Supplementary Audit Patterns and Auditor Independence: Evidence from China's B Share Market[1]

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ABSTRACT

The China Securities Regulatory Commission (CSRC) released the supplementary audit policy for A share listed companies (Document No. 16) at the end of 2001 in an attempt to introduce supplementary audit by internationally well-known CPA firms into A share companies' initial public offerings (IPOs) and secondary equity offerings (SEOs), ultimately improving the quality of accounting information in China's capital market. This policy has aroused great debate from accounting academics and practitioners, with one of the focuses on whether international accounting firms, represented by Big 5 auditors, could perform their expected role, especially in terms of auditor independence. This paper makes an attempt to provide empirical evidence by examining the effect of the supplementary audit arrangement in China's B share market. The evidence indicates that firstly, the international CPA firms acting as supplementary auditors in B share market, have been only limited to the scope of Hong Kong and China Mainland localized Big 5 auditors, while the degree of Hong Kong Big 5 auditors' participation in the supplementary audit is also limited. Secondly, under various supplementary audit patterns in the B share market, there is no significant difference in statutory auditors' tendency to express non-unqualified opinion or issue non-standard unqualified report. The empirical evidence has neither found that supplementary audits (especially the ones that Big 5 auditors have participated in) have significantly promoted statutory auditor independence, nor given support to common inference that localized Big 5 auditors are stricter than China's local accounting firms in statutory audits. Generally, the above evidence have two implications. First, it favors the hypothesis of regional disparity in Big 5 auditors' audit quality. Second, the evidence implies that adding layers of audit is likely to be ineffective.

Keyword: Supplementary audit, pattern, auditor independence, China's B share market, Big 5 auditors

I. RESEARCH MOTIVATION

1. Background

The CSRC released *Rule on Information Disclosure for Listed Companies No. 16— Provisional Rule on A share Listed Companies' Implementing Supplementary Audit* (hereinafter shortened as Document No. 16) at December 31, 2001. Document No. 16 requires that an IPO or SEO company in A share market shall engage a domestic CPA firm qualified for securities and futures-related engagements to audit, according to Chinese Independent Auditing Standards, its statutory financial statements prepared in accordance with Chinese accounting standards and disclosure rules, and should also engage an international CPA firm granted special permission by the CSRC and the

[1] This is a translation of the paper on pp.??-??.

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Ministry of Finance (MOF) to audit, according to international standards on auditing, its supplementary financial statements prepared in accordance with the international standards on accounting and disclosure.

To understand the particular policy setting for the release of Document No. 16, it is necessary to examine the motive behind it. The CSRC spokesman explained the setting for this policy following the release[3]:

> "Recently, there has occurred a series of fraudulent financial reporting incidents in the stock market, which has seriously undermined investors' confidence over listed companies and the whole securities market. Analysis indicates these have occurred because of management frauds, auditor incompetence and collusion, imperfect accounting standards and lack of vigorous government regulation. The State Council has made several important instructions for this. The CSRC has released the provisional rule on implementing more rigid and efficient audits, just in hope of improving the quality of financial information, restoring investors' confidence, pushing forward the internationalization of accounting standards, and strengthening supervision over the audit of listed companies."

In addition, the policymaker also explicitly expressed the intent of introducing world-renowned CPA firms' supplementary audit and pointed out:

> "The process of supplementary audit is actually the process of mutual help and supervision between world-renowned CPA firms and China domestic CPA firms, which will contribute to domestic auditors' moving closer to international standards and international auditors' familiarity with China's particular circumstances. Supplementary audit will also urge domestic CPA firms to withstand the pressure from listed companies, holding firmly to their own opinions and thus ensuring audit quality."

Furthermore, the policymaker explained the reason for the introduction of supplementary audit of world-renowned CPA firms:

> "Most of internationally well-known CPA firms have been long established and won great reputation all over the world. It is just the reason why we intend to bring them in to conduct supplementary audit. Of course, it's not to say that world-renowned CPA firms will never go wrong. However, their probability of going wrong has proven to be lower than that of other CPA firms.

From the above excerpts, we can easily find out that the cause of this new policy is a series of fraudulent financial reporting incidents starting from the mid of 2001.The core content of this policy is to introduce world-renowned CPA firms' supplementary audit into A share listed companies' IPOs and SEOs, with the primary aim of improving auditor independence and the quality of accounting information by adding layers of external supervision and monitoring.

2. Debate over Document No. 16

Supplementary audit policy is not a novelty for China's securities market. Previously, the policy has been implemented on B share listed companies, overseas listed companies (e.g. H share) and listed financial institutions. Nevertheless, Document No. 16 has still caused big social stir and heated debate.

First, various financial news media, including newspapers, magazines and websites, made quick response and showed bitter attitude over Document No. 16 [4]. A widespread article[5] put forward ten questions concerning the policy:

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[3] All the excerpts are from an article with the title 'The CSRC's News Release on Rules Regarding the Audit for Capital Raising' by He Zhufeng in *China Securities Journal* on December 31, 2001.

[4] See Ma, Xiong and Liu (2002) for a discussion on responses of the media, including the internet, after the release of Document No. 16.

[5] See Ma Xianming, 'Ten Issues in Relation to Supplementary Audit', in *China Financial and Economic News* on January 24, 2002.

(1) What is the purpose for this policy?
(2) Whether there is a legal base for the release of this policy?
(3) Who will conduct supplementary audit?
(4) What standard will be followed to conduct supplementary audit?
(5) Who on earth will be supplemented?
(6) Who will be held reliable for possible consequences from supplementary audit?
(7) Who will supervise the quality of supplementary audit?
(8) How to settle legal disputes?
(9) What if fraudulent financial reporting occurs?
(10) What about the national treatment?

These ten questions, in effect, are the points at dispute over the supplementary audit policy between the policymaker and considerable dissenters from the media, the accounting practitioners and accounting academics.

The discussions among China domestic academics on the supplementary audit policy had been centered within several months following the release of Document No. 16. Using the Enron Case as a counter-example, Ge and Huang (2002) proposed to neither exaggerate the independent auditor's function in the supervision of securities market, nor attribute the frauds by listed companies' management completely to auditors. Ge and Huang warned not to place blind faith over world-renowned CPA firms represented by Big 5 auditors[6] because Big 5 auditors' audit quality does not always deserve trust. Liu and Xu (2002) logically analyzed the relationship between audit quality and litigation risk, inferring that under China's current market environment with relatively less effective demand for quality financial information, low litigation risk would certainly result in low audit quality. Under this inference, world-renowned CPA firms represented by Big 5 auditors would also probably loose their audit quality because of lower litigation risk level in China. Li and Wu (2002a) put forward two concerns: One is on world-renowned CPA firms' audit quality in China and the other is on accounting market structure in the future. Yang and Wu (2002) used a specific case in China's securities market to present the Big 5 auditor independence for scrutiny.

3. Big Five's Auditing Behavior: Global Perspective

Although Big 5 international accounting companies are global ones and their member firms throughout the world share one brand, there are differences in audit quality among member firms of different regions. As early as soon after the outbreak of Southeast Asian Financial Crisis in 1997, the United Nations Conference on Trade and Development analyzed the relationship between disclosure of accounting information and the Crisis in a research report (Rahman, 1998) and pointed out that local member firms of Big 5 auditors had participated in the audit of most large companies and banks in Eastern Asia, but there is a big gap between the standard unqualified auditor's reports and the reality of auditees' being unable to continue as going concerns soon after the audits. The research report held out that international accounting companies have obligation of taking all necessary steps to ensure the audit service quality of their member firms in the regions beyond North America and Europe is not worse than those in North America and Europe.

Since the Enron vs. Arthur Anderson incident at the end of 2001, foreign scholars have paid extra attention to Big 5 auditors' auditing behavior. Using a large sample from 27 countries (excluding China), Francis, Wang and Nikitkov (2002)[7] found out that Big 5 auditors allow their larger clients significantly less discretion with respect to accounting accruals in countries with stronger investor protection than in countries with weaker investor protection.

[6] The Big 5 refers to the following accounting firms: PriceWaterhouseCoopers, Arthur Anderson, KPMG, Ernst & Young and Deloitte Touche Tohmatsu. In addition, the data pre-dates the demise of Arthur Anderson in the mid-year of 2002.
[7] Thanks are given to the first author, Jere R. Francis, who has granted written permission to cite the literature.

In addition, Big 5 auditors treat larger clients more conservatively than smaller clients in countries with stronger investor protection, but do not do so in countries with weaker investor protection. Their empirical evidence indicates a country's legal system has an influence on the behavior of Big 5 auditors and the discretion they allow clients with respect to accounting accruals and, by implication, the discretion to aggressively managing earnings. In combination with China's current imperfect legal system environment and weaker investor protection, weaker quality of Big 5 auditors in China could be inferred from Francis, Wang and Nikitkov (2002).

