



Address forms in Chinese audit opinions



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ABSTRACT

Although forms of address are widely used in textual and other types of disclosure, empirical evidence of their effects is rare. China provides a unique setting in which to test the economic consequences of the forms of address used in audit reports. From 2003 to 2011, about 60% of auditors surveyed addressed their clients by their real names in audit opinions, while the others used honorifics. Based on a sample of Chinese audit opinions, I report the following findings. First, the announcement of an audit opinion that uses the client's real name elicits a greater market response than the announcement of an opinion featuring an honorific form of address. Second, the effects of real-name forms of address are stronger in firms with weak board governance. Third, the association between audit fees and audit risk factors, such as loss-making, is stronger in firms that are addressed by their real names in audit reports. I conclude from these findings that the forms of address used in audit opinions may reveal private information on audit quality. The results of this study are consistent with the power-solidarity effect described by sociolinguists.

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1. Introduction

Digital indicators are widely used in financial reports to communicate private information. In addition to numerical information, textual information plays an important role in corporate disclosure. With the development of computer technologies, the textual analysis of financial reports has become increasingly common in developed capital markets. However, powerful tools for analyzing textual information are rare in China. For example, no emotion-mapping dictionary is available for use with Chinese financial reports. Therefore, Chinese audit reports provide a unique opportunity to examine the consequences of different forms of address. Due to the traditional politeness principle embedded in the Chinese language, two main types of address can be observed in audit opinions. From 2003 to 2011, about 60% of clients surveyed were addressed by their real

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names, while the others were addressed using honorifics ('guì gōng sī'). The clear distinction between these two types of address makes it easy to empirically analyze forms of address in Chinese audit opinions.

In ancient China, particular styles of writing were used to communicate political opinions. In a classic text entitled *Chūn qiū*, Confucius used subtle words to convey profound meanings. The aim of this research was to determine whether auditors select forms of address to disclose specific information about audit quality. I test two hypotheses, based respectively on the theories of audit quality and sociolinguistic theory. I find that audit opinions that address clients by their real names yield greater market returns than opinions featuring honorific forms of address. I also find that the effects of forms of address are more pronounced in firms with weak board governance. Finally, the relationship between audit fees and audit risk factors, such as loss-making, is stronger in firms addressed by their real names in audit opinions than firms addressed using honorifics. Viewed collectively, these findings suggest that independent auditors have a greater incentive to address clients by their real names. The results are consistent with the power-solidarity effect described by sociolinguists.

This study contributes to the literature in the following ways. First, it provides further evidence on textual disclosure via forms of address. The results show that the rules of the Chinese language affect communication between a company and its investors. Second, the findings of this paper suggest that investors distinguish between 'clean' opinions by textual differences, as the imperative of client confidentiality prevents potential investors from viewing unaudited financial reports. This conclusion may shed light on the insufficiency of information in the existing audit-report system. Finally, the results of the study indicate that digital indicators such as board independence are related to the consequences of textual information, suggesting that textual and numerical information interact.

The remainder of the paper is organized as follows. Section 2 provides background information on the topic under study, such as a review of the relevant literature in the fields of audit quality and sociolinguistics. In Section 3, I describe the study's methodology, with attention to the research sample and model. Section 4 provides the results of tests of the consequences of different forms of address. I conclude the paper with a summary of the findings and their implications for future research.

2. Address forms in audit reports: background and relation to past research

Despite important research on the information content of English-language text, evidence of the effects of forms of address is rare. China provides a unique setting in which to analyze the forms of address used in audit reports. I propose that auditors' choice of address affects the market reaction to audit reports. This hypothesis is based on three assumptions. First, as an unaudited financial report cannot be observed by investors, auditors have an incentive to reveal information on audit quality. Second, common guidelines for modes of address are accepted by all stakeholders in China's capital market. Third, there is some variation in the forms of address used in audit reports, due to power-related motives and the Chinese tradition of polite language.

2.1. Are all clean opinions the same?

I focus on clean opinions because they are not differentiated by numerical information. The audit quality of a client firm that receives a clean opinion depends on the quality of the client's unaudited financial report. However, investors cannot observe unaudited financial reports, due to client confidentiality. Auditors issue clean opinions to three types of clients. Firms in the first category receive clean opinions in return for high-quality unaudited reports. Second, firms that offer poor-quality unaudited reports but accept all of their auditors' suggestions for adjustment also receive clean opinions. Firms of the third type, which offer poor-quality reports and refuse to make all of the adjustments proposed by auditors, receive clean opinions only if the risk of litigation is low. Clearly, the audit quality of the second type of firm is higher than that of the third type. However, it is difficult to evaluate the audit quality of firms in the first category. Investors cannot differentiate between firms that receive clean opinions in return for high-quality reports because the audit service is unobservable. Some researchers argue that auditors are under pressure to issue unmodified opinions because modified opinions have a huge negative effect on clients (Sun and Wang, 1999; Zhao, 2007; Simunic and Wu, 2009). However, other researchers point out that auditors have an incentive to circumvent pressure from investors and regulators, and thus engage in collaborative governance with independent directors (Zhao and Zhou,

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