed in audit firms (Wang 1992). Before 1990, the majority of employees in audit firms were retired accountants or part-time accountants who worked full-time for government audit bureaus (Wang 1992). The poor quality of auditors could be seen from the fact that half of the 50,000 state auditors had not been trained (Tang et al. 1992, 184) and the fact that certified public auditors were qualified by review, not by examination (Cui 1993).

Therefore, both the CICPA and the CACPA saw the importance of improving personnel quality. Apart from organizing qualifying examinations and emphasizing training,¹⁶ the role of auditing standards was recognized. P. Lu (1993), then deputy director of the SAA, urged the CACPA to develop technical and ethical standards to enhance the quality of auditors. According to Ding (1996c), then Director of the CIASC, auditing standards would help raise CPAs' skills and knowledge by providing input into education, training, and qualifying examinations.

The Need to Improve Audit Quality and Credibility

The rapid increase in accounting firms was accompanied by quality problems. The Shanghai Zhonghua Sheke Accounting Firm (1994) reported many inconsistent practices or malpractices in the preparation of audit reports. These included no indication of auditing standards used, vague descriptions of the scope of the audit, and misleading audit opinions.

The CICPA realized the importance of audit quality almost since its formation. In 1989, a principle was established "to obtain credibility from quality and to develop on the basis of credibility" (Zhang 1989). Meanwhile, auditing standards were seen as a means of improving audit quality (Yang 1990). At the Second National Conference of the CICPA, the participants urged the CICPA to develop a complete

¹⁵ The firm was ordered to pay 46,000 yuan to a third party for providing an unfounded certificate on capital contributions verification after the client went bankrupt.

¹⁶ For example, three national CPA training centers were planned with a total capacity of training over 3,000 people at any time (Wang 1995). Two have been in partial operation in Beijing and Shanghai, although they are still being built. However, these centers are mainly, but not exclusively, used for training CPAs.

set of "independent auditing standards suitable for China"¹⁷ and a total quality control system (Zhang 1992).

The unethical behavior of CPAs was a root cause of poor audit quality. In a survey, the CICPA (1989) found that many accounting firms focused more on revenues than on quality and that they provided unfounded audit reports or helped clients prepare false or misleading financial statements. Ethical issues were thus discussed at almost every meeting of the CICPA Council. In particular, Zhang (1991) regarded ethics as the life-line of the profession and called for faster ethical standard setting and regular compliance reviews. Subsequently, the Shenzhen CPA Association issued a "Code of CPA Ethics" in 1991 and the CICPA followed suit in 1992.

Similar problems existed in audit firms (CICPA 1989; Wang 1994). These problems attracted the attention of social audit managers who considered that auditing standards were the solution. Therefore, Wang (1989), then Director of Social Audit Management at the SAA, urged audit firms to develop unified auditing standards and a code of ethics. Chao (1990), also at the SAA, proposed a framework of auditing standards.

The Need to Educate Auditees

Economic reforms (especially the introduction of a capital market) have reduced state intervention and made independent auditing an important monitoring mechanism (CICPA 1989). However, audits were mainly imposed by law or regulation and their importance was rarely perceived by auditees (Fu 1994). Many auditees had misconceptions of independent audits; some companies regarded being audited as being mistrusted. Not untypically, a company's chief executive said, "it is foolish of you to pay auditors to pick up your faults" (Fu 1994). Many auditees felt that auditors should be responsible for any remaining errors in financial statements once an audit was completed (Shu 1996).

A more serious challenge faced by auditors was that many clients forged accounts. Li (1995, 5), a State Councilor, described the problem in explaining the causes of the 138.3 billion yuan illegal spending and tax evasion discovered from 1985 to 1994:

Among many illegal acts which were responsible for the amount, the most common type was forgery. Original documents, accounting figures, and financial statements were forged, or two or even three sets of accounts were prepared to mask true financial conditions, evade tax, embezzle state revenues, and appropriate state-owned assets. These problems existed not only in companies, but also in government organizations. Why these problems? The ultimate source is self-interest and the corruptive notion that promotion comes from numbers and numbers generate promotion.

Some clients, however, expected auditors to help them conceal their frauds, as will be described later. Many companies would not appoint or re-appoint their auditors if the latter were unwilling to help them cover up their wrongdoings (Yang 1995). This was possible because there existed competitive bidding on the supply side and because most accounting and audit firms were attached to a government department and thus lacked a sense of audit risk. Another reason was that, as auditee companies lacked effective corporate governance, external auditors were often appointed by chief executives or finance directors (Yang 1995).