4. Research Questions

Supplementary audit policy involves two kinds of auditors, i.e. auditors performing statutory audit and auditors performing supplementary audit. Around the issue of auditor independence, the policy implies that world-renowned auditors' probability of going wrong is lower than that of other auditors, but it has not specified the range of CPA firms (especially world-renowned CPA firms) that are qualified to perform supplementary audit, which has left wide room for debate. About the issue, current debate is still confined to theoretical analysis and case study. There is little empirical evidence to testify any point in debate[8]. We are thus motivated to do some empirical test.

Specifically, since the concept of world-renowned CPA firms is set forth in the supplementary audit policy for A share listed companies, world-renowned CPA firms, represented by Big 5 auditors, have become the target and focus of debate over this policy. The most debated questions are listed as follows:

(1) Whether the CPA firms to perform supplementary audit of A share listed companies consist mainly of Big 5 auditors;

(2) Whether Big 5 auditors' performance of supplementary audit can play the expected role;

(3) Whether the quality, especially auditor independence, of Big 5 auditor in China is apparently higher than that of other auditors.

If the answer to the first question is "Yes", i.e. the policymaker gave policy support to Big 5 auditors, the positive answers to the second and third questions, to a great extent, must have played a role of evidential support. However, if we have not found that Big 5's supplementary audit has a remarkable influence on statutory audit, or the quality, especially auditor independence, of Big 5 auditors in China is not apparently higher than that of other auditors, the policymaker's potential favor for Big 5 auditors would not be justified.

Since the supplementary audit policy has long been implemented in China's B share market, necessary samples and data are available. This paper is aimed to provide preliminary evidence for the following aspects:

(1) In China's B share market where supplementary audit policy is implemented, how is the structure of the audit market, especially the structure of the supplementary audit market?

(2) How to evaluate the effect of supplementary audit?

(3) How is the auditor independence in Big 5 auditors' performance of statutory audits in China?

The second section will describe the statutory and supplementary audits in China's B share market and figure out the structure of the B share market and various supplementary audit patterns. The third section will statistically test auditor independence under various supplementary audit patterns by constructing auditor-reporting models. The fourth section will make an analysis on the results and their implication for policies. The last section is the summary and conclusion.

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[8] After the release of Document No. 16, there have been few literature aiming to provide empirical evidence. Hu (2002) attempts to prove that Big 5's reputation has significant information content by testing the initial under-pricing of Chinese IPO companies, thus claiming the justification of Document No. 16. However, there are some points to be justified in the research design and the statistical results are not convincing. In addition, Hu (2002) did not provide direct evidence on the differentiation in audit quality between domestic and overseas accounting firms. So even if the conclusion of the research on IPO companies' initial under-pricing is reliable, Document No. 16 is not directly supported yet.

II. STRUCTURE OF B SHARE AUDITING MARKET AND SUPPLEMENTARY AUDIT PATTERNS

1. Requirements over Supplementary Audits of B Share Listed Companies

In accordance with related provisions in *The Implementation Rules for the Regulations on the Domestically Listed Foreign Shares Companies* (hereinafter shortened as "*Implementation Rules*")[9], such as No.36 and 42 articles, companies issuing domestically listed foreign shares (B shares) may also present financial statements adjusted according to the International Accounting Standards in their annual reports, apart from financial statements prepared in accordance with Chinese Accounting Standards, which is required to be presented. A company may engage an overseas CPA firm that meets the State's requirements to review or audit its financial statements adjusted in accordance with the International Accounting Standards. The review or audit report of a company's financial statements to be disclosed domestically should be signed by Chinese CPAs and the CPA firm that they work for.

The purpose for supplementary audit for B share companies is mainly to provide reference for decision-making of overseas investors through overseas CPA firms' review or audit. Meanwhile, the supplementary audit policy has an influence on dividend distribution of B share companies.[10]

2. Structure of B Share Auditing Market

In order to investigate the structure of B share auditing market and supplementary audit patterns, we have carried out careful data collection and cleansing about the audit market for recent three years from 1999 to 2001 and contrasted the result with raw data about B share auditing market provided by Chief Accountant Office of the CSRC (2001a, b). The data comes from annual reports of B share listed companies. The information on the business addresses of the CPA firms performing statutory audit and supplementary audit usually may be obtained from the section of "Other Related Data - Names and Business Addresses of CPA firms" and corroborated or supplemented by "Material Events" and other relevant information sources[11]. In accordance with the requirements of *Implementation Rules*, the CPA firms performing supplementary audit of B share listed companies[12] are usually overseas CPA firms, but *Implementation Rules* have not yet compulsorily required that supplementary auditors be overseas CPA firms. We also have made a special investigation into the instances that supplementary auditors are domestic CPA firms[13], including domestic Big 5 auditors[14] and other domestic CPA firms.

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[9] See the Appendix to *The Notice on the Release of the Implementation Rules Concerning the Regulations of the Domestically Listed Foreign Shares Companies* issued by the State Council Securities Commission in 1996.

[10] In accordance with Article 40 of *Implementation Rules*, when a B-share listed company distributes its dividend, the distributable profit after tax should be determined according to whichever of the following two figures is lower: (a) Accumulated distributable profit after tax in audited financial statements prepared in accordance with Chinese Accounting Standards; (b) Accumulated distributable profit after tax in the audited financial statements based on Chinese Accounting Standards and adjusted in accordance with the International Accounting Standards.

[11] In some cases with insufficient disclosure, information in other fiscal years probably is needed for verification purpose. If the address of the auditor engaged by a company cannot be verified through the above procedure, such cases would be determined as " observations with insufficient disclosure".

[12] It is hereinafter shortened as "supplementary auditor". Accordingly, the accounting firm which performs the statutory audit of B share listed companies are shortened as "statutory auditor".

[13] The supplementary auditors who are domestic accounting firms are also called as nominal overseas auditors in this paper. The real identity of a supplementary auditor should be determined in accordance with the name and the business address of the accounting firm disclosed in the listed auditee's annual reports.

[14] Before 1998, Big 5 (then Big 6) international accounting companies have set up six Sino-foreign Cooperative CPA firms in China, including Price Waterhouse Da Hua, Arthur Anderson Huaqiang, KPMG Huazhen, Ernst & Young Huaming, Deloitte Touche Hujiang, and Coopers & Lybrand Zhongxin. In 1999, the Price Waterhouse merged with Coopers & Lybrand into PriceWaterhouseCoopers. In China, Price Waterhouse Da Hua remains as a Sino-foreign Cooperative CPA firm with a change in name as PriceWaterhouseCoopers

(1) Statutory Auditing Market

First, we conduct descriptive statistics on the statutory audit market of B share listed companies during 1999 ~ 2001, as shown in Table 1.

Table 1 Domestic Big 5 auditors' Shares in Statutory Auditing Market of B Share Companies (1999 ~ 2001)

	1999		2000		2001	
	Amount of clients	Market share	Amount of clients	Market share	Amount of clients	Market share
Price Waterhouse Da Hua	7	6.48%	7	6.14%	11	9.82%
Arthur Anderson Huaqiang	8	7.41%	12	10.53%	14	12.50%
KPMG Huazhen	3	2.78%	1	0.88%	2	1.79%
Ernst & Young Huaming	2	1.85%	2	1.75%	2	1.79%
Deloitte Touche Hujiang	3	2.78%	4	3.51%	5	4.46%
Coopers & Lybrand Zhongxin	2	1.85%	2	1.75%	3	2.68%
Total of domestic Big 5 auditors	25	23.15%	28	24.56%	37	33.04%
Total number of B share listed companies	108	100%	114	100%	112	100%

Note: Data is obtained from annual reports of B share listed companies.

On the whole, the statutory auditing market of China's B share listed companies is relatively scattered. Based on the CSRC's statistics of B share market from 1997 to 2000 and the result in Table 1, domestic Big 5 auditors' market share before the year 2000 is maintained at the level of 25%. But in the year 2001, domestic Big 5 auditors' total market share was increased dramatically by nearly 8.5%. We believe that it resulted mainly from the Yinguangxia vs. Zhongtianqin incident because eight of domestic Big 5 auditors' nine new clients engaged Zhongtianqin as their predecessor auditor.

(2) Supplementary Auditing Market

We then conduct an investigation into the supplementary auditing market of B share companies, especially the composition of nominally engaged overseas auditors. Take Big 5 auditors as an example, under normal circumstances, some B share companies at least nominally engage Hong Kong Big 5 auditors as their supplementary auditors, with the expression in disclosed information that the names and business addresses of engaged CPA firms are all marked as those of Hong Kong's CPA firms. While some other companies actually engage domestic Big 5 auditors as their supplementary auditors, with the expression in disclosed information either directly indicating that engaged CPA firms are domestic ones or marking business addresses as domestic ones. Accordingly, we classify the observations in which the supplementary auditor's address in disclosed information is marked as domestic one into the class of domestic auditors. Such a classification based on disclosed information cannot identify all supplementary audits that are actually conducted by domestic CPA firms. But it at least provides a minimum, which enables us to form a rough idea of the structure of supplementary auditing market and have a preliminary understanding of the actual implementation of the supplementary audit policy in B share market. Table

Zhongtian, while Coopers & Lybrand Zhongxin was no longer a Sino-foreign Cooperative CPA firm with a change in name as Xin Yong. Given a relatively strong persistence in clients, expertise, internal management and reputation inherited from Big 5, Xin Yong is still treated as a Sino-foreign Cooperative CPA firm in our sample period during 1999-2001. Unreported sensitivity tests indicate that an alternative treatment of Xin Yong as a domestic large accounting firm does not change statistical results as shown in Table 5 and Table 6 in this paper. For simplicity and uniformity, these 6 Sino-foreign Cooperative CPA firms are collectively referred to as domestic Big 5 auditors.

