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**The concept of *guanxi* within the  
Chinese audit framework**

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金灯也好，银灯也好，装上油才会发亮。

*Whether it's a gold lamp or a silver lamp, it will only shine with oil.*

*(Ancient proverb of the Bai)*

Thanks to all the people who have been the oil for my lamp.



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## 前言

中国已经成为世界上最大的投资市场之一。这对会计和审计行业意味着巨大的市场前景。

本文的目的是了解“关系”的概念如何影响中国的审计实务，重点是国内外审计公司。这个假设扎根于中国关系型社会，其特殊性值得分析。从毛泽东时代和1980年代开始，社会学家和人类学家已经指出了关系的演变。近几十年来，“关系”的概念已成为许多专家学者研究的对象。随着中国的发展，人们对“关系”的相关问题表示越来越大的关注。但是，涉及关系和审计的文献稀缺是事实。本研究在中国审计框架内探索关系的动态，并努力为现有文献做出贡献。

本文的第一部分重点是关系的定义。外国学者通常把关系称为“special relationships”。学者通常以两党之间的关系（Alston, 1989），恩惠交换（Lee; Warren, 2001）或社会资本的形式（Tung等, 2008）来形容它。这一部分包括其主要特征和相关概念，并特别提及儒家哲学。由于关系的概念发生了许多变化，因此本文的第一部分介绍关系的发展和分类，特别关注语言的发展。然后，介绍了中国审计实务，以及其在三个不同发展阶段的主要法律法规。特别是中国审计的机构，以及注册会计师的职责和责任。此外，还定义了中国会计准则。

因为审计事务所是通过开放政策可以建立的，所以中国的审计环境是最近的。由于CICPA成立于1988年，实际上是从那时起，政府开始建立会计和审计公司。第一部分的最后一阶段按时间顺序介绍了审计公司的发展历史，特别提到了四大巨头（普华永道，德勤，安永和毕马威）以及两家最大的国内公司（BDO中国和瑞华）。

本文的第二部分介绍关系对社会，公司业务和审计实务的影响。研究中国人际关系是揭示中国社会心理和行为的关键。尽管过去几十年来在中国大陆，台湾和香港发生了社会和经济层面的现代化进程，但关系仍然在塑造着及影响着中国的社会行为。从更广泛的角度（即社会层面）开始，第二部分在渗透越来越深，并缩小了关注范围。还强调了西方社交网络与关系之间的区别。关系似乎是影响公司业务的一个相关因素变量，因为事实证明，关系可以帮助公司克服市场挑战和薄弱的法律框架。这是因为在没有正式结构的社会中，人们开始依赖非正式结构作为获得确定性的主要工具。中国经济的市场结构和制度不稳定。从这个角度来看，关系网可以看作是非正式制度。另外，根据霍夫斯泰德的文化维度理论，中国的权力距离很高，人们在进行商业交易以克服这种距离时更容易建立关系。

八十年代的经济改革甚至导致了所谓的“关系资本主义”的发展。它承载着两个主要矛盾，也就是说，虽然在中国，市值和国际经济一体化增加了正式合同的使用，这样中国公司也可以在国际市场上宣布其合法性，但是制度上的不确定性增加了寻找成功企业秘诀的必要，依赖关系网络已成为必须的。在此前提下，本文的第二部分提供了基于所涉及的各方的基本分类，即组织 B2B（业务人员与业务人员的关系）和官僚 B2G（业务人员与政府官员的关系）。这两分类的动态，优点和缺点被介绍了。关于关系与审计实务之间关系的研究，大部分的研究跟关系对审计独立性的影响有关。在这方面，可以追溯到两种通用的关系：favor-seeking 关系和 rent-seeking 关系。

在 1996 年之前，政府完全控制了所有中国会计和审计公司，因此注册会计师的独立性受到损害。但是，通过中国注册会计师协会（CICPA）发布的从属关系计划，机构框架开始发生变化。由于这种



分离计划，以前建立的会计和审计公司的关系开始崩溃，为了生存，他们不得不组建新的关系。在西方国家，审计实践受独立性，客观性和廉正性原则的约束，而中国的环境似乎相当以服务为导向，并受关系管理。中国特色审计实践的兴起有其独特的解释路径，关系可以作为解释的关键之一。

因此，本文的第一和第二部分为第三部分的研究提供了理论基础。最后一部分也是通过经验数据建立的。这些经验数据均由中国注册会计师协会发布的《2014-2018年度业务收入前100家会计师事务所信息》和《上市公司审计年度报告》给出。本研究要回答的最重要问题是关系对审计实务的影响。研究问题的原因可以追溯到个人对中国社会动态的兴趣，而该兴趣在本研究中发现了审计水平的下降。以前有关关系与审计职业之间关系的文献都集中在关系对审计师独立性的影响上。尽管对与关系有关的问题的担忧更大，但仍学者对关系概念与审计收入之间的相关性的关注很小。本研究的目的是将现有研究与有关审计收入，分支机构和注册会计师数量的经验数据相结合，以确定关系对国内外审计公司在多大程度上影响了中国的审计实务。排名前六位的公司是四大公司（普华永道，德勤，安永和毕马威）和两位最大的国内公司（BDO中国和瑞华）。

文献综述显示关系与审计师的声誉之间存在相关性，因此第三部分的第一阶段概述了此类研究。在对关系与审计师声誉之间关系的概述之后，将《2014-2018年度业务收入前100家会计师事务所信息》介绍了，包括其参数和数据。然后，提出了每年的信息背景。具体来说，列出了排名前100位的公司的总业务收入，特别是四大公司。然后，将排名前六位的总收入及其注册会计师和分支机构的数量与《上市公司审计年度报告》中的数据进行比较。

第三章中的分析包括三组研究变量：因变量，自变量和混杂变量。由于本研究重点关注已建立的关系网络审计公司，因此在我的实证检验中仅考虑了一个因变量——关系，而自变量由审计收入的程度和审计公司的市场份额表示。混淆变量由影响审计收入的所有因素表示，这些因素已通过文献综述进行了概述。但是，由于缺乏有关此类混淆变量的数据，因此仅在描述性层面而不是经验性层面就可以进行理论整合。

近年来，国内外对上市公司的大量审计不力，使注册会计师的审计独立性受到了公众的质疑。本文还旨在回答是否有可能利用关系来克服这种问题。

## INTRODUCTION

China has become one of the largest investment market in the world, and this has created a huge market prospect for the accounting and the auditing industry.

The purpose of this work is to understand how the concept of *guanxi* influences the audit practice in China, with a focus on both domestic and foreign audit firms. This assumption finds its root in the Chinese relation-oriented society, whose peculiarity is worthy of analysis. The evolution of *guanxi* within the Chinese framework has been pointed out by sociologists and anthropologists, starting with the Mao era and the 1980s. In the recent decades, the concept of *guanxi* has been object of study by many experts and scholars, and great concern was shown about *guanxi*-related issues. However, the scarceness of the literature that involves both *guanxi* and audit is a matter of fact. This study explores the dynamics of *guanxi* within the Chinese audit framework, and strives to give a contribution to the existing literature.

The first part of this work focuses on the definition of *guanxi*, often translated as “special relationship”. Scholars usually address to it as a relationship between two parties (Alston 1989), as an exchange of favors (Lee; Warren 2001) or as a form of social capital (Tung et al. 2008). First, an overview of its meaning, going through its many facets and definitions, is presented. This part includes its main characteristics and related concepts, with special references to the Confucian philosophy. As the concept of *guanxi* has undergone many changes during decades, the first chapter highlights its development and differentiations, with a special focus on the linguistic evolution. Then, the Chinese audit framework is presented, with its main laws and regulations in three different stages of development. Definition of the main institutions its provided, as well as the duties and responsibilities of the Certified Public Accountants (CPAs). Additionally, Chinese Accounting Standards are defined.

The Chinese audit environment is quite recent, and the establishment of audit firms is made possible through the open door policy. As the CICPA was only founded in 1988, it was actually since that moment on that the government started to establish accounting and audit firms. The history of their development is chronologically presented in the last part of the first chapter, with particular references to the Big Four (PwC, Deloitte, Ernst & Young, and KPMG) and the two biggest domestic firms (BDO China and Ruihua).

The second part of the work is focused on the literature review regarding the effects *guanxi* have respectively on society, business of firms and audit practice. Studying Chinese interpersonal relationships is the key to revealing Chinese social psychology and behavior. Despite the modernization process of the social and economic dimension that took place in mainland China, Taiwan, and Hong Kong in the past decades, *guanxi* still play a significant role in shaping and influencing the social behavior in China. Starting from a wider point of view, that is, the societal level, the second chapter aims at seeing deeper and deeper and it narrows its focus. A distinction between Western social networks and *guanxi* is also highlighted. *Guanxi* seems to be a relevant factor variable that impact the business of firms, as it has been demonstrated that *guanxi* help firms to overcome market challenges and the weak legal framework. This is because in societies where formal structures are not developed or are even absent, people start to rely on informal structures as the primary tool for obtaining certainties. Chinese economy has underdeveloped market structures and institutional instabilities and in this perspective, *guanxi* networks can be seen as informal institutions. Additionally, on the basis of Hofstede's cultural dimension theory, China is characterized by a high degree of power distance, and people are more likely to establish *guanxi* when conducting business transactions to overcome such distance.

The economic reforms in the Eighties even led to the development of the so called “*guanxi* capitalism”, which is a bearer of two main contradictions. In China the market capitalization and the international economic integration have increased the employment of formal contracts, which have allowed Chinese firms to declare their legitimacy also on the international markets. However, the institutional uncertainty has increased the need to find a ploy for firms' success, and reliance on *guanxi* network has become a must. With this premise, a fundamental classification based on the parties involved is provided, that is, organizational B2B (business person to business person) and bureaucratic B2G (business person to government official). Their dynamics, advantages and disadvantages are further outlined. For what concerns the studies about the association between *guanxi* and the audit practice, they mostly investigate the influence *guanxi* can have on audit independence. In this regards, two more generic kinds of *guanxi* can be traced: favor-seeking *guanxi* and rent-seeking *guanxi*.

Prior to 1996, the government has the total control of all Chinese accounting and auditing firms and the independence of CPAs was therefore impaired. However, through the disaffiliation program issued by the Chinese Institute of Certified Public Accountants (CICPA), the institutional framework started to change. Due to this disaffiliation program, the previous-established *guanxi* of the accounting and audit firms began to crumble and they had to form new rent-seeking *guanxi* in order to survive. In opposition to the Western countries where audit practice is regulated by the principles of independence, objectivity and integrity, the Chinese context seems rather service-oriented and governed by *guanxi*. The emergence of audit practice with Chinese characteristics has its own unique interpretation path, and *guanxi* can be one of the interpretation keys.

The first and the second part of this work, therefore, provide the theoretical basis of the investigation of the third chapter, which is also built through empirical data. Such empirical data are given by The Information on Top 100 Accounting Firms in China by Revenue from 2014 to 2018, and by the Annual Reports on Auditing of Listed Companies, both issued by the CICPA. The most important question this study strives to answer is the effect of *guanxi* on the audit practice. The reasons of this research question can be traced back to a personal interest in the Chinese societal dynamics, which has found a declination on the audit level through this study. Previous literature on the relation between *guanxi* and audit profession has focused on the effects *guanxi* have on auditors' independence. Despite the greater concerns about the *guanxi*-related issues, a little scholar attention to correlation between the concept of *guanxi* and audit revenues is shown. The purpose of this study is to integrate the existing researches with empirical data regarding audit revenues, the number of branches and CPAs, in order to determine to which extent *guanxi* influence the audit practice in China, for both domestic and foreign audit firms. The firms taken into account are the top six in ranking, that are, the Big Four (PwC, Deloitte, Ernst & Young, and KPMG) and the two biggest domestic firms (BDO China and Ruihua).

As the literature review shows a correlation between *guanxi* and auditors' reputation, the first part of the third chapter strikes to outline such studies. The overview about the relation between *guanxi* and auditors' reputation is followed by the explanation of the aforementioned ranking, that is, its parameters and the data included.

Then, an empirical background of every year into consideration is proposed. Specifically, the total business revenue of the top 100 firms, with particular reference to the Big Four,

is stated. Then, the total revenues of the top six in ranking, with their number of CPAs and branches is compared to the data of the Annual Reports on Auditing of Listed Companies.

The analysis in the third chapter includes three groups of research variables: dependent variable, independent variables and confounding variables. As this research focuses on the *guanxi* network audit firms have established, only one dependent variable, *guanxi*, is considered in our empirical tests, while the independent variable is represented by the degree of audit revenue and the market share of the audit firms. Confounding variables are represented by all the factors that affect audit revenues, which have been outlined through the literature review. However, the lack of data regarding such confounding variables made the integration of theories possible only on a descriptive level and not on an empirical one.

In recent years, a large number of failed audits of listed companies in China and abroad have caused the CPAs' audit independence to be questioned by the general public. This work also aims at answering whether is possible to exploit *guanxi* to overcome such problem.

# CHAPTER 1: THE CONCEPT OF *GUANXI* IN THE CHINESE AUDIT FRAMEWORK

## 1.1 TRADITIONAL *GUANXI*: CONCEPTUAL FRAMEWORK AND CHARACTERISTICS

The concept of 关系 *guanxi* is deeply embedded in the Chinese society and it implies interpersonal connections. It is usually translated as “connection”, “special relationship” or “Chinese networking”, but in order to understand its true meaning, it is important to bring to the fore the value every linguistic component has, as both characters imply multiple meanings.

The character 关 *guan* originally alludes to a door, but its extended meaning refers to “to close up”; therefore, the expressions 关门 *guanmen*, means “to close the door” and 关闭 *guanbi*, means “to close down, to shut down”. 关 *guan* can express “to lock up” and it is used to form the character 关押 *guanya*, which means “put under detention”. As a verb it can also mean “to concern”, as in 关爱 *guan'ai* and 关心 *guanxin*, which have the same connotation of “to show concern and care for”, or 关照 *guanzhao*, meaning “to look after”. In the words 关联 *guanlian* and 关于 *guanyu*, 关 *guan* takes the meaning of “to implicate, to tie up with”. Otherwise, as a name, *guan* is usually used to indicate a pass, like in 关隘 *guan'ai*, meaning “mountain pass” or 关口 *guankou*, which indicates a gateway. It also indicates institutions that impose import and export tax, such as 海关 *haiguan*, meaning “customs” and consequently 关税 *guanshui* “customs duty”. 关 *guan* expresses also “an important turning point” and it shows this connotation in the characters 关节 *guanjie*, which means “crucial point” and 年关 *nianguan*, which indicates “the end of the year”, the formerly time for settling accounts.

The character 系 *xi* implies an affiliation not only on a family level, as in the characters 世系 *shixi*, meaning “kinship”, but it can also be used on an organizational level, such as in 系统 *xitong* and 系列 *xilie*, which respectively indicate a “system” and a “series”. It is also used to refer to teaching units by subject in colleges and universities, for example 中文系 *zhongwenxi* that indicates the Department of Chinese. As a verb, it usually implies

a connection, as in 关系 *guanxi*, but it also expresses a sort of worry, like in 系念 *xinian*, which means “to be concern about”.

Those characters, forming the word *guanxi*, express a special bond between two or more parts, “a network of social connections” (Fan 2002, p. 374). Actually it can assume three meanings, that are: (1) a relationship between people who share a pattern or are related to a third party, (2) an interrelation based on frequent contact, (3) a connection with little direct interaction (Bian, 1994).

According to the Chinese Xinhua Dictionary, the basic definition of *guanxi* is “the state of interaction and mutual influence between things or people<sup>1</sup>”. This dynamic is peculiar of the Chinese society; it does not only permeate Chinese daily live, but it is also a key component of business and a determinant of firm performance (Luo, 2007). Being able to establish and cultivate good personal relations is considered a real art, the so called *guanxiology* (关系学 *guanxixue*). It involves a series of tactics and practices that are translated into one’s ability to create a network. Such practices involve gifts, favors and meetings.

In order to better understand the Chinese *guanxi* framework, it can be analyzed through the Hofstede’s cultural dimension theory and the Confucian philosophy. According to the Hofstede’s cultural dimension theory, culturally-based values systems comprise five dimensions, such as: (1) Power distance, (2) Individualism / Collectivism, (3) Masculinity / Femininity, (4) Uncertainty avoidance and (5) Long-term / Short-term orientation. In collectivist societies such as China, the collective interest prevails over the interest of the individuals and the group aim at protecting such interests.

Consequently, the psychologist David Y.F. Ho talks about the relational self, where the self is not an independent entity anymore (Ho, 2019). This is the reason why Ho suggests that we have to consider how relationships are defined culturally in order to conduct relational analysis. In the Chinese society, the self is also influenced by a high power distance dimension, which involves a strong sense of hierarchy. The concept of *guanxi* has undergone many changes during decades, but we can trace some core characteristics to the Confucian philosophy, whose principles still dominate the modern Chinese society (Lytras; de Pablos 2008).

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<sup>1</sup> Chinese Xinhua Dictionary <http://xh.5156edu.com/html5/239820.html>



Taking into consideration the Confucian perspective, Hwang attempts to define the self in the Chinese society (Hwang 1987), where the self-relativism and hierarchy are strongly emphasized; *guanxi*, therefore, becomes a major dynamic. Harmony can only be reached in a society where everyone has his defined role in society and behaved accordingly. *Guanxi* is not an explicit content of Confucian philosophy as Confucius never mentioned the term “*guanxi*”, instead he used the word 伦 *lun*, which refers to “differentiated order among individuals” (King 1991, p. 66). The individual is not a separated entity, but instead is considered an interactive being (Moore, 1967).

According to his ideology, there are the so called 五伦 *wu lun*, which mean “five relationships” and the 三抗 *san kang* “three bonds”. Such doctrine established a hierarchical structure with proper social rules and values, in which the self in relation to others becomes the key of the individual experience. The five main relationships are: ruler to subject, father to son, husband to wife, elder brother to younger brother, friend to friend. In such relationships, both counterparts have duties and responsibilities: except friend to friend relation, in the other interdependent relationships, a vertical relation between inferior and superior can be traced, where the lower obeys the higher, while the higher mentor and protect the lower (Forbes 2020). The three bonds refer to the human obligations to monarch, parent and husband. The family hierarchy, which directly touches three of the five aforementioned relationships, is a model for the other two. The traditional family system is assumed as the fundamental key of social and political order in the Chinese society.

The Chinese framework appears to be different from the Western one. Some sociologists distinguish three dimensions of relationships in Chinese’s life based on the principle of Confucianism (Ke, 2018). First, there is the normative dimension, about norms and values that generally come from the *lunli* 伦理 (“ethics”), and from the interpretation in different contexts of the *yi* 义 that means the right, just and moral attitudes and behaviors of people in different kind of relationships. Then there is the sentimental dimension, which is characterized by the concept of *qing* 情, (“sentiment, personal feeling”) that is divided in two important aspects that are the attachment, affection and sentiment naturally developed during the relationship with other people, and the concept of *xin* 信 (“trust”), born from affection or direct experience between people. Then there is the instrumental

dimension, that relies on the concept of *jiao* 交 (“exchange”), that means how people build and maintain their social relations thanks the constant exchanges of thoughts, ideas, feelings and other resources. This dimension is considered the most related to the concept of social capital. Benefits and resources one gains can be considered the results of the interpersonal relations born from the other two dimensions.

As the first four relationships (ruler to subject, father to son, husband to wife, elder brother to younger brother) are ascribed, while the other left (friend to friend) is achieved, a *guanxi*-base is an essential component in this process. It is the criteria that allows an individual’s identification into a group and it “depends upon two or more persons having a commonality of shared identification” (Jacobs 1979, p. 243), which can be ascriptive or due to a shared pattern in life. *Guanxi* involves the mobilization of resources in a competitive environment, but as one’s share more patterns with more other individuals, he is able to establish more relationships and therefore he is set in an advantageous position (King 1991).

Guthrie identifies two macro categories of *guanxi*-base: the blood bases and the social bases (Gold et al. 2006). The first one encompasses those between members of a family, between relatives both blood and acquired; while the second macro category is generally divided into two micro categories, that is relationships based on locality, place of origin, ethnicity, and social relationships such as having attended the same school, professor-student relationship, being colleagues, neighbors, having served in the same unit, having experiences in common.

Many studies have been conducted on this topic and five main types of *guanxi*-bases have been detected. Locality refers to a commonality based on the native-place and dialect, but its boundaries are quite flexible. This is due to the fact that the native place can be ascribed as a region or a city or a small village and therefore expand or limit the related possibility of *guanxi* network. Kinship is a less flexible concept, as it depends on agnatic (blood tie) or affinal (through marriage) relationships. Family is a key unit in the Chinese society and therefore family *guanxi* is the most important one. However, its limitedness requires other types of *guanxi*-bases to establish, such as the so called fictive kinship, which refers to the organization of clans based on common surnames, even if it does not imply a shared genealogy. Classmates and people working at the same work place have the possibility to establish *guanxi*, based on friendship in the first case and on common goals on the

latter. It has to be clear that a *guanxi*-base does not necessarily imply the successful establishment of a *guanxi* and its relevance depends on the identity of the person concerned. Without a pre-existing *guanxi*-base, however, it is much more difficult to establish commercial relationships. A *guanxi*-base aims at paving the way for a possible *guanxi* by creating a connection between two individuals, subsequently providing the necessary element to fortify it and make it more stable.

All these *guanxi*-bases imply interactions amongst individuals and this is a strong principle that characterizes the Confucian relational self. One of the key concepts is *ren* 仁, which expressly states the human relatedness. The character *ren* 仁, which means “humanity”, is composed by the characters for “two” (*er* 二) and “person” (*ren* 人) and in the expression *renzhe ren ye* 仁者人也, Mencius points out that “the meaning of person (*ren* 人) is *ren* 仁”. In other terms, relationships are indispensable in achieving humanity (Yu 2020). This term has been variously translated as benevolence, perfect virtue or humanity. Confucius himself defined it by the ordinary Chinese word for love, *ai* 爱, saying that it meant to “love others”. He also made benevolent love the center of his ethical teaching, the unification of all morality under one concept and it is not surprising that Confucius occasionally used *ren* to mean “perfect morality” or “perfect virtue”.

Confucius was, however, a practical man who recognized that people loved most the people closest to them, especially their parents and relatives, so he qualified his teaching of love to others by adding that it is correct to love one’s relatives more than others. Benevolent love, then, is graded, greater to those closer to oneself and lesser to more distant persons. The Confucian virtues of filial piety and brotherly respectfulness are consequences on this emphasis upon graded love (Dubs 1951). The Confucian man-centered world has been depicted by Park and Luo as a spider web, where the self stays in the center of the *guanxi* network, and the different level of relations are located according to their intimacy distance or proximity to the self (Park; Luo 2001).

Different bases also generate different *guanxi* by nature, function, purpose and object of the exchange. Fan identifies three types of *guanxi*: *family guanxi*, *helper guanxi* and *business guanxi* (Fan 2002). The *family guanxi* have a *guanxi*-base of blood as their foundation and, therefore, have a root in Confucian values. They are led by emotions and what is exchanged is basically *qingqing* 亲情, affection. This relationship can be used to

ask for favors or to obtain resources but its emotional component will always have a primary position with respect to the instrumental one. *Helper guanxi* are defined as relationships with social *guanxi*-base, in which people can also feel a certain affection towards each other, but this will never be comparable to sentimental bonds. An example of this type of relationship is the one between work colleagues or classmates. *Business guanxi*, instead, refer to the process by which personal connections are exploited in order to gain entrepreneurial benefits. This type of *guanxi* is tactical, opportunistic and unstable, and the trust and mutual commitment, unlike the *guanxi family*, are very low (Fan 2002).

## 1.2 RELATED CONCEPTS TO *GUANXI*

*Guanxi* involves many other concepts that are proper of the Chinese society. *Guanxi* refers to special interpersonal ties, whereas *renqing* 人情 refers to “the special process of exchanging of resources in such ties” (Einhorn 1992, p. 25). *Renqing*, which can be translated as “human relationship”, is the description of the emotional distance between people, a tool to be used, exchanged or even traded, and a basis of judgement on matters and personal interests (Lin; Zhao 2016). According to Hwang, *renqing* comprises three different aspects (Hwang 1987). First, it refers to the individual’s emotional response towards daily life problems, where the emotional part prevails over the rational one. As stated in the Book of Rites (*Liji*), this feeling has many facets, which the individual acquires since birth, such as happiness, hanger, fear, affection and desire. The degree to which a person is able or not to understand other’s emotional response, define its empathy or apathy (Yuan 2013). Second, it refers to a material or abstract resource that can be exchanged. *Renqing* is connoted by reciprocity and implicit mutual obligations, which together create a form of social capital. In this respect, *renqing* as favor can be considered a social investment, which implies a return (Yang 1957).

According to the *renqing* frame, while exchanging a favor, the giver is expecting the beneficiary to repay it in the near future. As the exchanged resource can also be abstract, it is difficult to define its real value and comply a proper exchange of favor on the same level, but it’s fundamental to fulfil such obligation.

Three types of *renqing* favor are noticeable: a favor in need, purposive investment and gift exchange, which is connected to the concept of face, especially to *mianzi*. In this respect, a specification is needed; the concept of face in China is differentiated in *mian*

and *lian*, where *mian* can be defined as the “Social Face”, while *lian* is the “Moral Face” (Yang 2006).

The non-fulfilment of *renqing* obligation can jeopardize the *mianzi* (lit. “face”), leading to the “loss of face” (丢面子 *diu mianzi*). This will not only determine the loss of the *guanxi* but will trigger a chain effect whereby all the other *guanxi* connected to the first will be rendered useless (Chan 2006). In this respect, Hwang developed a theoretical model for *renqing* and *mianzi*, which categorizes them as mixed relationship, where “mixed” stays for a combination of affective and instrumental relationships (Hwang 1987). This means that in a mixed relationship, the giver and the beneficiary usually know each other and can show a sort of affection, but they are also bond by instrumental ties. Hwang pointed out the inter logic between *mianzi* and *guanxi*, which are related to the perception of the self the others have, that is, one’s *guanxi* network represents one’s power image and therefore it influences the perception of others. Good quality interactions can lead to an elevation of social status. According to one’s ability to develop his *guanxi* network and fulfill the obligations that this imply, one can not only gain face, but also lose it (*diu mianzi* 丢面子). It is important to notice that face is gained or lost not only from an individual own behavior, but also from how he is treated by others (Huang et al. 1987). This is due to reciprocity, which also influence the concept of face and it is always related to the individual’s claim, that is, gaining or losing face is not only a quantitative process, but it’s related also to the quality of one’s claim (Ho 1986).

