

# AUDITOR INDEPENDENCE IN POST-REFORM CHINA: A NEO-DURKHEIMIAN APPROACH

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## Abstract

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This study builds on the work of Durkheim (1915) by applying a neo-Durkheimian theoretical framework to audit failure in China following the implementation of economic reform and international auditing standards to highlight how embedded cultural norms, such as *guanxi* (a social network system involving the mutually beneficial and reciprocal exchange of personalised favours), limit adaptation and influence auditor independence. Specifically, this study adopts the grid-group dimensions proposed by Douglas (2003) to assist in understanding how Chinese auditors interpret their social relations based on cultural beliefs and overlaid them with characteristics of Chinese culture to demonstrate the influence of *guanxi*. The study is based on publicly available data focusing on the financial scandals of Yin Guang Xia (YGX) and Yunnan Green Land Biological Technology (Green Land) in China. We argue that Chinese auditing failure occurred because of socially embedded cultural values which limited thought processes and prevented adherence to formal international auditing standards. Policymakers and regulators must consider emerging economies' unique cultural environments when introducing economic reform. Different cultural contexts call for different interventions by a range of stakeholders to improve audit independence. The neo-Durkheimian (NDT) theoretical framework used in this study may be extended to examine auditing practices in other emerging economies across a range of cultures, and may also be relevant to other areas of professional practice.

**Keywords:** Auditor Independence, Corporate Governance, Culture, Guanxi, Economic Reform, Neo-Durkheimian

**Authors' individual contribution:** Conceptualization — W.H.; Methodology — W.H. and M.C.; Investigation — W.H. and M.C.; Writing — W.H. and M.C.; Visualization — M.C.

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## 1. INTRODUCTION

For almost 60 years, the controversial topic of auditor independence has been studied (Mautz & Sharaf, 1961) with increasing attention being paid to the topic after major corporate collapses in Western countries, including Enron and WorldCom in the United States (O'Connell, 2004); Independent Insurance, British Home Stores, Patisserie Valerie (Jolly, 2019), Carillion (Banham, 2018; Bhaskar & Flower, 2019) and Thomas Cook (Hodge, 2019;

Kollewe, 2019) in the United Kingdom; and One Tel (Barry, 2002; Monem, 2011), Ansett, HIH Insurance (Mak, Cooper, Deo, & Funnell, 2005) and Harris Scarfe (Kavrar & Yilmaz, 2017) in Australia (Fargher & Jiang, 2008). Failures in auditor independence have also been found in emerging economies, such as Satyam (Banerjee, 2011), Café Coffee Day, and Jet Airways (Ramasubramanian, 2020) in India (Gour, 2021) and repeated examples in China (DeFond, Wong, & Li, 1999; Allen, Qian, & Qian, 2005; Wang, Wong, & Xia, 2008; Zhu, 2012; Xiao, Yang, Zhang, &

Firth, 2016). High-profile Chinese companies such as Amoi Electronics, Yin Guang Xia, Lantian Stock, Green Land, and Grassland High Fact have been implicated in more recent examples, including (but not limited to) Kangde Xin Composite Material (Yiran, 2019), Reward Science and Technology Industry Group (Tan, 2019), Jiangsu Yabaite Technology (Shumin, 2019), Luckin Coffee (Crichton, 2020) and RYB Education (Tong, Xue, & Jia, 2021). The issue of auditor independence continues to have considerable implications for investors, policymakers, and the global profession. However, while many studies on auditor independence have focused on the collapse of companies in Western developed countries, there are limited studies examining the collapse of companies in emerging economies, specifically in China, or that consider the influence of national culture on company collapse.

This study fills the gap in research examining the link between audit independence and company collapse in China and responds to calls for further theoretical development outside the Western neoliberal context (Macve, 2021). It applies a neo-Durkheimian theoretical lens to the financial scandals of Yin Guang Xia (YGX) and Yunnan Green Land Biological Technology (Green Land) in China, to examine the influence of national culture on auditor independence. We contend that high-profile audit failure by large Chinese audit firms YGX and Green Land, which involved companies reporting excessive revenue growth, was due to the role of *guanxi*<sup>1</sup>. Through a neo-Durkheimian theoretical lens, this paper uses these cases to argue that informal systems such as *guanxi* make it difficult for institutional change such as that intended by China's Open Door policy.

There are several reasons for examining *guanxi* in relation to auditor independence in China. With the Chinese economy becoming increasingly globally integrated, there has been exponential growth in foreign direct investment and in the number of multinational corporations establishing subsidiaries in China (Wang & Tian, 2020). Further, with China implementing the Open Door policy in 1978 and the ensuing transition from a planned to a market-based economy, Chinese enterprises and the accounting profession experienced profound changes (Jefferson & Rawski, 1994; Hassard, Sheehan, Zhou, Terpstra-Tong, & Morris, 2007; Macve, 2021; Nee & Opper, 2012). Owing to enterprise reform and the separation of ownership, auditing has become an essential part of economic development in China. However, China has traditionally been known to impose minimal discipline on auditors from civil lawsuits and to have far less stringent investor protection institutions to hold auditors responsible for an unqualified opinion on materially inaccurate financial statements (He, Pittman, & Rui, 2016). This provides a fertile environment to study the influence of national culture on audit independence. Unlike Western developed societies, exchanging favours and gifts which help cultivate *guanxi* are common and acceptable business practices in China (Hwang, Golemon, Chen, Wang, & Hung, 2009), making it difficult for China to move from a collectivist culture

to an individualistic Western corporate structure that relies on auditor independence.