2 describes the structure of supplementary auditing market.[15]

Table 2 Market Share of the Supplementary Auditing Market of B Share Companies (1999 ~ 2001)

Composition of supplementary auditors	1999 Amount of clients	1999 Market share	2000 Amount of clients	2000 Market share	2001 Amount of clients	2001 Market share
Panel A: Big 5 auditors						
PriceWaterhouseCoopers (PWC)	27	25.00%	27	23.68%	27	24.11%
Including: PWC-Hong Kong	14		13		10	
PWC-domestic	13		14		17	
Arthur Anderson (AA)	26	24.07%	27	23.68%	24	21.43%
Including: AA-Hong Kong	17		17		19	
AA-domestic	9		10		5	
KPMG	9	8.33%	8	7.02%	7	6.25%
Including: KPMG-Hong Kong	5		5		4	
KPMG-domestic	4		3		3	
Ernst & Young (EY)	9	8.33%	11	9.65%	11	9.82%
Including: EY-Hong Kong	7		9		6	
EY-domestic	2		2		5	
Deloitte Touche Tohmatsu (DTT)	9	8.33%	7	6.14%	8	7.14%
Including: DTT-Hong Kong	6		4		4	
DTT-domestic	3		3		4	
Subtotal of overseas Big 5 auditors	49		48		43	
Subtotal of domestic Big 5 auditors	31		32		34	
Subtotal of nominal overseas Big 5 auditors	80	74.07%	80	70.18%	77	68.75%
Panel B: Non-Big 5 auditors						
Overseas non-Big 5 auditors	10		12		18	
Domestic non-Big 5 auditors	16		20		16	
Total of nominal overseas non-Big 5 auditors	26	24.07%	32	28.07%	34	30.36%
Panel C: miscellaneous						
Observations with insufficient disclosure	1		1		-	
Observations without conducting supplementary audit	1		1		1	
Total of miscellaneous observations	2	1.85%	2	1.75%	1	0.89%
Total number of B share listed companies	108	100%	114	100%	112	100%

Note: Data is obtained from annual reports of B share listed companies.

According to Table 2, supplementary auditing market is highly concentrated, with about 70% held by domestic and overseas Big 5 auditors. During 1999 ~ 2001, overseas CPA firms acting as supplementary auditors captured a 53.9%[16] share of the whole supplementary auditing market and these accounting firms all came from Hong Kong. Hong Kong Big 5 auditors took 75.7%[17] of the 53.9% share. At least 44.6%[18] of B share companies have engaged domestic CPA firms as their supplementary auditors, 65.1%[19] of which were domestic Big 5 auditors. However, the percentage of domestic CPA firms in supplementary auditing market is a conservative estimate. In fact, there must be more cases than disclosed that domestic CPA firms act as a supplementary auditor or actually perform supplementary audit.

The result in Table 2 indicates that overseas international CPA firms acting as supplementary auditors of B share companies have played their role only to a limited extent, whether in the scope or degree of participation.

[15] There is a difference in the scope of statistics between the data in Table 2 and the data provided by Chief Accountant Office of the CSRC (2001a, b). The latter does not specifically classify Big 5 auditors into domestic or overseas ones, but just on the whole.
[16] 53.9% ≈ (59+60+61)/(108+114+112)
[17] 75.7% ≈ (49+48+43)/(59+60+61)
[18] 44.6% ≈ (47+52+50)/(108+114+112)
[19] 65.1% ≈ (31+32+34)/(47+52+50)

World-renowned CPA firms available for choice by the policymaker are apparently confined to regional Big 5 auditors. So, for the implementation of supplementary audit policy for A share companies, the limited range of world-renowned CPA firms for choice is bound to stir up the debate over the potential effect and fairness of this policy, that is, whether the quality of Hong Kong and domestic Big 5 auditors could represent that of world-renowned CPA firms? And whether there exists a significant difference in audit quality, especially in auditor independence, between domestic non-Big 5 accounting firms and Hong Kong or domestic Big 5 auditors?

3. Supplementary Audit Patterns in B Share Market

The supplementary audit pattern refers to the combination mode of the statutory auditor and supplementary auditor engaged by a company under the supplementary audit policy. Around the concern of regulators, academics and practitioners about Big 5 auditors' reputation and audit quality, we classify statutory auditors and supplementary auditors as follows.

Statutory auditors are grouped into three categories. The first category is domestic Big 5 auditors, that is, the six Sino-foreign Cooperative CPA firms listed in Table 1 [20].The second category is domestic large accounting firms. The primary criterion is the ranking, sorted by listed clients' total assets, of market share of listed company auditing market during 1999~2000, which is available in Chief Accountant Office of the CSRC (2001a, p.257-259; 2001b, p.75-77). The accounting firms, excluding Sino-foreign Cooperative CPA firms, ranked in Top Ten are determined as domestic large firms. For the year 2001, restricted by the availability of data, we adopt the market ranking for the year 2000, excluding accounting firms that failed to pass the 2001 annual examination[21]. In all fiscal years, we also add Tianjian Xinde CPA Firm and Tianjian CPA Firm into the category of domestic large firms by virtue of their reputation[22]. The third category is domestic small CPA firms. By exclusive method, all other accounting firms acting as statutory auditors of B share companies, other than the above-mentioned domestic Big 5 auditors and domestic large firms, are all classified as domestic small firms. The above classification is for the convenience of comparing the differences in auditor independence, proxied as auditor reporting conservatism, between domestic Big 5 auditors, domestic large accounting firms and other domestic CPA firms.

Supplementary auditors are grouped into two categories: One category is overseas Big 5 auditors and the other category is overseas non-Big 5 auditors. It should be noted that overseas Big 5 auditors here refer to the nominal ones including Hong Kong and domestic Big 5 auditors. We do not separate nominal overseas Big 5 into Hong Kong and domestic ones because our main purpose is to test the reputation and auditor independence of Big 5 auditors as a whole; meanwhile the result as shown in Panel A of Table 2 is just a conservative estimate, and specific classification in nominal overseas Big 5 based on this makes little sense. Overseas non-Big 5 auditors are determined according to the range in Panel B, Table 2.

Now that statutory auditors and supplementary auditors have been classified, we can theoretically get the following 6 combinations of statutory auditors and supplementary auditors, i.e. supplementary audit patterns.

- Pattern I domestic Big 5 vs. overseas Big 5
- Pattern II domestic Big 5 vs. overseas non-Big 5

[20] When defining the range of domestic Big 5, only Sino-foreign Cooperative CPA firms are included, while Big 5's affiliate firms are excluded since these affiliate firms are relatively loosely connected with Big 5. By the end of the year 2001, only PriceWaterhouseCoopers has an affiliate firm in China, i.e. Yangcheng CPA firm.

[21] See Li and Wu (2003, p115-132) for a discussion on the change in the structure of 2001 China listed company auditing market and the 2001 annual examination.

[22] Among them, there is one observation where Tianjian Xinde CPA firm acted as the statutory auditor in 1999, one case for the year 2000 and two cases for the year 2001. During the period from 1999 through 2001, there is only one observation where Tianjian CPA firm acted as the statutory auditor in 2001.

- Pattern III domestic large firms vs. overseas Big 5
- Pattern IV domestic large firms vs. overseas non-Big 5
- Pattern V domestic small firms vs. overseas Big 5
- Pattern VI domestic small firms vs. overseas non-Big 5

After excluding five miscellaneous observations in Panel C of Table 2, we divide the B share market for the period during 1999 ~ 2001 into the above-stated 6 supplementary audit patterns, as shown in Table 3.

Table 3 Supplementary Audit Patterns in B Share Market (1999 ~ 2001)

		1999		2000		2001		Total	
Supplementary audit pattern		Obs.	Percent	Obs.	Percent.	Obs.	Percent	Obs.	Percent
I	Domestic Big 5 vs. overseas Big 5	25	23.58%	28	25.00%	36	32.43%	89	27.05%
II	Domestic Big 5 vs. overseas non-Big 5	0	0.00%	0	0.00%	1	0.90%	1	0.30%
III	Domestic large vs. overseas Big 5	34	32.08%	34	30.36%	23	20.72%	91	27.66%
IV	Domestic large vs. overseas non-Big 5	18	16.98%	24	21.43%	18	16.22%	60	18.24%
V	Domestic small vs. overseas Big 5	21	19.81%	18	16.07%	18	16.22%	57	17.33%
VI	Domestic small vs. overseas non-Big 5	8	7.55%	8	7.14%	15	13.51%	31	9.42%
Total		106	100%	112	100%	111	100%	329	100%

Table 3 indicates that Pattern I and Pattern III have higher frequencies of incidence, 27.05% and 27.66% respectively. Pattern IV and Pattern V have relatively low frequencies of incidence, 18.24% and 17.33% respectively. The frequency of Pattern VI is even lower, only 9.42%. Pattern II, the combination of a domestic Big 5 and an overseas non-Big 5, almost does not occur. Big 5 auditors as a whole, including domestic and overseas Big 5, participate in the supplementary audit of B share companies through Pattern I, II, III, and V, with the total market share of up to 72.34%.