Third, it involves specific norms based on two perspectives: within the *guanxi* network, one not only should keep in touch with other members and exchange favors or gifts, but also offer help to others in case of trouble and sympathize with them. In the framework of hierarchically structured relationships, *renqing* emphasizes the value of maintaining personal harmony and social order among persons situated in.

As stated before, reciprocity also involves the concept of face, which measures the extent to which one is able to develop and maintain a good quality *guanxi* network. It is related to social status and prestige, which is achieved through getting on in life, through success and ostentation (Hu 1944). As stated by the author Lin Yutang (Lin 1939), it is a difficult concept to define; he said:

“它像荣誉，又不是荣誉。它比任何世俗的财产都宝贵。它比命运和恩惠还有力量。比法律还受人尊敬”。

It is like honor, but it is honor. It is more precious than any secular property.

It is more powerful than destiny and grace, and more respectable than law."

According to Goffman, *mianzi* is the self delineated in terms of approved social attributes (Goffman 1955). *Mianzi* is the self as presented to others and the Chinese culture is highly focused on maintaining it (Loewenberg 2011). Saving face is very important in the Chinese society because allow one to control the dynamics in social networks (Lin 2011). Earning *mianzi* is not only a mere tool to display the self, but it also allows one to gain privilege within the *guanxi* network. An individual with high social status is considered to "have face" (*you mianzi* 有面子), in contrast with a man of low social ranking, who is considered not to have face (*mei mianzi* 没面子).

*Ganqing* 感情 is another key concept related to the *guanxi* process. It refers to an emotional involvement and it assumes personal connotation. It differs from *renqing*, as *renqing* refers to the human obligations and it is therefore social. *Ganqing* involves an emotional sphere, where the sentiment arouses by the closest of human ties (Guo 2001). The degree of affection is greater than in *renqing* and its personal connotation often goes beyond the social norms.

*Ganqing* gives an emotional connotation to the relationship, which otherwise would be perceived as instrumental. This renders *guanxi* a combination of emotional and instrumental elements, in opposition with Western social relations, where usually the delineation between emotional and instrumental relations is a sharp line (Herrmann-Pillath 2009).

*Ganqing* is chronologically developed and it expands through concentric networks around the individual. This means that *family guanxi* involves the deepest degree of *ganqing* as it is the most important relationship in the Chinese society, but such emotional commitment can evolve during time. *Friendship guanxi* also involves such emotional ties, as members usually share their sentimental feeling toward a common goal (Leung et al. 2008). Thus *ganqing* measures the emotional commitment of the counterparts, where such commitment is not gained through the practice of giving gifts, but instead it is gained through a sincere emotional connection. Social interaction and mutual help are the basic prerequisites of the

development and the maintenance of *ganqing* (Luo 2007). The cultivation of *ganqing* allows the parties to exploit a *guanxi*-base into a *guanxi* relationship.

*Ganqing* (emotional commitment) and *renqing* (reciprocal exchange of favor) lead to *xinren*, which refers to mutual trust. The deeper is the emotional ties between members, the greater is the degree of trust. That means that *guanxi* do not always involves *xinren*, but *xinren* always involves a sort of *guanxi*, mostly family and friendship *guanxi*. The reason why *guanxi* among family members or people from the same clan are stronger is because the Chinese people generally tend to be cautious to others outside this trustworthy *guanxi* circle. When there is mutual trust among parties, then repeated transactions over time will be facilitated even in the absence of legal and contractual mechanisms to monitor the veracity of their actions. Years of economic uncertainty and constant institutional changes have led the Chinese people to rely more on a moral ethic in governing relationships and transactions rather than on formal institutions, to the extent that in a business environment Chinese people consider personal trust much more important than trust in the system.

Through the interpretation of Chinese perceptions, Kriz and Keating developed a definition of trust, that is “the heart-and-mind confidence and belief that the other person will perform, in a positive manner, what is expected of him or her, regardless of whether that expectation is stated or implied” (Kriz; Keating 2010, p. 10). One’s trustworthiness is composed of ability and sincerity, as we can see from the picture.

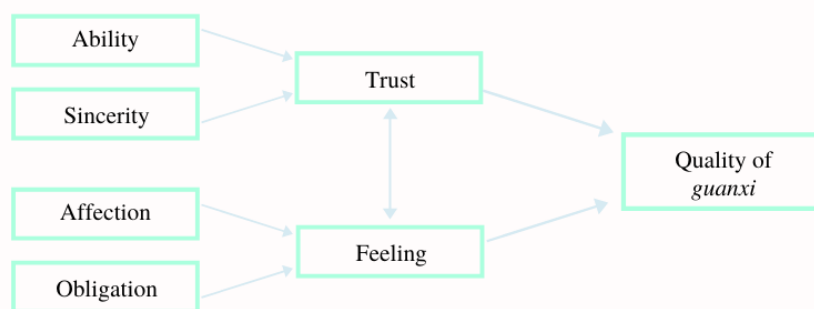


Figure 1: *Guanxi* framework. Source: Chen, X., Chen, C.C. *On the Intricacies of the Chinese Guanxi: A Process Model of Guanxi Development*. *Asia Pacific Journal of Management* 21, 305–324 (2004). <https://doi.org/10.1023/B:APJM.0000036465.19102.d5>

Nowadays, most of the debates on social capital tend to distinguish three levels of analysis based on the type of relation and kind of trust existing between people (Grote; Bonomi

2018). The first one is the micro level: this level is about small group like families, tribes, villages, and neighborhoods, in which a high level of trust is granted. The second one is the meso level: the study of this level concerns wider groups or organizations based on voluntary adhesion in which trust and trustful relations are born from sporadic exchanges that may become a long-lasting relationship. On this level the degree of trust between people becomes thinner. The last one is the macro level: this level concerns that type of hierarchical relations, like patron-client or mentor-mentee, in which there is no trust born by bonding with the other, but a form of systematic trust that we find in the state-society relations. *Xinren* relies on one's personal integrity, but as the previous concept it can deteriorate over time. It is a key pillar in the *guanxi* process, as it considered to restrain the likelihood of opportunistic behavior, especially in a business environment. In order to build *xinren*, an individual also must have confidence (*xinxin* 信心), belief (*xinnian* 信念), being sincere (*zhenxin* 真心), being honest (*zhong* 忠) and being loyal (*zhongxin* 忠心) (Kriz; Fang 2003). As China is a relation based society, *xinren* is not only important for what concerns *guanxi*, but also in all aspect of everyday life (Yeung; Tung 1996). Trustworthiness also involves credibility, that is *kexin* 可信. It defines a reliable and stable *guanxi*, in which counterparts are expected to mutually help each other and to keep promises. It can be shaped through one's social and educational background and through one's qualitative *guanxi* network (Luo 2007).

All of the aforementioned concepts (*renqing*, *mianzi*, *ganqing*, *xinren* and *kexin*) contributes to the realization of *tiaohe* 调和, that is "harmony". As it stands for the co-existence of differences and similarities, it is not a compromise, but rather the ability to balance all-sided *guanxi* (Hou et al. 2012). According to the Confucian framework, harmony stands for harmony of unequals (*he'erbutong* 和而不同), in which *tiaohe* is achieved through heterogeneity (Bian 2019).

As claimed by Yeung, *guanxiology* involves four different methods in order to maintain the *guanxi*. The first in the material exchange of gifts or favors, which is particularly useful especially at the beginning, but not fundamental. Increasing the connectivity and dependence between the member also contributes to the maintenance of *guanxi*.



### 1.3 NEW *GUANXI* AND LINGUISTIC DEVELOPMENT

In China, three different interpersonal relationships could be distinguished: *jiaren* 家人, that is, family members, *shouren* 熟人, friends and people with whom you are familiar, and finally *shengren* 生人, acquaintances or strangers. These three relational categories have different psychological and social implications and consequently determine dissimilar behaviors and rules between the parties. It follows that the approach to a *guanxi* with people belonging to different categories will also be influenced and reflect links of different depths. Due to these differentiations, Liang Shuming defines Chinese society not 本位本位 *geren benwei* - individualistic, nor 社会本位 *shehui benwei* - collectivistic -, but 关系本位 *guanxi benwei*, that is founded on relationships (Lu 2009).

As stated before, the term *guanxi* was not proper of the Confucian philosophy and in the Western society it is a relative new concept. The first references, indeed, can be traced back to the Eighties with some entrepreneurial articles that provided advice on how to do business in China (Fan 2002).

Surprisingly, despite the modernization process of the social and economic dimension taking place in mainland China, Taiwan, and Hong Kong in the past decades, the concepts above explained still play significant roles in shaping and influencing the social behavior in China (King 2020). On the contrary, during the Communist period (1949-1979) there was the tendency to avoid the traditional values such as the Confucianism, therefore it can be said that *guanxi* principles weakened in that moment in time. During this period there was a shift from what Vogel calls “friendship” to “comradeship” (Vogel 1965). He defines the first as a private relationship of mutual trust, while the latter instead is a moral universalistic ethic, which transcend from the *guanxi*-bases of locality and kinship. The growth of the new universalistic ethic helped the government to realize the massive modernization process that lead to the nowadays China. The core of the new Communist organization was the *guanxi*-base of the work unit, the so called *danwei* 单位, which at the time included work place, domestic life, and social activities.

According to Vogel, the cultivation of *guanxi* slowly returned to the dawn of time in the late 1970s, but it became a tool in the hands of entrepreneurs, who wanted to exploit new market opportunities (Vogel 1989). Economic *guanxi* started to develop alongside social *guanxi*, both aimed at securing resources. In this regard, *guanxi* often assumes negative

connotation (“bad *guanxi*”) such as a corruption, nepotism and fraud. Within this framework, we have

*quanli guanxi* 权力关系 (“exchange between power and interests”), which is linked to the weak institutional environment, in opposition with *qinyou guanxi* 亲友关系 (“exchanges of personal favor among family and friends”), that is linked to the Confucian relationalism (Su et al. 2003).

According to the institutional theory, the nature and the model of the economic transformation in China stimulated the spread of the *guanxi*. This is because in societies where formal structures are not developed or are even absent, people start to rely on informal structures as the primary tool for obtaining certainties. Chinese economy has underdeveloped market structures and institutional instabilities and in this perspective, *guanxi* networks can be seen as informal institutions. They were created to ensure the security of commercial relations and as a means of compensating for the inadequacy of formal structures and their application mechanism (Potter 2006).

In this connection, some specific characteristics must be outlined in order to deeply understand the phenomenon of *guanxi*. As stated before, *guanxi* is utilitarian since it has a special purpose, “which triggers the process” (Fan 2002, p. 10). In a business logic, the benefits of a good quality *guanxi* include obtaining information and business opportunities, but also easing business operations and transactions (Davies et al. 1995). Both social and business *guanxi* are reciprocal dynamics, that is both parties exchange *ganqing* or *renqing*. Once a sufficient level of *guanxi* has been established, both members can request a favor from the counterpart as they know that the opportunity to reciprocate will arise in the future (Song et al. 2012). The return of the favor is usually not immediate, but instead can take place over the years or decades. It can involve exchange of gifts, which was pointed out as an important aspect of relationship-building by Sahlins, “If friends make gifts, gifts make friends” (Sahlins 1972, p. 186). In a relationship of mutual help, the gift means appreciation to the helper, while gift means reciprocity to the one who receives the help. Gift became a tool that helps in developing *guanxi* and building respect, friendship and trust (Su et al. 2003). It is important to notice that such reciprocity has some peculiar characteristics, as it is shaped through its ancient history, its pervasive usage and its high degree of consciousness (Yang 1967). The disregard of such obligation can jeopardize the stability of the *guanxi*.

This requires a long-term investment as *guanxi* is not a short-term oriented relationship, which involves a time- and effort-consuming process.

The Confucian societies believe in the interdependence of events, where all social interactions are considered within a long-term prospective. Each *guanxi* is considered as a stock to be put aside and to be used in times of need. This is probably the main difference with western social transactions, which put more emphasis on immediate gain as considered as individual and isolated events.

Such long time effort aims not only at gaining the counterpart's trust, but it is fundamental in order to maintain the *guanxi*. This regards not only social *guanxi*, but also business *guanxi*, where the development of long-term *guanxi* and consequently the establishment of trust bases, can lead to business transactions (Redding 1990). As both parties are future-oriented, *guanxi* represents a warranty for both sides that the counterparts will reciprocate the favor in the long-run. This is also related to the costs involved in the cultivation of *guanxi*: the longer is the relationship, the greater are the costs allocated, and consequently the lower is the likelihood to discontinue the *guanxi*.

In this respect, *guanxi* represents is intangible and can be define as social capital. It is intangible as it is not a material resource, but instead, it depends on members' unspoken mutual commitment with a long-term prospective (Fiorentini; Infantino 2020).

As a matter of fact, the concept of Social Capital was first introduced by the French sociologist Bourdieu in 1986, who defines it as “the aggregate of the actual or potential resources which are linked to possession of a durable network of more or less institutionalized relationships of mutual acquaintance and recognition” (Bourdieu 1986, p. 21). The core of the notion of Social Capital is considered to be the social relationship, usually divided in three categories (ascribed by birth, blood, or marriage, happened relationships as neighbors, classmate, colleagues etc. and acquired or achieved relationships as friends or business partner), and the elements that most determined it, including social networks, civic engagement, norms of reciprocity, and generalized trust. It can also be considered as a collective asset in the form of shared norms, values, beliefs, trust, networks, social relations, and institutions that facilitate cooperation and collective action for mutual benefits. Such parallelism between *guanxi* and social capital, according to Gold et al., is due to the fact that “*guanxi* as social capital is accumulated with intention of converting it into economic, political or symbolic capital” (Gold et al. 2002, p.7).

*Guanxi* can also be transferable. This means that if person A wants to get in contact with person C, with whom he does not have any relation, he may seek an intermediary B, who has direct or indirect contact with C, allowing A to establish a *guanxi*-base with C. This leads to a *guanxi* network.

The implicit aims of *guanxi* are the mutual interest and benefits both parties can achieve, without a time limit (Xing 2018).

Within this framework it is necessary to specify that *guanxi* appears to be personal and its transferability applies only between persons but not between organizations, stating a difference with Western inter-organizational networking. This implies that in a firm environment, when the person who previously established *guanxi* with others leaves, the *guanxi* leaves with him (Luo 2007).

Besides, the cultivation of *guanxi* is totally contextual; every action (and consequently its meaning and interpretation) varies according to the place and the situation.

In the Chinese language, according to a distance scale, *guanxi* can be *jin* 近 (“close, near”) or *yuan* 远 (“distant, far way”), *shen* 深 (“deep”) or *qian* 浅 (“shallow”). As the *guanxi* becomes deeper, the relational distance becomes shorter. This implies a sentimental element and greater commitment on one hand, and greater accessibility to resources and greater influence on the counterparts on the other (Xing 2018). There is a flow of social capital, which can influence the process of decision making.

In this regard, a new terminology has been developed. 拉关系 *laguanxi* (“to pull a *guanxi*”) refers to the instrumental use or development of the *guanxi* relationship. It describes a process that aims at strengthening ties with others, with whom there is no pre-established relation or where the contacts are remote. It has no negative connotation and a *guanxi*-base can be a good starting point. Alternatively, an intermediary can intervene as a connection bridge. Another phrase related to the same procedure, is 走后门 *zou houmen*, that is “get in by the back door”, referring to the action of not using the official channels, but instead, metaphorically passing through the retro through exclusive or particular methods, which states for the use of personal contacts, in order to secure advantages. 挂关系 *guaguanxi* (“work on *guanxi*”), instead, has the same meaning but usually with a negative connotation.

没有关系 *meiyou guanxi* became an idiom with the meaning of “no matter”, but originally, it meant a person who had no knowledge in the right places.

有关系 *you guanxi* means “having relationships”, or “having access to people with a certain influence”. Regarding this idiom, there is a famous proverb in China, that states: 有关系, 就没关系; 没关系, 就有关系 *mei guanxi, jiu mei guanxi; mei guanxi, jiu you guanxi*, meaning “if you have connections, you do not have to worry; but if you do not have connections, you have to worry”.

有的是关系 *youde shi guanxi* means “what one’s have is *guanxi*”, usually used with a negative sense, because it refers to a person that has all the *guanxi* he may need, but there is something else fundamental that he lacks.

关系够呛 *guanxigouqiang* means the relationship has gone bad, usually because the parties involved lack of flexibility.

理顺关系 *lishunguanxi* means “to straighten out *guanxi*”, that is to put *guanxi* back into its proper order, often after a period of difficulty or awkwardness.

关系户 *guanxihu*, means a person, organization or governmental department, which occupies a focal point in one’s special *guanxi* network. This term has arisen after the economic reforms of Deng Xiao Ping, referring to those individuals or social organizations that would ignore market rationality in order to cultivate preferential *guanxi* (Chen 1995).

关系网 *guanxiwang* means “*guanxi* network” and identifies the entire network of *guanxi* used for favors and benefits. A *guanxi* network is based on exchange, information and the normative content of such exchange and information. The members are linked to each other by a series of transactions that go further a simple exchange action, as in the gift practice. What matters is not the gift itself but the relationship between the giver and the receiver, whose bond will be strengthened through reciprocity.

A *guanxi* network, as social network, also acts as vehicle of information, where various types of information can be transmitted from person to person. The members within the network have access to information, while the people outside this circle do not. Mutual expectations pervade the communication and exchange contents between members, and in this sense, *guanxi* networks act as a framework for assessing individuals' behavior (Mitchell 1973).

However, when *guanxi*'s intent becomes receiving an illegitimate benefit rather than to build a relationship, their behavior is no longer a legitimate *guanxi* practice, but rather it turns into an unethical *guanxi* practice or legal corruption, as stated by Harding (Harding 2014). According to his perspective, unethical *guanxi* practice refers to *guanxi* behaviors that violate Chinese Communist Party ethical rules, while legal corruption involves activities that violate China's anti-corruption Criminal Laws. According to China Criminal Law, the main forms of corruption in China are fraud (*tanwu* 贪污), corruption (*huilu* 贿赂), embezzlement (*nuoyong gongkuan* 挪用公款), misappropriation of public funds (*jiti sifen* 集体私分), abuse of power (*lanyong zhiquan* 滥用职权) and negligence (*wanhu zhishou* 玩忽职守).

Compared to ten years ago, corruption in China has dramatically increased.

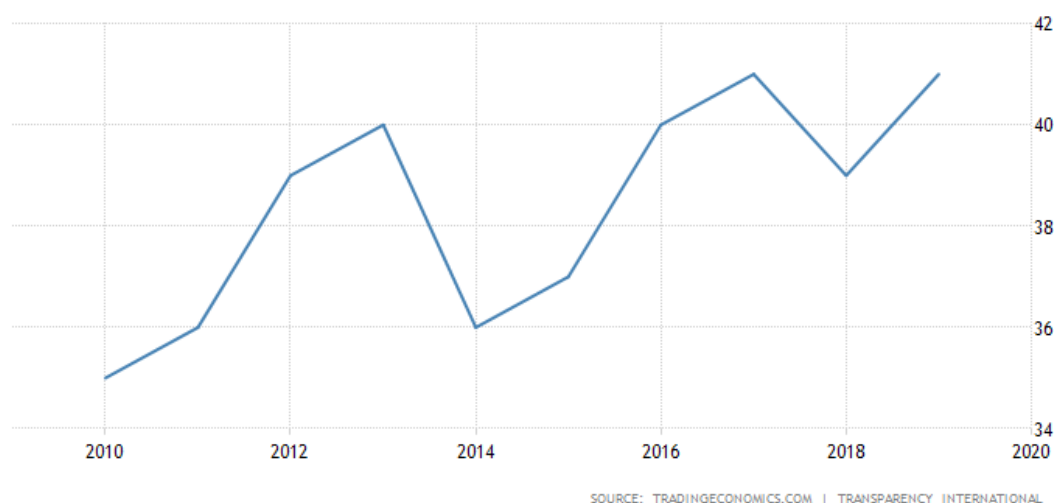


Figure 2: China Corruption Index. Source <https://tradingeconomics.com/china/corruption-index>

According to many scholars (Harding 2014; He 2000; Dong et al. 2010), China's corruption problem has increased along with the economic development. In this framework, the flaws in the institutional structures for regulating corruption and its bureaucracy also contributed to the trend. That is the reason why Chinese political agenda is focused on the anticorruption enforcement and bribery is becoming always riskier.

As *guanxi* is usually associated with bribery and corruption, Yang (Yang 1994) argues that a distinction between corruption and everyday *guanxixue* must be highlighted. The first has a more explicit purpose than *guanxixue*, which instead is based on innuendo. Besides, corruption is an illegal deviation from social norms, while *guanxi* is a legal practice according to social norms. It is important to specify that even if they can have in

common some methods to reach the goal, their judiciary implications differ. In addition, *guanxi* usually do not involve monetary exchange as in corruption.

Due to their age-old tradition in the Chinese society, it is difficult to define whether it is the corruption that is embedded in *guanxi* practice or it is *guanxi* that leads to corruption. However, it is noticeable that the institutionalization of corruption goes along with the enforcement of *guanxi* connection to social institution. This institutionalization involves an implicit code of conduct and, at the same time, it facilitates corrupted transactions. According to Li, it makes corruption an alive entity, which, in order to survive, mutates along the external environment (Li 2011).

Some risks and barriers hinder the corruption process, such as the risk of detection and punishment, the risk of opportunistic behavior and the moral costs involved. This is where *guanxi* can intervene removing such obstacles by minimizing the transactional costs and by reducing the likelihood of opportunist behavior. It implies a mutual understanding of members' obligations, whereas the gift-giving process plays an important role. Gift-giving process is not only a material exchange, but invokes parties' trustworthiness and commitment to the *guanxi*.

This leads to questioning whether *guanxi* are ethically acceptable or not. Such question regards only business *guanxi*, as family and helper *guanxi* are instead considered morally acceptable. The ethical line divides those *guanxi* whose implication do not harm third parties, in opposition to those *guanxi* in which not only a member directly violates a significant fiduciary duty defined in local social norms (Donaldson; Dunfee 1999), but also violates the interests of third parties. In conclusion, *guanxi* can be considered unethically when used to achieve sketchy purposes by causing damage to society or other individuals.

#### 1.4 AUDIT DEVELOPMENT IN CHINA

According to Mo et al (Mo et al. 1995), audit profession in China has been developed through three different phases. The first phase started in 1918 with the issue of a first series of regulations regarding the Certified Public Accountants (CPAs) and the foundation in 1921 of the first accounting company in Beijing. In 1928 the regulatory framework of the accounting profession in the Republic of China was represented by two regulations (the *Certification of Public Accountants* and the *Regulations for Accountants*), which

contained indications regarding the operational scope of the accounting figure, the qualifications and requirements, the legal responsibilities and the professional code of ethics to be followed.

This first stage of development of the accounting profession ended in 1949 with the founding of the People's Republic of *China* and the establishment of a planned economy. From that moment on, the formulation of the legislative framework of the accounting system suffered a setback. The second phase started with the open-door policy implemented between the late 1970s and the early 1980s, which led to the formulation of by the Ministry of Finance of the *Provisional Regulations on setting up of an accounting consultancy*. In the early 1980, state auditing was considered the most important activity conducted by auditors (Lin et al. 2000).

In 1986 the Council of State issued the *Regulations of the People's Republic of China on Certified Public Accountant*, which constitutes a first legislative framework with provisions regarding the national examination, education and experience requirements of the Certified Public Accountants. Nevertheless, compared to Western countries, the Chinese accounting profession still seems to lack experience.

In November 1988 the Ministry of Finance founded the Chinese Institute of Certified Public Accountants (CICPA *Zhongguo zhuce kuaijishi xiehui* 中国注册会计师协会), which is the national organization of accountancy profession. It was founded in compliance with *The Law of the People's Republic of China for Certified Public Accountants* and *The Regulations for the Registration and Administration of Social Organizations*. In October 1993, an attempt to standardization was made by the Fourth Session of the Eighth National People's Congress, who issued the Law of the PRC on CPAs, which was implemented it on January 1, 1994.

The establishment of the institute, the *Charter of CICPA* (2010), describes and regulates the organization's structure, the responsibilities and functions that it undertakes to perform. Among the other duties, it undertakes to provide some services to its members, such as examine and approve their applications, but also develop professional standards and rules for CPAs, monitor and review their implementation. It guides local CPAs and against those who do not follow its standards, CICPA can take disciplinary actions according to relevant laws. Besides, it also coordinates relationships within and beyond the



accountancy profession, support CPAs to adhere to the laws in conducting their practices and safeguard the legitimate rights and interests of members (CICPA Overview 20014). The National Assembly of Delegates is the body which regulates, monitor and approves CICPA's activities (Art. 14). It meets on a five-year basis and its members are chosen through an election, a consultation or by special invitation.

The National Assembly of Delegates is also responsible for choosing the members of the CICPA Council, which meets once a year. The members of the Council hold office for 5 years, but they can renew their mandate (Art. 17) and elect a President, a series of Vice Presidents and Executive Directors (Art. 19).

A series of Special Committees and Professional Committees assist the Council in its activities, as in solving technical and professional problems that may arise in the process of developing the accounting profession (Art. 27).

CICPA also has a Secretariat, which is its permanent executive agency and presides over the daily work of the CICPA. The establishment, adjustment, specific responsibilities and operating rules of Special Committees and Professional Committees, as well as the appointment and dismissal of members, are proposed by the Secretariat and approved by the Council.

There are seven Special Committees and one Professional Committee. Their main responsibilities are:

1. Auditing Standards Committee 审计准则委员会 is mainly responsible for reviewing and approving the draft of independent auditing standards;
2. Disciplinary committee 惩戒委员会 is mainly responsible for disciplining the accounting firms and certified public accountants who violate regulations and disciplines.
3. Appeal Board 申诉委员会 is mainly responsible for the appeal work of the accounting firm and the CPAs against the proposed disciplinary decision of the Disciplinary Committee of the CICPA. It determines whether to maintain or modify the decision of the Disciplinary Committee.
4. Rights Protection Committee 维权委员会 is mainly responsible for studying specific measures and methods for maintaining the legal practice of members; researching and discussing the ways and means to protect the legitimate rights and interests of the members, and proposing policy recommendations or research on rights protection report.

5. Education and Training Committee 教育培训委员会 is mainly responsible for researching and analyzing the practice status and capacity needs of the CPA industry; promoting, improving and guiding the pre-qualification education of CPAs; reviewing the CPA follow-up education system.

