Why Big 4 Accounting Firms Did Not Dominant China’s Stock Market As They Did Elsewhere

By

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ABSTRACT

The Big 4 accounting firms (PriceWaterhouseCoopers, KPMG, Deloitte and Ernst & Young) are dominating the audit markets in the U.S., European Union, Japan and theoretically every major capital market EXCEPT China. As of March 2015, there were around 86% of public companies listed in the New York Exchange (NYSE) as audited by the Big 4, while only 6% of the public companies listed in the Shanghai and Shenzhen Exchange as Big 4’s audit clients.

To understand this phenomenon, this thesis studies the problem not only from an auditor’s selection perspective but the audit firms’ client acceptance and continuance decision. Moreover, the regulatory environmental development was also discussed to better consolidate relevant factors that contributed to the formation of current auditing market landscapes in China.

With respect to conventional auditor selection theories like agency theories by Jensen and Meckling (1976)1, this thesis argued that managers of Chinese listed companies exercised heavy influence in the auditor selection process, resulting in reverse selection problems in auditor selection. The Big 4 accounting firms, on the other hand, enjoy fabulous auditing fee premiums from auditing market segments involving overseas investors/stakeholders because of their unique reputation. However, this fact limits their incentives to expand business to less lucrative market segments. The auditing regulatory environment was also becoming unfavorable to the Big 4 Accounting firms in recent years.
This thesis is constructed as below: First, there is an introduction to Big N accounting firms and their global presence. Second, the characteristics of listed companies in China’s stock market and the development of accounting and auditing industry in China were elaborated. The third part is specifically addressed to the Big 4 accounting firms and their development in China over the decades since their establishment in 1992. Later we review the current literatures regarding auditor selection, client acceptance and continuance decisions in the third part, and use these frameworks to develop our answers to topic questions in the fourth part. As the conclusion, the fifth part summarizes the arguments developed in the fourth part and addresses the limitations of this thesis.

The purpose of this thesis is to form an understanding concerning the question why Big 4 Accounting firms did not dominant China’s stock market as they had done in most of the developed markets. Based on these findings, Chinese policy makers may want to improve the corporate governance of the listed companies, especially in those areas related to the independence of auditing committees, if the government wish to improve their overall audit quality provided to domestic listed companies.

Thesis Supervisor: Joseph Weber
Title: George Maverick Bunker Professor of Management
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1 INTRODUCTION

To study the question raised, a brief understanding is needed about: the audit industry, the Big 4 Accounting firms, the regulatory environment in China, as well as the companies whose shares were publicly traded in exchanges in China. More specifically, we need to identify those unique or special characteristics and consider how these factors impact each other or combine together, which contribute to the status quo of limited market shares of Big 4 Accounting firms among listed companies in China.

1.1 The Origination of Global Big N Auditors

As the global economy of the 20th century grew, enterprises expanded their business externally to foreign countries where accounting and legal systems were different than those of their originating countries. This spurred auditing demands for financial statements of international subsidiaries with a high level of expectancy. Local audit firms in foreign countries may be available but investors were either not familiar with them or simply didn’t trust them. Some of the big audit firms in different countries therefore tried to merge with each other through contractual agreements and formed the strategic audit firm network that is defined by Lenz and James (2007)² as “a contractual cooperation between legally and economically autonomous national audit firms, which are organized based on partnership principles under the strategic leadership of one or more member firms for the joint fulfillment of international client needs”.

Some of these merged audit firms have done great and expanded their brand presence throughout the globe. The biggest ones are known as “Big N”. For most of the 20th century, or
precisely until 1989, the dominating international audit firms were the Big 8, i.e., Arthur Andersen, Arthur Young & Co., Coopers & Lybrand, Ernst & Whinney, Deloitte Haskins & Sells, Peat Marwick Mitchell, Price Waterhouse, and Touche Ross. In 1989, Ernst & Whinney merged with Arthur Young & Co. as Ernst & Young and Deloitte Haskins & Sells merged with Touche Ross as Deloitte Touche (later named as Deloitte). These merges effectively changed the Big 8 into the Big 6. Nine years later in 1998, the auditing landscape changed again when Price Waterhouse merged with Coopers & Lybrand to form PricewaterhouseCoopers (PwC). The resulting Big 5 status didn’t last long. Only 3 years later, the 2001 Enron scandal and the resulting obstruction of justice conviction, though overturned in 2005, effectively tore apart Arthur Andersen and transformed the Big 5 into the current Big 4 since 2002. However, mainstream research argues that the bigger the audit firm is, the higher the reputation risk they would face and thus be less likely to compromise with management; the bigger the audit firm is, the more resources could be allocated to develop staff skill and knowledge and thus have better technical expertise.3

The non-auditing services of the Big 4 Accounting firms have grown significantly and have become a significant part of their business in late 20th century. Following the Enron scandal, the Sarbanes-Oxley Act of 2002 (SOX) established the Public Company Accounting Oversight Board (PCAOB) and imposed strict rules on auditors by restricting them from providing specified non-auditing services, primarily management consulting services, to their same auditing clients. KPMG had spun off its management consulting business in 2001 already; PwC divested its consulting business by selling it to IBM in Oct 2002. In the same year, Ernst & Young sold its consulting business to Capgemini SA. Deloitte planned but didn’t implement the divestment of its consulting business, though it started from the end of the 2000s. PwC backtracked by a series of consulting firm acquisitions to rebuild its consulting business, while
Deloitte expanded its consulting business and created what it claimed “the largest consulting firm in the world”. The Big 4 appears to be back to consulting.

The Big 4’s 2014 annual reports were released publicly, and the below table is a glimpse of the performance of the Big 4 in comparison to a fortune 500 company. As shown below, the average revenue of the Big 4 Accounting firms in 2014 was US$30.1 billion. If they were given a rank in the Forbes 500, they would appear at around 100 of the list.