¹⁷ This was perhaps the first time that the term "independent auditing standards" was coined in the CICPA's documents.

Clearly, auditees needed a basic understanding of the independent audit. Thus, Hong (1994), then Deputy Director of the State Economic Restructuring Commission, urged the CICPA to educate auditees and the public as well as auditors by, among other measures, propagating the *CPA Law*. Chinese regulators considered auditing standards as a solution (Chen 1996, 1997). For example, Zhang (1995), then Deputy Minister of the MoF, proposed to improve the Chinese audit environment by educating company managers on auditing standards. In particular, auditing standards were expected to help distinguish auditors' liabilities from managers' accountability (Ding 1996c). This distinction was thought to be useful to protect CPAs.

The Need to Survive Competition

Apart from accounting and audit firms, there were, among others, asset valuation firms sponsored by the Administration of State-Owned Assets, taxation firms supervised by taxation authorities, and financial service firms attached to various state-run banks. All these firms fought for a slice of the audit market. Many firms were headed by government officials, or were government departments operating under different names.

Unethical approaches were often used by these firms. A bank-run consultancy firm, which was actually a division of the bank itself, threatened its customers that if they appointed other firms to undertake verification of capital contributions,¹⁸ they could lose their loans (CICPA 1989).

The competition between audit firms and accounting firms was fierce. Both the CICPA (1989) and the Jiangsu Accounting Firm (1990) reported that the two types of firms fought for clients using various unethical means such as helping clients cover up problems. The competition also involved the MoF and the SAA. To establish a new accounting or audit firm, the "CPA Regulations" required the approval of a finance bureau whereas the "Regulations on Audit" required the authorization of an audit bureau.¹⁹ Thus, in 1993, the MoF protested against the SAA's "illegal requirements" that the establishment of new accounting firms must be approved by an audit bureau (MoF 1993b).

The CICPA expected the competition to continue and urged CPAs and accounting firms to gain social recognition by improving the quality of their work. Therefore, the three issues (i.e., competition, quality, and standards) always appeared side by side in the CICPA's documents. For example, Zhang (1991, 2-3) considered auditing standards as a means of quality assurance and put forward "three competition strategies":

Firstly, the audit of companies using foreign investments is accounting firms' statutory right and thus we do not allow other firms to lay their hands on these companies. Secondly, we should compete with other firms for the audit of domestic companies. And finally, we should believe the "law of natural selection"...stick to professional standards, pursue audit quality, and protect the credibility of the profession.

To compete, a principle of "Service First, Credibility First, Quality First, and Growth Through Competition" was adopted by audit firms. Cui (1993), then Deputy Director of

¹⁸ Verification of capital contributions refers to the verification of the truthfulness and legitimacy of a firm's paid-in share capital and its relevant assets and liabilities in accordance with relevant laws and regulations.

¹⁹ This type of conflict is not untypical because different regulations may be drafted by different ministries.

the SAA, considered this as one of the “secrets of success” in the development of audit firms. Meanwhile, auditing standards were considered important for beating the competition. Wang (1989) proposed the setting of technical and ethical standards as the CACPA’s main task. Although the SAA had already issued a document entitled “Standards and Procedures for Social Audit” early in 1990, auditing standard setting still became one of the CACPA’s paramount tasks (Cui 1993).

Problems with Old Standards

The two sets of standards issued by the CICPA and the CACPA before the CIAS were developed suffered from a number of problems. Neither set was complete and many topics (such as the special circumstances of small businesses) were not covered. Neither set adopted any coherent conceptual framework, which resulted in inconsistencies and repetition between standards, and both sets lacked operational guidance. Perhaps the most serious problem was that neither set was enforceable because both were issued on a trial basis by the two nongovernmental agencies. Consequently, these standards had mixed effects:

I remember we went to Shanghai, Fujian, and Guangdong to collect feedback on three trial standards in 1990....We did not receive comments that we had expected; we received very loud protests. We were told that we were copying from Western countries....As the standards were issued under those circumstances, you can imagine that the effects were limited. (Interviewee E)

There were differences between the two sets of standards. First, they were developed on different bases. The CICPA’s standards were based on the “CPA Regulations,” whereas the CACPA’s were based on the “Rules on Social Audit.” Second, the two sets of standards did not cover the same topics. For example, audit reports and audit planning were addressed only by the CICPA’s standards. Finally, the two sets were inconsistent even when they dealt with the same topic. For example, whereas the CACPA’s standard on verification of capital contributions detailed the content and methods of verification, the CICPA’s standard focused on reporting.