6. Finance Committee 财务委员会 is mainly responsible for studying the industry's dues policy; guiding and standardizing industry financial work;

7. Editorial Committee of "China Certified Public Accountants" 《中国注册会计师》编辑委员会 is mainly responsible for reviewing the guidelines for the publication of "China Certified Public Accountants"; collecting and analyzing the opinions of members on it.

8. Professional Technical Advisory Committee 专业技术咨询委员会 is mainly responsible for studying the professional problems encountered by CPAs in the course of practicing; providing professional technical assistance to them; communicating with relevant government departments and making suggestions on related professional issues. As of 2019, according to some data provided by CICPA, China has more than 260,000 qualified accountants and nearly 400,000 employees in the industry, serving more than 4.2 million enterprises and institutions including more than 3,000 listed companies<sup>2</sup>.

The core values of CICPA are professional integrity and ethics. That is the reason why CICPA has established a registry-based monitoring system in order to monitor CICPA members and then disclose information regarding them. Noticeable is the fact that consistent information of CPAs is available online for public inquiry and supervision. Another responsibility of CICPA is to draft professional standards and rules, on which the Ministry of Finance makes the final approval and release.

Besides, since 1992, CICPA has released a series of documents regarding the ethics principles CPAs must follow. In 2009, CICPA released *Code of Ethics for Chinese CPAs* and *Code of Ethics for Non-Practicing Members of CICPA*. In convergence with IESBA *Code of Ethics for Professional Accountants*. A more detailed guide can be found in the Q&As related to Code of Ethics for Chinese CPAs, released in 2014, which provides a practical help to CPAs.

The credibility of the CPAs is also evaluated through an annual ranking of top 100 accounting firms released by CICPA.

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<sup>2</sup> For further data, refer to CICPA website [http://www.cicpa.org.cn/news/201909/t20190930\\_52129.html](http://www.cicpa.org.cn/news/201909/t20190930_52129.html)

The framework of China's independent auditing standard was developed in 1994 through a set of independent auditing standards. In 2006 new standards convergent with the international ones were released. They were updated in October 2010 and implemented in January 2012. Besides, in 2013, CICPA translated in Chinese the International Standards on Audit and Code of Ethics for Professional Accountants, enhancing their spread throughout China.

The role of CPAs is defined by the *Law of the People's Republic of China on Certified Public Accountants – CPA Law – (中华人民共和国 注册会计师法 Zhonghua renmin gongheguo zhuce kuaijishi fa)*, issued on October 31<sup>st</sup> 1993 and came into force on January 1<sup>st</sup> 1994. The law also defines the rules, the prerequisites and the responsibilities of a CPA, but also the services that can be offered. Besides, it authorizes the founding of the Chinese Institute of Certified Public Accountants. The CPA Law consist of 46 sections, divided in 7 chapters, which are entitled as follows: General Principles, Examination and Registration, Service Scope and Rules, Institute pf CPAs, Legal Responsibilities, Supplementary Articles.

The definition of a CPA provided the Law is: a “practicing accountant who has lawfully received the certificate of CPA and accepts assignments for auditing, accounting consultation or other accounting related service” (Art. 2). The certificate is issued after passing all the tests of the National Uniform CPA Examination. As specified in the Art. 8, the candidate must be a Chinese citizen who has completed at least a two-year college program at a recognized institution or who has acquired a middle-ranked technical title in accounting or subjects related to accounting. Residents of Hong Kong, Macao and Taiwan and other foreign countries may also apply for the exam as long as they have at least one degree recognized by the competent authorities in China or a CPA qualification (or other corresponding qualifications) in the own country.

After having passed the examination and two years of auditing services, the candidate can apply for registration as CPA (Art. 9), whose approval implies the issue of a certificate (Art.12). If the CPA is no longer able to perform his duties or in case of violation of the rules of conduct established by law, the certificate may be revoked (Art. 13). Violation of duties involves deliberate omission of financial information related to the customer, draw up false reports or reports that lack information and which could therefore damage the interests of the parties involved (Art. 21). Besides, a CPA cannot delegate his duties to

third parties acting in his name, he cannot carry out professional activities for more than one accounting company and he must not conduct other illegal activities (Art. 22). According to CPA Law, a CPA must work in an accounting firm, which is defined as “an organization lawfully established which performs professional accounting services”.

The CPA Law<sup>3</sup> defines the accounting company as an organization lawfully established, which offers professional accounting services (Art. 3); it is created through two or more CPAs in partnership (Art.23) which, subject to a series of conditions<sup>4</sup>, can take the form of legal entity with limited liability (Art. 24). The establishment of any new company or branch must be approved by the Ministry of Finance or the financial department at provincial, municipal or autonomous regional level under the directives of the central government (Art. 26-27). If approved first by the departments responsible for foreign affairs (both centrally and locally) and secondly by the Ministry of Finance, accounting companies can also be set up in the form of Sino-foreign Joint Ventures (Art. 44). Once founded, in order to enter into operation, accounting companies must compulsorily join the CICPA (Charter of the Chinese Institute of Certified Public Accountants 2010, Art. 6).

CPAs in China are responsible for audit, tax returns, management consulting and they represent clients on tax disputes with the government (Kliegman 2005). As an auditor, he has to verify the truthfulness of the published accounting information; he has to protect potential investors and prevent false information from altering the normal course of activities in the capital markets (Tang 2016).

Today the revision of the financial statements is required for listed public limited companies, for limited liability companies with only one owner, for state-owned limited liability companies, for Chinese companies operating outside China (Colombo 2005) and for all foreign companies or companies with foreign participation (Nobes; Parker 2016).

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<sup>3</sup> For further details, refer to the draft of the CPA Law [http://www.gov.cn/banshi/2005-05/26/content\\_1013.htm](http://www.gov.cn/banshi/2005-05/26/content_1013.htm).

<sup>4</sup> An accounting firm can be considered a legal entity with limited liability if (a) its registered capital is not less than 300 000 Yuan; (b) it has a number of full-time professional staff and at least five of them are CPAs; (c) it is compliant with the scope of professional activities and other conditions as stipulated by the Finance Department of the State Council.

## 1.5 AUDIT LEGAL FRAMEWORK

For what concerns local audit, such activity has been managed by the Chinese Institute of Certified Public Accountants since 1995.

For what concerns the legal framework, the Accounting Law (中华人民共和国会计法 *Zhonghua renmin gongheguo kuaiji fa*) acts as a primary source for the formulation of all the other administrative decrees and regulations and establishes guidelines for carrying out the accounting profession. It was promulgated by the Standing Committee of the National People's Congress (NPCSC) in 1985 as the first accounting law, revised in 1993 and 1999 to increase investor protection and recently amended in 2017.

The Accounting Law (2017) is composed of 52 articles divided into seven chapters, respectively entitled: general provisions, accounting practice, special provisions for company and business accounting, accounting supervision, accounting offices and accounting personnel, legal responsibility and additional provisions. In the general provisions the objectives of this law are affirmed: standardize the accounting practice, guarantee the authenticity and completeness of the accounting documents, strengthen the economic management and financial control, increase the economic results and maintain the order of the socialist market economy (Art. 1).

The second chapter defines the fundamental principles governing the accounting practice and provides indications regarding the basic accounting obligations, for instance which accounting books should be kept, which accounting methods to follow and how to prepare the financial statements. Other specifications addressed to companies and enterprises, as suggested by the title itself, are briefly illustrated in the third chapter and among these article 25 is explained, which establishes how to calculate and record the accounting elements and article 26 which exposes which deeds are forbidden to companies in accounting management. In the chapter regarding the accounting supervision, the need for supervision of accounting practice is stated. This responsibility lies with the supervisory "trinity" (Wu 2015, p. 241), that is, with the internal accounting supervision system set up by each organization, the CPAs and, at national level, the Ministry of Finance.

The basic guidelines on the organization of offices and accounting institutions can be found in the fifth chapter. It also defines the requirements (Art. 38) and the qualifications

of the accounting staff and affirms the CPAs' obligation to carry out their work according to the professional ethics (Art. 39). In the sixth chapter, a series of acts are described as illegal and the related sanctions are expressed. Some examples are the falsification or alteration of accounts, the preparation of false balance sheets and the destruction or concealment of documents that can be considered relevant in the accounting practice. The text of the Accounting Law ends with the additional provisions and in particular with article 52 which states the entry into force of the law starting from 1 July 2006.

With the authorization granted by the Ministry of Finance, in 1996 CICPA issued the Chinese Standards on Audit or Chinese Independent Auditing Standards (中国注册会计师审计准则 *Zhongguo zhuce kuaijishi shenji zhunze*). These standards marked a great step forward for the development of the accounting profession in China, with the intention to improve the competence of its Certified Public Accountants and to continue the process of harmonizing national accounting practices with international standards (Lin; Chan 2000). In order to reach international harmonization, the Chinese Standards on Audit have been modified several times to converge with the International Standards on Auditing; for the first time in 2006 (this change had a total of 48 principles), then in 2010, in 2016, in 2018 and subsequently in 2019. With the last improvement, 18 auditing standards including "China Auditing Standards for Certified Public Accountants No. 1101-General Objectives of Certified Public Accountants and Basic Requirements for Auditing Work" were approved and issued by the Ministry of Finance on February 20, 2019, and came into effect on July 1, 2019.

Currently the Chinese Standards on Auditing include: a basic standard for assurance engagements, 45 audit principles, a standard for review engagement, two standards for other assurance engagements, two standards for related services and a standard for firms' quality control. In order to improve the audit quality, CICPA has revised five Q&As to guide CPAs on the interpretation of the new auditing standards. They became effective on 31 December 2019 and include: Questions and Answers for China Auditing Standards No.1 – Professional Skepticism, Questions and Answers for China Auditing Standards No.2 – Confirmation, Questions and Answers for China Auditing Standards No.4 – Revenue Recognition, Questions and Answers for China Auditing Standards No.6 – Related Parties, Questions and Answers for China Auditing Standards No.12 – Audit of Currency Funds.

CICPA is also responsible for controlling the work of the CPAs and accounting firms. With the release of the *Rules on Quality Review of Accounting Firms* and the *Supervision Regulation on Audit of Financial Statement of Listed Companies* (respectively effective from 16 July and 31 August 2011), CICPA establishes a supervisory system aimed at assessing the quality of services provided by the accounting companies and to monitor the activity of the CPAs. Its strictness is shown by the data provided by the Overview of the accountancy profession in China 2018 (p. 10), according to which from 2004 to 2016, CICPA and local institutes reviewed accounting firms for 18,229 times, punished 2,475 firms and 4,932 CPAs.

In China CPAs are entrusted with the role of auditor, as they are the only ones that, according to the law, have the professional qualification and competence in the matter and sufficient analytical and judgmental ability to perform auditing activities (Lin; Chan 2000, p. 565). Their duties include the examination of the financial statements, the verification of the capital of the companies, the carrying out of reviews relating to the mergers, divisions and liquidation of companies by releasing the respective reports, and the undertaking of other auditing activities provided by other laws and administrative decrees.

In order to carry out its work with objectivity, confidentiality and in compliance with the auditing principles and the code of ethics, the CPA must be independent, not involved in the decision-making processes of the company from which he receives the audit engagement and free of links from the body that authorizes his activities (Lin; Chan 2000). The independency and liability of CPAs and audit firms has been jeopardized by the bound with the CPAs and audit firms and the government. To overcome this problem, the CPA Law of 1993 established that all accounting firms should have dissolved all ties with other organizations by 1999. Besides, in 1995 CICPA implemented a structural reform process according to which accounting firms should have had not only a management system suitable for the socialist market economy, but also should take on legal responsibilities, strengthen one's independence and pay greater attention to the risks of the activity and respect for professional ethics (Huang; Ma 2001).

For what concerns the budgetary review, the CPA must practice in conformity with ASBE. The Accounting Standards for Business Enterprises (企业会计准则 *Qiyè kuàijì zhūnzé*), are the principles that regulate the accounting practice. They were issued in 1992 by the

Council of State and subsequently modified over the years to be adapted to the context of business development and the Chinese capital market (Wu 2015). The ASBE are divided into ASBE - Basic Standards (基本准则 *jiben zhunze*), or fundamental principles and Chinese Accounting Standards (会计准则 *kuaiji zhunze*), or specific - practical principles. The latter were issued by the Ministry of Finance on February 15, 2006 with effect from January 2007 and with further changes, in 2012 China achieved the convergence with international standards. According to the Accounting Law, the ASBE (2006) are mandatory for all companies present in the Chinese territory (Art 2), especially for listed companies and large and medium-sized companies.

The provisions of the ASBE - Basic Standards aim at regulating the accounting recording and evaluation, giving indications concerning the principles and the basic elements of accounting. They also specify the contents and characteristics of the financial statements of the companies and the principles according to which they must be drawn up. The regulation prescribes all these rules to ensure the quality (Art. 1), the truthfulness and reliability (Art. 12) of the accounting information, which can influence the decision-making processes and the investments (Wu 2015).

In addition to the Basic Standards, the regulation also provides a series of "concrete principles" (Art. 3) complementary to the former. These principles are called Chinese Accounting Standards (CAS). Even the CAS have undergone changes and additions (the last time in 2014) to best meet the needs of a market oriented towards economic globalization. The current CAS are 41 and regulate in more detail the application of the legislative provisions, indicating the method of accounting recording of events, transactions and other particular accounting elements of Chinese economic activities (Colombo 2005). These specific principles are divided into three categories (Wu 2015). First, the general economic principles, which regulate the recording and evaluation of the economic operations of various companies (for example CAS no. 1, 2, 4 and 9). Second, the principles for special industries, relating to the accounting practice of particular industries such as CAS no. 5 and 27. Third, the reporting principles, concerning the compilation and publication of the financial statements (for example the CAS from n. 29 to 33).



In order to guide the practice of Chinese auditors, the Ministry of Finance published the ASBE - A guideline to the application (企业会计准则——应用指南 *Qiyekuaijizhunze - yingyongzhinan*).

Once the financial statements have been reviewed, the auditor will issue a report containing the name of the audited financial statements and the period to which they refer, the names of the budget manager and the auditor, the rules and procedures according to which the review has been conducted and final opinion with the related reasons (Lin; Chan 2000). In this regard, the CICPA has released Notice on the Preparation of Audit of 2019 Annual Reports of Listed Companies, which involves ethic requirements for auditors. It aims at improving quality control systems, with a focus on industries and audit area with higher risks. Among the industries with higher risks there are financial industry, real estate industry, pharmaceutical industry and listed companies with higher exposure at default, higher proportion of overseas business and sharp fluctuations in performance. Audit areas with higher risks include revenue, currency funds, goodwill, financial instruments, related party relationships and transactions, going concern, and material non-recurring transactions.

This assumes greater importance in the Chinese framework, were in June 2012, the Shanghai Stock Exchange and Shenzhen Stock Exchange launched a revised plan for the delisting system. China's stock exchanges were established in 1990 and since then, important laws and regulations related to the delisting system have been promulgated (1992, 2001, 2005, 2012, 2014 and 2018). The 2012 delisting system implemented more stringent measures in terms of regulatory measures and information disclosure, proposing more stringent requirements. Delisting indicators include: net assets, operating income, audit opinions, stock trading, report and disclosure requirements. The implementation of this delisting system has brought many effects to enterprises. For example, the new delisting system has increased the difficulty and cost of the companies' earnings manipulation, as the transparency of the company's information. According to the delisting system, if a company's net assets is negative for three consecutive years, or the operating income is less than 10 million yuan for three consecutive years, the company should terminate its listing.

In October 2014, the China Securities Regulatory Commission issued "Several Opinions on Reforming, Perfecting and Strictly Implementing the Delisting System for Listed

Companies", which was considered one of the most stringent delisting regulation in history, adding major violations such as fraudulent issuance and major information about disclosure violations. On July 27, 2018, the CSRC formally issued the "Decisions on Amending the Several Opinions on Reforming, Perfecting and Strictly Implementing the Delisting System of Listed Companies", which requires the improvement of major violations of the law and mandatory delisting, and the strengthening of stock exchanges. According to some data provided by China Business Daily, in 2019 the number of A-share delisting companies has reached 9 firms, a record in recent years. Looking forward, since 2011, the number of companies suspended from listing each year has remained at around two or three.

## 1.6 LOCAL AUDIT COMPANIES AND BIG FOUR IN CHINA

As for the accounting standards, the open-door policy also paved the way to the establishment of audit firms. The first pilot audit firm was founded in 1983 by the government, the Shanghai Accountants' Firm. As the CICPA was only founded in 1986, it was actually since that moment on that the government started to establish accounting and audit firms. After six years, in 1992, the Big 6 (Arthur Andersen, Price Waterhouse, Coopers & Lybrand, Peat Marwick Mitchell, Ernst Young, and Deloitte & Touche) entered China by establishing joint venture firms between local audit firms and the Big 6 member firms from Hong Kong. That year, there were 1,422 accounting firms and 2,812 audit firms in China (Gillis 2014a). Accounting firms were initially under the supervision of the Finance Bureaus, while the Audit Committee of China was responsible to control the audit firms. However, in 1998 the Chinese government decided to give more independence from the supervisory authorities to audit and accounting firms and by 1999 they reached independence. At the present time, they are under the regulatory of Ministry of Finance and guidance of China Institute of Certified Public Accountants (CICPA). In 2020 the MOD and the National Bureau of Industry and Administration issued the "Promoting the Large/medium size accounting firm to adopt the Special General Partnership in organization format". It can be considered a prescription especially for large accounting firms, like the Big 4 in China, to transform into a Special General Partnership (SGP) legal form. SGP is similar to a limited liability partnership in the United States and other developed economies. The reform was completed by the major

accounting firms, yet the majority of small and medium accounting firms in China have not reached SGP legal form.

Until 1989 the Big 8 (Arthur Andersen, Arthur Young & Co., Coopers & Lybrand, Ernst & Whinney, Deloitte Haskins Sells, Peat Marwick Mitchell, Price Waterhouse, and Touche Ross) dominated the international audit market, but then Ernst & Whinny merged with Arthur Young & Co. as Ernst & Young and Deloitte Haskins & Sells merged with Touche Ross as Deloitte Touche (later named as Deloitte). The Big 8 became Big 6, until 1998, when the Price Waterhouse merged with Coopers & Lybrand to form PricewaterhouseCoopers (PwC) and then in 2001 when the Arthur Andersen was torn apart. Since 2002 the dominating accounting firms are the Big 4. At first, Big 4 services were mainly addressed to foreign investment companies and later to State-Owned Enterprises which wanted to be listed overseas and some private enterprises. All the Big 4 accounting firms established management committees in order to tie their employees to the local costumes but always under the parent company's governance. This can be seen in Hong Kong and Macao, where legally independent KPMG member firms were established but always under the control of a management committee. Deloitte established the same governance structure while the management committee of both PwC and Ernst & Young included Singapore and Taiwan.

According to the information currently disclosed on the PCAOB website a total of 865 non-US accounting firms have registered with PCAOB in 92 countries or regions, amongst them 83 accounting firms are registered in China (including 29 in Hong Kong, 16 from Taiwan).

After more serious cases of financial fraud and audit failures occurred in China, especially after the “Yinguangxia” incident in 2001, it was evident that China needed some improvement in terms of practice environment of CPAs in order to ensure audit quality. The “Guiding Opinions on the Professional Ethics of Chinese Certified Public Accountants” (中国注册会计师职业道德规范指导意见) issued by China in June 2002 has stipulated that the accounting firms should periodically rotate the audit project leader and the signing CPA every five years. The audit rotation has two objectives. First, it can maintain audit independence and objectivity. This is reflected in two aspects: first, it can avoid that the tie between the accounting firm (and its auditor) and the client becomes too close. Accounting firms and their auditors serving the same client for a long period of

time may cause the accounting firm to become dependent on the client and cause the interests of the two to be closely tied together to form a de facto business partnership. This can lead to various compromises to clients and even fraud, thereby affecting the independence and objectivity of auditing. Besides, audit firms can avoid to be bought by customers. Accounting firms and their auditors who serve the same client for a long time, may provide convenience for clients to buy out auditors, which is extremely detrimental to ensuring the objectiveness and fairness of the audit.

Secondly, it is conducive to promoting the prudent practice of CPAs and it improves audit quality. This is reflected in two aspects: one is that it enables auditors to maintain the necessary level of prudence and professional ethics and strengthen quality control. Through the implementation of the audit rotation system, subsequent auditors may find that their predecessors have problems in their work such as violations of professional ethics or negligence, and the former auditors will be held accountable for this. The pressure to maintain the necessary level of prudence and professional ethics can strengthen quality control; second, it helps to find possible mistakes in the audit. The long-term cooperation will form the mindset of the firm and its employees. By changing the auditors and reviewing the company from another perspective, this problem may be solved.

According to the ranking released by CICPA on the Top one hundred Accounting Firms in China by revenue in 2015, 2016, 2017 and 2018 an evolutionary trend can be noticed amongst the top 5 Accounting Firms.

Since the release of the rankings by the China AICPA in 2002, PricewaterhouseCoopers Zhongtian (普华永道中天会计师事务所) has consistently ranked first in the industry in terms of business revenue. PwC's origins in China can be traced back to June 2, 1902. At that time Arthur Lowe registered as the first professional accountant in Hong Kong. The accounting firm he founded eventually became a member firm of PricewaterhouseCoopers in 1965. After the reform and opening up, PricewaterhouseCoopers and Dahua CPA (大华会计师事务所) jointly established PricewaterhouseCoopers, which lead to the merger of Beijing Zhangchen Certified Public Accountants (北京张陈会计师事务所) as its Chinese member firm. Besides, they absorbed the Guangzhou Yangcheng Accounting Office (广州羊城会计所) as an associate. In 1998, PricewaterhouseCoopers merged with Yongdao. In 2002, PwC's Hong

Kong and Mainland China departments merged, and on July 1, 2002, it merged with Arthur Andersen's business in Mainland China and Hong Kong. On June 7, 2013, it was restructured into a special general partnership and was renamed PricewaterhouseCoopers Zhongtian Certified Public Accountants (Special General Partnership). PricewaterhouseCoopers Zhongtian Certified Public Accountants Co., Ltd. was cancelled. According to PwC China's official website disclosure (<https://www.pwccn.com/zh/about-us.html>), PwC Mainland China, Hong Kong and Macao member institutions operate in accordance with applicable laws in various regions. Overall, the total number of employees exceeds 17,000, including more than 600 partners.

Deloitte Touche Tohmatsu Huayong CPA (德勤华永会计师事务所) got the second place in the years 2014, 2016, 2017 and 2018. Deloitte established an office in Shanghai in 1917, and so the Deloitte brand entered China. Today, Deloitte China provides comprehensive audit and assurance, management consulting, financial consulting, risk consulting and tax services for local and multinational and high-growth corporate clients in China. In October 1983, the first permanent representative office was established in Beijing. In December 1992, Shanghai-China Deloitte Touche Tohmatsu Certified Public Accountants Co., Ltd. (中外合作会计师事务所) was established in Shanghai in cooperation with Shanghai Certified Public Accountants (上海会计师事务所), and a Beijing branch was established in Beijing in June 1998. In 1997, Deloitte merged with Hong Kong's well-known Guan Huang Chen Fang accounting firm (关黄陈方会计师事务所) with long-term Chinese business experience, which greatly enhanced the strength of its Chinese business. The combined company became one of the largest professional service firms in China. According to Deloitte's official website disclosure (<https://www2.deloitte.com/cn/en/pages/about-deloitte/topics/creating-value/deloitte-journey-in-china.html>), its workforce in mainland China and Hong Kong has increased from 2,300 in 2003 to more than 8,000 in 2011. In 2004, Deloitte announced its five-year plan to invest 150 million US dollars in mainland China, which is also the largest investment Deloitte has invested in a single market in more than a century. In 2005 Deloitte China merged with Beijing Pan-China and Shenzhen Pan-China, increasing the client portfolio, especially with large state-owned enterprises.

In 2015 ranking, Deloitte has been passed by Ruihua CPA (瑞华会计师事务所). Ruihua Certified Public Accountants stated on its official website that it has more than 20 years of development history, but it has only been less than 6 years since the name "Ruihua" appeared because Ruihua had undergone a series of mergers and name changes before. According to data, Ruihua Certified Public Accountants originated from Wulian United Certified Public Accountants Co., Ltd. (五联联合会计师事务所有限公司). The predecessor of Wulian Certified Public Accountants Co., Ltd. was Gansu Certified Public Accountants (甘肃会计师事务所), Ningxia Certified Public Accountants(宁夏会计师事务所), and Qinghai Certified Public Accountants (青海会计师事务所). In December 1998, the above three accounting firms were separated from the Finance Departments of Gansu Province, Qinghai, and Ningxia, and restructured into limited liability accounting firms. They were respectively renamed as Gansu Wulian Accounting Firm Co. Ltd., Ningxia Wulian Accounting Firm, and Qinghai Wulian Certified Public Accountants. In September 2000, the three accounting firms jointly initiated the establishment of Wulian United Accounting Firm Co., Ltd., registered in Lanzhou. In November 2005, Wulian United Certified Public Accountants Co., Ltd. merged with Beijing Fangyuan Huaxin Certified Public Accountants Co., Ltd. (北京方圆华信会计师事务所有限公司) and changed its name to Beijing Wulian Fangyuan Certified Public Accountants Co., Ltd (北京五联方圆会计师事务所有限公司).

Afterwards, Beijing Wulian Fangyuan Certified Public Accountants Co., Ltd. merged with Bandung Asia Certified Public Accountants Co., Ltd., (万隆亚洲会计师事务所有限公司) Zhonglei Certified Public Accountants Co., Ltd. (中磊会计师事务所有限公司) headquarters and branches in Anhui, Jiangsu, Fujian, and Guangdong Foshan. The merged firm was renamed Guofu Horwath Certified Public Accountants Co., Ltd. (国富浩华会计师事务所有限公司). From 2010 to 2011, it evolved into a special general partnership accounting firm, and its name was changed to Crowe Horwath Certified Public Accountants (国富浩华会计师事务所 - Special General Partnership).

According to public information, in July 2012, it also merged with Shenzhen Pengcheng Certified Public Accountants (深圳市鹏城会计师事务所), the largest domestic-owned accounting firm in southern China at the time. The accounting firm of the limited

company (hereinafter referred to as Greenland) was involved into an IPO fraud scandal. From 2004 to 2009, Greenland had inflated revenues of 296 million yuan and raised nearly 350 million yuan in fraudulent IPOs. Shenzhen Pengcheng Certified Public Accountants acted as its audit agency for seven consecutive years from the establishment of Greenland to the IPO.