<table>
<thead>
<tr>
<th>USD ‘bn</th>
<th>Deloitte</th>
<th>PwC</th>
<th>E&amp;Y</th>
<th>KPMG</th>
<th>PMI *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2014</td>
<td>34.2</td>
<td>34</td>
<td>27.4</td>
<td>24.8</td>
<td>31.2</td>
</tr>
<tr>
<td>- Audit</td>
<td>10.1</td>
<td>15.1</td>
<td>11.3</td>
<td>10.5</td>
<td>-</td>
</tr>
<tr>
<td>- Tax</td>
<td>6.5</td>
<td>8.8</td>
<td>7.2</td>
<td>5.2</td>
<td>-</td>
</tr>
<tr>
<td>- Advisory</td>
<td>17.6</td>
<td>10</td>
<td>8.9</td>
<td>9.1</td>
<td>-</td>
</tr>
<tr>
<td>Year 2013</td>
<td>32.4</td>
<td>32.1</td>
<td>25.8</td>
<td>23.4</td>
<td>31.4</td>
</tr>
<tr>
<td>Growth</td>
<td>5.6%</td>
<td>5.9%</td>
<td>6.2%</td>
<td>6.0%</td>
<td>-0.3%</td>
</tr>
</tbody>
</table>

* PMI - Philip Morris International Inc. (NYSE: PM) is the 100th company of 2014 Fortune 500 (the 99th in 2013 Fortune 500). The revenue data was generated from www.fortune.com. Big 4 were not ranked in the list.

Source data: 2014 annual reports from PwC, Deloitte, E&Y, and KPMG.
1.2 Big 4 Market Shares in Global Stock Markets

Although the Big 4 Accounting firms are international auditing networks that are loosely connected with each other, and don’t oversee the management of one another, the Big 4 member firms do share a common success in all major developed countries.

I selected major capital markets, including the New York Exchange, London Exchange and Tokyo Exchange, Hong Kong Exchange, Shanghai Exchange and Shenzhen Exchange from China, to perform an analysis of how the auditing market landscape varies globally. Based on the data generated from S&P Capital IQ as of Mar 15, 2015, the Big 4’s dominating status seems unbeatable in all western developed countries. (See Appendix I for selection criteria of the data)

- Market Shares by Numbers of Clients

As shown in the above table, most of the listed companies in the London Securities Exchange (LSE), New York Securities Exchange (NYSE), Tokyo Securities Exchange (TSE)
and Securities Exchange of Hong Kong (SEHK) are clients of the Big 4. No wonder the US Government Accountability Office (GAO) called these Big 4 Accounting firms as an "oligopoly" in its Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services in 2003.

We note very significantly the different landscapes in China's auditing market in comparison with that of other developed countries. Only 120 listed companies, out of a total of 2,448, are auditing clients of the Big 4, and the percentage was even lower in the Shenzhen Exchange if looked at separately. The Big 4 firms audit merely 41 listed companies in the Shenzhen Exchange, which represents 3% market share by numbers of companies.

- Market Share by Revenue and Assets

Based on the same dataset, we analyzed the market share of Big N by revenue and assets of auditing clients. From this perspective, we could look from the client-based perspective, which may be more relevant considering the concentration of the market.
Using the auditing clients’ revenue and total assets, the auditing markets were even more concentrated than calculating the total number of clients. The Big 4 seized over 96% and over 90% of the listed companies in the above-mentioned markets, measured by their clients’ revenue and total assets, respectively. The market shares of the Big 4 in Mainland China looked better than that of using albeit being at the lowest level around the world.

Given the above, auditing clients of the Big 4 in China generated significantly higher revenues and owned more total assets than any non Big 4 clients in China. In other words, the Big 4 clients are bigger than any non-Big 4 clients in China.

- Market Share by Market Capitalization

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<table>
<thead>
<tr>
<th>Market Capitalization</th>
<th>LSE</th>
<th>NYSE</th>
<th>China (SH &amp; SZ)</th>
<th>SEHK</th>
<th>TSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non Big 4 Clients</td>
<td>55</td>
<td>411</td>
<td>3,778</td>
<td>220</td>
<td>319</td>
</tr>
<tr>
<td>Big 4 Clients</td>
<td>3,551</td>
<td>18,402</td>
<td>1,174</td>
<td>4,512</td>
<td>4,331</td>
</tr>
</tbody>
</table>
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For the western developed markets, the Big 4 market shares, measured by market capitalization, are very similar to those measured by their client’s revenues and total assets.
However, in China, the Big 4 market shares by market capitalization, shrunk significantly by comparison. That indicates that small non-Big 4 auditing clients in China indeed enjoy a valuation premium by local investors than do Big 4 clients.

To summarize, Big 4 Accounting firms dominated major capital markets, except China, in almost every measure. Although Big 4 clients in China obviously include some of the largest companies in terms of revenues and total assets, the valuation premium of non-Big 4 clients suggest that Chinese investors do not rely on high quality auditing to mitigate the risk of agency conflicts. Is it the case? Why or why not? We need to go further to understand China’s auditing and accounting industry, its stock markets as well as the development of the Big 4 in China, as elaborated in next section.

2 CHINA’S STOCK MARKETS AND THE DEVELOPMENT OF THE AUDITING/ACCOUNTING INDUSTRY

In this section, we will firstly discuss about the development of China’s stock markets that designed so different with those in developed markets but become more similar than ever in these days. We will explore the auditing and accounting industry of China in the second part.

I believe that the explorations in these areas are helpful for us to understand better the demand and supply side of auditing in China.
2.1 The Chinese Characteristics in Designing Stock Markets

Since the establishment of the Shanghai Exchange and the Shenzhen Exchange in the late 1990s, the numbers of listed companies being traded in the exchanges increased from 13 to 2,756 as of February 2015\(^5\). Despite this notable growth, China’s stock markets were born with heavy “Chinese characteristics”.

At the very early stage of China’s stock markets, the numbers of how many companies could be listed for a specific region, or sector was decided/planned in the central government level. Local governments and different ministries would then have authority to allocate quotas to specific company applicants. Guo and Wang (2005)\(^6\) pointed out that there were only a few quotas were allocated to the private enterprises. This was the case until 2001 when the China Security Regulatory Committee (CSRC) reformed the stock issuance system from the quota/approval mechanism to a certification mechanism\(^7\), which was considered more open and fair to private enterprises. According to a news report by the China Securities Daily in early 2013\(^8\), the annual National State-owned Asset Administration Meeting released that, as of 2012, there were 953 stated-owned listed enterprises, representing 38.5% of the total listed company numbers and 51.4% of total market capitalization of the listed companies’.

To maintain state control over the listed state-owned enterprises, the equity shares of listed companies in China were categorized in two categories: 1) Non-tradable shares, mainly comprised of state-owned shares and legal person shares that ultimately were controlled by the governments; and 2) Tradable shares that were owned by the public and could be traded freely in the stock exchanges. Chen and Thomas (2003)\(^9\) estimated that 65% of equity shares were state-owned, legal persons owned 20%, and therefore only 15% of the total equity shares in China’s stock markets were owned by the public and in fact tradable. Such institutional designs attracted
heavy criticism and the government eventually initiated reforms on the Non-tradable equity shares in 2005. Over 98% of the listed companies had completed their reforms by the end of 2007\textsuperscript{10}. However, there are still 15 companies not yet complete on their reforms for the Non-tradable shares as of March 2015.

