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# Auditors' Going Concern Reporting in the Pre- and Post-Bankruptcy Law Eras: Chinese Affiliates of Big 4 versus Local Auditors<sup>☆</sup>

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## Abstract

Unlike the situation in most developed countries, before the enactment of China's 2006 Bankruptcy Law it was difficult for Chinese-listed companies, which were mostly government owned, to declare bankruptcy. Our analysis of a sample of Chinese financially-distressed companies from 2001 to 2010 reveals that the Chinese affiliates of Big 4 auditors had a higher propensity to issue going concern (GC) reports than local auditors not only in the post-law period, but also in the pre-law period. This finding suggests that Big 4 auditors had incentives to maintain their reputations even when the clients' bankruptcy risk was low. We also find that there was a significant increase in local top-10 auditors' GC reporting propensity in the post-law period, which is consistent with the notion that the increased litigation/regulation risk due to the enactment of Bankruptcy Law has an effect on local large auditors.

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## 1. Introduction

Issuing a going concern (GC) opinion to a financially-distressed client is widely treated as a proxy for auditor performance (e.g., Carey & Simnett, 2006; DeFond, Raghunandan, & Subramanyam, 2002). Indeed, client bankruptcy has served as an *ex post* benchmark to assess auditor performance (e.g., Geiger, Raghunandan, & Rama, 2005; Hopwood, McKeown, & Mutchler, 1994; Mutchler, Hopwood, & McKeown, 1997). In most developed markets, publicly-traded companies exhibiting poor performance are faced with a real bankruptcy threat because there has long been an effective bankruptcy law.

However, until the enactment of China's Bankruptcy Law in August 2006, there was little room for Chinese-listed companies, which are mostly government owned, to file for bankruptcy. Distressed and insolvent firms were kept afloat and they were often subject to government-backed restructurings (Allen, Qian, & Qian, 2005; Kam, Citron, & Muradoglu, 2008). Despite this phenomenon, Chinese auditors did issue GC opinions to their listed clients even before the enactment of the Bankruptcy Law.<sup>1</sup> In this study, we take advantage of a setting in which there was a clear overall increase in bankruptcy risk for client firms to empirically examine different types of auditors' propensities to issue GC opinions before and after the enactment of the law.

Recent research has examined the role of Big 4 auditors in countries with varying levels of legal enforcement and investor protection (Choi, Kim, Liu, & Simunic, 2008; Choi & Wong, 2007; Francis & Wang, 2008; Khurana & Raman, 2004), and concerns have been raised that Big 4 auditors may not be of a higher quality in all contexts (e.g., when the risk of litigation is low). There has also been some discussion of whether audit quality differentiation exists in countries in which the Big 4 are not major players (Simunic, 2003). However, the findings so far are mixed and inconclusive (Choi & Wong, 2007; Francis & Wang, 2008). In China, most listed companies are audited by Chinese local auditors, and only about 6.5% of them were audited by Big 4 auditors during 2001–2010.<sup>2</sup> Therefore, the Chinese audit market provides an excellent institutional setting to further examine the issue. In addition, the Chinese Bankruptcy Law issued in 2006 can be used as a natural experimental cutoff to compare the reporting behavior of Chinese affiliates of the Big 4 auditors<sup>3</sup> with that of local auditors both before and after the enactment of the law.

Based on a sample of financially-distressed Chinese-listed companies from 2001 to 2010, we have three main findings:

- First, the Chinese Big 4 had a higher propensity to issue GC reports than the local top-10 auditors in the pre-law period, but that difference disappeared in the post-law period.
- Second, the Chinese Big 4 had a higher propensity to issue GC reports than do the local non-top-10 auditors in both the pre- and post-law periods.

<sup>1</sup> Appendix A summarizes two typical examples of GC opinions issued in China before the enactment of the Bankruptcy Law in 2006.

<sup>2</sup> According to China Stock Market and Accounting Research (CSMAR) Financial Database.

<sup>3</sup> "Chinese Big 4" hereafter, for brevity.

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