III. COMPARISON OF AUDITOR INDEPENDENCE UNDER VARIOUS SUPPLEMENTARY AUDIT PATTERNS

1. Research Design

(1) Dependent Variable

To examine the auditor independence under supplementary audit environment is one of our major research purposes. According to the policymaker's interpretation of supplementary audit, supplementary audits should be able to urge domestic auditors to withstand the pressure from listed companies and to safeguard auditor independence. When examining the effect of supplementary audits, we focuses on the influence of supplementary auditors on statutory auditors' independence, which requires controlling the differences among various supplementary audit patterns.

A large number of auditing literatures use auditor's opinion as the proxy for auditor independence. The paper continues to use this method. Basic methodology is to compare the influence of various supplementary audit patterns on the types of statutory auditor opinions while controlling for other variables.

There are four types of audit reports: (a) unqualified opinion, including standard unqualified opinion and unqualified opinion with explanatory paragraphs; (b) qualified opinion; (c) adverse opinion; and (d) disclaimer of opinion. Some of past literature (e.g. Chen, Chen and Su, 2001; Zhang and Liu, 2002) adopts the classification of standard unqualified opinion vs. non-standard unqualified opinion to study auditor independence, while Li and Wu (2002d, p.1-28) found that auditor's expressing an unqualified opinion with explanatory paragraphs might suggest impairment of auditor independence to some extent. In order to measure auditor independence in a more conservative way, here we adopt the classification of unqualified opinion vs. non-unqualified opinion[23] as a benchmark, while the classification of standard unqualified opinion vs. non-standard unqualified opinion as an alternative for comparison purpose. Accordingly, we have two sets of the dependent variable, i.e. benchmark setting and alternative setting, which facilitates an examination of the difference of the two settings on statistical results.

Benchmark setting: *OP*=1, indicating a statutory auditor has issued the report with a non-unqualified opinion; =0, indicating a statutory auditor has issued the report with an unqualified opinion.

Alternative setting: *OP*=1, indicating a statutory auditor has issued the report with a non-standard unqualified opinion; =0, indicating a statutory auditor has issued the report with a standard unqualified opinion.

(2) Theoretical Comparison between Supplementary Audit Patterns and Setting of Experimental Variables

The theoretical comparison of various supplementary audit patterns is based upon the following assumptions. First, Big 5's auditor independence is superior to that of non-Big 5 auditors, therefore superior to that of overseas non-Big 5, domestic large and small accounting firms. Second, large accounting firms' independence is superior to that of small firms, therefore domestic large firms' independence is superior to that of domestic small firms. Third, the existence of supplementary auditors serves to urge statutory auditors to safeguard auditor independence. Under these assumptions, we can infer the ranking of various supplementary audit patterns in terms of auditor independence, the sequence from high to low of which is as the following: Pattern I > Pattern III > Pattern IV and V > Pattern VI.[24] Accordingly, we have three kinds of settings for experimental variables.

(i) Comparison among various supplementary audit patterns

The above ranking order shows that the expected auditor independence under Pattern VI is the lowest, so it is selected in contrast against other supplementary audit patterns. Considering that there are 5 patterns available for statistical test, four dummy variables are set.

PATN-I=1, indicating that the supplementary audit pattern is the combination of a domestic Big 5 auditor and an overseas Big 5 auditor; =0, indicating other supplementary audit pattern.

PATN-III=1, indicating that the supplementary audit pattern is the combination of a domestic large accounting firm and an overseas Big 5 auditor; =0, indicating other supplementary audit pattern.

PATN-IV=1, indicating that the supplementary audit pattern is the combination of a domestic large accounting firm and an overseas non-Big 5 auditor; =0, indicating other supplementary audit pattern.

PATN-V=1, indicating that the supplementary audit pattern is the combination of a domestic small accounting firm and an overseas Big 5 auditor; =0, indicating other supplementary audit pattern.

(ii) Supplementary audits with vs. without Big 5 auditors' participation

The combinations of various supplementary audit patterns may serve for different comparison purposes. The observations in Pattern I, III, and V are the supplementary audits with Big 5 auditors participation, while

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[23] Non-unqualified opinion refers to the audit opinion other than unqualified, including qualified opinion, adverse opinion and disclaimer of opinion.

[24] Due to the extremely low frequency of incidence, Pattern II is not considered here. And we cannot directly compare the auditor independence between Pattern IV and V. However, we can observe the difference between them in subsequent statistical tests. If the auditor independence in Pattern IV is higher than that in Pattern V, and the fundamental assumption that domestic large accounting firms are more independent than domestic small firms is true, we could make a preliminary judgment that overseas Big 5's supplementary audits are not enough to make up domestic small CPA firms' deficiency in auditor independence, thus generating less promotion to statutory audits than expected. If the auditor independence in Pattern V is higher than that in Pattern IV, and the fundamental assumption that domestic large accounting firms are more independent than domestic small firms is true, we could make a preliminary judgment that overseas Big 5's supplementary audits can make up domestic small firms' deficiency in auditor independence, thus generating expected promotion to statutory audits.

observations in Pattern IV and VI are the supplementary audits without Big 5 auditors participation. The comparison of these two categories contributes to our direct observation of the influence of overseas Big 5 auditors on statutory audits. The experimental variables are set as follows.

BIG5=1, indicating the supplementary audit with Big 5 auditors participation; =0, indicating the supplementary audit without Big 5 auditors participation.

(iii) Domestic Big 5 vs. domestic large firms vs. domestic small firms

Under various supplementary audit patterns, the statutory auditor in Pattern I is a domestic Big 5, the statutory auditor in Pattern III and IV is a domestic large accounting firm, while the statutory auditor in Pattern V and VI is a domestic small firm. The comparison of these three categories is equivalent to an examination of the differences in auditor independence among different statutory auditors without consideration of potential influence of supplementary audit on statutory audit. The experimental variables are set as follows.

LCBIG5=1, indicating that the statutory auditor is a domestic Big 5; =0, others.

LCLARGE=1, indicating that the statutory auditor is a domestic large accounting firm; =0, others.

(3) Control Variables

The factor reflected in the above experimental variables is the characteristics of listed companies selection of their auditors. Apart from it, auditors will also be affected by many other factors when expressing their opinions. Based on prior literature (e.g. Lennox, 2000; Chen, Chen and Su, 2001; Zhang and Liu, 2002; Li and Wu, 2002d), these factors are grouped into three categories. First category is the company characteristics, such as profitability, financial position, evidence of earnings management and type of previous audit opinion; the second category is other characteristics in auditor selection, e.g. auditor changes; the third category is other features, such as the fiscal year dummy variables.

(i) Return on assets

In order to reflect a company's persistent profitability and to eliminate the influence of non-recurrent gains or losses, operating profit after deduction of other business profit is adopted as the earning indicator.

ROA = (operating profit - other business profit) / total assets.

(ii) Significant non-major business profit

Li and Wu (2002d, 2003) found that the existence of material non-major business profit has a significant negative impact on the conservatism of auditor's reporting. This indicator is used to examine whether a company reporting a profit has increased its profit with material non-recurrent gains, thus controlling the evidence of earnings management to some extent.

IRRGLPRF=1, when net profit>0 and (total pre-tax profit - operating profit + other business profit) / total pre-tax profit ≥20%; =0, others.

(iii) Leverage

The indicator is used to reflect a company's financial position.

LEVERAGE= total liabilities / total assets.

(iv) Type of the audit report for the previous year

Prior literature found the type of audit opinion is highly persistent (e.g. Lennox, 2000). For correspondence with the two settings of dependent variable, this variable also has two settings.

Benchmark setting: *PREOP*=1, indicating a statutory auditor issued the report with a non-unqualified opinion in previous year; =0, indicating a statutory auditor issued the report with an unqualified opinion in previous year.

Alternative setting: *PREOP*=1, indicating a statutory auditor issued the report with a non-standard unqualified opinion in previous year; =0, indicating a statutory auditor issued the report with a standard unqualified opinion in previous year.

(v) Statutory auditor change and its interaction item with the variable of the previous year audit opinion

Prior literature (e.g. Lennox, 2000; Li and Wu, 2002b) found that auditor change and its interaction item with the previous audit opinion significantly influence successor auditor's opinion.

AUDCHG=1, indicating that the statutory auditor changes in the reporting period; =0, indicating that no change has occurred with the statutory auditor in the reporting period.

Benchmark setting: *AUDCHG*PREOP*=1, indicating a statutory auditor issued the report with a non-unqualified opinion in previous year and a change has occurred with the statutory auditor in the reporting period; =0, others.

Alternative setting: *AUDCHG*PREOP*=1, indicating a statutory auditor issued the report with a non-standard unqualified opinion in previous year and a change has occurred with the statutory auditor in the reporting period; =0, others.