China's stock markets are separated into two independently functioning markets in both the SHSE and SZSE: 1) A share market that is designed for domestic investors, and 2) B share market that is designed for foreign investors.

2.2 The Accounting and Auditing Industry In China

*The development of Accounting Standards:*

Right after the establishment of People's Republic of China (PRC) in 1949, Mainland China has become a planned economy, which is totally different with western market economies. The government substantially controls all sectors and distributes not only the income but also daily commodities to its people through state-controlled organizations or state-owned enterprises. In that environment, the intrinsic demand of independent auditing was theoretically abolished until 1978.

On Dec 22, 1978, the Third Plenum of the 11th Central Committee of the Communist Party of China made an announcement declaring the "open door" policy and to establish market economy with Chinese characteristics. This announcement was an historic and an important economic event to date since the PRC was established.
Zeng (2013)\textsuperscript{11} categorized the development of China’s accounting rules since 1978 into four stages: The first stage was defined as the period from 1979 through 1992 for China to understand the western accounting system and to learn from it mainly to create accounting standards for foreign investment enterprises. During this period, “Rules regarding the finance accounting problems in Sino-foreign joint ventures” was issued in 1979 and “Accounting Rules for Sino-foreign Joint Ventures” was issued in 1985. Both of these rules were designed by reference to the western accounting rules. The second stage was from 1993 to 2000, marked by the establishment of “Corporate Accounting Standards”, “Corporate Accounting General Principles”, as well as the specific accounting rules for 13 industries and specific finance management rules for 10 industries effective since July 1993. During this period, China had systematically, but still basically, established its accounting system. 16 specific accounting standards were issued during this period. The third stage was from 2001 to 2006, marked by the “Corporate Accounting Rules” effective since 2001. In this period, specific accounting rules for different industries were abandoned and the unified accounting system was established. 39 specific new accounting standards in reference to the IFRS and IAS were announced along with 48 auditing standards in reference to the International Standards of Auditing. The fourth stage was from 2007 when 39 specific new accounting standards and 48 auditing standard came into effect. At this stage, China had established sophisticated accounting standards that were equivalent to the IFRSs and continued to seek the convergence with the IFRSs. The European Commission acknowledged that the accounting standards of China were equivalent to the IFRSs, which were adopted by European countries since 2012.
The evolution of the auditing profession in the PRC:

Similar to the accounting standard developments, there was a nearly blank period in terms of independent auditing in the PRC before the open-door policy was enacted and foreign investors flooded in. The first pilot audit firm, Shanghai Accountants' Firm, was founded by the authorities in 1983, but the “China Certified Public Accountants Regulations” was only issued in 1986 (replaced by “China Certified Public Accountants Law” in 1994). The China Institution of Certified Public Accountants was established in 1988 with initial members of around 3,000 people.

The authorities started to establish accounting firms and audit firms since then. The Big 6 (Arthur Andersen, Price Waterhouse, Coopers & Lybrand, Peat Marwick Mitchell, Ernst & Young, and Deloitte & Touche) entered China in 1992 by establishing joint venture firms between local audit firms and the Big 6 member firms from Hong Kong. As of 1992, there were 1,422 accounting firms and 2,812 audit firms in China.

At that time, accounting firms were under the supervision of the Finance Bureaus while the audit firms were under the direct supervision of the Audit Committee of China. Liu and Lin (2000)\(^{12}\) believed that such situations were mainly because of conflict of interests with authorities and became hurdles during the modernization of China’s auditing industry. The Chinese government pushed hard in 1998 and forced all of these accounting firms and audit firms to be independent from their supervisory authorities by 1999. All of these firms were renamed as accounting firms and under the regulatory of Ministry of Finance and guidance of China Institute of Certified Public Accountants (CICPA).

Even though accounting firms had been independent from the government authorities since then, most accounting firms were established in the legal forms of Limited Liability
Companies (LLC). Firth, Mo and Wong (2011) studied this transition and pointed out that even though such legal form was named as “limited liability”, its different with the “limited liability partnership (LLP)” in the United States. “While LLPs in the United States limit the liabilities of non-negligent partners, the negligent partners’ personal assets are still at risk. … … By contrast, the limited liability CPA firms in China limit the liabilities of both the negligent partners and non-negligent partners.”

The LLC legal form of audit firms was considered good at protecting individual property at that time, especially since China’s legal environment concerning property was weak. However, the LLC legal form was obviously not suitable for any long term development of the auditing industry, because: 1) mismatch of liability, 2) limitations of LLC shareholders to 50 only under China’s Corporate Law, leaving it difficult for accounting firms to grow into a large scale; and 3) double taxation problems, etc.

In 2010, the Ministry of Finance and National Bureau of Industry and Administration jointly issued the “Promoting the Large/medium size accounting firm to adopt the Special General Partnership in organization format” (Caikuai[2010]N0.12), encouraging accounting firms, especially large accounting firms, like the Big 4 in China, to transform into a Special General Partnership (SGP) legal form that is similar to a limited liability partnership in the United States and other developed economies. The major accounting firms, including Big 4 China, have completed the reform but the majority of accounting firms, mostly small and medium size firms, have yet to commence reforms as of 2014.

As of 2014, there were 8,295 audit firms in China. 40 of those firms are allowed to audit the securities and futures related engagements while 11 firms, including the Big 4 member firms in China, are allowed to audit the Hong Kong listed Mainland Companies. The number of
individual members of China Institute of Certified Public Accountants was over 200,000, including 99,045 practicing members and 103,566 non-practicing members\(^{14}\).

2.3 **Hong Kong in Different Situation**

Though Hong Kong was returned as part of China since 1997, the legal institutions and free economy system were well developed during the colonial times and remained very different with those of Mainland China even after its return.

Xie and Jiang (2005)\(^{15}\) compared the legal system, listing rules and related party transactions in Hong Kong and Mainland China’s stock markets, concluded the Hong Kong’s legal system was more protective to the investors and the Hong Kong listing rules was more restrictive than those in Mainland China. Besides, Hong Kong is a free economy that anyone from anywhere around the world could invest in Hong Kong’s stock markets.