This paper is a historical study of two Chinese cases of audit failure, which, by applying a neo-Durkheimian frame (Tansey, 2004; 6, 2015; Linsley, Linsley, Beck, & Mollan, 2016) demonstrates how and why informal rules sometimes trump formal ones. In a neo-Durkheimian frame "informal institutions are causally key" (6, 2015, p. 771). Accordingly, we contend that the time-honoured Confucian informal rule or the "cultural-cognitive" norm of *guanxi* has proven to be far stronger than the formal rule or "regulative and/or normative" elements (Scott, 2013) of auditor independence.

In addition to extending Durkheim's (1915) theory, this study further enhances academic understanding of the strong influence of cultural and social forces on auditor independence. As Durkheim states in his discussion on the influence of religion, this "does not lie in the apparent ends which they pursue, but rather in the invisible action which they exercise over the mind and in the way in which they affect our mental status" (Durkheim, 1915, p. 361). As a result, this study provides useful insights into the powerful influence of culture on auditor independence, regardless of any formal structures that may exist. Such insights may cross borders and prove useful for governments, business organisations, and professional bodies when implementing significant institutional changes in emerging economies. Furthermore, the study provides a valuable resource for the education of current and future accounting professionals in China and internationally, as they learn from real cases about the hidden complexities and power of culture and the impact it can have on independence and the community more broadly.

The remainder of this paper is structured as follows. Section 2 reviews the relevant literature on *guanxi* in addition to neo-Durkheimian theory. Section 3 describes the research methodology and provides the conceptual framework that underpins the study. Section 4 presents the results of applying the Neo-Durkheimian theory (NDT) to two case studies which are further discussed in Section 5. Section 6 outlines the implications of our findings and highlights the importance of future research.

## 2. LITERATURE REVIEW

### 2.1. What is *guanxi*?

*Guanxi* can be defined as "the system of social networks and the relationships between people that are helpful and useful in business" ("Guanxi", n.d.). While *guanxi* is associated with Chinese culture and is often discussed in the context of business ethics in China (Liu, 2013), sociologists have linked *guanxi* to social capital (Gold, Guthrie, & Wank, 2002). Similar forms of *guanxi* can be found across a range of emerging economies, such as *blats* in Russian culture (Law, 2017), *ubuntu* in South Africa (Gade, 2012), and *wasstah* in the Middle East (Hudaib & Haniffa, 2009). Each of these is based on social relationships which involve specific responsibilities and behaviours that are not adequately reflected by traditional Western practices (Holtbrügge, 2013) in developed economies and are more relations-based.

<sup>1</sup> The mutually beneficial and reciprocal exchange of personalised favours.

*Guanxi* is one of the most important components of Chinese culture, being deeply embedded in Chinese history and the emerging Chinese market (Gong, He, & Hsu, 2013), as well as in everyday dealings in Chinese society (Hwang, Staley, Te Chen, & Lan, 2008; Law, 2010). To fully understand the uniqueness of *guanxi* in Chinese culture and the pervasive impact of *guanxi* on all decisions made in Chinese society, one must also understand its ancient origin in Confucianism.

## 2.2. Chinese culture: Confucianism and *guanxi*

Chinese culture is an ancient culture dating back to Confucius' time (550–478 BC). Confucianism is an ancient belief system grounded in social relationships embedded in all aspects of Chinese society. A critical feature of this is *guanxi*, in the form of hierarchical relationships within the government, family, and community (Gong et al., 2013). Acceptance and fulfilment of one's role in the hierarchical system are viewed as essential for the smooth functioning of society (Dunning & Kim, 2017).

As a collective social system full of personal and social interconnections, Confucianism has high regard for harmony and hierarchy, with individuals viewing themselves in terms of their relationships with others and having a strong sense of their social surroundings. This then also leads to the importance of "face" or reputation (Hofstede, 1991).

*Guanxi* is rooted in Confucianism by building relationships and social ties. While Confucianism is a way of life, *guanxi* refers specifically to the personal and social connections that exist between individuals. These relationships and connections permeate every aspect of society in China and are built over time through the reciprocal exchange of favours. Favourable treatment may be secured in both personal and organizational situations. Connections may be with extended family members or with others who share the same birthplace, educational institution, or workplace and involve implicit mutual obligations and assurances (Holtbrügge, 2013). As such, *guanxi* may be informal (derived from personal connections, such as family, familiar ties, and close acquaintances) or formal (related to hierarchy and firm-level connections derived from state ownership) (Han, 2017; Liu, Wang, & Wu, 2011).

## 2.3. *Guanxi* and business practices in China

*Guanxi* practice is "distinct from the forms of networking found in other societies" and remains "an essential feature of Chinese culture" (Nolan, 2011), dominating all business and social activities in China (Haveman, Jia, Shi, & Wang, 2017; Hwang & Staley, 2005). The cultural, institutional, and political contexts of Western countries with strong capitalist ideologies differ significantly from Chinese culture and China's institutional and political conditions (Dwivedi, 1967).

