LEGAL AND REGULATORY MODEL FOR THE AUDIT PROFESSION: THE UK AND CHINESE MODELS COMPARED

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The article discusses whether the UK's liberal regulatory model for the audit profession could benefit China as it continues its reform towards a western-inspired liberal market economy. China has already carried out substantial reforms: the disaffiliation programme, audit industry consolidation, and the diffusion of international audit norms. However, substantial deficiencies in the Chinese audit profession remain, and corporate audit continues to lack credibility. Adopting a system modelled on that used in the UK could resolve these issues. However, if China chose to adopt the UK's liberal regulatory model, it would not only require economic reform, but also structural reform to its political system. This would include removing conflicts of interest between the audit profession and companies controlled by public authorities; the development of an independent self-regulatory system accountable to the judiciary; corporate democratisation; the development of private enforcement and the introduction of an independent judicial system.

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Introduction

China has experienced tremendous economic growth since the Open Door policy was initiated in the late 1970s with the intention of modernisation and improvement to living standards. This has led to a state-directed market economy that also embraces the establishment of the liberalist financial markets that open up the country for investment both foreign and domestic, public and private. Acceptance of western liberal market economics, facilitated by the financial markets, has brought it with an increasing importance of the audit profession which acts as gatekeeper for corporate governance and safeguards market confidence by ensuring the probity of company financial and business affairs.The audit profession has become an indispensable element in the western liberal market economy and China, in modernising its economy towards a similar system, has introduced professional audit and made attempts to align it with western standards of independence, objectivity and integrity. It also now requires the skills and judgement expected of the western audit profession.

Despite reforms to the audit profession, deficiencies remain and foreign regulators have expressed concerns about the credibility of the audit profession in China. The question for policy-makers, regulators, and investors is to what extent, and under what conditions, China can continue improving the standard of its audit profession and audit quality. If China's intention is to build its economy based on the liberal economy model, should a liberal regulatory model also be used for the audit profession? This article will use the UK's liberal regulatory system as a potential model for China's reform of the audit profession and will examine the problems that China would face in introducing such a model. In doing so, the paper will firstly identify the steps that China has already taken to modernise its audit profession and point outthe major deficiencies that continue to jeopardise its audit credibility. Secondly, the main features and characteristics of the UK's liberal regulatory model will be discussed as a suitable device for the development of the liberal market economy towards which China is working. Thirdly, the paper will identify the problems that China would encounter in implementing such a liberal regulatory model. In conclusion, it will attempt to envisage to what extent this regulatory model might be adopted, and specify the conditions needed to make such a model operate effectively.

I. CHINA'S LIBERALIST REFORM OF THE AUDIT PROFESSION

A. The Making of Modern Chinese Audit Profession

China has recognised the audit profession as an indispensable element in the operation of the financial markets which drive economic growth. The quality of audit depends on the professionalism of the auditors: their independence, objectivity, integrity, as well as their skill and judgement. To this end, China's liberalist reform has had three objectives: disaffiliation of audit firms from public authorities, consolidation of a fragmented audit industry, and the adoption of international audit standards.

The first two objectives represent a fundamental structural reform that goes beyond simply prescribing the behaviour norms and know-how for the audit profession. The aim is to place the auditors of a consolidated industry in an open market at arm's length from the companies they are auditing, in order to ensure their independence.

B. Disaffiliation of the Audit Firms from the Public Authorities

Audit firms in the past have been affiliated with public authorities, and this poses a major problem by compromising the independence of the audit process when auditing public projects. Audit quality is jeopardised. Disaffiliation has therefore been essential and has served three purposes: first, introducing an arm-length relationship between auditors and audited companies; second, minimising political interference by public authorities during the audit process; and third, providing enforcement bodies with market-oriented disciplinary actions against both auditors and their client firms, without undue interference from public authorities.

Before 1996, Chinese audit firms were affiliated with the public authorities: firms affiliated to administrative units such as government agencies or government controlled not-for-profit organisations and firms affiliated with academic institutions such as universities. The majority of the senior partners in audit firms were formerly public officials.[1] Affiliation and connection with public authorities gave firms a high percentage of the audit

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[1] D Wong, *The Development and Reform of the China's Audit Firms*, 17 MODERN BUSINESS TRADE INDUSTRY, 163 (2011).

market share[2] because former public officials working in the audit firms maintained good links with public authorities, granting them privileged access to the audit market. Such an affiliation of audit firms with public authorities reduced audit independence and damaged the credibility of the audits, especially the many audits carried out on enterprises owned and controlled by public authorities.[3]

To make things worse, former public officials working in the audit firms were not adequately trained modern auditing techniques and the skills required for credible audits. Auditors who were former public officials, through their connections with public authorities, were able to provide the audited companies, as well as the audit firms, with undue protection against enforcement by designated bodies such as the Chartered Institute of Certified Public Accountants (CICPA) or the provincial branch of the CICPA, because the CICPA officials were former colleagues of the auditors.

For this reason, in 1996 the Chinese government started a process of disaffiliation that was nominally completed in 1998. Despite this, informal affiliation between audit firms and local or central public authorities continues. And those authorities still dominate most of the economically significant enterprises. Many of them are listed companies, so the supposed arm's length separation is in practice blurred, resulting in *de facto* conflicts of interest.

C. Audit Industry Consolidation

By comparison with western liberal economies such as the UK's, the Chinese audit market was fragmented with many local and small audit firms that could easily give in to the pressure from the management of large, state-controlled enterprises. They were therefore unable to deliver independent audit opinions. In such an over-fragmented market, audit firms competed fiercely for audit business and tried to please the management by not embarking on audit switches at a cost to investors or to the detriment of market confidence. This "over-competition" through market fragmentation with too many small, local firms and too few large-scale firms compromised the independence of the audit process.