On the other hand, the accounting and auditing industries of Hong Kong were also developed much earlier than in Mainland China. The Hong Kong Statements of Standard Accounting Practice was launched in 1976 by reference to the English Statements of Standard Accounting Practice of England. Up until 1991, there were already 25 items of standard in effect. In 1995, two years before Hong Kong’s annexation to China, the Hong Kong Society of Accountants (later changed its name to the Hong Kong Institute of Certified Public Accountants) In 2004, they declared that it would develop Hong Kong Accounting Standards (later as Hong Kong Financial Reporting Standards (HKFRS)) on the basis of International Accounting Standard. The HKFRS were later acknowledged as converged with International Financial Reporting Standards with effect from 1 January 2005, except for some minor differences.
3  BIG 4 CHINA AND THEIR DEVELOPMENTS

As discussed, the Big 6 entered China in 1992 through establishing joint ventures firms between local audit firms and the Big 6 member firms from Hong Kong. Price Waterhouse and Coopers & Lybrand merged as PwC in 1998; four years later in 2002, the collapse of Arthur Andersen US resulted in its China member firm, Arthur Andersen Huaqiang, abandoning the name of Arthur Andersen and merged with PwC in China. According to their joint venture contracts, the joint ventures of Deloitte, Ernst & Young, and KPMG would expire by 2012; and in 2017 for PwC.

In the beginning, Big 4 in China mainly provided services to foreign investment companies and later expanded to State-Owned Enterprises who seek oversea listing and some private enterprises. Li (2010)\textsuperscript{16} investigated the management structure of Big 4 China member firms and found that all the Big 4 accounting firms had established management committees that closely tied the Big 4 member firms in the region and exercise effective governance to all member firms under their governance. For example, In Hong Kong and Macau, the two Special Administrative Regions of China, there were legally independent KPMG member firms established; however, a management committee was in place to manage all the offices in China, Hong Kong and Macau. Deloitte established similar governance structure while PwC and Ernst & Young included Singapore and Taiwan in their Greater China management committee.

According to the a report concerning the transformation of Big 4 in China from Sino-Foreign Joint Venture to SGP by The Accounting Department of Ministry of Finance in August 2014 “Hundred Years of Big 4, New Look in China”\textsuperscript{17}, the percentage of foreigner partners among all the partners in Big 4 China were 58% as of 2010, representing 70% in KPMG, 61% in PwC, 55% in Ernst & Young and around 50% in Deloitte. Similar percentages were noted in
the management committee, which were the highest decision making organizations in the Big 4 in China. In the mean time, as the local partners were comparatively new and young with less experience, their position among the partners were junior and thus with limited power in the decision making of the Big 4 in China. The Big 4 in China was substantially controlled by a group of foreigner partners mainly from Hong Kong, and this situation did not substantially changed until recently.

While the Big 4 in China did grow rapidly, local firms adopted the merge and acquisition strategies in response to the call of MOF. "Some opinions regarding accelerating the development of Certified Public Accountants Industry" in October 2009, which explicitly promoted the local audit firms to "grow bigger and grow stronger" through mergers and acquisitions, are aiming at around 10 large audit firms to compete globally with the Big 4 and hundreds of medium size audit firms to serve the rapidly growing domestic demands.

According to the top 100 accounting firms ranking released annually by CICPA, KPMG was out of the top 4 since 2012 and Ernst & Young was out since 2013.

<table>
<thead>
<tr>
<th></th>
<th>Revenue 2013</th>
<th>Revenue 2012</th>
<th>Revenue 2011</th>
<th>Revenue 2010</th>
<th>Revenue 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Big 4 Firms</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>1 PwC</td>
<td>3,351</td>
<td>3,226</td>
<td>2,957</td>
<td>2,960</td>
<td>2,578</td>
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<tr>
<td>2 Deloitte</td>
<td>2,881</td>
<td>3,045</td>
<td>2,928</td>
<td>2,600</td>
<td>2,370</td>
</tr>
<tr>
<td>3 Ernst &amp; Young</td>
<td>2,364</td>
<td>2,236</td>
<td>2,277</td>
<td>2,094</td>
<td>1,960</td>
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<td>4 KPMG</td>
<td>2,347</td>
<td>2,136</td>
<td>1,928</td>
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<tr>
<td><strong>Domestic Firms</strong></td>
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<td>1 Rui Hua</td>
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<td>2,437</td>
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<tr>
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<td>907</td>
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<td>503</td>
</tr>
<tr>
<td>4 Da Hua</td>
<td>1,239</td>
<td>1,008</td>
<td>803</td>
<td>640</td>
<td>510</td>
</tr>
</tbody>
</table>
4 LITERATURES REVIEW

There is extensive research literature about auditing in developed countries especially in the US and UK. Theories and arguments were developed regarding audit quality, auditor selection, audit risk management and regulatory impacts on audit quality, etc. Given the relative short history of modern accounting and auditing, the audit related literatures were not sufficient in understanding the auditing practices in China, and a lot of this literature was merely adopting models or theories developed in the developed countries with evidence from China. Nevertheless, both the conventional researches from the developed countries and the researches in China provided valuable resources and framework in accomplishing this thesis.

4.1 Of Auditor Selection

Jensen and Meckling (1976) developed the agency theory so that explained why the independent auditor would be engaged by management to testify the financial statements voluntarily prepared and provided by the management of the companies.

DeAngelo (1981) argued that different level of cost would cause different levels of auditing service, i.e. different audit quality. He defined the audit quality as a) discovering a breach and b) reporting the breach. DeAngelo (1981) further argued that the audit quality is positively related to the audit firm size because auditors with a greater number of audit clients have “more to loss” by failing to report a discovered breach, and audit firms would “specialized in a uniform level of audit quality” in response to quality evaluation from needs their clients. He concluded that audit clients would seek to change audit firms in order to change the level of audit quality purchased. Given that Big 4 firms enjoyed reputation of prestige in the auditing industry and had the biggest offices, it’s evident that the Big 4 firms provide the highest audit quality.
Some other research concerns auditor selection from both the auditor characteristic perspective and the audit committee/management characteristics perspective using surveys and interviews.

In later studies, Addams and Allred (2002) successfully surveyed 102 CEOs of the fast growing companies and found that auditor’s technical and expertise were two of the most significant factors in selecting auditors, however, the relationships between the audit firm’s key people and the company’s key decision makers was also critically important in the selection process. The proposed auditing fee, in this study, was considered as a fairly important factor affecting auditor selection. The availability of international service seems to be at the lowest importance for these small but fast growing companies. For more details of the surveys results, please refer to Appendix II.

Almar, Philbrick, and Rupley (2014) performed surveys and interviews to auditing committees of listed companies in the US finding that the audit firm’s reputation for industry specialization, together with the accessibility and capability of the concerning audit partner, were the key factors affecting the selection decision of auditors. Some other factors, for example, the relationship between the audit firm members and the management or auditing committee, are negative factors that hinder auditing committees from choosing its auditor. Auditing fees, however, were only fairly important to the auditor selection based on research, ranking higher than the availability of international services. For more details of the surveys result, please refer to Appendix III.