In 2013, Crowe Horwath Certified Public Accountants (Special General Partnership) merged with Zhongrui Yuehua Certified Public Accountants (中瑞岳华会计师事务所 - Special General Partnership) and changed its name to Ruihua Certified Public Accountants (Special General Partnership). This series of changes of Ruihua Certified Public Accountants is also reflected in the changes in auditing institutions announced by listed companies. That is to say, part of the current Ruihua Certified Public Accountants' projects are customers of previously merged accounting firms.

The position of Ernst & Young Hua Ming CPA (安永华明会计师事务所), instead, varies during the period of time considered. Its history can be traced back to 1968, when the predecessor of Ernst & Young, Astra Young Certified Public Accountants (雅特杨会计师事务所) established its first member office in Hong Kong. In 1981, Ernst & Young became one of the first international professional service companies approved by the Chinese government to set up an office in Beijing. In 1992, Ernst & Young was approved by the Ministry of Finance of China to establish a Sino-foreign cooperative firm - Ernst & Young Hua Ming Certified Public Accountants. Currently, it has offices in 14 cities with a total of more than 8,000 employees. In July 2012, according to the requirements of the Ministry of Finance for the localization of Chinese-foreign cooperative accounting firms, and under the leadership and strong support of the MoF and other relevant ministries and commissions, Ernst & Young Hua Ming CPA became a special local company with international brands, international management and concepts.

The position of BDO China Shu Lun Pan CPAs (立信会计师事务所) similarly is not stable. BDO China Shu Lun Pan was founded in Shanghai in 1927 by Mr. Pan Xulun, a Chinese accountant, and is one of the earliest and most influential accounting firms in China. According to the provisions of the Sarbanes-Oxley Act of the United States, non-US audit institutions that need to audit overseas subsidiaries of U.S. listed companies need to register with the PCAOB (Public Company Accounting Oversight Board), which

Lixin had obtained in August 2004. In 2009, BDO China Shu Lun Pan joined BDO International, the fifth largest international accounting network in the world. In December 2010, it was restructured into the first special general partnership accounting firm in China. BDO China Shu Lun Pan currently has more than 6,000 employees, including more than 1,600 certified public accountants. Its clients are from all over the country, including more than 500 listed companies, more than 2,000 foreign-invested companies, and provide auditing and auditing services for large central enterprises, state-owned groups, banks, securities companies, futures brokerage companies, insurance companies, trust companies, and fund companies.

KPMG Huazhen (毕马威华振会计师事务所) is one of the Big Four that appears on the ranking, but not always amongst the top five.

KPMG China's business can be traced back to 1945. When Hong Kong fell in December 1941<sup>5</sup>, the HSBC head office was forced to temporarily move to London. One of the bank's auditors at the time, Peat Marwick Mitchell & Co of London, was appointed to assist the bank in preparing its accounts. After the war, the HSBC head office moved back to Hong Kong. In order to maintain the continuity of audit work and at the request of the bank, Peat Marwick Mitchell & Co., who was then the bank's auditor, set up an office in Hong Kong. In 1945, Peat Marwick Mitchell & Co.'s partnership business in Hong Kong was formally established. In 1987, Peat Marwick Mitchell & Co and Klynveld Main Goerdeler merged globally to form KPMG Peat Marwick. Then in 1992, KPMG became the first international accounting firm approved to establish a joint venture in China. The same year, KPMG became the first international accounting firm approved to operate as a joint venture in Mainland China. KPMG China nowadays has 26 offices in 24 cities with around 12,000 partners and staff. Services provided in Mainland China include: auditing, internal auditing, information risk management, taxation, and financial consulting.

The ranking and the influence of *guanxi* on it will be further analyzed in the third chapter.

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<sup>5</sup> On the 8th of December 1941, the Japanese launched an assault on Hong Kong and the fall of Hong Kong was signed on the 26<sup>th</sup>.



## CHAPTER 2: *GUANXI* INFLUENCE ON SOCIETY, BUSINESS OF FIRMS AND AUDIT PRACTICE

### HOW *GUANXI* AFFECT THE CHINESE SOCIETY

In the recent decades, the concept of *guanxi* has been object of study by many experts and scholars, starting from the late 1970s, when it was first proposed with a sociological approach (Jacobs 1982). Since then, great concern was shown about *guanxi*-related issues. The reasons can be due to the unique role *guanxi* plays in the Chinese daily life, as it is an important tool in regulating human behavior in Chinese society and business practice. Studying Chinese interpersonal relationships is the key to revealing Chinese social psychology and behavior. In the past, many scholars have done general discussions on this issue at a more abstract level, such as Liang's ethical standard (1988), Fei's differential order pattern (1985), Hsu's situational center theory (1970), Yang's social orientation (1992). There are also some specific and qualitative studies, such as Jin's research on human sentiments and face (1988), while others are quantitative studies, such as Yang's study on gift giving (1988), Zhu's study on face (1991), and Li's study on the boundary between people and self (1993).

The focus of the major studies is on an individual level (Chen et al. 2004; Gold 1985) and organizational level (Park and Luo 2001; Tsang 1998). In all of these studies a *guanxi* behavior can be traced, which encompasses face-saving and emotional commitment (Shou et al. 2011). The three dimensions of *guanxi* behavior are expressed through the assistance from family, the help of friends and the favors amongst colleagues (Taormina, Gao 2010). This implies a collectivism that is rooted in the Confucian tradition, and whose dynamics have a direct impact on the development of *guanxi* (Wong et al. 2010). Some scholars believe that the role of *guanxi* seems to get weaker among the younger generations in China (Kwong 1994, Ralston et al. 1999, Lin; Ho 2009) but yet *guanxi* has been a fundamental pattern in the societal, business and economic environment (Wong et al. 2010, Kim et al. 2013). In this respect, according to Nolan (2011) the importance of *guanxi* has even increased during the economic progress, leading in many cases to nepotism (Kwong 1994).

As stated by Di (1993), in-depth studies of *guanxi* related concepts can shed light on the relationship between the elements of culture and Chinese psychology and behavior, but it is not trapped by Western concepts. Chinese traditional ideology and culture itself is characterized by an emphasis on the relationship between people, and this is applied in philosophy, ethics, history, folklore, management, psychology, society, and education. When researching, scholars all face the same concepts, such as benevolence, righteousness, loyalty, forgiveness, filial piety, ladder, etiquette. When it comes to them, it becomes ambiguous, turning the study of sociology and social "rationality" into a study of philosophical ethics. In addition, these concepts are too abstract in nature and are not suitable for sociology or social psychology.

The emphasis on human relations is a prominent feature of Chinese Confucian culture. Chinese culture with Confucian moral philosophy as its core has strong moral orientation, and has a complete set of moral norms with its own characteristics. It also plays a dominant role in the interpersonal relationship of traditional Chinese society, thus making Chinese society a strong ethic-oriented society.

As Russell pointed out in "The Problem of China" (1993), for Chinese people the correct moral quality is more important than meticulous scientific knowledge. This kind of thinking derives from the Confucian tradition. Although some of the ethics in Chinese cultural traditions have changed overtime and have even been eliminated with the development of society, many of them still exist in Chinese society and has an important influence on contemporary Chinese interpersonal relations.

Taking ethics as the general principle of interpersonal relations will inevitably lead to the moralization and hierarchy of interpersonal relations. Especially in case of conflict, Chinese people are often used to using ethics as the criterion for determining right from wrong. In the modern society, where it seems that people pursue material civilization and self-interest, the tendency of emphasizing morality in interpersonal relationships helps to promote people to pay attention to moral cultivation, to restrain improper behavior, and cultivate a good social atmosphere.

Although the process of China's modernization has challenged and impacted this model, it has not really shaken its foundation. This is mainly due to the deep-rooted Confucian cultural tradition. As stated in the first chapter, family life is the most important social

life of Chinese people; relations with relatives, neighbors, and friends are the second most important social life for Chinese people.

Interpersonal relations in China have always developed along the value orientation of Confucian holism. The fundamental principle of holism as the leading value principle is still used by the Chinese in handling the relationship between themselves and the group. However, holism orientation is a double-edged sword. On the one hand, holism emphasizes overall interests in interpersonal relationships, and emphasizes individual attachment and obedience to the group. This leads to the promotion of interpersonal cooperation, to the improvement of interpersonal relationships, and to the reduction of conflicts. However, on the other hand, the holism orientation does not pay attention to individual rights and values, which easily leads to the suppression of human personality and creativity, especially the expansion of authoritarian power and the breeding of corrupt behavior.

The evolution of *guanxi* within the Chinese framework has been pointed out by sociologists and anthropologists, starting with the Mao era and the 1980s. At that time, the communes practiced a strict control over resources, which led people to lean on their personal connections with local officials in order to receive special treatments and have access to important necessities. As bureaucrats had relative power in resource allocation, people highly relied on their *guanxi* network (Bian 2018). In job allocation, for instance, good quality *guanxi* could tip the balance in favor of one candidate, even if all of the candidates had the same qualification. Walder et al. (1999) claim that such favoritism was essential in Mao's China in order to survive.

Many researchers have tried to simplify the complexity of such concept through definitions, but it seems difficult to encompass all the aspects of *guanxi* in a definition or in a merely translation. Usually, scholars address to it as a relationship between two parties (Alston 1989), as an exchange of favors (Lee; Warren 2001) or as a form of social capital (Tung et al. 2008). Moreover, according to Fan (2002), *guanxi* is a tridimensional dynamic, as it is simultaneously a connection, an exchange and a resource. It is a connection because it works "like an electric circuit" (Fan 2002, p. 548), where the parties are bounded by dynamic ties. It also involves a tacit exchange of favors and benefits, which motivates the parties to cooperate and to submit their obligations. This has been demonstrated at the workplace, where a positive outcome seems to be directly correlated

with the establishment of obligations among the *guanxi* network (Ahmed et al.2013). Besides, *guanxi* allow the parties to have access to resources that otherwise would be impossible to allocate. In many cases these resources can be information about the market trends and the access to powerful *guanxi* networks.

Conforming with the literature review about it, the complexity of *guanxi* has been shaped through three analytical dimensions, that are: affective, normative and instrumental (Hwang 1987). First, the affective dimension is related to the establishment of a relationship on a sentimental basis, which is gender specific. Second, the normative dimension refers to prescriptive ties as in friendship and kinship. Third, the instrumental dimension, in opposition to the affective one, is focused on the advantages and resources one can allocate through the establishment of a *guanxi*. Generally speaking, it is unusual to find only one specific dimension when a *guanxi* is analyzed, but instead, a mix of the three ties is found. Even if they seem difficult to melt, such mix does not prevent the establishment of a *guanxi*, but at most, the grater the inconsistency is between the three dimensions, the weaker and unstable the *guanxi* will be.

It is important to specify that even if it is a Chinese peculiarity, the *guanxi* practice is also present in other collectivist and high power distance countries. Therefore, it can be confusing to Westerners who try to orientate in a society where people rely more on their *guanxi* network than on the institutionalized rules. That is the reason why foreigners often mistake *guanxi* with bribery and attempts of corruption, especially when there is a material exchange of gifts between the two parts (Steidlmeier, 1999; Su and Littlefield, 2001). This is due to the lack of a proper bureaucratic system able to guide individuals, who instead have to establish *guanxi* with the bureaucratic power (Warren et al. 2004). Due to economic reforms, indeed, radical changes in China have occurred and this has jeopardized the stability of the country. In a long-term prospective Douglas Guthrie (2002) attempts to foresee the future of *guanxi* in a dynamic structure as China. According to him, “the extent to which *guanxi* matters in China’s transforming economy depends on crucial ways on the institutions that define economic and social action, and these institutions are changing dramatically” (Guthrie 2002, p. 38). Besides, the significance of *guanxi* is strictly related to the social role of the parties involved, that is, powerless individuals tend to perceive the establishment of good quality *guanxi* network in order to compensate.

In this perspective, some scholars believe that *guanxi* can be considered a form of relationship marketing in China (Bjorkman; Kock 1995, Wong 1998a, 1998b), but actually two main differences need to be considered. First, relationship marketing is a service-oriented way of doing business, that is, it not only comprises the relationships and it encompasses therefore a broader perspective than *guanxi* (Leung; Wong 2001). Second, *guanxi* implies an interpersonal relationship that can endure only if the person who established such relationship remains, while relationship marketing persists even if the *guanxi* person goes away.

A distinction between western social networks and *guanxi* also must be highlighted. Luo (1997) suggests that *guanxi* includes all western social network qualities, but some differences still persist. As reported by Streeter and Gillespie (1993), western social networks are shaped through boundaries, connectedness and social units. A parallelism between the concept of boundary in the Western cultures and the concept of door for *guanxi* can be made, that is, in both cases the person inside the boundary or door is considered an insider. On the opposite, a person who does not enter the door does not merit trust and acceptance (Luo, 1997). In line with the suggestion of Hammond and Glenn (2004), the insider and outsider of a *guanxi* relationship can be compared to the nine western concepts that regulate the networking.

Nevertheless, the focus in a *guanxi* dynamic is more on the insiders, while in a Western dynamic outsiders are exploited to obtain information and opportunities (Hammond; Glenn 2004). The strong relation between parties in the *guanxi* practice is stronger than the relationship marketing, which usually does not encompass mutual obligations. While western social networks can be set at the individual, local or national level, *guanxi* instead is “the individual’s connection to the whole” (Hammond; Glenn 2004, p. 26).

This can be applied, for instance, to the recruitment practice at the workplace. It has been found that *guanxi* is convenient for a firm as a strategic tool of captivation, as it improves the fit between employees and the firm itself (Aarstad et al. 2019). Besides, *guanxi* is also used by the recruiters to increase the number of candidates and enhance their bargaining power. When the pool of potential candidates is tied with the recruiter’s *guanxi* network, he can easily obtain information about them and this can be extremely relevant especially for hiring a high status position.

In the past, hukou (a sort of domestic passport used as a registration system for individuals and communities) and danwei (unit work) determined one's job allocation and *guanxi* networks were fundamental in order to reach the best local opportunities. Nowadays, good quality *guanxi* are still the key in social life, but it may happen that one finds better opportunities outside its relationships cycle (Mukhopadhyay 2019). Relying only on one's *guanxi* network, therefore, can be counterproductive, as it may limit performance and business results.

Within this framework, another classification of *guanxi* can be stated, that is external, within and back-stage *guanxi*. Such *guanxi* have been analyzed in the perspective of woman entrepreneurship (Zhang et al. 2020). External *guanxi* refers to B2B *guanxi*, where both parties are business people, and B2G *guanxi*, where one party is related to the government (Fan 2002). In the Confucian societies, relationships are lead through intimacy/distance, superiority/inferiority and righteousness/propriety (Hwang, 2000). Besides, a strong patriarchy regulates the social norms, according to which the role of women should be family oriented. The reliance on external *guanxi* networks is therefore less likely to manifest for women, and indeed, they tend to develop their external *guanxi* through the support of a male mentor.

Within the concept of *guanxi* a paradox can be detected, namely the Chinese paradox of the unclear distinction between private life and work life. It refers to the relationships between the supervisor and his subordinates, which is influenced by the Confucian philosophy. Therein, respect for elders is essential.

As stated by many scholars, in a business environment, women tend to pay more attention on their firm's internal affair, while male entrepreneurs prioritize external ties (Parker 2011). The empirical evidence suggests that a good quality *guanxi* network can be exploited by women entrepreneurs in a work environment.

Back-stage *guanxi* is permeated by family ties, locality, education or work place, but it can be a double-edged sword for women, as the family base is the basis in the Chinese society, but it can also hinder work possibilities for a woman (Huang; Aaltio 2014, Scott et al. 2014).

In compliance with the research of Zhang et al. (2020), the importance of *guanxi* in the work environment has been recognized by Chinese women managers as a strategic tool able to facilitate their career (Chen et al. 2004) and to obtain resources.

Most of the studies conducted on *guanxi* are set in a working environment, with a special regard to how and to which extent such special relationship can influence the judgments and the social dynamics within firms. It has been recognized that *guanxi* influence the objectivity of managers when they are called to evaluate subordinates, impairing their judgments (Nikos 2007). Besides, *guanxi* also influence the decision-making process, and therefore the employee's perception of procedural injustice (Chen et al. 2011) and their expectations.

According to most managers' perspective, *guanxi* is a social capital within a firm. On the individual level, *guanxi* can boost their career through promotions, while on the organizational level *guanxi* can provide strategic resources. Pablos (2005) outlined the experience of two European executives in Shanghai and Taipei during the 1990s, who stated the importance of *guanxi* networks regarding job allocation in an urban context. According to them, *guanxi* can also facilitate work position shift. This implies the engagement of the concepts of *mianzi* (face), *renqing* (favor) and *ganqing* (affect) and the expectation of a return of benefits.

With a focus on how to build *guanxi*, many scholars have pointed out the importance of the participation in social activities and common interests (Ying 2002, Warren et al. 2004, Chen et al. 2012), as charity. As the other Confucian societies, charity is linked to the relational self and its cycle of closeness (Liu 2015). This is also suggested by some Chinese expression, such as *nei wai you bie* 内外有别, which states the division between the inside and the outside, and *qin shu you bie* 亲疏有别, which states the division between close and distant. *Guanxi* base, historically, highly influenced the likelihood of Chinese individuals to get involved in charity programs, especially family base *guanxi*. Specifically, *guanxi*-oriented charity has been able to overcome the governments bureaucratic holes in this sector and hence, to support more people (Yan et al. 2007). With the modernization process, new waves of internal migration have struck China. Internal migrants have come into contact with new communities, changing the relational social structure. For what concerns charity, therefore, nowadays family base has lost its importance overtime and the government has started to develop charity organizations.

However, according to some scholars, family bonds can boost the sense of obligation and the favor exchange, facilitating the development of long-term *guanxi* Chen and Chen (2004) in specific sectors. In tourism, for instance, a long-term *guanxi* through family ties

can be established between tourists and the destination (Wang et al. 2018). This is due to the fact that the external environment can generate *ganqing* and through the recognition of a cognitive image, tourists are more likely to choose the destination.

The environmental activism is strictly related to *guanxi* network too. Relational connections among people, which can have a family base, a friendship base or can be related to the workplace, have been the pillars of the Chinese environmental movement. Actually, the concept of environmental activism is still relatively new in China and often informal rather than be shaped through formal organizations. There, *guanxi* have two main peculiarities. First, the *guanxi* practice operate in this sector in order to overcome the lack of formal and institutionalized structures. Secondly, *guanxi* act as a booster of solidarity and mobilization of members as it involves trust and shared identity patterns.

Trust refers to the perception towards others in the context of a transaction and in a trust-building process, Chinese people tend to trust more their relations than institutions.

The social media represent a big tool for connectivity, as they allow to overcome space barriers. In this sense, they also facilitate the establishment and the maintenance of *guanxi*, especially WeChat acts as “an instrument of communicating and coordinating daily *guanxi*” (Hao; Hai-Tao 2020, p. 14). Gift giving is also possible through Chinese social media, as WeChat has a mini-program that allows users to exchange the so called “red pocket”.

Within a social media platform perspective, Anson (2020) has conducted a study about the exchange of likes and its connection with the concept of *guanxi*. According to his research, likes can be considered a digital gift of *renqing*, enabling users to establish and maintain online ties. He distinguished two ties: weak ties and strong ties. The first one refers to not frequent interactions, while the latter refers to regular interactions and they are often similar to close friendship relations. The stronger is the bound, the higher is the demand of reciprocity and the sense of obligation. The concept of *mianzi* is also involved in online ties, where often the exchange of likes is based on a fear of damage one’s reputation and the interpersonal relationship. The reconceptualization of *mianzi* here is strictly related to an emotional exchange over time, which is expressed through the nonverbal likes. They ease the communication and strengthen the sense of agreement between the members, generating a flow of *renqing*.



Zhao and Zhang (2020) adopted the same perspective and tried to understand how *guanxi* can influence the exchange of likes on social media. In accordance with the study of Anson (2020), Zhao and Zhang found out the *guanxi*-related concepts (especially *mianzi*, *ganqing* and *renqing*) highly influence the users in the process of exchanging likes, involving a real emotional commitment. Therefore, WeChat is not only used to share interests, but also to nourish *guanxi* (Wang et al. 2016). The implications of the aforementioned exchange of *renqing* are reciprocity, mutual expectations and gratification. Wang et al. (2016) assume that social media are a helpful tool in the *guanxi*-building and maintenance process, as they allow users to express their emotions through likes, reviews and instant messages.

The sociologist Fei Xiaotong (1992), pointed out the differential modes of association (*chaxu geju* - 差序格局) that characterize *guanxi*-oriented societies, with a specific focus on China. His theory refers to the difference between the individual user as the center, and the distance between various relationships and oneself. He proposed the concept of differential order when studying the structure of Chinese rural areas, where every family takes its own status as the center, and a circle is drawn around it. The size of this circle depends on the thickness of the central power.

The formation of this differential pattern has the following factors: blood relationship, geographical closeness, economic level, political status, knowledge and cultural level. The size of the circle is directly proportional to the size of the above factors. The larger the blood organization, the larger the circle, and its attribute rules are based on ethical generation. The closer the geography is, the easier it is to form a differential circle. The economic level and political status are the most important factors in the formation of circles, and they symbolize the size of power domination. Cultural knowledge is what rural residents generally lack and desire. The formation of the circle may be the result of one factor, or it may be a combination of several factors. As *guanxi* is strictly related to relational particularism, individuals in the Chinese society are more likely to short the social distance, and therefore increase the degree of particularism, when a resource advantage can be seen. Instead, the degree of particularism lowers with the decrease of the advantages involved. Lo and Otis (2003) also outlined such trend, which goes beyond the primordial relationships. In traditional society, the most primordial relationship in this pattern is the family, but with the advent of industrialization and frequent population

movements, the importance of unit organizations to individuals has increased. As a result, the emergence of unit groups has replaced single family groups.

Balance is an essential principle in Chinese interpersonal relationships. When two people form a relationship, the way of communication is determined by the two people, as the husband and wife relationship. In the interaction of three or more people, instead, a kind of checks and balances begin to appear. It is not easy to achieve an ideal state of balance. As long as the third party wants to be one of the interactors, he must exchange according to this principle, otherwise it will lead to an imbalance in the structure of interpersonal relationships, and produce contradictions and conflicts. The closer the relationship, the more important the balance and the more balance standards. Such standards can be tangible, such as money, gifts, rewards, or intangible, such as actions and speech. The standard depends on different events and different occasions. Each individual in the interaction generally evaluates the distance between him and the other interactor. In this way, when he wants to consider the issue of balance, he can choose one or several balance standards among similar distance relationships. A kind of balance maintenance is generally only manifested among people of the same attributes, such as between relatives, colleagues, and friends. As a kind of psychological pressure when complying with the standard, the closer the relationship distance, the stronger the performance, and the more complicated the balance factor considered. On the opposite, the longer the relationship distance, the less it matters. In this case, kinship, colleague relationship, teacher-student relationship, and doctor-patient relationship are short-distance relationships in the temporary relationship network. Therefore, balance is relatively important, and there must be cognition, emotion, and gift in the balance standard. Obviously, in addition to the fact that this standard can be formed without psychological pressure, the standard that has generally been formed will bring psychological pressure to the associate, forcing him to give up his own autonomy in action and go with others (Li 1994).

## HOW *GUANXI* AFFECT THE BUSINESS OF FIRMS

In the literature review regarding the performance of firms, a variety of variables are observed to impact their business. Such variables include firm size (Hall; Weiss 1967), pricing (Gallego; VanRyzin 1994), advertising (Chauvin; Hirschey 1993), and R&D intensity (Hoskinsson; Johnson 1992). *Guanxi* represent a significant variable too.

In China, *guanxi* is been detected as a determinant factor for the business of firms, as it helps them to overcome market challenges (Dinh; Calabrò 2019) and the weak legal framework. On the basis of Heide's (1994) guideline of relationship governance mechanisms, *guanxi* can be considered as such and it is a direct consequence of the Confucian collectivist philosophy (Hwang 1987, Xin; Pearce 1996).

On the basis of Hofstede's cultural dimension theory, China is characterized by a high degree of power distance, and people are more likely to establish *guanxi* when conducting business transactions (Park; Luo 2001) to overcome such distance. Therefore, Chinese firms tend to prefer to hire people with a good quality *guanxi* network (Warren et al. 2004), who are able to expand their web of contacts, and compensation is related to this (Young; Tsai, 2008). Indeed, since the Eighties with the Chinese economic reforms, the concept of "*guanxi* capitalism" started to develop (Boisot; Child 1996, McNally 2011).

The term was first coined by Hamilton (1998), specifically regarding Taiwan private business, which was characterized by the fast grow of private firms, mostly established on a family *guanxi* level, and by the creation of *guanxi qiye* 关系企业, literally "*guanxi* enterprises". The difference between Chinese and Western business practice was outlined. *Guanxi* capitalism is a bearer of two main contradictions. In China the market capitalization and the international economic integration have increased the employment of formal contracts, which have allowed Chinese firms to declare their legitimacy also on the international markets. However, the institutional uncertainty has increased the need to find a ploy for firms' success and reliance on *guanxi* network has become a must.

It is not only a problem of uncertainty but often of inefficiency because of weak infrastructures, bureaucratic delays and length of negotiations (Zhang et al. 2019). The Chinese government has tried to make up and improve the business environment, but the disproportion in the allocation of resources (especially between the private and public sector) has encouraged the establishment of *guanxi* as a strategic asset. Social obligations

and reciprocity bind people involved in a business *guanxi*, and violating such norms will jeopardize one's reputation, even leading to the loss of face (*mianzi*). *Guanxi* allow firms to overcome the inefficiency of the legal system, providing a certain degree of trust and certainty (Wang 2002).

In a business perspective, *guanxi* with local business partner can expand firms' network, while political connections can facilitate, for instance, the access to some information (Chung; Ding 2010). In this prospect, Fan (2002) offers a further classification based on the parties involved, that is, organizational B2B (business person to business person) and bureaucratic B2G (business person to government official). B2B *guanxi* aim at developing relationships with executives on a firm level, with suppliers, buyers, partners and even competitors (Dubini; Aldrich, 1991). B2G *guanxi*, instead, are on a political level and aim at establishing relationship with officials and bureaus.

