This article is (c) Emerald Group Publishing and permission has been granted for this version to appear here (http://epress.lib.uts.edu.au/research/handle/10453/10248). Emerald does not grant permission for this article to be further copied/distributed or hosted elsewhere without the express permission from Emerald Group Publishing Limited.'

THE UNINTENDED CONSEQUENCES OF REGULATION IN CHINA

WENDY GREEN*
University of New South Wales

ROBERT CZERNKOWSKI **
The University of Sydney

YI WANG

15th August, 2007

General Area: Auditing and Regulation

* Dr. Green is Senior Lecturer in the School of Accounting, University of New South Wales, Sydney N.S.W. 2052 Australia; E: w.green@unsw.edu.au; T: +61-2-9385-5805; F: +61-2-9385-5925

** Dr. Czernkowski is Senior Lecturer in the Discipline of Accounting, Economics and Business Building (H69), The University of Sydney, Sydney, N.S.W., 2006, Australia; E: r.czernkowski@econ.usyd.edu.au; T: +61-2-9036-7092; F: +61-2-9351-6638 (corresponding author)

1. INTRODUCTION

Regulation of Financial Reporting has become an issue of increasing importance in China over the last two decades since the Chinese economy was fully nationalised. In 1998 in order to enhance the confidence of investors in the Chinese stock market, the Chinese Government introduced a unique form of regulation, the Special Treatment (ST) designation. This designation was to be applied to companies viewed as being at high risk, defined in terms of quality of profits and/or financial information. The purpose of this paper is to trace the behaviour of companies receiving an ST designation in order to determine the extent to which the application of this regulation may have led to companies engage in activities conducive to removal of the ST designation. In particular, the paper examines evidence regarding opinion shopping by these firms, and/or (broad) evidence of earnings manipulation associated with auditor changes.

The remainder of this paper is organised as follows. Section 2 provides an overview of the regulations relating to Special Treatment (ST) system. Section 3 discusses background evidence, and develops the research hypotheses. Section 4 details the method used to address the hypotheses. Section 5 describes the results of hypothesis testing. Section 6 provides a summary of the findings and concluding comments.

2. SPECIAL TREATMENT (ST) SYSTEM

A unique characteristic of the Chinese stock market is the Special Treatment (ST) system. This system was introduced on 22nd April, 1998 by the Chinese stock exchanges as part of a series of corporate governance reforms (see Figure 1). Under this system a company is designated as a special treatment company if it satisfies one or more of the following six criteria:

1. The company has negative net profits for two consecutive fiscal years;
2. The shareholders' equity for the company is lower than the registered capital (the par value of the share);
3. The auditor has issued the company a disclaimer or an adverse audit opinion for the current year;
4. The company's operations have been stopped due to natural disaster or serious accident and have no hope of being restored within three months;
5. The company is involved in a damaging lawsuit or arbitration; or
6. The company is bankrupt.

FIGURE 1: INSTITUTIONAL BACKGROUND CHANGES

Date	Event
Before Investigation Period:	
23/12/1980	Issuance of "the Interim Guideline for the Establishment of Accounting Consultancies"
1989	Establishment of the Chinese Institute of Certified Public Accountants
26/11/1990	Revivification of the Shanghai Stock Exchange
1992	Establishment of E&Y Huaming
1992	Issuance of "Accounting Standards for Business Enterprises"
01/1994	Issuance of "Listed Company Disclosure Standard No. 2: Content and Format of Annual Reports"
1995	Promulgation of a New Set of Auditing Standards
1996	Issuance of the First Qualified Audit Opinion in China
1998 (revised in 2001)	Issuance of "Accounting Regulations for Listed Companies"

FIGURE 1 (contd..)

Period Examined in the Study:	
22/04/1998	Establishment of Special Treatment (ST) System
1999	Preliminary Earnings Announcement Required for Listed Companies with Sharp Earnings Movements
By the end of 1999	Separation of CPA Firms from their Sponsors Completed
2000	Electronic Version of Listed Companies' Full Annual Reports Available on Internet
19/02/2001	B Share Open up to Domestic Market
22/02/2001 (revised on 05/12/2001)	Implementation Measures for Suspending and Terminating the Listing of Loss-Incurring Listed Companies
23/04/2001	The First Company being de-listed on the Shanghai Stock Exchange
2001	Issuance of "the Guidelines for the Annual Review of the Security Related Service License" and seven CPA Firms failed in the 2001 annual review
At the end of 2001	Issuance of "Standards for Content and Format of Information Disclosure of Public Companies No. 14"
2002	E&Y Merged with Dahua Auditing Firm
2003	CICPA updated the Chinese Specific Independent Auditing Standard No. 7- Audit Reports

