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The impact of corporate governance on auditor choice: Evidence from China

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ABSTRACT

As the largest and fastest growing emerging market, China is becoming more and more important to investors throughout the world. The purpose of this paper is to investigate the determinants of firms' auditor choice in China in respect of their corporate governance mechanism. Normally firms have to take a trade-off in their auditor choice decisions, i.e., to hire high-quality auditors to signal effective audit monitoring and good corporate governance to lower their capital raising costs, or to select low-quality auditors with less effective audit monitoring in order to reap private benefits derived from weak corporate governance and less-transparent disclosure (the opaqueness gains). We develop a logit regression model to test the impact of firms' internal corporate governance mechanism on auditor choice decisions made by IPO firms getting listed during a bear market period of 2001–2004 in China. Three variables are used to proxy for firms' internal corporate governance mechanism, i.e., the ownership concentration, the size of the supervisory board (SB), and the duality of CEO and chairman of board of directors (BoDs). We classify all auditors in China into large auditors (Top 10) and others (non-Top 10), assuming the large auditors can provide higher quality audit services. The empirical results show that firms with larger controlling shareholders, with smaller size of SB, or in which CEO and BoDs chairman are the same person, are less likely to hire a Top 10 (high-quality) auditor. This suggests that when benefits from lowering capital raising costs are trivial, firms with weaker internal corporate governance mechanism are inclined to choose a low-quality auditor so as to capture and sustain their opaqueness gains. On the other hand, with improvement of corporate governance, firms should be more likely to appoint high-quality auditors.

1. Introduction

The purpose of this study is to investigate the association between firms' internal corporate governance mechanism and their auditor choice decisions in China. Auditor choice, i.e., client–auditor alignment, can be viewed as the minimum cost match between client needs (the demand side) and auditor services (the supply side) in a certain auditing environment (Datar, Feltham, & Hughes, 1991). Studies on auditor choice to date have been conducted predominantly in the U.S. (Chow & Rice, 1982; Copley & Douthett, 2002; Copley, Gaver, & Gaver, 1995; DeAngelo, 1982; Geiger, Raghunandan, & Rama, 1998; Hogon, 1997; Hudaib & Cooke, 2005; Johnson & Lys, 1990; Krishnan, 1994; Lee, Mande, & Ortman, 2004; Pittman & Fortin, 2004), with occasional studies in countries such as Australia (Beatty, 1989; Craswell, 1988), New Zealand (Firth, 1999; Firth

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& Smith, 1992) and the UK (Beattie & Fearnley, 1995; Chaney, Jeter, & Shivakumar, 2004), where the auditing environments are relatively similar.

One reason why audit markets in these countries have been studied extensively relates to the developed capital markets in these countries. However, there are few empirical studies that examine auditor choice decisions in the emerging economies; even the auditor choice issue has a critical impact on the credibility of corporate financial reporting and the operation of capital market. Emerging economies have less developed equity markets and very different auditing environment than the developed ones (Fan & Wong, 2005; Woodward, 1997). This study extends the auditor choice literature further from the developed capital markets to the less developed Chinese market.

Shortly after the founding of the People's Republic of China in 1949, the auditing profession in China became non-existent. Independent audits were virtually non-existent under the planned economy before the 1980s, as the State both owned and ran all enterprises directly. Mushrooming Sino-foreign joint ventures resulting from China's open-door policy adopted in the early 1980s, however, led to the re-emergence of independent auditing in the country. Due to non-state owned interests in the joint ventures, demands emerged for verification of capital contributions and audits of annual financial statements and income tax returns by non-government employed professionals, which brought about the reappearance of Chinese certified public accountants (Xiao, Zhang, & Xie, 2000).[1] Independent audits are thus called for to alleviate the agency problems in Chinese enterprises. The shift of ownership rights from the state to private and institutional investors as a result of increasing diversification in the Chinese economy after the resurgence of stock companies and capital market at the turn of 1990s has further promoted the monitoring role of independent audits.

