

ABSTRACT

Firm Ownership, Institutional Environment, and Audit Collusion: Empirical Evidence from A Transitional Economy

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Motivated by the renewed interest in, but insufficient empirical evidence of, collusion between auditors and corporate management, I examine this issue in the unique environment of China, which is characterized by a high level of government control over listed companies and auditors, strong competition for audit clients, and uneven economic and legal development across the country. In contrast to prior studies, I employ a two-stage regression approach to study the determinants of audit collusion in China. In the first stage, I develop an audit opinion prediction model of Big 4 auditors (viewed as “typical” auditors) that corrects for self-selection bias. I then apply this opinion prediction model to clients of non-Big 4 (local) auditors. I define audit collusion as the discrepancy between the *actual* opinions that clients of local auditors received and the opinions these clients would have received under similar circumstances had they hired typical auditors (i.e., Big 4 auditors): that is, the *predicted* opinions. In the second stage, I regress an audit collusion proxy on client and auditor characteristics and institutional variables to detect the determinants of audit collusion in China.

Audit collusion depends on the closeness of the relation among three parties – the company owner, the company manager, and the auditor. Prior studies suggest that state-owned enterprises (SOEs) and local auditors have the closest relationship and that their interests are mostly aligned. As audit qualification and client loss are costly for SOE managers and local auditors, respectively, both parties have strong incentives to abide by a self-enforcing collusive agreement. Therefore, I expect audit collusion to occur in SOEs that demonstrate poor firm performance (which could lead to qualified opinions), in listed companies that are characterized by a strong government presence and the audit reports of which are subject to government interference, and when market forces are not strong enough to deter collusive behavior.

Using a sample of 4,874 firm-year observations over the 2001-2006 period, I find statistically robust evidence to confirm my hypotheses. Specifically, I find that SOEs in poor financial condition and for which the government is the largest shareholder

tend to collude with their auditors. In addition, I find that the relation between non-SOEs (regardless of their financial condition) and audit collusion to be significantly negative, which suggests that the interests of non-SOEs are mostly aligned with the interests of individual investors. Consistent with prior studies, I also find that audit collusion usually occurs in regions in which the underlying institutional features of the market environment are not in place to punish auditors.

Prior research generally uses auditor switching to test for the existence of collusive auditor behavior by comparing observed pre- and post-switch audit opinions. As a result, relatively little attention has been paid to the possibility of audit collusion in the absence of auditor switching. Moreover, comparison of observed opinions before and after companies switch auditors is subject to potential self-selection bias, as post-switchers are not randomly assigned to audit firms. The present study overcomes these problems by considering all listed companies (regardless of auditor switching) and using the two-stage Heckman approach to control for self-selection bias. Further, in contrast to most prior research, which uses an analytical model to distinguish honest and dishonest auditor reporting, I empirically test collusion by comparing the difference between the actual opinions that client firms receive and the opinions they would have received had they used independent, higher quality auditors.

My results suggest that as long as the interests of the company and the auditor coincide and neither party has an incentive to break the collusive agreement, audit collusion can occur even when auditor switching does not take place. The finding that audit collusion exists in China suggests that government rules and regulations alone are not sufficient to create a healthy audit market. Rather, the government should improve the overall institutional environment through measures such as the reduction of government ownership of firms, withdrawal of the government from involvement in both the stock and audit markets, and development of a credit market and legal environment that deter collusive auditor behavior.