B2G is considered a strategic tool to get economic resources, such as raw material, new technologies and expertise, which are relevant in the increase of efficiency (Acquaah 2007). Additionally, B2G impacts the firm's learning process, as it facilitates the acquisition of financial assets (Acquaah 2007, Child & Tse 2001, Davies et al. 1995, Sheng et al. 2011). This acquisition is possible through the legitimacy gained with the B2G, whose influence reflects also on preferential treatments. The advantages are lower borrowing costs, favorable policies and lower tax rate (De Soto 1989).

As B2G presumes the involvement of government officials, it can be considered a ploy to bypass laws and regulations and it is often considered as a "harmful *guanxi*" (Fan 2002b) in China. The harm such *guanxi* can cause is related to the fact that, for instance, in state-owned companies the leading positions are not assigned on a merit basis, but rather on a *guanxi* basis (Lin 2004). Additionally, according to the Chinese Company Law, the CEO and the Chairman of Board is directly appointed by the controlling shareholder, who in most cases is the state itself. Other critical issues regard the fact that a high degree of dependence from a B2G could inhibit the explorative learning process of the firm, for instance, if the *guanxi* tie leaves the *guanxi* network (Chung 2011, Sheng et al. 2011, Tsang 1998). The development of a B2G requires a high amount of resources and time, and this could affect the disposable resources of the firm. Besides, a conflict of interest may arise.

Previous studies outlined the benefits business *guanxi* can bring, such as the access to information and the enhancement of performance (Atuahene-Gima; Murray 2007, Li et al. 2009, Wang; Chung 2013). *Guanxi* with suppliers and its benefits for firm's development are stated by Li et al. (2009), who found a positive correlation between such *guanxi* and the acquisition of high quality materials and services.

The research of Chung et al. (2015) analyzes to which extent business performance is affected by organizational learning and *guanxi*. A comparison is done on 120 Chinese firms and the results outline a positive correlation between business *guanxi* and explorative learning process, contrary to political *guanxi* as stated before. These results are supported by Luo et al. (2008) with reference to supply chain system.

Western marketing studies have long since identified the importance of relational aspects between companies and the different perspectives through which it is possible to analyze their dynamics, as well as the relational components in the relationship with final consumers were analyzed. In particular, with reference to the aspects linked to interchange regulated by mutual trust and long-term orientation (Gronroos 1990, Shani; Chalasani 1992, Morgan; Hunt 1994), it is highlighted how in the complex network of producers, distributors and consumers, the influence of the cultural variable can be, in certain contexts, particularly relevant. Such variable is capable of significantly changing the external organizational structures of companies, depending on the relationships they sustain, and the related processes of value construction (Ambler, 1994).

In the business context, both the Western network approach and the *guanxi* approach focus on the development of trust between parties (Johanson; Mattson 1988), but the difference lies in the process to develop it.

In the first case, the involvement is at a firm level through the mutual share of knowledge and usually not on a strictly personal level (Johanson; Mattson 1988). Besides, here the business transactions are conducted through formal written contracts, which come before the establishment of trust. There is a contract-based approach, which lays the foundations on the strong legal system (Jensen; Meckling 1976).

In the second case, instead, trust is developed through the interactions between the parties involved and the *guanxi*-oriented approach is applied in the business of firms. This forces Chinese managers to put a lot of time and effort in order to first establish solid trust base and only then to conduct a successful transaction (Xin & Pearce, 1996). Trust is built

through social activities such as drinking, KTV and dining, whereas friendship comes before business. Wee and Combe (2009) believe that a business relationship based on friendship rather than on a rigid contract is less vulnerable and more durable. This is due to the strong bond of *renqing* established in the *guanxi* process, where the distinction between business interests and private interests vanishes.

Other differences can be observed. Both are long-term oriented, but relationship marketing is focused on strategic issues, while *guanxi* is focused on tactical issues (Arias 1998). If relationship marketing seems more customer oriented, that is, its objective is to develop solutions for its customers, *guanxi* instead, seems to be exploited to solve current issues.

Their dimension and their commitment also differ. Relationship marketing is set on an organizational level with a calculative commitment, while *guanxi* is an individual and affective tie. This reflects also on their objective. In the first case, there is a transactional basis, while *guanxi* is more relational oriented (Flambard-Ruaud 2005).

The exclusiveness of the latter is in opposition with the universalistic nature of the former, that is, it is more difficult to enter a *guanxi* network without an intermediary.

However, some commonalities can be observed. Both implies a relationship tie with a long-term perspective, which is cultivate through cooperation (Wang 2007).

*Guanxi* are exploited by both domestic and MNEs in China (Leung et al. 2011, Li et al. 2008). Foreign managers have understood how *guanxi* can influence their business in China, from supply chain management to marketing. *Guanxi* can be considered as cross-organizational tie between firms' representative, who are also called channel-boundary personnel (Zhang et al. 2019). Here *guanxi* is essential in the exchange of business information, advice and in lowering costs. Its development requires continuous interactions and a long-term perspective. The objective is to acquire knowledge on possible business opportunities and market trends. *Guanxi*, indeed, become an important asset for the firm and can be a distinctive competitive advantage. However, Abdallah (1992) noticed that an upside down control have to be exercised from the managers to subordinates in order to avoid a too high reliance on *guanxi* network. The dependence on personal relationships rather than formal rules and contracts have been observed also by Merchant et al. (2011).

Lee et al. (2001) offer a guideline for Western marketers about how to develop *guanxi* with Chinese partners. Communication is the first step in order to better understand the counterpart's expectations, which are often implicit. Second, Western marketers should clarify their intentions and improve their emotional commitment, that is, they should not limit the relationship to a utilitarian perspective. Third, Western marketers should limit their opportunistic behavior, otherwise they would negatively influence the relationship. Opportunism is considered a violation of the *guanxi* social norms and the normative expectations. Fourth, in order to strengthen the relationship, Western marketers should try to find similarities with the counterpart, that is, common interest for instance can enhance the perceived commitment.

This theory is supported by Perks et al. (2009), whose study shows that, in addition, *guanxi* improve integration in certain business areas, as in R&D–marketing integration. The necessity of a *guanxi* network in the business environment is undeniable (Lee and Dawes 2005), and as other kinds of *guanxi*, it need a *guanxi* base too in order to get consolidated. This consolidation is achieved through *ying chou*, that is, socializing activities outside the workplace. *Ying chou* among colleagues, but also between firms and clients become a relevant tool in developing and maintaining *guanxi*. It allows parties to develop a solid base, that is not merely rent-oriented, in order to start a trust-building process.

The link between *guanxi* and share ownership has been outlined by several scholars. According to Su et al (2003) the *guanxi*-oriented approach is more likely to appear in private companies rather than in state-owned companies, as private companies can only rely on themselves and on their *guanxi* network. This result is supported also by Millington et al. (2005) and Xin and Pearce (1996), who confirm that private companies attach a lot of importance to their business connections and are even more involved in unethical activities to get profit (Chan et al. 2002).

This complex framework has received the title of “network capitalism” (Boisot et al. 1996), where *guanxi* are exploited in order to manage economic transactions, gather information and gain access to better resources. This theory is supported by Redding (1990), who stated that the *guanxi* represent the core of the Chinese capitalism.

The dimension of the market orientation is highly affected by the *guanxi* in China, as personal relationships can intensify the market orientation and therefore influence the

firm's performance (Luo et al. 2008). The trust base that *guanxi* create is a functional tool in customers' orientation, and hence the firm is able to go towards the market needs on time. The upside is shown in a comparison among competitors. As a matter of fact, firms with a better quality *guanxi* network seem to be more informed about the competitors' strategies (Yeung; Tung 1996, Luo; Chen 1997, Park; Luo 2001, Luo et al. 2008).

The study of Ma et al. (2020) shows how different types of *guanxi* influence the legitimacy of the firm during the different stage of its life cycle. The main subdivision regards market *guanxi* and government *guanxi*, based on previous studies (Park; Luo 2001, Dubini; Aldrich 1991). The results outline a positive correlation between both market and government *guanxi* and the three kind of legitimacy, that are cognitive, regulative and normative legitimacy. More specifically, during the start-up period of a firm, the market *guanxi* positive affect the cognitive legitimacy, on which government *guanxi* has no remarkable effects. Besides, it seems that both *guanxi* do not impact cognitive legitimacy, while they are positive related to regulative legitimacy. According to the study, entering the mature stage of a firm implies a positive correlation between market *guanxi* and normative legitimacy, but government *guanxi* instead is not relevant. These outcomes prove the importance of *guanxi* for firms in order to improve their legitimacy. If they should allocate more resources in developing both market and government *guanxi* during the start-up phase, then during the mature stages instead, they should focus on improving market *guanxi*. This is in line with the observations of Zimmennan and Zeitz (2002), who stated that *guanxi* is usually exploited by firms to increase their legitimacy. On the first stage of development, firms should seek to establish a good quality *guanxi* network, which has to be nourished during the following stages through interactions and exchange of favors. Favors can include preferential treatment and preferential access to resources. Although favors within a *guanxi* perspective are often equate to favoritism under a Western point of view, they are at the same time an accepted precondition of business dealing in China.

*Guanxi* is often equated to corruption, as it seems far from the Confucian philosophy and more rent-seeking oriented in the modern society. It is important to specify that actually, *guanxi* is not a precondition of corruption, but it seems to be a facilitator in a demoralized environment (Li 2018), where a shift from favor exchange to power exchange has



occurred. Some scholars argue that *guanxi* and corruption are strictly intertwined (Gold 2002, Smart 1993, Yu 2008), while others argue that they are two separate phenomena. According to the latter, the main difference is that corruption is impersonal and instrumental (Yang, 1986, 1994) while *guanxi* involves an emotional commitment (Barbalet 2017, Jones 1994, Yang 1986).

A solution to this negative side of *guanxi* can be found in the improvement of the legal system and the refinement of the control measures (Arias 1998, Davies 1995, Wong 1998b).

Bedford (2011) provides a sub classification of *guanxi*, that is, working *guanxi* and backdoor *guanxi*. The former refers to individual ties on the work place established on purpose to receive some benefits on the workplace, while the latter refers to economic *guanxi* whose utility reflects in facilitating business negotiations.

Previous researches (Batjargal 2007, Batjargal; Liu 2004, Carlisle; Flynn 2005, Wu; Leung 2005) found out a correlation between *guanxi* and entrepreneurial outcomes in China. Guo and Miller (2010) provide a further explanation of how *guanxi* is intertwined with the entrepreneurship process and the growth stages of a firm. The influence of *guanxi* ties, based on kinship, friendship or with other *guanxi* basis, are relevant as other industrial factors.

During the start-up period, a core *guanxi* circle is created, which usually involves family members and close friends and is quite closed to others. These strong ties are not profit driven but rather based on stable connections with strong emotional commitment. Within this core *guanxi* circle, there is a perception of sincerity amongst members and the entrepreneurial ideas are discussed in an open manner. The main issue during this stage is the allocation of resources and the channeling of *ganqing* helps in gather resources from the family and friends.

Then, during the early stage of the firm, the core *guanxi* circle is expanded due to the further need of resources, which the sole reliance on family and friend cannot provide. Intermediary *guanxi* circles are established with suppliers, banks, bureaus and partners. The main role of intermediaries is to build an information bridge between external investors and company insiders, so they need to be trusted by both parties. Here the ties are not strong and structural holes may exist amongst member, as there is an economic driver. With reference to the use of intermediaries as a strategy to safeguard the "face", it

must be considered that the importance of not exposing oneself in the first person in situations that can damage one's image towards others leads the Chinese to frequently use a third part to deal with situations of conflict or potentially such. For this reason, it is frequent, especially in negotiations, to rely on intermediary subjects who have the task of not letting the interlocutors expose themselves in the tensest phases of the negotiation. It must be an individual well known on both sides to be sure of his neutrality, and often that role is filled by close friends on both sides or by older and more respected people. Chinese interpreters who are part of the delegations in charge of negotiations with foreign delegations, for instance, often assume this role of mediation, which therefore goes beyond simple linguistic mediation.

Subsequently, during the later stage of the firm, new *guanxi* are established in order to find better business opportunities and be informed about market trends. These *guanxi* are distant from the core *guanxi* cycle, as the former are not strictly related with the daily business operation but rather with the outcomes of firms' performance. They are opportunistic ties which may turn out in good business opportunities.

The effects of *guanxi* on a firm level are explained also by Gu et al. (2008), who took into account data from 282 firms in China and found out that *guanxi* directly influence the brand performance. Additionally, they observed that *guanxi* is weakened by competitive intensity. *Guanxi* are considered a proper marketing tool (Luo 1997a), which influence sales growth (Gu et al. 2008, Luo 1997a, Park; Luo 2001, Zhang; Li 2008). Sales growth usually relies on the *guanxi* network on executive level.

Johanson and Vahlne (2009) perceive the business environment as a webs of relationships and they investigate the situation of "outsidership". Such situation may lead to difficulties in the allocation of resources and they call this phenomenon the "Liability of Outsidership" (LoO). To overcome the LoO, trust building and commitment are necessary. As regards the Chinese firms in Europe, it seems that their pre-existing *guanxi* in Mainland China cannot be exploited in Europe (Chen 2017) and they need to develop new *guanxi* networks. The possibility to translate such peculiarity also to non-Confucian countries has been stated, however the degree of this transferability is not comparable to Confucian countries. This is due to fact that *guanxi* seems to be less relevant in a mature institutional environment (Chen; Chen 1998).

Within a Chinese business environment, instead, *guanxi* represent a base of trust, helping them to set a long-term vision of relationship. This improves also the mutual satisfaction and lower the perceived distance between firms (Leung et al. 2005), facilitating transactions. This can be sometimes translated into credit-extension for the insiders of the *guanxi* network. The intensity of accounts payable is therefore directly related to the intensity of the *guanxi* established. The seller, indeed, would avoid to jeopardize the counterpart's face who is temporarily unable to pay. The Chinese monetary policy often leads to difficulties in payment, but according to the norms on which *guanxi* are based, the seller should avoid pressing his clients for payment. A virtuous circle is established: the credit-extension contribute to build expectations about further purchasing order, according to the principle of reciprocity. The maintenance of harmony therefore seems to be indicative of higher performance (Luo 1997).

*Guanxi* shapes the business in China and in turn is shaped by the continuous changes in the economic and social framework. On the basis of ancient cultural logics, *guanxi* are able to create new paradigm of behavior, adjusting to the moment of time. Lo and Eileen (2003), indeed, noticed a flexible facet of *guanxi*, able to adapt to the surrounding environment.

As *guanxi* is not a stated concept but rather dynamic, its effectiveness and relevance varies by region and industries (Cai et al. 2010, Park; Luo 2001). The degree of importance is related to the degree of uncertainty and competition, which affects different kinds of industries. The rivalry in the Chinese market place is fierce and *guanxi* can help in reducing the pressure. Regional differences regard the business environment, the market players and the local policies (Park; Luo 2001). The role of *guanxi* decrees in mature markets, while it reveals critical in less mature markets. In this perspective, Guthrie (1998) argues that, with further reforms and development, the reliance on *guanxi* in both the private and public sector should gradually decrease.

In a vast area such as China, where there is a huge normal of local markets, yet loosely interconnected, developing *guanxi* network can enhance firms' channel capability and therefore constitutes a crucial competitive advantage (Ambler et al. 199, Davies et al. 2004).

The cooperation is fostered by trust and shared values and this can be consistent applied to distribution channels, which need reliability in order to persist. Members who actively

participate in the channel will help other members in avoiding environmental threats, even if it implies a sacrifice of resources (Zhang et al. 2003)

It is worth noting that the governance of relationships includes not only the mutual transactions of people within the network, but also how related parties as a group trade with traders outside the relationship. For example, when politicians and entrepreneurs establish a B2G *guanxi* and help them get promoted accordingly, the governance mechanism must not only ensure the mutual trust between politicians and entrepreneurs, but also ensure that the transactions of both parties are approved by politicians' superiors. Additionally, when the company establishes an offensive or defensive alliance with its customers to maximize the value of the transaction, it must also obtain the approval of other companies affected by its transaction behavior, otherwise the offensive and defensive alliance cannot be realized (Li 2017). The extent to which such external effects of related party transactions will be internalized by related parties depends on the impact of the institutional environment on the costs and benefits of internalization.

Today, *guanxi* is a term also used in the Western countries, but while understanding its meaning on a theoretical level seems easy, it is actually very difficult to apply it in practice for your business in China if you have no experience in this regard. Also depending on the geographical area in China, the concept of *guanxi* could have different applications and the privileges of a certain *guanxi* depend on the degree of interpersonal relationship. However, this should not prevent Western firms to establish business in China, but instead it should stimulate them to establish *guanxi* as a facilitator of business.

#### HOW *GUANXI* AFFECT THE AUDIT PRACTICE

As the world's largest emerging economy, China has become a major market growth point for many multinational companies. With the rapid growth of China's economy, a set of accounting systems with both Chinese and Western characteristics have developed. Accounting and audit practice play an important role in promoting global economic integration.

The auditing profession reflects one's country social construct, and therefore its dynamics are local and can involve cultural characteristics (Pollner 1987). Similarly, Chinese auditors have to manage their profession in a complex set of social norms and political influences, which deeply influence their practice. Li and Sun (2009) described China's

characteristic institutional variables from three aspects: institutional environment, institutional arrangements, and social culture. Wong (2016) emphasized state-owned equity and government intervention, government bureaucracy, legal control and administrative systems, and cultural customs.

In addition, the impact of cultural factors (including *guanxi*) on professional ethics has also become another research topic. After entering the 21st century, in addition to the issues mentioned above, scholars have begun to pay attention to the influence of *guanxi* on auditing. Within the accounting framework, relationships can be considered both assets and liabilities. *Guanxi* is an asset, which originally belong to a person, but in the company organization, if the company allows individual employees (up to the chairman or CEO, down to general employees) to rely on their own relationships to help the company's business, then the relationship can also become an asset of the company. However, if the person who established the relationship leaves the company, the relationship may also leave. Whether *guanxi* is an asset or a liability and to which extent is very difficult to estimate, as so are the costs connected to the maintenance of such relationship. Therefore, it is an intangible property and cannot be listed on the balance sheet.

The audit relationship (*shenji guanxi* 审计关系) generally refers to the economic responsibility among the audit subject, the audit object and the audit client. It is the prerequisite and guarantee for the effective development of audit activities. The logical starting point of the modern audit relationship lies in the separation of property ownership and management rights. This, has led to a distortion of the audit *guanxi*, as there is an asymmetric distribution with an absolute information advantage from the agent. Since the principal cannot directly obtain the information related to its investment activities and the identification and judgment of the agent's contract activities, an independent third party understands the relevant inside information of the agent for the purpose of preventing and timely discovering the agent's moral hazard. The audit relationship can be seen as a production line, in which the property owner entrusts the business manager to operate and manage his property, the property manager entrusts the accounting firm to conduct audits, the accounting firm assigns the auditing business to the auditors, the auditors accept the management control of the accounting firm, and provides the audit report to the unit

management authority. Lastly, the operating manager finally submits the audit report and financial report to the property owner.

Huang Qiumin (2007) believes that the direct consequence of the distortion of the audit relationship is the serious decline in audit quality, and the failure of the corporate governance mechanism has weakened the audit practice. Corporate governance works at two level: internal and external. The company's internal governance mechanism is mainly carried out through the arrangement and operation decided by the general meeting of shareholders, the board of directors, and the board of supervisors. The external governance mechanism, instead, includes external pressures and restraints operated through government supervision and capital market, manager market, takeover market and public opinion orientation. For what concerns the external audit practice, according to the current corporate system, the appointment and change of an accounting firm by a listed company, theoretically, must be approved by the general meeting of shareholders. Actually, it is only a formality, and the company's managers have the real right to hire an accounting firm.

The direct impact of this type of appointment on auditing is that it distorts the audit relationship and makes the triangular audit relationship evolve into a linear type. This affects the audit commission and the payment, which are completely controlled by the company's managers. As a result, auditors often have to succumb to the pressure of listed companies and insiders in the process of audit, losing their independence and affecting the audit quality. Although in China the formal audit relationship still exists, in fact, the real audit client is absent, and the audit object has become the actual client, that is, the audit client and the audit object are combined. The integration of the audit client and the auditee will make the fair auditor lose the audit business, and the unfair auditor will get more audit business because of the affinity between the unfair auditor and the auditee. This will inevitably lead to the rejection of high-quality audit services in the entire audit market, and eventually the entire audit market will collapse. Such distortion also affects investors, creditors, potential investors, government agencies, and other stakeholders, whose interests are not guaranteed.

The aforementioned integration has led to many scandals in the audit world, such as Enron, Waste Management and Global Crossing in the United States. According to Clikeman (1996) the practice known as the "revolving door" has jeopardized the quality in the

financial reporting. However, the majority of the studies on the audit quality regards ruled-based economies, while China has a relationship-based economy. In this framework, two kinds of relationships can be highlighted: management affiliation and state ownership. The opinion of experts about the effects state ownership and *guanxi* have on audit seems to be controversial. According to Wang and Zhao (2003) and Han (2008), the state ownership has a negative effect on audit quality, while Liao and Wang (2008) believe that it has a positive effect. Liu et al (2011) analyzed how state ownership and management affiliations impair audit independence and therefore audit quality in a *guanxi*-based economy, and they found that both increase the probability of receiving a clean audit opinion. Such *guanxi* not only affect local auditors, but also the Big Four. Through a sample of 524 questionnaire responses from Chief Financial Officers (CFOs) of Big 4 and Non-Big 4 auditors, Law et al (2013) found that *guanxi* strongly influences the perception of auditor independence in the Chinese society. The study especially highlights the connection between the duration of *guanxi* and auditor independence, that is, a *guanxi* which persists at least for five years strongly impair auditors' independence. The concept of *guanxi* is also reflected on the size of audit firms. Law et al (2013) found that auditor independence is not only impaired by the *guanxi* established, but they also discovered that large client size negatively impacts the perception of auditors' independence. The "Rules on Quality Review of Accounting Firms" (Released by CICPA on July 16, 2011) prescribe that the CICPA shall base its disciplinary measures on facts, in line with the principles of independence, objectiveness and fairness.

In this respect, the Ministry of Finance stated that the objective of auditors is to assist in the development of the socialist market economy, that is, auditing profession has to serve the country and the public interest (Ministry of Finance 1993). In 1993 the General Standard on Professional Ethics (GSPE) were issued, but no formal definition of independence had been stated. However, in 2003, both the concepts of independence in fact and independence in appearance were adopted. The cross-cultural study of Jakubowski et al. (2002) about the Codes of Professional Conduct of CPAs across eight countries and regions, shows that Hong Kong and Taiwan tend to be less explicit in the formulation of their Codes, in opposition to countries like the USA, Canada and Australia. The omission of a formal definition of independence influence the Chinese auditors, whose personal judgments tend to affect their practice.

Theoretically, the independence of auditors refers to the ability to perform audit and accounting affairs objectively and impartially, both in fact and in appearance. Therefore, even if the accountant himself believes that the relationship will never affect his own independence and impartiality, as long as he believes that the relationship will affect the accountant's independence in the eyes of others, if the accountant still performs audits on the company he has a relationship with, it can be considered a violation of the professional ethic. Hwang and Staley (2005) underline the risk of potential audit violation of ethics for audit company when operating in a relation-oriented society, as it seems inevitable that an auditing firm will be involved in a *guanxi* process when operating in China.

Douglas et al. (2001) conducted a study on the application of the Code of Professional Conduct in China. The results of this research show that Chinese auditors are aware of the importance of the Code, but their study did not analyze the Chinese auditors' perception on the content of such Code.

The studies which have investigated the association between *guanxi* and the audit practice mostly regard the influence *guanxi* can have on audit independence. In this regards, two more generic kinds of *guanxi* can be traced: favor-seeking *guanxi* and rent-seeking *guanxi* (Su; Littlefield 2001). The first is culturally rooted in Confucian societies, while the latter seems to be a product of economic reforms and is based on power exchange. Ang and Leong (2000) developed a scale based to measure favor-seeking *guanxi* orientation, which is based on nine items. Such items refer to: (1) maintaining a good network, (2) knowing the right people, (3) developing the right contacts, (4) building social relationships, (5) being in the "inside" circle, (6) returning favor, (7) gift giving, (8) maintaining a good relationship is the best way to enhance business, (9) frequent cooperation. Based on this scale, Fan et al. (2012) proposed a 12 item two dimensional *guanxi* scale for measuring Chinese auditors' orientations towards *guanxi*.

Such scale is a two-dimensional model, with 8 items measuring favor-seeking *guanxi* and 4 items measuring rent-seeking *guanxi* (see the table below).



Favor-seeking <i>guanxi</i>	Rent-seeking <i>guanxi</i>
(1) Maintain a good network	(9) Back-door deals
(2) Knowing the right people	(10) Bureaucratic privilege
(3) Developing the right contacts	(11) Dominant parties to a deal (power exchange)
(4) Building and maintaining social relationships	(12) Gifts giving
(5) Being in the “inner” circle	
(6) Returning favor for favor	
(7) Maintaining good relationships	
(8) Frequent cooperation	

The research of Fan et al. (2012a) was aimed at discovering the Chinese auditors’ perception towards the two kinds of *guanxi* explained before. Their orientation (favor-seeking and rent-seeking) was analyzed across gender, age, education, position, and audit experience. The results of this study show a usage above average of both *guanxi* by the Chinese auditors, especially they use favor-seeking *guanxi* as a strategic tool to develop business. The comparison across gender, age, education, position, and audit experience suggests that female, old and experienced auditors are less likely to use rent-seeking *guanxi* compared to male, young and less experienced auditors. Besides, locality seems to imply a higher score in both favor-seeking and rent-seeking *guanxi*. Besides, favor-seeking *guanxi* assumes a positive connotation, while Chinese auditors view rent-seeking *guanxi* as negatively associated to ethical judgments. Braendle et al. (2008, p. 389) compared this negative kind of *guanxi* to a “two-edged sword that can harm local governance systems and hinder economic development and global business”. The consequences of a rent-seeking orientation mainly regard the social costs it can have, in the face of personal gains (Fan 2002). However, whether rent-seeking *guanxi* is ethical or not is difficult to assess, as also cultural differences must be taken into account.

The concept of corporate governance entered China only at the end of the 21st century (Qian; Wu 2000). A weak corporate governance can not only increase the costs the lower the operating performance of a company, but it can also lead to corruption (Wu 2005). It can be seen in many corporate scandals in China, such as the one regarding Lantian Co. Ltd., an agricultural company which increased its net profit up to 60 million dollars. The

concerns about the efficiency of Chinese corporate governance developed in the issuing of the Code of Corporate Governance for Listed Companies in China (2001) by the China Securities Regulatory Commission.