To remedy this structural deficiency of excessive fragmentation and competition, it became a regulatory objective to consolidate the audit

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[2] C Lin & H Lin, *Auditor Size, Brand Name Reputation, Market Competition and Audit Fees: Evidence from China*, 49 THE INTERNATIONAL JOURNAL OF ACCOUNTING STUDIES, 35-72 (2009).

[3] L Hua, G Georgakopoulos, I Stoiropoulos & E Galanou, *Main Principles and Practices of Auditing Independence in China: A Multifaceted Discussion*, vol. 6 no. 7 ASIAN SOCIAL SCIENCE, 3-11 (2010).

industry[4], to have fewer firms in the market, to make audit firms and auditors avoid the practice of "low-balling" (reducing fees for the first audit with a view to gaining more audit and non-audit services in other units of the audited state enterprise) and to resist management pressure on the audited companies for audit switch.[5] Local audit firms without a national-level operation can easily submit to pressure from the management of companies which are controlled and owned by local public authorities. The rationale is that if audit firms are large, have a solid financial basis, have access to the most up to date audit expertise, and are given powers in law and by political mandates, they will be more resilient against management pressure to deviate from audit norms. Furthermore, a more consolidated audit industry with a small number of large firms would also offer those firms the opportunity to develop the modern skills necessary for the kind of audit appropriate for the development of financial markets.

However, despite China's efforts to consolidate the audit industry, the problem remains. As already mentioned, local governments control a large number of Chinese companies through shareholdings, and audit firms retain a close relationship with local governments because of their affiliation with administrative units through personal relationships. Not surprisingly, local governments also exercise administrative control over their auditors through local finance departments and the local branches of the CICPA. Companies controlled by local public authorities tend to choose local audit firms, or to switch to local audit firms and be away from non-local ones, if they issue qualified reports. In an attempt to gain business, local audit firms tend to charge less to local companies than consolidated national firms. Furthermore, since consolidated national firms are also keen to gain business from state enterprises, they practice "low-balling". Chinese governments have therefore issued a number of laws controlling the fees charged.[6] This is further evidence of the dysfunction of the audit market despite the fact that competition was meant to increase audit quality.

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[4] The Document No. 56 of 2009 Issued by the Chinese State Council (In Chinese), *available at* http://www.gov.cn/zfwj/bgtfw.htm.

[5] The Chinese Securities Regulatory Commission in 2000 issued "The rules governing the qualification of auditors for the auditing of listed companies" (In Chinese), *available at* http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/.

[6] *See* the law given jointly by the Commission of National Development Bureau and the Ministry of Finance on the rules governing the audit fee, *available at* http://www.china.com.cn/policy/txt/2010-02/01/content_19344360.htm (In Chinese). Further more, the local governments can also issue the similar law. In Hu Nan province *see* http://www.hnczt.gov.cn/cztnews/TongZhiGongGao/10824.html (In Chinese), in Jiang Xi Province *see* http://www.jxdpc.gov.cn/departmentsite/sfc/jggl_3836/sfgl/qtsfgl/201109/P020110901630532488091.doc (In Chinese) and in Liao Ning Province *see* http://www.cicpa.org.cn/topnews/201112/t20111208_31635.htm (In Chinese).

D. Adopting International Audit Norms

This is the process of transplanting international audit norms, know-how and behaviour to the Chinese audit regulatory system. Since China started its economic reform in the late 1970s, many market-based audit concepts have gradually been introduced into the regulatory system. China recognises the need to modernise its audit profession and to bring it into line with up to date international standards. Auditors' norms of independence, objectivity, and integrity have now been transposed into law. However, the diffusion of these norms has largely been undertaken by central, as opposed to local, administration so the current[7] problem is not whether the norms have been written into the accounting books, but whether their enforcement is effective. In addition to the problem of historical affiliation, the unbalanced development of court systems across the country means that many local courts are not conversant with modern concepts of corporate audit and corporate governance, so they are unable to provide meaningful enforcement in actions brought by private individuals.[8]

The central public authorities control companies which are mostly monopolistic, and therefore have less concern for corporate profitability and growth. That is not to say that such companies can be given the benefit of the doubt on the credibility of their audits.

II. THE UK LIBERAL REGULATORY MODEL

A. Essential Features and Characteristics

The liberal regulatory model of the audit profession in England and Wales is characterised by market-driven regulation and enforcement that is orientated towards the interests of investors. Auditors are expected to be independent of the companies they audit, and to work on behalf of investors. Since the purpose of audit is essential to promote the efficient flow of information in financial markets, rather than furthering any political agenda,

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[7] This can be seen in a number of regulations issues by the CICPA including in 2000 "The rules governing audit integrity and the evaluation of the assets of the audit firms" *available at* http://www.cas.org.cn/xwdt/xydt/13875.htm, in 2003. The rules governing of the integrity files of the auditors *available at* http://www.cicpa.org.cn/Legal_norms/bmgz/200804/t20080428_3163.htm，and in 2008 "The system of disclosure by auditors and the audit firms" *available at* http://www.cicpa.org.cn/Column/Information_regulations/Audit/200805/t20080530_12678.htm (In Chinese) and in 2007 "The guidance on the internal governance of the audit firm" *available at* www.cicpa.org.cn (In Chinese).

[8] X, Kawn, *The Judicial Intervention in Corporate Governance in China*, 4 TRIBUNE OF POLITICAL SCIENCE AND LAW (In Chinese) (2009).

self-regulation forms the basic governance ethos. Freedom of negotiation and private contracting between audited companies and their auditors form the regulatory principles with a view toreinforcing audit standards and quality. Since investors, rather than the companies being audited, are the main stakeholders in financial markets, greater power for them is built into the corporate structure with the effect of diffusing management power and increasing the arm's length relationship between companies and auditors. In this way, the accountability of auditors is enhanced. Arm's length audit goes hand in hand with an open audit market which itself operates as an enforcement tool in the liberal regulatory model. In an open and competitive market, auditors not only face legal risks in an audit failure, but their reputation is also at stake. This is a significant threat when credibility is highly valued by investors. As in most liberal regulatory regimes in which public enforcement does not play the primary role, the state does not make the law, rules and regulations that lead to direct criminal and civil sanctions. This prevents political interference by the state fromentering the private sphere of the liberal market economy.

