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Government ownership, audit firm size and audit pricing: Evidence from China

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A B S T R A C T

The present study provides empirical evidence on the impact of government ownership on audit pricing behaviour based on data from Chinese listed companies between 2001 and 2008. Our findings, having controlled for auditor choice, indicate that state-owned enterprises (SOEs) incur significantly lower audit fees than non-SOEs. The results also reveal a significant interaction between the type of SOE (i.e., owned by central vs. local government) and audit firm size, which also affects audit fees. More specifically, large auditors tend to charge the central-SOEs lower audit fees than local-SOEs (province, city and county), while small auditors charge central-SOEs higher fees than local-SOEs. We explore a political economy rationale from a supply-side perspective in explaining the results.

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1. Introduction

The impact of government ownership on audit fees remains largely under-studied despite the development of an extensive body of literature on audit pricing over the last few decades (e.g., Hay et al., 2006). The growing debate on the effects of government ownership on perceived business risks and corporate governance (Faccio, 2009; Gul, 2006) nevertheless warrants further study in this area. The present study addresses this gap in the audit literature by examining the impact of government ownership, type of state-owned enterprises (SOEs) and audit firm size on audit fees using data of Chinese listed firms from 2001 to 2008. More specifically, the present study examines whether (i) there is

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a significant difference in audit fees between SOEs and non-state owned enterprises (hereafter non-SOEs), and (ii) there is an interaction between the type of government ownership, (i.e., local-versus central-SOEs) and audit firm size affecting audit pricing of SOEs.¹

In doing so, we adopt a supply-side perspective and draw on the political economy literature (Leuz and Oberholzer-Gee, 2006) to argue that business risks tend to vary with the extent and type of government ownership, and that they, in turn, affect audit risk assessment and ultimately audit fees. In addition, we contend that undertaking the present study within the Chinese capital market context is warranted and timely as it is characterised by varying levels of government ownership of business entities and a highly competitive audit market (Chen et al., 2007). Furthermore, the Chinese capital market, fuelled by a rapidly developing national economy, is increasingly looking to the auditing profession to enhance market reliability and efficiency. Thus, further research on audit fee behaviour in China is likely to inform issues related to both auditor independence and audit quality management. Empirical evidence on government ownership and audit fee behaviour in China, with the exception of that provided by Wang et al. (2008), however, remains scant. Evidence based on Wang et al.'s (2008) analysis of Chinese firm data for the period 2001–2003 suggests that compared to non-SOEs, SOEs (both local and central) tend to choose small local auditors.² However, further analysis of the implications of firm ownership and auditor fees indicates inconsistent findings. As noted by Wang et al. (2008), “compared to non-state firms (non-SOEs) the (fee) discount is smaller for central-SOEs but not for local-SOEs, consistent with our demand argument for central-SOEs but not for local-SOEs” p. 128.

Our study extends and complements prior studies in two ways. First, we utilise data with a longer timeframe (2001–2008) of Chinese listed firms so as to capture the effect of various regulatory and accounting professional developments on audit fees in China in recent years. In particular, investor awareness and activism have substantially grown as a result of corporate misbehaviour and scandal (Chen et al., 2010). For example, Chen et al. (2010) note that subsequent to the Supreme Court issuing a Notice on accepting civil lawsuits against false statements in the securities market in 2002, an unprecedented escalation of lawsuits has occurred against firms and auditors. The developments, in turn, have increased the pressure on corporate governance including audit choice and quality. However, empirical evidence on audit pricing behaviour in this rapidly evolving environment remains scant.

Second, unlike Wang et al. (2008) who had predominantly undertaken an audit demand approach to rationalising audit fee behaviour, we explore a supply-side perspective drawing from the political economy literature for understanding the impact of government ownership on audit pricing. More specifically, central to Wang et al.'s (2008) argument is that the demand for small local auditors by SOEs in general may explain the lower fee discounts incurred by such entities. However, their results, as noted above, were not consistent with those predicted by an auditor choice rationale in the case of local SOEs relative to non-SOEs. Given these mixed results, we explore a supply-side perspective (i.e., auditors' viewpoint) to better understand audit behaviour from an alternative viewpoint. More specifically, given that there are political benefits to be gained from association with SOEs, it is likely auditors' perceptions of overall audit risk of clients may be affected by the nature of ownership of the firm (i.e., government or not), which ultimately may affect their audit pricing. Given that such a perspective remains largely neglected in extant studies on audit fee behaviour of Chinese firms, such an approach appears appropriate and worthy of further consideration.

The rest of the paper is organized as follows. Section 2 provides discussion of hypotheses development followed by a delineation of the research method in Section 3. Section 4 presents empirical results including robustness tests, and Section 5 discusses conclusions.

¹ In this study, in a similar vein to Wang et al. (2008), we distinguish government ownership as being either local or central government. Local-SOEs pertain to firms owned by provincial, city and county governments, while central-SOEs refer to firms owned by the central government.

² Wang et al. (2008) define small local auditors as auditors that are small (non-top 10) and from the same locality as their clients.

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