Sources: [1],[2],[3],[4],[5],[6],[7],[8],[9],[10],[11]

Once a company is designated as an ST company it has additional controls imposed on it. For example, it is required to provide audited semi-annual financial reports, and its stock is subject to a daily 5% stop-buying and stop-selling limit, in other words, the maximum allowed daily fluctuation in the price of a ST share cannot exceed 5%[1]. However the potentially most damaging additional regulation these companies face is that where a listed company has suffered three consecutive years of losses, the stock exchange will suspend such company's stocks from public trading. The de-listing rules were introduced by the CRSC through the issue of the "*Implementation Measures for Suspending and Terminating the Listing of Loss-Incurring Listed Companies*" on 22nd February, 2001. These rules were further revised on 5th December, 2001. According to these rules, the suspended company has a six month tolerance period in which to show a profit.[2] During this time the company has to disclose at least once per month the specific measures taken to achieve profitability in the near future. If a suspended company makes a profit with an unqualified audit opinion in the next half of the year, it can apply to have its stocks re-listed. However, a suspended company may have its stock removed from the trading floor permanently, if (1) it fails to disclose its first semi-annual financial statement by the statutory time limit; or (2) it suffers a loss in the first half-year after being suspended; or (3) the shareholder meeting decides to terminate the listing; or (4) its application to be re-listed is turned down by the CSRC; or (5) after the listing of the company's stocks is resumed, the company fails to disclose its first annual financial statements by the statutory time limit; or (6) it has been in the red for the first year after resuming the listing; or (7) it does not receive an unqualified audit opinion for the first year after resuming the listing (Xinhua News Agency, 6th, December, 2001).

[1] Normal shares are subject to a daily 10% stop-buying and stop-selling limit.

[2] The tolerance period before stocks are delisted will start from the date of suspension. The revised rules shortened the one-year tolerance period to six months.

De-listing is seen as a critical step in improving the performance of the Chinese stock market. During the period 1999-2003, four companies were withdrawn from the Shanghai stock market. The first de-listed company in China was Narcissus Electric Appliance Company listed on the Shanghai Stock Exchange. On 23rd April, 2001, the CSRC made a decision to terminate the listing of the stock of Narcissus Electric Appliance Company as it had been operating at a loss for four consecutive years and failed to put forward concrete arrangements to stop losses and to generate profits in the short term (commented by the spokesman of the CSRC on 24th April, 2001). Another three companies were de-listed due to (1) reporting consecutive losses in the first half-year after suspension (Anshan No.1 Construction Machinery Company, 16th September, 2002), (2) a decision to terminate the listing by the shareholder meeting (Shanghai Citic-Jiading Industrial Company, 22nd September, 2003), and (3) a disclaimer opinion being issued for the first year annual report after resuming the listing (Hubei Jianghu Ecology Company, 23rd May, 2003).

It is clear that the requirements associated with an ST status place great pressure on a company to achieve both a profit and an unqualified audit opinion. Thus, there are potential incentives to manipulate profit, to the extent that profit manipulation can remove an ST imposed due to a loss, and to switch auditors if this can change the probability of a continuing audit modification. Whether such behaviour is effective is ultimately an empirical question, which we address in this paper.

3. BACKGROUND AND HYPOTHESES

A. BACKGROUND

During the period 2000-2004, there were 211 ST designations, which represents 7.86% of the entire sample of company years in the sample. Table 1 presents an analysis of these ST designations. This table shows that 89 companies incurred the ST designation for the first time. In addition, 60 companies received a second ST designation, while 30 received a third ST designation during this period. Interestingly and as already noted, despite the regulations requiring a company with ST designations to be de-listed, 17 companies received a fourth, seven companies received a fifth, five companies received a sixth, and three companies received a seventh ST designation.

TABLE 1: NUMBER OF ST BY YEAR

	ST1	ST2	ST3	ST4	ST5	ST6	ST7	Total
2000	10	7	9	0	0	0	0	26
2001	13	4	6	8	0	0	0	31
2002	17	10	1	4	4	0	0	36
2003	31	14	5	1	2	3	0	56
2004	18	25	9	4	1	2	3	62
Total	89	60	30	17	7	5	3	211

These statistics reveal that the number of new ST designations has been increasing over the period, with a peak after the tightening of regulation around company reporting in 2003.