The next sections discuss these features of a liberal regulatory system for the audit profession based on the UK model. The questions to be borne in mind are: to what extent this liberal model could be implemented in China; what conditions are needed to make the model operate effectively there, and at what cost.

B. A Liberal Profession and Self-Regulation

Auditors in England and Wales are private professionals rather than civil servants or semi-public state officials, whether for tax collecting purposes or compiling national statistics.[9] UK auditors enjoy the power to define their own identity and are free to negotiate that identity with market participants, societal stakeholders, and public authorities. The audit profession is not state-defined or state-led and the state does not have direct control over it.[10] Auditors can offer non-audit services and can associate with other professions in providing services. A number of professional bodies govern auditors, including the Chartered Institute of Accountants in

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[9] In England and Wales, solicitors and barristers, although not strictly civil servants, are officers of the court.

[10] This is specifically provided by Article 2.2 of the 8th Company Directive of EU that member states may designate "professional associations" as authorities responsible for approving statutory auditors and ensuring that the requirements of the Directive are met. These self-regulated professional bodies are competent authorities whose acts or omissions are questions of public rather tan private law and can be open to challenge in courts.

England and Wales (CIAEW), the Association of Chartered Certified Accountants (ACCA), the Association of International Accountants (AIA), and the Charted Institute of Public Finance and Accountancy (CIPFA).[11] Scotland and Ireland have equivalent bodies: the Institute of Chartered Accountants of Scotland (ICAS), the Institute of Chartered Accountants in Ireland (ICAI). These professional governing bodies are private associations recognised under UK law as Recognised Qualifying Bodies (RQBs). They are not directly under the control of the state but are subject to state approval so long as the state is satisfied that their rules and practices are such that only members meeting the standards required are granted the right to carry out statutory audit. Furthermore, there is no monopoly of a single association supplying auditors, and this ensures a degree of competition amongst the associations on the supply side of the audit industry. Each association regulates its own members. Thus, for example, the ICAEW sets the requirements for a person to be qualified as one of its members and to undertake corporate audits. It is responsible for issuing its own professional ethical rules[12], investigating alleged defaults committed by members and for exercising disciplinary power.[13]

The professional bodies have their own regulatory and disciplinary power.[14] Although their decisions are subject to judicial review (a proceeding to review the decision of a body which exercises a function in the interest of the public), there is no direct control by pubic authorities such as the Treasury (the UK equivalent of the Ministry of Finance in China) or the Department for Business, Innovation and Skills (the UK equivalent of the Chinese Ministry of Economics). The state does not have direct disciplinary power, neither does it set mandatory accounting standards, provide official guidelines nor supervise the practices of auditors. Instead, the Financial Reporting Council acts as a supervisory body quite separate from any government department.[15] It consists of a number of bodies such as the Independent Accounting Standards Board, which governs accounting standards and is responsible for regulating corporate reporting and

[11] Others professional bodies include The Institute of Chartered Accountants of Scotland, the Institute of Chartered Accountants in Ireland, the Charted Association of Certified Accountants.

[12] The FRC and ICAEW together issued the Audit Firm Corporate Governance Code in 2010 in response to the criticised audit firm's responsibility in the collapse of Lehman Brothers.

[13] *See* the web page of the Chartered Institute of the Accountants in England and Wales *available at* http://www.google.co.uk/search?hl=en&q=ICAEW&meta=.

[14] Their Chinese counterparts do not currently possess these powers.

[15] In Roman England, municipalities and cities were established on the legal form of corporation. Although the municipalities and cities had autonomy, the court could appoint an auditor to inspect their state of affairs in the interest of the King's Court, representing public interest.

governance.[16]

In addition to professional rules, much of the quality control of audits is maintained and promoted through competition in the audit market where reputation plays a vital part because investors in financial markets place crucial importance on the credibility of auditors and audit firms.

The question for China is whether such a liberal identity of the audit profession, whose function is to serve the private benefit of providing efficient information flow in the financial markets, can sit comfortably with its existing social arrangements. Furthermore, can self-regulation without political mandates be constitutionally possible and practically viable, bearing in mind the problems of historic personal affiliations, the imbalanced development of the judicial system, and the need for further consolidation of the audit industry?

C. Private Enforcement and Freedom of Negotiation

1. Civil Liabilities of Auditors

Civil liabilities enforced by private individuals—mainly audited companies and investors—are a legal risk for auditors. In theory, the greater the risk, the greater the vigilance by the auditors, so that an increase of the legal risk will increase audit quality. However, legal risk can become overwhelming, and this can result in fewer audit firms in the market. It can also pose a problem in recruitment to the audit profession, thus reducing the talent pool and the capacity to offer good audit services. A balance has therefore to be struck when considering civil liability regime for auditors and the freedom of auditors to negotiate optimal contracts between, on the one hand, providing redress to damaged parties, and on the other, audit capacity in the market.

In the UK, auditors or audit firms owe a contractual duty and a professional/expert duty of care to client audited companies. Under section 498 of the Companies Act 2006, auditors have a duty to carry out amandatory investigation into corporate affairs in order to form an opinion. Whether the shareholders of a client company or the general investors—the so-called interested third parties—would have claims against auditors has never been a clear-cut point under English law. The general principle says that auditors owe a duty of care to shareholders as a whole, rather than to individual shareholders. This does not mean that shareholders cannot bring a

[16] *See* the web page of the Financial Reporting Council *at* http://www.frc.co.uk/.

derivative action against auditors. Auditors do not owe a specific duty of care in tort to investors who suffer a loss, without any other supporting circumstances, by simply relying on audit reports issued by the auditors. The restriction on individual shareholders' and investors' action against an audit is to prevent excessive legal risk being imposed on the profession.