Wong (2016) advocated the “Top-Down” research framework, that is, the system-market-enterprise logical system. This system can help us track the influence path of the national-level institutional characteristics on corporate behavior. The theoretical system uses property rights as the analysis origin, emphasizing the impact of the system on transaction costs and contract structure. Williamson (2000) summarized the four levels of the system, namely, the embedded mechanism (that is, informal systems such as culture, customs, etiquette, and religion), the institutional environment (that is, formal systems such as law, politics, and bureaucracy), the governance mechanism (that is, the organizational structure, contracts and other transaction mechanisms), resource allocation (that is, price mechanism and transaction behavior), and emphasizes the progressive relationship of the above four levels and their respective modes of change. In China, due to the state's authority, coercive power and monopoly, the government and other market entities are not in the same position.

As stated in the first chapter, prior to 1996, the government had the total control of all Chinese accounting and auditing firms and the independence of CPAs was therefore impaired (DeFord et al. 2000). However, through the disaffiliation program issued by the Chinese Institute of Certified Public Accountants (CICPA), the institutional framework started to change. Due to this disaffiliation program, the previous-established *guanxi* of the accounting and audit firms began to crumble and they had to form new rent-seeking *guanxi* in order to survive.

According to some scholars (Bushman et al. 2004, Chaney et al. 2011), political connections impair transparency and lower the financial reporting quality. Besides, Gul (2006) outlined a correlation between the increase in audit fees and the 1997 Asian Financial Crisis. Such increase in audit fees is also related to the greater concern about audit efficacy, which is translate into a greater demand of audit effort. The empirical evidence of this study is applied to the Malaysian society, but can also be set in the Chinese environment, as both are relationship-oriented contexts. The *guanxi* with the government have several consequences and compromise auditors' independence in many respects (Chan et al. 2006; Gul et al. 2007; Wang et al. 2008), as some information can

be hidden (Johnson; Mitton 2003) in order to protect public interests and favoritism can be noticed (Salim 2006).

In this relation, Law (2016) conducted a comparative test, with a sample of auditors from Big 4 and non-Big 4 firms in China and the U.S. The aim of his study was to acknowledge the perceptions of auditors' independence for Chinese auditors and for the U. S. auditors within a *guanxi* framework. The results show a negative perception of *guanxi* by Chinese auditors, but not for the U.S. auditors. The reasons are to be found in the cultural differences between the two countries. According to some studies (Iacobucci; Ostrom 1996, Rodriguez; Wilson 1995), relationships do not play a relevant role in business transactions for American managers. This is quite the opposite of the Chinese business framework, where *guanxi* is a necessary precondition in order to first develop a bond and then realize a business transaction. Ambler (1994) outlined the fact that in the Chinese culture friendship leads to business, while in the West business can lead to friendship. However, according to Brandt et al. (2014) the Confucian values and the related cultural customs (such as *guanxi*) seems to be incompatible with modernization and tend to jeopardize the economic dynamism.

This is connected to the audit framework, where, as stated by Liu et al. (2011), two kinds of *guanxi* can affect auditor independence in China, that are *guanxi* at a firm level and personal contacts with external auditors. The study of Liu et al. (2011) outlines that both types of *guanxi* impair the independence of auditors and increase the probability of receiving a clean audit opinion. The experiments of Du et al (2015) are also focused on the negative influence of *guanxi* on external audit, with a specific stress on delisting motivated earning management. The results show that Chinese auditors are less likely to modify earning management caused by the regulation and it seems that *guanxi* between clients and external auditors is a determinant factor in auditors' reluctance.

For what concerns the convergence with international audit principles, according to the Institute of Chartered Accountants of Scotland (ICAS, 2010), the difficulty of verification of fair values in China effects the likelihood of the Chinese governments to move towards the full convergence with international standards. Besides, during the adoption of IFRS, some adaptation must occur, such as in the regulatory and taxation systems. Additionally, translation seems to be the major liability in this process (Nobes 2006, 2013; Zeff 2007; ICAS 2010). In this perspective, He et al (2012, p.539) consider China "incompatible

with fair value accounting” due to the fact that business transactions are mostly carried out within an inside circle of social and political relationships. However, no references to the concept of *guanxi* have been stated in this study. On the contrary, Au and Wong (2000) linked *guanxi* with the level of ethics in the Chinese auditors, that is, the higher the level of ethics, the lower is the negative perception of *guanxi* on audit adjustments.

Based on this premise, a study of Balfort et al. (2017) analyze how *guanxi* effects the efficacy of fair value in China. According to them, the extent to which value information is necessary in the decision-making process within a *guanxi* context is questionable. This is due to the fact that decision factors in a collectivist society (such as China) differ from a more individual-oriented society. The first of these factors can be trace in the family-*guanxi*, that is the counterparty’s relation to the family network. Then the level of trust between the parties must be considered when conducting transactions. Third, the occurrence of exchanged favors and accumulated debts are also relevant.

Although the Chinese auditing practice is shifting toward the international standards, the government authorities represent the biggest information users (Ding 2000), yet influencing the auditing practice. In China, during the financial audit process, the relevant information is transferred within the *guanxi* network and the fair value loses its efficacy, because the information become not reliable anymore. Fair value, instead, can only adapt to trustworthy markets. Balfort et al. (2017) pursue this theory, where the lack of stability of the Chinese context do not fit the qualitative neutrality and faithfulness of the fair value principle.

The dual accountability of Chinese auditors regards the improvement of the clients’ information and the assurance of its legitimacy for external users. The contradictions of the Chinese context affect the expectations on auditors’ function. The Big Four play an important role in the global standardization of the audit practice and they try to develop their mission also in the transitional economies, homogenizing the audit profession worldwide.

The unique cultural background of China, requires the auditors to invests in cultural skills such as in developing good quality *guanxi* network (Wen 2019) and the Big Four are not an exception. As a result, the Big Four in China operate in an autocratically way, that is senior partners seems unlikely to be challenged by junior auditors (Gillis 2014b) and the

stress is on loyalty rather than competence. This is the reason why developing and maintaining one's *guanxi* network is essential for auditors in China.

This implies not only auditors-to-clients *guanxi*, but also auditors-to-auditors *guanxi*. Both superiors and subordinates have their duties and responsibilities. The “dinner table culture” is peculiar of the Chinese tradition and it plays an important role in socializing and maintaining relationships. Besides, it facilitates the development of “family” bonds among colleagues (Kosmala; Xian 2011).

For what concerns auditor-to-client *guanxi*, such relationships are essential in developing the business of auditors. For instance, original clients can bring more clients to the audit firm, while the audit firm may help clients through its *guanxi* network that involves banks and institutions (Kosmala; Xian 2011). In opposition to the Western countries where audit practice is regulated by the principles of independence, objectivity and integrity, the Chinese context seems rather service-oriented and governed by *guanxi*.

Accounting theories in the West regard independence as an important criterion for evaluating the reputation of market intermediaries. In the West only audit reports of independent auditors will be recognized by the market, and analyst reports that obtain information by pleasing companies will be doubted by market investors. Under the relational transaction model, only by integrating into the company's social network can it be possible to obtain real information, because social relations can help transmit proprietary information, establish trust relationships and reduce contract performance costs (Granovitter 1985, 2005). If the intermediary is completely independent of the listed company, it cannot verify its accounting information.

Different from the market-oriented transaction model which relies on equal competition and market prices guaranteed by the national public governance mechanism, the governance of the *guanxi* transaction model relies on private governance mechanisms such as reputation. Whether it is accounting measurement, information disclosure or third-party verification, the accounting behavior of relational business models is very different from market-oriented business models. According to the different governance goals and governance mechanisms, relational business models can be divided into B2G relations and B2B relations. The former involves bureaus and its main goal is to please superiors and obtain political promotion, while the latter involves business people. The role of accounting information in relational business models is not only embodied in

maintaining the governance of network insiders, but also used by related parties for transactions between network insiders and outsiders to enhance the value of the entire network.

This transaction model has brought many challenges to the western traditional accounting information production method. Fan et al. (2014) found that the existence of B2G relations significantly reduced the value relevance of surplus. Therefore, the possibility of assessing the company's operating conditions based on accounting information will also decrease. Besides, relational transactions require strong concealment, and public information disclosure may reveal the company's trade secrets.

Whether it is a state-owned enterprise or a private enterprise, Chinese companies are more likely to choose relational transactions, which is significantly different from the market-based transactions commonly used in developed countries. We can measure the relational transaction patterns of Chinese companies from multiple dimensions, such as concentrated equity structure, B2G relationships, related party transactions within the group, and concentrated customer-supplier relationships. For example, it is difficult to imagine how a listed company that relies on a B2G can fully disclose the content of bribery. Therefore, the possibility of supervising management to provide real accounting information through competition from different sources of information is reduced.

The emergence of audit practice with Chinese characteristics has its own unique interpretation path, and *guanxi* can be one of the interpretation keys.

The following table aims at summarize the previous literature review.

## Summary table

Paper	Country	Methodology	Results
<b>Taormina, R. (2010).</b>	Macau (China)	Quantitative analysis through statistical inquiry.	Strong associations with <i>Guanxi</i> and one's personality, values, family relations, and social orientation.
<b>Chen, C., &amp; Chen, Y. a. (2004).</b>	USA and Mainland China	Survey study and empirical study.	Negative effect of <i>guanxi</i> practices on trust in management depending on <i>guanxi</i> bases.
<b>Park, S. H. &amp; Luo, T. (2001).</b>	USA	Survey study of 128 firms in central China.	Positive relation between <i>guanxi</i> and sales growth, but little impact on profit growth. Positive relation between <i>guanxi</i> and market expansion and competitive positioning of firms, but no effects on internal operations.
<b>Shou, Z., Guo, R., &amp; Zhang, Q. a. (2011).</b>	Mainland China	Survey study of 354 Chinese purchasing managers.	At the firm level, direct influence of calculative trust on <i>guanxi</i> behavior, with negative effects of competence trust on <i>guanxi</i> behavior.
<b>Wong, Y., &amp; Wong, S. a. (2010).</b>	Hong Kong (China)	Survey study of 292 employees in joint ventures in Southern China.	Reliance on <i>guanxi</i> and trust in the workplace within a Chinese framework.
<b>Kim, T., &amp; Lee, J. a. (2013).</b>	South Korea	Comparative survey study of administrative office workers (i.e. marketing, HRs and finance) in four Korea-based companies, which also have operations in Beijing, China.	Stronger influence on turnover in China rather than in Korea supervisor and co-worker relationships.
<b>Nolan, J. (2011).</b>	UK	Survey study of 26 bank managers.	Necessity of adjustments to local conditions when making business, sometimes associated with <i>guanxi</i> .
<b>Bian, Y. (2018).</b>	Mainland China	Survey study in a timeframe from 1978 to 2009	<i>Guanxi</i> appears to be a facilitator in the exchange of money and power.
<b>Su, C. S. (2003).</b>	USA	Survey study of 200 business firms.	Reliance of Chinese enterprises on <i>guanxi</i> for business.

<b>Mukhopadhyay, B. (2019).</b>	UK	Survey and quantitative study.	Difficulties in communication between non- <i>guanxi</i> staff and <i>guanxi</i> -based staffs within Sino-foreign colleges.
<b>Zhang, C., Kimbu, A., &amp; Lin P. and Ngoasong, M. (2020).</b>	UK, Mainland China, South Africa	Qualitative analysis of women managers from 24 medium and large tourism firms in China.	Importance of <i>guanxi</i> in the exchange of favors, specifically regarding women intrapreneurship.
<b>Bozionelos, N. a. (2007).</b>	UK	Survey study of 106 white-collar workers employed in a Chinese new state-owned enterprise.	Dependence of <i>guanxi</i> and <i>mianzi</i> on the evaluations of performance, especially where there was a lack of objective performance criteria.
<b>Zhao, H. a. (2020).</b>	Mainland China	Survey study of 327 respondents using PLS-SEM.	<i>Mianzi</i> , <i>renqing</i> and <i>ganqing</i> positively affect WeChat users' expected <i>guanxi</i> benefit, which predicts the intention to like.
<b>Dinh, T. a. (2019).</b>	Germany, France	Systematical review of 148 published articles in peer-reviewed journals from 1980 to 2015.	Reliance on personal <i>guanxi</i> network and B2G for family firms in a weak legal framework. Cultural values and social norms as corporate governance mechanisms in Asian family firms.
<b>Xin, K. a. (1996).</b>	USA	Survey study of 15 state-owned-company executives, 8 collective-hybrid-company executives, and 9 private-company executives.	Stronger reliance of private-company executives on B2B and B2G connections compared to state-owned-company executives.
<b>Zhang, C., &amp; Hong, S.-J. a. (2019).</b>	France	Quantitative survey study on the base of empirical data regarding 186 firms operating in France and Chinese people working in France as buyers.	Relevance of <i>guanxi</i> in doing business with Chinese companies.
<b>Chung, H. a. (2010).</b>	Taiwan (China), USA	Quantitative survey study of 35 Taiwan based family business groups from 1988 to 2002.	Evidence of the B2G influence on corporate decision.



<b>Li, J., &amp; Zhou, K. a. (2009).</b>	Hong Kong (China)	Survey study of 600 FIEs in manufacturing sectors located in three major areas (Beijing, Guangzhou, and Shanghai) in China.	Foreign firms benefit from B2B connections, but strong reliance on B2G affects profitability.
<b>Chung, H., &amp; Yang, Z. a. (2015).</b>	New Zealand, Hong Kong and Taiwan (China)	Survey study of 450 firms from the Chinese Enterprises Yellow Pages, operating in both manufacturing and service industrial sectors in major Chinese cities such as Beijing, Shanghai and Guangdong/Shenzhen.	B2B positively affects the performance of firms. B2G positively enhances the effect of exploitative learning on strategic performance, but it negatively affects the relation between explorative learning and strategic performance.
<b>Perks, H., &amp; Kahn, K. a. (2009).</b>	UK	Quantitative survey study of Chinese high-technology organizations, managed by Chinese nationals with headquarters in China.	<i>Guanxi</i> can act as a unifying force in underdeveloped processes and can help in overcoming external and institutional deficiencies.
<b>Luo, X., &amp; Hsu, M. a. (2008).</b>	USA	Survey study of 332 high-technology firms located in three metropolitan areas.	Networking enhances the customer orientation–customer trust/commitment–firm performance (CTP) causal chain.
<b>Ma, Q., Li, X., &amp; Chaudhry, P. a. (2020).</b>	Mainland China	Survey study of 496 firms located in 27 provinces in China from January –March 2014.	In the early growth stage, a firm should establish strong B2G and B2B, while in the mature growth stage, the governmental control should be reduced.
<b>Guo, C. a. (2010).</b>	USA	Multiple-case method.	<i>Guanxi</i> dynamics and its benefits change across the stages of the entrepreneurship process.
<b>Gu, F., &amp; Hung, K. a. (2008).</b>	Hong Kong (China)	Survey study of senior executives in 282 firms in China's consumer products.	<i>Guanxi</i> direct effects on market performance. Technological turbulence and competition intensity can reduce the governance effects of <i>guanxi</i> .
<b>Cai, S., &amp; Jun, M. a. (2010).</b>	Canada, USA, Hong Kong (China)	Quantitative analysis of data collected from 398 Chinese manufacturing companies.	<i>Guanxi</i> dynamics significantly affect trust, which subsequently influences information sharing and collaborative planning.
<b>Law, P., &amp; Yuen, D. a. (2013).</b>	Hong Kong (China)	Survey study of 524 Chief Financial Officers (CFOs), Big 4 and Non-Big 4 auditors.	CFOs consider <i>guanxi</i> to affect the reliability of the audited accounts.

<b>Ang, S. a. (2000).</b>	Singapore	Survey study of 75 and 102 Chinese business undergraduates from Hong Kong and Singapore respectively.	The negative effects of <i>guanxi</i> and <i>mianzi</i> were more pronounced for the Hong Kong than Singapore sample.
<b>Fan, Y. H. (2012).</b>	Australia	Survey study of 519 Chinese auditors.	Chinese auditors' favor-seeking <i>guanxi</i> orientations were positively associated with their ethical judgments but their rent-seeking <i>guanxi</i> orientations negatively impacted on their ethical judgments.
<b>Braendle, U., &amp; Gasser, T. a. (2005).</b>	UK, Austria	Comparative analysis on the influence of <i>guanxi</i> on the Chinese corporate governance system.	B2G <i>guanxi</i> can harm the Chinese corporate governance system and its further growth.
<b>Liu, J., &amp; Wang, Y. a. (2020).</b>	Mainland China	Survey study of 3048 firm-year observations from the Sino Financial Information Service database, in a timeframe from 1998 to 2007.	State ownership and management affiliations impair auditor independence.
<b>Au, A. a. (2000).</b>	Hong Kong (China)	Survey study of 70 accountants respondents in Hong Kong,	The extent to which <i>guanxi</i> impact an auditor's judgement is depending on the level of ethical reasoning.
<b>Balfoort, F., &amp; Baskerville, R. a. (2017).</b>	New Zealand, Germany	Comparative analyze on the basis of Williamson's governance structure and contracting theory.	<i>Guanxi</i> may not meet the qualitative characteristics of neutrality and faithful representation in fair value measurement of assets and liabilities.
<b>Kosmala, K. a. (2011).</b>	UK	Survey study.	Professional identity is built through <i>guanxi</i> dynamics.
<b>Fan, Y., &amp; Woodbine, G. a. (2014).</b>	Australia	Survey study of 111 Australian accounting professionals.	Rent-seeking <i>guanxi</i> is seen to directly influence ethical judgment, but favor-seeking <i>guanxi</i> do not seem to influence ethical judgment.

## CHAPTER 3: THE LINK BETWEEN *GUANXI* AND AUDIT PRACTICE ON THE BASIS OF EMPIRICAL DATA

### 3.1 *GUANXI* AND AUDITORS' REPUTATION

In recent years, with the failure of Enron and the collapse of Arthur Andersen, the audit behavior and the reputation of auditors have attracted the attention of regulatory authorities and academia (Chaney; Philipich 2002, Barton 2005, Krishnamurthy et al. 2006).

Evidence shows that auditors with impaired reputation will have a negative impact on the stock prices of their clients (Krishnamurthy et al. 2006, Weber et al. 2008), while reputable auditors can increase client stock prices and reduce the underpricing rate (Beatty 1989). According to the research of Jensen and Meckling (1976) and Watts and Zimmerman (1981), the effectiveness of the Western auditing mechanism is due to the price mechanism of the securities market. The price of securities includes no effect on the behavior of managers (auditors) and the results of securities prices. By partial estimation, the price of securities is "price-protected", that is, the holder of the securities can adjust the price of the securities according to rational expectations. In the Chinese audit market, a trend of increasing audit independence and decreasing audit market share (DeFond et al. 2000) can be traced.

When a company decides to go public, it needs to hire an auditor to audit its financial statements. It is generally believed that the choice of the auditor will affect the company's stock pricing (Titman; Trueman 1986). Titman and Trueman (1986) used a model analysis to prove that companies with more favorable private information are more likely to hire high-quality auditors than those without unfavorable information. Therefore, the higher the auditor's reputation, the more the company's information is inferred, and hence the stock price. Balvers et al. (1988) and Hogan (1997) have also confirmed this conclusion, which shows that in the US market, the reputation of auditors affects stock pricing and reduces the underpricing rate.

Since investors cannot directly observe the audit quality nor understand whether financial information is an unbiased estimate of the company's performance, auditor's reputation becomes a substitute for the quality and accuracy of client financial statements. Due to

the information asymmetry between issuers and investors, investors must rely on the company's disclosure to evaluate company performance and future expectations. Choosing high-reputation auditors has several advantages and companies need to consider cost-effectiveness when hiring auditors. First, it can increase the reliability of financial statements, thereby reducing supervision costs. Second, high-reputation auditors can complete high-quality audits, better verify the reliability of financial statement information, and reduce information asymmetry. Third, reputation of auditors can reduce the uncertainty of the issue price, making the company's issue pricing closer to the true price. At the same time, high-reputation auditors have the effect of insurance compensation, which can further reduce issuance risks and obtain higher valuations. Therefore, on the whole, high reputation auditors can increase the company's stock issuance price and reduce the level of underpricing (Liu; Zhou 2007).

The importance reputation is shown by a survey of relevant groups of accounting firms by YCY Accounting Industry Observation, which released the ranking Best Performing Accounting Firm of 2018. PricewaterhouseCoopers Zhongtian, Deloitte Touche Tohmatsu, Ernst & Young Hua Ming, KPMG Huazhen, Tianjian, ShineWing Zhonghe, Tianzhi International, and Zhiping were selected as eight accounting firms. The total revenue of these 20 accounting firms in 2017 was 37 billion, accounting for nearly half of the industry; 84,000 employees accounted for nearly 30% of the industry. In general, the survey results are ranked as

- (1) Business quality (such as penalties, industry reputation), 91%;
- (2) Customer satisfaction, 58%;
- (3) Employees and other internal personnel are satisfied, 53%;
- (4) The ability to create income, 47%;
- (5) Innovation ability, 40%

The "income-generating ability" is a factor considered relevant by less than 50%. This may mean different views on accounting firms' "big is good" and "big is strong", or it may be a response to the intensive administrative punishment cases in recent years. In addition to the candidates, eight executives put forward their supplementary opinions on which aspects of the performance of an accounting firm are important, specifically:

- (1) The degree of informatization and technology;
- (2) Industry image;

- (3) Public research materials, such as "Summary of Accounting" published by Ruihua, and a new book published by Grant Thornton at the beginning of the year;
- (4) Fairness, impartiality and independence as a third party;
- (5) Internal governance mechanism and management system;
- (6) Effective balance between principle and flexibility;
- (7) Brand development;
- (8) Social responsibility.

The data reveal the importance of the image, that is *mianzi*, an accounting firm has, and it is therefore necessary to cultivate it.

The survey shows that on average, auditors use specific methods to understand their firm in which they operate, respectively:

- (1) Personal experience, 79%;
- (2) Listen to the evaluation of acquaintances, 67%;
- (3) See media reports, 50%;
- (4) Look at online reviews, 43%;
- (5) Look at the accounting office's own propaganda, 19%.

The importance of firm's reputation is a recurrent data and as *guanxi* has been observed to be a mechanism to enhance firm's reputation, it has to take into account. Corporate reputation is a competitive advantage that involves reliability and trustworthiness (Fombrun 1996). It is a relatively new concept in China, which at the beginning was confused with brand awareness and advertising. In China reputation has two facets, that are, the formal one given by official recognition, and the informal one given by *guanxi* network.

Although *guanxi* can increase one's reputation, in reality, the two concepts differ in terms of magnitude, that is, the damage of reputation with a particular individual do not jeopardize the general reputation one's have. On the other side, instead, the violation of *guanxi* norms strongly affects the whole *guanxi* network and could result in an expulsion (Standifird 2006).

Reputation can be place on the same level of *mianzi*, that is not only a psychological phenomenon, but also a socially recognized self. Specifically, it represents the prestige that people gain through social achievements and it is visible on a societal level.

The choice of auditors is affected by political institutions too (Wang et al. 2008), as local SOEs seem to be more likely than non-state firms to hire small local auditors. The dominance of state owners in the audit framework has been analyzed by scholars. Chan et al. (2007) found that the audit quality is highly correlated with the government held shares, that is, an increase in government held shares leads to a decrease in audit quality in Chinese stock markets.

With the Opening of China, the Big Eight firms started to develop their business in China and they immediately understood the importance to establish *guanxi* network. In order to do so, they hired personnel on the basis of linguistic skills and assigned this task to American and Hong Kong Chinese employees. Actually these employees spoke Cantonese, but at least they were insiders in the Chinese culture and could better understand its dynamics (Gillis 2011). After the establishment of B2G *guanxi*, the Big Eight were able to develop their business in the Chinese market. The competition here is fierce and auditors seek to acquire new clients. The actual Big Four do not have an oligopolistic power and the concentration ratio is quite low (Chen et al. 2010, Wang et al. 2015; Gul et al. 2019). To overcome this situation, in order to charge higher fees and maintain business relationships, auditors should go beyond regular contractual auditing services, and start providing more useful information (Hope et al. 2019).

The good reputation of the Big Four is recognized in both statutory and supplementary markets, but the difference lies in the degree of competition. Fee competition is recognized to be a good tool to improve audit quality (Asthana et al. 2019), especially in the Chinese market, where there is a less concentrated audit market. Chen et al. (2007) conducted a comparison of pricing of the Big Four in both the competitive statutory market and the less competitive supplementary market. Results outline a correlation between Big Four audit fees and their dominant position.

Although the Chinese government has taken some measures to strengthen the weak institutional environment, the level of uncertainty is still high and the investor-protection regime is not equal to that in more developed markets (Chan et al. 2006, Wang et al. 2015). Additionally, the low litigation risk and the low litigation costs do not represent good assumptions in the prevention of violation.

On the opposite, the Big Four have more professional standards, professional ethics, practicing skills, and good quality internal management. Besides, the Big Four stand out

for good quality control and internal control evaluation, their corporate culture, talent training, and incentive mechanisms. Their brand has formed over a long period of time and has become very strong. The market recognition and the value of intangible assets are very high, and it seems difficult for domestic firms to catch up in the short term.

The survey conducted by Chow et al. (2006) highlights some characteristics of the audit process in China. Comparing the Big Four and domestic audit firms, they found out differences in clients' portfolio and in the internal structure. Similarities regarding the relevant factors in the client acceptance decision have been found.

After the establishment of the CSRS in 1992, the Chinese A-share market has been the scene of several financial scandals related to audit reporting in the first decades. The CSRC decided to set a specific number of accounting firms under its supervision, giving license to sixty-eight of them (Xu; Xu 2003). The first attempt to move closer towards international standards was the rectification campaign in 1997. Its objective was to scrutinize all the accounting firms, including the local ones. Completed in the 1999, it leads to dramatic result. As reported by Narayan and Reid (2000) more than five hundred accounting firms were closed and punishments affected almost 12,700 local CPAs.

The Rectification practice is still in place. According to the Performance Report of National Audit Office of the People's Republic of China, in 2011 the rectification program helped the government to save 9.46 billion *yuan* for the state's revenues and expenditures, and to avoid a loss of 6.07 billion *yuan*. 93% percent of the audit problems found have been rectified and made public.

In 2001 the CSRC required all the shared companies a secondary audit report issued by an international accounting firm (Gillis 2001) with the assumption that it will lead to higher audit quality reports, but then this regulation has been canceled.

