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## **Institutional Arrangements and Government Audit Independence in China**

**Running title: Institutional Arrangements and Government Audit Independence**

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# **Institutional Arrangements and Government Audit Independence in China**

## **Abstract**

China has adopted an Executive-dominated government audit system (GAS), which is frequently criticized for lacking independence. Through a questionnaire survey and interviews, we investigate whether and how the reporting/control requirements of the GAS (hereafter, the institutional arrangements) result in a lack of government audit independence in China and how this affects budget supervision by the People's Congress. We contribute field evidence to support the prediction that an Executive-dominated GAS lacks independence and transparency, which in turn is detrimental to the wider accountability regime. However, the specific level of independence varies according to the types and levels of government audit. Our findings enrich the government audit literature, enhance our understanding of the relationship between institutional arrangements and audit independence in a transition economy, and serve as a call for institutional reform relating to the Chinese GAS.

**Key Words:** Auditing; Audit Independence; Audit Storms; China; Government Audit; People's Congress

## **INTRODUCTION**

Independence is often considered a cornerstone of any contemporary audit system (Dewar, 1988). It is frequently used as a means to define, defend, and extend the jurisdiction of accounting in light of external competition and challenges (Sikka and Willmott, 1995) and is considered the founding principle of auditing by the International Organization of Supreme Audit Institutions (INTOSAI) (Otbo, 2009).<sup>1</sup>

Government auditing systems (GAS) can be classified into four main types depending on who they report

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<sup>1</sup> In the private sector, the lack of audit independence is identified as a major cause of many corporate failures such as Enron. These events have resulted in regulations that seek to strengthen audit independence such as the Sarbanes-Oxley Act that came into effect in the US in 2002 and the Statutory Audit Directive issued in the EU in 2006.

to (and who might therefore ‘control’ them) and their level of expected independence. They are: the *Legislature-oriented system* typified by the National Audit Office of the UK, the *Judicial GAS* represented by the French Court of Audit, the *Executive-dominated GAS* as exemplified by the National Audit Office in China, which is a department of the State Council – the executive organ of the government, and the *Independent GAS* such as the Audit Courts in Germany and Japan. In most cases, national legislation or relevant rules and regulations state that the government audit office should be independent. Thus, GAS reports should not be influenced by the views or biases of those who they report to, those who they report on, or those who fund them. However, whether there is independence in fact is subject to debate.

We focus our attention on independence from the Executive as this is seen in the literature to be the minimum requirement of government audit independence (Normanton, 1966; Goolsarran, 2007) and use data and evidence from China. China’s Constitution (National People’s Congress, NPC, 1982) and Audit Law (NPC, 1994) require that the GAS be subject to no interference from any administrative organization, social body, and individual. However, Chinese GAS is Executive-dominated because it reports to, and is financed by, the Executive branch of the government. As a result, there are claims that it lacks independence. Therefore, we set out to ask experts their views on the independence of GAS in China and how the lack of audit independence affects budget supervision by the People’s Congress.

We undertake this study for three important reasons. First, there is relatively little research on institutional arrangements for GAS and their impacts on audit independence. What research there is has been undertaken in developed countries, especially in Anglo-Saxon countries. Funnell (1994), for example, finds that although a state audit office was created to audit the Executive on behalf of the parliament in the UK, the Executive (mainly through the Treasury) actually dominated the audit office’s work during the 19<sup>th</sup> century. This suggests that even where audit independence from the Executive is assumed in a

*Legislature-oriented* GAS, it may not be realized in practice. English and Guthrie (2000) document how the adoption of New Public Management practices to deliver public services resulted in the erosion of the traditional parliamentary oversight over government management and reporting activities. In particular, the employment of private sector auditors to audit the emerging semi-autonomous government agencies or companies for delivering public services resulted in audit reports being presented directly to government officials, rather than to the parliament. This change not only eroded the power of the parliament, but also jeopardized audit independence from the Executive.<sup>2</sup> The study also demonstrated that the level of independence of the GAS may vary over time. However, few studies of GAS independence have been undertaken in the context of emerging and transition economies. Nikodem (2004) is an exception, but his study only focuses on the constitutional provisions on the GAS and finds that there is generally high constitutional protection provided for the independence of the GAS vis-à-vis the Executive in central European countries. Little is known of whether a GAS is effectively independent from the Executive in emerging and transition economies nor what the consequences are of a lack of independence.

Second, audit independence is determined by many factors, for example, institutional arrangements; the social and ethical environment that the audit firm/office, the client organization, and auditors face; competition among auditors; and auditor and auditee characteristics (Kleinman and Palmon, 2001). The extant government audit literature has made a limited examination of the effect of institutional arrangements on audit independence, but the investigation is mainly at the conceptual level (e.g., Mautz and Sharaf, 1961; White and Hollingsworth, 1999) or is otherwise qualitative (e.g., Funnell, 1994; English and Guthrie, 2000). There is little quantitative evidence on GAS independence and few attempts to isolate the effects of institutional arrangements from those of other determinants.

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<sup>2</sup> Similar developments have been documented for the UK (Bowerman et al., 2003), New Zealand (Lovell, 1996), and Canada (Free and Radcliffe, 2009).

Third, there is an ongoing debate in China about whether and how the Executive-dominated GAS should be reformed. Some criticize it for lacking independence and for operating as a black-box in the sense that few audit findings are disclosed to the public. Indeed, several reform proposals have been put forward to enhance audit independence (Yang and Xiao, 2004). However, these proposals are based on a presumption, rather than systematic empirical evidence, that there is a lack of audit independence in the current GAS, and the lack of independence is caused by the institutional arrangements and results in ineffective and weak supervision of budget implementation by the People's Congress. Investigating these issues requires detailed multivariate analysis. Moreover, some argue that the current Chinese GAS performs an effective monitoring role and thus the status quo should be maintained. This view has especially been proffered after a series of controversies (Audit Storms) blew up after the Auditors-General of the National Audit Office (NAO) reported certain audit findings to the National People's Congress (NPC) since 1999 and to the public since 2003. These audit findings have alerted the NPC and the public that serious wrongdoings have been committed by some central government departments and other government agencies. Such acts of disclosure and the contents disclosed (about the wrongdoings) have caught the attention of the public, attracted extensive media coverage, and generated some heated discussions and debates over such issues as the need to reform the GAS, government accountability, and the role of the People's Congress in holding the government accountable. This phenomenon has been dubbed in the media as Audit Storms. Some commentators argue that evidence of Audit Storms indicates problems are being properly aired and there is no pressing need to reform the GAS in China (e.g., Ma, 2005). Given the conflicting views and anecdotal evidence to date, we believe the time has come for more systematic evidence on the independence and effectiveness of the Chinese GAS.

Our focus is on government audit in general, but we also refer to budget implementation audits (BIA)

as an example to illustrate our arguments and to test the effects of the institutional arrangements. BIA is chosen because budget implementation is one of the most important elements of budget management as defined by the Budget Law (1994) and has become one of the most important areas of government auditing in China. In addition, since the Budget Law requires the People's Congress to play a budget supervision role and the government to prepare and implement budgets, BIA provides a suitable setting to examine the effect of audit independence on the role of the People's Congress in budget supervision. Furthermore, BIA is a more suitable setting to test our hypotheses and address our research questions because it is a type of parallel auditing which makes it more difficult to maintain audit independence than top-down auditing (see next section for details of both types of auditing). Finally, although BIA reflects a recognition of the importance of addressing a significant auditing gap, no study has assessed whether BIA has lived up to people's expectations.

