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Client Importance and Audit Quality under Civil Law versus Common Law Societies

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Abstract**—**Accounting scandals and auditing frauds are perceived to be driven by aggressive companies and misrepresentation of audit reports. However, local legal systems and law enforcements may affect the services auditors provide to their 'important' clients. Under the civil law and common law jurisdictions, the standard setters, the government, and the regulatory bodies treat cases differently. As such, whether or not different forms of legal systems and extent of law enforcement plays an important role in auditor's Audit Quality is a question this paper attempts to explore. The paper focuses on the investigation in Asia, where Hong Kong represents the common-law jurisdiction, while Taiwan and China represent the civil law jurisdiction. Only the ten reputable accounting firms are used in this study due to the differences in rankings and establishments of some of the small local audit firms. This will also contribute to the data collected between the years 2007-2013. By focusing on the use of multiple regression based on the dependent (Audit Quality) and independent variables (Client Importance, Law Enforcement, and Press Freedom), six different models are established. Results demonstrate that since different jurisdictions have different legal systems and market regulations, auditor's treatment on 'important' clients will vary. However, with the moderators in place (law enforcement and press freedom), the relationship between client importance and audit quality may be smoothed out. With that in mind, this study contributes to local governments and standard setters' consideration on legal reform and proper law enforcement in the market. Perhaps, with such modifications on the economic systems, collusion between companies and auditors can finally be put to a halt.

Keywords**—**Audit quality, client importance, jurisdiction, modified audit opinions.

I. INTRODUCTION

THE aftermath of Enron with 2001 Arthur Anderson case [1] and the 2008 Lehman Brothers with Ernst and Young case [2], auditing scandals are also hitting the news headlines hard and frequent – to the extent that investors and the public have taken it as 'habitual' news.

The consequence of collusion between companies and auditors will not only bring in waves of the financial crisis but also drag investors into distrust of listed companies' financial statements, as well as reputable auditors' renown audit opinion. Our economy will suffer [3]. Audit failures and collusion between managers and auditors are, in fact, not fully litigated in courts [4]. There is still a significant confusion in numerous courts about the auditor's specific role and responsibility in the failure of audit reports [5]. Some auditors are willing to accept side-payments from their clients in exchange for their acceptance of the risk of collusion with the management [6]. Such corruptions are not preventable merely by a country's anti-corruption commissioner, but rather, a corporate governance modification, legal reform, or a reconstruction in auditor's business model. Such changes will bring long-term positive impacts to the economy instead.

The root cause of such scandals may be due to the legal systems and local law enforcements. This paper is, therefore, an important investigation with the attempt to identify the underlying cause of auditing frauds, and how standard setters should modify the enforcement schemes of legal systems such that collusion between companies and auditors can finally be put to a halt.

Previous studies and literature focused on the effect of the accounting scandals, primarily in the United States and in the United Kingdom. Other studies investigated the relationship of client importance and audit quality either in common law societies or in civil law societies; however, none of which had combined and compared both legal systems simultaneously in one investigation. With this in mind, the focus of the paper will suggest the fact that audit quality can be improved significantly with a reform of the legal system, specifically due to the fact that auditors will be less motivated to issue audit opinions according to the importance of their clients, just to retain their business relationship.

Given the above motivation, this paper will be based on two jurisdictions, among three locales – Hong Kong will represent the common-law jurisdiction, while the Republic of China and Taiwan will represent the civil law jurisdiction. The three jurisdictions used have distinct features present, where the origins of the laws, the roots of the accounting and auditing standards, and the societal and cultural differences, are distinctively clear.

The results of the study should prove useful to accounting standard setters and government's law enforcers that there may be a difference in the relationship between Audit Quality and Client importance for common law versus civil law jurisdictions. All in all, law enforcement schemes and media press freedom should play a significant role in influencing accounting firm's audit report quality on their important clients, due to market pressure and the potential financial risks of misreporting.

II. BASIC METHODOLOGIES

By focusing the investigation in Asia, while comparing the legal systems between civil law and common law societies, the sample firms for this paper will base only on publicly

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listed companies between the years 2007 to 2013 across the three locales. Hong Kong, Taiwan, and China's financial data are obtained from the Main Board Listed Companies' Annual and Interim Reports from the Hong Kong Stock Exchange, the Taiwan Economic Journal Database, and the Shanghai Stock Exchange and Shen Zhen Stock Exchange from China Stock Market and Accounting Research Database, respectively [7].