Two years later, in 2003, the Regulation on the Auditor Rotation of CPAs was issued by the CSRC and the MoF. The peculiarity is that in this case the rotation regards the personnel and not the audit firm in general. The prescription specifies that listed companies have to rotate the person in charge of the audit periodically every five years. This new regulation had no relevant influence on the business of the Big Four, as they already had similar internal regulations to address the potential deterioration of audit independence.

Audit independence seems to be impaired by the financial interests auditors may have in their clients (Mautz; Sharaf 1961). On this basis, Chen et al. (2020) conducted a study on a sample of 8,917 firm in a timeframe from 1995 to 2004. Results from 1995 to 2000 show that client importance impaired audit quality in China, when the degree of investor protection was lower. Besides, with the implementation of regulations and punishments after 2001, results show that important clients are more likely to receive a modified audit opinion (MAO). The reason may be traced back to the fierce competition of the Chinese audit market, which forces audit firms to look for rent-seeking *guanxi*. However, competition is not perceived as the main reason for the erosion of Chinese auditors' independence (Hua et al. 2010). After the disaffiliation program in the Nineties, the presence of foreign local firms has increased and at the end of 1997 they had a ten percent of the auditing market (Yang et al.2003). They started establishing joint venture with local firms, must restrictions were in place in order to promote local auditing. Such restrictions regard the need of government authorization for listed firms, which demand a foreign auditor to issue their report. Additionally, foreign accounting firms were not allowed to audit most of the SoE and unlisted companies.

The disaffiliation program gave CPAs more autonomy and their number has increased over time.

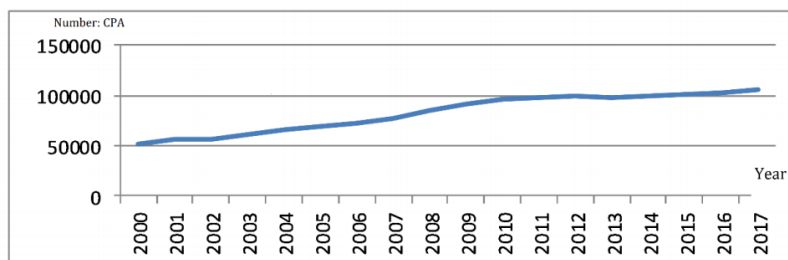


Figure 3: Number of CPAs from 2000 to 2017.

Source <http://www.jyousin.com/?introcicpa/laws/201806/W020180622541151711832.pdf>

However, the state control still persists. On the local level, governments have the legal authority to ask SoE not to appoint auditors (Wang et al. 2008), as well as the influence to affects audit firms' business. Additionally, the B2G *guanxi* are strong in the audit sector, as among the partners' portfolio of audit firms, many of them are ex bureaucrats.

The empirical results from previous studies are controversial. Gul et al. (200) found a positive correlation between the disaffiliation program and the audit quality, that is, after the disaffiliation program, the number of qualified audit opinions of listed companies has



increased. Besides, a positive impact of the Chinese government on the independence of auditors has been observed, specifically in small accounting firms. On the other hand, Wu and Patel (2015) pointed out the government influence on the appointment of auditors, which impairs their independence.

Although the number of accounting firms has continued increasing, actually their independence is strongly affected by the higher bargaining power of the listed companies.

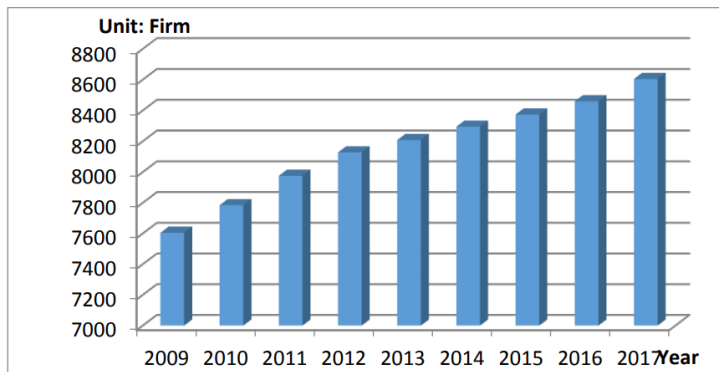


Figure 4: Number of Accounting Firms from 2009 to 2017.  
 Source: <http://www.jyousin.com/?introcicpa/laws/201806/W020180622541151711832.pdf>

Data of 2006 show a relative low number of listed companies (1,400) compared to the number of authorized audit firms (73). Such trend remains unchanged over the years, as shown by the data of 2015, where there are 40 public accounting firms to conduct securities and futures-related business for approximately 2,800 listed companies (The Chinese Institute of Certified Public Accountants, 2016).

In this high-competitive market, Li et al. (2009) found that big audit firms are more likely to preserve auditors' independence and to bear client pressure.

The problem of dependence on important client is also emphasized by the lack of demand for quality auditing. SoE benefit from a special treatment that allows them to report a three-years estimation of their pre-IPO earnings (Wang et al. 2008), overcoming the need of independent auditors. Whereas in the US firms are more likely to engage big audit firms in order to prove the truthfulness of their reports, the circumstances are not the same within the Chinese framework. There, the control of the government of most listed firms acts as a guarantee for future success for investors (DeFond et al. 2000). This reflects on the decision in the appointment of auditors and discourage firms to hire independent auditors.

Penalties and risks for non-compliance with audit standards have increased in severity. The violation of standards could lead to the revocation of the license or even to the imprisonment in the worst scenarios (DeFond et al. 2000).

Previous studies regarding market with higher level of investor protection show a positive relationship between strong incentives to protect investors and high quality audit report (Bushman and Piotroski 2006).

Allen et al. (2005) compared the level of investor protection in the Chinese market to other countries, and observed a lack of effectiveness in the measures undertaken by the Chinese government. According to Brockman and Chung (2003) this is due to the conflict of interests between fair practice and the state power.

The World Economic Forum analyzed the level of investor protection in 2017 in 137 countries, where the first in ranking is New Zealand and the last one is Haiti. China is placed to the 102<sup>o</sup> place.

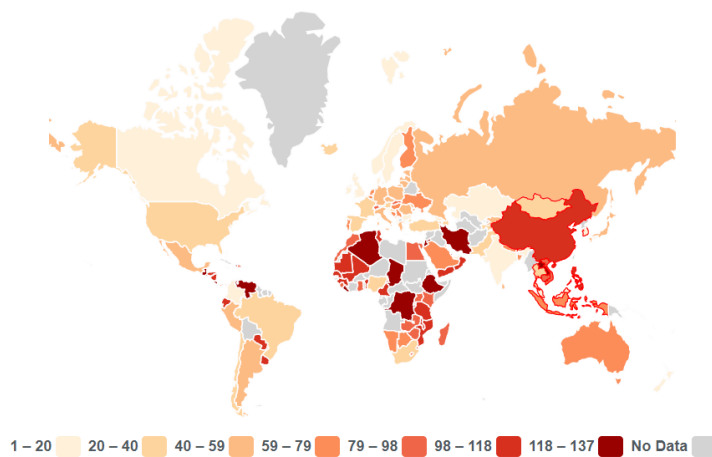


Figure 5: Strength of Investor Protection A. Source: <https://tcdata360.worldbank.org/indicators/h2e15b0d6?country=CHN&indicator=647&countries=HTI,NZL&viz=choropleth&years=2017>

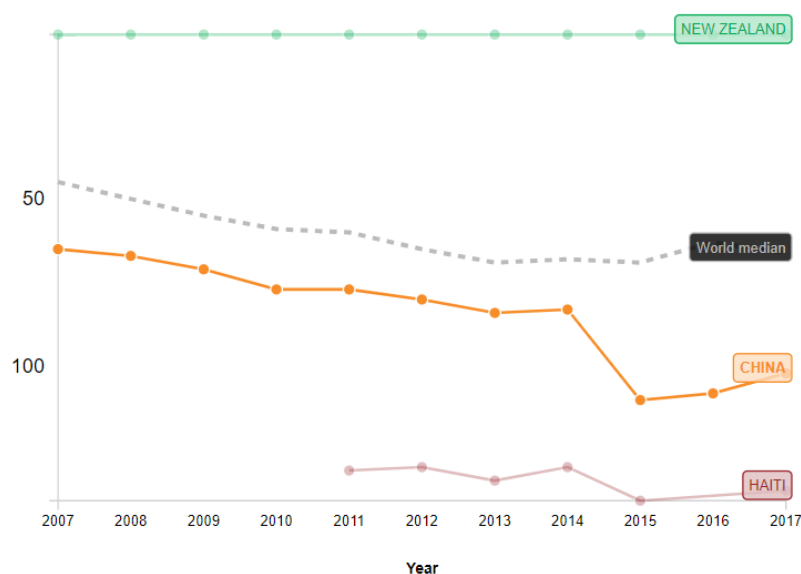


Figure 6: Strength of Investor Protection B. Source: [https://tcdata360.worldbank.org/indicators/h2e15b0d6?country=CHN&indicator=647&countries=HTI,NZL&viz=line\\_chart&years=2007,2017](https://tcdata360.worldbank.org/indicators/h2e15b0d6?country=CHN&indicator=647&countries=HTI,NZL&viz=line_chart&years=2007,2017)

Although the institutional improvements and the increase in sanction risks for auditors, yet it did not prevent the series of audit scandal that characterized the beginning of the 21<sup>st</sup> century in China. Specifically, the scandals involved ZhengBaiWen (Stock Code: 600898), MonkeyKing (Stock Code: 000535), Yorkpoint (Stock Code: 000008), and YinGuangXia (Stock Code: 000557).

Gul and Lu (2011) observed that corruption compromises the social, economic and political structure of China, often with a waste of resources that could be better employed. The personal moral code of auditors seems to be one of the reasons of this critical problem. From the studies of Craft (2013), it appears the relevance of the cultural backgrounds, which goes beyond morality and ethics. It impairs their independence, and doing so the efforts of the audit firm and the quality of the report (Yu 2011). Their experiences, families and educational background undermine auditors' judgements.

According to DeFond et al. (2000) although the disaffiliation program has increased the auditors' independence, yet the *guanxi* code seems to be more relevant than a good quality audit report. Investors, indeed, often judge auditors on the basis of the firm's brand and its reputation.

### 3.2 THE INFORMATION ON TOP 100 ACCOUNTING FIRMS IN CHINA BY REVENUE

The Information on Top 100 Accounting Firms in China by Revenue is a ranking according to which accounting firms are rated on the basis of their business income. The top 100 firms are all large-scale accounting firms, and their regional distribution is highly consistent with the level of economic development and market economy development in each region.

The business income of a firm refers to the income obtained by conducting business with the firm as the main body. At the same time as the total business income of the firm is announced, the income from the assurance services and the income from the non-assurance business are made explicit.

Assurance services comprise audit of financial statements, audit of internal control, capital contribution and tax-related verifications. Non-assurance services include asset appraisal, accounting services, tax services and management consulting.

In addition to the annual business income, the following information of the top 100 firms are also announced, as specified by the Measures for the Release of the Information on Top 100 Accounting Firms in China by Revenue (Art. 6):

- (1) Business income from other professional institutions operated in unison with the firm.
- (2) The number of certified public accountants practicing in the firm.
- (3) The number of employees in the firm (not including the number of employees in other professional institutions that operate uniformly with the firm).
- (4) The number of branches of the firm.
- (5) The number of membership of the same international accounting network and the international accounting union (counting by country or region, not by country or branch office).
- (6) Penalties and punishments received by the accounting firm and its CPAs in the past three years that is, whether in the last 3 years, the firm and its CPAs have received criminal penalties, administrative penalties, and industry penalties for their practice.

The above information is based on December 31 of the previous year.

The rankings of 2014, 2015 and 2016 differ in some parts from the ones of 2017 and 2018. First, the former, also show the per capita business income as a relevant factor, that is the firm's own business income divided by the number of all employees of the firm (number of partners plus number of non-partner certified public accountants plus number of

employees). Second, in the rankings of 2014, 2015 and 2016 the business income per division is also expressed, that is the business income of the firm divided by the number of certified public accountants of the firm (number of partners plus number of non-partner certified public accountants).

In the first cases, the comprehensive evaluation score is equal to the business income indicator score plus the comprehensive evaluation scores of other indicators, minus penalties and punishments that imply a deduction of points. Other indicators of comprehensive evaluation refer to basic information, internal governance, practice quality, human resources, international business and information technology.

In 2014, 2015 and 2016, the scored are assigned as follow:

- ❖ Business income index score = [median business income of the top 100 candidate firms + median business income of the top 100 candidate firms  $\times$  (the natural logarithm of the business income of the firm - the natural logarithm of the median business income of the top 100 candidate firms)]/correction coefficient.
- ❖ Firm's business income = the firm's own business income + the business income of other practicing institutions that operate uniformly with the firm  $\times$  5%.
- ❖ Correction coefficient = business income score of the highest business income among the top 100 candidate firms (before revision)/1000.
- ❖ Scores of business income indicators and other indicators of comprehensive evaluation, with a maximum score of 1000.

As regard for penalties and punishments, points should be deducted as =  $\Sigma$  [number of criminal penalties, administrative penalties and industry penalties  $\times$  relevant points].

Points are deducted according to different types of penalties and punishments. If the firm is penalized by suspension of business and imposed concurrently with other penalties, 8 points will be deducted at a time; in case of a single warning, confiscation of illegal income, fines, and the above three or two penalties are imposed, 6 points will be deducted at a time; for public condemnation, 6 points will be deducted once; for those who are criticized by notification, 4 points will be deducted; for those who are admonished, a reduction of 2 points will incur.

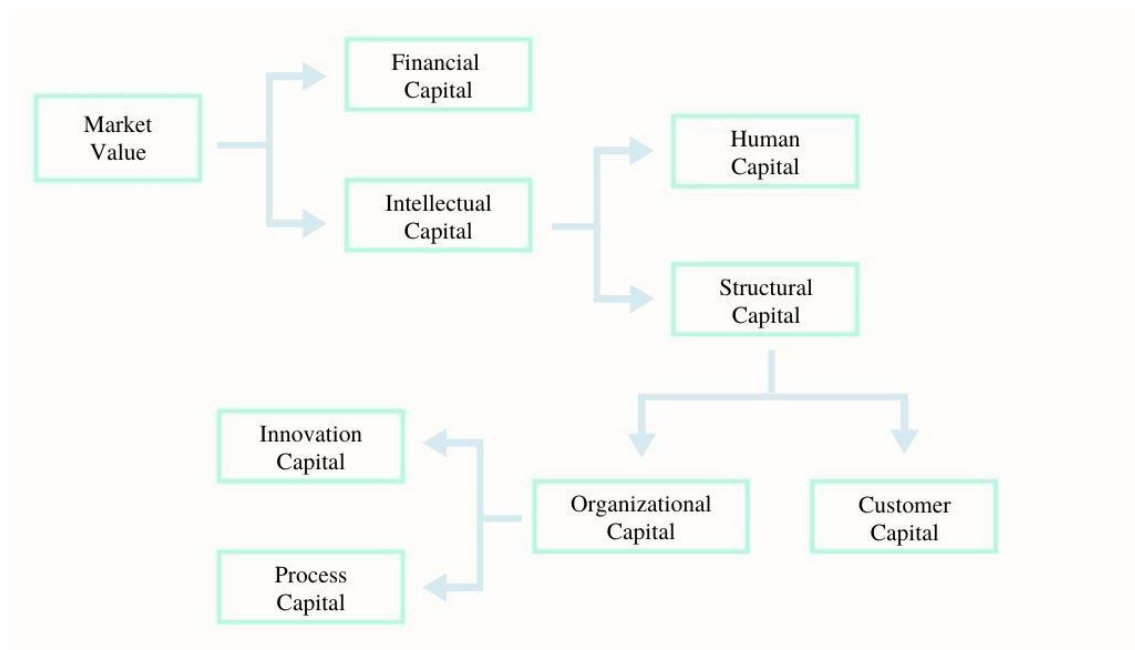
It can be seen that the AICPA pays more attention to the firm's business income indicators, that is, the level of income determines the business. The higher is the income, the greater is the weight and the more scores a firm obtains.

The firm shall fill in and update the CPA industry management information system in a timely manner, and it is responsible for the authenticity of the information reported. All provinces, autonomous regions, and municipalities directly under the Central Government shall supervise and guide the filling and updating of the relevant information of the CPA industry management information system by the local firms (Art. 7).

After the information is released, if it is found that the information provided by the firm is not true, the AICPA shall order the relevant firm to announce the correction within a time limit. Those firms shall be punished by the Disciplinary Committee of the AICPA in accordance with the Measures for the Disciplinary Practice of Members of the Chinese Institute of Certified Public Accountants (Art. 10).

The current evaluation index of the AICPA mainly encourage the accounting firm to get bigger, but it lacks the necessary assessment of the firm's solid foundation. The size of income it is not necessary correlated to strong basis and it should not be the only goal of the firm. In fact, judging from the recent and continuous scandal in the audit sector in China, a certain degree of uncertainty can be noticed. Firms cannot be strong if they don't have the foundation to be refined and specialized. However, a firm that is not strong will collapse no matter how big it is.

The Skandia's IC model for measuring intellectual capital is based on human capital and structural capital:



His scheme was further supported by scholars, who observed that specifically, the structural capital supplies a better environment for the development of human capital through institutional regulations and management control. These are translated into knowledge, skills and expertise (Cagaňová et al. 2019). Structural capital is therefore a prerequisite for organizations and can be exploited as a competitive advantage. As regards accounting firms, their structural capital lays its foundation on the legal form, that is both liability and partnership (Yuan; Li 2003). The limited liability ensures investors' protection, lower the risk of individual losses and boost business. The partnership encourages mutual supervision under the principle of equal rights and obligations. Recently, Wong et al. (2018) have pointed out the fact that limited liability audit firms are usually bigger and able to provide good quality audit report. Per contra, the Chinese audit paradox is characterized by "big but not strong" and "big but not specialized". Reasons have been found in the lack of a unified management (Yuan; Li 2003). Most of the large accounting firms in China, indeed, are the result of merger and this impairs the audit quality.

Besides, the reputation of audit firms seems to be related to the fees they charge. Audit fees are a good proxy for measure the audit quality (Simunic 1980), as they influence the perception of firms towards auditors, that is, high audit fees are perceived as indicator of good reputation (Rahmina; Agoes 2014, Suseno 2013).

Due to the late promulgation of relevant policies, the China Securities Regulatory Commission only began to require listed companies to publicly disclose audit fees in December 2001. Since then, Chinese scholars have begun to conduct research on audit pricing behavior, and most of the existing researches on audit pricing in China are based on the Simunic's model.

The scholar Simunic (1980) selected the data of listed companies in the United States in 1977 as a sample, established a multiple regression equation to study the significant influencing factors of audit fees. Among them, the number of subsidiaries included in the consolidated financial statements of listed companies, their industries, asset-liability ratios, and audit opinion types are also significant factors. First, the size of the audited unit is a very important factor for the audit cost, and for the audit fee. The larger the company is, the more business volume and the more complex the internal control system are. Second, the difficulty of auditing is also considered. The complexity of the audit is

directly proportional to the auditor's workload and the audit risk, and consequently to the audit fees. Third, the audit risk refers to the possibility that there are material misstatements or omissions in the accounting statements, and the CPA will issue inappropriate audit opinions after auditing. Once such incidents occur, accounting firms will face dangers such as litigation, administrative penalties, and compensation claims, and the cost will be very high. Therefore, the greater the audit risk is, the greater the potential risk the auditor will face, resulting in higher audit fees.

Xu and Li (2004) conducted research on the audit fees of PricewaterhouseCoopers Zhongtian's 2002 audit client annual reports. It is found that the main factors affecting the audit fees of domestic annual reports include the ratio of total assets. This theory is supported by Zhang et al. (2005), who took Shanghai stock market listed companies in 2003 as the research object, and found that the total assets of listed companies are significantly related to audit fees.

Wu's (2003) research shows that the audit fee pricing is significantly positively correlated with the size of the company and whether it is audited by the top five international organizations.

Zhu and Zhang (2003) used empirical evidence of listed companies on the Shanghai Stock Exchange in 2001 and found that the size of accounting firms, the industry distribution of listed companies, the nature of equity, and profitability have significant effects on audit fees.

The research of Liu and Guo (2004) outlines that the total assets of listed companies, the number of top ten accounting firms, the number of controlled subsidiaries included in the consolidated statement, and the number of independent directors are significantly positively correlated with annual audit fees. Specifically, the most critical factor seems to be the size of the listed company, as confirmed by Zhang and Xu (2005). The results of their study confirmed that audit fees are significantly related to the size of the listed company, the complexity of the audit of the listed company, and the location of the listed company. Zhou (2007) tested the structure model and found that large-scale companies need to pay higher audit fees than small-scale companies, and there is a significant positive correlation between firm size and audit fees.

Wang (2004) believes that audit fees are related to the types of audit opinions, and stated that clean audit opinions are charged higher fees to make up for losses that may be caused



by subsequent audit failures, while in non-clean audit opinions the risk of auditing is avoided, and the fees charged are lower. Liu (2006) believes that audit fees are related to earnings management.

Furthermore, the workload deriving from clients has an effect on the degree of audit revenues, as observed by Ye et al. (2018), who found a positive relation between audit fees and audit workload.

On the other hand, some scholars argue that higher audit fees may imply economic dependence of the auditors on clients (Tepalagul; Lin 2015, Tobi et al. 2016), undermining auditors' independence and audit report quality.

All these aspects have to be taken into account when taking about audit revenues.

### 3.3 RESEARCH HYPOTHESIS

The most important question this study strives to answer is the effect of *guanxi* on the audit practice. In addition, this link between *guanxi* and auditing is also hypothesized to be depending on the growth of revenues attained through the Information on Top 100 Accounting Firms in China by Revenue from 2014 to 2018. Specifically, the top six in ranking will be taken into account, that are, the Big Four (PwC, Deloitte, Ernst & Young, and KPMG) and the two biggest domestic firms (BDO China and Ruihua). Additionally, the Information on Top 100 Accounting Firms in China by Revenue is supplemented by the data provided through the Annual Reports on Auditing of Listed Companies, issued by the CICPA.

### 3.4 RESEARCH VARIABLES

This study includes three groups of research variables: dependent variable, independent variables and confounding variables.

As this research focuses on the *guanxi* network audit firms have established, only one dependent variable, *guanxi*, is considered in our empirical tests, while the independent variable is represented by the degree of audit revenue and the market share of the audit firms.

Confounding variables have been outlined in the previous chapter and in this chapter with the literature review, which have highlighted all the factors that affect audit revenues.

However, the lack of data regarding such confounding variables made the integration of theories possible only on a descriptive level and not on an empirical level.

This paper assumes that that audit scandals have led to a damage of *guanxi* relationships and therefore to a lower degree of revenues. No correlation between higher revenues a broader *guanxi* network has been found.

### 3.5 ANALYSIS AND EMPIRICAL RESULTS

The descriptive statistics for variables are summarized as follows. First, an empirical background of every year into consideration is proposed. Specifically, the total business revenue of the top 100 firms, with particular reference to the Big Four, is stated. Then, the total revenues of the top six in ranking, with their number of CPAs and branches is compared to the data of the Annual Reports on Auditing of Listed Companies issued by the CICPA.

#### 3.5.1 REVENUE ANALYSIS OF 2014

2014 is the twelfth consecutive year since the AICPA established an information release system for the top 100 accounting firms.

In 2014, the total income of national securities-qualified accounting firms was 32.6 billion *yuan*, an average of 815 million *yuan* for each. Among them, the audit business income was 29 billion *yuan*, accounting for 89% of the total revenue, with an average of 725 million for each.

The total business revenue of the top 100 firms was 34.756 billion *yuan*, representing the 61.81% of the industry's total revenue, a slight increase from 61.63% in the previous year. The business revenue growth rate was 10.52%, which was also slightly higher than the industry's overall growth rate of the previous year (10.51%).

The business income of the international Big Four Chinese member firms accounted for 31.49% of the total income of the top 100, which was a continuous decline from 33.79% in 2013 and 37.48% in 2012.

Starting with the Information on Top 100 Accounting Firms in China by Revenue in 2014, the total revenues of the top five in ranking are respectively:

- (1) PricewaterhouseCoopers CPA (PwC) with a total revenue of 335,141.01 ten thousand *yuan*;

- (2) Deloitte CPA with a total revenue of 288,123.29 ten thousand *yuan*;
- (3) Ruihua CPA with a total revenue of 277,592.64 ten thousand *yuan*;
- (4) BDO China CPA with a total revenue of 250,911.05 ten thousand *yuan*;
- (5) Ernst & Young CPA with a total revenue of 236,433.79 ten thousand *yuan*.
- (6) KPMG CPA with a total revenue of 234,717.41 ten thousand *yuan*.

The audit fee for the 2014 annual report of listed companies was RMB 3,746.24 million, and each company paid an average of RMB 1.44 million. In 2014, the total audit fees of the four major firms were 1.658 billion, representing the 44% of all audit fees of listed companies in the year.

From the analysis of the annual report audit fee, there are 35 companies that pay more than 10 million yuan in audit fees, and the Big Four account for 86% of them. They have an absolute advantage in this field.

### 3.5.2 REVENUE ANALYSIS OF 2015

In 2015, the total income of national securities-qualified accounting firms was 38.7 billion *yuan*, with an average of 969 million *yuan* each. Among them, audit business revenue was 34.7 billion *yuan*, accounting for 90% of total revenue, with an average of 867 million *yuan* per company.

The total business income of 100 accounting firms was 39.37 billion *yuan*, an increase of 4.614 billion *yuan* from the 34.756 billion *yuan* in the previous year, an increase of 13%. The CPA industry has become stronger and bigger.

Compared with 2014, the ranking of large domestic firms, especially securities qualification firms, is relatively stable. The reason is that in recent years, especially after 40 securities-qualified accounting firms completed the transformation of special general partnerships at the end of 2014, there has been no major merger.

Compared with 2014, the top five firms in the comprehensive evaluation have maintained a growth rate of over 8% in their business income, achieving steady growth.

For what concerns penalties, it is worth noting that Ruihua was deducted by 8 points, so that the total score of comprehensive evaluation was overtaken by Ernst & Young Huaming, and Ruihua could only rank fourth. Even so, Ruihua is still the benchmark for domestic investment firms, and Ruihua has also achieved the top ranking among domestic firms for three consecutive years from 2013 to 2015.