Consequently, *guanxi* is the only consistent key success factor for businesses in China (Yeung & Tung, 1996; Abramson & Ai, 1999; Hwang & Staley, 2005). *Guanxi* can take many years to nurture and cultivate as it involves building relationships

and networks. Westerners often associate *guanxi* with corruption and bribery in business transactions (Law, 2017) as *guanxi* involves the exchange of favours and gifts (Pederson, 2006; Wang, Wang, & Zheng, 2014; Law, 2017) which are common and acceptable business practices in China (Hwang et al., 2009) but strongly discouraged in Western societies (Hwang & Staley, 2005). Further, with China's relatively weaker legal system, greater importance is placed on *guanxi* to conduct business (Liu, 2013).

While *guanxi* can be healthy for a firm to maintain important relationships with a positive long-term view of collaboration by solving problems, improving efficiencies, and reducing transaction costs (Huang & Bond, 2012), it can also be unhealthy or bad when there are expectations of reciprocity that do not necessarily reflect the values of both parties and may involve corruption (Nolan, 2011). On the other hand, healthy *guanxi* is cultivated through ethical leadership (Ko, Ma, Kang, English, & Haney, 2017) by promoting what Su and Littlefield (2001) refer to as favor-seeking *guanxi* (interpersonal, reflecting Chinese moral values of loyalty and exchange of favours) and suppressing what Su and Littlefield (2001) refer to as rent-seeking *guanxi* (based on power exchange in the Chinese planned market economy). In business deals, it is possible for both favour-seeking *guanxi* and rent-seeking *guanxi* to be viewed as interfering with "independence" as individuals are focused on maintaining harmony in relationships with decisions based on family ties or social connections rather than an objective evaluation of the facts (Yeung & Tung, 1996). Thus, *guanxi* may also influence auditor independence.

## 2.4. Auditor independence and *guanxi*

Repeated instances of failure in auditor independence globally have received considerable attention in the accounting literature (Lu, 2006; Fargher & Jiang, 2008; Daniels & Booker, 2011; Suseno, 2013; Tepalagul & Lin, 2015; Kavrar & Yilmaz, 2017; Bhasker & Flower, 2019) with numerous studies examining the influence of *guanxi* on auditor independence and audit quality in China (Au & Wong, 2000; Yang, Dunk, Tang, & Lin, 2003; Zhang & Zhang, 2006; Law, 2010; Liu, Wang, & Wu, 2011; Du, Ronen, & Ye, 2015; Wu & Patel, 2015; Wu & Ying, 2016). Liu et al. (2011) established that *guanxi* affects auditor independence by showing that formal *guanxi* derived from state ownership and management connections with auditors increases the probability of receiving unqualified audit opinions at the firm level and that informal *guanxi*, or personal connections with auditors, are important to non-state-owned enterprises.

*Guanxi* is an important factor in a company's auditor selection (Wu & Ying, 2016), with personal connections and familiarity (informal *guanxi*) used by auditors to attract and retain clients. Both privately owned and state-owned enterprises (SOEs) in China rely strongly on their interpersonal or informal *guanxi* network to gain access to clients or acquire scarce resources to withhold transition uncertainty. Individuals often gain access to these resources from key persons, with whom they have

the obligatory, reciprocal, or even utilitarian type of *guanxi* (Zhang & Zhang, 2006). In China, personal connections and loyalties are often more important than professional rules or legal standards (Luo & Chen, 1996). *Guanxi* partners are considered more reliable and trustworthy, and auditors are thus more likely to be appointed through personal connections in the *guanxi* network (Zhang & Zhang, 2006). The centrality of *guanxi* for accounting firms to obtain audit engagement, especially in SOEs, was demonstrated in a study by Wu and Patel (2015), who utilised neo-institutional theory to explain the “loose coupling” of *guanxi* as a core feature of Chinese culture and in the adoption of new institutions.

With *guanxi* deeply embedded in Chinese culture, and personal relationships being seen as more important than professional rules, auditors in China may compromise their integrity and professionalism in order to maintain healthy *guanxi*. For example, auditors who have close *guanxi* with managers are less likely to recommend adjustments. As a result, *guanxi* is responsible for undermining auditors’ ability to correct earnings management (Du et al., 2015). Further, in Chinese societies where auditors have joined their former audit clients as employees, auditor independence has been found to be compromised to maintain healthy *guanxi*, as the audit team is more reluctant to challenge the decisions of the former colleague (Law, 2010).

Au and Wong (2000) found that *guanxi* affects auditors’ professional judgment and that an auditor’s level of ethical reasoning is an important mitigating factor. Auditors have intentionally helped clients falsify accounts or provide false certificates of capital contribution verification and unqualified audit reports because of *guanxi*, with audited clients committing illegal acts such as forging accounts to mask true financial positions, tax evasion, embezzlement, and appropriation of state assets (Yang, Dunk, Tang, & Lin, 2003). This is primarily because *guanxi* elevates the importance of harmonious relationships over other obligations and responsibilities. In this paper, we examine this phenomenon through a neo-Durkheimian lens and argue that the concept of “independence” is difficult to reconcile in Chinese society where *guanxi* is central to all decisions and promotes harmony and relationships. An independent decision that may risk destroying a harmonious relationship will be avoided (Lim, 2009); thus, a person is unlikely to resist foreign wills to maintain their independence. This interplay between harmony and independence is further developed in the next section.

## 2.5. Neo-Durkheimian theory

Neo-Durkheimian theory (NDT) is a relatively unexplored branch of institutional theory (Tansey, 2004; 6, 2015; Linsley et al., 2016; Abdelrehim, Linsley, & Verma, 2017) and complements the extant work invoking institutional theory (Hoffman, 2007; Barbu & Baker, 2011; Smothers, Murphy, Novicevic, & Humphreys, 2014; Bruce & von Staden, 2017).