Table 2 provides an analysis of the reasons companies incurred their initial ST designation. This table shows that the main reason for receiving an initial ST designation was due to incurring a loss (60 company years). The second most common reason was due to negative shareholder's equity (26), while 9 received an ST due to an unclean audit opinion. During the period under study, there were no instances of an initial ST under the categories of Accident, Lawsuit or Bankrupt.

TABLE 2: NO. OF ST BY REASONS AND YEAR

		2000	2001	2002	2003	2004	Total
ST1	Loss	6	10	8	21	15	60
	Negative shareholder's equity	1	8	2	13	2	26
	Audit opinion	0	0	4	3	2	9
	Accident	0	0	0	0	0	0
	Lawsuit	0	0	0	0	0	0
	Bankrupt	0	0	0	0	0	0
	Others	2	2	3	2	1	10

The reasons for being classified as ST companies are as follows:
(1) it has negative net profits for two consecutive fiscal years; (2) the shareholders' equity is lower than the registered capital (the par value of the share); (3) the auditor issues a disclaimer or an adverse audit opinion for the current year; (4) a company's operations have been stopped due to natural disaster or serious accident and have no hope of being restored within three months; (5) the company is involved in a damaging lawsuit or arbitration; (6) the company is bankrupt or (7) others.

Descriptive statistics relating to the auditors of ST companies are provided in Tables 3, 4, 5 and 6. Table 3 shows that the majority (203, 96.21%) of the ST designations were for companies audited by Local audit firms, with only eight (3.79%) Big Firms auditing ST companies. Table 6 shows that 144 (68.25% of the ST companies received a qualified audit opinion, with the most common type of qualified opinion Unqualified with explanatory notes 63 (29.86%), followed by Disclaimer opinions, 37 (17.54%) and Qualified with explanatory notes 32 (15.17%). The qualification rate for the ST companies (58.13%) is much higher than that for the non-ST companies (8.43%).

TABLE 3: NO. OF ST BY AUDITORS

	Auditor	ST1	ST2	ST3	ST4	ST5	ST6	ST7	Total
2000	BIG	1	1	0	0	0	0	0	2
	LOC	9	6	9	0	0	0	0	24
2001	BIG	0	0	0	0	0	0	0	0
	LOC	13	4	6	8	0	0	0	31
2002	BIG	0	1	0	0	0	0	0	1
	LOC	17	9	1	4	4	0	0	35
2003	BIG	1	0	1	0	0	0	0	2
	LOC	30	14	4	1	2	3	0	54
2004	BIG	1	1	0	1	0	0	0	3
	LOC	17	24	9	3	1	2	3	59

TABLE 4: NO. OF AUDITOR SWITCHES

	ST								Non ST
	ST1	ST2	ST3	ST4	ST5	ST6	ST7	Total	
2000	4	1	0	3	0	0	0	8 (25.81%)	37 (8.49%)
2001	4	6	1	2	3	0	0	16 (44.44%)	70 (13.73%)
2002	6	3	2	1	0	1	0	13 (23.21%)	40 (7.03%)
2003	0	6	4	0	0	0	1	11 (17.74%)	35 (5.6%)
Total	14	16	7	6	3	1	1	48 (25.95%)	182 (8.5%)

The corresponding sample for this table includes company/year observations from 2000 to 2003, as certain observations in 1999 do not have enough data to judge auditor switches. The first year listed companies are also excluded from the sample.
The percentage is the companies with auditor switches out of the group population.

TABLE 5: NO. OF SWITCHES FROM BIG TO LOCAL OR REVERSE

		ST								Non ST
		ST1	ST2	ST3	ST4	ST5	ST6	ST7	ST Total	
2001	B to L	0	0	0	0	0	0	0	0	1
	L to B	0	0	0	0	0	0	0	0	1
	B to B	0	0	0	0	0	0	0	0	0
	L to L	4	1	0	3	0	0	0	8	35
2002	B to L	0	0	0	0	0	0	0	0	0
	L to B	0	1	0	0	0	0	0	1	1
	B to B	0	0	0	0	0	0	0	0	0
	L to L	4	5	1	2	3	0	0	15	69
2003	B to L	0	0	0	0	0	0	0	0	2
	L to B	0	0	0	0	0	0	0	0	5
	B to B	0	0	1	0	0	0	0	1	10
	L to L	6	3	1	1	0	1	0	12	23
2004	B to L	0	1	0	0	0	0	0	1	7
	L to B	0	1	0	0	0	0	0	1	2
	B to B	0	0	0	0	0	0	0	0	0
	L to L	0	4	4	0	0	0	1	9	26

The corresponding sample for this table includes company/year observations from 2000 to 2003, as certain observations in 1999 do not have enough data to judge auditor switches. The first year listed companies are also excluded from the sample.

