



The development of quality management accounting practices in China

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Abstract

Purpose – The concept of the market economy is gaining ground in China. So also, with the growth of international business partnerships and collaboration with the West, is the significance of management accounting. The purpose of this paper is to provide some background for the development of management accounting practices in China.

Design/methodology/approach – As enterprises gain more autonomy, management accounting techniques such as capital budgeting, cost of capital concept, just-in-time inventory, inventory model concept, cost-volume-profit analysis, total quality management and others will become more important. This paper examines the development of management accounting practices in China from the perspective of transitional economies.

Findings – Evidence suggests that the national culture and values practiced for centuries by Chinese business influence the concerted efforts for information dissemination and developing management accounting practices. Because of the lack of understanding of western management accounting practices, the pace of development of Chinese management accounting practices might be slow for now.

Research limitations/implications – The paper attempts to analyze the development of management accounting practices in Chinese business by looking at the background and contemporary thoughts; however, the value of the paper could be raised if the results were tested empirically, though discussion was aligned to empirics from other research and existing literature.

Practical implications – This paper argues the necessity of recognizing the significance of culture-based management accounting systems and practices, but also of realizing that, since the Chinese government opened its doors to foreign investment, international standards and practices have a major role to play.

Originality/value – This paper attempts to analyze the challenges that China, a transitional economy, faces and what factors it seriously needs to consider for developing much needed management accounting practices. It also examines the evolution of management accounting systems in China, with their distinctive features, in order to provide a better understanding of their development.

Keywords Culture (sociology), Management accounting, Market economy, China

Paper type Research paper

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Introduction

Management accounting provides an important competitive advantage for an organization that helps create better decision-making value and provides an integrating perspective to the management’s strategic, operational and financial decisions. Management accounting provides information from its environment to management to facilitate decision-making. If the development of management accounting systems trails behind the demands of management, the systems will eventually lag behind the operations of the organization, because their development is responsive to the demands of management and the environment.

In this paper, quality management accounting practice is understood to be a practice that uses techniques and tools currently available to management accountants, which help provide management accounting information for decision-making in a competitive market.

Quality improvement in practice consists of systematic and proactive pursuit of improvement opportunities in process to increase the level of quality (De Mast, 2004), which will provide a greater competitive advantage. The qualitative decisions taken by management that ensure success depend on an interaction between management accounting and the environment. Management accounting adapts to organizational change, and three major forces cause organizations to evolve: technological change, globalization, and customer needs (McWatters *et al.*, 2001). Ashton *et al.* (1991) maintain that strategic management accounting systems need to look at the organization holistically and to examine its competitive position.

The model of Chandler (1962), shown in Figure 1, affirms that organizations, through interaction with the environment, achieve objectives and define strategy, and that structure is the mechanism through which strategy is defined; the systems provide the flow of information and other resources to enable the management process to operate. Most people, though, want to understand the facets of change, but an organization’s leadership sometimes fails to communicate the necessary information (Johnson, 2004); and readiness for change is a prerequisite to the implementation of a quality system (McNabb and Sepic, 1995). Change needs to take the form of adaptation to the exogenous shifts in the environment (Benson *et al.*, 1991), which should involve

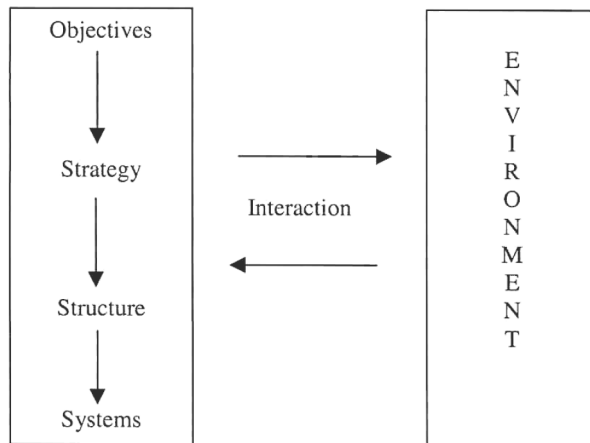


Figure 1.
The model of Chandler
(1962)

adapting to the tried and tested tools used in management accounting. Lorence and Jameson (2003) documented in their study that evidence-based decision support systems have resulted in recognition of data quality improvement as a key area of both strategic and operational management.