In China, however, Li (2006) found the notion that higher agency costs would drive demand for higher audit quality provided by large audit firms was NOT applicable to the auditing market of China. He argued that there was huge difference of shareholding structure
and corporate governance between China and the US market, which led to different agency relationships; on the other hand, the auditing market structure is very different to the US market.

Liu and Zhou (2007)\textsuperscript{25}, based on data from the Shanghai Exchange and Shenzhen Exchange for the year 2002 and 2003, argued that the Big 4 China member firms faced very limited legal risks in China, and the audit quality provided by the Big 4 China member firms was no difference, if not worse, when comparing with those of Non Big 4 audit firms. Liu and Mai (2006)\textsuperscript{26} concluded similar findings. Guo (2011)\textsuperscript{27} gathered empirical research using data from 3,874 companies listed in the Shanghai Exchange and Shenzhen Exchange for the period from 2007 to 2009. The conclusion was that there were no observable differences in Earning Management perspective between the Big 4 auditing clients and Non Big 4 auditing clients, i.e., Big 4 audit firms provide no higher audit quality in China’s listed companies.

Lisic, Silveri, Song and Wang (2015)\textsuperscript{28}, however, found that companies audited by large audit firms are less likely to commit financial fraud in China. They argue that serious governmental sanctions, despite the weak legal environment on audit firms, contribute to the better audit quality of large audit firms. However, they don’t separate the Big 4 and Non Big 4 firms in this study.

Although main stream opinions suggest that the Big 4 doesn’t provide higher quality audits in China, Li and Xue (2007)\textsuperscript{29}, using China’s listed companies from 2000 to 2002, found that Big 4 firms enjoyed significant auditing fee premiums, while the local big 5 audit firms enjoyed somewhat notable auditing fee premiums, compared to those medium and small size audit firms providing auditing services to the listed companies. Wang and Liu (2014)\textsuperscript{30} reaffirmed similar conclusions using data from 2003 to 2010.
4.2 Of Client Acceptance and Continuance Decisions

Compared to the research on audit quality and auditor selection, there is fewer literature concerning the Client Acceptance and Continuance Decisions. Drira (2013)\textsuperscript{31} examined the two existing approaches, single-client approach and client portfolio approach, and tried to develop a general theory of Client Acceptance and Continuance Decisions (CACD), in which he argued: “Depending on the audit firm resources limitations and clientele capacity, the firm decides on the new clients who should be accepted/ rejected and the existing clients who should be retained/resigned from. As a consequence, the audit firm new portfolio of clients is formed. Obviously, if any of the acceptable clients is not interested in the audit firm services or decides to dismiss it, it would be replaced by the next best acceptable client.”

Krishnan, Sun, Wang, and Yang (2013)\textsuperscript{32} found that 1) charging higher abnormal auditing fees and 2) resigning from risky clients are the two viable strategies for client risk management. They also noted that auditors tend to firstly charge higher abnormal auditing fees when the trade-off of risk and return is in acceptable ranges, and if potential risks were beyond an acceptable level, auditors would then resign from the clients.

In China, Du and Zhu (2010)\textsuperscript{33}, suggest that client acceptance management is a major way of managing audit risk for China accounting firms. Wang (2011)\textsuperscript{34}, based on the data from 1997 to 2007 in, tested the client portfolio theory in China found that the theory was not robust in China, suggesting that the regulatory environment was very weak for audit firms.
4.3 Of Government Regulatory

Research on auditing in developed countries garnered mixed results on the effectiveness of regulatory measures in improving audit quality (DeFond and Zhang, 2014). However, research in China generally suggests that the government or authorities should take the leading role in monitoring the auditing markets to improve audit quality (Du, 2002; Cao and Zhao, 2004; Liu and Zhou, 2007; Liu and Wang, 2015). Firth, Mo and Wong (2014) argue that regulation became more important to the auditing market than it may be in developed countries. They found that in China, regulatory sanctions on auditors changed auditors’ behavior in a conservative way; more of “going-concern” opinions were issued by sanctioned auditors, and thus improved the quality of audits.

As China transformed from a totally planned economy in which government regulation played a crucial role in the economy, it is fact that China’s legal system was not properly established as developed countries did. The government is still believed to be able to exercise significant impact in the auditing market.

5 DEVELOPING ARGUEMENTS

A transaction can only be accomplished when the supply meets demand. The Big 4’s low market share in China’s stock markets could be analyzed from two perspectives: the supply side factors and the demand side factors. In addition to that, discussing the impact of the regulatory environment is important. The following sections focus the discussion from three perspectives: Auditor Selection, Client Acceptance and Continuance Decisions, and Regulatory.
5.1 Client Acceptance and Continuance Decision Perspectives

**Argument 1:** The Big 4 China member firms were presumed to have the highest audit quality provider and enjoyed fabulous audit fee premiums in China, limiting their incentives for less lucrative audit market.

Although some Chinese research found it difficult to argue that Big 4 China member firms had provided higher quality audits than local audit firms, using the models of Earning Management Models, their research was mostly biased by the problem of self-selection. There were only a few listed companies audited by the Big 4 China member firms; it's not abnormal that some intrinsic financial characteristics of these limited samples are different from those other listed companies.

DeFond and Zhang (2014) reviewed different proxies used in measuring audit quality but found no consensus on current literature which served the best. These measures are classified into two categories: Output-based measures and Input-based measures. Material Misstatements, Auditor Communication, Financial Reporting Quality, Perceptions, Auditor Characteristics and Auditor-client Contracting Features are the most used categories in measurement. However, from the auditor selection perspective, the most relevant measurements, would be the market's perception on audit quality provided by different auditors instead of the audit quality itself. The audit quality measurements might have been well measured by the output/input measures as summarized by DeFond and Zhang (2014), but there was limited research on how to measure market perception on audit quality, in other words reputation. One other possible, and simple measurements would be the audit firm's ranking as widely spread in the market. CICPA, the quasi-official authority body oversees the audit industry in China, publishes
the rankings of audit firms annually since 2003, using the criteria of revenue, numbers of CPA, misconducts, etc. The summary of the rankings is as follows:

