

## **Audits in China - how do they differ?**

If you are contemplating investing in or trading with a Chinese company or are already doing so, you will want to satisfy yourself about the company's financial position and results and will no doubt consider the company's financial statements. If these are audited, you may feel that you can place some reliance on them for your purposes. While a proper audit adds credibility to the financial statements, as a potential investor or trading partner you must always recognise that audits are carried out for a particular purpose and are not designed to meet your information needs. You may therefore want to commission special due diligence work to provide specific assurance on matters that are important to you. However, audited financial statements are nevertheless part of the background information that may shape your thinking, so it is worth understanding how audits in China may differ from those you are used to.

Audit is an add-on to financial reporting, designed to add credibility, so in order to understand any differences in audit, it is necessary first to understand some differences in financial reporting practice.

### **Financial reporting practice**

Firstly, financial statements for unlisted Chinese companies are not generally on the public record. This is similar to the USA but dissimilar to Europe, where the financial statements of all limited companies are on the public record (in theory, at least). Financial statements of private companies in China have to be prepared for the tax authorities and various other government bodies.

Listed companies have to use modern Chinese accounting standards (Accounting Standards for Business Enterprises or ASBEs), which are similar to International Financial Reporting Standards (IFRS), but private companies often still use the previous system. This form of financial statements is of limited use to a potential investor or other trading partner. Unlike financial statements prepared under IFRS, they are not designed to provide information of use to investors. Areas where differences often exist between financial statements prepared under the old Chinese system and under IFRS include:

- accounting for land use rights as intangible assets rather than operating leases
- doubtful debt provisions based on ageing formulae, rather than realistic appraisal of recoverable amounts
- use of 'standard' asset lives and residual values, rather than realistic estimation
- deferral of expenditure such as start-up costs and R & D
- lumping together taxes on income with indirect, sales and other taxes
- deferred tax
- inclusion of the results of subsidiaries in the parent company's individual accounts

In addition to these differences between the old Chinese rules and IFRS, unaudited financial statements of private companies often do not even comply with the old Chinese rules. Adjustments are only made when financial statements are audited and submitted to the tax bureau. So in Unaudited accounts it is common to find that:

- revenue recognition is on a cash basis rather than an accruals basis
- recognition of costs depends on whether an invoice has been received, not on whether the goods or services have been received

Having noted the potential differences in financial reporting practices, we can consider audits.

### **Audit requirements**

Chinese law says that every company shall have its financial report audited by an accounting firm each year (The Company Law of the People's Republic of China (revised in 2005) Article 165). In practice, this does not always happen. Some companies, such as listed companies,

state-owned enterprises, foreign invested enterprises and some types of company specified by local tax bureaux have to have audits but the tax bureaux do not insist on it for many private companies. Of course, some companies choose to do so without compulsion.

### **Nature of audits**

The nature of local audits is quite different from audits under International Standards on Auditing (ISAs) or US Generally Accepted Auditing Standards (GAAS). They are usually done primarily for tax or other government regulatory purposes.

CPA firms in China have been required to comply with new Chinese auditing standards since 1 January 2007. These standards are similar, though not identical, to ISAs. However, the way they are interpreted and applied by Chinese accounting firms can be significantly different from the way ISAs are applied in other countries where they have been adopted, such as throughout Europe. To understand why this should be so, you have to understand the background from which each group of auditors has come.

In China, audits come from a background of a planned economy and serving government's needs rather than serving investors' needs. Chinese auditors were used to checking 'regularity', as happens in audits of public sector bodies in Western countries, where one objective is to check whether funds have been spent only for the purposes for which those funds were made available to the entity. This is not, of course, an objective of audit in the private sector, where directors are free to spend funds as they see fit, for the benefit of shareholders.

Auditors in China also often focus heavily on the transactions and the accounting records, whereas the focus of 'Western' auditors is primarily on the financial statements and often more on the balance sheet, with the interest in the accounting records being only in furtherance of forming a view on the financial statements. One sometimes sees Chinese auditors commenting on the use of the 'wrong' account to record a transaction, when the 'right' and 'wrong' accounts are in fact aggregated for reporting in the financial statements. Other aspects that Chinese auditors typically place more importance on than Western auditors are the existence of official stamps, official receipts ('fapiao'), procedures, capital verification and approvals generally.

Some Chinese auditors can feel less comfortable about making judgements than auditors who come from a 'Western' tradition. From a rules-based background where process is more important than outcome, and where reliability is more important than relevance, there is a greater inclination to rely on formulae or rules of thumb than to reach a considered view based on what 'feels right', taking into account all the circumstances.

