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**Article**

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# The China puzzle: Opportunities for accounting research<sup>☆</sup>

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## ABSTRACT

How can China achieve phenomenal economic growth despite what is considered as “weak” institutions in market-based economies? Xu (2011) provides a framework to understand this puzzle. Specifically, he suggests that China’s institutional framework of Regionally Decentralized Authoritarian regime was likely responsible for the phenomenal economic growth despite what is considered “weak” institutions for market-based economies. While recent accounting research provides insights into the relationship between agency issues, and accounting and control systems in the China context, accounting researchers can use the institutional feature of RDAs to provide insights into the role of accounting and control systems in non-market-based settings.

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## 1. Introduction

Accounting research in the context/setting of China has increased in the last decade. This reflects both the importance of China as a global economic force and China being an interesting setting for providing insights into the role of accounting. The call for papers for this symposium nicely summarizes the latter point by stating: “Ownership structure, the incentives of managers and auditors, board monitoring, enforcement, and other institutional features of the economy all have an important impact on financial reporting outcomes. It is also conceivable that accounting standards and these institutional features complement each other in determining accounting quality. Asian-Pacific economies, including China, offer an ideal setting to examine these important issues given the relatively weak legal protection and enforcement in these economies.” In

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short, China provides an interesting setting because examining its evolution from a presumably “weak” institutional and market-based regime to strong, one can provide important insights into accounting issues. My objective in this article is to broaden this perspective by directing attention to the fact that mechanisms that enabled China to succeed economically, did so despite what we term as “weak” institutions. The institutional features that enabled such phenomenal economic growth would have necessarily relied on accounting and control systems. As such, examining the role of accounting and control systems in the institutional framework prior to and during China’s transition to a market-based economy would help expand our insights. For this purpose, I draw on the framework in the economics literature that shows the unique institutional features in China that possibly contributed to its economic success (Xu, 2011).

## **2. The China puzzle**

China’s GDP has grown from US\$ 1325 Billion in 2001 to US\$ 7318 billion in 2011, which represents a year-over-year growth rate of roughly 19%; the stock market capitalization increased from US\$ 524 Billion in 2001 to US\$ 3389 in 2011, representing a year-over-year growth rate of 21%; the value of stocks traded increased from US\$ 449 Billion in 2001 to US\$ 7671 in 2011, representing a year-over-year growth rate of 33% (see Table 1). These statistics indicate not only a tremendous growth in economic activity, but also a concerted move toward a market-based economy.

Conventional wisdom in economics suggests that the government should protect private property rights, enforce contracts, and separate itself from business enterprise (North, 1990; Acemoglu and Robinson, 2012). In contrast to this conventional wisdom, the Chinese government conducts and directs business development. Not surprisingly, China ranks below average on its institutional makeup of rule of law and governance quality (Allen et al., 2005). Thus, based on conventional wisdom, China’s institutions are weak, so much so that the institutional infrastructure should not have supported the phenomenal economic growth and the move toward a market-based economy. This is a seeming puzzle that is referred to as the China puzzle by Xu (2011) who states, “This incredible contrast between poor institutions and China’s spectacular performance challenges our general understanding of the mechanics of institutions and our understanding of institutional quality.”

## **3. The institutional structure of China’s economic success**

Broadly speaking, institutions refer to mechanisms that coordinate economic activities and thus govern the incentives of agents (Coase, 1992; Stiglitz, 2002; Hurwicz, 2007). North (1990) defines institutions as “rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction.” The key aspects embedded in these definitions are that institutions are a set of rules chosen by society, and in an economic sense, these rules facilitate exchange. Coase (1937, 1991, 1992) in his discourse on the boundaries of the firm and markets – where do firms end and markets begin – proposes that institutions act as coordination mechanisms to facilitate exchange; when markets cannot do the job of coordination well enough, then the coordination occurs in firms (see also Williamson, 1985, 2002). As to which coordination mechanism is better suited for a particular activity is referred to, under the omnibus fuzzy terminology of “transactions costs.” Under this broad view of institutions, Xu (2011) argues that it would not have been possible for China to achieve such phenomenal growth without effective coordination mechanisms or institutions. What was the institutional structure that enabled China’s phenomenal growth? Xu (2011) outlines the salient aspects of China’s institutional feature that enabled the phenomenal economic growth.

