



The Psychology of Auditing in China: The Need To Understand Guanxi Thinking and Feelings as Applied to Contractual Disputes

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Abstract

Chinese contracts normally are not very detail. This is because the Chinese, being entrenched in thousands of years of Confucian teachings, believe in the moral principle that relationships (guanxi) are paramount to formal terms and conditions. Because of the lack of detail, contractual disputes most certainly will arise. When they do, auditors must decide whether or not the disputes will mature into present obligations for which provisions for loss must be booked into the financial statements of the affected party. In order to make that decision, auditors need to understand the psychology of guanxi that is deep-rooted in the minds of the Chinese. In this article, we theorize that if there is quality guanxi between the contracting parties, when contractual disputes do appear, the way of thinking of the parties would be that they would renegotiate in order to maintain a long term relationship. Thus, contingent liabilities will not give rise to present obligations. The art of auditing as applied to China requires auditors to investigate the mind and heart of the contracting parties in order to make an informed judgment on the quality of the relationship (guanxi) that exists between them.

Keywords: China, business risk, guanxi, affect-trust, cognition-trust

Introduction

This article addresses both the science of auditing as it applies to potential contractual disputes in China, as well as the art of auditing to superimpose cultural psychological factors into the audit evidence. The framework underlying this article is as follows:

- (A) The audit approach to evaluating potential contractual disputes in China is to apply Generally Accepted Accounting Principles (herein GAAP) and Generally Accepted Auditing Standards (herein GAAS) in the context not only of the business but also of the cultural environment in which the subject business is operating.
- (B) In China, this means taking into consideration the attitude of the Chinese parties towards contracts and the importance of relationships (herein guanxi).
- (C) In deciding whether or not to disclose a contingent liability or book a provision for loss when confronted with a potential contractual dispute, auditors need to apply judgment and creativity to ascertain the quality of the guanxi between the contracting parties. The stronger the guanxi quality, the more likely a present liability will not surface.

The Art of Auditing as Applied to China

Auditing is becoming more of an art. New methods of auditing that emphasize assessment of business and process risks in conducting an audit are being employed by most large accounting firms. Audit emphasis is shifting significantly away from substantive testing to applying reasonable judgment based upon understanding the client's business and the environment in which the client is operating (Eilifsen et al, 2001). Auditors increasingly need to rely on extensive enquiry based evidence (Liu, 2004). Enquiry based evidence involves seeking of information from knowledgeable persons inside and/or outside the entity, and then confirming through corroborating evidence. The information can come in the form of written and/or oral enquiries (Heintz et al, 1999). International Standards of Auditing (herein ISA) 500 recognizes enquiry and confirmation as an appropriate audit procedure. ISA 500 is mirrored by Chinese Standards of Auditing (herein CSA) 5 (Lin and Chan, 2000).

When dealing with China, understanding the client's business and environment requires understanding the importance of relationships (guanxi). Some foreign executives who do business in China are of the opinion that what matters most is guanxi; contracts carry very little weight (Farh et al, 1998). Taking this into consideration, in order to make a reasonable judgment about contingent liabilities and provisions relating to contractual disputes, auditors must gather all available evidence. Among other things, auditors need to understand the attitude of the Chinese towards contracts and enquiry into the guanxi between their clients and contracting parties (Huang and Staley, 2005).

Chinese Attitudes towards Contracts

Lawyers from the West are trained to be as meticulous as possible to craft contracts that cover every possible contingency. Detailed contracts are negotiated and drafted with care to ensure that the language used is precise and without any ambiguity, resulting in voluminous documents. Western lawyers view contracts as instruments of control through terms and

conditions obligating the transaction parties (Joskow, 1987). To the Chinese, a contract is merely a formality, and entered into without much consideration to legal enforcement (Leonhard, 2009).

The Chinese loathe relying on contracts (Koehn, 2001) so that contracts normally are only a few pages in length, with more an emphasis on setting out the spirit and intent of the transacting parties than strict adherence to contractual terms (Yao and Yueh, 2009). They might even not read long contracts, since they consider complicated contracts as merely confirming they intend to do business with you, not how the business will be conducted (De Mente, 1994). The attitude of the Chinese towards contracts is due to the several thousands of years of history and culture through the teachings and writings of great philosophers such as Confucius (Kwock et al, 2013). Confucius emphasizes moral standards and long term relationships over formal law (Zhang, 2006). To maintain a long term relationship, the contracting parties are expected to work hard to accommodate each other, keeping their own biases and self-righteous in check. Insisting on complete adherence to contractual terms is an indication of mistrust and betrayal of the relationship (Koehn, 2001).

However, disputes surface when contracts are incomplete and there is ambiguity in contractual terms. When that happens, the Chinese expect the contracting parties to be flexible and reasonable and to be make compromises as and when required within the objectives of the dealings (White III, 2003). Rather than strictly requiring adherence to the terms of the contract, when the economic situation underlying a contract changes, the Chinese party expects the terms of the contracts to be renegotiated (Yao and Yueh, 2009). Contributing to this attitude is the general mistrust of the court process (White III, 2003) and the relatively high transactional cost of lawsuits for short-term gains from an opportunistic breach of contract as opposed to the long term benefits of maintaining the relationship (Schramm and Taube, 2003).

Given the Confucius attitude towards harmony and good relationships, Chinese parties prefer settlement of disputes through negotiation. The negotiation is by way of amiable discussion and consultation or by mediation (Trebilcock and Leng, 2006).

From the foregoing, we theorize that the quality of the relationship (hereinafter *guanxi*) between the transacting parties is an important factor to consider in deciding whether or not to disclose a contingency or book a provision for loss. The stronger the quality of the *guanxi*, the more probable the parties will renegotiate terms at issue and a present obligation will not emerge from the contractual dispute.

2. Literature review

Audit requires not only understanding the client's business but also inquiring into the environment in which the business is operating in order to take into account potential business risks (Heintz et al, 1999; Lin and Chan, 2000; Schultz et al, 2010). Accordingly, when auditing businesses in China, auditors must enquire into the *guanxi* between transacting parties since relationships is at the core of doing business in China and, thus, will have a strong bearing on how contractual disputes are handled (Park and Luo, 2001).

2.1 What is Guanxi?

Guanxi can be defined in many different ways depending on the perspective taken (Chen and Chen, 2004). However, getting down to the basics, *guanxi* is made up of two words, *guan* and *xi*, which literally means connection. It is a personal connection bound by the moral

commitment to maintain a long term relationship through mutual commitment, loyalty and obligation. No matter how guanxi is based or categorized, it entails reciprocity of both feelings and material needs (Chen and Chen, 2004).

Another component of guanxi is that it can be described from a network/group perspective instead of from a dyadic (individual) perspective. Although either approach can be taken, for this article, we will apply the dyadic because our purpose is to identify the factors that will contribute to building quality guanxi between transacting parties.

2.2 Building guanxi

We theorize that if there is quality guanxi between the transacting parties, contractual disputes would be settled amicably through renegotiation so that loss provisions need not be booked in the financial statements of the party concerned.

According to Chen and Chen (2004), quality guanxi is built through three sequential stages – initiating, building, and using the guanxi after it has developed into sufficient quality. In the initiating stage, the general objective is to set up a guanxi base. This is done by the parties voluntarily disclosing personal information about them during a familiarization process.