Our data are collected through a questionnaire survey of, and interviews with, People's Congress officials, government and finance officials, government auditors, academics and other relevant experts. We find that there is a positive and significant association between institutional arrangements and perceived lack of audit independence in general and in BIA in particular and the perceived lack of audit independence is positively and significantly associated with the perceived weak budget supervision by the People's Congress. We also identify a number of ways by which the institutional arrangements lead to a lack of audit independence, which in turn negatively affects the monitoring role of the People's Congress. Our study makes four important contributions. First, it provides detailed statistics and information about the Chinese GAS and how it operates, which are little known outside of China. Second, it provides empirical evidence to support the prediction that an Executive-dominated GAS lacks independence and

transparency, which in turn is detrimental to the broader accountability regime.<sup>3</sup> This adds to the literature on the types of GAS and their impacts on audit independence, which, as discussed earlier, is underdeveloped in general and particularly underdeveloped in emerging economies. Third, to the extent that much of our evidence is based on a survey and analysed through quantitative and multivariate methods, it enriches the literature on government audit independence that to date mainly consists of conceptual or qualitative analysis and represents a first step towards isolating the effect of institutional arrangements on audit independence. Finally, our empirical findings enrich the aforementioned debate on whether the Chinese GAS lacks independence, and also serve as a call for institutional reforms to strengthen audit independence and enhance public accountability.

The next section introduces the institutional background. Then we formulate our hypotheses and research questions while the following section describes the methods of data collection and the models and variables used to test the hypotheses. The fifth section assesses the current GAS and budget implementation audit, tests the hypotheses, and answers the research questions. The final section concludes the paper.

## **BACKGROUND**

China's central government, in a broad sense, consists of the State Council, which is the administrative arm or the Executive; the National People's Congress (NPC), which is the legislature; the Chinese People's Political Consultative Conference (CPPCC);<sup>4</sup> the Supreme People's Court; and the Supreme People's Procuratorate. According to China's Constitution, these state organs are under the leadership of the

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<sup>3</sup> In 2009 and 2013, China was ranked 79 and 80 in Transparency International's Corruption Perceptions Index (<http://www.transparency.org>). The weak government audit system at least partially explains the extent of corruption in China.

<sup>4</sup> CPPCC is an organization in which different political parties, social institutions and individuals forge a united front, with three functions: (1) political consultation; (2) democratic monitoring, and (3) discussion of policies and participation in policy making.



Communist Party of China's (CPC) Central Committee and its standing body, the Politburo. Local governments at the provincial, municipal, and county levels are also made up of these apparatuses, which are under the leadership of local CPC committees.

Following its foundation in 1949, China did not immediately establish a GAS. It was not until 1981 when the Constitution was being amended, that the Constitution Amendments Committee felt that an audit organ would help economic reform and socialist construction and hence proposed that a provision relating to the establishment of an auditing department be included in the Constitution. The Committee also solicited opinions from government units and departments. While there was a consensus on the establishment of such an organ, there was a dispute over where this department should be placed, the NPC or the State Council.<sup>5</sup> Out of a consideration that the NPC should focus on law making instead of being burdened by auditing, the State Council formally set up the National Audit Office (NAO) in September 1983 as a government department and local governments subsequently established local audit offices (LAOs).<sup>6</sup> According to China's Constitution and Audit Law, the Auditor-General of the NAO is nominated by the Premier, approved by the NPC, and announced by the president of the state. The auditor-generals of LAOs are nominated by the heads of local governments and approved by local People's Congresses in consultation with the audit office at a higher level.<sup>7</sup> In addition, the Audit Law requires the State Council and local governments to secure the funds needed to run the NAO and LAOs, respectively.<sup>8</sup> Following the rapid growth over the last 30 years, this system has now evolved into a network of offices at four levels (i.e., central, provincial, metropolitan, and county) with about 80,000 auditors.

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<sup>5</sup> For convenience, the State Council and its local counterparts are referred to as the government or the Executive whereas the National People's Congress and local people's congresses are referred to as the People's Congress.

<sup>6</sup> The Constitution of the PRC (1982, revised in 2004) requires that 'The State Council establishes a National Audit Office to exercise audit supervision over the financial income of and spending by the departments of the State Council, local governments, enterprises and institutions' (Clause 91) and 'Local governments at or above the county level set up local audit offices...responsible to the local governments and the audit office at a higher level.' (Clause 109).

<sup>7</sup> See Clauses 62, 63, 68, and 80 of The Constitution of the PRC (1982, revised in 2004) and Clause 15 of The Audit Law of the PRC (1994, revised in 2006).

<sup>8</sup> See Clause 11 of The Audit Law of the PRC (1994, revised in 2006).

Before the *Audit Law* and *Budget Law* were enacted in 1994, the GAS had mainly performed the audit of state-owned enterprises' financial revenues and expenditures (Leng, 2005). However, they have been undertaking fiscal budget implementation audits since the two laws were promulgated. The GAS now also performs the audit of financial institutions, the use of special purpose funds and social welfare funds, and economic responsibilities of government officials and state-owned enterprise managers.<sup>9</sup> There are two main types of auditor—auditee relation: top-down audits and parallel audits. In the former, an audit office at a higher level of government audits an auditee at a lower level of government, for example, the audit of the annual accounts of a county government by a municipal audit bureau. In the parallel audit, the audit office and the auditee belong to the same level of government, or are both constituent parts of the same government, for example, the municipal audit bureau audits the budget implementation of the municipal finance bureau, or undertakes an economic responsibility audit of the head of the municipal taxation bureau. Government auditing consists of several phases: planning audits annually, delivery of an audit notice to the auditee, undertaking field work, reporting audit findings to the auditee, government, People's Congress and the public, and enforcing audit resolutions in which the audit bureau monitors the auditee's progress in addressing identified problems.

Independence is widely accepted by Chinese academics, practitioners, and regulators as the essence of auditing and a basic requirement for the proper functioning of an audit. The Constitution (Clause 91, 1982, revised in 2004) and the Audit Law (Clause 5, 1994, revised in 2006) require that the NAO and LAOs

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<sup>9</sup> There are as many as 12 levels of government positions in the Chinese administrative hierarchy. The regulations and practices concerning government official appointment, promotion, and dismissal have varied from time to time, but according to Luo and Zhao (2009), over the last few decades, there has been a tendency of combining democratic opinion and organizational monitoring and appraisal, and a consideration of both ethical and competence criteria. In theory, government audit, especially economic responsibility auditing (ERA), plays an important role in these processes; that is, the government or government department heads' fulfilment of his/her economic responsibilities during his/her office terms are audited and the audit results are included in the official records about him/her. The central government began to subject county level government officials and below to ERA in 1999, but only extended ERA to government officials above the county level in 2010. In practice, the occurrence of a large number of corruptions and bribes in China indicates that there is ample scope to improve the real effectiveness of ERA.

independently exercise their legal audit supervision powers under the leadership of the State Council and local governments, respectively, subject to no interference from any administrative organization, social body, and individual. Despite these legal provisions, audit independence may be considered to be lacking in the Chinese GAS because the NAO and LAOs are seen as an internal function of the State Council and local governments, respectively, they are financed by their parent governments, and the hiring and firing of the head of an audit office is effectively determined by the head of the parent government.<sup>10</sup> Some commentators maintain that only when the system is reformed, can audit independence be guaranteed and they propose several different reform approaches. Xiang (2002) and Gao (2003) propose a “One Council and Three Courts” system, i.e., an Audit Court to be set up side by side with the State Council, the Supreme People's Procuratorate Court, and the Supreme People's Court. To protect the independence of local audit offices, Li (2001) argues that the current dual leadership structure (an audit office is a department of its parent government but is also technically supervised by a higher level audit office) should be replaced by vertical leadership (i.e., an audit office should only be under the leadership of a higher level audit office). However, Yin et al. (2001) argue that the current basic structure of the audit system should be maintained, but the rank of the NAO should be upgraded by half a level so that the Auditor-General of the NAO would be the equivalent of a Vice-Premier or State Councilor and would have more organizational power over the NAO's auditees. A similar arrangement would also be made at lower levels of audit offices and governments. In contrast, Yang (1991) and Qin (2004) propose that the NAO (LAOs) should break away from the State Council (local governments) and be set up under the umbrella of the NPC (local People's Congresses). Taking into account many difficulties in moving the GAS directly to a legislature-oriented audit system, Yang and Xiao (2004) put forward a “Dual-Track System” in which the

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<sup>10</sup> Despite the legal requirement that the hiring and firing of the heads of audit offices should be determined by the People's Congress, in practice, the People's Congress may only rubber-stamp the recommendation of the head of the government.