While institutions in most parts of the world – the Americas, Africa, Australia, South, and Far East Asia – are greatly influenced by the Western governance systems due to colonization, China has a 2000 year-old imperial history that was not directly influenced by the European institutions. The structure that prevailed during the imperial regime provides the pillars of the institutional framework that guided the transition to China’s market-based economy. Xu (2011) refers to the institutional structure as the Regionally Decentralized Authoritarian (RDA) regime. The RDA regime features a combination of a highly decentralized decision-making with respect to economic resources; a highly centralized decision-making with respect to policy and personnel.

Table 1

China's economy and stock market. *Source:* The conference board, total economy database.

Year	GDP, Current US \$ (Billions)	Number of Domestic Listed Companies	Market Cap Current US \$ (Billions)	Stocks traded, Current US \$ (Billions)
2001	1325	1160	524	449
2002	1454	1235	463	333
2003	1641	1296	681	477
2004	1932	1384	640	748
2005	2257	1387	781	586
2006	2713	1440	2426	1635
2007	3494	1530	6226	7792
2008	4522	1604	2794	5471
2009	4991	1700	5008	8956
2010	5931	2063	4763	8030
2011	7318	2342	3389	7671
CAGR	19%	7%	21%	33%

CAGR is the compounded annual growth rate from 2001 to 2011.

On the one hand, economic decision rights are decentralized and delegated to sub-national governments. Regional economies – provinces, municipalities, and counties – are responsible for initiating and coordinating economic activity by providing public services and enforcing laws within their jurisdictions. On the other hand, sub-national government officials are appointed, promoted, and rotated by the center, which helps to provide high-powered incentives for regional officials to follow the central government's policies and achieve economic performance. This institutional feature is different from centrally-planned structure such as the erstwhile Soviet Union where decision-making was centralized. This institutional setup is different from federalism as in the U.S., because the regional officials are not accountable to the local constituents and citizens.

The institutional structure makes China similar to a large conglomerate during its move toward a market-based system: referred to in the rest of the paper as China Inc. Similar to the headquarters of a conglomerate, China Inc., provides high-powered incentives for sub-national government leaders, i.e., division managers through personnel decisions. Similar to divisions of a conglomerate, the sub-national governments have decision rights over resources such as land, enterprises, financial resources, energy, and raw materials. They initiate, negotiate, implement, divert, and resist reforms, policies, rules, and laws. They drive or hamper regional/national economic development and macroeconomic conditions. They compete to achieve economic success and initiate experiments with new reforms. The organizational setup of China Inc. follows the general precept espoused in managerial accounting textbooks such as [Zimmerman \(1997\)](#) and accounting theory such as [Sunder \(1997\)](#) that decision-making should be delegated to the locus of information and expertise. Accordingly, it is interesting to examine what control and coordination mechanisms helped achieve China's phenomenal growth, i.e., the success of a conglomerate.

While we have some understanding on the role of accounting in arms-length contracting and equity markets, or at least a framework for understanding the role of accounting in market-based economic settings, China Inc. provides an excellent setting to examine the role of accounting in a different framework of institutions that were effective in achieving China's economic growth? Even though capital markets or labor and product markets may not have existed in China Inc., accounting and control mechanisms should have necessarily existed to help coordinate activities under decentralized decision-making.