That being said, with an increase of statutory rights—reflecting their duties and complementary to the rights of third parties—conferred on auditors, there is an increased expectation of auditors as gatekeepers for maintaining trust and confidence of the market from investors and the users of audit reports. It is possible to manage concerns about excessive damage to auditors by providing clear circumstances in which the element of proximity, a legal requirement in tort law, can be established. For instance, professional investors or financial institutions may demand audits to be carried out by a particular audit firm and if their demand for and reliance on the specific and particular audit opinion has been made known to the auditors, this may give rise to the legally required element of proximity.

The question for China is whether an increase in legal risk could effectively enhance audit quality. Who would bring a legal action against auditors and their firms if the audited companies fail to do so? Does the current legal system allow private individuals to bring an action against auditors? Even if the legal system allows such a legal action to be brought, would a court be able to adjudicate the case competently and fairly in order to provide appropriate redress? Would civil legal sanctions unduly burden the development of a liberal profession or might they have the benefit of encouraging talented auditors at the expense of those falling below the standard?

2. The Use of the Limitation Liability Agreement

Excessive and disproportionate legal risk could have adverse consequences to the development of the profession by imposing extra financial burdens on small and medium size audit firms. If a larger firm were to collapse, it could significantly reduce audit capability in the market. To avoid this, auditors can restrict their civil liability through legal agreements (contract). The rationale is similar to choose the LLP as the associative business form to manage legal risk.

In the UK, the use of an agreement to restrict/limit an auditor's legal liability was not allowed until the coming of the Companies Act 2006. This Act allows an auditor's civil liability to be limited so long as their main terms are authorised by the shareholders of the audited client company, and so long as the amount to which liability limited is fair and reasonable.[17] What is fair and reasonable is a question of law and fact.[18] This provision affirms the fundamental role of freedom of contract whereby the parties regulate their affairs with respect to their rights and liabilities by way of contract. In most situations, it is for a board of directors to provide the necessary rationale and persuade shareholders to accept such an agreement. The Companies Act 2006 provides procedural protection to investors before they enter into such a contract.[19] Such investor protection is only possible when the shareholders' meeting is a forum to hold the board and the auditors to account. Minority shareholders, likely to be those who did not vote for the agreement, can bring a lawsuit to challenge the validity of the agreement.

As already mentioned, contracts—even though approved by shareholders at a general meeting—should be fair and reasonable in law and courts have the power to develop rules for the allocation of risks.[20] This demonstrates multilayer control within the liberal regulatory model.

There are two questions here for China, one practical and one legal. The practical question is: Could such a limitation agreement be used to escape liability incurred by poor audit function and could the reduced legal risk defeat the purpose of further audit industry consolidation? The legal question is: Is there scope for this kind of interplay between the management of audited companies, the majority shareholders (likely to be local public authorities) and the minority shareholders, under the existing corporate structure? Even if there was, would the courts have the capability to scrutinize an agreement if asked to by the shareholders?

3. Minority Shareholders' Protection in the Appointment and Removal of Auditors

The power to appoint and remove an auditor demonstrates who can form a direct relationship with the auditor and demand accountability. The appointment of an auditor can be determined by market competition and is dependent on the relative power of the management, the majority shareholders and the minority shareholders of the audited company. But the removal of an auditor signifies something different. Often an auditor is removed not because another auditor can offer a more competitive service,

[17] Companies Act 2006 s 534.
[18] Companies Act s 537(1). The agreement is effective to limit the auditor's liability only to the amount that is fair and reasonable in the circumstances, having regard, amongst other things, to the auditor's responsibilities under the Act and the professional standards expected of the auditor.
[19] Companies Act 2006 s 534 (2), 535 (1), and 536.
[20] Companies Act 2006 s 537.

but because there is something wrong in the audit mission. When there are legal consequences of a removal of an auditor, the removal can become subject to regulatory surveillance. This prevents audit switches, should an unqualified opinion be expected of the auditor by the audited company?

In the UK, an auditor can be appointed by ordinary resolution either by the board of directors or by shareholders at an accounts meeting.[21] Whoever appoints the auditor will have the right to set his remuneration.[22] A board of directors has the power to terminate a director's appointment during his term of office but, by contrast, directors do not have the power to remove an auditor during his term of office[23] unless the shareholders at a general meeting approve the removal by an ordinary resolution.[24] The power of shareholders to appoint, set the remuneration and remove an auditor from office is an important element of the UK liberal regulatory model. This diffuses corporate management power over the auditors. In this way, the law confers rights and powers to the shareholders to regulate auditors by increasing the arm-length relationship between a company and its auditors.

In addition to board control, where non-executive directors can scrutinise the audit engagement and control by shareholders at the general meeting, the audit committee also plays a role in the internal governance of audit engagement. Audit committees have long been considered an important institution in assisting boards of directors in improving the transparency and integrity of financial reporting. They are expected to enhance the quality of financial reporting by commenting on, and approving, accounting policies, reviewing financial statements, and maintaining and reviewing the adequacy of internal controls. Research has shown that the effectiveness of audit committees is affected by factors such as size, independence, the number of meetings and the financial expertise of committee members.[25] The audit committee acts by providing checks and

