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# Executive integrity, audit opinion, and fraud in Chinese listed firms<sup>☆</sup>

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### ABSTRACT

We examine the influence of auditors on mitigating corporate fraud in China, which is known to have weak legal enforcement, weak investor protection along with tight control of the media and labour unions. We find that firms with executives that have lower integrity, indicated by a greater degree of earnings manipulation, are associated with higher propensity of regulatory enforcement actions against corporate fraud in the subsequent year. We show that this effect is moderated by the issuance of a modified audit opinion report by the auditors. This finding implies that auditors can serve as external governance mechanism to discourage executives with lower integrity in committing fraud. Our results have policy implications for further strengthening auditor independence in emerging countries like China.

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## 1. Introduction

In this paper, we seek to examine whether auditors contribute to corporate fraud deterrence in China. Over the past decade, a string of financial scandals and high profile corporate frauds have shaken investor confidence and increased financial market instability in many developed economies. Following the most

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recent financial crisis, where corporate governance deficiencies were seen to result in fraud in its most extreme cases, is a topical issue and has prompted regulatory reform in both developed and emerging markets. The Dodd–Frank Act in United States (“the US”), and the *Interim Measures for the Supervision and Administration of Integrity in the Securities and Futures Markets* and *Code for Governance of Securities Companies* in China are examples of such reactions to calls for regulatory reform. In many emerging markets however the weakness of internal and external control mechanisms remains to be a serious problem. In such institutional environments, managerial integrity plays a crucial role in mitigating corporate fraud while auditors serve an increasingly important function as an alternative control mechanism. Since China is seen as a leading emerging economy yet one that is in transition, we believe our study has wider implications for other developing countries.

Integrity is defined by Erhard et al. (2007) as “a state or condition for being whole, complete, unbroken, unimpaired, sound, perfect condition.” They distinguish between integrity for an individual as being solely a matter of that person’s word, and for a group or organizational entity as being comprised solely of what is said by or on behalf of the group or organization. They argue that for these entities to have integrity, they must honor their words. Jensen et al. (2004) suggests that integrity may be lacking in the course of financial reporting choices, as managers are motivated to manage “street” expectations. They argue that “managing earnings” amounts to lying to shareholders to whom managers have fiduciary responsibilities. Based on these arguments, the degree to which firms manage their earnings can serve as an empirically observable proxy for managerial or executive integrity. Dikolli et al. (2012) provide empirical evidence of an association between managerial integrity and earnings management. They measure CEO integrity based on employee surveys and annual shareholder letters. They find that the CEO integrity measure is positively related to earnings quality as measured by accruals. We note of course, that in addition to managerial integrity, earnings management can also be affected by weaknesses in internal and external control. Therefore, we believe to empirically research the application of earnings management measures as a proxy of CEO integrity, it is important to control for corporate governance characteristics.

Top management characteristics have also been identified as an important determinant of corporate fraud (e.g. Ashforth and Anand, 2003; Baucus, 1994), where fraud is defined as the deliberate actions of management to deceive, swindle, or cheat investors or other stakeholders (Zahra et al., 2005). Other determinants identified by extant literature includes organization culture (e.g. McKendall and Wagner, 1997), board composition (e.g. Dunn, 2004), regulatory conditions (e.g. Hou and Moore, 2010), environmental hostility (e.g. Baucus and Baucus, 1997), environmental dynamism (e.g. Hansen et al., 1996), industry cultures (e.g. Baucus and Near, 1991), and industry concentration (e.g. McKendall and Wagner, 1997). Black (2005) classifies corporate fraud into opportunistic and reactive. The former occurs when executives seize an opportunity for enhance gains by manipulating disclosure and the latter occurs when executives respond to declining firm performance by window dressing financial statements. Corporate fraud results in serious consequences to stakeholders, employees, and the wider society (e.g. Davidson and Worrell, 1988; Szwajkowski, 1985; Zahra et al., 2005) therefore it follows that fraud deterrence has been widely studied. In terms of fraud deterrence however, the literature largely focuses on internal corporate governance mechanisms. For instance, board independence, the existence of an audit committee, and the presence of accounting and banking professionals on the committee decreases the incidence of fraudulent activities (see Beasley, 1996; Beasley et al., 2000; Dechow et al., 1996; Uzun et al., 2004). Denis et al. (2006) find that option intensity in CEO remuneration encourages risk taking and induces fraud, while Erickson et al. (2006) show that the exercise of executive options and sales of executive stocks are not significantly higher for fraudulent firms. External governance mechanisms such as investors, employees, analysts, auditors, media, and regulators are relatively less examined in the literature. Among them, Dyck et al. (2010) provide evidence that investors and auditors contribute less to fraud detection in the US than employees, media, and industry regulators.

China provides a unique setting to examine the efficacy of deterrence mechanisms against fraud due to its institutional setting as a transitional economy. Compared to Western developed countries, China is known to have weak legal enforcement and shareholder protection (Allen et al., 2005) as well as tight control of the media (Besley and Prat, 2006) and labor unions. As a result, external governance mechanisms are expected to be less effective compared to internal governance mechanisms. Indeed, studies of fraud deterrence in China have also largely focused on internal governance mechanisms and

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