#### 4. The focus of China accounting research

As highlighted by the call for papers of the CJAR symposium, research in accounting focuses on China's transition to a market economy wherein regulatory changes that facilitate transition from the traditional Chinese institutions to Western ones that are suited for market economies are examined. [Chen and Schipper \(2008\)](#) highlight the focus of China based accounting research very aptly in the following way: "Recently published Chinese accounting research has addressed the causes and consequences of issues related to auditor

independence, causes and consequences of related-party transactions (for example, the extraction of resources from a listed firm by means of “tunneling”), earnings management and accounting implementations, the governance of listed Chinese firms including ownership structure and executive turnover. Because of the focus on corporate governance, accounting research in China currently has closer ties to corporation finance than does accounting research in the U.S.” They then go on to point the potential research questions that State Owned Enterprises (SOEs) and the privatization of these enterprises provide.

China provides an excellent setting to examine the role of accounting and agency issues. Agency issues arise from the separation of ownership and control, referred to as the Type I agency problem) and arise from the conflict between controlling and non-controlling shareholders, referred to as the Type II agency problem (see Ali et al., 2007). The contrast between State Owned Enterprises (SOEs) and non-SOEs provides an excellent setting to examine Type II agency problems. China research has used the differential severity of agency problems to examine its effects on earnings management and accounting quality (for example, see Jian and Wong, 2010; Chen and Yuan, 2004; Chen et al., 2010b, 2011; Fan et al., 2012; Haw et al., 2011; Haw et al., 2005; Kim et al., 2011). China research has used the emerging auditing and public accounting setting to provide interesting insights into the interactions between agency issues and audit quality/auditor independence (see for example, Chen et al., 2010a, 2010c, 2000; DeFond et al., 2000; Wang et al., 2008; Fan and Wong, 2005; Gul et al., 2009; Choi et al., 2010; Yang, forthcoming). Overall, China accounting research provides useful insights into how agency issues are related to financial reporting quality and audit quality.

Even though in the next section, I provide other possible avenues for China accounting research, the focus of examining agency issues is still nascent and has the potential to contribute many more insights. In addition, China provides a setting to examine the development of markets in fast-forward. Specifically, the development of the private audit market where consolidation, scaling-up, and gaining expertise occurred in a relatively short span of time provides an interesting avenue to gain insights into the evolution of the audit services market – specifically the effects of market concentration on audit quality and audit fees (for example, see Chan and Wu, 2011).

## 5. Further opportunities for accounting research in China

This section outlines research questions that will help us enhance our understanding of the role of accounting in non-market-based settings. In our tradition of research silos, these questions likely belong to the genre of managerial accounting. The questions may not have the same appeal as managerial opportunism, and how better market-based institutions help “prevent” or “stop” such opportunism. The Chinese setting could help us understand forces and empirically test insights from analytical studies. We have considerable insights from game-theory based studies into the role of accounting in market-based versus implicit contract-based institutional settings (see Glover, 2012; Baldenius, 2008; Ederhof et al., 2010; Ewert and Wagenhofer, 2011; Kanodia, 2006; Arya and Mittendorf, 2010; Liang, 2010). Also, as Chen and Schipper (2008) posit, analytical modeling of forces particularly relevant for the China setting could provide us with more insights.

These studies should utilize a combination of methods – archival empirical, field-study empirical, analytical and case study, and/or a combination of methods so as to provide us with insights as well as highlight new areas of management accounting and institutional research.

### 5.1. Commitment to enforcing contracts without laws<sup>1</sup>

China had no “effective” commercial code for contracting up until the 1990s and no formal private property protection laws up until 2004. Theoretically, during this period, ownership of shares in enterprises would hold little water, and as such, the valuation and stock returns that are used in empirical tests were based on belief that such private property protection laws would be enacted and enforced. Similarly, customers contracted with suppliers without the framework of a uniform commercial code, under the belief that informal institutions were effective in implementing contracts. Did it imply that China had no institutions in the broad sense? The answer is an unequivocal no. Xu (2011) states that RDAs exercised semiformal and informal

<sup>1</sup> These categories are not mutually exclusive. I provide the categories to bring to fore the multifaceted and rich context.

protection of private property and contract enforcement mechanisms that were primarily based either on the rich history of China or by social norms. These informal institutions are generally ignored by accounting research.<sup>2</sup> Examining the role of these institutions can help provide useful insights into commitment, rules, and standards. Some broad research questions are as follows:

1. What were the informal institutions that acted as a commitment device for buyers contracting with suppliers? Did sub-national governments enable such coordination?
2. How was reputation for such commitments formed? If these were effective, what was the need for uniform commercial codes?