Broadly speaking, the institutional theory attempts to account for how the behaviour of “players” — actors and organisations — is shaped by the surrounding institutions or formal and informal “rules of the game” in which they are embedded (North, 1990). As Zhou, Gao, and Zhao (2017) argue, “(b)ecause institutions reflect a nation’s history, culture, and ideology, they create the rules of the game and regulate business activities through formal and informal constraints” (p. 378). Consequently, the aforementioned enterprise reforms and the concomitant changes to the auditing profession in China represented an attempt by “institutional entrepreneurs” — both individuals and professional associations engaged in “institutional work” — to shift from a “state logic” to a “profession logic” by means of institutional change in terms of altering formal and informal rules apropos auditor independence (Yee, 2020).

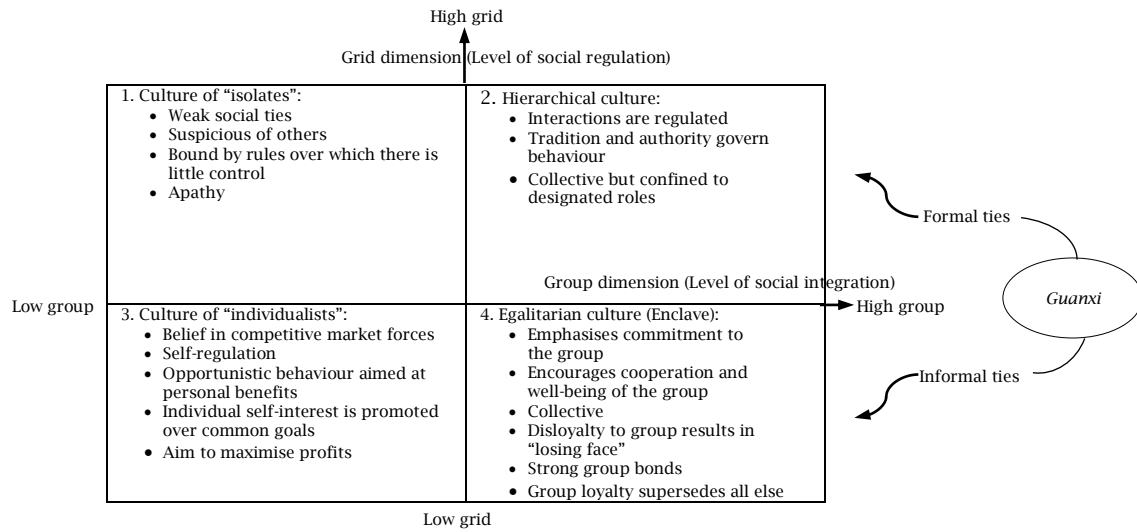
NDT highlights the critical impact of socio-cultural dynamics on human behaviour by building on Emile Durkheim’s premise that, because culture exerts a strong impact on human cognition, individuals interpret their social context based on cultural values and beliefs. The latter therefore exerts a subtle but powerful influence on behaviour akin to a type of unconscious motivation (Wright, Berrell, & Gloet, 2008; Tansey, 2004). Douglas (2003) augmented this idea, positing that our preferences apropos to our ways of life are highly dependent on how social relations are arranged. Adherence to a particular way of viewing the world legitimises a consequent type of social relationship (Linsley et al., 2016). In this way, “informal institutions are causally key...[and] cultivate biases in people to seek, deliberately or otherwise, to deepen, amplify and reinforce that institutional ordering, both by blinking against the imagination of other possibilities and by cultivating institutional imperatives to operate in prescribe ways” (6, 2015, p. 771). Furthermore, NDT suggests that cultural biases can legitimise a corresponding form of social relations.

## 3. RESEARCH METHODOLOGY

### 3.1. Conceptual framework

We have adopted the grid-group dimensions proposed by Douglas (2003) to assist in understanding how individuals interpret their social relations based on cultural beliefs and overlaid them with characteristics of Chinese culture in Figure 1 to demonstrate the influence of *guanxi*. Applying Durkheim’s two dimensions of social regulation and social integration produces four different ways of life as reflected in the four quadrants. The model supports the legitimacy aspect of institutional theory as “the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (Suchman, 1995, p. 574).

**Figure 1.** Grid-group dimensions and *guanxi*: A Neo-Durkheimian approach



Sources: Adapted from Douglas (2003), Loyens (2003), and Linsley et al. (2016).