(vi) Listing status

The B share market consists of companies issuing both A and B shares and companies issuing B shares only. Lu and Li (2001) found the difference in reported net profit between statutory and supplementary financial statements of companies issuing both A and B shares is higher than that of companies issuing B shares only, which could be interpreted as companies issuing B shares only have no such pressure of manipulating returns on equity (ROE) for SEOs as A share companies bear. This might suggest a difference between companies issuing both A and B shares and companies issuing B shares only, so we adopt the listing status as a control variable.

LISTYPE=1, indicating that the company issues both A and B shares; =0, indicating that the company issues B shares only.

(vii) Fiscal year variables

Different years may imply variance in audit environment. Since the sample period is during 1999 ~2001, two dummy variables are set.

Y2000 = 1, when the sample is an observation in the year 2000; = 0, others.

Y2001 = 1, when the sample is an observation in the year 2001; = 0, others.

(4) Auditor Reporting Models

Since the dependent variable is set as dichotomous, logistic regression is usually adopted[25]. According to three different settings of experimental variables, the logistic regression models are as follows.

(i) Comparison among various supplementary audit patterns

$$\text{logit } OP = a_0+a_1 \mathit{PATN\text{-}I}+a_2 \mathit{PATN\text{-}III}+a_3 \mathit{PATN\text{-}IV}+a_4 \mathit{PATN\text{-}V}+a_5 \mathit{ROA}+a_6 \mathit{IRRGLPRF}+a_7 \mathit{LEVERAGE} +a_8 \mathit{PREOP}+a_9 \mathit{AUDCHG}+a_{10} \mathit{AUDCHG*PREOP}+a_{11} \mathit{LISTYPE}+a_{12} \mathit{Y2000}+a_{13} \mathit{Y2001}+e \quad (1)$$

(ii) Supplementary audits with vs. without Big 5 auditors' participation

$$\text{logit } OP = a_0+a_1 \mathit{BIG5}+a_2 \mathit{ROA}+a_3 \mathit{IRRGLPRF}+a_4 \mathit{LEVERAGE}+a_5 \mathit{PREOP}+a_6 \mathit{AUDCHG} +a_7 \mathit{AUDCHG*PREOP}+a_8 \mathit{LISTYPE}+a_9 \mathit{Y2000}+a_{10} \mathit{Y2001}+e \quad (2)$$

(iii) Domestic Big 5 vs. domestic large firms vs. domestic small firms

$$\text{logit } OP = a_0+a_1 \mathit{LCBIG5}+a_2 \mathit{LCLARGE}+a_3 \mathit{ROA}+a_4 \mathit{IRRGLPRF}+a_5 \mathit{LEVERAGE}+a_6 \mathit{PREOP}+a_7 \mathit{AUDCHG} +a_8 \mathit{AUDCHG*PREOP}+a_9 \mathit{LISTYPE}+a_{10} \mathit{Y2000}+a_{11} \mathit{Y2001}+e \quad (3)$$

[25] The statistical principle of logistic regression is to estimate the coefficients b_i using actual observations of interested events and independent variables based on the logistic function as $p=1/[1+\exp(-\Sigma b_i x_i)$. Logit transformation is then conducted as logit $p = \ln [p/ (1 - p)]$, thus achieving the linear expression of logit p (Guo, 1999, Chapter 6).

All variables relating to audit opinion in Model (1) to (3) have two settings. The variables are collected manually from Chief Accountant Office of the CSRC (2001a, b) and publicly disclosed annual reports of B share companies. SPSS10.0 is used to carry out statistical tests.

2. Sample Selection and Descriptive Statistics

(1) Sample Selection

For statistical tests, we select samples on the basis of Table 3. First, considering that there is only one observation in Pattern II, this observation is excluded. Thus, we only compare other five supplementary audit patterns[26]. Secondly, considering that the variable of the audit opinion for the previous year is required, observations lacking previous audit opinion data because of insufficient listing age are excluded. As the result, one observation in Pattern I for the year 1999, 5 observations in Pattern I for the year 2000 and one observation in Pattern V for the year 2000 are excluded from Table 3. Finally, we obtain 321 observations (firm/year) in the sample.

(2) Descriptive Statistics

Table 4 shows the descriptive statistics on dependent and independent variables under various supplementary audit patterns.

Table 4 Descriptive statistics

	Pattern I	Pattern III	Pattern IV	Pattern V	Pattern VI	Total sample
Panel A: Categorical variables						
OP (benchmark)=1	3	6	15	2	5	31
	(3.61%)	(6.59%)	(25.00%)	(3.57%)	(16.13%)	(9.66%)
OP (alternative)=1	5	18	29	6	12	70
	(6.02%)	(19.78%)	(48.33%)	(10.71%)	(38.71%)	(21.81%)
IRRGLPRF=1	40	50	38	19	19	166
	(48.19%)	(54.95%)	(63.33%)	(33.93%)	(61.29%)	(51.71%)
PREOP (benchmark)=1	4	7	14	1	8	34
	(4.82%)	(7.69%)	(23.33%)	(1.79%)	(25.81%)	(10.59%)
PREOP (alternative)=1	6	21	29	3	16	75
	(7.23%)	(23.08%)	(48.33%)	(5.36%)	(51.61%)	(23.36%)
AUDCHG=1	10	5	17	6	14	52
	(12.05%)	(5.49%)	(28.33%)	(10.71%)	(45.16%)	(16.20%)
*AUDCHG*PREOP* (benchmark)=1	0	0	4	0	2	6
	(0.00%)	(0.00%)	(6.67%)	(0.00%)	(6.45%)	(1.87%)
*AUDCHG*PREOP* (alternative)=1	0	1	9	0	7	17
	(0.00%)	(1.10%)	(15.00%)	(0.00%)	(22.58%)	(5.30%)
LISTYPE=1	57	78	54	37	28	254
	(68.67%)	(85.71%)	(90.00%)	(66.07%)	(90.32%)	(79.13%)
Panel B: Continuous variables						
ROA	3.58%	1.47%	-6.6%	3.35%	-19.60%	-1.2%
	(4.55%)	(7.40%)	(12.91%)	(6.47%)	(65.94%)	(22.72%)
LEVERAGE	43.25%	51.97%	69.94%	39.38%	92.07%	54.75%
	(19.03%)	(16.00%)	(35.45%)	(14.27%)	(90.36%)	(38.17%)
Observations	83	91	60	56	31	321

Note: Pattern I indicates the combination of a domestic Big 5 and an overseas Big 5; Pattern III indicates the combination of a domestic large accounting firm and an overseas Big 5; Pattern IV indicates the combination of a domestic large accounting firm and an overseas non-Big 5 auditor; Pattern V indicates the combination of a domestic small accounting firm and an overseas Big 5; Pattern VI indicates the combination of a domestic small accounting firm and an overseas non-Big 5 auditor.
For Panel A, the figure outside and inside the parenthesis represents the number of observations and sample means, respectively.
For Panel B, the figure outside and inside the parenthesis represents sample means and standard deviation, respectively.
The variables are defined as in the "III.1." Section.

[26] Although subsequent statistical tests do not include Pattern II, the sequence numbers of the patterns are kept unchanged for consistency in the representation of the whole paper.

Table 4 shows that among the 321 samples:

(i) There are a total of 70 observations with non-standard unqualified audit opinions in the reporting period, among which 39 cases are unqualified opinions with explanatory paragraphs, 31 are qualified opinions, adverse opinions or disclaimers of opinion. Among various supplementary audit patterns, Pattern IV has most incidents of either non-standard unqualified audit opinions or non-unqualified opinions.

(ii) There are 166 observations recognizing material non-major business profit in the reporting period. Among various patterns, Pattern IV and VI have most incidents for the recognition of material non-major business, 63% and 61% respectively. Pattern III and V have lower frequencies of observations recognizing material non-major business profit, 48%, 55% and 34% respectively.

(iii) There are 52 observations that have changed their statutory auditors in the reporting period, among which 6 cases were expressed a non-unqualified opinion by predecessor statutory auditor and 11 cases were expressed an unqualified opinion with explanatory paragraphs. These 17 observations with potential motive for opinion shopping are all in non-Big 5 audit environment, i.e. Pattern IV and VI.

(iv) Auditees in Big 5-participating patterns (i.e. Pattern I, III and V) commonly have higher profitability and lower leverage, compared with those in non-Big 5 audit patterns (i.e. Pattern IV and VI). Especially in Pattern VI, sample companies have a mean value of *ROA* of -19.60% and *LEVERAGE* up to 92.07%. This may reflect, to some extent, a difference in client characteristics between Big 5 and non-Big 5 auditors in B share market.

Unreported variables correlation matrix indicates the highest Pearson correlation coefficient between various variables in the regression model is -0.798 (between *ROA* and *LEVERAGE*). Further collinearity diagnostics shows that the variance inflation factors (VIF) of all variables are smaller than usual critical value 10, with the maximum value of 3.437. Thus, multicollinearity is not a serious problem with the regression model.

