Audit Quality and Information Transparency of Audit Firms in China: A Constructive Framework

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ABSTRACT: After an investigation of the audit information transparency system of securities markets in China, we found that auditor firms, as an independent authentication third-party, disclosure their auditing information very limited, which impede investors to evaluate auditing quality. Based on agency theory and auditing independence theory, we analysis the relation between audit quality and information transparency and proposed some policy suggestion to improve audit information transparency of Chinese securities market, which include making the specification between compulsory disclosure and personalized disclosure content, strengthening the audit quality and disclosure of independence related information, establishing and improving the supervision of the audit business and credit system.

KEYWORDS: Audit firms; Information Transparency; Auditing Independence; Information Asymmetry

1 INSTRUCTIONS

Audited financial statements are a primary resource for investors’ evaluation of public companies. Financial frauds over the last decade focused attention on the role of auditors in the capital markets and caused securities regulators to examine more closely the reliability of public company financial statements, including ways to improve audit quality and the availability and delivery of audit services\textsuperscript{1} to public companies (IOSCO, 2009). But information transparency of audit firms is still low. Audit firms themselves, as important executives of listed companies’ information transparency system, are still a ‘black box’ which reveals so a few auditing relative information about themselves to public (Chen & Liang, 2011). Currently, audit firms principally compete on factors including reputation, size, industry expertise, and audit fees. Audit committees, investors, and other stakeholders have insight into these factors but have limited ability to provide market incentives for audit firms to compete directly on audit quality because of lack of significant transparency about how audit firms manage and compare in terms of audit quality.

China is a typical representative of new emerging security market. Some jurisdictions require audit firms to disclose certain information, but the result isn’t as good as expected. This paper analysis the relationship of audit quality and information transparency of audit firms, and proposes some measurements to enhance information transparency of audit firms.

2 INSTITUTIONAL BACKGROUND

2.1 Audit information transparency in domestic securities market

Corporate transparency refers to the widespread availability of relevant, reliable information about the periodic performance, financial position, investment opportunities, governance, value, and risks related to publicly traded firms (Bushman et al. 2004). Here information transparency means the extent of audit firms disclose their qualifications, credit and other executive information to public investors.

The Information Disclosure System of Certified Public Accountants and Public Accounting Firms was promulgated by Chinese Institute of Certified Public Accountants (CICPA) in 2007, which specifies the information disclosure of certified public accountants (CPA) and public accounting firms, and it is the symbol that an information disclosure system has been officially established in accounting industry in China. There are 13 terms in
the information disclosure system which includes principles, categories, contents, channels and responsibilities, etc.

Furthermore, Guidelines of Internal Governance for Accounting Firms was released in 2008 by CICPA, in purpose of achieving greater transparency and openness in how audit information shall be disclosed. According to Section 18, Chapter 9 (Information Communication and Disclosure) of the Guidelines, audit firms are encouraged to establish their specific disclosure regulations in order to disclose their information to public, which includes internal governance of the CPA firm, basic information about their shareholders and CPA, charging policy, audit risk control and quality guarantee system, serious violation of laws and regulation, and received penalties, etc.

So far the performance of domestic audit information disclosure system shows that listed companies disclose their audit relative information adequately, especially about audit fee and the change of CPA firms. But audit firms haven’t done well in audit information disclosure.

On the management information system public query platform of CICPA, investors can only see the audit firm’s basic registered information in Bureau of Industry and Commerce, such as firm’s name, phone number, approval file number and so on. Audit firms also release promotional information such as principal business category and operation performance, but these information is far from satisfying the stipulation of information disclosure system. Investors cannot get a few useful information to distinguish audit quality.

2.2 Audit information transparency in western securities markets

The Eighth Directive on Statutory Audits (Revised Edition) passed by European Union in May 2006 carried out mandatory requirements towards annual transparency reports of listed companies, which includes setting up registration centers to protect the third party, such centers should be open to the public and they should have the latest basic information of qualified CPAs; releasing annual authentic censorship reports about independent audit quality; publishing transparency reports its website when an audit firm conducts statutory audits towards public interest entities.

The United Kingdom, as one state member of the EU, is the leader in audit information transparency. Other countries like US and Canada also established comparative perfect audit information transparency system. Audit relative information such as audit risk control and quality guarantee, payment policy of partners and audit report of audit firms themselves has been disclosed comparatively. Audit firms in western countries often have standard disclosure of QSC, risk management, pay policy of partners, and their audit reports, etc.

3 THEORETICAL ANALYSIS

3.1 Principal-agent theory

The principal–agent theory refers that one or more behavior subjects (the principal) designate and employ other behavior subjects (the agent) serving for them according to an explicit or implied contract, meanwhile authorize the latter power to make some decisions, and pay corresponding reward by the quantity and quality of services provided by the latter. Principals and agents, all as the rational brokers, are seeking for maximization benefits of their own. However, due to the conflicts of interests between them, they usually damage interest of clients for that of their own by information superiority in business, which is called moral hazard. Namely, it is the agency cost.

Listed companies’ principal-agent relationship in audit service is showed in Figure 1. Being entrusted by the Board of directors (major shareholders), CPAs audit financial reports. At that time principal-agent relationship forms between major shareholders and CPAs. Investors identify the financial reports by its audit report so that they can value the assets entrusted management performance of corporate management layer.

![Figure 1. Principal-agent relationship in audits.](image)

Audit reports issued by CPAs have attestation effects. The reports will be submitted to external institutions such as CSRC, tax authorities, financial authorities, banks as the reference for decision making and attracts potential investors to entry capital market.

When there are potential interest conflicts between major shareholders and external regulatory authorities or between major shareholders and minority investors, shareholder and management layer often have common interest demand and they
maybe ask CPAs issue audit opinion beneficial to
to themselves. Audit firms are a profitable organization
in the auditing market. Being entrusted by major
shareholders, they concern about how to maximize
their interest with minimized legal liability. So
CPAs often face a tradeoff between to release
reports of high quality or to adjust audit opinions for
more benefits. The choice of the latter one may
decrease the quality and credibility of audit reports
and damage the interest of minority investors and
even that of entire society. Hence an information
transparency system of audit firms should be
enhanced to regulate audit behaviors and improve
the audit quality.

3.2 Auditor independence
Audit independence refers to CPAs conduct audit by
independent third party, which means that CPAs is
unaffected by external stress or other factors that
weaken their ability of making audit decision on
objective and impartial attitude. The nature of
auditor independence is that there should be
radically no interest relationship between accounting
firms or CPAs and clients. But under the present
buyer-oriented market of auditing services, every
audit firm leaves no stone unturned to obtain
available engagements for more economic income.
Thus CPAs may face the conflicts between interest
of auditees and that of their own when they declare
modified audit opinions in objective and fair
attitude. To some degree, audit independence will be
influenced inevitably. Therefore, only to establish
and perfect laws relative to audit business to regulate
listed companies and accounting firms, the profit-
oriented economic entities in market economy, can
CPAs’ audit independence be improved.

In view of audit quality control, CPAs disclose
some key information relative to auditing process
and its results, this can help supervisors and
investors make better assessment on the quality of
the finished audit projects. Therefore, opportunistic
behavior of CPAs will be restrained and the audit
independence will be improved.

For example, requiring CAPs disclosure the list
of important clients and corresponding audit fee
serves a way for investors to detect economic
dependence of CPAs on the particular clients, which
makes the judgment of their independence and audit
service. For another example, through disclosing
salary system of audit firms’ partners, especially
salary policy related to non-audit services, investors
can know if their partners had lowered the audit
quality because of excessively pursuing for more
business and available chances of non-audit services.
Therefore, the significant measure to improve audit
quality is to enhance audit information disclosure
and to strengthen the audit independence.

3.3 Information Asymmetry
Information asymmetry refers to a situation in which
one party in a transaction has more or superior
information compared to another. This creates an
imbalance of power in transactions. Since
information of parties is different, the party who
knows more has the upper hand whereas the party
who knows less is at a disadvantage. The theory
claims that sellers know more than buyers. One
party with less information will try to get
information from the other party, so the party who
knows more can take advantage of the other party’s
lack of knowledge. Besides, signaling can moderate
the problem of asymmetric information in some
degree.