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[21] Companies Act 2006 s 489.
[22] Companies Act 2006 s 492.
[23] Companies Act 2006 s 510(4).
[24] Companies Act 2006 s 510 (1), (2) (a), (4).
[25] L Abbott, S Parker & G Peters, *Audit Committee Characteristics and Restatements*, 23(1) AUDITING, 69-87 (2004); Y Zhang, J Zhou & N Zhou, *Audit Committee Quality, Auditor Independence Internal Control Weakness*, 26(3) JOURNAL OF ACCOUNTING AND PUBLIC POLICY, 300-327 (2007); L Abbott, Y Park & S Park, *The Effects of Audit Committee Activity and Independence on Corporate Fraud*, 26(11) MANAGERIAL FINANCE, 55-68 (2000); D McMullen & K Raghunandan, *Enhancing Audit Committee Effectiveness*, 182(2) JOURNAL OF ACCOUNTANCY, 79-81(1996); Y Gendron & J Bedard, *On the Constitution of Audit Committee Effectiveness*, 31(3) ACCOUNTING, ORGANIZATIONS AND SOCIETY, 211-239 (2005); R STEINBERG & C BROMILOW, AUDIT COMMITTEE EFFECTIVENESS: WHAT WORKS BEST (2nd ed., Institute of Internal Auditors 2000); R Weiss, *Audit Committee Characteristics and Monitoring Effectiveness: An Evaluation of Independence, Financial Expertise, Firm Support, and Oversight Activities* (VDM Verlag 2009).

balances to the board and by de-centralising the power of appointment and removal. Making auditors accountable to the audit committee and the audit committee answerable to the board can further avoid possible conflicts of interest between the board and the auditors, a problem that exists between the management of state controlled companies and their auditors in China. In this UK model, although the strict legal relation is still between the company and the auditors, in practice auditors are also accountable to other players in the internal control system and not just to the sovereign corporate which has most control over the audit engagement. By giving rights to shareholders in such a corporate democratisation process is evidently a more effective method for diffusing management power over auditors and instilling a separation of powers, in order to bring about audit accountability.

Hence the question for China is: What rights do shareholders, including minority shareholders, have in the appointment and removal of auditors? If shareholders were to share power with management, and the power of auditing committees was increased, would corporate democratisation be enhanced so that auditors were made more accountable for their actions?

D. Promoting Competition through Limited Liability Partnership (LLP)

Limited liability partnership, a legal innovation equivalent to a limited liability company, allows auditors to form an association in order to carry out audits without being held personally liable for acts committed by another partner. In the UK, an audit firm can choose a limited liability partnership (LLP)[26] under the Limited Liability Partnerships Act 2000 as the business entity tomanage the legal risk of being held liable for another auditor's liability.[27] An LLP acquires a separate legal entity, and the client audited company could only bring a contractual claim, an easier claim than a tort claim, against the firm rather than the individual auditor. The company may also bring an action in tort against an individual auditor.[28] In deciding whether or not an auditor who carries out an audit is liable to a client, the

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[26] Partnerships Act 1890.

[27] For audit firms' involvement in bringing about UK LLPs, *see* J Freedman, *Limited Liability Partnerships in the UK: Do They Have a Role for Small Firms?*, The Governance of Close Corporations and Partnerships US and European Perspectives (J McCahery, T Raaijmakers & E Vermeulen eds, OUP Oxford 2004), at 293; For general partnership law reform *see* G Morse, *Limited Liability Partnership and Partnership Law Reform in the United Kingdom*, The Governance of Close Corporations and Partnerships US and European Perspectives (J McCahery, T Raaijmakers & E Vermeulen eds, OUP Oxford 2004), at 317.

[28] *Williams v Natural Life Foods Ltd* [1997] 1 BCLC 131 (CA). The CA decided in this case that a company director was personally liable for negligent advice on the basis that he had assumed personal liability.

courts would have regard to various factors including whether the auditor of the LLP assumed personal responsibility for the audit, whether the client relied on the assumption of responsibility, and whether such reliance was reasonable.[29]

On this basis, the auditors' choice for the business form between a normal partnership and an LLP is liability-driven and, to a great extent also, fiscal-driven (taxation). On one hand, auditors choose the optimal business arrangements through an LLP and a limited liability agreement against legal risk of an audit failure. On the other hand, the audited companies choose the audit firm whose limited liability range for an audit failure is acceptable to them. Such a market arrangement affirms the principle of freedom of contract where the parties can allocate their risks freely. Through competition, the market will weed out undesirable firms as the audited companies will not engage with an audit firm with an unacceptable limited liability range and the audit firm will not carry out an audit of a company if an audit failure would damage the ability of other auditors in the same firm to carry out audits.

Allowing this kind of arrangement gives small and medium-sized firms greater opportunity to engage in corporate audits, because they can limit financial exposure associated with civil liability. Allowing audit firms to organise themselves as LLPs in this way enhances competition in the audit market and provides a greater choice of auditors and audit firms, which can then serve more companies in the market.

The question for China is whether a form of the UK LLP would provide adequate redress to audited companies who suffer a loss due to an audit failure, so as to maintain investor confidence and also to remove excessive financial exposure of civil liability. If the UK type of LLP can enhance competition, a market form of regulation, should China encourage it in its currently fragmented audit industry?[30]

E. Public Enforcement

The UK public authorities have comparatively little scope in making, implementing and enforcing rules that lead to criminal and civil sanctions. Although the Secretary of State, under the Companies Act 2006, can make provision by regulations, the self-regulatory body of the Financial Reporting

[29] *Williams & Anor v (1) Natural Life Health Foods Ltd (2) Richard Mistlin* (1998) 1 WLR 830.
[30] D Han, *Influence of New Auditing Standards on Small and Medium Accounting Firms and Countermeasures*, 25 (5) JOURNAL OF JILIN PROVINCE ECONOMIC MANAGEMENT CADRE COLLEGE, 26-32 (2011).

Council makes the majority of the regulations of the audit profession. Public authorities do not have the power of direct supervision or direct power to set standards. The Secretary of State has no general power to revoke the authorisation of an auditor individually approved by a professional body and there are no intermediate sanctions available to the state, such as the power to reprimand, fine or suspend authorisation for a period. It is for the individual professional body to decide if an auditor member should be removed from membership. One of the exceptions is the power conferred on the Financial Services Authority (FSA), the UK's financial market regulator, by the Financial Services and Markets Act 2000 to disqualify an auditor appointed under the same Act for the purpose of auditing an "authorised person",[31] from being the auditor of any authorised person or any particular class of authorised person.[32] However, such a specific and precise power given to the FSA does not extend to a general one to disqualify an auditor from practising.