The paper will collect the variables from all the listed companies. Variables such as sales turnover, profitability, market-to-book ratios, switch of auditors used, market share of the auditors and of the client, law and market regulation index earnings per share ratio, the adoption of IFRS, as well as the corporate governance measurement, will be collected and adapted into the paper's regression model. The paper will be narrowed to clients who are audited by one or more of the 10 reputable accounting firms. The value of Audit Quality, Client Importance, Law Enforcement, and Press freedom will then be calculated using the stated equations.

Continuing with the analysis, the top 10 audit firms - limiting to audit firms that operate in Mainland China, Hong Kong, and Taiwan -that this paper will narrow down to and investigate on, includes: Pricewaterhouse Coopers, Ernest & Young, Deloitte, KPMG, BDO, Grant Thornton, Baker Tilly, Crowe Horwath, RSM, and Mazars.

In comparing the three locals under and two different legal jurisdictions, through inductive reasoning, the paper's proposed hypothesis is that:

H1: In common law jurisdictions, the audit quality of the Top 10 accounting firms on client increases, as client importance increases.

Under civil law jurisdictions, the legal system is rather bureaucratic and is greatly influenced by traditions and cultural practices. The court judges have the responsibility to place formal charges and decide on the case within a framework established by a comprehensive codified set of laws. Therefore, the government in a civil law society is the ultimate controllers of the legal environment and the accounting system. Ultimately, investors' protection will suffer in countries with a lack of accounting disclosure and transparency.

With minimal investor protection in civil law countries, investors will be less willing to invest much capital in the market. This will increase the ownership concentration in a company and in the economy. Such consequence is an equilibrium effect due to the low level of investor's protection, as the companies' manager will face agency problems.

Agency problems and the shift of ownership concentration emerging in recent years, a study shows that there is a strong positive relationship between ownership concentration and audit fees [8]. This is due to the fact that majority shareholders, whom usually are institutional shareholders, demand high-quality information from the company. This supports the idea that the benefits for an auditor under a common law jurisdiction to provide their clients with clean opinions does not outweigh the costs of being sued for financial misreporting and audit misrepresentation.

Such reasoning is the direct opposite from Hypothesis 1, as shareholder protection schemes are weaker in civil law jurisdictions, where the financial benefit and self-interests gained by audit partners outweigh the potential legal consequences from the government. This suggests that law enforcement schemes and a country's legal standards will affect the auditor's behavior, leading to the second hypothesis that:

H2: In civil law jurisdictions, the Top 10 accounting firms' audit quality on clients decreases as client importance increases.

Furthermore, media and press freedom also have a significant influence on audit quality. In civil societies, press freedom suffers continuously with a downward trend. But on the other hand, under the common-law societies, the government is more tolerant towards the people's right to inform or be informed, and the media welcome complaints and opinions. In turn, there is an increased pressure on the auditors when issuing their audit opinion with a true and fair view. There is less incentive for the auditors to satisfy their client's needs rather than to face litigation charges and to put their public reputation at risk. This will, therefore, force the top 10 auditing firms to focus on risk assessment procedures in locales with a better law enforcement scheme, and a higher degree of media freedom, the integrity of the accounting system can, therefore, be better maintained. This brings the paper to the third and last hypothesis, that:

H3: Quality law enforcements with flexible press freedom in civil law societies will mitigate the relationship between top 10 accounting firm's audit quality and client importance.

III. Research Methods

Audit quality, the dependent variable, is a factor with a high level of subjectivity when defining it. While some accounting bodies define audit quality as to whether the financial report conveys constructive information to investors, others, such as the Hong Kong Auditing and Assurance Standards and the Hong Kong Quality Control Standards, define audit quality as "addressing quality control procedures across the whole audit firm and focuses on quality control in the context of individual audit engagements". Due to such subjective view on audit quality, this paper will use (1) Abnormal Accruals (2) Earnings Response (3) Modified Audit Opinions (4) Financial Restatements, in defining Audit Quality.

Theoretically, a high level of abnormal accruals implies the existence of earnings management and hence lower earnings quality and audit quality from the auditor. This means that if the auditor sees the benefit of satisfying a high-value client over potential litigation cost and public reputation, then abnormal accruals will increase as the client's importance increases. Consequently, Audit quality plunges.