According to Information on Top 100 Accounting Firms in China by Revenue in 2015, the total revenues of the top six in ranking are respectively:

- (1) PricewaterhouseCoopers CPA (PwC) with a total revenue of 371,348.24 ten thousand *yuan*;
- (2) Deloitte CPA with a total revenue of 313,092.45 ten thousand *yuan*;
- (3) Ernst & Young CPA with a total revenue of 283,323.15 ten thousand *yuan*;
- (4) Ruihua CPA with a total revenue of 306,202.57 ten thousand *yuan*;
- (5) BDO China CPA with a total revenue of 290,695.72 ten thousand *yuan*.
- (6) KPMG CPA with a total revenue of 235,071.87 ten thousand *yuan*.

The total audit fees of the four major firms totaled 1.753 billion *yuan*, accounting for all listed companies 42% of audit fees. Although the advantages of the audit fees of the four major firms are still obvious, they have declined compared with the 45% market share in 2014, and have shown a downward trend year by year. While the number of clients of the four major firms accounted for only 6% of the total, actually they accounted for the leading listed companies in the industry. Industry experts have observed that the income scale of domestic investment firms is increasing, but there is still a big gap between domestic firms and the Big Four. At present, the businesses of the Big Four are increasingly concentrated in financial auditing and consulting. Its extensive international network, brand professional influence, and advanced partnership culture still occupy a greater advantage.

### 3.5.3 REVENUE ANALYSIS OF 2016

In 2016, the total income of national securities-qualified accounting firms was 44.03 billion *yuan*, more than 60% of the total income of the national certified public accountant industry. Among them, audit business revenue was 40 billion *yuan*, accounting for 90.9% of total revenue.

The audit fees of the top ten accounting firms in 2016 totaled 3.62 billion *yuan*, accounting for 77.6% of all listed companies' audit fees; the total audit fees of the four major member firms totaled 1.78 billion *yuan*, representing the 38.3% of company audit fees. The Big Four still have obvious advantages in audit fees, but they have declined compared with the 42% market share in 2015, showing a downward trend year by year.

The total income of 100 firms in 2016 was 4,648,691.38 thousand *yuan*, an increase of 17.75% over 2015.

Comparing with the Information on the Top 100 Accounting Firms issued by the CICPA in recent years, it is found that the top accounting firms have a relatively high percentage of deductions in the evaluation system.

According to the Information on Top 100 Accounting Firms in China by Revenue in 2016, the total revenues of the top six in ranking are respectively:

- (1) PricewaterhouseCoopers CPA (PwC) with a total revenue of 411,733.06 ten thousand *yuan*;
- (2) Ruihua CPA with a total revenue of 403,014.91 ten thousand *yuan*;
- (3) Deloitte CPA with a total revenue of 332,477.32 ten thousand *yuan*;
- (4) BDO China CPA with a total revenue of 350,168.60 ten thousand *yuan*;
- (5) Ernst & Young CPA with a total revenue of 296,071.83 ten thousand *yuan*.
- (6) KPMG CPA with a total revenue of 253,335.25 ten thousand *yuan*.

Although the number of clients of the Big Four only accounted for 6.2% of the total, they accounted for the leading listed company in the industry, and the market concentration calculated on the basis of total customer assets was as high as 83.9%.

#### 3.5.4 REVENUE ANALYSIS OF 2017

The release of this information is the first appearance of the ranking of the top 100 firms after major changes in the ranking index system. This change makes annual business revenue the only decisive indicator for the AICPA to release information on the top 100 firms, ranking the top 100 firms based on their annual business revenue from high to low. The promulgation of this method indicates that the AICPA has completely changed the original firm ranking method based on comprehensive evaluation.

In 2017, there were five financial institutions with audit fees exceeding 100 million *yuan*, all of which were divided up by the Big Four. According to Wind data, among the top 20 clients of listed companies, the top 19 are undertaken by the Big Four, and the 20th is managed by the domestic Zhongtianyun accounting firm.

Additionally, Wind data show that the top five clients with the highest audit fees in China in 2017 were all financial institutions, namely Bank of China with 215 million *yuan* audit fees, audited by Ernst & Young Hua Ming; China Construction Bank with 137 million *yuan* audit fees, audited by PricewaterhouseCoopers; Industrial and Commercial Bank

with 136 million yuan *audit* fees, audited by KPMG Huazhen; Agricultural Bank with 122.3 million *yuan* audit fees, and Ping An of China with 103 million *yuan* audit fees, both audited by PricewaterhouseCoopers. Most of China's high-quality client resources and high-end business projects have been undertaken by the Big Four, reflecting the lack of confidence in domestic branded accounting firms. Undoubtedly, the long-term brand effect of the Big Four is very strong, with high market recognition and intangible asset value.

The number and proportion of clients of the ten firms with the largest annual report auditing business of listed companies have maintained an upward trend year by year. The average business volume of each listed company is 242.4 firms for the top ten, which is significantly higher than the industry average (87.8 firms).

According to the Information on Top 100 Accounting Firms in China by Revenue in 2017, the total revenues of the top six in ranking are respectively:

- (1) PricewaterhouseCoopers CPA (PwC) with a total revenue of 516,595.15 ten thousand *yuan*;
- (2) Deloitte CPA with a total revenue of 402,977.04 ten thousand *yuan*;
- (3) BDO China CPA with a total revenue of 369,015.54 ten thousand *yuan*;
- (4) Ernst & Young CPA with a total revenue of 332,337.36 ten thousand *yuan*;
- (5) KPMG CPA with a total revenue of 312,685.02 ten thousand *yuan*;
- (6) Ruihua CPA with a total revenue of 287,998.62 ten thousand *yuan*;

The audit clients of the Big Four are mainly in the finance, insurance, transportation, and warehousing industries. In 2017, the Big Four have a market share of 49.35% in the financial and insurance industries, and a market share of 17.17% in the transportation and storage industries.

In 2017, the average fee for auditing the financial statements of listed companies was RMB 1.5612 million, an increase of 3.13% from the 2016 RMB 1.5138 million.

From 2006 to 2017, audit fees of listed companies were basically the same as the trend of changes in GDP. Correlation analysis shows that the correlation coefficient between audit fees of listed companies' financial statements and the country's GDP is 0.9421, which is significant. The total audit fees of listed companies (the sum of financial statement audit fees and internal control audit fees) and GDP is 0.9579 and significant, indicating that

audit fees are highly correlated with GDP. A correlation analysis of audit fees and gross domestic product is shown:

	Financial Statement Audit Fees	Total Audit Fees
GDP Correlational Coefficient	0.9421	0.9579
Statistical Significance	0.0000	0.0000

### 3.5.5 REVENUE ANALYSIS OF 2018

In 2018, the total income of national securities-qualified accounting firms was 45.88 billion *yuan*, an increase of 8.8% over the previous year, representing the 57.9% of the total income of the national CPAs industry. Among them, the audit business income was 42.03 billion *yuan*, an increase of 4.6% over the previous year, which stands for 91.6% of the total revenue.

In 2018, the annual report audit fees of listed companies totaled 5.99 billion *yuan*, with an average value of 1.654 million *yuan*, an average increase of 6.5% over 2017. The audit fees of the top ten accounting firms totaled 4.49 billion *yuan*, accounting for 75.0% of all audit fees of listed companies. Among them, the total audit fees of the Big Four were 2.15 billion *yuan*, accounting for 35.9% of all listed companies' audit fees.

According to the 2018 annual audit of Shanghai and Shenzhen listed companies, further statistical analysis based on Wind's original data shows that each listed company paid an average of about 1.64 million *yuan* for the annual report audit, with a median of 900,000 *yuan*.

According to the Information on Top 100 Accounting Firms in China by Revenue in 2018, the total revenues of the top six in ranking are respectively:

- (1) PricewaterhouseCoopers CPA (PwC) with a total revenue of 517,228.23 ten thousand *yuan*;
- (2) Deloitte CPA with a total revenue of 446,654.24 ten thousand *yuan*;
- (3) Ernst & Young CPA with a total revenue of 389,583.73 ten thousand *yuan*;
- (4) BDO China CPA with a total revenue of 366,794.73 ten thousand *yuan*;
- (5) KPMG CPA with a total revenue of 336,189.57 ten thousand *yuan*;
- (6) Ruihua CPA with a total revenue of 287,855.10 ten thousand *yuan*;

Although the number of clients of the Big Four in Mainland China only accounts for 6.7% of the total, because the clients are mainly industry-leading listed companies, their share is as high as 82.6% based on the total amount of client assets.

In terms of audit remuneration, the Big Four are still among the top. This is related to the size and business complexity of the firms. For example, the listed companies audited by the Big Four include the four major banks, that are, the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC), and the China Construction Bank Corporation (CCB).

### 3.5.6 COMPREHENSIVE ANALYSIS AND RESULTS

The ranking by revenue highlights the supremacy of the Big Four plus BDO China for what concerns audit fees, but this is inconsistent with the effective number of audited clients.

Regarding audit fees, China still does not have a unified audit fee standard. The Administrative Measures for Intermediary Service Charges and the Price Law stipulate the audit fee standard methods, such as fixed price  $\pm$  floating percentage. Due to the differences in the choices of different methods, there is a big gap between different regions in determining their own charging policies. Each accounting firm can be based, for instance, on the registered capital of the audited entity, the total assets of the balance sheet or the amount of profit for the fiscal year to extract the corresponding proportion of audit fees.

International accounting firms consider audit costs and audit risks as the two most important factors. Western accounting firms generally calculate audit fees by the hour of work needed, and classify the hourly wages of assistants and project leaders in detail. In this way, they also provide a more uniform and simple standard for audit fees. Generally speaking, for the same listed company audit fees, there is a significant difference between the fees charged by domestic and foreign firms.

Therefore, in order to establish whether *guanxi* is nor a deeply rooted concept in the audit practice, other important data have to be taken into account when analyzing the ranking. Such data are the number of CPAs and the branches of the accounting firms.



Among the top six in ranking, when talking about the total number of CPAs, a big gap between Big Four and the domestic firms Ruihua and BDO China is noticed. The following table outlines the data concerning the number of CPAs in the top six accounting firms in the timeframe from 2014 to 2018.

	<i>PwC</i>	<i>Deloitte</i>	<i>EY</i>	<i>KPMG</i>	<i>BDO China</i>	<i>Ruihua</i>
2014	959	800	885	616	1,811	2,335
2015	1007	849	910	646	1,920	2,357
2016	1056	852	999	714	1,939	2,514
2017	1094	872	1124	731	2,135	2,459
2018	1157	1013	1167	799	2,108	2,266

The number of CPAs of all the top six in ranking has increased over time, with the exception of Ernst & Young in 2016. As noticed, the number of CPAs of the Big Four is not large. This data can be integrated with the number of branches, which is shown in the following table. However, such data appear only in the 2017 and 2018 ranking, after the major changes in the index.

	<i>PwC</i>	<i>Deloitte</i>	<i>EY</i>	<i>KPMG</i>	<i>BDO China</i>	<i>Ruihua</i>
2017	21	13	16	11	31	40
2018	22	13	17	12	31	40

Both tables show higher level of CPAs and branches in the domestic firms, stating domestic capillary distribution, which helps them in broadening their *guanxi* network, both firm-to-client and firm-to-firm. This is the reason why Chinese firms tend to prefer to hire people with a good quality *guanxi* network (Warren et al. 2004), who are able to expand their web of contacts.

No correlation between *guanxi* and revenue is found, as it appears that a higher level of revenue does not imply a broader *guanxi* network, but yet a strong brand awareness and a higher reputation. The impact of brand awareness of the Big Four has prompted big domestic listed companies to choose them to audit their annual financial statements, as Big Four are perceived more authoritative. In order to reduce this brand disadvantage,

domestic firms try attract business by lowering prices, adopting a "low-balling strategy", while the Big Four exploit their high fees as an indicator of good quality. The Big Four can charge higher audit fees, which largely depends on their solid audit skills and well-known brands. Companies that want go to foreign listings will appoint one of the Big Four as auditor and are willing to spend high prices in exchange for a trustworthy audit report.

Domestic pricing is generally based on two standards, that are, the total assets of the audited entity, and the working hours of the CPAs. However, because working hours are difficult to measure, most accounting firms set a preliminary fee standard based on the total assets of listed companies, and then adjust them appropriately. Therefore, domestic charging standard is relatively low.

Accounting firms of different sizes focus on different target customer groups. The Chinese government, the Association of Accountants and other industry related departments have established a series of qualification restrictions on the certified public accountant industry, which to a certain extent divides the target market of large, medium and small firms. Accounting firms have their own target customers, and clients also have their own target service providers. This is also related to the size of the audit firms, that is, different sizes have different capabilities to undertake business and bear risks, so they target different customers.

However, a trend of domestic firms to appoint other domestic firms rather than Big Four or international firms over the deadline of the audit partner rotation is evident. This observation takes its basis on the List of changes in the audit firm of the financial statements of listed companies, published every year by CICPA. Reasons of this trend explain the relevance of *guanxi* network within domestic firms, which also states their identity and locality. Consistently with the literature review, audit firms should invest in the development of *guanxi* networks as a strategic asset (Wen 2019). In accordance with the theory of Kriz et al. (2013), multiple branches can be considered as multiple sources of information and basis of contacts.

Taking into account the recent scandals that involved Ruihua CPA, it can be see how they have affected the audit quality and consequently the *guanxi* network.

According to data released by the company's official website, as of August 31 2019, Ruihua CPA has served a total of 288 listed companies. Among them, 43 companies are

listed on the Shanghai Stock Exchange and 245 are listed on the Shenzhen Stock Exchange. Compared with the list previously disclosed by Ruihua, the number of listed companies served by the company has decreased by 31. Among them, 25 listed companies cut the Ruihua firm in August. According to the information of the top 100 accounting firms in 2018 by the Chinese Institute of Certified Public Accountants, Ruihua's 2018 operating income was 2.879 billion *yuan*, and the number of certified public accountants was 2,266, the highest in the country. At the same time, the number of company branches is 40, which also ranks first on the list. In fact, the reasons of the aforementioned listed companies to no longer cooperate with Ruihua can be traced back in the violation of securities-related laws and regulations during the audit process. Subsequently, the IPO process update status of many companies in which Ruihua acted as an accounting firm was suspended or terminated, and the refinancing projects of some listed companies were therefore stagnated.

With the continuous occurrence of false accounting statements of listed companies and the continuous increase of investors' expectations of listed companies, the demand for high-quality auditing in the Chinese securities market will increase in the future. In this case, the outstanding companies are sparing no effort to hire better-branded accounting firms to reflect their own credibility. Audit fees may become one of the standards by which people measure good companies and bad companies. On the other hand, although the Big Four accounting firms have established a firm foothold in the Chinese auditing market, a number of domestic firms are also emerging. Through the establishment of a complete management system like an international accounting firm (including quality control system, risk control system, financial management system, and training system), their audit fee standards should gradually move closer to internationalization.

The competition of accounting firms is ultimately the competition of human resources. Many domestic accounting firms are paying more and more attention to the training of talents for talents and have increased investment in the improvement of the quality of human resources. The current audit practice environment makes the image of CPAs seem particularly important. For this reason, the accounting firm must improve the overall quality of the team, strengthen the education and training of professional ethics and professional skills, maintain good contact with customers, and create a good practice environment for the development of the industry.

Under such circumstances, the audit costs of these large domestic accounting firms will gradually be in line with the international accounting firms, and their audit fees may also be considered to match their audit quality, audit costs and audit risks.

However, in China, the accounting firm as the main body of social auditing does not exist independently in the society. It will be affected by various relational factors. Li (2010) proposed that cultivating the firm's expertise is a necessary means to expand the firm's scale and enhance its competitiveness.

On the one hand, my China became the second largest investment market in the world in 2009, which created a huge market prospect for the accounting and auditing service industry; on the other hand, some international firms entered the audit market in China, and the competition in the audit service market is unprecedentedly fierce.

Corporate competitiveness has always been a long-standing topic. For a company, the connotation of its competitiveness, some scholars believe that it should be defined from the outside of the company, that is, a comparative analysis with the company's competitors. The World Economic Forum, for instance, defines the competitiveness of an enterprise as the ability of an enterprise to produce more wealth in the market than other competitors in a balanced manner. Philip Kotler (2001) proposed that the competitiveness of a company is the ability that the company possesses to meet consumer expectations more effectively than its competitors in the industry. Other scholars conduct research from the inside of the company to explore more sustainable core competitiveness. For instance, the American economist CK Prahalad and the British scholar Garry Hamel (1990) believe that the core competitiveness of a company are the skills and knowledge formed after the integration of various resources and skills within the company. A company have to fully considers the needs and value of customers or consumers, and continuously improves quality.

There are few domestic researches on whether the audit business volume of accounting firms will affect audit quality, and most of them are normative studies. Most domestic scholars have studied the relationship between the increase in the business volume of accounting firms and audit quality. The research of Fich and Shivdasani (2006), Ahn et al. (2009) all confirmed that the more the number of audited units, the busier the accounting firm is. In order to obtain more income, accounting firms are willing to provide audit services to major clients. Huang Huifang (2012) empirically found that

audit fees are positively correlated with the size of the audited unit. However, the busier the accounting firm is, the less attention it will focus on the overall audit work of the client. This reduces the audit quality and will inevitably lead to a drop in audit fees. There is a significant negative correlation between the busyness of the accounting firm and audit quality (Coles et al., 2006). According to DeAngelo's (1981) reputation theory, the reputation of an accounting firm has an important value. Once the accounting firm is busy and compromises with its clients and issues an untrue audit report, and this opportunistic motive is discovered, the reputation of the accounting firm will suffer huge losses, resulting in the loss of the accounting firm's customers and reduced revenue.

Therefore, it can be stated that broadening one's *guanxi* network could be counterproductive within the audit framework, especially with a rent-seeking perspective. Chinese audit firms should devote a lot of manpower and material resources to customers with strong profitability and low audit risk, which imply a high controllability of potential risks in the future. Through the *guanxi* dynamics, Chinese audit firms can implement customer satisfaction and customer loyalty strategies, establish a mutual trustworthy, stable, and long-term cooperative relationship. To sum up, in the increasingly competitive CPA business market, firms must conduct systematic management in order to survive better.

Customers are an important asset of an enterprise. In order to overcome the high level of competition and the costs involved, audit firms should take customer relationship and relationship value as the research object in a long-term perspective.

The implementation of such strategy enables the firm to analyze target customers according to appropriate standards, that is, to select those loyal old customers, profitable large customers, small customers with development potential, and new customers with strategic significance for level investment. Cost input and profit output are objectively compared, so as to achieve the best results with the least cost, and after the accounting firm conducts accurate and objective analysis on customers, it can also greatly reduce the audit risk. The customer loyalty is improved through good service, which is conducive to the firm's establishment of a good reputation and expansion of the firm's influence degree. Additionally, it improves the social status of the firm, so as to achieve the purpose of establishing the firm's brand.

On the premise of ensuring service quality, Chinese audit firms have to comprehensively consider the costs, benefits and risks of customer relationship management, implement customer satisfaction strategies, and promote accountant affairs while retaining and expanding customers' portfolio. Therefore, the firm must consider the value of the relationship that can be obtained based on its ultimate goal, that is, the value that the audited firm can bring to the audit firm by establishing and maintaining a long-term relationship. This relationship value reflects that accounting firms may obtain higher market profits by establishing long-term and stable relationships with valuable clients. It emphasizes not the revenue that a single transaction of the customer brings to the enterprise, but the value of the customer's life obtained by maintaining a long-term relationship with the customer.

For certified public accountants, in the process of practicing, it is important not only meet the requirements of customers, reflecting the business philosophy of "customer-centered", but also maintain independence is a relevant factor.

Like a company's products, customers also have a life cycle. It is generally believed that the longer the customer retention period, the higher the relative return on investment of the company, and the greater the profits it will bring to the company. It can be seen that retaining customers is very important, but what kind of customers to retain and how to retain customers are important issues raised by the company. The purpose is to discover, cultivate and retain customers who have established a long-term and stable relationship with the company and can be considered a plus value.

Independence, objectivity and impartiality are the prerequisite and foundation for the survival and development of the auditor profession. Only by maintaining independence can auditors issue audit reports objectively and fairly. Investors can make rational investment decisions based on objective and fair audit reports.

In recent years, a large number of failed audits of listed companies in China and abroad have caused the CPAs' audit independence to be questioned by the general public.

The "Guiding Opinions on the Professional Ethics of Chinese Certified Public Accountants" issued by AICPA, focuses on how CPAs should maintain their professional independence and professional competence, prevent irregular fees and commissions, and avoid incompatibility with assurance services. Specific provisions have been made on business, standardizing business solicitation, and clarifying the responsibilities of former

and previous CPAs. Integrity building has become the main line of the work of the CPA industry in China.

In this perspective, good quality *guanxi* can bring many advantages for the domestic audit firms. First, in accordance with the literature review, a narrow clients' portfolio should increase the trustworthiness of the CPAs' reports. Second, the establishment of brand awareness is strictly related to the perceived reliability of the audit practice. Third, this will allow domestic audit firms to change their price strategy, from a low-balling strategy, to an increase of fees charged. Adopting these changes could upset the ranking in the future and give more authoritative power to the Chinese accounting firms.





## CONCLUSIONS

The purpose of this study is to analyze the dependence between *guanxi* and audit practice in China, with a focus on both domestic and foreign accounting firms. The concept of *guanxi* is quite new in the Western world and often mistaken for relationship marketing or Western networking. For this reason, the first part of the work aim at inspect its specificities in the detail, in order to give a complete overview. *Ganqing* (emotional commitment), *renqing* (reciprocal exchange of favor), *mianzi* (face) and *xinren* (trust) are the core related values here discussed.

The reason why this study has been developed is related to the assumption that the auditing profession reflects one's country social construct, and therefore its dynamics can involve cultural characteristics. Specifically, in a relation-oriented society such as China, some cultural peculiarities can have an influence at the audit level.

Although the Chinese government has taken some measures to strengthen the weak institutional environment, the level of uncertainty is still high and the investor-protection regime is not equal to that in more developed market. Therefore, *guanxi* are exploited as strategic assets in order to reduce the level of uncertainty. Additionally, they act as informal institutions in an unstable framework, where the lack of a proper bureaucratic system able to guide individuals made the reliance on *guanxi* essential. The dependence on *guanxi* within the Chinese framework, especially on both the societal and business level, has been outlined by scholars.

For what regards the audit practice, the Chinese context seems to be service-oriented and highly governed by *guanxi*. Previous researches indicate that in China auditors have to manage their profession in a complex set of social norms and political influences, which deeply influence their practice and professional ethics. Whether it is a state-owned enterprise or a private enterprise, Chinese companies are more likely to choose relational transactions, which is significantly different from the market-based transactions commonly used in developed countries. We can measure the relational transaction patterns of Chinese companies from multiple dimensions, such as concentrated equity structure, B2G relationships, related party transactions within the group, and concentrated customer-supplier relationships.

Yet, the scarceness of literature about the dependence between *guanxi* and audit practice is a matter of fact, and this work is an attempt of contribution and a platform of knowledge for further studies. Prior to 1996, the government has the total control of all Chinese accounting and auditing firms and the independence of CPAs was therefore impaired. However, through the disaffiliation program issued by the Chinese Institute of Certified Public Accountants (CICPA), the institutional framework started to change. Due to this disaffiliation program, the previous-established *guanxi* of the accounting and audit firms began to crumble and they had to form new rent-seeking *guanxi* in order to survive.

In this perspective, this dissertation encompasses the previous literature and integrate it with a descriptive and quantitative analysis of the total business revenue of the top 100 firms (with number of CPAs and branches) and of the data of the Annual Reports on Auditing of Listed Companies. The ranking by revenue highlights the supremacy of the Big Four plus BDO China for what concerns audit fees, but this is inconsistent with the effective number of audited clients. First, this is due to the fact that China still does not have a unified audit fee standard, and foreign firms are more likely to charge higher fees. Second, this is highly related to the reputation of firms taken into account. Audit fees, indeed, are perceived as an index of good or bad reputation and therefore of quality. The Big Four can charge higher audit fees, as they have solid audit skills and well-known brands. Domestic firms have tried to reduce this brand disadvantage by lowering prices and adopting a "low-balling strategy", but it does not seem effective.

In this perspective, in order to establish whether *guanxi* is nor a deeply rooted concept in the audit practice, data of revenues cannot be the only parameter to analyze, but other important data have to be taken into account. Such data are the number of CPAs and the branches of the accounting firms. Among the top six in ranking, when talking about the total number of CPAs and branches, a big gap between Big Four and the domestic firms Ruihua and BDO China is noticed. It appears that domestic firms have higher level of CPAs and branches, stating their domestic capillary distribution, which helps them in broadening their *guanxi* network, both firm-to-client and firm-to-firm.

Data also shows an optimistic trend of domestic firms to appoint other domestic firms rather than Big Four or international firms over the deadline of the audit partner rotation is evident. This observation highlights the relevance of *guanxi* network within domestic

firms and suggests an exploitation of their multiple branches as platforms for further contacts and information.

Overall, this study suggests that there is no correlation between *guanxi* and revenue, as it appears that a higher level of revenue does not imply a broader *guanxi* network, but yet a strong brand awareness and a higher reputation. Although the Big Four charge higher audit fees, actually their portfolio of clients only account for the 6% of the total. In order to obtain more income, domestic accounting firms are willing to provide audit services to major clients, but previous literature review shows that this highly impair the quality of their reports, affecting their reputation. The busier the accounting firm is, the less attention it will focus on the overall audit work of the client. This reduces the audit quality and will inevitably lead to a drop in audit fees.

With the assumption that audit fees may become one of the standards by which people measure good companies and bad companies, domestic firms should consider this factor when charging fees to clients. Through the establishment of a complete management system like an international accounting firm (including quality control system, risk control system, financial management system, and training system), their audit fee standards should gradually move closer to internationalization. This will lead to a gradually convergence of domestic audit fees with international audit fee standard, considering audit costs and audit risks.

As stated before, in China, the accounting firm as the main body of social auditing does not exist independently in the society, but are rather affected by various relational factors, which can bring many advantages. First, narrowing their clients' portfolio they should increase the trustworthiness of their CPAs' reports. Second, the establishment of brand awareness is strictly related to the perceived reliability of the audit practice. Third, this will allow domestic audit firms to change their price strategy, from a low-balling strategy, to an increase of fees charged.

*Guanxi* can therefore become the spark that allows this virtuous circle to work, granting authoritativeness to the Chinese accounting firms. Then relational factors and audit practice can be properly balanced, and Chinese society can move toward a harmonious and fair society.



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