To disqualify an auditor or a firm, either a private individual or a state department such as BIS and FSA must make a complaint to the professional body, i.e., the Chartered Institute of Accountants of England and Wales (CIAEW) against an auditor CIAEW member. The CIAEW Investigation Committee has the power to investigate such a case and to refer it to the Disciplinary Committee, which in turn has the power under the Charter to make disciplinary orders against an auditor and/or firm. Parties who are not satisfied with the decision of the Committee may appeal to the Appeal Committee, whose decision is subject to judicial review based on the principle of "reasonableness" as set out in *Associated Provincial Picture Houses v Wednesbury Corporation*.[33]

Such an arrangement shows that the professional body is not subordinate to the state regulators, but is a self-regulatory professional body whose disciplinary powers are beyond direct state intervention. The professional disciplinary body can act independently without the interference of the state. Even the state would have to submit to the power of the self-regulatory body in a complaint against an auditor. This is particularly important when the public authorities have a direct interest in an audited company, and hence could not be expected to act in good faith and impartiality in disciplinary proceedings.

For China, this would imply a submission of the state power to the private self-regulatory authority whose decisions can only be scrutinised by

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[31] Financial Services and Markets Act 2000 s 340.
[32] Financial Services and Markets Act 2000 s 345.
[33] *Associated Provincial Picture Houses v Wednesbury Corporation* (1948) 1 KB 223.

the judiciary. Constitutionally, this may prove to be legally difficult if not impossible. In practice, how strongly can a self-regulatory body, without political backing from any public authority, resist political interference, especially from the local public authorities, when an auditor or firm is subject to disciplinary action? Whether self-regulation can be made accountable to the judiciary in order to ensure fairness and proportionality, is still uncharted territory in China?

III. PROBLEMS OF ADOPTING THE UK LIBERAL REGULATORY MODEL IN CHINA

A. Not a Liberal Profession and No Self-regulation

The UK considers auditors belong to a liberal profession that provides commercial services. China does not approach the audit profession in the same way and nor does it consider self-regulation to be either legitimate or sufficient. For China, relationships between the audit profession and third parties need state regulation. Chinese auditors are by their nature semi-public officials.[34] Auditors' examinations and admission are directly administered by the Ministry of Finance; it is only after going through the state-administered admission system that a person can be authorised to conduct a statutory audit.[35]

Thus, the audit profession is a state-defined and state-led profession under the direct supervision of the Chartered Institute of Certified Accountants (CICPA) which was established in 1988. The state-controlled CICPA has governing statutes that must be endorsed and approved by the Finance Department of the State Council.[36] It is also stipulated in the Charter of the CICPA that it is a national social group, subject to the leadership of the Ministry of Finance.[37] At the provincial level, "self-regulatory audit professional bodies" need to be approved and guided by local finance departments.[38]

When regulatory power and disciplinary power are vested in public authorities, they are prone to political interference. This is particularly the case when the function of the relevant public authority is not precisely or

[34] D Wong, *The Development and Reform of the China's Audit Firms,* 17 MODERN BUSINESS TRADE INDUSTRY, 163 (2011).
[35] The CPA Law Art. 7.
[36] The CPA Law Art. 34; *Also see* The CPA Law Art 35, the CICPA undertaking to establish professional standards and rules for auditors.
[37] J LI, HISTORY OF AUDIT IN CHINA (vol III Foreign Languages Press, Beijing 2007).
[38] The CPA Law Art. 34.

specifically defined. So, for example, the Communist Party, through its appointment of a secretary-general to the Communist Party committee within the CICPA, influences the decisions and policies of the CICPA. The secretary-general of the CICPA is currently the Vice-Minister of Finance. The presence of the Communist Party in commercial associations is not uncommon in China and such interference reduces the scope for the audit profession to develop its own rules through negotiations with other economic actors and societal stakeholders.

Under the current model, the CICPA implements the laws and regulations issued by the Ministry of Finance and the Ministry may delegate the power of rule-making to the CICPA. The CICPA's rule-making process, policy direction, and enforcement are thus influenced by the political agenda of the central government. For instance, the CICPA issued the Ethical Standard Rules in 2009, enforceable in 2010. These are to implement "the opinion for speeding up the development of the audit firms" issued by the Ministry of Finance.[39] This effectively makes the CICPA subordinate to the Ministry of Finance and the Communist Party.

The CICPA's regulatory function can go beyond the remit of promoting audit standards. In 2012, the CICPA issued an order capping at 40% the number of foreign-qualified partners that a Chinese Big Four affiliate may have as of August 2012, and at 20% by 2017. The rules also provide that each of the Big Four's senior partners eventually must be Chinese citizens. This is an example of how CICPA's supervisory power can be driven by political agenda.

For China to relinquish statecontrol over the audit profession would require a political transformation. This would involve the Ministry of Finance and the Communist Party giving away their power over the profession. At a practical level, allowing auditors to be a liberal profession free to develop rights and duties for itself, through negotiation with other economic players, may not be ideal in the current situation where the public authorities may also be the client audited companies.

B. LLP for the Audit Industry Consolidation Rather Than Competition

In China, the CAP Law provides limited liability for auditors. It is easy for an audit firm to obtain limited liability status in China and this gives them extra protection against legal risk. Furthermore, limited liability status also helps individual auditors consolidate their businesses so as to increase

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[39] For the law, *available at* http://www.cicpa.org.cn/Legal_norms/Laws_regulations/200910/t20091012_19190.htm (In Chinese).

audit capacity in the market. This law, similar to the UK's LLP, facilitates the process of consolidating the audit industry and modernising China's audit firms, especially if audit firms need to be disaffiliated from the public authorities.