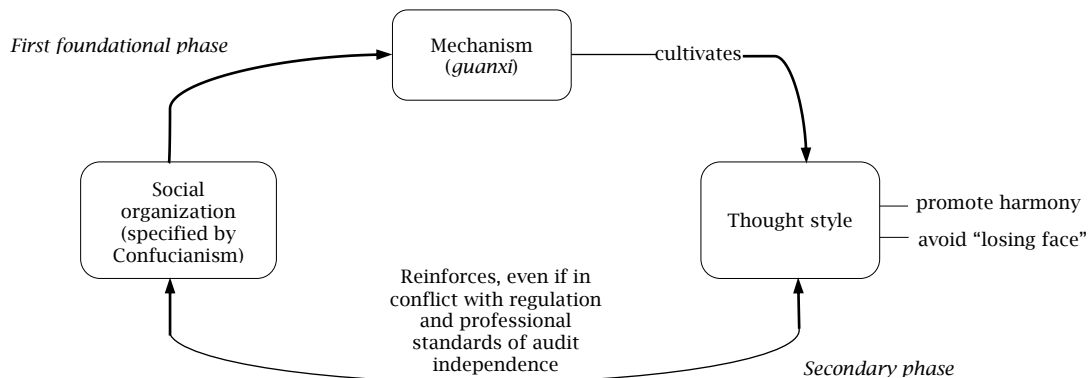
We present the way of life according to Chinese national culture on the right-hand side of Figure 1, reflecting shared ontological assumptions, including Confucian notions of collectivism, group norms, and *guanxi*. Views of the self differ across quadrants and thus cultures, particularly between Western and East Asian cultures, where the Western "self" is "an independent self, which perceives itself as separate from others", and the East Asian culture is "an interdependent self, which sees itself as connected with others" (Littlewood, 1999, p. 79). While the self in Western culture is of the autonomous individual, "characterized by independence and separation individuation" (Fishbane, 2001, p. 273) as represented in quadrant 3 of Figure 1, it differs from East Asian cultures that emphasise harmony and cooperation and place importance on preserving "face" as represented in quadrant 4.

NDT argues that informal institutions, such as those provided by *guanxi* in Chinese culture, impact

how people make decisions and may stifle accounting reforms implemented in emerging economies in the face of globalisation if the reforms are inconsistent with local circumstances and needs (Hopper, Lassou, & Soobaroyen, 2017). Just as it is not possible to fit a round peg into a square hole (Smith, as cited in Bell, 1980), it is not possible to turn a collectivist institutional society — which has been using *guanxi* for thousands of years — into an individualist one by simply introducing policies.

When people in a group share the same attitudes, customs, and beliefs (collectivism), they tend to act in ways that reinforce those institutions. Institutions amplify cultural biases, thus creating a "feedback loop" whereby the foundational informal social organisation cultivates thought styles, which then leads people to act in ways that reinforce that same social form (6, 2015). To demonstrate this, we have incorporated *guanxi* into 6's (2015) model as shown in Figure 2.

**Figure 2.** Conceptual model of NDT in a high group context (China)



Source: Adapted from 6 (2015, p. 772).

In accordance with NDT, our model demonstrates the excessive reliance on the foundational informal social organisation of Confucianism in China, triggering the mechanism of *guanxi* which promotes harmony and undermines the new form of institution introduced through the Open Door

policy, thus reinforcing existing cultural norms. The model provides the conceptual framework that underpins the methodology in this study and allows for descriptive analysis of audit failure in China following the implementation of economic reform and international auditing standards.

### 3.2. Methods

This study adopts an interpretive research approach that utilizes the case study method to provide a rich understanding of the institutional context and the dynamic processes associated with auditor independence in China. It utilizes two high-profile cases to investigate the auditor independence experience in an emerging economy with powerful unwritten social codes.

The company collapses of YGX and Green Land at the turn of the century provide useful historical experiences that can be interpreted through NDT to understand the phenomenon associated with auditor independence in China following economic reforms. The case studies utilize a variety of historical documents, including data sourced from publications of the China Securities Regulatory Commission (CSRC), annual reports lodged with the Shenzhen Stock Exchange, and documents published on websites and in public media (such as news). All the data collected was from publicly available resources and covered the years 1996 through 2013. Documents that were published in Chinese were translated from Chinese to English prior to analysis. A Chinese native speaker reviewed the translations for accuracy. While this study's focus was on the archival evidence of two case studies, the authors also acknowledge that alternative methods suitable for this research may include surveys and/or in-depth interviews with key actors in cases concerning auditor independence in post-reform China.

The data collected for this study was triangulated and the concept of NDT was applied using the conceptual framework presented in Subsection 3.1. Through a neo-Durkheimian lens, a descriptive analysis of audit failure for the two case studies was conducted to demonstrate the challenges of adopting institutional reform in the form of international accounting standards, when embedded cultural norms exist.

## 4. RESULTS

The main case study findings of YGX and Green Land as they relate to NDT and impaired auditor independence in post-reform China are presented below.

### 4.1. Yin Guang Xia

Yin Guang Xia (YGX) was the first publicly listed company in the Ningxia Hui Autonomous Region. Before corporate reform, YGX was a well-known and important state-owned enterprise. After restructuring, YGX became a company limited by shares with a board of directors, a board of supervisors, and managers. YGX issued 74,000,000 shares to the public in 1993 when approved by the Ningxia Hui Autonomous Region Economic Restructuring Committee, the Chinese Ministry of Foreign Trade and Economic Cooperation, and CSRC. Stocks traded on the Shenzhen Stock Exchange were referred to as "China's first blue chip stock" for their impressive performance.

Upon listing, YGX's market capitalisation was more than 1,458 million yuan<sup>2</sup> which was the highest on the Shenzhen Stock Exchange for the transportation segment in which it was categorised. Unlike its segment competitors, much of YGX's activity involved agribusiness, mainly in grape planting, wine-making, and wine sales.

From 1998 to 2000, the annual reports of YGX showed large revenue growth (49%), with the profit margin increasing from 14.6% in 1998 to 46% in 2000, and the cash flow-to-revenue ratio increasing from -3.4% to 13.7%, as shown in Table 1.