Another issue rooted in a cultural difference is the difficulty for audit staff of asking direct, blunt questions, for example those regarding management's knowledge of any fraud. ISAs make explicit requirements about enquiries auditors must make of management and of those charged with governance. However, in a Chinese context, these questions can seem very blunt, if not downright rude. It is not surprising, therefore, if Chinese auditors choose to go about these enquiries in much less direct ways.

### **The need for different audit methods**

Various aspects of Chinese culture and business life call for different audit methods from those one would expect to see in the West. A simple example is written versus oral evidence. The auditing literature (see, for example, ISA 500 'Audit evidence' paragraph 9) tells us that documentary evidence is to be preferred to oral evidence. However, in Chinese business life, the terms of written agreements are often vague and even where they are not they are often not followed. What determines the commercial outcome is not what is written on paper but the relationship between the parties. This can often only be gleaned by discussion with management and not by looking at the documentation.

As indicated above, the Chinese tendency to classify transactions according to their form or type rather than by their effect or outcome means that the auditor needs to spend more time looking at the individual transactions, to see whether apparently similar transactions, which have been treated in the same way, are in fact similar in nature and outcome. It is not uncommon to find wildly differing items lumped together in a single account. On the other hand, transactions with similar effects are sometimes split up and treated in different ways depending on their form and will need to be considered together in order to form appropriate audit conclusions.

Corporate governance varies widely in all countries and China is no exception. In the West, larger companies and those with greater public accountability have more formalised corporate governance systems. However, in many enlightened smaller companies, some aspects of corporate governance practices have 'trickled down'. This is less common in China, where it is very rare to find any constraints on management's absolute discretion in private companies. It is very rarely, then, that the auditor can place any reliance on the control environment in such companies.

Chinese bookkeeping tends to be mechanical, with transactions recorded according to their form, but this leaves plenty of scope for misrecording unusual transactions. Experience shows that in many companies, staff faced with a transaction that they do not fully understand will not enquire of management about it but will post it to any convenient account. This means that auditors may need to look at a larger sample of transactions and balances than they might otherwise do, in order to find the anomalous ones.

For private companies it has been the norm for the same firm to prepare the annual accounts and to audit them. Under modern international ethical rules this is still allowed, subject to appropriate safeguards, for unlisted companies but not for listed companies or their material subsidiaries. Chinese companies that are now becoming subject to the stricter independence rules often find it hard to adapt to the new relationship with their auditors. Few private Chinese companies have the ability to produce IFRS-compliant financial statements in-house and they find it difficult to understand why they should have two accounting firms involved in the preparation and audit of their financial statements.

The result of these issues is that one sees a number of audit reports in China that say that the audit has been carried out in accordance with ISAs but where this obviously is not the case. Even some audit reports themselves do not comply with ISA 700 'The independent auditor's report on a complete set of general purpose financial statements'. You only have to look at the low audit fees or the short time spent on some audits to see that they can only possibly comprise a small subset of the procedures required for an audit under ISAs or US GAAS. In many cases, one can readily see that financial statements that purport to have been audited do not comply with the stated framework (IFRS or Chinese GAAP). Another indication that some audits have not complied fully with ISAs comes in situations where our firm has succeeded another firm as auditor. When we have asked management questions that we are explicitly obliged to ask by ISAs they have questioned why we are asking, saying that they have never been asked these questions before as part of their audit. Similarly, when we have carried out other procedures explicitly required by ISAs, management have questioned why, indicating that the previous auditors never did this. It is therefore clear that there has been a wide diversity in audit practice in China.

### **Implications for potential foreign investors/trading partners**

If you want financial statements in a familiar form and providing the same information as the financial statements you are used to, you need to use an accounting firm that understands the differences in accounting standards and practices and knows where to look for things that might need adjusting. Some questions to ask when considering a firm might be:

- How do you think land use rights should be accounted for?
- How will you calculate the deferred tax provision or asset?
- How would you account for a transaction where the company has received a service but has not yet been invoiced for it?

If you want an audit that concentrates on substance rather than form, you need to choose the right firm, with the right experience. Some questions to ask of prospective auditors might be:

- How does your risk assessment work?
- How will you assess whether debts are recoverable?
- How will you satisfy yourselves that the recorded liabilities are complete?

Some things that look superficially familiar may in fact tell quite a different story. Be wary of accepting financial statements of Chinese companies at face value, even if they are audited.

**By Tony Upson, PKF Beijing. This article first appeared in Practical China Tax and Finance Strategies, published by WorldTrade Executive. For more information go to <http://www.wtexec.com/tax.html>"**