People's Congress and the government set up separate auditing organizations exercising different audit responsibilities.<sup>11</sup>

The main difference between the above reform proposals lies in their different suggestions for enhancing audit independence. However, a major caveat of all these proposals is that they are not based on empirical evidence as to whether there is indeed a lack of audit independence and if there is, whether the lack of audit independence is caused by the current institutional arrangements of the GAS. Nor are they based on empirical evidence that the lack of independence has resulted in major undesirable consequences. Therefore, an obvious alternative to the above reform proposals is to maintain the status-quo. This default option is deemed attractive by some people as it will not incur reform costs. Moreover, the status-quo has obtained greater support after a series of Audit Storms that have broken out since 1999 (Ruan and Song, 2005). The Audit Storms are closely related to audit disclosure. The Audit Law requires the Auditor-General of the NAO to make annual reports to the NPC or its Standing Committee and changed the wording 'refer the audit results to auditee government departments' in the previous audit regulations to 'refer audit results to auditee government departments or disclose them to the public'. The Audit Law Implementation Rules issued in 1997 provide more specific guidance as to what should be disclosed to the public.<sup>12</sup> However, little happened until June 1999 when Auditor-General Jinghua Li reported to the 9<sup>th</sup> NPC's Standing Committee on the findings from auditing central budget implementation and other financial revenues and expenditures carried out in 1998. He revealed many wrongdoings committed by central government departments. For example, 18 departments failed to disclose budget revenues of RMB 1.73 billion yuan, 36 departments appropriated RMB 2.11 billion yuan for illegal uses, and 20 departments

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<sup>11</sup> Under this system, the audit organs of the People's Congress operate budget implementation auditing whereas the audit offices under the government undertake other audit functions (such as enterprise auditing, economic responsibility auditing of government and party leaders, financial service auditing, etc.).

<sup>12</sup> The Audit Law Implementation Rules (1997) identifies three types of audit results that can be disclosed to the public: those required by the parent government or the audit office at a higher level, those that are of concern to the public, and those that are required to be disclosed by law and regulations.

illegally retained fiscal funds of RMB 5.66 billion yuan. These findings shocked the members of the Standing Committee of the NPC. In addition, news reports on the event also caught the attention of the media and public. In June 2004, the Auditor-General presented yet another audit report to the Standing Committee of the NPC. This again exposed many wrongdoings in fiscal budget implementation committed by central government ministries. The exposed problems caused a lot of heated commentary by the public, attracted a large volume of media coverage and follow-up press investigations, and ignited many discussions and debates (Chen, 2005).<sup>13</sup> Since then, an Audit Storm has arisen every year when the Standing Committee of the NPC meets.

Some commentators argue that the Audit Storms have produced several positive effects on government auditing. First, it has sped up the process of increasing auditing transparency as now the GAS has become a system through which the results of special audits or super-significant audits are disclosed. Second, it has enhanced government auditing services to the People's Congress. For example, the Audit Law requires the NAO to report to the Standing Committee of the People's Congress.<sup>14</sup> As a result of this, there is less of a need to reform the GAS as encapsulated by Mao's (2005) following remarks:

The National Audit Office can launch an audit storm and exercise strong monitoring over powerful government departments so long as it properly uses the powers given to it by the Constitution and the Audit Law and operates transparently. Some people argue that it is better to upgrade the NAO, make it independent from the State Council, or place it under the NPC in order to make the NAO more effective. But this is not necessary because the NAO can obtain powers from the law so long as it follows the legal requirements, and publishes its audit report.

In light of the above claims and counter claims, there is a need for more evidence to justify the calls for the reform of GAS in China.

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<sup>13</sup> For example, almost all major Internet media companies such as People's Net, Sohu.com, Sina.com, and Tom.com launched dedicated websites on Audit Storms. Many national newspapers or magazines such as China Youth Newspaper, 21<sup>st</sup> Economic Herald, South China Weekend Newspaper, and Finance and Economics Magazine reported on the government departments and their wrongdoings mentioned in Jinhua Li's audit report.

<sup>14</sup> Other commentators have ascribed additional positive effects to the Audit Storms beyond government auditing. For example, Leng (2005) argues that the Audit Storms have promoted the construction of political civilization in China, while Mao (2005) argues that they have pushed government governance reform.

## RESEARCH HYPOTHESES AND QUESTIONS

It is well-understood that for an audit report to have any value to its users, the auditor must be both technically competent and honest (Moizer, 1995, 1997). A technically competent auditor will have the necessary expertise to discover all the material errors and wrongdoings by the auditee. An honest auditor will ensure that all material errors and wrongdoings are corrected or that they are fully disclosed in the audit report. In line with this argument, Watts and Zimmerman (1980) and DeAngelo (1980) define the level of auditor independence as the conditional probability that, given that a breach has been discovered, the auditor will report the breach. As a result, the quality of the audit report may be used as a proxy for audit independence. That is, low audit reporting quality is indicative of a low level of audit independence. However, this definition of audit independence does not indicate the reasons for the auditor not to disclose a discovered breach. The concept of independence in appearance discussed below is useful in this regard.

Lee (1993) argues that independence is an attitude of mind in which the auditor's opinion and findings cannot be subjected to pressures and influences of conflicting interests. Mautz and Sharaf (1990), however, hold that independence should be viewed from two levels: auditors' independence in an engagement process and the independence of auditors as a professional body in appearance. The INTOSAI (1977, 2007a, b) applies the idea of independence in appearance to government audit institutions in its *Lima Declaration of Guidelines on Auditing Precepts*. It views independence of audit institutions from three perspectives, i.e., organizational independence, financial independence, and independence of members and officials. However, independence in essence and independence in appearance are interrelated. For example, audit independence in essence can be impaired by auditors' organizational, financial, and personnel dependence on the government as the auditee (INTOSAI, 1977, 2007a, b). As mentioned before, the NAO and LAOs in China are dependent on the State Council and local governments, respectively, in

all these three aspects. For example, as a municipal audit office is an internal department of a municipal government, it is financed by the municipal government, its staffing level is determined by the municipal government and its auditor-general is nominated by the municipal government although approved (usually rubber-stamped ) by the municipal People's Congress. Under such circumstances, government auditors would find it hard to withstand government interference in the audit process (including audit planning, evidence collection, audit reporting, and enforcement of audit remedies). This could result in an undiscovered breach (intentionally or unintentionally), and if discovered, not reported. Moreover, such dependence on government in finance, organization, and personnel can result in a lack of audit independence from the government in both parallel auditing and top-down auditing. In top-down audits, there could still be interference from the auditor's government. For example, the head of the auditor's government may be in a good position to cover wrongdoings in a lower level government or its departments by intervening in the audit process. This analysis leads to our first hypothesis:

**Hypothesis 1:** the institutional arrangements of government audit are positively associated with a lack of audit independence in China.

As an important component of government auditing, BIA encounters additional difficulties in maintaining independence. Unlike top-down audits, BIA is a parallel audit. That is, BIA is the audit of the implementation of the budgets for the parent government and its departments or subsidiaries. Thus, it suffers from greater governmental control (Li, 2007). Based on this analysis, we put forward our second hypothesis:

**Hypothesis 2:** the institutional arrangements of government audit (including BIA) are positively associated with a lack of BIA independence in China.

Although by law the audit office needs to report to the People's Congress or its standing committee on

behalf of the government, there are several barriers to effective audit reporting. First, audit findings are reported to the government first before they are reported to the People's Congress or disclosed to the public. This creates an opportunity for government officials to censor negative findings (Li, 2007). Second, only a summary report is presented to the People's Congress or its standing committee. Third, audit reporting is only done once a year and so the information contained in the report is usually untimely. Our discussions with several government auditors, government officials, and People's Congress officials in the preparation of the survey instrument indicate that BIA is tightly controlled by the government and the People's Congress does not have its own channel or is short of resources to obtain information about budget implementation. As a result, the People's Congress can suffer from information shortage and be ill-informed, and the congress' budget supervision role is likely weak. Thus, we put forward the following hypotheses:

**Hypothesis 3a:** The lack of BIA independence is positively associated with the People's Congress' shortage of information relating to budget implementation;

**Hypothesis 3b:** The lack of BIA independence is positively associated with the weak budget supervision role played by the People's Congress.

