QUALIFIED AUDIT OPINIONS IN CHINA

The need for external independent auditors arises because potential creditors and investors are naturally suspicious of the financial reports prepared by company managers. Managers have incentives to favorably bias the reported numbers such as to make it easier to get loans, to attract investors, and to increase their own bonuses and job advancement opportunities. An independent auditor increases the reliance that external users can place on the management-prepared financial statements.

Before the 1990s, there was no need for external auditors in China. When all companies in China were owned by the state and managed by central planners in Beijing, company financial statements were viewed as confidential government documents not available to outsiders. There was no need for independent external auditors because there were no external financial statement users. The economic reforms of the 1980s resulted in decentralization of the ownership of the Chinese state-owned enterprises (SOEs). The demand for external audits of Chinese companies increased dramatically with the establishment of the Shanghai and Shenzhen Stock Exchanges, in 1990 and 1991, respectively.

In response to this demand for the independent certification of the financial statements of publicly traded companies, in 1995 the Chinese government adopted a more rigorous set of auditing standards to be followed by Chinese CPA firms. Before these standards were enacted, qualified audit opinions were rare and were not publicly announced. The first publicly announced audit qualification under the new standards was published in the Shanghai Securities Journal on February 15, 1996. (Note: In China, all listed companies are required to print their annual report and auditor’s opinion in one of seven designated newspapers.) On this date, YANZHONG ENTERPRISES, a Shanghai-based conglomerate, revealed that its auditor, DA HUA CPA, had qualified the audit report for the 1995 financial statements. The reason for the qualification was that Yanzhong had misclassified investment gains and interest income as part of operating income and refused to revise the presentation. The reaction to this audit qualification was rapid and negative—the Da Hua CPA firm received many phone calls asking whether Yanzhong was on the verge of bankruptcy. Overall, for the ninety-six Chinese audit qualifications announced in 1996, 1997, and 1998, the average loss in company market value was 2% in the three days surrounding the qualification announcements.

QUESTIONS:

1. At the end of 1997, there were 105 CPA firms authorized by the Chinese government to audit the 740 listed companies. This is a large number of CPA firms competing for a small set of clients. What problems can be caused by this type of audit industry structure?

2. Exactly why would a company’s stock price decline upon announcement that the company’s financial statements have received a qualified audit opinion?

SOURCE: