A Political–economic Analysis of Auditor Reporting and Auditor Switches

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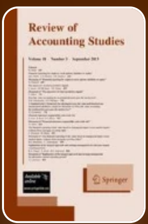

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Abstract

This study examines whether auditor opinions are affected by political and economic influences from governments. We use auditor locality (local versus non-local) to capture such influences from local governments in China. Based on data from China's stock markets for the period 1996–2002, we find that *local* auditors, who have greater economic dependence on local clients and are subject to more political influence from local governments than non-local auditors, are inclined to report favorably on local government-owned companies to mitigate probable economic losses. Moreover, companies with qualified opinions are more likely to switch from a non-local auditor to a local auditor than companies with unqualified opinions. Contrary to some prior studies, we find that in China's political environment, local government-owned companies that switched from a non-local auditor to a local auditor after receiving a qualified opinion can succeed in opinion shopping.

Notes

1. Privatization and capital market development are key aspects of economic reforms adopted by many transitional economies, including China and its neighbors like Russia and Vietnam. A common feature of corporate share ownership structure in transitional economies is the dominance of insider

ownership and government control, particularly in strategic industries like defense, minerals, and precious stone extraction (Krivogorsky, 2000; Wright & Nguyen, 2000). Concentrated corporate ownership and a long history of heavy government influence on business activities reduce the demand for independent auditing in these economies (Sucher & Bychkova, 2001).

2. *State shares* are held by the state, with the local government being the controlling owner in most of the listed companies. State shares are non-tradable, but are transferable to government related institutions. *Legal person shares* are held by state-owned institutions, including securities firms, trust and investment companies, mutual funds, and state-owned enterprises that have at least one non-state owner, and can only be traded in blocks in a designated market. Tradable *A shares* and *B shares* are held and traded mostly by individuals in stock exchanges. On average, these tradable shares comprise of about one third of all the shares of Chinese listed companies.

3. Managers can manipulate earnings by modifying how they interpret accounting standards, or by timing or structuring transactions (Healy & Wahlen, 1999). Nelson, Elliott and Tarpley (2002, 2003) define earnings management as broadly including earnings management that is (1) consistent with GAAP, (2) difficult to distinguish from GAAP, and (3) clearly not GAAP. They explain that while auditors are most likely to require the client to make an adjustment in situation (3), they are less likely to do so in the other two situations. However, in any case, auditors are only likely to require adjustment of earnings management attempts that they identify as *material*. Failure to make a required adjustment could result in qualified opinions. In this paper, we are mainly concerned with earnings management that will lead to qualified reports.

4. In China, it is very difficult for individual shareholders to pursue lawsuits against the controlling government owners. For example, recently two groups of residents in Shanghai took legal actions against the government for corrupt dealings in the allocation of land to a property developer. Not only did the

residents lose the cases, the lawyer who represented the residents was also sentenced to 3 years in jail (SCMP, 2003).

5. We do not expect audit fees to be a significant factor affecting auditor switches in China. The Chinese Institute of Certified Public Accountants and the Pricing Bureau set a minimum limit on the audit fee which is based on a percentage of a client's total assets (Beijing Pricing Bureau, 2001; Li & Jin, 2003). With the exception of the Big Five (Four) audit firms, most audit firms in China do not charge significantly above the limit due to competition. In addition, with the rapidly increasing workload due to new regulations, audit firms are unlikely to use "low-balling" strategies to entice companies to switch auditors. For example, in this study, for companies that switched auditors in 2001, 85 companies voluntarily disclosed their audit fees for 2000 and 2001. We find that these switching companies paid comparatively higher fees in 2001, by an average of RMB83,800 (approximately US$ 10,000) per engagement, or by 0.014% of total assets. Similarly, for companies that switched auditors in 2002, 56 companies disclosed their audit fees for both 2001 and 2002. The mean audit fee paid by these switching companies in 2002 is also higher than that paid in 2001 by RMB49,142 (approximately US$ 5,920) per engagement, or by 0.003% of total assets. While the Big Five firms do charge more than others, there were only a few switches away from the Big Five firms in our study period. As explained in our sensitivity analysis later, including or excluding the Big Five auditors does not change any of the conclusions of our analysis.