Both the Chinese Constitution and Audit Law require government audit to be independent as mentioned in the background section. Additionally, the Audit Storms might suggest an improvement in audit independence. Nevertheless, the very fact that the government auditor is under the control of the Executive may imply that the oversight roles of government audits may lack independence.

Moreover, hypothesis testing will only tell us whether there is an association between the institutional arrangements and the lack of audit independence and whether the lack of audit independence is associated with budget supervision by the People's Congress. It does not show how the institutional arrangements impair audit independence and how the lack of audit independence affects budget supervision by the



People's Congress. Thus, we are also interested in answering the following additional questions:

**Further Research Questions:** If the institutional arrangements impair audit independence in general and in budget implementation, how does the impairment take place in practice? How does the lack of audit independence affect budget supervision by the People's Congress? We aim to provide some insights into these questions by synthesizing the views expressed by the questionnaire respondents and interviewees.

## RESEARCH METHODS

### *Questionnaire Survey*

The quantitative data used in this paper are collected from a questionnaire survey. In addition to a section that collects information about the respondents and their institutions, the questionnaire consists of two sections that relate to this paper (see Appendix A). The first section concerns the general conditions of China's government auditing. It focuses on the orientation, current situation, merits and defects of government auditing in the current political and economic climate. The second section focuses on budget implementation auditing (BIA).<sup>15</sup> It consists of questions on the current situation of BIA, the existing problems of BIA, and their consequences on the budget supervision role of the People's Congress. The respondents were asked to choose from one of five options for each questionnaire item in the two sections: 1 = strongly disagree, 2 = disagree, 3 = neutral, 4 = agree, and 5 = strongly agree.

The formulation of the questionnaire was based on our review of the literature (e.g., INTOSAI, 1977, 2007a, b; Moizer, 1995, 1997; Chinese Auditing System Research Group, 1999; Yang and Xiao, 2004) and discussions with a number of government auditors, auditing researchers, and government and People's

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<sup>15</sup> Reasons for our focus on BIA were provided earlier in the introduction.

Congress officials. We selected respondents from five groups of people: (1) the People's Congress group, including leaders and officials of the People's Congresses and their financial and economic committees at various levels; (2) the government and finance department group, including leaders and officials of governments and their finance departments at various levels; (3) the government audit bureau group consisting of government audit officials and auditors at all levels; (4) the academics group consisting of experts in law, finance, economics, politics, sociology, accounting and auditing; and (5) the others group consisting of company managers, delegates of the Chinese People's Political Consultative Conference (CPPCC) at different levels, legal practitioners, and cadres of the Chinese Communist Party. We use multiple sources such as government websites, address-lists, publications, assistance from organizations and persons that we are familiar with to select the survey respondents.

We pilot-studied the initial questionnaire and found that it is hard to answer some questions and there were too many questions. As a result, we revised the questionnaire and targeted a ten percent (or better) response rate and 1,500 as the initial sample size to ensure a sufficient number of usable responses. Eventually, we contacted 1,498 people in total. Table 1 shows the distribution of the responses. We collected 438 questionnaires (of which 402 were valid) in six months with two follow-ups after the initial dissemination. A total of 44 questionnaires were not delivered because of wrong addresses, movements of respondents, and clerical mistakes. As shown in Table 1, the overall response rate was 30.12% ( $= 438/(1498-44)$ ) with the rate of valid responses being 27.65% ( $= 402/(1498-44)$ ).

[Insert Table 1 About Here]

Comparing the questionnaires received in the first month with the questionnaires received in last three months, we find a statistically significant difference between the two groups in just four questionnaire

items.<sup>16</sup> As there are over 60 question items in the questionnaire, the fact that there is a statistical difference in just four items indicates that the non-response bias should not be a major concern.

### *Interviews*

To support and extend the survey results, we also undertook interviews with an NAO official, a former auditor-general and two divisional directors of provincial audit bureau A, two divisional directors of provincial audit bureau B, the chairperson of the finance and economic committee of a provincial People's Congress, a deputy chairperson of a city People's Congress standing committee, a director of a city bureau of finance, a deputy auditor-general of a city audit bureau, a county director, an official of a county People's Congress, the director of a county bureau of finance, and an auditor-general of a county audit bureau. One or two of the researchers did the interviews with one or two research assistants in all cases. As we were not allowed to tape-record the interviews, we took detailed notes. All the interviews were undertaken in Chinese. In most cases two sets of notes were taken so that they can be cross-checked. Interviews lasted from one to one and a half hours. In the interviews, we asked questions about the interviewees' personal and organizational backgrounds, but mainly focused on the further research questions listed in Section 3 and thus the interview questions were semi-structured. All the interviews were translated into English. To analyze the interview data, we basically adopted the seven-stage approach proposed by Easterby-Smith, Thorpe, and Lowe (1991): case familiarization, reflection on contents,

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<sup>16</sup> These are: (1) The earlier respondents (47.69) are significantly older than the later ones (42.67), which justifies the inclusion of age as a control variable; (2) the average response to the statement 'It is one of the People's Congress' main supervision areas to review and approve the fiscal budget and supervise budget implementation' from earlier respondents is 4.73 whereas that from the latter group is 4.40; (3) the average response to the statement 'Government officials unlawfully interfere in the disclosure of the audit findings to protect their performance' from earlier respondents is 4.05 whereas that from the latter group is 4.36; and (4) the average response to the statement 'As the BIA results are first reported to the government, then the People's Congress, the report received by the People's Congress contains only second-hand materials' from earlier respondents is 4.27 whereas that from the latter group is 3.89. The differences are significant at the 0.05 or better level. The third item is a component of the variables *BIA Problems*, *BIA Lacking Independence*, and *BIA Reporting Problems* while the fourth item is a component of the variable *People's Congress' Information Shortage*. Deleting the two items do not qualitatively affect the main results.

conceptualization, cataloguing of concepts, recoding, linking, and re-evaluation. In the process of data analysis, the further research questions were used as a guide to locate relevant materials.

### ***Models and Variables***

To test H1, which relates to government audit independence in general, we use the following equation:

$$\text{Perceived Lack Of Audit Independence} = a + \delta_1 \mathbf{\text{Government Control Over Auditing}} + \delta_2 \text{Age} + \delta_3 \text{Academic Qualification} + \delta_4 \text{Professional Title} + \delta_5 \text{Years In Organization} + \delta_6 \text{Respondent Group Dummies} + \text{Error Term}$$

[Eq. 1]

To test H2 relating to BIA, we use the following equation:

$$\text{Perceived BIA Lacking Independence} = a + \beta_1 \mathbf{\text{Government Control Over BIA}} + \beta_2 \text{Government Control Over Auditing} + \beta_3 \text{Age} + \beta_4 \text{Academic Qualification} + \beta_5 \text{Professional Title} + \beta_6 \text{Years In Organization} + \beta_7 \text{Respondent Group Dummies} + \text{Error Term}$$

[Eq. 2]

To test H3a and H3b, which concern the effects of BIA problems on the budget supervision role of the People's Congress, we use the following equation:

$$\text{Perceived Ineffectiveness Of Budget Supervision By The Congress} = a + \lambda_1 \mathbf{\text{BIA Lacking Independence}} + \lambda_2 \text{Government Control Over Auditing} + \lambda_3 \text{Government Control Over BIA} + \lambda_4 \text{Age} + \lambda_5 \text{Academic Qualification} + \lambda_6 \text{Professional Title} + \lambda_7 \text{Years In Organization} + \lambda_8 \text{Respondent Group Dummies} + \text{Error Term}$$

[Eq. 3]

In the above equations, the dependent variables are *Perceived Lack of Audit Independence*, *Perceived BIA Lacking Independence*, and *Perceived Ineffectiveness Of Budget Supervision By The Congress*. *Perceived Lack Of Audit Independence* is based on S3.1, S3.2 and S3.3 in Appendix A)<sup>17</sup>. *Perceived BIA Lacking Independence* is based on S4.9-S4.13. *Perceived Ineffectiveness Of Budget Supervision By The Congress* is measured by perceived *People's Congress' Information Shortage* (based on S4.18 to S4.21), and perceived *People's Congress' Weak Budget Supervision Role* (based on S4.22 to S4.24).