**Table 1.** Summary of financial data: YGX

<i>Measure</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>
Profit margin	14.6%	24.3%	46%
Asset turnover ratio	46.1%	26.1%	32.6%
Debt ratio	53.8%	53.7%	57.1%
Interest coverage	3.3	3.22	7.00
Cash flow to revenue	-3.4%	-1.1%	13.7%
Operations index	-23.3%	-4.4%	29.7%

In 2001, a major financial scandal involving YGX was exposed, alleging "impossible production, impossible price, and impossible output" (Jin, 2001) in relation to the reporting of exports to a German company by a subsidiary company, Tianjin Guang Xia (TGX). The productive capacity of TGX did not support the claimed output, the export price of products was absurd, and some products did not comply with the export contract in Germany.

From 1998 to 2001, YGX declared cumulatively fraudulent revenues, totalling 1,049.626 million yuan, resulting in inflated profits of 771.567 million yuan. Due to the loss of financial information on TGX in 1998 and in previous years, the actual profit of YGX in 1998 could not be determined. In 1999, 2000, and the first half of 2001, YGX reported significant profits, which in fact resulted in substantial losses, as shown in Table 2 (Chinese Securities Regulatory Commission [CSRC], 2002).

**Table 2.** Fraudulent profits and the actual loss of YGX from 1998 to 2001

<i>Year</i>	<i>Inflated profits (million yuan)</i>	<i>Actual profits/(loss) (million yuan)</i>
1998	17.761	N/A
1999	177.819	(500.320)
2000	567.047	(149.401)
2001 (1~6 months)	8.94	(25.571)
Total	771.567	(675.292)

Source: CSRC (2002).

Underlying YGX's fraudulent activities was the need to demonstrate financial solvency to attract investors, while the reality was that their large diversification investments were unsuccessful. In the annual auditing process for YGX, the Shenzhen Zhong Tian Qin public accounting firm signed unqualified opinion reports in 1999 and 2000, suggesting that auditors did not discover inflated profits, fake sales contracts, or other fraud. As the auditors did not follow the procedures outlined in the Independent Auditing Standards, the fraud went undetected, and the audit reports failed to disclose accounting fraud. Further, auditors who lacked knowledge of foreign trade and were not

<sup>2</sup> 230.4 million United States dollars. As at February 2022, 1 million yuan equals approximately 158,000 United States dollars.

professionally competent were appointed to the auditing project based on their close relationships with the auditees (Wu & Ying, 2016). This involved maintaining close interpersonal relationships and reciprocal obligations for the sake of social harmony, as prioritised in Chinese culture over all else (Ramasamy, Yeung, & Chen, 2013).

Further testimony to the power of *guanxi* in China, this scandal also engulfed the Shenzhen Certified Public Accountants (CPA) Association, which was tasked with the role of supervising and inspecting the auditing activities of public accounting firms in that province and sought to maintain harmonious relationships and healthy *guanxi* with public accounting firms. Members of the Shenzhen CPA Association included many partners from public accounting firms, including a partner in Shenzhen Zhong Tian Qin. Consequently, they gave “face” to Shenzhen Zhong Tian Qin to maintain a harmonious relationship — one of the fundamental philosophies in Chinese culture (Caia, Cohen, & Tribe, 2019), and so the disclosure of the fraudulent activities to other supervising departments did not occur.

YGX was imposed a fine of 600,000 yuan (CSRC, 2002). However, considering the degree of damage caused by this corporate scandal, the punishment was merely symbolic. The fine was not large enough to deter auditors from choosing the ancient custom of *guanxi* over new auditing independence standards and regulations.

Applying the conceptual model in Figure 2 to the YGX case, we can see that in a relationship-rich society such as China, strongly grounded in Confucianism and characterised by *guanxi*, the “transplant” of auditor independence into China as a new institution struggled to be fully adopted, with harmony and “giving face” dominating all thought processes. While auditor independence requires auditors to avoid any relationship likely to impair objectivity, this is at odds with the Chinese tradition, where auditing is viewed as a critical social function involving critical sociocultural activities. In the case of YGX, the conceptual NDT model suggests that to promote a harmonious environment, giving face was important in building and maintaining the ethical code of good *guanxi*, even if it conflicted with newly introduced auditing independence standards and regulations. Thus, the case study demonstrates the strong influence that *guanxi* exerts on auditor behaviour in China, as explained by NDT as akin to a type of unconscious motivation that reinforces existing social structures.

While the auditors did not uncover fraudulent transactions, even if they did, according to the conceptual model, *guanxi* would have restricted them from disclosing these activities, as this would risk destroying a harmonious relationship (Lim, 2009) and “losing face” (Hofstede, 1991; Caia et al., 2019). Thus, to ensure the smooth running of society, as alluded to by Dunning and Kim (2017), informal rules of *guanxi* were accepted over the new formal rules contained in the Independent Auditing Standards. This extended to the supervisory body (Shenzhen CPA Association), responsible for supervising the audit firm (Shenzhen Zhong Tian Qin) which also placed *guanxi* above their formal requirement to disclose fraud by avoiding disharmony and “giving face” to the audit firm.

Accordingly, the unwritten informal rules of *guanxi* are more supportive of the “interdependent” conception (Littlewood, 1999) that exists in a high group society that emphasises harmony and cooperation, as opposed to the “independent” conception of an individualistic society which involves confrontation and competition (see Figure 1). Thus, NDT can provide a useful lens through which to examine the influence of culture on auditor independence in developing and emerging economies when implementing regulatory reform.

