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Effect of auditing: Evidence from variability of stock returns and trading volume

Charles J.P. Chen [a], Bin Srinidhi [b,*], Xijia Su [a]

[a] China Europe International Business School, 699 Hongfeng Road, Pudong, Shanghai, PR China
[b] University of Texas Arlington, USA

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ABSTRACT

Although the benefits of auditing are uncontroversial in developed markets, there is scant evidence about its effect in emerging economies. Auditing derives its value by increasing the credibility of financial statements, which in turn increases investors' reliance on them in developed markets. Financial statement information is common to all investors and therefore increased reliance on it should reduce divergence in investors' assessment of firm value. We examine the effect of interim auditing on inter-investor divergence with a large sample of listed Chinese firms and find that it decreases more for firms whose reports are audited compared to non-audited firms. This finding suggests that investors rely more on audited financial information. Results of this study are robust to variations in event window length and specification of empirical measures.

1. Introduction

Global competition for scarce financial resources has made it important for emerging economies to stimulate the investment environment by improving the information that is available to ordinary investors. Emerging economies like China have responded by undertaking two approaches to reducing the divergence between sophisticated and other investors both in the public information made available to all investors and making it easier for the public to invest: improving market and legal institutions; and regulating auditing and related institutions to improve the credibility of financial statements. China set up the Shanghai and Shenzhen stock exchanges in the early 1990's and undertook major legal and market reforms in 1992. On

* Corresponding author.
E-mail addresses: ccharles@ceibs.edu (C.J.P. Chen), srinidhi@uta.edu (B. Srinidhi), sxijia@ceibs.edu (X. Su).

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the regulatory side, it re-established the auditing profession in 1980, allowed international audit firms to practice in China in 1992, established legal penalties for violating audit standards in 1992, promulgated the first set of independent auditing standards in 1995, made audit firms independent of local governments in 2000, made auditors responsible for damages suffered by investors from audit negligence from[1] 2005 and adopted international accounting and auditing standards in 2007. Similar measures have been adopted by other developing economies.

Improving the reliability of financial statements by better auditing is beneficial to ordinary investors only if such improvement makes a discernible difference in asset pricing. Otherwise, the demand for auditing will collapse and even if auditing is mandatory, audit quality will race to the bottom. While the beneficial effects of auditing in developed economies where investors are sophisticated and auditors face high legal and reputation costs are widely recognized (see US based evidence such as in Brown and Pinello, 2007), there is little evidence[2] that auditing benefits investors in emerging economies with less developed markets.

From a policy perspective, for developing economies that face competing demands for scarce resources, it is not clear whether establishing auditing as an independent institution[3] prior to establishing effective legal and market institutions[4] will lead to a lower divergence between investors and greater confidence among ordinary investors. A resolution of this issue demands the collection of systematic evidence on the effect of auditing in emerging markets. Such evidence is scarce. This paper provides evidence supporting the beneficial effects of auditing in an emerging economy.

Financial statement information affects stock prices in two ways. The first is the price effect. Beaver (1968) points out that price changes in response to earnings announcements reflect the average change in traders' beliefs. However, the average hides differential reactions between traders who rely solely on public information and sophisticated investors who develop private information in anticipation of the earnings announcement (Kim and Verrecchia, 1997). This divergence between investors is captured by stock return variability and trading volume (Callen, forthcoming; Beaver, 1968). A complete analysis of the effect of auditing calls for an examination of *inter-investor divergence*[5] in addition to *average* price changes. We argue that a reduction in inter-investor divergence – a more level playing field – creates greater confidence among ordinary investors and creates an environment that stimulates investment.

Haw et al. (2008) examines the price effect of auditing in China using a window of opportunity in which numerous listed Chinese firms had their *semi-annual* statements voluntarily audited by external auditors (annual audits are mandatory). They show that earnings response coefficients (ERC) of audited firms are higher than those for non-audited firms. In contrast, we investigate the effect of auditing on inter-investor divergence, using two measures: variability of risk-adjusted abnormal stock returns and trading volume. This approach differs from the ERC approach in three important ways. First, it captures the differential effects of auditing whereas ERC captures the average effect. Second, returns variability and trading volume encompass the overall

[1] The *Act about the Acceptance of Tort Cases Caused by Fraudulent Financial Reporting in Security Market* enacted by the Chinese Supreme Court in 2002 defined individual auditor's liability for damages to investors for undetected material misstatements and the *Act of Security,* passed in 2005 mandates that auditors be held liable for damages to investors.

[2] Chinese and other emerging markets exhibit some market tensions because of weak country-level governance, weak legal and extra-legal institutions and political economy variables (Craig, 2005; Leahy, 2004) that might reduce the overall reliability of financial statements (LaPorta et al., 1998; Haw et al., 2004; Dyck and Zingales, 2004). A strand of recent literature, however, has addressed the differential effect of auditing on the reliability of financial statements and suggests that auditing substitutes for weakness in the institutional variables mentioned above (Srinidhi et al., 2008; Choi et al., forthcoming). The results of this study are consistent with the argument that the effect of auditing in these emerging markets is in fact, stronger than in the more developed markets.

[3] Establishing the audit institution and making it effective is costly. The cost includes the costs of training and certifying competent auditors and setting up a structure in which they can provide independent opinions in addition to the cost incurred by all listed firms in getting their financial statements audited.

[4] The issue is NOT whether auditing should be promoted at all. The issue is the sequence in which reforms are undertaken. If auditing has a direct effect on asset pricing even when the legal and market institutions are weak, a reform of the auditing institutions should be undertaken early in the sequence of reforms. On the other hand, if auditing is only effective in a sophisticated market with strong legal and market institutions, audit reform is best undertaken after building those institutions.

[5] We use the term "inter-investor divergence" instead of "information asymmetry" in this paper to denote inter-investor differences in information, because the term "information asymmetry" has the connotation of information differences between managers and investors, which is not the focus of this study.