6. The number of audit firms licensed to audit listed companies was quite stable for the period 1996–1999 but has decreased significantly from 106 in 1999 to 78 in 2000 and 72 in 2002. The major reason for the decrease is the mergers of audit firms. In this study, we also excluded companies that switched to new entrant auditors. The new entrant auditor might have been an audit firm without a license to audit listed companies but was engaged to conduct the audit on behalf of the predecessor. When the non-licensed firm was granted its own license, it might keep the client and sign the audit report. Although the auditor identity is different, it is not really an auditor switch. If the new entrant auditor happens to be a local auditor, then this could potentially bias

the findings in this study. However, there were only a few new entrant auditors subsequent to 1996 (five in 1998 and two in 2002) and most of them did not participate in the audit of listed companies until several years later. Specifically, for the five new entrant auditors in 1998, only one engaged in auditing the financial statements of listed companies in that year, whereas for the two new entrant auditors in 2002, none participated in the audit of listed companies in that year.

7. The database was prepared by Shenzhen GTA Information Technology Company Limited based on the detailed information about the top ten shareholders disclosed in the annual reports of listed companies and other relevant publications such as company prospectuses for the period 1996–2002. To ensure the accuracy of the database, we have cross checked the data for a sample of 100 randomly selected companies against their annual reports, and if necessary, prospectuses and websites. We also confirmed the reliability of the data with partners of two CPA firms, who have audited listed companies in China.

8. For example, the largest shareholder of Xinjiang International Industry (XII) Co. Ltd (stock code: 000159) is Xinjiang Foreign Trade (Group) Co. Ltd., which holds 53.43% of XII’s total stock. According to the background information on the controlling shareholder (i.e. Xinjiang Foreign Trade (Group) Co. Ltd.) disclosed in XII’s annual report, the ultimate owner of Xinjiang Foreign Trade (Group) Co. Ltd. is Xinjiang Tongbao Asset Management Co. Ltd., a wholly owned company of Xinjiang provincial government. Thus, XII Co. Ltd. is classified as a local government-owned company. On the other hand, the largest shareholder of Sinochem International Company Ltd (stock code: 600500) is China Chemical Import & Export Corporation which holds 64.4% of the total shares outstanding. As disclosed in the annual report of Sinochem, China Chemical Import & Export Corporation is a state-owned company established in 1950 and directly controlled by the State Council of the central government. Therefore, Sinochem International Company Limited is classified as a non-local government-owned company.

9. Before 2000, virtually no audit firm in China had multiple offices in different provinces. The number of audit firms with multiple offices has increased subsequent to 2000. As at the end of 2002, of the 72 audit firms licensed to audit listed companies (including the Big Four), 17 firms have two offices and three firms have three offices (including the head office) located in different provinces in China. For those audit firms that have offices in different provinces, the 50% requirement for local auditor status is satisfied only if every office has local clients comprising over 50% of the office's clientele, i.e. over 50% of the clients' total assets come from clients in the same province where the office is located. This implies that the firm as a whole serves mainly local clients. This definition for multi-office local audit firms is rather conservative. In a few cases, a firm has one office serving mainly local clients and one office serving mainly non-local clients. Such firms were classified as non-local. Alternatively, we classify an audit firm with multiple offices as local if the combined local clients of the offices are more than 50% of the total clientele of the entire audit firm (regardless of the distribution in any one office). This classification measures the extent of local services for the firm as a whole. Our sensitivity test results indicate that the main results are insensitive to this alternative definition of local auditor for multi-office firms. Moreover, we also conducted a sensitivity test on the three regression models by excluding audit firms with multiple offices from the data. The results are substantially identical to our main analyses discussed later. The significance of all the main test variables remains unchanged.

10. Our analysis on qualified companies that do not switch their auditors also indicates that local auditors are more likely (by 8%) than non-local auditors to issue a subsequent clean opinion to qualified local government-owned companies.

11. One may argue that local auditors have special local information or expertise that allows them to attract better clients and do a better evaluation of local companies. Thus, they may issue more clean opinions than non-local auditors. However, our empirical evidence indicates that overall, local auditors do not have better clients. Furthermore, given our definition of local

auditor, all the clients of a local auditor are located in the same province as the auditor. In other words, all the clients of a local auditor are local clients regardless of their ownership. Therefore, if local auditors have information advantage about the local business environment, this advantage should apply to all clients, not just the local government-owned clients. We attribute the differential treatment by local auditors to their local government-owned clients to the effect of political influence rather than information advantage.

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Appendix A

Appendix Demographics of audit firms in China

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