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</tr>
</thead>
<tbody>
<tr>
<td>PwC</td>
<td>1</td>
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<td>1</td>
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<td>1</td>
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<tr>
<td>Deloitte</td>
<td>2</td>
<td>2</td>
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<td>3</td>
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<td>3</td>
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<tr>
<td>RuiHua</td>
<td>3</td>
<td>3</td>
<td>6</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>6</td>
<td>6</td>
<td>8</td>
<td>6</td>
<td>6</td>
<td>6</td>
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<tr>
<td>LiXin</td>
<td>4</td>
<td>5</td>
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<td>6</td>
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<td>5</td>
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<td>5</td>
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<td>5</td>
</tr>
<tr>
<td>Ernst &amp; Young</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>2</td>
<td>2</td>
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<td>4</td>
<td>4</td>
<td>4</td>
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<tr>
<td>KPMG</td>
<td>6</td>
<td>6</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>2</td>
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<td>2</td>
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<tr>
<td>TianJian</td>
<td>7</td>
<td>8</td>
<td>7</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>13</td>
<td>15</td>
<td>12</td>
<td>13</td>
<td>13</td>
<td>19</td>
</tr>
<tr>
<td>DaHua</td>
<td>8</td>
<td>10</td>
<td>10</td>
<td>11</td>
<td>11</td>
<td>21</td>
<td>30+</td>
<td>30+</td>
<td>30+</td>
<td>30+</td>
<td>30+</td>
<td>30+</td>
</tr>
<tr>
<td>XYZH</td>
<td>9</td>
<td>9</td>
<td>8</td>
<td>9</td>
<td>7</td>
<td>10</td>
<td>7</td>
<td>7</td>
<td>6</td>
<td>7</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>DaXin</td>
<td>10</td>
<td>7</td>
<td>11</td>
<td>10</td>
<td>10</td>
<td>9</td>
<td>8</td>
<td>11</td>
<td>13</td>
<td>20</td>
<td>21</td>
<td>30+</td>
</tr>
</tbody>
</table>

Not to mention the Big 4 accounting firms' global exposure and the high reputation in the most developed capital markets around the world, the CICPA rankings deliver a clear message to the local markets that the Big 4 China member firms represent the highest reputation and quality in China. These reputations and market perception on high audit quality then transfer into fabulous audit fee premiums for the Big 4 China member firms.

It's widely acknowledged that the Big 4 China member firms charges higher audit fees than local auditors for both branding and specialization\(^2\). They earn even higher audit fee premiums in less competitive supplementary markets\(^3\), i.e. the B share market where Chinese companies issued equity shares to the oversea investors. Indeed, given that none of the Chinese local auditors had ever expanded their businesses overseas nor promoted their brand abroad until recently, oversea investors are preferring the Big 4 instead of the other local auditors, resulting in strong preference and high audit fee premiums to Big 4 China for audit engagements involving oversea investors.

Such preference creates two major market segments for the Big 4 China member firms: 1) group reporting audits for foreign invested enterprises and 2) oversea IPO audits. It is not clear
how much of these businesses count in the overall business the Big 4 China were doing because such information has not been disclosed. No public studies and research could be found, however, according to my working experience in one of the Big 4 China member firms in China, such oversea investor involved audits comprises a majority of Big 4 China’s overall business. For example, approximately over 80% of their audit engagements in my department had involved foreign investors or oversea IPOs as mentioned above; the situation was very similar in other audit departments.

The lucrative audit engagements in less competitive market segments supported Big 4 China member firms’ rapid growth and guaranteed a high return, but also limited their incentives to seize more markets which will in turn reduce the average return per audit partner. Unlike other companies, the Big 4 audit firms’ net profits are shared among the equity partners, who are also the key decision makers of the firms. By engaging in more competitive audit markets, i.e. the local statutory audit market, the Big 4 audit firms have to allocate similar levels of resources in return of less profit. Because the working capacity of an audit firm was limited by its human capital, including the number of audit partners, when audit partners are fully occupied by lucrative audit engagements, a decision from the firm to expand to the less lucrative market would decrease the benefits of existing audit partners and thus is not favorable. The extraordinarily high return market segments may also help to explain why there were few mergers and acquisitions of local audit firms initiated by Big 4 firms in China.

Chow, Ho and Mo (2006) administered a survey to 102 experienced/senior auditors in China, including 40 from Big 4 firms and 62 from non-Big 4 firms, to study the auditing approach adopted by these firms. Their results show that there are no substantial differences for auditors from Big 4 firms and non-Big 4 firms in the qualitative consideration when making
decisions of client acceptance and continuance. The findings also support the argument that Big 4 China member firms select their clients mainly based on the audit fees instead of other qualitative factors.

CICPA’s annual accounting firm ranking summarized the revenue and numbers of CPA of each of the top 100 audit firms in China, offered us an proxy to look at the difference in profitability between Big 4 firms and non Big-4 firms. The following table is the top 10 accounting firms’ data in year 2014.

<table>
<thead>
<tr>
<th>&quot;RMB million&quot;</th>
<th>Revenue</th>
<th>No. CPA</th>
<th>Per CPA</th>
<th>Per Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>PwC</td>
<td>3,351</td>
<td>1,959</td>
<td>1.70</td>
<td>0.55</td>
</tr>
<tr>
<td>Deloitte</td>
<td>2,881</td>
<td>1,000</td>
<td>1.29</td>
<td>0.51</td>
</tr>
<tr>
<td>RuiHua</td>
<td>2,776</td>
<td>2,355</td>
<td>1.18</td>
<td>0.35</td>
</tr>
<tr>
<td>LiXin</td>
<td>2,509</td>
<td>1,811</td>
<td>1.39</td>
<td>0.35</td>
</tr>
<tr>
<td>Ernst &amp; Young</td>
<td>2,364</td>
<td>911</td>
<td>2.59</td>
<td>0.53</td>
</tr>
<tr>
<td>KPMG</td>
<td>2,347</td>
<td>616</td>
<td>3.81</td>
<td>0.68</td>
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<tr>
<td>TianJian</td>
<td>1,341</td>
<td>1,389</td>
<td>0.97</td>
<td>0.35</td>
</tr>
<tr>
<td>DaHua</td>
<td>1,238</td>
<td>976</td>
<td>1.27</td>
<td>0.30</td>
</tr>
<tr>
<td>XYZH</td>
<td>1,175</td>
<td>1,096</td>
<td>1.07</td>
<td>0.31</td>
</tr>
<tr>
<td>DaXin</td>
<td>1,101</td>
<td>1,032</td>
<td>1.07</td>
<td>0.32</td>
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</table>

5.2 Auditor Selection Perspectives

*Argument 2: The management of listed companies heavily influences the auditor selection decision, resulting in a reverse selection problem for high quality audit services.*

Agency theories suggest that managers would turn to independent third party, i.e., the auditor, for assurance of their financial statements in order to avoid high verification cost from shareholders. However, DeFond and Zhang (2014) reviewed recent literatures regarding the correlations between the demand of high audit quality and the agency conflicts of the companies,
finding that even most of the research finds support the agency theory, “the evidence is relatively limited”.