Another way of measuring Audit quality is through Modified Audit Opinions. Since the paper will be focusing on the top 10 accounting firms in the three locales, the paper assumes that such top 10 audit firms will have more to lose if they fail to disclose client's accounting breaches, and therefore will be motivated to issue audit reports that are true and fair. Also, due to big auditing firm's public reputation and stakeholder expectations, they are more conservative in issuing unmodified audit reports to their clients, just so to strategically minimize their audit risk when issuing such documents to the public. As such, it can be assumed that a larger number of Modified Audit Opinions issued by a top 10 auditor indicates the higher Audit Quality reports published. In the context of this paper, Modified Audit Opinions will include "Unqualified opinion with Emphasis of Matter," "Qualified opinion with Emphasis of Matter," "Qualified opinion," and "Disclaimer opinion." Modified Audit Opinions will exclude "Unqualified opinions" as such financial statements are assumed to be presented in a true and fair manner.

Additionally, Financial Restatements of audit reports are also used to measure Audit Quality. Financial Restatements is when a company or an auditor discovers an error made in the financial statement from the previous year while filing and disclosing such amendment to the public regarding the 'correct' figure. In the public's eye, however, Financial Restatements indicates negligent auditors, poor audit quality, and inadequate corporate governance policies within a company. Some investors even perceive Financial Restatements as a sign of auditors' reduced audit effort in an attempt to make an engagement profitable. In effect, as seen in the recent 2014 Chinese Stock Market, a high figure of Financial Restatements will lead to losses in firm equity valuations. Therefore, it can be assumed that a low figure of Financial Restatements issued by top 10 auditors indicates the higher Audit Quality reports issued by them throughout the years.

IV. Model Specifications

Through the use of the Multiple Regression models, it will enable the paper to test and verify whether the three hypotheses' equations used to satisfy the relationship between Audit Quality and Client importance. Accordingly, four different dependent variables will be used to measure audit quality – specifically, Modified Audit Opinion, Financial restatements, abnormal accruals, and Earnings response. In Hypothesis 3, Law Enforcement and Press freedom will be included into the regression model as well (as direct independent variables), in testing whether such variables can offset the relationship between Audit Quality and Client importance as stated from Hypothesis 2. It is predicted that the relationships between the variables stated will not be related linearly since indirect variables such as the audit firm's size are not taken into account, SPSS's natural log for values will be used to transform some data.

In order to factor out external influences such as economy changes, political reforms, society influences, and technological developments, the paper's regression models includes controlled variables. Controlled variables are used to eliminate environmental changes and factors, such that the regression model itself can reflect and clearly identify the relationship between the independent variables and the four dependent variables. As such, the controlled variables include, Company's total assets, audit firms' size, company's profit or loss making of the stated financial reporting period, GDP, stock price, market share of the audit firm, as well as the accounting and auditing standard changes being adopted (such as the use of IFRS or HKFRS).

Further to the stated regression model, Client importance is the test variable, where Client Importance is measured through the percentage of one client's audit fees relative to the total revenue. This definition is based on the assumption that a client's level of importance is dependent on its size, which in turn, affects their affordability in allocating monetary resources to external auditing services. In effect, the equation is used to calculate each client's level of importance to their respective external top ten auditors. It is predicted that client importance has a positive relationship with modified audit opinion. In other words, client importance has a negative relationship with audit quality. This is due to the fact that auditors, regardless their size or ranks, are fonder of retaining important and large clients. Such clients generate large amounts of income and revenue for the audit firm, which will directly link to the auditor or the audit partner's remuneration and year-end bonuses. Without a doubt, the large clients will also help audit partners in meeting performance quota. Therefore, audit firms are very keen in attracting and retaining such large 'important' clients. Consequently, if the legal environment or the business culture of the jurisdiction is not stringent, auditors are more willing to issue unqualified opinions to their important clients, despite its earnings management.

Following this idea, the paper hypotheses that audit firms within the civil law jurisdiction, namely, Mainland China and Taiwan, are willing to issue Unqualified clean opinions to their clients regardless their earnings management, while auditors under the common-law jurisdiction are less willing to diverge from the accounting standards and rules and regulations of the accounting and auditing framework.