We are confronted with technological change, and it has changed the way we manufacture, work and live. These new technological changes have affected, in turn, the world of management accounting systems and the procedures used to collect data and process and disseminate information for decision-making. Specifically, the management accountant should continually monitor and assess rapidly changing production technologies and manufacturing practices. As manufacturing processes are automated through the use of robots and other computer-aided machines, direct labor costs decline and manufacturing overhead increases in importance (Hilton, 2002). The efficacy of management accounting as a management process is faced with serious challenges in the era of globalization, in which low costs, operating efficiency and just-in-time production are the focus.

Transitional economies such as Russia and all erstwhile USSR provinces, China, Eastern European countries and others are witnessing a huge amount of international investment. By the end of 1984, China witnessed US\$3 billion of foreign direct investment, which had risen to US\$45 billion in 1998 (Beijing Review, 1999). Tang (2000) observed:

To realize its ambitious modernization plan, China needed capital and advanced technology. This led China to adopt a policy to attract foreign direct investment. By the end of 1997, China had approved 303,000 projects of foreign capital, with a total contracted amount of \$742 billion . . . During the period, Chinese companies started to raise funds on the international capital market by issuing shares and bonds. The internationalization of economic activity has accentuated a move to conform to international accounting practices.

Investments are also being made in other emerging, transitional economies. International investors are faced with local financial and management accounting practices that may not conform to western standards. This points to an urgent need of establishing management accounting practices that are understood by these investors when they are dealing with the new environments of these transitional economies. These economies have to either develop or reinvent management accounting practices in light of the present need.

We attempt in this paper to analyze the challenges that China, a transitional economy, faces and what factors it seriously needs to consider for developing much needed management accounting practices. We examine also the evolution of management accounting systems in China, with their distinctive features, in order to provide a better understanding of their development.

Management accounting development

The environment and the nature of management accounting today are far different than they were 50 years ago (Kaplan, 1984). Such a transformation is to be expected given the remarkable changes in the economy, technology, and society that have occurred over the past century. Yet, as recently as the 1980s, critics were charging that all of the methods, techniques and concepts taught and used by management accountants were developed before 1920 to serve a mechanically based manufacturing

industry, an industry that is far different from the modern, diverse enterprises that employ most management accountants today.

There are three primary, interacting forces that have shaped the occupational roles of today's management accountants over the past century. These operate within the context of trends in a socio-political environment (E).

For the past approximately 75 years, management accountants have joined together in professional associations. The aims of these professional associations (P) are to set standards of practice and to expand the influence and the importance of the profession and of its individual members. Through their efforts at establishing minimum qualifications; educational requirements; research, advertising and professional standards; and lobbying of governmental agencies, they have had a significant impact on the makeup and operation of the profession and the roles of their membership in organizations.

One hardly needs to emphasize the importance of the next force, technology (T), in changing the nature of the work and the roles of the management accountant. The career ladder of the management accountant used to begin at a level where thousands of clerks entered routine data in the books. These jobs have all but been eliminated, and the job of the mid-level management accountant has been altered dramatically.

The final force is the theory or conventional wisdom about the nature of costs and the purpose of management accounting. This conventional wisdom (W) has been shaped by a tension between academics and practicing managers. While both groups concede that decision-making support is the ultimate objective of management accounting, academics pursue the matter with regard to rationality and ideal systems while managers require methods that are primarily expedient, easily understandable and cost effective.

Most of the concepts and techniques used in traditional cost accounting, which is the forerunner to and continues to be at the core of management accounting, were developed in the nineteenth century. However, until the 1920s, management accounting was not a very important function. Cost accountants, often called works accountants, were generally poorly trained, junior personnel whose main job was to go into the factory in order to gather various data for production managers and for financial accountants. Most of what is now considered within the purview of management accounting was then the exclusive domain of the production manager's aides and industrial engineers with respect to product and department cost accounting. Matters of managerial strategy control and strategy were under the control of production and other levels of management.

The importance of the income statement gave a spin to cost accounting, which evolved into a decision-making science and became known as management accounting, followed by an increase in its status among the various functions of management. A major reason for the rise in importance of management accounting was the ability to reconcile with financial statement income numbers, which became increasingly more important. However, with the *ad hoc* cost studies or cost estimates, based on experience and some cost inputs, that had been the norm in all but the largest firms in the nineteenth century, aggregate product or department costs could not be reconciled to the income statement. With a comprehensive system of management accounting in place, the cost books had to balance with the financial books. The aggregate of product costs and or department costs had to add up to the total cost on

the income statement and the aggregate of product margins had to reconcile with the gross profit shown on the income statement.