In China, agency costs of the Chinese listed companies are high due to the weak corporate governance standards and regulatory environment. However, it’s not necessarily true that the listed companies with higher agency costs would choose larger audit firms, i.e., higher audit quality. Li (2006) using the IPO data from 2002 to 2004 in China, found that the choice of large audit firms were not significantly correlated with the agency conflict proxies except the size of the company. These findings were important because it indicates that the agency conflict dynamics were empirically different from those companies in western developed markets. A possible reason for this difference was that capital markets in developed countries are pretty mature and efficient after a long history of development while such cases are not true in China. More specifically, most of the listed companies are state-owned or family owned in China. These companies issued part of their shares to the public but the controlling equity holders normally maintain absolute control of these listed companies. Most critically, there has been a lack of strong evidence on how the agents would be punished by maintaining a high agency cost in stock markets where high agency cost was the norm.

Although the audit committee or board of directors, according to regulations, should make auditor selection decisions independently, it is common practice that the senior managements of listed companies heavily impact auditor selection decisions. Zhang, Li and Zhang (2010) documented this in their research based on data from China stock markets.

Luo and Zhao (2014) further found that, in China’s listed companies, the more power senior management could exercise in impacting corporate governance, the lower the audit quality it would choose. Their argument was interesting but convincing. From the perspective of
managers, the higher quality auditors were comparatively more skillful and thus would be able to identify more issues, which suggested low quality of management’s work; on the other hand, the higher audit quality normally means the larger of the audit firm. A smaller audit firm with less audit clients would rely more on the listed companies auditing clients so could then compromise more in issuing its audit opinion.

To summarize, China’s stock market experienced dramatic growth in terms of size and quality over the past 25 years, however, corporate governance of listed companies are still weak and the market is still far from efficient. Under such circumstance, the managers of listed companies tended to exercise reverse selection of high audit quality that represented by the large size audit firms, especially the Big 4 China member firms, resulting small market shares of Big 4 China member firms.

**Argument 3: Listed companies without foreign investors involvement prefer local auditors who are more accessible to solve problems and with better understanding of local businesses**

Listed companies without foreign investors involvement mainly represent small/medium and some large listed companies that don’t issue shares or bonds to oversea investors. This group represents most of the listed companies because there are only a few of China’s companies that have substantially expanded to the other parts of the world recently.

A survey concerning what drives auditor selection performed by Almar, Philpbrick, and Rupley (2014) found that, apart from auditor reputation and industry specialization, the auditing partner addressing auditing issues on a timely basis was the most important factors along with that auditing partner’s high accessibility (Appendix II). Although the survey and interviews were performed to US listed companies, similar concerns are commonly shared among China’s listed companies.
As mentioned above, Hong Kong professionals controlled the Big 4 China member firms and most of the decision-making partners were Hong Kong people who do not speak fluent Mandarin, which is the common language in Mainland China. This fact creates a certain level of distance between the local managements and the Big 4 China member firms. On the other hand, Hong Kong professionals come from Hong Kong a place where the legal environment is well developed and corporate behavior is more standard. While companies in China generally have different kinds of corporate governance problems and sometimes doing business in legally grey areas, audit partners from Big 4 China member firms therefore tend to be more prudent and less flexible than audit partners from local audit firms.

Secondly, the audit fees of each specific audit client, except certain financial institutions, may only make up a very small percentage of the total revenue of the any of the Big 4 China member firms, making the managements less important than they could have been, and thus would have less accessibility if they choose Big 4 China member firms.

It’s also worth noting that the state-owned enterprises counted a significant part of listed companies. Even after years of dilution by the private listed companies, according to the president of China Securities Regulatory Committee⁴⁹, as of September 2014, there were still 1,007 state-owned listed companies, accounted for 39% of total number of listed companies and 55% of total market capitalization in China’s stock markets. Considering the prosperity of privately owned companies in getting listed in recent years since 2005, the percentages of state-owned enterprises were even higher in early days. The managers of these state-owned enterprises had maintained close relationships with local government authorities and officers. When comparing the Big 4 audit firms with the local audit firms that originated from the
governments and with extensive local government/business resources, such commonality would stand out and affect the auditor selection decision.

In fact, in his doctoral dissertation, Professor Xia (2005) from Shanghai University of Finance and Economics studied the government intervention and market failure concerning auditor selection in China, concluded that state-owned listed companies were more likely to choose small audit firms that represented lower audit quality. He argued that on one hand, local government benefited from the state-owned enterprises and thus indulged and even assisted them in managing earnings that could impact the capability of financing from the stock markets. On the other hand, the local audit firms were used to be affiliates to the local government authorities, and somehow politically and economically dependent on the local government. Therefore, local state-owned enterprises had stronger intention to collude with local audit firms than private enterprises.

5.3 Regulatory Perspectives

*Argument 4: The regulatory environment in China is changing from favorable to unfavorable for Big 4 China member firms.*

In China, the government still exercises significant impact on the development of its economics and even to specific industries and companies, and it used to be in great favor of Big 4 China member firms.

In January 2001, CSRC and China Insurance Regulatory Committee (CIRC) jointly issued a regulation “Administrative Rules of Temporary Auditing License to Foreign Audit Firms in Providing Audit Services to Listed Financial Institutions”, requiring ALL listed banks
and insurance companies in China to employ one of the Big 4 audit firms, in addition to the one existing local audit firm, for the supplementary annual financial statement audit.

In August 2001, the “Yingguanxia (SZ.000557)” was disclosed to media for massive and extensive fraudulent financial reporting. Investigations by CSRC further found that its auditor Shenzhen Zhongtianqing Accounting Firm, the single biggest audit firm with the most listed companies as its clients at that time, failed to meet most requirements of the auditing standards. The result was shocking to the market as well as to regulatory bodies. Soon in December 2001, CSRC issued “Corporate Information Disclosure Requirements for Public Offering No.16 – Supplementary audit requirements for A share listed companies” (Notice No.16)\(^{51}\), require ALL IPOs and refinancing of existing listed companies should hire “globally well known” audit firms to perform supplementary audits in accordance with International Accounting Standards.