Since the YGX scandal occurred during the early stages of Chinese enterprise reform and convergence to international auditing standards, it could be argued that auditors had insufficient time to develop the “critical distance” from the sway of the informal norm of *guanxi* to act differently (Jun Lin, Xiao, & Tang, 2008; Whittington, 1992). However, after the YGX scandal was disclosed, and despite China adopting additional Western regulations to converge to international practice (e.g., the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, Chinese CPA Implementation Standards, and Chinese Auditing Standards), instances of corporate scandal and auditing failure in China continued, such as that provided by Green Land. This highlights the strength of the “cultural-cognitive” norm of *guanxi* over the introduced “regulative and/or normative” elements (Scott, 2013) of auditor independence.

#### 4.2. Yunnan Green Land Biological Technology

Yunnan Green Land Biological Technology (Green Land) became the first listed company in the horticultural industry and the first listed company in Yunnan province, listing on the Shenzhen Stock Exchange in 2007. Green Land was an agricultural enterprise at a time when agricultural development was of crucial importance to the development of the entire Chinese economy (Zhao & Tang, 2018) with agricultural production in China achieving rapid growth (Mrówczyńska-Kamińska & Bajan, 2019). Green Land’s registered capital was 150 million yuan, compared to its main competitor, Dengai Seeds, with a market capitalisation of 880 million yuan. Green Land owned 29,000 acres, with its main business activities including the greening of cities through design and construction, seedlings for planting, and greening project sales. From 2004 to 2007, Green Land’s revenue more than doubled, as did operating cash flows, as shown in Table 3.

**Table 3.** Green Land profit data: 2004 to the first half year of 2006

	2004	2005	2006	Total
Net profit	33.421	37.236	47.070	117.727
Revenue	146.736	157.792	190.545	495.073
Net operating cash flow	19.937	3.349	47.517	70.803

Note: Unit: 1,000,000 yuan.

Source: IPO prospectus of Green Land (Shenzhen Stock Exchange, 2007).

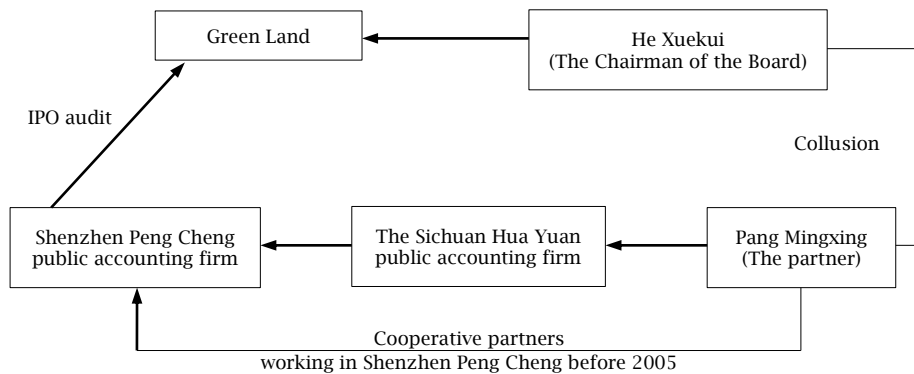
Green Land had been committing accounting fraud since 2004, mainly by inflating assets through false contracts. The Shenzhen Peng Cheng public

accounting firm reported unqualified opinions on Green Land's financial reports in 2004, 2005, and 2006, and the first half year of 2007 (Yunnan Green Land Biological Technology Co., Ltd., 2007, p. 3). Applying our conceptual model in Figure 2, we argue that this was because the complex *guanxi* between Green Land and the public accounting firm that had begun several years earlier dominated auditors' thought processes, thwarting auditor independence as required by the new professional standards.

He Xuekui, the Chairman of the Green Land Board of Directors, appointed Jiang Kaixi as the chief financial officer (CFO) in 2001 and issued some original shares. In 2003, Jiang Kaixi introduced

He Xuekui to an auditing expert, Pang Mingxing, a partner in a public accounting firm, Sichuan Hua Yuan, who helped Green Land engage in fraudulent accounting procedures immediately prior to their listing. It is significant that Shenzhen Peng Cheng handled the initial public offering (IPO) audit for Green Land because Pang Mingxing had earlier been an employee of Shenzhen and the two firms had a good working relationship, as illustrated in Figure 3 which enabled the development of *guanxi*. We argue that this *guanxi* was responsible for Green Land's falsified annual reports which allowed it to list.

Figure 3. The relationship between Green Land and public accounting firms



The Green Land case demonstrates the neo-Durkheimian notion that “informal institutions are causally key” (6, 2015, p. 771), insofar as Chinese auditors' ability to achieve independence is hampered by the cultural-cognitive norm of *guanxi*. Applying our conceptual framework, *guanxi* was responsible for undermining Pang's ability to correct earnings management (Du et al., 2015) and helping Green Land falsify accounts, resulting in unqualified audit reports (Yang, Dunk, Tang, & Lin, 2003). Although this *guanxi* ethos conflicted with professional auditing standards, the thought process demonstrated unconscious motivation (Wright et al., 2008; Tansey, 2004) to prioritise human relationships over all else, as the “reciprocity of favor exchanges is the most pervasive rule guiding Chinese social and economic interactions” (Chen & Chen, 2004). In accordance with the conceptual model, this simply reinforced the close informal ties between Pang Mingxing and Green Land.