The increased importance of the income statement and the power of reconciliation of cost accounting to it led to the development of the controllership function as part of the top management team of many enterprises. Just as management was demanding a point estimate for income, it was also demanding point estimates for product costs and for responsibility center costs. But it was more obvious in management accounting than in financial accounting that such point estimates were erroneous and often misleading. The problems that could not be swept under the rug were that product costs depended on the application of overhead to departments and then the arbitrary allocation of overhead to products. Thus, under the accepted model, there could be no objective product cost in the sense that managers demanded them. Despite the knowledge that what they were attempting to do was impossible, management accountants continued to supply point cost because, first, that is what was demanded and, second, it increased the dependence on management accountants and thus their power and influence in the firm.

A number of solutions were proposed for the “costing problem.” Academics tended to favor cost determination based only on variable costs, which did not depend nearly as much on volume and thus would be far more stable under various conditions and from period to period. However, since managers knew that in the final analysis they would have to recover full costs by selling products, they demanded a cost number that would incorporate all fixed overhead costs. There were arguments to the effect that pricing decisions included many factors other than cost and that by using direct cost all that had to be done was to increase margins, which was the managers’ prerogative to begin with. It was also proposed that there could be different costs for different purposes so that, depending on the decision to be made, the most appropriate cost estimate could be calculated from the cost of inputs. Management resisted such arguments and the use of the full, single cost amount remained dominant.

Contemporary management accounting thoughts

More recently, as the basic income-statement-centered model came under sustained theoretical and anecdotally based attack, academic theoreticians also developed solutions for the weaknesses of management accounting. In the 1970s, a method called “activity-based costing” (ABC) was devised by Robin Cooper and Robert Kaplan at Harvard University. Their theory was that it is the activities needed in making products that cause costs rather than the products themselves. Therefore, proper product costing depends on determining the costs of activities that then, so the theory goes, can be rationally allocated to products depending on the degree or amount of each activity they consume in the manufacturing process. The cost of activities include below the line, marketing and general costs as well, so they are more comprehensive than traditional cost systems. In addition, the method requires that more of the total costs relegated to overhead in traditional systems be considered the cost of activities to ultimately be directly applied to products.

The problems with ABC is that it tends not only to be industry specific but also firm specific and depends on a thorough and detailed understanding of the productive processes of each firm. Only the general approach is transferable from firm to firm. A knowledgeable management accountant can far more easily

implement and master a traditional cost accounting system than an activity-based one in a new firm. Any change whatsoever in activities or sequencing of operations, which is to be expected at least every couple of years if not more often, will result in a great deal of expensive revision of the system. Finally, although costs determined by ABC can be significantly different from the costs determined by traditional methods, and ABC has “face validity,” especially in extreme cases, it nonetheless cannot be proven on a rational basis to provide superior cost numbers in all or even most normal situations.

For these and other reasons, ABC was transformed into “activity-based management” (ABM), wherein it is not incorporated into the daily process of gathering and allocating costs. Rather, the activity-based costs of products are determined periodically and then used in making management decisions until they are revised and new costs used.

The growth of the service and non-manufacturing sectors of the economy has also undercut traditional management accounting, since the model, which is based on the manufacturing process, is limited in its applicability to non-manufacturing organizations. To finesse the limitations of the income statement and to make management accounting more relevant to a wider spectrum of enterprise, academics proposed the “balanced scorecard” (BSC) approach, wherein various key measures of customer satisfaction, supplier performance, employee performance, development and growth as well as process measures are determined and used. The underlying theory is that, in order to be useful, the income number must be augmented with the key measures of every critical aspect of the enterprise. It is possible to shine with respect to a single measure, such as net income, but if other measures, such as employee morale or customer relations, decline – and if they are critical – future problems can be predicted. Management decisions and practices that optimize all of the measures of the balanced scorecard are most likely to yield success.

The balanced scorecard is not integrated with the daily cost accounting process. The measures in the balanced scorecard are only computed periodically, generally once per year at a significant cost that must be sold to top management as being beneficial. Although the balanced scorecard is also customized for each individual firm, so far as accountants are concerned, the knowledge gained by the mastery of the basic balanced scorecard method is far more easily transferable to new firms. Many of the key measures used are applicable to a wide area of situations and can be obtained with similar methods.

