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Accounting fraud, auditing, and the role of government sanctions in China☆

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ABSTRACT

We use the unique economic, legal, and political landscape of China to examine the impact of auditors on the incidence of accounting fraud. In particular, we examine whether large audit firms reduce the incidence of financial statement fraud in China, an emerging market in which auditors face strong government sanctions but low litigation risk associated with audit failures. We find that companies audited by large audit firms are less likely to commit financial statement fraud. This effect is stronger for regulated industries and for revenue-related frauds. Our results are robust to considering the severity of fraud, excluding firms cross-listing in other jurisdictions, using alternative measures of fraud, accounting for the self-selection of auditors, and controlling for other corporate governance mechanisms. Our results highlight the role of government sanctions in assuring audit quality and have important practical implications to help international audit firms – and businesses more generally – successfully compete in China.

1. Introduction

China is now the world's second largest economy and growing at a faster rate than most western countries. The size and growth of China's economy present many business opportunities. However, understanding China's unique economic, legal, and political landscape is imperative for any firm to successfully compete in China. One of the prominent differences from the west is the direct role the government plays in detecting and dealing with accounting fraud. We focus on the relation between auditor size and the incidence and consequences of financial statement fraud in China, an environment where auditors face negligible litigation risk but severe government sanctions for audit failures.

The goal of an independent audit is to provide reasonable assurance that financial statements are free from fraud or material error. Auditing is thus essential in ensuring the proper functioning of the financial reporting system. Some studies find that large audit firms provide higher quality audits using data from countries where auditors face significant litigation risk (Francis & Krishnan, 1999; Khurana & Raman, 2004; Lennox & Pittman, 2010). In contrast, other studies find no difference in audit quality between large and small audit firms in countries with a relatively low level of legal protection for claimholders (Hope & Langli, 2010; Jeong & Rho, 2004).

Using China as a setting, where auditors face negligible litigation risk but harsh sanctions from government agencies for providing low quality audits, we examine whether large audit firms reduce the incidence of financial statement fraud. On the one hand, litigation against auditors in China is very rare. The court only accepts fraud case allegations *after* the government has already sanctioned the auditor for fraud (see "Several Regulations about Fake Statement Litigation in Security Market (2003)" enacted by the Supreme People's Court). Although few cases have been brought to court, there has *never* been a successful case of shareholder litigation against an auditor due to low audit quality. Given this legal environment, it is not clear whether auditors in general and large auditors in particular have sufficient incentives to provide high quality audit services.

On the other hand, government agencies such as the Chinese Security Regulatory Committee (CSRC) and the Ministry of Finance sanction audit firms that fail to detect and report fraud in clients' financial statements (Firth, Mo, & Wong, 2005). The Chinese government is motivated to improve financial statement quality in order to attract foreign investment. Depending on the severity of the fraud, the penalties for audit firms range from fines, to reprimands, to suspension of audit work, to revoking licenses.

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We seek to shed light on whether government sanctions can substitute for claimholder litigation in ensuring audit quality. Using all government enforcement actions against companies in China whose financial statements are challenged by government agencies for accounting malfeasance, we identify 270 financial statement frauds committed during 1999–2005. We find that the incidence of fraud declines over our sample period. We also find that, despite a very different legal landscape, government sanctions in China appear to have a similar effect on audit quality as litigation does in the U.S. Importantly, we show that clients audited by large accounting firms are less likely to commit financial statement fraud.

Certain industries are more heavily regulated and monitored by the CSRC due to strategic considerations (Tian & Estrin, 2008; Wei, Xie, & Zhang, 2005). These industries include energy, iron and steel, oil refinery and petrochemicals, communications, and heavy machinery. Since these industries potentially pose a higher risk of government sanctions for financial fraud, we expect and find a more negative relation between audit firm size and financial statement fraud in these industries.

In China, revenue-related fraud is more consequential than asset-related fraud because income performance is an important criterion for initial public offerings, rights offerings and maintaining exchange-trading status (Aharony, Lee, & Wong, 2000; Chen & Yuan, 2004). In addition, investors rely on accounting earnings to evaluate a company's performance. Firth et al. (2005) find that auditors are more likely to be sanctioned when they fail to detect and report revenue-related fraud compared with asset-related fraud. Accordingly, we partition the sample into revenue-related and asset-related fraud. We find that the negative association between fraud and auditor size is stronger for revenue-related fraud than for asset-related fraud.

Some firms in our sample are cross-listed in other countries and regions such as the U.S. or Hong Kong, or have B-shares. As a result, such firms are potentially subject to both government sanctions and litigation risk. In order to provide a cleaner sample of firms that are subject to government sanctions only, we drop these cross-listed firms and find that our results remain robust.