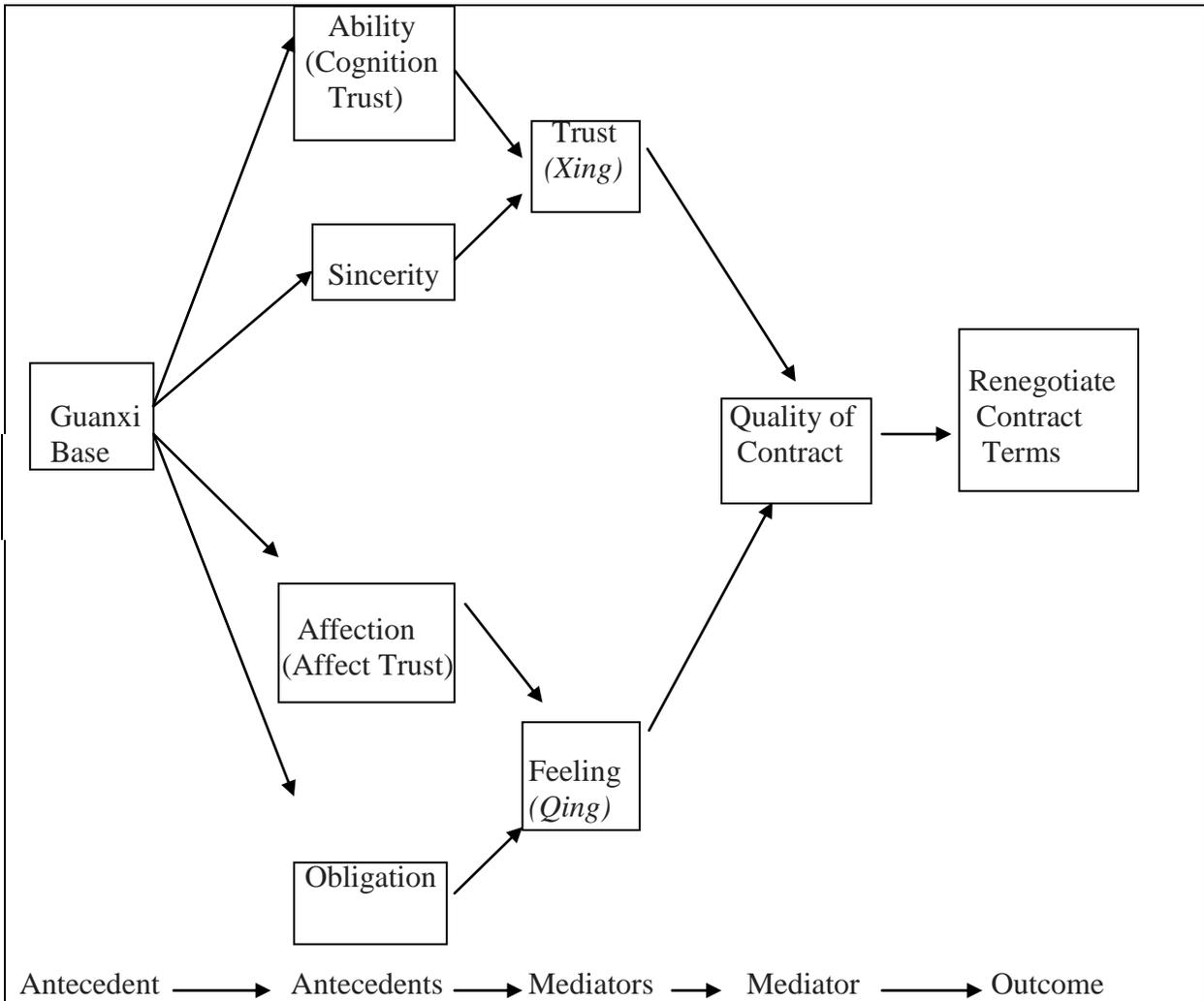
After a guanxi base is set up, the next task is to enhance the quality of the guanxi through reciprocal exchanges of expressive and instrumental transactions. Expressive transactions amount to emotional understanding and connection through sharing of feelings such as happiness and fears - akin to the Western concept of “affect trust”. Instrumental transactions refer to sense of obligation and indebtedness arising out of social and economic transactions of the parties during the course of their relationship. Expressive and instrumental transactions build all factors needed for quality guanxi – ability (akin to cognition trust), sincerity, and affection (akin to affect trust) as well as obligations (Chen and Chen, 2004). Even though affect trust and cognition trust are distinct, they intertwine and interact with each other (Jiang, 2008). Chinese tend to develop guanxi by engaging concurrently in expressive transactions (such as sharing of meals and gift giving) and in instrumental transactions (such as exchange of business favors) (Chua et al, 2008). This would be improper in an American culture, where it is unacceptable to mix business with pleasure (Weber et al, 2002; Zelizer, 2005)

The final stage is where quality guanxi is achieved, allowing the parties to exchange favors based upon long-term equity (Chen and Chen, 2004). Long-term equity involves keeping the reciprocal favors in balance. Nonetheless, immediate repayments to even the score are foolish since it can close the relationship (Mei-Hui, 1994). It is better for repayments to be unequal so as to escalate the favors (Hampden-Turner and Trompenaars, 1997). The quality of the guanxi at this stage can be measured by frequency and stability of the exchanges (Brass, 1995) as well as the trust, satisfaction, and commitment to the relationship (Bejou et al, 1996).