Since both the ABM and BSC are “ad hoc” systems, they do not necessarily reconcile to the income statement numbers nor can what has become the necessary work of traditional management accounting be used as the basis of either of the measures. In both cases, it remains to be seen whether they will remain merely useful tools selectively applied by specialists or whether they will be further developed to become the “bread and butter” of the management accounting profession, integrated as part of professional qualification education and universally used in some form in every enterprise.

Some future decision points are clear for management accounting. Shall the profession remain a lesser subspecialty of the accounting profession or move on to become more of a discrete, independent one, and if so, what should the profession be called? With much political heat and some loss of credibility, an argument can be made

for disassociation and moving in the direction of being specialists in ABC-ABM or BSC and making these and similar techniques part of the mainstream for the profession. As long as management accounting remains tied primarily to absolute reconciliation with the income statement, the path of development and expansion remains limited. Practitioners will always find comfort under the financial accounting umbrella to the extent that innovations inconsistent with this model will not be taken seriously.

Moving away from the currently used income-statement-driven model is fraught with difficulty. Most management accountants today have the same temperament and training as financial accountants, take the same classes at school and often move from financial to managerial accounting and back. As H. Thomas Johnston has said, the training of people to be practitioners of the ABC will be more akin to training industrial engineers than traditional accountants. **Balanced scorecard techniques required expertise in survey methodology and social science as well as other non-accounting skills.** If salaries and costs cannot be justified on the basis that most of the work done would have to be done anyway to support the financial accounting function, the new profession will have to prove its worth.

Background of management accounting in China

The change in management accounting practices in China dates back to **the late 1970s, when the Chinese government undertook its economic reform program.** The economic reforms implemented in China since 1978 have brought about significant growth in its GDP and in individual personal savings. This should be an added impetus for the much needed development of an accounting profession.

During the socialist period in China, all enterprises had to meet production quotas, and the government controlled prices and investment decisions. Managers at the micro level had no decision-making authority and did not bear any economic responsibility for the performance of the enterprise (Adhikari and Wang, 1995). Though costing, budgeting, responsibility accounting, production planning, cost analysis and other practices were in place, they were **in the socialist form, without any planning for revenue, profit, variance analysis, cost of capital, present value or other common management accounting techniques applied in other parts of the world.** The systems utilized in a prior era cannot fulfill the needs of present-day China.

An important feature of China's accounting reform program is a trend toward international harmonization. The impact on management accounting practices will be large – the informal and unregulated management accountants association in China will seek to join with one of the large management accounting professional associations in the west or create its own (similar) one. One can expect that China will move in a direction similar to the US, UK and Canada, who now have well developed management accounting professional bodies – the Institute of Management Accountants (IMA) in the US, the Certified Institute of Management Accountants (CIMA) in the UK and the Society of Certified Management Accountants (CMA Canada) in Canada.

As China moves from a centralized to a market economy to realize efficiency, government interference has been restrained and the government's sphere of actions and decision-making authority are limited mostly to the macro economy. The adoption of the scientific management system has created an environment to motivate and facilitate the use of management accounting (Jones and Xiao, 1999). The growth and

change of decision-making authority and level from the government to the enterprise has been the most important factor that has created the demand for practicing management accountants in China. “Zhoulu Fertilizer Ltd. has successfully implemented a ‘responsibility cost management system.’ The costs are fixed according to market competition and duties of various responsibility centers are then defined” (Jones and Xiao, 1999). Gradually, the way was given to the use of benchmarking when enterprises started defining and referring cost elements to the best performance of the market. However, it will be difficult for China to compete solely on the basis of a reactive, low-cost-based strategy that relies on cheap labor, and Chinese firms must make a strategic shift, such as utilizing a proficient management accounting practice providing sound information for decision making, to develop and adapt to a new competitive edge based on quality (Lee, 2004). Adhikari and Wang (1995) documented:

Of all the western management accounting techniques, the contribution margin (CM) and the cost-volume-profit (CVP) analyses have been the most popular techniques with Chinese enterprises. The attractiveness of the CM and CVP approaches lie in their ability to link profit with operational planning. Both techniques have provided Chinese managers with simple but powerful tools to analyze the effect that different operational decisions will have on revenue and costs. The use of CVP analysis and the CM approach such as planning and control tools in Chinese enterprises is continuing to increase.