Our results are also robust to considering the severity of fraud as measured by the punishment imposed after the fraud is discovered. Our inference regarding the relation between auditor size and the incidence of fraud remains robust to accounting for the self-selection of auditors and controlling for corporate governance mechanisms that potentially reduce the incidence of fraud. Finally, we examine alternative measures of fraud by investigating high abnormal accruals and find similar results.

Our study contributes to the academic literature on three levels and has important implications for firms looking to compete in China. First, our study furthers our understanding of China's unique economic environment. As a developing country with a very different legal landscape to the U.S., China presents a low litigation risk environment for businesses including audit firms. However, the Chinese government is motivated to improve financial statement quality in order to attract foreign investment. For example, the former Chinese Premier Zhu Rongji set ‘No Fictitious Records’ as a motto for the Shanghai National Accounting Institute at its Inauguration Ceremony in 2001. Thus, the government uses an alternative mechanism to litigation, namely government sanctions, to ensure high quality audits. Understanding this feature is important for international audit firms who intend to successfully compete in China. For example, if an audit firm draws from its experience in the U.S. where the threat of litigation is a key driver of audit quality, the firm might erroneously conclude that it can get away with lower quality audits in China absent such litigation risk. However, our findings suggest that government sanctions in China substitute for litigation risk to ensure audit quality.

Second, our paper also has implications for client companies successfully competing in China's capital markets. We document that firms using larger audit firms are less likely to be sanctioned by the Chinese government. The accounting literature generally suggests that larger auditors provide higher quality audits and this brings economic benefits to client firms in the capital markets. For example, clients of larger auditors exhibit higher earnings quality (Teoh & Wong, 1993) and lower underpricing when they undertake an initial public offering (Hogan, 1997). In addition, firms switching from small auditors to large auditors tend to experience a positive stock market reaction (Knechel, Naiker, & Pacheco, 2007). Thus, a key implication of our results is that hiring a large audit firm in China ensures higher audit quality (i.e., lower fraud rate), which translates into economic benefits for client firms in the capital markets. Hiring a large audit firm in China helps client firms successfully compete in China.

Third, we add to the audit literature by suggesting that government discipline potentially serves as an alternative mechanism to litigation to ensure high quality audits. As Allen, Qian, and Zhang (2011) argue, the alternative mechanisms found in many fast-growing economies can be superior to using the law as the basis for finance and commerce. Our findings thus have potential policy implications for other countries with a less litigious environment. Public enforcement (government sanctions) may be able to substitute for private enforcement (class action law suits) to ensure high quality audits in these countries.

Our paper proceeds as follows. In Section 2, we discuss the institutional background of the audit market in China and review the relevant literature. In Section 3, we develop our main hypothesis and specify the research design. Section 4 presents the sample selection process and the descriptive statistics. Section 5 reports the empirical results and additional analyses and Section 6 concludes.

2. Institutional background and literature review

Since the 1978 economic reforms, interest in business practices in China has grown substantially. China's fast growing economy presents numerous opportunities for firms in China as well as for foreign firms considering entering China's capital markets. The subsequent rapid development of China's capital market has created a demand for high quality external audits. Chinese regulators have also taken steps to improve audit quality in order to attract foreign investment and to restructure state-owned enterprises. For example, the Chinese Institute of Certified Public Accountants was established in 1988 to regulate Certified Public Accountants (CPAs). The CPA Act, which mandates that auditors be indicted for fictitious audit reports, was enacted in 1993. In 1995, the Ministry of Finance adopted a new set of auditing standards that are closely modeled after the International Auditing Standards. The China Securities Regulatory Commission (CSRC) and the Ministry of Finance introduced the Audit Firm Disaffiliation program in 1997 to sever ties between CPA firms and government agencies. The CSRC has also issued several regulations since 2000 to encourage the mergers of small- and medium-sized audit firms into larger firms.

Despite significant regulatory reforms, however, the role of the auditor in assuring accounting information quality in China's capital markets is still unclear. The major concern is derived from the legal landscape in China. Litigation risk is a major factor ensuring high quality audits in developed countries such as the U.S. In contrast, suing auditors in China is rare and to date there has not been a successful case of shareholder litigation against auditors.

Although litigation risk is negligible, auditors who provide low quality audit services in China do bear other risks, namely government penalties. Both the CSRC and the Ministry of Finance have authority to monitor and sanction audit firms that fail to detect and report financial statement fraud such as misreporting income, misreporting assets and liabilities and facilitating fictitious transactions. Chapter 10 of The Security Law delegates the CSRC as the main regulator of security markets in China, which has authority to investigate and sanction listed companies and market intermediates (including auditors) involved in securities fraud and malpractice. The CSRC regularly reviews and randomly inspects listed companies, especially when they receive complaints from investors or the media. Once a financial statement fraud is