However, the adoption of limited liability status in the UK and in China serves very different purposes. In the UK, LLP is intended to increase the number of audit firms in the market and thereby increase audit market competition. In China, audit firms are offered the benefit of this status with the aim of encouraging individual auditors to group together and reduce audit competition. The idea is to create more "Big Four" like audit firms with a view to increase audit quality, since more talents and skills can be pooled to undertake complicated audits. Currently, China does not see competition in the audit market as a means of increasing audit quality, but rather to generate more financially robust firms through consolidation, with the result that they can resist management pressure from the companies they audit.

C. Limited Freedom of Contracting

Freedom of contracting is an important element in the UK's liberal regulatory model where private individuals have been given power to protect themselves through negotiation. This is also a method of increasing market competition when an auditor's financial exposure for audit failure can be limited. The use of a contract to restrict an auditor's liabilities is not known in China.[40] There have been discussions about the use of liability limitation agreements to improve audit competition following the same economic rationale as in the UK. However, no legal or regulatory provision has been made to that effect. In the UK, the rationale for allowing a liability limitation agreement is to improve the audit market competitiveness so that small and medium-sized firms would be in a better financial position to offer more risky audit services. The ability of auditors to enter into a liability limitation agreement serves the further purpose of increasing competition in the UK audit market because a sudden collapse of audit firms can lead to a shortage in the supply of audit services.

However, these arguments do not apply in China since China's audit market share is not dominated by the Big Four audit firms. The audit market is over-competitive and the balance of bargaining power lies with the audited

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[40] The competition argument used in England and Wales is not applicable to China. *See also* C Chen, *Market Competitiveness and Big 5 Pricing: Evidence from China's Binary Market*, 42 (1) INTERNATIONAL JOURNAL OF ACCOUNTING, 1-24 (2007). For arguments against market competition as regulation *see* C Wang & X Xu, *The Government's Control over the Listed Companies*, 6 INDUSTRIAL TECHNOLOGY & ECONOMY (2004).

companies. Companies controlled by local public authorities tend to employ small and medium-sized audit firms rather than the Big Four or internationally affiliated audit firms, because smaller and medium sized firms are less powerful in resisting financial or political pressure from the companies.

Furthermore, since neither companies nor investors bring civil suits against auditors or audit firms in court, liability limitation agreements would not be useful in achieving the objective of further audit industry consolidation. Minority shareholders do not acquire the right to bring an action against auditors for an audit failure if the company decides not to bring such an action. Even if an action can be brought in a Chinese court, the general civil law, though progressively developed since 1978, has not been developed to the extent that it is able to cope with as many eventualities as English common law. Even though there is still a debate about the scope of civil liability in contract[41] and in tort that is available for protecting investors against auditors, the Chinese courts do not have adequate skills or understanding of the modern concept of auditing. In addition, the institutional arrangements of the judicial system differ significantly from the UK's judicial system. The courts, especially local ones, are prone to administrative influence by public authorities which control the companies.

Furthermore, the UK's model places emphasis on the disclosure of the liability limitation agreement to the shareholders at the general meeting for their approval. China has not yet laid down a corporate governance in which shareholders, either majority or minority, and other independent committees can monitor the suitability of the liability limitation agreement.

D. China's Absence of Corporate Democratisation

One important factor missing in the Chinese model is the regulation of the appointment and removal of auditors. In the UK, there are provisions for the appointment and removal of auditors, under which shareholders are at liberty to remove auditors by an ordinary resolution at a general meeting.[42] There are procedures to follow for exercising this power and there are legal effects and consequences for the removal of the auditor.[43] Auditors have a right to report to the general meeting and to notify public authorities.

[41] G Yu & Z Hao, *Adaptive Efficiency and Financial Development in China: The Role of Contracts and Contractual Enforcement*, 11 JOURNAL OF INTERNATIONAL ECONOMIC LAW, 459-494 (2008).
[42] Companies Act 2005 s 510 & 511.
[43] P MORTON, AN INSTITUTIONAL THEORY OF LAW: KEEPING LAW IN ITS PLACE 155 (Clarendon Press, Oxford 1988); Law as enabling, *see* N MAC CORMICK, INSTITUTIONS OF LAW: AN ESSAY IN LEGAL THEORY 155 (OUP Oxford 2007).

The absence of an institutionalised framework for shareholder democracy has two implications. Firstly, the board has full power in negotiation with the auditors and this becomes the only power to which the auditors are accountable. Non-controlling shareholders and minority shareholders have no power to monitor in the governance. Secondly, if a non-controlling shareholder cannot issue proceedings in court over the issue of appointment and removal of auditors, the courts lose the opportunity to develop regulatory norms to protect investors. Unlike in the UK, where shareholders do not normally control the board, Chinese companies are controlled by shareholders who have the power to appoint the board of directors. If shareholders are to play a part in audit governance, minority shareholder protection should be addressed in the legal system.

E. Reliance on Public Enforcement

1. The Absence of Judicial Involvementin China

The courts do not play a role in the regulatory model in China because courts and prosecutorial offices are controlled at the local level. Therefore, courts and prosecutorial offices pay significant respect to the power of local public bodies which often control local companies as well as having significant influence on the audit firms through historical affiliation. The relationship between the Supreme Court and the local courts is not the same as in the UK. Local public authorities, through the power of the local people's assembly and the local political standing committee, have more power than the Supreme Court in local courts. This would have an impact on the effectiveness of imposing administrative and criminal sanctions on auditors in order to improve audit quality.

Administrative control is the most popular regulatory tool in China, and administrative regulations, special laws, and criminal laws are used to discipline auditors for breaching the law. This has the effect of increasing their legal risk, and hence improving audit quality. In China, administrative enforcement is considered indispensable and more effective than private enforcement by boards, shareholders, and investors. However, the absence of the courts' independent power to override administrative decisions, as in the UK through judicial review, allows public authorities to make arbitrary decisions.