In a very recent study (Yang *et al.*, 2001), it was documented that cost analysis is the most widely used (72.6 percent) method followed by the investment feasibility study (71.2 percent), CVP (68.5 percent) and variable cost analysis (58.9 percent). In the pre-market economy, there was hardly any necessity for maintaining the conceptual differences between committed (fixed) and flexible (variable) costs and their application in decision-making. In the market economy, product-pricing decisions under different demand scenarios have motivated managers to differentiate between the nature and significance of the costs in decision-making. This has provided a great scope in applying pricing policy and pricing differentials for different demands. The study by Yang *et al.* (2001) documented further that the majority of the companies under study consider (in order of decreasing importance) “exercising effective control,” “making accurate predictions” and “helping scientific decision” as the primary purposes of management accounting application. As the Chinese enterprises gain more autonomy, other management accounting techniques such as capital budgeting, cost of capital concept, discounted cash flow, application of activity-based costing, inventory control model, just-in-time inventory practice, theory of constraints and total quality management will become more important. The technology-based production environment and industrialization in transitional economies, such as the Chinese economy, would affect cost characteristics (as it would in developed economies) and understanding of management accounting practice and its application in cost estimation. Not surprisingly, foreign-joint ventures demonstrated their success, though partial, in the application of management accounting techniques in China. With rising competition and market economy practice, management accounting will be used by the Chinese enterprises as a tool of competitive advantage.

Xiang (1998) argues that accounting rules in China should not be formulated to cater to the needs of a small number of firms, which are already listed on foreign stock exchanges and therefore already use international accounting standards (IAS).

Accounting in China should be geared toward the large industrial and commercial enterprises that are characterized by extensive managerial autonomy and an effective separation of ownership and control. These firms are the reasons why there is an urgent need to establish standard managerial accounting practices.

Hilmy (1999) identifies four stages in the development of accounting theory in China. These stages are as follows:

- (1) *The Mao Tse-Tung Initial Society (1949 to around mid-1960s)*. The Soviet accounting model provided important guidelines for the new Maoist regime. The emphasis of the five-year plan (1953-1957) was focused on implementing centralized control and planning; accounting basically served to ensure that, regardless of cost, the plan's goals were achieved.
- (2) *The post-revisionist era and the counter-revolution (mid-1960s to early 1980s)*. Accounting systems and regulations were promulgated. Concern for production, economic efficiency or profitability were condemned. Economic and administrative units sought self-sufficiency.
- (3) *Opening-up of the Chinese economy to outside capital (early 1980s to around 1992)*. The Chinese economy was opened up to outside capital. Foreign goods became available in China. A new accounting theory emerged.
- (4) *Microeconomic liberalization of state enterprises (since 1993)*. The objective was to increase productivity and efficiency.

The 1993 accounting reform included making a clearer distinction between product and period costs. This change had a direct impact on management accounting practices in China. Before the reform, product costs included certain administrative costs. These administrative expenses (which included certain interest expenses and certain foreign currency gains/losses) were capitalized and were linked to products as opposed to periods. In 1993, this method was abolished to bring the treatment and definition of product costs in line with those in the west.

Xu-Ying (1998) discussed similarities and differences in managerial accounting practices between the west and China, and since then and with the changes that occurred around 1993, management accounting in China has indeed developed and moved closer to that in the west.

Management accounting and financial accounting information for decision making in China

Management accounting and financial accounting share common sets of data, processed in the financial accounting area. There is a clear relationship between management accounting practices and GAAP, even though management accounting professionals are not obligated to follow GAAP. Many of those that are responsible for producing reports and other supporting documents to justify or argue a matter that requires accounting analyses were trained and were/are influenced by the current overall accounting profession.

Studies show (Chen *et al.*, 1999) that reported earnings based upon Chinese GAAP are significantly different from those based on IAS. These differences are caused by "differences in accounting standards and financial rules, opportunistic applications of Chinese GAAP, and unusual market-wide events" (p. 91). The reported earnings under

Chinese GAAP are 20-30 percent higher than the reported earnings if calculated according to IAS rules.