3. Logistic Regression Results

(1) For Regressions by Benchmark Setting of the Dependent Variable

Table 5 presents the statistical results of Model (1) - (3) for regressions by benchmark setting of the dependent variable. On the whole, the regression relationship is significant and model fit is good (Chi-square value is significant at the level of 0.0005 and Pseudo-R^2 is about 45 percent).

Table 5 indicates the following:

(i) For all experimental variables of Model (1), only *PATN-IV* has a coefficient with positive sign and all of the other three experimental variables have coefficients with negative signs. However, the coefficients of all these four experimental variables are not significant. It means that under various supplementary audit patterns, statutory auditors' conservatism in expressing opinions have no significant differences. Statutory auditors under the combination of a domestic large firm and an overseas non-Big 5 auditor have a higher, though not significant, tendency to express non-unqualified opinion.

(ii) The coefficient of the experimental variable *BIG5* in Model (2) is significantly negative at the level of 1%. It implies that in Big 5-participating supplementary audit patterns, statutory auditors' tendency to express non-unqualified opinions is significantly lower than that in non-Big 5 audit environment.

(iii) The coefficients of experimental variables *LCBIG5* and *LCLARGE* in Model (3) are both insignificant, indicating the lack of significant difference in auditor conservatism among domestic Big 5, domestic large accounting firms and domestic small firms.

(iv) The coefficients of *PREOP* in three models are all significantly positive at the level of 0.0005, suggesting the strong persistence of the conservatism of auditor's opinion.

(v) The control variable *IRRGLPRF* is significantly and negatively correlated with the dependent variable *OP* in Model (1) and (2) at the level of 10% and 5%, respectively. It indicates that the statutory auditor is more likely to express unqualified opinions when there is a clear evidence of auditee's recognition of material non-major business profits.

(vi) Both of the fiscal year dummy variables *Y2000* and *Y2001* in three models have significant negative correlations with the dependent variable *OP* at the level of 5% or 1%. It implies that the statutory auditors have a declining tendency to express non-unqualified opinions in the recent two years, compared with the year 1999.

Table 5 Logistic regression Results by benchmark setting of the dependent variable

	Mode (l)	Model (2)	Model (3)
Dependent variable: *OP*	Coefficient (Wald statistics)	Coefficient (Wald statistics)	Coefficient (Wald statistics)
Experimental variables			
PATN-I	-0.754 (0.523)	-	-
PATN-III	-0.721 (0.594)	-	-
PATN-IV	0.901 (1.179)	-	-
PATN-V	-0.719 (0.405)	-	-
BIG5	-	-1.444 (6.672***)	-
LCBIG5	-	-	-0.218 (0.067)
LCLARGE	-	-	0.552 (0.877)
Control variables			
ROA	1.841 (1.934)	1.749 (1.817)	1.834 (2.273)
IRRGLPRF	-0.954 (3.264*)	-1.046 (4.066**)	-0.785 (2.525)
LEVERAGE	1.305 (1.997)	1.093 (1.533)	1.578 (3.348*)
PREOP	3.193 (24.758***)	3.146 (24.730***)	3.277 (27.739***)
AUDCHG	0.514 (0.462)	0.428 (0.320)	0.834 (1.257)
*AUDCHG*PREOP*	-1.853 (1.878)	-1.626 (1.542)	-1.542 (1.408)
LISTYPE	0.691 (0.792)	0.682 (0.814)	0.552 (0.573)
Y2000	-1.352 (5.226**)	-1.299 (4.933**)	-1.288 (4.936**)
Y2001	-2.215 (8.230***)	-2.266 (8.759***)	-2.170 (7.943***)
Constant	-2.854 (4.628**)	-1.985 (4.020**)	-3.548 (14.167***)
Chi-square	79.357***	78.096***	73.109***
Pseudo-R^2	0.466	0.459	0.433
Sample size	321	321	321

Note: Chi - Square is the index for the overall effectiveness of the regression model. Pseudo-R^2 adopts Nagelkerke R^2 index to measure the goodness of model fit.
Figure outside and inside the parenthesis represents the coefficient and Wald statistics, respectively.
* * *, * * and * indicates significance at the levels of 0.01, 0.05 and 0.1, respectively.
Definition of variables:
OP = 1, indicating a statutory auditor has issued the report with a non-unqualified opinion; = 0, indicating a statutory auditor has issued the report with an unqualified opinion.

PATN-I = 1, indicating that the supplementary audit pattern is the combination of a domestic Big 5 auditor and an overseas Big 5 auditor; = 0, indicating other supplementary audit pattern.
PATN-III = 1, indicating that the supplementary audit pattern is the combination of a domestic large accounting firm and an overseas Big 5 auditor; = 0, indicating other supplementary audit pattern.
PATN-IV = 1, indicating that the supplementary audit pattern is the combination of a domestic large accounting firm and an overseas non-Big 5 auditor; = 0, indicating other supplementary audit pattern.
PATN-V = 1, indicating that the supplementary audit pattern is the combination of a domestic small accounting firm and an overseas Big 5 auditor; = 0, indicating other supplementary audit pattern.
BIG5 = 1, indicating the supplementary audit with Big 5 auditors participation; = 0, indicating the supplementary audit without Big 5 auditors participation.
LCBIG5 = 1, indicating that the statutory auditor is a domestic Big 5; = 0, others.
LCLARGE = 1, indicating that the statutory auditor is a domestic large accounting firm; = 0, others.
ROA = (operating profit - other business profit) / total assets.
IRRGLPRF = 1, when net profit>0 and (total pre-tax profit - operating profit + other business profit) / total pre-tax profit ≥ 20%; = 0, others.
LEVERAGE= total liabilities / total assets.
PREOP = 1, indicating a statutory auditor issued the report with a non-unqualified opinion in previous year; = 0, indicating a statutory auditor issued the report with an unqualified opinion in previous year.
AUDCHG=1, indicating that the statutory auditor changes in the reporting period; =0, indicating that no change has occurred with the statutory auditor in the reporting period.
*AUDCHG*PREOP* =1, indicating a statutory auditor issued the report with a non-unqualified opinion in previous year and a change has occurred with the statutory auditor in the reporting period; = 0, others.
LISTYPE= 1, indicating that the company issues both A and B shares; = 0, indicating that the company issues B shares only.
Y2000 = 1, when the sample is an observation in the year 2000; = 0, others.
Y2001 = 1, when the sample is an observation in the year 2001; = 0, others.

(2) For Regressions by Alternative Setting of the Dependent Variable

The alternative setting of the dependent variable OP has actually loosened the standard for auditor independence. So long as auditors add explanatory paragraphs after the opinion paragraph of an unqualified audit report, the value of the dependent variable is still 1, indicating the auditor independence is high. Table 6 presents the statistical results of Model (1)-(3) for regressions by alternative setting of the dependent variable. On the whole, the regression relationship is significant and model fit is good (Chi-square statistics is significant at the level of 0.0005 and Pseudo-R^2 is about 54 percent).

The statistical results in Table 6 indicate the following:

(i) The coefficients of all experimental variables in three models are not significant. This suggests there is still no significant difference in statutory auditors' tendency to express non-standard unqualified opinions under various supplementary audit patterns.

(ii) In three models, the coefficients of *ROA* are significantly negative at the level of 1%, while the coefficients of *LEVERAGE* are significantly positive at the level of 5%. It means that the weaker auditee's profitability from major operations is or the higher its leverage is, the more conservative the statutory auditor tends to be.

(iii) The coefficients of *PREOP* in three models are all significantly positive at the level of 0.0005, again indicating the strong persistence of the conservatism of auditor's opinion.

(iv) The negative correlation between such control variables as *IRRGLPRF*, *AUDCHG*PREOP* and the fiscal year variables and the dependent variable *OP*, are weakened. The coefficient sign of *IRRGLPRF* changes from negative in Table 5 to positive in Table 6. On one hand, this indicates that loosening the standard for auditor independence has an influence on regression results, i.e. a weakening effect as to the observation of auditor independence. On the other hand, this also indicates that statutory auditors' tendency to replace non-unqualified opinions with unqualified opinions with explanatory paragraphs is increasing, thus offsetting the decreasing tendency in the expression of non-unqualified opinions.

(v) Even if the standard for auditor independence is loosened, the coefficient signs of the fiscal year variables

Y2000 and *Y2001* in three models are still negative. The significance level of the negative correlation between *Y2000* and *OP* is 10%. It implies that auditors' tendency to express non-standard unqualified opinions has declined slightly in the recent years, compared with the year 1999.