The establishment of the two stock exchanges in Shanghai and Shenzhen in 1990 and 1991, respectively, and the promulgation of new accounting and auditing standards have played an important role in this process. The China Securities Regulatory Commission (CSRC) requires that all listed firms have their annual reports audited by the Chinese certified public accountants (Chinese CPAs). The monitoring of both public and private enterprises by independent auditors has gradually been employed by the government as an important mechanism in transforming the Chinese economy from one directed by the "visible hand" of centralized planning to the one guided by the "invisible hand" of market forces.

By the end of 2000, there were about 1000 auditing firms operating in China, most of which were initially set up or sponsored by government agencies (the public finance, state auditing or taxation authorities) or social institutions such as universities or professional associations. Under this kind of sponsorship arrangement, the independence and quality of audit services were challenged by various user groups. Thus the Chinese government introduced a reform in the mid 1990s to delink all auditing firms from their original sponsors, both financially and personally. The reform was completed by 1999 with all auditing firms reorganized as professional partnerships in the country. The government further encouraged auditing firms to merge across different provinces or geographical regions in order to reduce the dependency of auditing firms on their original sponsors (the local governmental authorities in particular). At the same time, new accounting and auditing standards that are modeled after the international norms have been introduced and enforced. As a result, the quality and independence of Chinese auditors have been substantially improved, which help to promote a more effective functioning of auditing services in the country.

In attesting to the credibility of accounting information provided by management, independent audits play an external monitoring role on behalf of the owners/shareholders and are an essential component of the corporate governance mosaic (Abdel-khalik, 2002; Ashbaugh & Warfield, 2003; Cohen, Krishnamoorthy, & Wright, 2002). Nonetheless the utility of audit services depends upon the quality of auditing. Several prior studies documented that firms with high agency costs are inclined to choose a high-quality auditor to improve their corporate governance and alleviate the potential agency problems (Fan & Wong, 2005; Hay & Davis, 2004). Relatively speaking, low-quality auditors may not be able to exercise an effective monitoring of clients' financial reporting process (Claessens, Djankov, Fan, & Lang, 2002; Mayhew, Schatzberg, & Sevcik, 2003). Thus the quality of independent audits will directly affect firms' corporate governance and operations (Cohen et al., 2002). There is always a trade-off between hiring a high-quality auditor to improve corporate governance and hiring a low-quality auditor to sustain the opaqueness gains from relatively weak corporate governance mechanism (e.g., benefits through earnings management and "tunneling" behaviors for the controlling owners of the listed firms). Thus auditor choice is an issue with significant theoretical and practical implications (Fan & Wong, 2002; Parker, Peters, & Turetsky, 2005).

The audit market in China presents an interesting arena for the study of auditor choice. Unlike those in developed economies, the Chinese accounting and auditing profession is not only regulated but also administered by government agencies. The government exercises control by setting the professional standards and by directly monitoring the operations of auditing firms. It is therefore of great interest to examine whether independent audits are value relevant in a market where stringent government control often prevails over market mechanisms. In addition, the bear market in China during 2001–2004, when the incentives for raising capital in the stock market were low, provides a good opportunity to study the association between internal corporate governance mechanism and firms' auditor choice decisions.[2]

[1] With the reappearance of Certified Public Accountants in China, the Chinese Institute of Certified Public Accountants (CICPA) was established in the early 1980s.

[2] China experienced a continuous span of bear market in 2001–2004. During this period, the Chinese listed firms were unlikely to reissue new stocks to the public as both stock prices and market confidence were low. The CSRC even suspended the listed firms from reissuing equity stocks in 2002. Since reissuing new equity is unlikely, benefits from lowering capital raising costs are correspondingly trivial. Then, the opaqueness gains derived from weak corporate governance might become a major concern in auditor choice decisions.