Bao and Chow (1999) explain the differences between Chinese reports and IAS reports along three different lines:

- (1) Differences between accounting regulations in China and IAS rules. The main items that caused differences relate to bad debt allowance, depreciation, inventory valuation, long-term investment and foreign currency translation.
- (2) Differences arising because of specific government policy. An example is the unification of the official exchange rate of local currency with the market rate.
- (3) Differences in professional judgments between local auditors and international auditors. These differences are mainly reflected as revenue and/or expense timing differences.

Even though differences are expected to narrow in the future, changes in attitude take a long time, especially in an environment like China's.

A Chinese accounting information system is basically biased toward financial accounting. In financial accounting data processing, management accounting information is either ignored or not preserved. Conceptually, management accounting as a separate domain has not been widely developed, and management accounting positions do not exist in the industries to take care of data from management accounting perspectives (Yang *et al.*, 2001). Almost all the companies that have tried management accounting have ended up with incomplete, distorted and system-biased data. It is argued that only by gradually perfecting the information system can there be a good foundation for management accounting practices. However, this presupposes the existence and working of sound financial accounting information processing.

The Chinese cultural value prevalence in decision making

Chow *et al.* (2000) documented that, due to the divergence of national culture as well as of political and economic importance, national cultural attributes may facilitate or impede dissemination of intra-organizational information flow. Other prior studies (Triandis, 1989; Erez and Earley, 1993) show that national culture influences concerted, oriented actions and those certain actions are encouraged and others discouraged. Similar arguments were gathered and documented by Jeffries *et al.* (1995) in the European Accounting Association Convention:

Accounting information is not neutral; it is a product of social and historic forces – social construction rather than a rational instrument (Perez).

It was also identified that:

Accounting is the most important system in a firm's decision-making process . . . behavior is a factor that affects the role of providing information. In accounting, the logic of appropriateness (whether an act is in accordance with social standards) is more dominant than the logic of consequentiality (the best means used to achieve a specific goal) (Busch).

Culture and ethics in Chinese accounting practice

Under the centrally planned economic system, organizations in China had to follow rules set by the central government. There was no necessity for individual judgment

and interpretation. Compliance with the government's laws and rules was considered to be most important, and such compliance could hardly give rise to any cause for ethical conflict. Conflicts of interest emerge out of relationships between one set of defined roles, specifically roles which create morally (or legally) determined expectations of behavior, and another set with competing expectations, interests or obligations, whether to self or to others, for example, accountant-manager, lawyer-client, professor-student relationships (Meyers, 1999).

The congruence or fit between an individual's objective and an organization's is likely to predict an individual's behavior at work. This has been an important area of study in the fields of psychology and organizational behavior (Nadler and Tushman, 1980; Schwepker, 1999). When personal interests, that had been looked after by the government-state, were liberated to be pursued by the force of individual choice, behavioral disorganization might be expected to have appeared. Liedtka's (1989) model of "value congruence" suggests that an individual's decision making involving some value judgment is affected by assessing the fit between a proposed course of action (or organizational values) and the individual's self-image (or personal values). If the concept of ethical attitudes is central to the understanding of the moral framework within which business people operate (Bucar and Hisrich, 2001), then the ethical attitudes of the people of China may be predicted as to "the product of personal values, experiences, and the environments in which one works and lives" (Donaldson and Dunfee, 1999).

Compliance with the new accounting practice would conflict with the pre-market business practices in China. As in any other controlled society, business operations and success in China depended on so-called connections and personal relationships with other parties. The connections provided assurance (*Guanxi*, in Chinese) of success in business operations (Chang, 1998). *Guanxi* is still so powerful in China that advantage in *Guanxi* networks can lead an individual or organization to succeed. Because *Guanxi* is transferable from person to person, the links develop into a network of relationships that can ensure economic benefit. Because the parties in a *Guanxi* relationship are bound by an unwritten agreement to grant reciprocal favors, a knowledge of the incentive structure surrounding the relationship (assurance), rather than relying on inferences of the personal integrity of the individual (trust) (Standifird and Marshall, 2000; Fock and Woo, 1998) is key to business success.

The *Guanxi* relationship may lead to a situation where personal interests would be considered a higher priority than ethical requirements and organizational values. Therefore, it effectively impedes development and undermines ethics in Chinese accounting.