If there were no Enron scandal, the auditing markets in China’s stock markets might look very different to what it is today. In October 2001, the Enron scandal came to light. Its auditor Arthur Anderson, one of the global Big 5 audit firms at that time, admitted to destroying files related to Enron in January 2002, resulting in litigations and, more importantly, the collapse of the firm. This scandal heavily affected the reputation of the Big 4 accounting firms in China. The resistance to the Notice No.16 from local audit firms grew dramatically and the CSRC had to issue another notice in March 2002, refined the applicable scope of Notice No.16 to only those listed companies issuing over 300 million shares, and extended the scope of qualified accounting firms that could perform supplementary audits to those firms “with supplementary audit certification” instead of “globally well known”. Later in March 2007, CSRC abandoned all these requirements considering the new accounting rules and auditing standards were in place.
Starting from 2008, the CICPA and the Ministry of Finance kicked off the “Growing Big and Strong” strategy that has profoundly changed the auditing industry in China. The strategy was, in a 5 to 10 years span, to build around 100 large accounting firms that are capable of serving large corporations and group companies, including 10 of them, which should be capable to serve China's “Going out” strategy by providing high quality cross-border professional services. The CICPA explicitly encourages local audit firms to merge with each other and pledge to proactively help the local audit firms to solve problems arising from the merge. As of 2014, two of the biggest audit firms in China are local firms.

It was not only about the size of the accounting firms. Jiang, Liu and Cui (2009) conducted research on the effect of audit fees on these mergers of local accounting firms, finding that although there was still significant gaps between the auditing fees level of Big 4 China member firms and local non-Big 4 accounting firms, mergers of local accounting firms did increase auditing fees and market concentration of local auditing markets.

In 2011, not far from the Big 4 China member firms’ joint venture agreement expiration, all of the Big 4 China member firms fully transformed into Special General Partnership (SGP) entities. All of the local audit firms were encouraged to transform into SGP entities as well. Upon the transformation in the second half of 2014, all the Big 4 China member firms completed their transformation, and theoretically were no longer FOREIGN accounting firms.

Looking forward, as China’s economy grows, there will be more and more international investments from China and thus more opportunities for Chinese accounting firms venture into markets outside China. With the pledge to develop local accounting firms, it is believed that the Chinese government will continue to support local accounting firms in different domains. Recently in April 2015, the State-owned Assets Supervision and Administration Commission of
the State Council announced that it would appoint seven accounting firms to provide inspection and verification services to those stated-owned assets outside of China. The Big 4 won only one seat out of the total seven seats. Although the amount was only around USD2 million, it was the first time the Chinese authorities requested direct audits to the oversea assets. The dominance by local accounting firms in this bid indicated government’s preference on local firms, implying a tougher situation for the Big 4 China member firms.

6 CONCLUSION AND LIMITATIONS

By reviewing the relevant literatures and the history of China’s accounting and auditing industry developments, this thesis offers arguments concerning why the Big 4 China member firms are not dominating auditing markets in China from three perspectives: Client Acceptance and Continuance Perspective, Auditor Selection Perspective, and Regulatory Perspective. Firstly, the existing lucrative auditing market segments limits the Big 4 audit partner’s incentive to expand their business into statutory audits with fewer margins. Secondly, auditor selection decisions were heavily impacted by the managers of the listed companies and thus create an adverse selection problem. In addition, managers prefer local audit firms that are more accessible and flexible. Finally, the influential government authorities turned from a position of being in favor of the Big 4 audit firms to promoting the development of local audit firms. All of these contributed together to the current situation of the Big 4 China member firms in China’s stock markets.

However, this thesis was built on existing empirical research and used their findings as the basis to form the above arguments; a lack of independent empirical evidence using updated
relevant data to prove all those arguments limits these arguments. Also, the arguments don’t go into depth enough to further analyze why corporate governance was so weak in China given that China has theoretically established many rules and regulations in this regard.
Appendix 1

Screening Criterion on S&P Capital IQ

**Exchanges (All Listings):** (NYSE) New York Stock Exchange **OR** (LSE) London Stock Exchange **OR** (TSE) The Tokyo Stock Exchange **OR** (SEHK) The Stock Exchange of Hong Kong Ltd. **OR** (SHSE) Shanghai Stock Exchange **OR** (SZSE) Shenzhen Stock Exchange

(Extracted on March 15, 2015)

During the processing of data, we removed those observations with missing values in variable “most recent auditor”; we also removed those companies who were not primarily listed in the above exchanges.
Appendix II

Addams and Allred, 2002

Why the fast-growing Hire and Fire Their Auditors

Selection Criteria - Rating:

- The quality of the CPA firm’s technique expertise – 4.92
- The personnel relationships established between the CPA firm’s key people and the company’s key decision makers – 4.81
- The quality of the CPA firm’s expertise – 4.51
- The CPA firm’s proposed fee – 4.28
- The range of service available – 3.95
- The quality of formal oral presentation – 3.80
- The location of the CPA firm – 3.68
- A recommendation from friend/other organization – 3.68
- The quality of initial written proposal – 3.56
- The size of the CPA firm – 3.50
- A CPA firm acquaintance with a key employee or member of the board of directors – 3.14
- The international services available – 2.38

(* Scale: 6 = great importance, 0 = no importance)
Appendix III

Almar, Philbrick, and Rupley, 2014

What Drives Auditor Selection? — based on US listed companies (Audit Committee Feedback)

1, Audit firm has reputation for strong industry experience – 6.74
2, Partner identifies and address accounting issues on a timely basis – 6.68
3, Audit firm has reputation for strong technical expertise – 6.50
4, Partner is highly accessible – 6.48
5, Partner effectively liaises with audit firm’s national technical office – 5.78
6, Written proposal is high quality – 5.68
7, Audit firm has international service available – 4.99
8, Company management has express preference for a specific firm – 4.70
9, Proposed fee is significantly lower than the other bidding firms – 4.60
10, Audit firm offers a range of non-audit services – 4.16
11, Audit firm is a regional firm – 3.13
12, Audit committee member or other board member is an alumnus of audit firm – 3.05
13, Company financial managements are alumni of the audit firm - 2.89
14, Audit firm members and board members have a personal relationship – 2.75
15, Audit firm members and financial management have a personal relationship – 2.50

(Scale: Respondents rated whether each factor listed above would decrease, increase, or have no impact on their likelihood of hiring an audit firm using a seven-point Likert scale where 1 = decrease likelihood to hire, 4 = no impact, and 7 = increase likelihood to hire.)
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3 Auditor Size and Audit Quality, DeAngelo, 1981

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5 According to the statistics from Shanghai Exchange and Shenzhen Exchange. Website:


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