Take listed companies for an example, The board
of directors (major shareholders and the
management) entrust audit firms with auditing
corporate financial report and releasing audit reports.
The audit reports have three attestation function: the
first is the supervision from major shareholders to
the management layer about the performance of
entrusted assets responsibility, the second is
identifying cooperate operation performance to
attract middle-small investors to increase
investment. The third is basis for government
departments to conduct regulation of taxation and
for banks to supervise corporate assets as creditors.
Here major shareholders and the management, as a
representative of corporate entire interest, have
absolute advantages in internal information and have
option to entrust corporate audit business to some
audit firms. Audit firms gain information of
corporate operation performance by auditing listed
companies. External institutions such as relevant
department of government, banks and minority
investors can only collect corporate financial
information by reading published corporate financial
reports, so they are vulnerable group of information
possessing. Interest groups and information
transmission path in audit business is showed in the
Figure.2

![Figure 2. Information transmission path in audit business.](image)

The existence of the information asymmetry
make it possible that major shareholder and
management layer, as an interest community, take
advantage of their information to select some audit
firms inclined to release an audit opinion which is
benefit to themselves but harmful to other interest
relatives. The fundamental way to deal with audit
information asymmetry is to build up and perfect information disclosure system so that the market participate of information vulnerable group can be endowed sufficient right to know.

4 MEASURES FOR HIGHER INFORMATION TRANSPARENCY SYSTEM

4.1 Specifications on mandatory disclosure and personalized disclosure

Aimed at problems as immature legislation structure and audit information disclosure in a mechanical way that exists in audit information system of audit firms in China, Ministry of Finance, China Security Regulatory Commission and Institute of CPAs and so on should formulate jointly laws and regulations to strengthen audit information transparency system in domestic securities market, which specify the contents of mandatory disclosure and personalized disclosure. The mandatory disclosure published by accounting firms and CPA should be shown as an appendix to the corresponding audit reports so that users can look up conveniently.

Mandatory disclosure information generally should be necessary for users to make decisions but obviously reluctant to be disclosed by CPA as lacking voluntary motives, which includes governance structure of audit firms, motivation and capacity for high quality audit service, audit quality insurance and risk control system, salary arrangement of partners, human resource policy and procedure, client list and audit fee for listed companies, and other factors influencing audit quality and audit independence.

On the basis of mandatory disclosure, personalized voluntary disclosure is encouraged and advocated, Which is out of statutory requirement but investors cares about and reflects the advantage and characteristic of the audit firm. Audit firms can disclose these information in form of various reports which is easy to be read and understood. CICPA industry management information system should uniformly release the legal mandatory disclosure contents of each audit firms, which should also be open for the public to consult and supervise. Whereas, each audit firm only needs to disclose the personalized information on their own websites.

4.2 Improving audit quality and disclosure related to independence

Audit information disclosure in China is still at primary stage so far. Improvement of mandatory disclosure serves as a basis form for promoting auditing information transparency. Mandatory disclosure focuses on the core issues concerned by investors, which mainly involves information related to audit quality, CPA independence and audit firms’ internal governance.

Information related to audit quality emphasizes the micro-level of audit information disclosure, which includes audit procedures, risk control and accounting frauds test and so on. Audit independence is the soul of audit and is crucial for fairness and justness of audit service, which is directly influenced by competences of auditors, abilities to undertake engagements, charging system of accounting firms, internal management and so on. Internal governance information of accounting firms mainly covers organization structure and assets scale, financial situation, human resource management and partner compensation system, etc.

In addition, appropriate disclosure frequency should be definite. As for relatively stable information, such as audit firms’ basic situation, internal governance and quality insurance system, reduced frequency, say disclosure one time every two or three years, can be taken into consideration. As for information changing relatively fast, like financial information, latest annual quality inspection result, important clients list of listed companies, annual disclosure is necessary.

4.3 Perfecting supervision and credit system for audit service

To strengthen industry supervision is to regulate audit fee standard and make law play an important role in audit market management, which covers industry access restriction, treatment of unqualified audit firms, construction of credibility archive of each audit firm, etc. Regulators should periodically carry out special examinations of information disclosure quality and give corresponding punishments to those behaviors disclosing false, missed or misleading information. Meanwhile, it is necessary to promote and perfect social supervision system of audit information disclosure by establishing the false information reporting system, the investors’ complaint system and public media supervision system.

CICPA should set up accounting firms’ credit archive system to collect annual professional information of audit firms and disclose it to the public on a unified websites. These professional information include clients list of audit firms, audit service undertaking and significant audit faults, lawsuits and compensation liabilities, etc. Institute of Certified Public Accountant should also supervise CPAs’ professional behavior and establish CPA personal credit archive, and disclose the relevant information about CPA’s personal credit if necessary.
REFERENCES