The differences between the two sets of standards confused both auditors and auditees. Although they helped normalize audits and enhance audit quality, their deficiencies were at least partly responsible for many of the major financial scandals. Standard setters realized that they could no longer meet the needs of the growing profession and that a more comprehensive system of auditing standards would need to be developed (Chen 1995).

The Effect of Major Scandals

A number of major financial scandals erupted in the early 1990s and exposed publicly the ethical and quality problems that had existed in accounting and audit firms for some time. This created tremendous pressures for improving auditing standards.

The first scandal caused the Shenzhen Special Economic Zone Accounting Firm to be closed down and the firm’s key CPAs to be disqualified for material negligence (CICPA 1992). One of the firm’s clients was Shenzhen Yuanye Industrial Corporation Limited, a joint venture involving a Hong Kong partner. Although it posted a loss every year from 1989 to 1991, the client reported a cumulative profit of 77.4 million yuan during that period. It was found later that the accounting firm provided ten false certificates

on capital contribution verification and unqualified audit reports for the client. The firm was also found guilty of helping the client falsify accounts.

Perhaps most notorious was the "Great Wall Fund Raising" scandal which implicated the Zhongcheng Accounting Firm (Zheng and Chen 1993). In this case, the Great Wall Electrical Engineering Science and Technology Co. illegally raised one billion yuan in a few months between 1992 and 1993 by issuing very high coupon securities to over 100,000 private investors in 17 large cities in China. The money raised was partly embezzled and partly used to establish over 20 subsidiaries and more than 100 branches all over the country. A branch of the Zhongcheng Accounting Firm played a key role in the fraud; its three CPAs provided an unfounded certificate confirming 0.3 billion yuan capital after just one day's work with only 25 pages of working papers (Wang 1993). The CPAs' involvement in the case gained nationwide publicity. For example, the *People's Daily* published an article entitled "An Unjust CPA Firm" on July 29, 1993. The fraud caused a huge stir. While the investors were the first victims, five CPAs from the accounting firm were disqualified and the whole firm was dismantled. The president of the client company received the death penalty, a deputy minister was jailed for bribery, and the president of the People's Bank of China was terminated.

These scandals can be attributed to many causes. Interviewee D believed that the lack of auditing standards was the major cause. In a government-organized review of accounting firms qualified to audit listed companies, he found that audit practices were different not only between accounting firms but also between CPAs in the same firm. The CICPA (1989) found that the lack of standards created loopholes for overstating intangible assets provided by foreign investors while understating physical assets supplied by Chinese companies in Sino-foreign joint ventures.

Although some standards existed, they were not enforceable because they were issued by the CICPA or the CACPA on a trial basis. This explains, in part, why the Zhongcheng Accounting Firm failed to follow the necessary procedures for capital contribution verification and financial statement audit and provided a total of 18 certificates on capital contribution verification and two audit reports—all ungrounded (Wang 1994). The unenforceability was also a reason why the first CIAS were issued as government regulations.

Another major cause of the crisis was perceived to be the low level of social morality at that time. Li et al. (1991) described it in terms of short-termism, officialism, no respect for law, money fetishism, corruption, false accounting and reporting, and lack of economic order. Wang (1994, 216) believed that these problems had a negative effect on auditors and led many to think that "because so many people provide false reporting, I will be safe."

The exposed problems threatened the credibility of the audit profession. A survey published in *China Securities Daily* on May 16, 1995 showed that over 60 percent of investors had no confidence in audited financial statements. Another survey of over 30 accounting firms found that 90 percent of them could have been brought to court and would have been unable to defend themselves (Yang 1995). These figures indicate that the problems were widespread.

In response to the crises, the MoF planned to draft the *CPA Law* in 1992 (Zhang 1992). In 1993, the *CPA Law* was published, which made auditing standard setting a legal requirement. In the same year, the MoF (1993a) launched a nationwide campaign to rectify wrongdoings by accounting firms. In 1995, the CICPA established the Division of Practice Supervision to monitor CPAs' compliance with the CIAS and laws. In

early 1994 the CICPA began to draft the CIAS (Lu 1995). Tao (1995, 27), then President of the CICPA, clearly indicated the influence of the scandals on the setting of the CIAS:

The CICPA will endeavor to develop auditing standards. Once standards are set, they must be strictly complied with. We must penalize those auditors who only care about money and pay no attention to audit quality or have no respect for ethics....Further development of the profession will be severely hampered if the scandals occur again....

Audit firms also learned a lesson from these scandals. In May 1993 the SAA participated in the investigation of the role of Zhongcheng Accounting Firm in the "Great Wall Fund Raising" case. In September 1993, the SAA ordered a review of all audit firms to prevent them from being involved in similar scandals. In the same year, the CACPA issued its first auditing standard.