Many of the companies with an ST designation switched auditors after receiving the designation. As noted earlier, it was expected that ST companies would switch auditors in order to audit opinion shop. If a ST company wants to terminate its ST status, it should have a positive profit and clean audit opinion in the next year, otherwise the company will have a high risk in suspension of stock trading or de-listing. Therefore, ST companies are prone to switch auditor to 'shop' for a clean audit opinion. The results provided in Table 4 show that the rate of auditor switching was higher for ST companies than for non-ST companies. Of the 230 auditor switches, 48 were for ST companies and 182 were for non-ST companies, representing a rate of switching in the period of 25.95% and 8.5% for ST and non-ST companies respectively.

Analysis of the 48 switches for ST companies reveals that 44 (91.67%) of these switches were from one local audit firm to another local audit firm, with only 1 switch from big to local firm, 2 from local to big, and 1 between big firms. This suggests that the ST companies are not looking for higher quality audits generally associated with the larger audit firms.

B. HYPOTHESES

Given these patterns of behaviour, we seek to explicitly tests whether these patterns provide appropriate evidence of relationships between the ST designation and auditor switching. In particular, auditor switching may be motivated by the desire to more easily obtain a clean (unmodified) opinion and the possibility that a profit change (from negative to positive) may be more easily achieved with a potentially more pliable auditor. We therefore jointly test auditor flexibility and company motivation through the formulation of hypothesis 1:

H1: $\text{Switch}_{ST} > \text{Switch}_{non\text{-}ST}$

where Switch is a dummy variable; 1 denotes that a company switched auditors from year t-1 to year t; 0 denotes it did not

ST denotes that a company was designated ST in year t-1; non-ST indicated that the company was not designated ST in year t-1.

TABLE 6: NO. OF ST COMPANIES BY AUDIT OPINIONS

		1999	2000	2001	2002	2003	Total
ST1	Unqualified with Explanatory Notes	2	2	3	7	5	19
	Qualified Opinions	0	0	1	3	0	4
	Qualified with Explanatory Notes	2	6	0	3	1	12
	Disclaimer Opinions	0	0	6	5	4	15
	Adverse Opinions	0	0	0	0	0	0
ST2	Unqualified with Explanatory Notes	0	3	3	3	11	20
	Qualified Opinions	1	0	0	0	1	2
	Qualified with Explanatory Notes	2	0	3	2	2	9
	Disclaimer Opinions	2	0	0	6	3	11
	Adverse Opinions	1	0	0	0	0	1
ST3	Unqualified with Explanatory Notes	4	1	1	2	3	11
	Qualified Opinions	0	1	0	0	1	2
	Qualified with Explanatory Notes	2	0	0	0	1	3
	Disclaimer Opinions	3	2	0	0	1	6
	Adverse Opinions	0	1	0	0	0	1
ST4	Unqualified with Explanatory Notes	0	3	1	1	3	8
	Qualified Opinions	0	0	0	0	0	0
	Qualified with Explanatory Notes	0	2	2	0	0	4
	Disclaimer Opinions	0	3	0	0	0	3
	Adverse Opinions	0	0	0	0	0	0
ST5	Unqualified with Explanatory Notes	0	0	1	0	0	1
	Qualified Opinions	0	0	0	0	1	1
	Qualified with Explanatory Notes	0	0	1	1	0	2
	Disclaimer Opinions	0	0	1	0	0	1
	Adverse Opinions	0	0	0	0	0	0
ST6	Unqualified with Explanatory Notes	0	0	0	1	0	1
	Qualified Opinions	0	0	0	0	0	0
	Qualified with Explanatory Notes	0	0	0	1	1	2
	Disclaimer Opinions	0	0	0	0	0	0
	Adverse Opinions	0	0	0	0	0	0
ST7	Unqualified with Explanatory Notes	0	0	0	0	0	0
	Qualified Opinions	0	0	0	0	1	1
	Qualified with Explanatory Notes	0	0	0	0	0	0
	Disclaimer Opinions	0	0	0	0	0	0
	Adverse Opinions	0	0	0	0	0	0
ST total	Unqualified with Explanatory Notes	6	12	9	14	22	63 (29.86%)
	Qualified Opinions	1	1	1	3	4	10 (4.74%)
	Qualified with Explanatory Notes	6	8	6	7	5	32 (15.17%)
	Disclaimer Opinions	5	5	7	12	8	37 (17.54%)
	Adverse Opinions	1	1	0	0	0	2 (0.95%)
Non ST	Unqualified with Explanatory Notes	55	49	32	24	14	174 (6.04%)
	Qualified Opinions	12	6	9	8	2	37 (1.28%)
	Qualified with Explanatory Notes	12	9	7	3	2	33 (1.14%)
	Disclaimer Opinions	0	0	0	0	0	0 (0%)
	Adverse Opinions	0	0	0	0	0	0 (0%)