Criminal liability can be used against auditors but local governments play a significant role in the proceedings and this can undermine the objectives that the proceedings set out to achieve. The CPA Law provides mandatory investigation for violations of the law and three major departments have the power of investigation: the people's police, the prosecutorial office and the National Security Department. Under Chinese law, prosecuting power rests with the prosecutorial department. If there is a violation at the provincial level, a provincial department should launch an investigation and refer the case to the provincial prosecuting department in order to launch a prosecution. This touches upon a sensitive area of politics involving the appointment and removal system of chief prosecutors. A provincial chief prosecutor is nominated by the national chief prosecutor. However, the appointment must be approved by the provincial people's assembly. Furthermore, the provincial people's assembly also controls the budget of the prosecutorial department. Without the aid of investigation by the local public authorities, it is unlikely that criminal proceedings against auditors can be brought successfully. This further demonstrates that the effectiveness of pubic enforcement can be undermined by the lack of an independent judiciary.

2. Public Enforcement Comes Before Private Enforcement

A further powerful enforcement institution is the China Securities and Regulatory Commission that supervises China's capital markets.[44] It regulates the financial reporting and share trading of listed companies according to the Temporary Rules and Regulations on the Management of Share Issues and Trade promulgated by the State Council in April 1993.[45] The potential punishments of auditors by the CSRC include warning, fine, suspension or termination of practice. A sanction by CSRC will be followed by a civil lawsuit by the investors against the auditor and/or the firm. In fact, civil lawsuits against auditors of listed companies can only be brought after a CSRC administrative sanction. Since 2000, the CSRC has introduced a number of regulations aimed at consolidating the audit industry as well as allowing firms to set up cross-province branches. This aims at improving audit quality by encouraging non-local audit firms to undertake audit services in the market. In 2001, CSRC also introduced a further law (supplementary audit statement No 16) that requires companies launching IPOs and re-financing to have a supplementary audit by an international audit firm. The same law also requires B-share listed companies to have a double audit, in other words audit by a resident auditor as well as an auditor

[44] M Firth, P Mo & R Wong, *Financial Statement Frauds and Auditor Sanctions: An Analysis of Enforcement Actions in China*, 62 JOURNAL OF BUSINESS ETHICS, 367-381 (2005).

[45] For the arguments justifying CSRC's control over the auditors in China *see* X Xu, *Governance for Auditors in Securities Markets*, master dissertation, Southwest University, China 2004 (In Chinese).

outside China. Since 2003, the CSRC has required periodic rotation, as in the UK, through its ethical rules.

The CSRC therefore acts as a powerful supervisory body over the audit profession. Top-down control, centralised administration, and the absence of court intervention are a consequence of the CSRC's enforcement model. Private investors can only rely on the CSRC's actions against auditors for audit failure. Furthermore, the CSRC's power is restricted to listed companies. Non-listed companies cannot be disciplined and controlled by the CSRC. Hence, companies controlled by local government, and their auditors, can avoid entanglement with the regulation and enforcement power of the CSRC. Reliance on CSRC's enforcement provides no incentive for China to develop a private enforcement regime, which is an important aspect of a liberal regulatory model. This further damages the enforcement of audit quality of local government controlled companies.

CONCLUSION

Adopting the UK's liberal regulatory model for the audit profession would require China to change many of its current procedures. It would need to recognise auditors as members of a liberal profession free from state intervention. The services provided by such a liberal profession would be for the private benefit of companies, investors and the market. When this is the case, self-regulation forms the basis of governance, aiming at maintaining investors' confidence in the financial and investment market, as opposed to direct state regulation which can be driven by non-market agenda. Since an audit failure would invite civil liability for causing damage to companies and investors of market companies, private action is the main means of enforcement in the liberal model. Auditors can also be given the choice of limiting their civil liabilities by forming a limited liability partnership or by a limitation agreement to reinforce the ethos that the market can be a means of enforcement. China would also need to introduce corporate democratisation into its company law regime by conferringon shareholders and investors the power to make auditors accountable through general meetings, audit committees and in court. It follows that an impartial and competent judicial system is required to adjudicate any disputes that may arise.

However, if China were to opt for a UK-style liberal model, its difficulties would lie not only in its economy policy but also in political reform. Where pubic authorities continue to control Chinese enterprises through shareholdings, as well as exercising direct supervision over the audit profession, a*de facto* conflict of interest is created since an audit should be carried out with independence, objectivity, and integrity. To yield supervisory control over the profession to the profession itself could damage the current institutional arrangement in which the Communist Party leads the course of economic development. Corporate democratisation by conferringon shareholders, especially minority shareholders, the power to make auditors accountable can directly challenge the management and the majority shareholders who are normally public authorities. An impartial judicial system is required to resolve disputes according to a robust system of civil law and procedural rules. China would need to resolve the conflicts between the central judicial body and the local courts, which are influenced by local politics. The prevailing reliance on public enforcement removes the incentive to develop private enforcement and this slows down the process of corporate democratisation.

Even though China has experienced tremendous economic growth in recent years through developing a western-inspired liberal market economy, the adoption of a liberal regulatory model to further the process could introduce uncertainty into its economic development. The introduction of a liberal regulatory model would come with unacceptable political costs.

So, to answer the question in the title of this article, the introduction of a liberal regulatory model for the audit profession could provide China with a means of convincing critics that its audit system is reliable and thereby encouraging international investment. But bringing about the changes necessary would place great strains on the Chinese political regime which sets great store by state control and place little trust in the ability of private individuals or companies to regulate themselves. The Chinese must therefore balance the benefits of liberal self-regulation by the audit profession against their reluctance to trust the probity of individuals without state control. Chinese culture and history have always emphasised top-down control, so it may well be that introducing a liberal audit system, such as the UK’s, is a step too far for China’s rulers and if they want to reassure critics of their current audit system, they will have to find another means of doing so.