2.3 Quality Guanxi, Resulting from Trust and Feeling, Leads to Renegotiations

To judge whether or not a loss provision from a contractual dispute should be booked, auditors need to evaluate and predict the quality of the guanxi. If the quality is good, the contracting parties are likely to renegotiate the disputed terms rather than insist on strict enforcement. To assist in the prediction, a conceptual framework is adapted from Chen and Chen (2004).

Figure 1
Predictors of Quality Guanxi



3. Proposition development

3.1 Guanxi base

The process of developing quality guanxi begins with identifying a guanxi base by each party familiarizing himself with the other party. Guanxi bases can come from common social identities (Jacobs, 1982) such as common birthplace, educational institution or work-place. It can also come from a third party with whom the transacting parties both have guanxi (Chen and Chen, 2004). Chen and Chen (2004) also identifies a third possible guanxi base that they call anticipatory base - where the parties do not yet share anything in common but enter into a relationship in anticipation of future exchanges, collaborations, or joint ventures.

Proposition 1: A guanxi base is required as an antecedent to developing trust and feelings.

3.2 Trust (Xing)

For there to be quality guanxi, there must be trust. To be trustworthy, a person must show ability and sincerity. Ability corresponds to the Western concept of “cognition trust” – a person’s competence or expertise in certain areas usable by the other party. The basis of this trust is the belief in the technical competence and reliability of the other person (McAllister, 1995). Cognition trust is calculative in that it is based on a prediction of a party that the second party will perform an action in the future that will benefit the first party (Luo, 2002).

Sincerity means true intentions to enter into and stay in the relationship. Sincerity can be shown by a person exhibiting concern for the other party. Sincerity also can be demonstrated by a person volunteering personal information. Conversely, not willing to self-disclose can mean the lack of sincerity (Chen and Chen, 2004).

Proposition 2: For there to be quality trust, there must be ability (corresponding to the Western concept of cognition trust) and sincerity (true intentions to enter into and stay in the relationship).

3.3 Feeling (Qing)

Quality guanxi also depends of feelings. Feeling has two different components – affection and obligation. Affection is akin to the Western concept of “affect trust” which is derived from reciprocal caring and concern for each other’s welfare and interests (McAllister, 1995). The parties become emotionally connected and loyal to one another. In contrast to cognition trust (which is from the head), affect trust evolves (from the heart) through feelings of emotional closeness, empathy and rapport (Chua, 2012). Unlike their American counterparts (Kriz and Keating, 2010), Chinese rely heavily on affection in the decision to trust (Tan and Chee, 2005). Affect trust exerts positive effects on cognition trust, and vice versa (Jiang, et al, 2011). For the Chinese, affection can also have instrumental motives (Li, 2008). Affection is developed through social activities such as participating in celebrations of birthdays.

Obligations refer to indebtedness arising out of an accumulation of social and economic transactions of the parties during the course of their relationship - usually related to work or business (Chen and Chen, 2004).

Proposition 3: For there to be quality feelings, there must be affection (akin to the Western concept of “affect trust”) and obligation.

3.4 Results of Quality Guanxi

Once guanxi has reached the quality stage of development, that guanxi can be used to settle contractual disputes amicable through renegotiation of controversial terms.

4. Discussion and Contributions to Future Research

The focus of this article has been on evaluating guanxi to assist auditors of Chinese companies to determine whether or not parties would renegotiate disputed contractual terms. Since guanxi is a strong cultural value in China, it affects practically all aspects of dealings in China. Therefore, the concepts presented in this article can be applied for future research in other contexts.

We believe that guanxi is entrenched into the sole of the Chinese people and therefore will continue to influence their business dealings. Nonetheless, for future consideration and research is how guanxi and its predictors might change, fade, or be replaced as international business practices are assimilated into China.

5. Conclusions

Our theory is that, because guanxi is at the core of doing business in China, when contractual disputes arise in China, auditors must investigate the quality of the guanxi between the transacting parties in order to decide if a contingent liability is likely to mature into a present obligation requiring that a provision for loss be booked into the financial statements of the affected party. In order to make that decision, the auditor needs to obtain evidence as to the stage in which the predictors of quality guanxi has reached. If the quality of the guanxi is high, the parties likely will renegotiate the terms of the contract instead of insisting on strict enforcement. The approach to gathering the necessary evidence and factors to consider presented by this article provides auditors with a structure for determining the quality of guanxi that exists – this is the art of auditing in China.

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