Table 6 Logistic regression Results by alternative setting of the dependent variable

	Model (1)	Model (2)	Model (3)
Dependent variable: *OP*	Coefficient (Wald statistic)	Coefficient (Wald statistic)	Coefficient (Wald statistic)
Experimental variable			
PATN-I	-0.292	-	-
	(0.126)		
PATN-III	0.285	-	-
	(0.170)		
PATN-IV	0.815	-	-
	(1.611)		
PATN-V	0.773	-	-
	(0.851)		
BIG5	-	-0.395	-
		(0.832)	
LCBIG5	-	-	-0.687
			(1.077)
LCLARGE	-	-	0.168
			(0.142)
Control variable			
ROA	-8.311	-8.420	-8.744
	(6.567***)	(6.893***)	(7.604***)
IRRGLPRF	0.468	0.354	0.439
	(1.331)	(0.821)	(1.241)
LEVERAGE	2.241	2.073	2.063
	(4.694**)	(4.479**)	(4.446**)
PREOP	2.525	2.449	2.457
	(32.795***)	(32.877***)	(32.907***)
AUDCHG	-0.074	-0.194	-0.054
	(0.011)	(0.076)	(0.006)
*AUDCHG*PREOP*	-0.804	-0.746	-0.794
	(0.695)	(0.609)	(0.689)
LISTYPE	0.515	0.531	0.426
	(0.880)	(0.981)	(0.613)
Y2000	-0.851	-0.839	-0.827
	(3.319*)	(3.224*)	(3.152*)
Y2001	-0.658	-0.685	-0.622
	(2.054)	(2.278)	(1870)
Constant	-4.068	-3.252	-3.494
	(13.793***)	(14.279***)	(19.380***)
Chi-square	139.917***	136.139***	137.617***
Pseudo-R^2	0.544	0.532	0.537
Sample size	321	321	321

Note: Chi - Square is the index for the overall effectiveness of the regression model. Pseudo-R^2 adopts Nagelkerke R^2 index to measure the goodness of model fit.

Figure outside and inside the parenthesis represents the coefficient and Wald statistics, respectively.

* * *, * * and * indicates significance at the levels of 0.01, 0.05 and 0.1, respectively.

Definition of variables:

OP = 1, indicating a statutory auditor has issued the report with a non-standard unqualified opinion; = 0, indicating a statutory auditor has issued the report with a standard unqualified opinion.

PATN-I = 1, indicating that the supplementary audit pattern is the combination of a domestic Big 5 auditor and an overseas Big 5 auditor; = 0, indicating other supplementary audit pattern.

PATN-III = 1, indicating that the supplementary audit pattern is the combination of a domestic large accounting firm and an overseas Big 5 auditor; = 0, indicating other supplementary audit pattern.

PATN-IV = 1, indicating that the supplementary audit pattern is the combination of a domestic large accounting firm and an overseas non-Big 5 auditor; = 0, indicating other supplementary audit pattern.

PATN-V = 1, indicating that the supplementary audit pattern is the combination of a domestic small accounting firm and an overseas Big 5 auditor; = 0, indicating other supplementary audit pattern.
BIG5 = 1, indicating the supplementary audit with Big 5 auditors participation; = 0, indicating the supplementary audit without Big 5 auditors participation.
LCBIG5 = 1, indicating that the statutory auditor is a domestic Big 5; = 0, others.
LCLARGE = 1, indicating that the statutory auditor is a domestic large accounting firm; = 0, others.
ROA = (operating profit - other business profit) / total assets.
IRRGLPRF = 1, when net profit>0 and (total pre-tax profit - operating profit + other business profit) / total pre-tax profit ≥ 20%; = 0, others.
LEVERAGE= total liabilities / total assets.
PREOP = 1, indicating a statutory auditor issued the report with a non-standard unqualified opinion in previous year; = 0, indicating a statutory auditor issued the report with a standard unqualified opinion in previous year.
AUDCHG=1, indicating that the statutory auditor changes in the reporting period; =0, indicating that no change has occurred with the statutory auditor in the reporting period.
*AUDCHG*PREOP* =1, indicating a statutory auditor issued the report with a non-standard unqualified opinion in previous year and a change has occurred with the statutory auditor in the reporting period; = 0, others.
LISTYPE= 1, indicating that the company issues both A and B shares; = 0, indicating that the company issues B shares only.
Y2000 = 1, when the sample is an observation in the year 2000; = 0, others.
Y2001 = 1, when the sample is an observation in the year 2001; = 0, others.

4. Further Test

When regressing model (1)-(3), we also adopt stepwise method, instead of enter method, to identify stable relationships between dependent and independent variables. In addition, we have conducted pair wise regressions, only comparing sub-samples of any two from five available supplementary audit patterns. All unreported regression results are consistent with the results reported in Table 5 and Table 6.

IV. POLICY IMPLICATIONS

1. Who Will Act as the Supplementary Auditor?

The concept of internationally renowned accounting firm is set forth in the supplementary audit policy for A share companies. However, our analysis on the structure of China's B share auditing market indicates that currently, nearly half of accounting firms acting as supplementary auditors of B share companies are domestic auditors. Even for accounting firms whose addresses are publicly disclosed as overseas addresses, they are mainly from Hong Kong. Under the internationalization strategy of foreign accounting firms, localization is a common shortcut and form. Therefore, the range to be selected as international CPA firms acting as supplementary auditors, as specified in Document No. 16, will be in fact very limited and possibly confined to Hong Kong and domestic Big 5 auditors. Evidently, under the circumstances where there is no empirical evidence to prove the differentiation in audit quality, especially auditor independence, between localized Big 5 and domestic accounting firms, especially domestic large firms, it is bound to stir up heated debate if to give a favorable policy for localized Big 5.

2. Effect of Supplementary Audit and Comparison of Auditor Independence Under Various Patterns

Since there are continuing debate over the comparison of auditor independence between Big 5 and non-Big 5 auditors, it is necessary to provide evidence. After examining auditor independence under supplementary audit patterns, no matter how the auditor independence is measured, the statistical results stably indicates that there is no significant difference in auditor conservatism under various supplementary audit patterns. In the combination of a domestic large firms and an overseas non-Big 5 auditor, the statutory auditor has a higher, though not significant tendency to express non-unqualified or non-standard unqualified opinions. Under the supplementary audits that Big

5 auditors participate in, statutory auditors' tendency to express non-unqualified opinions is significantly lower than that of the statutory auditors in the supplementary audits that Big 5 auditors do not participate in. Leaving aside the difference of supplementary auditors and simply comparing domestic Big 5, large firms and small firms, there is also no significant difference in auditors' reporting conservatism. When considering the above empirical evidence collectively, we have not yet found that supplementary audits (especially the ones that Big 5 auditors have participated in) have significantly promoted statutory auditor independence, or give support to common inference that domestic Big 5 auditors are stricter in statutory audit. Contrarily, our evidence is consistent with the regional disparity hypothesis regarding Big 5's audit quality (e.g. Rahman, 1998; Francis, Wang and Nikitkov, 2002; Ge and Huang, 2002; Liu and Xu, 2002; Li and Wu, 2002a).

3. Subsequent Revisions to Supplementary Audit Policy for A Share Companies

On March 1, 2002, soon after the release of Document No. 16, the CSRC released *The Notice on Pilot-testing Supplementary Audit in A Share Companies* (hereinafter shortened as "*Notice on Pilot-testing*") to make a modification of Document No. 16. First of all, *Notice on Pilot-testing* basically restricts the range of companies for pilot testing to the ones issuing no less than 300 million shares of stock at a time. This has actually raised the threshold for the implementation of supplementary audit. Secondly, *Notice on Pilot-testing* makes explicit the qualification of accounting firms to perform pilot-testing supplementary audit, i.e. the accounting firms should be qualified to conduct securities and futures-related engagements with granted permission by the MOF and the CSRC, have good expertise and high professional ethics, and be familiar with both Chinese and International accounting and auditing standards. Thirdly, it stipulates that supplementary audit must be conducted based on Chinese accounting standards. In the event that there is a difference between Chinese and international accounting standards, the difference should be explained and publicly disclosed.

It deserves mentioning that *Notice on Pilot-testing* also stipulates that the accounting firm that performs supplementary audit should not perform statutory audit for the same listed company. Obviously, it is very common in B share auditing market that the statutory auditor and the supplementary auditor of a B share company are in the same group or even the same firm. In our sample of 321 observations, such instances account for 52 percent. From the perspective of policy intent, supplementary audit of A share companies is expected to improve the quality of statutory audit through the restraint between the statutory auditor and the supplementary auditor and the comparison of audit results. However, when the statutory auditor and the supplementary auditor of a company are in the same group or even the same firm, the self-review threat to auditor independence appears and there is much less possibility to see any difference between the result of statutory auditor and that of supplementary auditor. Then, the implementation of the supplementary audit policy will be more likely to be fruitless. Actually, prior to the release of *Notice on Pilot-testing*, the CSRC had released *The Notice on Handling the Application for Public Offering of Securities in the Year 2002* on January 24 2002, clearly requiring that the accounting firm that perform either the supplementary audit or statutory audit must not be in the same group. *Notice on Pilot-testing* further prohibits that an accounting firm acts as the statutory auditor and supplementary auditor at the same time. This revision has two important roles. First, it is consistent with the theoretically expected effect of supplementary audit and with the policy intent. Secondly, it relieves the pressure of overseas and domestic auditors in the competition for market shares, i.e. an accounting firm can only choose to act as the statutory auditor or supplementary auditor, but not both, thus balancing the interests of the proponents and opponents of supplementary audit policy in A-share market.

