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Implementation of "audit committee" and "independent director" for financial reporting in China

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ABSTRACT

This study examines the effectiveness of audit committees and independent directors in China with a focus on their responsibilities in relation to financial reporting. In particular, it reveals issues arising from the importation of internationally acceptable governance mechanisms, using an integrated institutional perspective that incorporates institutional shapers and intra-organizational dynamics. The findings suggest that the institutional environment in China has yet to fully support the imported concepts. The implementation of audit committees and independent directors seems to be largely symbolic because the concepts are hardly used as instruments to improve the quality of financial reporting in China. They also show how contradictory institutional pressures shape loose coupling between regulations and actual operations, and intertwine with organizational players' conflicts of interest and power dependence within China's institutional setting.

1. Introduction

China's corporate governance system has been reformed by emulating the Anglo-American model (Lau, Fan, Young, & Wu, 2007; Miles, 2006; Tam, 2002). Accordingly, the concepts of "audit committee" (AC) and "independent director" (ID) as main corporate governance mechanisms were formally introduced in the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (hereafter, Guidelines), and Code of Corporate Governance for Listed Companies in China (hereafter, Code) by the China Securities Regulatory Commission (CSRC) in 2001 and 2002, respectively.[4] The Code stipulates that the board of directors of a listed company may establish an AC with an independent chair, a majority of independent directors, and at least one independent accounting expert. According to the Code, the main duties of the AC consist of recommending the external auditor, reviewing the internal audit, overseeing the interaction between the two, inspecting financial reporting, and monitoring internal control. However, the effectiveness of adopting these corporate governance mechanisms remains a subject of debate. The major concern is whether these imported principles are likely to function effectively in China's context (e.g., Chen, 2004; Miles, 2006). China is a transitional economy undergoing significant institutional changes. Although effective implementation of internationally acceptable principles in its changing environment is a major challenge facing the Chinese government, this issue has not been the subject of in-depth investigation. The purpose of this study is to fill this gap by examining the effectiveness of audit committees (ACs) and independent directors (IDs) in China with a focus on their responsibilities in relation to financial reporting.

The governance effects associated with ACs and IDs have attracted ample research attention (for reviews of academic studies in this regard, see Turley & Zaman, 2004; Wu, 2011). However, the majority of such studies have been conducted in Anglo-American countries. Studies focusing on countries where capital markets are less sophisticated and governance mechanisms are still evolving are limited (Goodwin & Seow, 2000). The following studies focused on corporate governance issues in China, Gao and Kling (2008) and Shan (2013) on the effects of independent directors on preventing tunnelling behaviours by controlling shareholders, Liu, Miletkov, Wei, and Wang (2015) on the effects of board independence on firm performance, and Cheung, Stouraitis, and Tang (2011) on the effects of overall corporate governance, including board independence, on firm valuation through investment efficiency. Furthermore, previous studies have generated mixed results. For example, in the US market, some studies show a negative relation between AC independence and earnings management (Abbott, Parker, & Peters, 2004; Bedard, Chtourou, & Courteau, 2004; Klein, 2002; Xie, Davidson, & DaDalt, 2003), while others find that the independence of ACs has no significant impact on the quality of reported earnings (Agrawal & Chadha, 2005; Lin, Li, & Yang, 2006). These findings suggest that there

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[4] The concepts of AC and ID are inextricably linked. IDs who are expected to be independent of management and particularly concerned about protecting the interests of minority shareholders must constitute the majority of an AC according to the Code (CSRC, 2002). These concepts are fundamental to corporate financial reporting in Anglo-American countries (e.g., Sarbanes-Oxley Act 2002).

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is no uniform pattern in the relation between corporate governance mechanisms and expected effectiveness. Moreover, a number of high-profile corporate failures and accounting scandals involving companies such as Enron, WorldCom, and Tyco International in the United States, and HIH and One Tel in Australia, have raised serious concerns about the effectiveness of corporate governance mechanisms in general (Rezaee, 2005). Given the problems experienced by Anglo-American countries, where relatively mature economic and legal systems could be expected to ensure good corporate governance, countries that lack essential supportive infrastructure are likely to encounter greater problems (see also Shi, 2005).

There are also calls for research that takes into account the institutional context in which ACs operate and processes associated with AC operation (Leblanc & Schwartz, 2007; Turley & Zaman, 2004, 2007). Many studies on ACs examine the association between AC characteristics (e.g., independence, expertise, and diligence) and AC performance (e.g., restatements, fraud, and auditor reports) (Beasley, Carcello, Hermanson, & Neal, 2009). Although such studies are important, they have failed to examine AC operation in practice as they have largely neglected the institutional influences on ACs (Beasley et al., 2009; Gendron & Bédard, 2006; Turley & Zaman, 2004). This study adopts a holistic approach, incorporating institutional factors such as political, economic, legal, and cultural environment, and the interplay between power relations and conflicts of interest in organizations, to examine the implementation of Anglo-American concepts of AC and ID in China.

