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Does the transformation of accounting firms' organizational form improve audit quality? Evidence from China[☆]

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ABSTRACT

In this study, we examine the effects of the transformation of accounting firms' organizational form on audit quality. We find that the transformation from limited liability to limited liability partnerships has a significant negative effect on the absolute value of discretionary accruals of audited companies. In particular, the transformation has a significant negative effect on positive discretionary accruals and no effect on negative discretionary accruals. We also find that CPAs are more likely to issue modified audit opinions in the year after the transformation, and that there is no evidence that accounting firm size and listed company ownership influence the relationship between the transformation and audit quality. Our conclusions provide empirical evidence for policy makers and enrich the literature on accounting firms' organizational forms.

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1. Introduction

Along with the reforms to China's economy, Chinese accounting firms have undergone rapid development. At present, there are more than 7400 accounting firms, over 8.5 million CPAs and nearly 30 million employees in China. The scopes of the audit business and accounting firms have gradually increased, along with steady improvements in the special capabilities of CPAs and the CPA industry's regulatory standards, making CPAs an indispensable force for healthy economic and social development. However, due to CPAs' weak foundations, poor audit quality has attracted attention within the rapid development of accounting firms. In recent years, CPAs' credibility has been increasingly questioned due to frequent cases of accounting fraud.

To accelerate the healthy development of China's CPA industry, in 2010 the State Council and the Ministry of Finance issued "The Notice Regarding Several Opinions on Accelerating the Development of the Chinese CPA Industry" (Guo Ban Fa [2009] No. 56) and the Ministry of Finance and the General Administration for Industry and Commerce jointly issued "The Regulation on Promoting Large and Medium Accounting Firms to Transform to Limited Liability Partnerships" (Cai Kuai [2010] No. 12), hereafter referred to together as the "Regulations." In response, large accounting firms were the first to change their organizational form from limited liability to limited liability partnerships (LLPs). This change was expected to improve audit quality by increasing the legal liability of CPAs. In this study, we examine whether this unique transformation improves audit quality.

There have been no consistent conclusions made in extant theories on the correlation between such transformations and audit quality. From a risk perspective, the transformation from limited liability to LLPs increases partners' legal risks. According to the law, an accounting firm's partners must not only compensate for audit failures through the firm's total investment, they may also need to use their personal assets to compensate for audit failures. Therefore, partners may devote more time and effort to supervising the implementation of audit procedures to improve audit quality. From an organizational perspective, accounting firms can benefit from changes in organizational form that provide for sharing and insurance for audit risks and more opportunities for CPA promotion. However, because the entire transformation process is dominated by the government, accounting firms can receive other benefits from the transformation. For example, "The Notice of Accounting Firm Commitment of Central Governance Enterprises" requires that, under the same conditions, large accounting firms that have undergone the transformation are recommended to engage in H-share business and receive priority for audit work for central government business groups. In addition, to participate in H-share business, accounting firms must be organized as LLPs. Therefore, transformation is required to obtain these benefits, which may lead to increased internal conflict of interests and reduced audit quality.[1] Due to the complicated nature of the transformation's effect on audit quality, this remains an open question to be addressed.

We use A-share listed companies from 2007 to 2012 to examine the effect of the transformation of accounting firms' organizational form on audit quality. We find that the transformation has a significant negative effect on the absolute value of discretionary accruals of audited companies. The results also show that the transformation significantly decreases the level of positive discretionary accruals, but has no significant effect on negative discretionary accruals. We also find that the transformation's positive effect on audit opinions only lasts for one year.

We also examine the transformation's effect on audit quality from the perspective of accounting and client firms' characteristics. Unfortunately, we find that accounting firm size and listed company ownership have no significant effect on the relationship between the transformation and audit quality. The transformation increases audit risk due to greater legal obligations, which makes the partners more cautious about undertaking audit work. Meanwhile, the partners are also more cautious in dealing with upward earnings management behavior, as it is more prone to audit failures. However, given the transformation regulations, the transformed accounting firms tend to be larger, but we do not find that our results differ by accounting firm size and listed company ownership.

[1] We appreciate the helpful suggestions of the chief editor, Professor Donghui Wu.