### 5.2. Deviant behavior and commitment issues

Becker (1974) brings economic analysis to crime and punishment and shows that the optimal enforcement depends on cost of catching and convicting the offenders, the punishment meted out and the response of offenders to the changes in enforcement and punishment. These form part of social capital. Putnam (1993, p. 167) defines social capital as “features of social organization, such as trust, norms, and networks, which can improve the efficiency of society by facilitating coordinated actions.” Putnam (1993, p. 173) argues, “The denser such networks in a community, the more likely that its citizens will be able to cooperate for mutual benefit.” As a thought exercise, one should wonder why it is that we hear about accounting/audit failures only after China has transitioned to using institutions to support the market-based system. Is it because the institutions that mete out punishment are not in sync? Is detecting more accounting failures a hallmark of good institutions? Is detecting more accounting failures indicative of informal or traditional institutions in China being adequate to mitigate agency problems? In Putnam’s framework, is it possible that arms-length contracting makes these networks less dense and as such the social norms and cooperation for mutual benefit does not occur? Answers to these questions can provide some key insights into the role of accounting<sup>3</sup>.

Sunder (1997) points out that the firm is “an arena in which self-motivated economic agents play by mutually agreed upon or implied rules to achieve their respective objectives.” The comparative advantage of a firm over formal institutional arrangements that we observe under arms-length contracting is in enforcing implicit contracts. Considering China Inc. as one behemoth firm, the natural question that arises is that did the informal and implied rules enable enhanced coordination of activities? The existence of informal institutions and the variation across RDAs could provide a rich context of examining the costs and benefits of these setups. For example, informal institutions by their very nature cannot be scaled-up. An interesting question to examine is the following: even though market-based institutions facilitate scaling-up operations and thus enhance economic growth, what is the associated costs – is it the additional failures in market-based systems when compared to informal settings?

### 5.3. State Owned Enterprises and private small and medium enterprises

Xu and Zhuang (1998) point out that roughly 2000 counties in China had State Owned Enterprises (SOEs) producing agricultural machinery, 300 counties had steel plants. Regional SOEs produced 69% of China’s total fertilizer output and 59% of its total cement; and about 20 provinces had SOEs producing automobiles or tractors in the early 1990s. This decentralized production structure and autonomy for decision-making

<sup>2</sup> This malaise is not typical to accounting research. Xu (2011) points out that cross-country studies that include China in the economics literature and states, “according to some “standard” policy advice, these more informal institutions might be regarded as obstacles that should be replaced by “standard” institutions as quickly as possible, even though setting up “standard” institutions may be very difficult, time-consuming, or even counter-productive under certain political conditions.” Basu (2012) emphasizes about how accounting research has been influenced by the economics or finance literature. And as such it is not surprising that we are ardent followers of main-stream cross-country economics research as well.

<sup>3</sup> Firth et al., 2012 examine the changing legal liability of auditors and its effect on the way auditors are organized and the accounting quality.



created competition among the SOEs. While the central government lay out the strategic plan and vision, the RDAs are allowed to experiment and be innovative with respect to the transition to the market-based economy. Studying the incentive schemes of promotions and transfers and their relationship to accounting and other performance measures will provide interesting insights. Recent studies provide insights into some of these aspects. For example, [Du et al. \(2012\)](#) examine the evaluations of SOEs and find that the political connections of SOE, CFOs, geography of the SOE, and the political rank of the SOE influence their evaluations. In addition, studying the failed experiments as well as the successful ones could provide us with insights into the institutions that are necessary or sufficient for markets and enterprises. Were CEOs of SOEs rewarded for experimenting or were they rewarded for bottom-line performance?