The implementation of these concepts in Chinese listed companies is essentially a regulatory requirement. The objective of this study is not to ascertain the desirability of these mechanisms, but rather to enhance understanding of the operation of these concepts in China by examining how they are implemented and what issues emerge in China's context.

This study found that the regulations regarding these concepts had become loosely coupled with actual operations over time. This finding is consistent with the institutional view that adopting internationally acceptable governance mechanisms may be primarily driven by a desire for legitimacy. Also, this paper examines loose coupling as a dynamic process rather than simply assuming that it is an automatic outcome of contradictory institutional pressures (see also Burns & Scapens, 2000). The loose coupling had occurred through the ongoing interplay between conflicts of interest and power dependence among organizational actors, including the government, controlling shareholders, management, IDs, AC members, and auditors, substantially reflecting the institutional idiosyncrasies in China.

2. Theoretical underpinnings

In their review of the development of institutional theory, DiMaggio and Powell (1991) distinguish between old and new institutionalism. Under old institutionalism, organizational structures and changes are largely shaped by competing values, coalitions, and power relations within the organization (see also Clark, 1972; Selznick, 1957), whereas new institutionalism places emphasis on the organization's desire for legitimacy and its embeddedness in external institutional settings (see also Meyer & Rowan, 1977). Old institutional theory focuses on the importance of existing internal rules, norms, and routines in shaping processes of change (Burns & Scapens, 2000; Caccia & Steccolini, 2006). It suggests that the operation of group interests within the organization may cause actual organizational practices to diverge from expressed organizational goals (see, e.g., Selznick, 1949). In contrast, new institutional thought emphasizes the role of environmental forces in shaping and constraining organizations (DiMaggio & Powell, 1991). This perspective assumes that organizational practices, including corporate governance structures, are largely shaped by wider socio-cultural contexts (Dobbin, 1994). Organizations operating in similar environmental settings are expected to have similar features, including internal structures and procedures considered appropriate by society (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Meyer & Scott, 1983). Thus, in this view, an organization legitimizing its operations by conforming to external pressures rather than by improving internal efficiency explains the adoption of particular institutional arrangements.

New institutional theory has been widely invoked in analysing isomorphism of organizational practices (Lounsbury, 2008). Nevertheless, it has been criticized for its typically "macro" focus on influences exerted by institutional environments and for lacking insight into internal dynamics within organizations (Greenwood & Hinings, 1996; Moll, Burns, & Major, 2006). Oliver (1991) also indicates that organizations do not passively adapt their formal structures to the requirements of external institutions. Similarly, Scott (2008) points out that this view considers institutional environments as "contexts imposing requirements and/or constraints on organizations… implying a top-down perspective" (pp. 429–30), and that institutional demands are "subject to interpretation, manipulation, revision, and elaboration by those subject to them" (p. 430).

Selznick (1996) argues that drawing a sharp line between old and new institutionalism inhibits the contribution of institutional theory to major issues of bureaucracy and social policy. Some institutional theorists such as Moll et al. (2006) call for a more complete account for understanding the emergence, persistence, and abandonment of institutions, and the interactive nature of institutional processes.

Consistent with Selznick (1996) and Moll et al. (2006), this study takes a broad perspective that incorporates ideas from both new and old institutionalism. Accordingly, it integrates the strength of old institutionalism in examining internal competing values, coalitions, and power relations, and ideas from new institutionalism that highlight the importance of examining external institutional environment. The study focuses on the interaction between internal and external forces to understand the operation of the concepts of AC and ID in China's context. More specifically, this study provides insights into issues arising from the implementation of the Anglo-American concepts in China by examining the interactions among ACs, IDs, and important organizational players including managers, internal and external auditors, and external institutional forces.

ACs and IDs are an important part of corporate governance as they are expected to provide a vehicle for monitoring and oversight (Beasley et al., 2009; Turley & Zaman, 2007). However, the effects of these imported concepts are shaped by the internal and external forces impacting their operation (see also Caccia & Steccolini, 2006). Although the Chinese government is able to impose the establishment of AC and ID in a top-down manner, it is the listed companies that interpret and practice these alien concepts. Rather than viewing organizations as passive recipients of institutional pressures, this study argues that an examination of the role of organizational actors and their interaction with institutional environment is important in providing an understanding of the manner in which these concepts are implemented. Taking a broad institutional perspective, it provides a comprehensive analysis of the institutional context and intra-organizational dynamics as well as the interests and power relations of the parties involved as factors influencing the implementation of these concepts in China.

3. Institutional context

3.1. Political/economic system

Gourevitch, Carney, and Hawes (2003) argue that the political system of a country contributes substantially to the pattern of corporate governance in that country. Similarly, Roe (2003) points out that political forces are the primary determinants of the degree of shareholder diffusion and the relationships among managers, owners, and other stakeholders of an organization. Political institutions create incentives that influence the behaviours of corporate managers, investors, regulators, and other market participants. Corporate governance