Through the above modification and adjustment to Document No. 16, the vehement stir has been relieved to some extent. And to our knowledge, a final list of accounting firms qualified for performing pilot-testing supplementary audit of A-share companies determined by regulatory authorities in September 2002 has included several domestic large firms. Document No. 16 has, in effect, enlarged the range of supplementary auditors.

No matter how we understand the background and reason for the change of the supplementary audit policy for A-share companies[27], the empirical evidence in this paper at least provides support for the amendment to the policy, especially including some domestic large accounting firms as supplementary auditors.

4. Policy Implication from Other Findings

Consistent with Li and Wu (2002d), this paper finds that auditors are more likely to express unqualified opinions with explanatory paragraphs when there is a clear evidence of auditee's recognition of material non-major business profits, implying the necessity to strengthen the containment of listed companies' profit manipulation and to pay attention to auditors' modification to their opinions. Notably, the MOF has released a revised *Chinese Independent Auditing Standard No. 7 — Audit Report* in April 2003 to standardize auditor's reporting behavior, especially regarding the expression of unqualified opinions with explanatory paragraphs[28].

Lennox (2000) and Li and Wu (2002b) found that when a company receives an unfavorable auditor opinion in the previous period and then changes the auditor in the current reporting period, the successor auditor is more likely to express a clean opinion. The empirical evidence in this paper further indicates to some extent that such behavior only applies to the instances where companies receive non-unqualified opinions in the previous period and supports regulators' concern about potentially unfavorable economic consequences of auditor changes and recent counter-measures (see Li and Wu, 2002c).

Consistent with Li and Wu (2002d; 2003, p.72-91), the evidence in this paper documents that auditors have not been more conservative in contrast with an increasing rigidity of regulatory environment for recent years. We believe that improvement of quality of accounting information can only realize with comprehensive measures and auditors are probably playing a limited and passive role in the governance of the capital market.

V. SUMMARY AND CONCLUSIONS

1. Major Findings

The CSRC released the supplementary audit policy for A share listed companies at the end of 2001 in an attempt to introduce supplementary audit by internationally well-known CPA firms into A share companies' IPOs and SEOs, ultimately improving the quality of accounting information in China's capital market. In despite of its good original intention, this policy has sparked heated debate in domestic practitioners and academics, with one of the focuses on whether international accounting firms, represented by Big 5 auditors, could perform their expected role, especially in terms of auditor independence. This paper makes an attempt to provide empirical evidence by examining the effect of the supplementary audit arrangement in China's B share market.

(i) The analysis on the basic structure of B share auditing market and various supplementary audit patterns indicates that world-renowned accounting firms that act as supplementary auditors in B share market have played

[27] Ma, Xiong and Liu (2002) discussed the release and revision settings of Document No. 16, interpreting the revision reasons as the upsurge of unfavorable public opinion caused by the opposition of domestic CPA firms and relatively effective theoretical research, together with the timeliness of the Enron Case. They also believe that the release of *Notice on Pilot-testing*, in effect, has sentenced Document No. 16 to death.

[28] Article 22 of the revised Audit Report standard clarifies the situations that auditors should (or should consider to) add explanatory paragraphs behind the opinion paragraph in the auditor's report to give an emphasis, i.e. when there exists a going concern problem or other material uncertainties, which have no influence on the expressed opinion. Otherwise auditors should not add explanatory paragraphs or languages behind the opinion paragraph to prevent the users of financial statements from misunderstanding. In addition, the revised standard also stipulates that auditors should state clearly in the explanatory paragraph that the content of the paragraph(s) is (are) only used to remind the users of an attention and there is no influence on auditor's opinion.

their role only to a limited extent, whether in the scope or degree of participation. The policymaker has to rely more on localized Big 5 auditors. So, the presumption of Document No. 16 is that localized Big 5 auditors are significantly more independent than domestic accounting firms.

(ii) The empirical evidence has neither found that supplementary audits (especially the ones that Big 5 auditors have participated in) have significantly promoted statutory auditor independence, nor given support to common inference that localized Big 5 auditors are stricter than China's local accounting firms in statutory audits.

(iii) The evidence supports the policymaker's later amendment to the supplementary audit policy for A-share companies, especially including some domestic large accounting firms as supplementary auditors.

Generally, the evidence is consistent with the hypothesis of regional disparity in Big 5 auditors' audit quality (e.g. Francis, Wang and Nikitkov, 2002; Liu and Xu, 2002), implying that country-specific variance in the maturity of legal system and the degree of investor protection have an influence on Big 5 auditors' reporting behavior. Also, this paper contributes to the literature with an examination of the effect of multiple audits under particular environment, providing some evidence and further thinking for our understanding and evaluation of the effectiveness of multi-audit system.[29]

2. Further Discussions

This paper takes whether supplementary audits could promote statutory auditor independence as the measurement for the effect of supplementary audit policy, but does not deny world-renowned accounting firms represented by Big 5 auditors have implanted long-established quality control system and professional competence in the course of localization. And also, the supplementary audit policy may have positive effects in other aspects.

A potential positive effect is that, although not promoted statutory auditor independence, supplementary auditors express their own opinions clearly different from those of statutory auditors, thus remaining highly independent. However, analysis indicates a very few substantial differences between the opinion of supplementary auditor and that of statutory auditor (i.e. non-unqualified opinion vs. unqualified opinion). Among 304 observations in which both statutory and supplementary auditor opinions are disclosed, there are only 7 cases (i.e. 2.3% of the sample) with substantially different opinions, in all of which supplementary auditors expressed qualified opinions while statutory auditors expressed unqualified opinions. Among the seven observations, 3 cases engaged non-Big 5 while 4 cases engaged Big 5 as their supplementary auditors. From this viewpoint, the positive effect of supplementary audits is not evident.[30]

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[29] Dontoh, Ronen and Sarath (2003) analytically demonstrated the feasibility and superiority of the introduction of financial statement insurance. Meanwhile, they believe that it may be inefficient and costly for the government by adding layers of supervisions and monitoring. Multi-audit system is a kind of adding layers of supervisions. The empirical evidence in this paper indicates the inefficiency of multi-audit to some extent.

The ideology of strengthening regulations by adding layers of supervisions has been continuing. On February 28, 2003, the CSRC released *Public Offering Examination Standard Memorandum No.16 — Specific Review Requirements for IPO Companies*. According to this Memorandum, if the CSRC when examining an IPO application finds any substantial issues regarding the financial statements submitted by the applicant, or believes there may be some material defects in the applicant's internal controls in respect of financial accounting and thereby resulting in material issues with the financial materials submitted, the CSRC may require the company to engage another accounting firm with securities practice qualifications and sound reputation to conduct a special review of specific items in the financial materials. The Memorandum also determines the list of the accounting firms that are qualified to perform special reviews. Special review requirement is another representation of multi-audit system. How to evaluate its effectiveness and social cost need to be further studied.

[30] Zhang, Chen and Tan (2003) conducted a descriptive statistics and univariate analyses on the differences in domestic and overseas audit opinions about listed companies issuing both A and B shares. Though they concluded that overseas auditors are more likely to issue unfavorable audit opinions, further multiple regression analysis are to be conducted for convincing conclusions. According to Zhang, Chen and Tan's (2003, Table3) cross tabulation on domestic and overseas audit opinions about 233 sample companies issuing both A and B share, there are 10 observations, only accounting for 4.5%, where the overseas audit opinion is more unfavorable than the domestic audit opinion, excluding 2 cases where there is a difference between the disclaimer of opinion and the adverse opinion. So,

Another potential positive effect is that, even if both the statutory auditor and the supplementary auditor express opinions of the same type, the supplementary auditor has reflected audit adjustments in supplementary financial statements while the statutory auditor has not reflected audit adjustments in statutory financial statements. Currently, the difference in accounting numbers between statutory and supplementary financial statements are mixed with the difference between international accounting standards and Chinese accounting standards. Under such circumstance, it is difficult in research design to separate out real difference in audit quality, thus difficult to evaluate the potential effect of the supplementary audit policy in this respect.

Furthermore, this paper attempts to infer potential consequences of the supplementary audit policy for A share companies through the implementation of the supplementary audit policy for the B share market. However, since the supplementary audit policy for A share companies is a newborn thing and heated debate has been aroused around Big 5's independence and audit quality, it is possible for Big 5 auditors to adjust their reporting behaviors under such environment and to display a characteristic different from that in B share market. Of course, if the debate precipitates Big 5 to cherish their reputation in the course of localization, or promote auditor independence of domestic accounting firms, the debate itself has probably a positive effect.

Finally, with regard to the continued implementation of the supplementary audit policy for B share, H share and financial listed companies and further pilot-testing supplementary audit for A share listed companies, there are still some issues that deserves concern and in-depth exploration, including how to further improve and supervise the disclosure relating to supplementary audits, how to evaluate and regulate the quality of supplementary audits, how to define legal liability of supplementary audits, etc. Further study on these issues would benefit for the policy-making in the opening of Chinese accounting market.

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even if there is evidence for overseas auditors' higher tendency to express unfavorable audit opinions, the probability of the incidence of difference in opinions between domestic and overseas auditors is still very low on the whole and we cannot hereby infer that supplementary audits play a significantly positive role in this regard.

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