The explanatory variables of interest are set in bold in Equations 1-3. *Government Control Over*

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<sup>17</sup> *Perceived Lack Of Audit Independence* is measured by the factor value derived from a principal component analysis based on S3.7, S3.8, and S3.9. A similar procedure is used for the other dependent variables. A higher score means a greater perceived lack of audit independence.

*Auditing* (based on S1.1 to S1.6) in Equation 1 measure the Executive-dominated institutional arrangements of government audit. We test whether it is associated with the perceived problems in the GAS and BIA. *Government Control Over BIA* (based on S4.7 and S4.8) in Equation 2 is a proxy for the institutional arrangements of government audit in relation to BIA. We test whether it is related to the perceived problems in BIA. In Equation 3, we test whether *BIA lacking Independence* is associated with the measures of *Perceived Ineffectiveness Of Budget Supervision By The Congress*.

The above variables are aggregated measures derived from the relevant questionnaire items by using principal component analysis with the oblimin rotation method as the constructs may not be independent. In all cases where aggregated measures are derived, only one factor is extracted. Tables 2 and 3 provide information about their underlying components, eigenvalues<sup>18</sup> and Cronbach's Alpha values of the scale.<sup>19</sup> All eigenvalues are well above 1 indicating that they are significant. Moreover, all the Cronbach's Alpha values are above 0.6, suggesting that the underlying components are internally consistent.

[Insert Table 2 About Here]

[Insert Table 3 About Here]

*Age, Academic Qualification, Professional Title, Years In Organization, and Respondent Group Dummies* are common control variables for Equations 1, 2, and 3 as people with different ages, academic training, professional experiences, and organisational experiences may have different perceptions of audit independence and transparency.<sup>20</sup> We also assume that the respondents working in different types of organization (e.g., People's Congress, government and public finance bureaus, audit offices, and academic

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<sup>18</sup> Eigenvalues are the variances extracted by the factors. The sum of the eigenvalues is equal to the number of variables. Statistically, the factor with an eigenvalue greater than 1 accounts for the variance of at least a single variable (Kaiser, 1960). Therefore the factor with an eigenvalue of over 1 is considered significant and retained for interpretation.

<sup>19</sup> The generally agreed upon lower limit for Cronbach's  $\alpha$ , a reliability coefficient that assesses the consistency of the entire scale, is 0.60 for explorative research.

<sup>20</sup> Footnote 16 provides some reasons for controlling for respondents' age and the correlation analysis section provides further justifications for controlling for the four variables.

institutions) may have different perceptions about audit independence. Table 4 provides descriptive statistics on these control variables. In Equation 3, we also control for the general environment for BIA by including *Government Control Over Auditing*, and *Government Control Over BIA*.

[Insert Table 4 About Here]

## DATA ANALYSIS

### *Descriptive Statistics*

In this section, we analyze all questionnaire items listed in Appendix A to provide an overall picture of government auditing in China. A one sample Chi-Square test shows that the number of respondents who agreed or fully agreed on each of the statements in Tables 2 and 3 is larger than the number of respondents who disagreed or completely disagreed, significant at the 0.01 level. This indicates that a majority of respondents supported the statements.

***Nature and independence of government auditing.*** From Panel 1 of Table 2, it can be seen that there is a high degree of consensus (by 76 - 95 percent of respondents) concerning the six statements on institutional arrangements in China: government auditing is part of the government economic supervision function, in actuality it is internal auditing, and has not yet become a supervisory mechanism of the People's Congress; the government determines the audit duties and work plans, a unitary leadership by the parent government has become dominant, and the appointment of local government audit bureau directors is entirely in the hands of local governments and Party committees, which often lacks professional consideration. This shows that government auditing was perceived to be essentially an internal audit function within the government and thus subject to tight government control.

Six advantages of the GAS are often claimed in the literature, but they receive the least acceptance

among the questionnaire respondents (see Panel 2 of Table 2). Specifically, only 53-63 percent of respondents agreed that it is easy for auditors to obtain support from the government and its leaders, government leadership is beneficial, it assures greater availability of financial resources and improved work conditions, audit supervision is more efficient when consistent with governmental objectives, it is speedier to deal with audit results and recommendations, and possessing enforcement power is a merit.

In contrast, as shown in Panel 3 of Table 2, there is a higher level of consensus about disadvantages (by at least 79 percent of respondents). Of particular interest, the GAS was perceived by at least 79 percent of respondents to lack audit independence and full disclosure of audit findings, and is excessively influenced by the government head's personal characteristics. This suggests that there is a lack of audit independence in government auditing. In addition, at least 75 percent of respondents agreed that the GAS weakens auditors' authority, restricts intensive budget implementation auditing, prevents carrying out complete or intensive "3E" auditing (i.e., a type of auditing that assesses whether organizations are undertaking their functions efficiently, effectively, and economically), does not satisfy the requirements of budget control, and cannot restrain government behaviour.

***Budget implementation auditing.*** Panel 2 of Table 3 shows that 88 - 94 percent of respondents agreed that the government actually directs the compilation, implementation and adjustment of the fiscal budget, and that government, rather than the People's Congress, also actually directs BIA, suggesting that the People's Congress lacks power over BIA.

Panel 3 of Table 3 relates to perceived problems in BIA. One important problem is that BIA was seen as lacking independence by at least 73 percent of respondents as shown in S4.9 to S4.13 of Panel 3, Table 3. In particular, these respondents believe that BIA lacks independence and provides an inappropriate

check and balance on the behaviour and responsibility of the government and its leaders, the audit office's enforcement power in BIA is limited, and some government officials unlawfully interfere in the auditor's decision to avoid exposure of their poor performance. In addition, the majority of respondents considered that the preparation and formation of the audit report is an interactive process which involves negotiation, balancing and compromises among the related parties, and the audit report only discloses a small proportion of the problems discovered.

Overlapping the independence problem is the ineffective audit reporting system, as shown in S4.11 to S4.14 of Panel 3, Table 3. Apart from unlawful interference with audit reporting, compromises in the audit reporting process, and selective reporting mentioned in the previous paragraph, current audit reporting is considered by a majority of the respondents as basically a 'self-examination' by the government. In addition, 89% of respondents consider the current GAS as not being conducive to the discharge of, or investigation into, the responsibilities of government officials in budget implementation. Overall, this evidence is consistent with budget implementation audits lacking independence and transparency.

As Panel 4 of Table 3 shows, more than 82 percent of respondents believe that the information that the audit office provides to the People's Congress is problematic. As BIA results are first reported to the government, then to the People's Congress, the People's Congress may receive filtered second-hand materials, which constrains its monitoring of the budget implementation. To be able to hear about and review the audit report does not mean that the People's Congress understands the budget implementation situation. Indeed, there is no effective organizational and working mechanism through which the audit office reports to the People's Congress. These problems suggest that the People's Congress can be ill-informed or even misled, resulting in a serious information asymmetry problem.

At least 82 percent of our respondents perceive that the People's Congress plays a weak budget



supervision role as shown in Panel 6 of Table 3. Specifically, the People's Congress does not have an effective means to interfere with and supervise budget setting and implementation and could not achieve effective budget supervision. Importantly, over 87 percent of respondents did not believe that the current GAS is suited to the requirement of strengthening budget monitoring and BIA.

In summary, there was a high degree of agreement among the survey respondents that government auditing in China is internal auditing in nature and lacks audit independence. Also they agreed that BIA suffers from a lack of independence and, at the same time, the People's Congress' budget supervision is weak.