It should be noted that it was the MoF and the CICPA that took the initiative to develop the CIAS, although the SAA and the CACPA did react to the scandals. This was because the *CPA Law* clearly empowered the MoF and CICPA, not the SAA and CACPA, to set auditing standards. In addition, the much-publicized scandals implicated only accounting firms, which put the MoF and CICPA under pressure.²⁰ When asked whether the CACPA or the SAA was involved in the making of the first CIAS, Interviewee F replied:

No involvement at all. Although it was acknowledged that the CIAS were approved by the MoF and the SAA, there was no involvement from the SAA....Those who had been involved in the preparation of the standards issued by the CACPA did not participate in drafting the first batch of the CIAS.

The Need to Develop a Legal Regime to Govern the CPA Profession

Auditing standards had been considered an important means of quality assurance, but they were now seen as part of the effort to develop a legal system to govern the CPA profession after the *CPA Law* was promulgated in 1993. For example, Liu (1994, 3), then Minister of Finance, remarked at the 1993 CPA National Conference:

The *CPA Law* is a general framework for regulating the CPA profession. More work needs to be done in order to develop a complete, scientific, and coherent regulatory regime suitable for China and in harmony with international conventions. This system includes (1) various economic management rules in finance, taxation, and accounting to support the CPA profession; (2) auditing standards to normalize audit practice; (3) a professional code of ethics to discipline auditors and accounting firms; (4) an effective administrative system to ensure the healthy growth of accounting firms; and (5) internal controls to enable accounting firms to operate efficiently....Let's do our best to develop such a system in three to five years.

²⁰ As audit firms were involved in smaller frauds, the pressure for them to develop standards was relatively small (Wang 1994). Interviewee F provided three reasons: (1) audit firms' engagements were smaller than those of accounting firms; (2) auditees would not expect audit firms to cover up their frauds; and (3) the SAA had strict control and monitoring. Interviewee D, however, pointed out that as the majority of audit firms' engagements were undertaken on behalf of the SAA, the influence of the frauds had been internalized by the SAA.

The rationale for this approach was provided by Yang (1996), the CICPA's first president: "A market economy needs regulations. The operation of a market economy requires management according to market rules. Both accounting and auditing standards are important market rules."

By 1993, a legal regime governing the CPA profession had emerged. The *CPA Law* became its centerpiece. It was supplemented by the *Bankruptcy Law* (1986), the *Company Law* (1993), the *Accounting Law* (1985, revised in 1993), the *Tentative Regulations on the Management of the Issuing and Trading of Securities* (1993), various tax laws, the *Civil Law*, the *Criminal Law*, *Accounting Standards for Business Enterprises* (1992), and other laws and regulations. Auditing standards would be important to ensure compliance with these laws and regulations. However, a complete and unified set of auditing standards was still lacking.

As auditing standards were seen as part of the legal regime, the CIAS were subsequently issued as government regulations.

The Need to Achieve International Harmonization

It was shown earlier that the open-door policy was a direct cause of the re-emergence of the private audit profession in China. The policy, however, also created a need for harmonizing Chinese audit practice with international auditing conventions. It not only attracted foreign investments, but also promoted foreign trade and pushed many Chinese companies to invest or list in overseas capital markets. However, the voluntary standards issued earlier lacked international comparability and caused many problems in the audit of companies with foreign investments (Zhang 1993). International harmonization was thus established as a principle for the development of the CIAS (Chen 1995, 1996, 1997). A Foreign Advisory Expert Group was established partly for that purpose.

The desire for international harmonization was reflected in the CICPA's busy foreign activities. For example, from 1992 to 1993, the CICPA exchanged visits with CPA societies in eight countries and was in contact with the World Bank, the International Monetary Fund, and the International Accounting Standards Committee (B. Lu 1993). The MoF, and later the CICPA, had worked toward joining the International Federation of Accountants (IFAC) since 1983 and the CICPA became a member of the IFAC in 1997. The CICPA has also maintained a close relationship with CPA societies in Hong Kong and Taiwan.

A direct push came from China's desire to rejoin the World Trade Organization (WTO). As a result of negotiations between China and the WTO, China opened up its audit market²¹ and accepted that this would become part of the world audit market (B. Lu 1993). Ding (1996c) and Chen (1997), then Director and Deputy Director of the CIASC, respectively, expected the CIAS to promote harmonization with international audit practices.