In addition, to maintain good *guanxi*, the Chinese supervision departments promoted harmony and “gave face” by approving Green Land's IPO application, failing to follow policies and procedures in carrying out their work duties (Leung & Wong, 2001). With *guanxi* deeply embedded in Chinese culture, placing personal relationships above all else, including laws and professional rules, is legitimised.

## 5. DISCUSSION

Supporting DeFond, Wong, and Li (1999), our findings suggest that government regulation alone is insufficient to create financial markets that foster auditor independence. When people in a group share the same attitudes, customs, and beliefs (such as

maintaining healthy *guanxi*), they tend to act in ways that reinforce those institutions because culture exerts a strong impact on cognition (Douglas, 2003).

Thus, in countries with a strong cultural and political environment, such as China, NDT demonstrates that auditing professionals need to cultivate a new cognitive framework to enable true auditor independence. With culture “the ‘social glue’ holding people together” (Lee, 2015, p. 1), cognition cultivation, or “thought style” is likely to be stifled unless there is a significant shift in cultural context.

NDT can assist in explaining the behaviour of players involved in each of the two case studies, as their actions are shaped by informal, socially constructed institutional rules which have been embedded into their way of life (North, 1990) and accepted as legitimate (Suchman, 1995).

Applying a conceptual framework of NDT, the case studies of YGX and Green Land showed that while Chinese auditing practices increasingly adopted formal international standards in the post-reform era, auditors continued to use *guanxi* to promote harmony and audit engagements. *Guanxi* is in direct conflict with the spirit of auditor independence, which made it difficult to enforce insofar as the well-established Chinese culture did not change. Chinese auditing failure and financial fraud occur because culture cultivates a particular thought style that limits individuals' cognitive development, making it difficult to make sense of new institutional concepts such as auditor independence. This is explained by NDT which suggests that culture has an invisible power over the mind (Durkheim, 1915) and that informal rules, without appropriate levels of punishment, will continue to trump formal ones. Stronger punishment by Chinese authorities through fines and other



disciplinary actions for auditors rendering an unqualified opinion on materially inaccurate financial statements may help shape future behaviour to align with more formal rules, but this may take some time, given the influence of ancient culture.

This study highlights the importance of national culture on auditor independence. While China's intention of adopting international auditing standards was to improve the quality of Chinese auditing reports and encourage foreign investment, the real challenge was in changing the "socially embedded and unwritten codes that influence people's daily activities" (Ostrom, 2005, p. 18).

## 6. CONCLUSION

Our study extends the work of Douglas (2003), Loyens (2003), and Linsley et al. (2016) on grid-group dimensions and applies a conceptual neo-Durkheimian theoretical framework to two case studies in China to demonstrate the powerful influence of the time-honoured Confucian "cultural-cognitive" norm of *guanxi* on auditor independence. Although there are penalties for breaching auditing standards in China, the socially embedded culture can result in auditors attaching more importance to informal social rules (*guanxi*) than formal written rules, such as professional auditing standards containing "regulative and/or normative" elements of auditor independence. Studies show that this may result in unqualified audit reports, even when auditing standards are not followed, supporting Ostrom's "rules-in-form vs. rules-in-use" (Ostrom, 2005, p. 138).

Durkheim (1915) suggested that one must free oneself of all pre-conceived ideas, passions, and habits. To do this, auditors might be encouraged to gain exposure to different and new ways of doing things by working in international audit firms (Liu, 2013) or pursuing accounting education in other countries with different cultural values. Furthermore, Chinese universities could incorporate more international case studies and international mobility into their accounting programs. Cross-cultural education of accountants is of international importance, as other cultures also learn more about Chinese culture to assist them in conducting business in China.

This study also has implications for investors in emerging economies, as audits conducted by local firms may rely more heavily on cultural norms than

on international auditing standards. Locally trained auditors may also be exposed to a greater risk of imprisonment, and large financial fines should they expand their work internationally and continue to place higher importance on national culture and social connections and relationships than on the relevant legal requirements of the country where they perform their auditing role.

While this exploratory case study research is limited to two case studies spanning the short period of the introduction of new institutions and their regulations in China, the results as informed by NDT may be transferable to comparable situations (Eisenhardt, 1989; Streb, 2010) in other emerging economies. This paper is important for future research as it provides a new explanatory conceptual framework that can be used to analyse the impact of embedded cultural norms across a range of contexts. Future research could use the neo-Durkheimian framework adopted in this study to examine auditing practices in other developing and emerging economies across a range of cultures and investigate whether emerging economies with strong cultural influences can successfully transform audit practices over time. Similarly, the framework could be applied to other corporate governance practices where new policies and procedures are introduced.

Policymakers and regulators must consider the unique cultural environment of their countries when attempting to introduce regulatory reforms. Different cultural contexts call for different interventions by a range of stakeholders to improve audit quality. The research demonstrates how NDT can assist in understanding the importance of informal institutions, such as national culture, on how people may make decisions and why these decisions may not always be in accordance with the prevailing laws or policies of a formal institution, such as a government or profession. Although auditor independence is a core value for auditors, there is no such thing as pure independence because human beings are social beings who are heavily influenced by their cultural environment. This is especially true in relationship-oriented societies such as China, which values *guanxi*. By using NDT as a new lens to examine audit independence, this study also serves as a useful resource for current and future accounting professionals to understand the strong influence of culture on audit independence in an emerging economy and the implications that this may have for broader society.

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