However, are the Chinese institutional arrangements a cause of the lack of audit independence in government audits (including BIA)? Is the lack of audit independence responsible for the People's Congress' weak supervision over budget implementation? We examine these issues in the next three sections.

### ***Correlation Analysis***

Untabulated correlation coefficients between the variables used in Equations 1-3 support all three hypotheses. However, as this analysis does not control for the impact of other variables, there is a need for more stringent tests of the hypotheses. This will be done using multiple regressions in the next section. The largest correlation coefficient between any pair of explanatory variables (i.e., the test variables and control variables) is 0.48 (Spearman correlation, significant at the 0.01 level, which is between *Government Control Over Audit* and *Government Control Over BIA*). This implies that multicollinearity should not be a major concern. Finally, each of the control variables (*Age*, *Academic Qualification*, *Professional Title*, and *Years In Organization*) has a significant correlation with at least one dependent variable. This provides support for their inclusion as control variables.

## ***Hypothesis Testing***

***Test of H1.*** Table 5 presents the ordinary least square (OLS) regression results based on Equation 1. The F ratios show that all Models 1 to 3 are statistically significant at the 0.001 level. The results in Model 1 suggest that *Government Control Over Auditing*, which is a proxy for the institutional arrangements of government audit, is positively associated with the perceived *Lack Of Audit Independence*, and statistically significant at the 0.001 level. This supports H1.

[Insert Table 5 About Here]

Table 5 also shows the results from two additional tests in Models 2 and 3. Model 2 is used to test whether *Government Control Over Auditing* is associated with the disadvantages of the GAS including the lack of auditing independence. The results show that institutional arrangements have a positive association with *Disadvantages Of GAS*, significant at the 0.001 level. This result is also consistent with H1. Model 3 is used to test whether *Government Control Over Auditing* is associated with the advantages of the GAS as claimed in prior studies (e.g., Chinese Auditing System Research Group, 1999). The results show that *Government Control Over Auditing* has a negative coefficient although statistically insignificant at any conventional level.

Among the control variables, *Age* has a positive and significant association with *Advantages Of GAS*, indicating that older respondents tend to consider the GAS more beneficial than younger ones. In addition, *Government Audit Bureau Group* has a positive association with *Advantages Of GAS*, significant at the 0.10 level, suggesting that the respondents from this group considered the GAS more favourably than the benchmark group: *Others Group*. This may reflect an intention to justify the importance of the GAS by government auditors themselves.

**Test of H2.** Table 6 reports the results of testing H2 on the effect of the institutional arrangements of government audit on BIA. All models (1 to 3) have significant F ratios and high R square values, indicating that the variables jointly explain a highly significant portion of the variance in the dependent variables.

[Insert Table 6 About Here]

Model 1 shows that *Government Control Over BIA* and *Government Control Over Auditing* have significant and positive associations with the perceived lack of independence in BIA. Similarly, Model 2 suggests that the two variables are also positively and significantly associated with the perceived BIA reporting problems. In Model 3, *Government Control Over BIA* and *Government Control Over Auditing* are significantly and positively associated with perceived *BIA Problems* including the lack of independence and audit reporting problems. In short, the results in all three models support H2. Among the control variables, *Years In Organization* has a positive and significant (at the 0.10 level) association with both *BIA Reporting Problems* and *BIA Problems*.

**Tests of H3a and H3b.** Table 7 presents the results relating to the relationship between the lack of BIA independence and the budget supervision role of the People's Congress. Both models have highly significant F ratios and high R square values, indicating that the variables jointly explain a highly significant portion of variance in the dependent variables.

[Insert Table 7 About Here]

Model 1 indicates that *BIA Lacking Independence* is positively associated with the perceived information shortage problems encountered by the People's Congress in supervising budget

implementation, significant at the 0.001 level. This finding is consistent with H3a. Similarly, Model 2 suggests that *BIA Lacking Independence* is positively associated with the perceived weak budget supervision role of the People's Congress, significant at the 0.001 level. The result supports H3b.

Among the control variables, *Government Control Over Audit* has a positive association with *People's Congress' Weak Budget Supervision Role*, significant at the 0.001 level. *Academic Qualification* is positively and significantly associated with *People's Congress' Weak Budget Supervision Role*, suggesting that the more academically educated respondents considered the People's Congress' supervision role less effective. In addition, *People's Congress Group* has a positive association with *People's Congress' Information Shortage*, significant at the 0.10 level. This indicates that this group of respondents were more concerned about their own information shortage problems compared with the benchmarking group.

Table 8 presents the results relating to the relationship between *BIA Reporting Problems* and the budget supervision role of the People's Congress. Both models have highly significant F ratios and high R square values, indicating that the variables jointly explain a highly significant portion of variance in the dependent variables. Model 1 shows that *BIA Reporting Problems* is positively associated with the perceived information shortage problems encountered by the People's Congress in supervising budget implementation, significant at the 0.001 level. This finding supports H3a. Similarly, Model 2 suggests that *BIA Reporting Problems* is positively associated with the perceived ineffective budget supervision by the People's Congress, significant at the 0.001 level. The result supports H3b. Again, among the control variables, *Government Control Over Audit* has a positive and significant association with *People's Congress' Weak Budget Supervision Role*, and *Government Control Over BIA* has a positive and significant association with *People's Congress' Information Shortage*, and *People's Congress' Weak Budget Supervision Role*. Finally, *People's Congress Group* has a positive association with *People's Congress'*

*Information Shortage*, significant at the 0.10 level.

Panel 1 of Table 3 shows that at least 88 percent of respondents believed that BIA should be an important budget supervision mechanism for the People's Congress. Specifically, in the view of the majority of respondents, it is one of the key supervision areas for the People's Congress to review and approve fiscal budgets and monitor budget implementation, the budget supervision function of the People's Congress cannot be effectively implemented without the necessary support of BIA, and BIA should be an integral part of budget supervision by the People's Congress. Similarly, at least 78 percent of respondents accept BIA as a means of both fiscal supervision and power restriction. However, the fact that H3a and H3b are supported indicates that BIA does not live up to expectations.

***Hypotheses testing by group of respondents.*** We run separate regressions for each group of respondents. The untabulated results show that, in each group subsample, there is a positive and significant association between *Government Control Over Audit* and *Lack Of Audit Independence*, suggesting that all groups of respondents consider that the institutional arrangements are a reason for the lack of audit independence. Similarly, for each respondent group, there is a positive and significant association between *Government Control Over BIA* and *BIA Lacking Independence*, indicating that there is a consensus among the groups of respondents that institutional arrangements are a reason for BIA's lack of independence. These are consistent with H1 and H2. However, there is a divergence of opinion concerning the relation between *Government Control Over BIA* and *BIA Reporting Problems* as it is insignificant for the Academics and Others groups.

In addition, in all groups of respondents except for the *Others* group, both *BIA Lacking Independence* and *BIA Reporting Problems* are positively and significantly associated with both *People's Congress'*

*Information Shortage* and *People's Congress' Weak Budget Supervision Role*. Therefore, there is a high degree of agreement among the respondents that *BIA Lacking Independence* and *BIA Reporting Problems* are at least partly responsible for the People's Congress' information shortage and weak role in monitoring budget implementation, which supports H3a and b.

***Exploring the consequences of lacking audit independence using partial least square regressions.*** The above hypothesis tests are done using ordinary least square regressions. As there may be a cascading effect from the institutional arrangements for government auditing to the lack of audit independence, to People's Congress's shortage of information, and to People's Congress' weak role in budget implementation supervision, we use partial least square regressions to examine these chain relationships.<sup>21</sup>

Figure 1 presents the reflective measurement model and structural model. The structural model consists of four latent variables: *Government Control Over BIA*, *BIA Lacking Independence*, *People's Congress' Information Shortage*, and *People's Congress' Weak Budget Supervision Role*.<sup>22</sup> In Panel A, the numbers in the eclipses are  $R^2$  values and the numbers along directional lines are the path coefficients. In Panel B, the numbers along directional lines are t statistic values. They show that all the path coefficients are positive and significant, confirming the findings reported above: *Government Control Over BIA* has a positive and significant effect on *BIA Lacking Independence*, which in turn significantly and positively affects *People's Congress' Shortage Of Information*, and *People's Congress' Weak Budget Supervision Role*.