Sub-national regions developed industry clusters. For example, private small and family enterprises in the town of Datang focus on producing socks, in Shengzhou focus on buttons for clothes, in Songxia focus on producing umbrellas. There are many such industry clusters. [Liu \(2008\)](#) shows how the small enterprises are important for economic growth, and how the regional and national governments helped develop such industry clusters. It will be interesting to examine whether the performance evaluation measures used for regional SOEs are partly driven by their role in helping the infrastructure development and promotion of industry clusters. In essence, are the SOEs a vehicle for supporting regional economic development? And if this question is answered in the affirmative, could this be the reason why their stock performance lags behind the non-SOEs.

#### 5.4. Accounting and control systems in conglomerates

As mentioned earlier, similar to a conglomerate, in China Inc., the personnel decisions for the RDAs were made by the headquarters/central government. The headquarters could provide high-power incentives based on promotions and transfers to other sub-national units so as to transfer knowledge or as a demotion.<sup>4</sup> Given the economic success of China Inc., many interesting questions related to management control systems and incentives can be examined in the following broad categories.<sup>5</sup>

1. What measures of performance are used for performance evaluation and promotion?
  - a. Were they measures of infrastructure, i.e., institutions that are necessary for transitioning to market-based economy or were they based on bottom-line measures of profitability?
  - b. Were they output, intermediate or input measures?
  - c. Given that most of the institution building exercise would have relied heavily on intangibles and human capital, what measures were used for such intangibles?
  - d. Were there different measures at different stages or was there an all-encompassing measure such as GDP or bottom-line for SOEs?
  - e. For SOEs in particular what type of measures were used? Were they based on the concept of profits for the owners?
  - f. Were performance measures more precise at lower levels than at higher levels of the hierarchy?
  - g. Were the measures subjective or objective?
  - h. Were the measures aggregated or granular?
2. Were disclosures of these performance measures voluntary or mandatory? Were performance measures changed and modified based on the nature of experiments?
3. What commitment mechanism was in place to provide credibility to the relationship between incentives and measures? Was it implicit or explicit?

<sup>4</sup> Of course, given the extent of corruption it will be difficult to disentangle whether the motivating force is monetary or non-monetary. [Hung et al. \(2012\)](#) examine why SOEs with strong political connections are more likely to list overseas than non-politically connected SOEs and find that overseas listing itself appears to be a goal; as such, the bottom-line performance metrics are more poor for politically connected than non-politically connected SOEs.

<sup>5</sup> Recent studies provide insights into these aspects. For example, [Du et al. \(2012\)](#) examine the evaluations of SOEs and find that the political connections of SOE, CFOs, geography of the SOE and the political rank of the SOE influence their evaluations.

4. How were the measures verified? What enforcement mechanisms were in place for deviant behavior?
5. Were principles of transfer pricing and cost allocation used? If yes, how and why?
6. Were performance measures uniform or were they changed to suit local conditions?
7. How were performance targets set? Were they participative, i.e., bottom-up or top-down? How are variances of the actuals from the targets dealt with for incentives?

The premise underlying the questions outlined above may look as if China Inc.'s management control systems were designed so well such that the costs of conglomerates were "fully" overcome; however, this is not likely to be the case. For example, it is well known that conglomerates are more likely to overinvest (Maksimovic and Phillips, 2002); similar to this, casual empiricism suggests that there are considerable overinvestments – for example, there are ghost cities such as Zhengzhou. Studying these costs of conglomerates, i.e., overinvestments, would provide interesting insights for accounting and management control systems.

## 6. Conclusion

China provides an excellent setting to examine questions on coordination and control mechanisms for conglomerates and provide insights for management accounting. Furthermore, gaining insights into the costs and benefits of informal and formal institutional setup would be important to draw distinctions between aggregation and disaggregation of information for planning and control purposes. While this will be challenging, editors of journals should be proactive in encouraging such inquiry.

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