

DOCTORAL THESIS

Corporate governance, auditor choice and auditor switch: evidence from China

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Corporate Governance, Auditor Choice and Auditor Switch

--- Evidence from China

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ABSTRACT

In recent years, the quality of disclosure has become one of the most important issues in the public debate on corporate governance. Investors need relevant and reliable financial and operating information. It is regarded as a critical feature for proper functioning of corporate governance: disclosure allows public investors to monitor firms, and thus supports capital market development. Auditing is among the most important mechanisms for proper information disclosure.

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 association between firms' internal corporate governance mechanism and their auditor choice and auditor switch decisions and how investors respond to firms' auditor choice and auditor switch decisions in the Chinese context.

High ownership concentration is a basic feature of the listed firms in China. In firms with high ownership concentration, controlling owners have a tradeoff between improving corporate governance and reaping opaqueness gains from weak corporate governance mechanism. One major benefit with improved corporate governance is firms can raise capital at a lower cost (Fan and Wong 2005). In this study I carefully choose a specific period of 2001-2004, when China saw a continuous bear market. During this period, the Chinese listed firms are unlikely to issue equity to the public, hence benefits from lowering capital raising costs are trivial. Accordingly, concerns of reaping the opaqueness gains from weak corporate governance mechanism likely dominate the listed firms' auditor choice and auditor switch decisions.

Several factors motivated this study. First, the unique auditing market in China presents an interesting arena for the study of auditor choice and auditor switch. Different from the developed economies, the Chinese accounting and auditing professions are not only regulated but also administered by government agencies (Chen et al. 2000). Second, the Chinese Institute of Certified Public Accountants (CICPA) has just begun to rank auditors in China, which presents an opportunity for identifying high-quality auditors in the Chinese context. Third, controlling shareholders have incentives both for and against hiring a high-quality auditor. Hiring a high-quality auditor may improve firms' corporate governance, but in doing so the controlling shareholders may lose the opaqueness gains. It is usually difficult to disentangle the two incentives. However, during the bear market of 2001-2004, the "for" incentive is greatly suppressed, which provides a good opportunity to study the association between firms' internal corporate governance mechanism and their decisions on auditor choice and auditor switch. Fourth, the market response to firms' decisions on auditor choice and auditor switch may be different from that in the developed Western world because the incentives for earnings management in China are of distinctive nature.

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 the CEO and the chairman of the board of directors (BoD). Since the year of 2003, CICPA publicizes the ranking of audit firms in China according to their annual revenues. I classify all auditors in China into the large auditors (Top 10) and others (non-Top 10). The empirical results show that firms with larger controlling owners, with smaller size of SB, or in which the CEO and the BoD chairman are held by the same person are less likely to hire a Top 10 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 sustain their opaqueness gains.

Further to prior research, I identify two major types of auditor switch, namely switching to a larger auditor and switching to a smaller auditor. Results of auditor switch tests show that firms with larger controlling owners or in which the CEO and the BoD chairman are held by the same person are more likely to switch to a smaller auditor rather than to a larger one. However, the size of SB has an insignificant effect. This finding suggests that in general, firms with weaker internal corporate governance mechanism tend to switch to a more pliable auditor to sustain the opaqueness gains. The insignificant influence of SB size may suggest that the monitoring role of SB is not effective because members of SB are mainly from inside rather than from outside the firm.

The market implications model show that audit quality and switching to a larger auditor have a positive (negative) impact on earnings response coefficients (ERCs) for firms with positive (negative) abnormal earnings. On the contrary, switching to a smaller auditor has a negative (positive) impact on ERCs for firms with positive (negative) abnormal earnings. The results suggest that Top 10 auditors in China are perceived more effective in curbing income-increasing earnings management, leading to higher (lower) ERCs for clients with positive (negative) abnormal earnings. Firms' switching to a larger auditor may signal good earnings quality, investors therefore appreciate their stock prices more for positive abnormal earnings and depreciate their stock prices less for negative abnormal earnings. Vice versa, switching to a smaller auditor may signal lower earnings quality and would hence result in opposite market responses. The evidence, in general, suggests that audit information in China is valued by the market and large auditors have been able to product-differentiate themselves in the Chinese market.

Keywords: Corporate Governance, Auditor Choice, Auditor Switch, Market Response to Audit Quality and Auditor Switch, Opaqueness Gains

TABLE OF CONTENTS

DECLARATION	I
ABSTRACT	II
ACKNOWLEDGEMENTS	IV
CHAPTER ONE	1
INTRODUCTION	1
1.1 RESEARCH MOTIVATIONS.....	1
1.2 MAJOR FINDINGS.....	10
1.3 CONTRIBUTIONS	12
1.4 THESIS STRUCTURE	13
CHAPTER TWO.....	15
THE IMPACT OF INTERNAL CORPORATE GOVERNANCE ON AUDITOR CHOICE	15
2.1 LITERATURE REVIEW.....	15
2.1.1 <i>Audit Utility and Audit Quality</i>	15
2.1.2 <i>Corporate Governance, Opaqueness Gains, and the Monitoring Role of Audits</i>	18
2.2 HYPOTHESES DEVELOPMENT.....	25
2.3 RESEARCH METHODOLOGY	34
2.3.1 <i>Model Specification</i>	34
2.3.2 <i>Sampling</i>	38
2.4 EMPIRICAL RESULTS.....	41
2.5 SENSITIVITY TESTS.....	43
CHAPTER THREE.....	45
THE IMPACT OF INTERNAL CORPORATE GOVERNANCE ON AUDITOR SWITCH.....	45
3.1 HYPOTHESIS DEVELOPMENT	45
3.2 RESEARCH METHODOLOGY	46
3.2.1 <i>Model Specification</i>	46
3.2.2 <i>Sampling</i>	50
3.3 EMPIRICAL RESULTS.....	52
3.4 SENSITIVITY TESTS.....	54
CHAPTER FOUR	56
THE MARKET IMPLICATIONS OF AUDITOR CHOICE AND AUDITOR SWITCH.....	56
4.1 LITERATURE REVIEW.....	56
4.1.1 <i>Information Quality, Information Credibility and Audit Quality</i>	56
4.1.2 <i>Earnings Response Coefficients</i>	58
4.1.3 <i>Earnings Management in the US and in China</i>	59
4.1.4 <i>Auditors' Role in Curbing Earnings Management</i>	64
4.1.5 <i>Auditor Switch and its Market Implications</i>	66
4.2 HYPOTHESIS DEVELOPMENT	67
4.3 RESEARCH METHODOLOGY	72
4.3.1 <i>Model Specification</i>	72
4.3.2 <i>Sampling</i>	75
4.4 EMPIRICAL RESULTS.....	78
4.4.1 <i>Results for Firms with Positive Abnormal Earnings</i>	78
4.4.2 <i>Results for Firms with Negative Abnormal Earnings</i>	80
4.5 SENSITIVITY TESTS.....	81

CHAPTER FIVE	84
CONCLUSIONS.....	84
5.1 SUMMARY	84
5.2 LIMITATIONS	89
5.3 FUTURE RESEARCH OPPORTUNITIES.....	90
APPENDIX: RANKING OF AUDITORS IN CHINA.....	92
REFERENCE	93