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<sup>21</sup> We thank an anonymous reviewer for suggesting this additional analysis.

<sup>22</sup> For parsimony, we exclude several control variables: *Government Control Over Auditing*, *Age*, *Academic Qualification*, *Professional Title*, and *Years In Organization*. Including these control variables does not qualitatively change the results. Also, replacing *BIA Lacking Independence* with *BIA Reporting Problems* and *BIA Problems* produces qualitatively similar results.

In addition, *People's Congress' Shortage Of Information* has a positive and significant effect on *People's Congress' Weak Budget Supervision Role*.<sup>23</sup>

The measurement model shows the relationship between the four latent variables and their respective indicators. In Panel A, the numbers along the directional lines from the latent variables to their indicators are the factor loadings. Panel B shows that the factor loadings are all positive and significant.<sup>24</sup>

### ***Further analyses***

***How do the institutional arrangements affect audit independence in general and in budget implementation in particular?*** Our interviews provide some insights that can be used to help interpret and understand our questionnaire survey results. First, the audit office is a functional department of a central or local government. Because of the organizational, financial and personnel dependence on the parent government, the audit work plan and focus are usually determined by the parent government. This government control can be seen from the remarks made by a divisional director of provincial audit bureau A using BIA as an illustration: 'because BIA is a parallel audit, what to audit and how to deal with audit findings and implement audit resolutions are all under the control of the parent government; the audit office in effect does not have much *ziyou kongjian* (autonomy).' A deputy auditor-general of a city audit bureau further distinguished between two ways of government control over audit planning. On the one hand, the auditors will usually not propose the audit of certain areas to avoid making trouble for the government and its head. On the other hand, the government head can direct auditors away from certain

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<sup>23</sup> The structural model meets the usual assessment criteria:  $R^2$  values range from 0.439 to 0.594 showing above moderate strength; the path coefficients are positive and significant for all latent variables;  $g^2$  values for all variables are significantly large than zero;  $f^2$  and  $g^2$  for *People's Congress' Weak Budget Supervision Role* are 0.10 and 0.05 respectively when *BIA Lacking Independence* is excluded from the model.

<sup>24</sup> The measurement model meets the usual convergent and discriminant validity criteria: the AVEs of the latent variables range from 0.59 to 0.76; the factor loading for each indicator is larger than 0.70; the composite reliability values and Alpha values for all latent variables are larger than 0.80 and 0.76 respectively; and the square root AVE value of each latent variable is greater than its unsquared correlations with all other latent variables. Moreover, all indicators' loadings with their corresponding latent variables are higher than their cross loadings with other latent variables.

areas where errors, wrongdoings and inefficiency might be found. According to this interviewee, off-budget funds and their uses, revenues from land use rights transfers, and local government debts would often be excluded from auditing or, if audited, the audit results would not be reported to the People's Congress or the public.

The organizational, financial, and personnel dependence on the parent government also provides opportunities for the government head to censor audit findings before they are reported to the People's Congress or disclosed to the public. Indeed, a divisional director of provincial audit bureau B considered this as the biggest problem in China's audit system: 'At the reporting and audit decision implementation phases of auditing, independence is greatly compromised. For example, in the audit reporting process, the auditee department needs to be consulted and the opinions of the auditee and the responsible government leader are taken into account.' This argument is seconded by all interviewees at all levels who were asked about audit reporting. A deputy auditor-general of a city audit bureau also revealed that the auditee would sometimes invite many influential people to lobby the audit bureau to reduce the negative effect of a significant audit finding on the auditee and the implicated people. As the audit office and its officials also feel obliged to serve and protect the parent government, they may even choose to collude with the auditee.<sup>25</sup> As a result, in practice, the audit report usually only exposes some problems of other government departments, but never of the parent government itself. In this connection, the auditor-general of a county audit bureau said bluntly in the interview: 'The current audit system does not audit government heads and the purpose of auditing is not to check on them, but to serve them.'

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<sup>25</sup> The 5<sup>th</sup> Clause of the Audit Law (2006) requires that audit offices independently exercise auditing supervision powers, and should not be interfered with by any administrative organizations, social bodies, or individuals. However, it does not specifically suggest how an audit office maintains independence from its parent government and other fellow government departments. The Government Auditing Standards of the People's Republic of China only provides guidelines on how individual auditors maintain independence (National Audit Office, 2010). The prescribed measures that auditors can take to maintain independence include avoidance, abstention, restriction on auditors' other activities, restriction on the scope of auditing, and additional audits. But the standards do not deal with personnel independence.



Second, as a government department, the audit office is placed side by side with many other departments. This interdepartmental relation can be competitive, cooperative, or mutually monitoring and constraining (Gao and Zhu, 2010). While the audit office is an important monitoring mechanism, the other departments possess other powers that may affect the audit office. For example, the finance department is at the centre of power for allocating financial resources while the personnel department manages human resources and could affect the staffing of the audit office and the promotion of audit officials. If not careful, the audit office can become the target of retaliation by other departments, *youyi huo wuyi* (intentionally or unintentionally). A divisional director of provincial audit bureau A complained: ‘when there are clashes between the audit office and another department, there is a need for the government and some government leaders to intervene and coordinate. This *does* (original emphasis) happen frequently. As a result, audit independence would be lost in the process of retaliation or reaching compromises.’ In anticipation of, or having experienced, retaliation or threats, the auditors have to be cautious about the other departments’ reaction to their activities and reports. This is so for two reasons. First, at the individual level, the heads of departments are political rivals in terms of political career advancement. Second, at an organizational level, there is prevailing departmentalism in China in which government departments attempt to build and protect departmental interests and ultimately personal interests at the expense of public interests or state interests (Sun, 2006). Under such circumstances, the audit office is perceived to be a great threat to departmentalism and thus its monitoring can back fire. Take a finance department as an example. Because the audit office’s funding is constrained by the finance department, our interviewees generally agreed that the audit office often finds it hard to report the irregularities and wrongdoings committed by the finance department and even more difficult to propose and deal with them in accordance with the law. In addition, the audit office may have to deal with the government head or a deputy head who approved the

problematic revenues or expenditures. Our interviewees all agreed that such problems are either neglected in the audit or recorded, but not reported.

*How does the lack of audit independence affect budget implementation and the budget supervision by the People's Congress?* By law, the NPC has a responsibility to monitor budget setting and implementation. However, many People's Congresses lack information on budget implementation. The BIA report can be an information channel but is currently not a good one for the People's Congress. Although the audit office has to report to the standing committee of the People's Congress around June every year on behalf of the government, the BIA results are censored by the government. A deputy chairperson of a city People's Congress estimated that less than 40% of problems identified by auditors would be reported to the People's Congress. This situation was described by a divisional director of provincial audit bureau A as 'It will be fine if the governor is satisfied even if congress persons are not satisfied. This is a Chinese circumstance.' The People's Congresses are also seriously short of staff, especially specialists, and thus many are unable to judge whether the budget is reasonable and lawful. Similarly, many are unable to evaluate the audit report on budget implementation nor make use of them. Our interviews indicate that this is a common phenomenon at the provincial and lower levels.

As a result of ineffective BIA and weak budget monitoring by the People's Congress, our interviewees revealed several serious problems in budget management in general and budget implementation in particular. These include preparing budgets on behalf of budget units (rather than by the budget units themselves), bundled budgets without specifying fund uses, excessive spending, self-interest protection by the finance department, and the existence of much off-budget revenues and expenditure and hidden funds (*xiao jinku*). Moreover, as reflected in the comments made by several interviewees, many of

these problems recur from one year to the next.