In defining the direct independent variables, Law Enforcement in common and civil law countries are defined by the governor's ability and power to implement laws and regulations in their locale, along with the ability for shareholders to file a charge against an auditor when the auditor fails to issue a true and fair audit opinion. In other words, a better regulated legal and social environment is defined as whether layman investors or institutional investors are able to bring negligent auditors into court, due to the fact that they have issued unqualified opinions to qualified financial statements. With such, Law Enforcement is defined with an equation.

Given that the degree of legal standards being enforced under common law versus civil law jurisdictions is different, it is predicted that Mainland China and Taiwan, who are under the civil law jurisdiction, have a weaker Law enforcement index than Hong Kong, the common-law jurisdiction. Other factors that the variable of Law Enforcement may take into account is the social stability and culture. However, such variables and external influences will be assumed constant in the study.

Another independent variable, Media Press Freedom, is measured by the EU's annual index, where the larger the index indicates a lower level of press freedom in that country. In order to reverse the index such that a higher index will denote a freer country, the paper will define press index with an equation.

Likewise, the Freedom index is included to measure the local journalists' degree of freedom to inform or being informed by the public. It is predicted that a high degree of Freedom will discourage auditors being tolerant over client's poor earnings quality. This is due to the fact that company's public reputation in their respective jurisdictions is crucial. If the media is able, legally and resourcefully, to express their views and opinions freely to the public, especially on issues such as the listed company's financial position, corporate governance, and its corporate social responsibility acts, then the management and top executives will be less willing to manipulate their financial statements, causing misrepresentation of financial figures.

A high degree of media freedom, therefore, links to whether the external investors and shareholders are able to access to company's information freely. Consequently, investor's willingness and confidence to invest and contribute capital to the company will be affected. Hence, the freer the media, the paper presumes the management will abide by financial and auditing standards in a precise manner.

In order to expand the understanding of the relationships among the independent variables within the model, mainly Client Importance, Law Enforcement, and Freedom index, interaction terms are added to account for the relationship between the independent variables. As such, Client Importance is multiplied to Law Enforcement and Freedom.

Model (1), Model (2), and Model (3)'s Audit Quality will be computed for each of the top ten accounting firms in all the three jurisdictions -Mainland China, Hong Kong, and Taiwan. As such, Hypothesis 1 and Hypothesis 2 can be analyzed accordingly after running the regression, while Hypothesis 3 can be observed thereafter.

However, in order to test Hypothesis 3, the interaction of Law Enforcement and Press Freedom may be able to offset the relationship between client importance and audit quality in civil law societies. Therefore, Law Enforcement index will be included in measuring the government's monetary resources allocated and invested in maintaining the locale's legal system and enforcing the laws. It is estimated that a high-level Law Enforcement will increase Audit Quality

V. Tentative Findings and Conclusion

Up until the date of writing this paper, only preliminary data from Mainland China and Hong Kong is collected and compiled -with the Client Importance's p-value of 0.066* and -0.093*, respectively.

The preliminary running of the regression proves that the relationship between the variable of Client Importance and Audit Quality is positive in Mainland China (civil law jurisdiction), and negative in the Hong Kong (common law jurisdiction). This translate to the fact that in Mainland China, important clients tend to receive unqualified audit opinions, despite their audit quality, while Hong Kong auditors are less concerned about client's importance, and more concerned about whether the entity's financial statements are ultimately free from error and are reported in a true and fair view.

Such results are therefore consistent with the paper's first hypothesis that, under common law jurisdictions, accounting firms' audit quality on clients increases as client importance increases. Similarly, the results, therefore, satisfy the paper's second hypothesis too, that under civil jurisdictions, accounting firms' audit quality on clients decreases as client importance increases.

It is important to note that the regression and results obtained, at the time of writing this paper, is not yet complete. Data are collected in a preliminary stage, where detailed data collection and investigation will be conducted thereafter. Nonetheless, it is of confidence that the relationship between the independent variable of audit quality, namely, Modified audit opinion, Abnormal accrual, Financial restatement, and Earnings response, has a strong relationship with Client importance, depending on the locale and jurisdiction it operates under.

At the time the detailed and actual results results from the Common-law jurisdiction (Hong Kong) and from the Civil law jurisdiction (Mainland China and Taiwan), are complete, a stronger relationship can be expected thereafter.

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