SUMMARY AND CONCLUSIONS

This paper has identified a number of factors that motivated the setting of auditing standards. Before the CIAS were promulgated, the CICPA and the CACPA had already issued auditing standards on a voluntary basis. Those voluntary attempts were made to educate auditors and auditees, improve audit quality, overcome ethical problems,

²¹ See footnotes 9 and 10.

and help their members survive the competition between accounting, audit, and other consultancy firms.

However, the voluntary standards failed to achieve their objectives and could not prevent CPAs from being involved in widely publicized financial scandals. The scandals caused confidence crises and led to the promulgation of the *CPA Law*, which requires the setting of, and compliance with auditing standards. Meanwhile, auditing standards were now seen as part of the regulatory system for the CPA profession and a growing need for international harmonization developed. The CIAS finally emerged under these circumstances.

Apart from contextualizing the developments of auditing standards in China, the above factors provide an explanation of a number of characteristics of the CIAS (e.g., being government-sanctioned, mandatory regulations, and foreign-standard based). The factors also reveal some major features of the Chinese audit market, such as the lack of audit independence, the shortage of well-qualified auditors, an environment of massive corruption, and the existence of many misconceptions about the audit. These conditions will significantly hinder the further development of the audit profession in China. In particular, they provide further evidence to support the argument that independent/professional auditing will be unattainable in China in the foreseeable future (Xiang 1998). Moreover, they will severely impair the effectiveness of the CIAS and slow down the process of Sino-foreign accounting and auditing harmonization. Most importantly, these conditions, together with their impact on accounting and auditing, mean that investments in Chinese companies will involve considerable risks. Of course, a full assessment of investment risks requires the consideration of other factors. These include the recent developments in accounting standard setting (Xiang 1998; Chen et al. 1999), the current attempts to transform state-owned accounting and audit firms into partnerships or limited corporations, and the introduction of the *Securities Law* in 1998.

History repeats itself. Just as the American Institute of Certified Public Accountants developed auditing standards in 1939 in response to the McKesson and Robbins case, the CICPA responded to the "Great Wall Fund Raising" and other major frauds with the establishment of the CIAS. This supports the perception of auditing standard setting as a means of crisis management (Chandler 1997b). However, whereas the U.S. audit profession developed standards on its own, the CICPA and its predecessors have been heavily dependent on the government. Consequently the U.S. standards had professional authority whereas the Chinese standards have resorted to the authority of the government.

The difference in the evolution of auditing standards between China and the U.K. is more significant. Although Britain established the first professional accounting body in the world in 1853 and made the audit of the balance sheet compulsory as early as 1844, British auditors were reluctant to set auditing standards until 1961, even though they were under both internal and external pressures (Chandler 1997a). By contrast, the CICPA and the CACPA developed auditing standards, voluntarily or compulsorily, in their early years. Arguably, Chinese auditors can now borrow auditing standards developed elsewhere, whereas early British auditors had no example to follow until the 1930s when auditing standards appeared in the U.S. However, even though auditing standards had been available elsewhere since the 1930s, British professional accounting bodies only began to develop auditing standards in the 1960s.

The difference may be because U.K. auditors enjoyed a better legislative and judicial environment (Hein 1963), whereas a market-oriented legal and judicial infrastructure is

emerging in China. Furthermore, it could be argued that the U.K. auditors could maintain audit quality without auditing standards because U.K. professional accounting bodies emphasized professional education, training, and examinations (Chandler 1997a). By contrast, these are still not well developed in China and thus greater attention has to be paid to the development of auditing standards. This comparison seems to suggest that the importance of auditing standards depends on how well the other elements of the system for regulating the audit profession²² are developed. It would be interesting to subject this point to further examination.

Chandler (1997c) has observed that Western auditing standards play a number of roles. This paper indicates that some of these observed roles (e.g., the educational, quality control, and disciplinary roles) are also expected by the Chinese. However, some factors identified here appear to be peculiar to China. For example, competition between professional accounting bodies promoted voluntary auditing standards in China, whereas such competition had little effect on standard setting at least before the 1960s in the U.K. Furthermore, while auditing standards were developed to perfect the legal system for regulating the audit profession in China, they are thought to have been used to stave off government legislation in the West (Chandler 1997c).

The CIAS are now expected to play an important role in advancing the audit profession (Ding 1996a; Yang 1996), although criticized by some for their lack of practicality in China (Sun 1996). It would therefore be useful and interesting to evaluate their impact. One aspect of the evaluation would be to assess whether the CIAS have achieved their intended outcomes.

²² According to the Cohen Commission (AICPA 1974), the system that regulates the audit profession comprises high standards of skills and competence, technical and ethical standards, quality control policies and procedures, and an effective disciplinary system. This system, in the view of the current authors, should also include legislation.

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