***Other interview findings.*** Although the interview results generally support the survey responses in that the GAS lacks independence, they also reveal that the degree of audit independence varies between types of audit and levels of audit. Several interviewees argued that top-down audits are more independent than parallel audits. Also, the level of independence is considered higher at the central government level than at the local government levels. While an LAO often suffers from a lack of independence from both the government head and its fellow departments, the NAO interviewee argued that the NAO is independent from other central government departments under the State Council and claimed that ‘the level of transparency is very high at the NAO level’,<sup>26</sup> even though he also admitted the existence of “*soft resistance*” from the auditees and the influence of ‘*guanxi*’. Indeed, several interviewees suggested that the lower the audit office, the less independent its audits.

Finally, although the interviewees revealed many problems of the GAS, several of them acknowledged that the status of the audit office and auditors has been improved over the years. For example, when BIA was first introduced, it was difficult for auditors to even enter the auditee organization as there was strong hostility. But gradually, this has become less of a problem. Some interviewees (both auditors and auditees) even reported that auditors are now sometimes invited to undertake an audit by the auditee voluntarily as they are seen as experts who can help resolve problems for the auditee. This change can be seen as some acknowledgement of the useful role of government auditing in China.

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<sup>26</sup> Following a reviewer’s suggestion, to test this interview finding using questionnaire responses, we introduce a dummy variable, which equals 1 if the respondent is from a central government office and 0 otherwise. However, the variable is insignificant when we include it in the regression models in Tables 5-8. This may be because the respondents did not focus on institutional arrangements and their effects on audit independence at their respective level; instead, they might have treated the GAS as a whole. Therefore, an avenue for future research is to provide more systematic evidence to ascertain the interview finding.

## **SUMMARY, DISCUSSION, AND CONCLUSION**

Theory suggests that the degree of audit independence in part depends on the type of institutional arrangements adopted (Mautz and Sharaf, 1961). However, existing studies suggest that the theoretical relationship between institutional arrangements and audit independence may differ from the actual relationship (Funnell, 1994) and that it is changeable (English and Guthrie, 2000). Therefore, it is important to examine the actual relationship empirically and to understand the causes, processes, and consequences of the change in the relationship. This relationship has been investigated, mainly qualitatively, in a number of studies in developed countries, especially in the Anglo-Saxon sphere (Funnell, 1994; English and Guthrie, 2000; Bowerman et al., 2003; Lovell, 1996; Free and Radcliffe, 2009), but rarely in emerging and transition economies.

China has adopted an Executive-dominated GAS, which is frequently perceived to lack independence from government even though there is little systematic evidence to show the extent of this problem and its consequences. In this study, we have attempted to document whether and how the Executive-dominated GAS results in a lack of audit independence and some consequences of the lack of audit independence using the data obtained from a questionnaire survey and interviews.

Our survey respondents formed a high degree of consensus that the defining feature of the GAS in China is that it is internal auditing and tightly controlled by various levels of government. This means that the Chinese GAS is Executive-dominated not only by design, but also in practice. This contrasts with the UK Legislature-oriented GAS, which was supposed to be independent from the Executive by design, but in actuality was dominated by the Executive in the 19<sup>th</sup> century (Funnell, 1994). By analysing the survey responses, we find that the institutional arrangements of government audit are positively associated with the disadvantages of the GAS, especially the lack of audit independence in general and in the specific case

of BIA. Surprisingly, the results show that the government's monopolistic control over government auditing has a negative (though insignificant) association with the advantages that are often claimed by the proponents of the current GAS (Chinese Auditing System Research Group, 1999). We also find that the perceived lack of BIA independence and restricted BIA reporting are positively and significantly associated with the information shortage suffered by the People's Congress concerning budget implementation, and the ineffective budget monitoring role played by the People's Congress. Through analysing the interviews, we find that because the audit office is an internal department of the central or local government and is dependent on the government financially, organizationally, and in personnel, its audit plans are determined by the government and its disclosures to the People's Congress and the public are filtered by the government. Facing retaliation and counter-restraining threats, it also suffers interferences, lobbying, and *guanxi* in the audit of, and reporting on, fellow government departments. Such problems, together with other factors, explain the fact that the People's Congress, in many cases, is short of information on budget implementation and its monitoring of budget implementation is weak. These findings show that the institutional arrangements for government auditing in China make the GAS lack independence in appearance, i.e., the dependence of auditors on the government financially, organizationally, and in personnel (INTOSAI, 1977, 2007a, b; Mautz and Sharaf, 1961). These forms of dependence have detrimental effects on auditors' independence in audit planning and reporting, and facilitate retaliations and restraining threats from other government departments. Such problems also have negative effects on the operation of the wider accountability regime, i.e., the role of the People's Congress in budget implementation supervision.

To the best of our knowledge, this is the first attempt to provide quantitative evidence on the lack of audit independence in the Chinese GAS, to test statistically the relationship between institutional

arrangements and audit independence, and examine the effect of the lack of independence on the budget supervision role of the People's Congress. In addition, we provide interview-based evidence on how the institutional arrangements reduce audit independence and how the lack of independence negatively affects the effectiveness of budget implementation monitoring by the People's Congress. Apart from corroborating and strengthening the survey results, the interviews also revealed that while there is a general lack of audit independence, the lack of audit independence varies between the types and levels of government audit.

Notwithstanding the usual limitations of questionnaire surveys and interviews, these results should enhance our understanding of the Chinese GAS and enrich the government audit literature. They also provide a valuable insight into why corruption is so pervasive in China<sup>27</sup> and furnish the much needed empirical rationale for the aforementioned proposals in the literature for reforming the Chinese GAS (Yang and Xiao, 2004). They show that the need for reform arises from three interrelated sources. First, the inherent problems of the Executive-dominated GAS (e.g., lacking audit independence and reporting transparency) creates audit gaps in which the conducts of the audit office's parent government and the heads of the government are not effectively monitored. This does not help maintain a transparent and clean government, nor is it conducive to discharging the accountability of government officials. To the contrary, the institutional weaknesses help mask or even breed corruptions, briberies, and crimes. Second, because the People's Congress does not have a proper monitoring mechanism and information channel, its constitutional powers (e.g., in budget supervision) cannot be appropriately exercised. Third, while the Audit Storms in China have indicated an increase in audit disclosure, the fact that our respondents agreed that the Chinese GAS lacks independence and transparency after several Audit Storms suggests that further

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<sup>27</sup> However, reforming the GAS alone will not be sufficient because many problems identified in the audit report are caused by other factors. Gao (2005) suggests that there is a need to normalize the government budget management system. In particular, he argues that the People's Congress should become the main driver of the budget system reform. Zhang (2006) complains that Audit Storms are after all aftermath monitoring and argues that there is a need to strengthen the monitoring over budget preparation and approval.

reform is needed. While the Audit Storms have increased the exposure of certain problems, wrongdoings, and illegal conducts, because they have not overcome the inherent institutional constraints, they cannot prevent the problems, wrongdoings, and illegal conducts from recurring. Moreover, such Audit Storms are not easily copied by LAOs because there may be no support from local government leaders (Jiang, 2005).<sup>28</sup>

While this study has obtained empirical support for a government audit reform, it is crucial to investigate further what kind of reform is needed and how to undertake the reform. Perhaps an appropriate starting point is to establish a systematic set of principles or criteria that can be used to design an appropriate reform approach and guide the process of the reform. As there have already been several existing proposals for government audit reform, such a set of principles can be used to compare and evaluate them. In considering approaches to audit reform, it must be recognized that government audit institutions cannot attain absolute independence (INTOSAI, 2007a, b) and the current GAS can still play an important monitoring role even as an internal auditing mechanism. If the internal audit function is to be maintained, a possible direction of future reform could be to set up an independent external audit function, perhaps under the legislature, resulting in a dual track audit system like those adopted by large corporations.

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<sup>28</sup> Jinhua Li, then Auditor-General, is quoted to have said that the strongest support that can be given by the Central Committee of the Party and the State Council for GAS is that there should be no interference from them. Jiang (2005) finds that this non-interference is unrealistic in local areas and gives an example through a case study.

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