Management accounting, *Guanxi* and agency theory perspectives

Agency theory is the theoretical underpinning of human behavior in the management-owner relationship of a firm. The basic assumption is that people are rational individuals who maximize their expected benefits and are resourceful and innovative in actions and decisions. Inherent also in this theory is that there is a conflict of interest between the owners of a firm and the managers. In emerging market-economy countries (e.g. China, Poland), weak governance creates a unique set of agency concerns (Cho, 1999). Agency solutions in an efficient governance context prevalent in most developed economies (Holl and Kyriazis, 1997; Kochhar,

1996) might not necessarily be effective in the weak governance context prevalent in emerging economies (Dharwadkar *et al.*, 2000). A market economy presupposes transfer of property ownership from the government to new owners, thereby creating new agency relationships (Dharwadkar *et al.*, 2000). The Chinese economy, as do most emerging economies, experiences an underdeveloped labor market with few managers with the knowledge and skills required for managing these new firms (Stoever, 1996). Therefore, because of *Guanxi* and to fill the vacuum created in management, Chinese state-owned enterprise (SOE) managers interact extensively with government and party officials in policy formulation and execution (Xu and Wang, 1997). It is implied that *Guanxi*, a strong networking party, plays a shadow role in the form of a principal-agent-agent (sub-agent) in the decision-making processes and success of a firm. Therefore, in the context of Chinese business and management accounting practice, it is not unthinkable that, eventually, agency theory may explain how ethical norms become established in many situations and, consequently, how unethical behavior (for example, *Guanxi* in the perception of western businesses) may be defined in relative terms (Thornton, 1984). Though *Guanxi* and the process of ethical practice may pose a conflict in building an agency relationship at the moment, gradually, *Guanxi* might give way to some form of acceptable relationship and practice.

Development in ethical perspectives – recent evidence

China's entry into the World Trade Organization makes its presence felt more than before. This process of internationalization for China will involve abolishing some of the old practices to ensure quality information for dissemination and management accounting practice. So, the question is whether or not there has been a change in business ethical culture and accounting systems and practices in Chinese business between 1978 (when China virtually started its accounting reform) and the present. Based on research and empirics available (Islam and Gowing, 2003), we tried to put China's management accounting practice into perspective.

A recent study (Islam and Gowing, 2003) documented that there has been an overall change, though not extensive, in ethical cultural practice in Chinese business between 1978 and 2000, the year of the study. In the same study under reference, more than 64 percent of the respondents do not want government regulation and control in Chinese accounting and business practice, and 31 percent want some government control in one form or another. The study also documented that a greater number of respondents confirmed that they practice a code of conduct. This corresponds to the required practices identified by the Chinese Institute of Certified Public Accountants (CICPA) in the General Standard on Professional Ethics. Documentary evidence from the west, the Treadway Commissions report in the US, suggests that a written code of conduct enforces a corporate ethical climate. It sends signals to all employees to conform to the code for conducting the company's affairs. CICPA, the Chinese Association of Certified Public Auditors (CACPA) and pronouncements by other multiple-trust-producing institutions enjoying Chinese government support and sanctions to practice accounting and business may lead the way to create the desired ethical environment for conducting business and accounting practice.

Some discussions

The Chinese government policy is to allow the extension of the sphere of the private economy, cutting back controls over private industry so that market forces can play their role. This is seen as an important positive element after the entry of China into the World Trade Organization (WTO).

Historically, transition from one form of economy to another brings about changes in social, political and economic structure. Awareness of those changes by the people in the infrastructures of development is a prerequisite to economic progress. It is observed the business enterprises in China are taking cognizance of the government policy, which will help in the making of appropriate business decisions.

Giving autonomy to the enterprises presupposes a need for systems of accountability to public authority in the forms of publication of information about the affairs of the company – financial, production, profitability and others. In the principal-agent perspective, autonomy and accountability are sensitive issues in the management of enterprises both at macro and micro levels, and periodic review of performance with reference to objectives and goals will gradually help develop the principal-agent relationship and controlling process of the enterprises. The increase in autonomy (financial, managerial and others) offered to enterprises by the Chinese government, it is argued, cannot and should not be unrestricted (Beckingham, 1987). This may be the reason that about one-third of the respondents in the Islam and Gowing (2003) study expect to have some form of government intervention.

The working environment for the business and accounting practices of China is not familiar to the west. With China's reforms adopting an open-door policy, it needs to assure its partners in the western world that appropriate steps will be taken to develop and foster a business culture with which the western countries are acquainted. Therefore, the Chinese accounting practitioners have begun to refine and adapt accounting practices, and previous practices have been re-evaluated in light of the new social, economic and political environment. In management accounting, specifically, the situation seems to be encouraging. Comments regarding bringing practices in line with the international model, made by the sample respondents in the Islam and Gowing study, are promising. Because of competition in business, the management accounting role is being redefined to provide management accounting information for decision-making. Awareness of the economic changes and sense of management transparency along with a clear understanding of principal-agent relationships will help develop management accounting information systems and practices.

Self-governed institutions like the CICPA and the CACPA, which could control and guide the accounting practice objectively, are relatively new in China. The CICPA was established in 1988 and the CACPA in 1991, and though they are technically private organizations, they are governed and regulated by the Ministry of Finance (MOF) and the State Audit Administration (SAA). A relatively low degree of professionalism is expected in China, as many CPAs have not received the systematic academic education and do not have the experience that would help them deal with market economy functions (Graham, 1996). In China, only foreign investment enterprises and listed companies are required to have a legal audit by CPAs. There is generally no statutory requirement as to types of business that must receive financial statement auditing (Lin and Chan, 2000), which makes for a low degree of management accounting practice and information dissemination.

A management accountant gathers some of the information from external sources, and if the information is not verifiable, management may fail to make proper decisions. The lack of adequate adherence to ethical standards by Chinese CPA firms has been serious, which may create problems in gathering objective, verifiable information for processing. The practice review of CPA firms in 1998 has resulted in 344 CPA firms being closed; 1,509 firms being penalized by temporary suspension of licenses, fines, forfeiture of illegal gains and compulsory restructuring; and 1,441 branch offices being shut down. The certificates of 352 CPAs were cancelled, and other actions such as suspensions or warning were given to 2,396 CPAs (Tang, 1999). This may be a result of conflicting behavioral problems for value preservation (*Guanxi*). The ideas involving rewards and formal enforcement could greatly contribute to resolving the accountability problem of the profession and provide long-term benefits to the public interest (Yi-Hui, 2001).

The accounting changes that are a result of the “reform of China’s economic structure” (October 1984) may be summed up as follows:

The economic reform has had a significant impact on various aspects of accounting. The critical factors including the review of accounting standards and related conceptual issues include changes of government functions in macroeconomic management, diversification of business operations and ownership, the increasing complexity of business transactions, internationalization of economic activities and development of the accounting profession (Tang *et al.*, 1996).

Conclusion

The changes in the way enterprises are run in China have required more management information, and this has led to the promotion and advancement of planning and control concepts within management accounting practices. Luther and Logden (2001) argued that management accounting practice is not universally uniform and cannot be understood without reference to the political, cultural and economic factors important in countries (Hopper, 2000). Kaplan (1985) showed that there was a cause-and-effect relationship between accounting change and its environment. Even though it is commonly accepted that environments actually have an impact on accounting (Kikegaard, 1997), it is difficult to implement the expected changes in the accounting system (Kaplan, 1985; Gosselin, 1997).

In China, culture dominates. For this reason, anticipated changes might not be in the desired direction and at the expected speed. Abdallah (1992), quoting Irl Hicks, said:

Get greater control over all your subordinates to prevent the operation of the *Guanxi* system.

This system was suggested as being one of the major obstacles to required change.

In an emerging Chinese market economy, if the government’s actions are geared toward supporting and supplementing the effort of professional organizations’, compliance of the *practice* (emphasis added) by the companies possibly might be higher than without it at least for sometime until intermediary and institutional trusts are fully developed and self-governed (Islam and Gowing, 2003).

Because of insufficient training facilities for and education of the current population, it may take some time before Chinese management accountants can be expected to provide adequate information and be capable of using management accounting

techniques such as cost-volume-profit analysis, theory of constraints, flexible costing and cost allocation methods.

Finally it is not expected that the Chinese government will fully open the accounting sector to international practices until the sector reaches a point where it can stand-alone and compete with international practices. The initiative to undertake programs to propagate the value of information for reporting and dissemination should come from organizations such as the CICPA and the CACPA. When the Chinese government decides to include management accounting in the academic curricula of educational institutions, it will mark the beginning of a new direction. The market itself will no doubt help this along, as firms increasingly understand the necessity of using management accounting as a means to achieving a competitive advantage.

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