Fundamentally, this hypothesis postulates an association between auditor switching and ST status. Although we cannot examine the confidential negotiations that happen between c company and its auditor, we can determine whether the pattern of switching behaviour is consistent with a desire by firms to lose the ST designation. Thus, Hypothesis 1 essentially asks: is auditor switching associated with possession of the ST designation?

Now, if switching is in fact associated with being an ST company, the next step is to determine whether an audit switch enables pursuit of the supposed goals of a switch: changing a loss to a profit, and/or improving an audit opinion. The first goal is examined in hypothesis 2 – is a change from loss to profit associated with switching auditors?

H2: $NLP_{switchers} > NLP_{non\text{-}switchers}$

where NLP is a dummy variable; 1 denotes that a company went from loss in year t-1 to a profit in year t; 0 denotes that the sign of profit did not change, or changed from profit to loss

switchers are companies that changed auditor from year t-1 to year t; non-switchers are companies that did not change their auditor.

Hypotheses 3 and 4 together address the issue of opinion improvement. Hypothesis 3 is formulated in the form of an opinion change: if all possible opinions are ranked in order of severity, can a firm improve its rank by switching auditor?

H3: $opinion_change_{switchers} > opinion_change_{non\text{-}switchers}$

where opinion_change is an ordering variable; 1 denotes that a company's audit opinion improved from year t-1 to year t; 0 denotes that it did not. For the purpose of measuring improvement, audit opinions are coded as follows: 5=unqualified (no modification); 4=unqualified with explanatory notes; 3=qualified; 2=adverse; and 1=disclaimer. Change is measured as the difference in codes between year t-1 and year t.

switchers are companies that changed auditor from year t-1 to year t; non-switchers are companies that did not change their auditor.

Hypothesis 4 asks the same questions in a less distributionally dependant form; it abstracts the magnitude of the rank change, and tests opinion changes merely in the form of a variable which measures whether a positive opinion change occurred, irrespective of the magnitude:

H4: $opinion_improvement_{switchers} > opinion_improvement_{non\text{-}switchers}$

where opinion_improvement is a dummy variable, set to 1 where opinion_change is positive, and 0 otherwise.

switchers are companies that changed auditor from year t-1 to year t; non-switchers are companies that did not change their auditor.

These hypotheses are addressed in the next sections.

4. METHOD

This study focuses on all A-share companies that are listed on the Shanghai Stock Exchange, with financial data available for the years 1999 to 2003. As the China Securities Regulatory Commission (CSRC), which plays a similar role to the US Security and Exchange Commission, has required all listed companies to submit their annual reports to the Stock Exchange where they are listed, the website of the Shanghai Stock Exchange (http://www.sse.com.cn) was scanned for annual report announcements. The earliest release

of annual reports on the website of the Shanghai Stock Exchange was in 1999 and the latest one available was in 2003. Therefore, the five year releases, namely from 1999 to 2003, of annual reports for all A-share companies listed on the Shanghai Stock Exchange were manually collected from the website. Stock market data were retrieved from a database provided by Guo Tai An Information Technology Co. Ltd[3].

The hypotheses are analysed through the use of basic parametric comparisons (t-tests). Controls are not utilised at this stage.

5. RESULTS

The original sample consisted of 3228 company/year observations. Those companies with incomplete data were excluded, which reduced the sample to 3218 company/year observations. Table 8 describes the type of audit modifications received by these companies: 386 modified audit opinions and 2742 unqualified audit opinions for the 1999 to 2003 investigation period. Table 1 describes the number of companies under Special Treatment in particular years. Note that, although companies can theoretically only be under Special Treatment for three years, the fact that some companies remain in this category for years beyond the three-year limit suggests some flexibility in the enforcement of the rules, with three companies remaining in Special Treatment and still listed in 2004.

TABLE 8: DISTRIBUTION OF AUDIT OPINIONS ISSUED FROM 1999 TO 2003 IN THE SHANGHAI STOCK EXCHANGE

	1999	2000	2001	2002	2003	Total
Unqualified with Explanatory Notes	64	60	41	38	35	238
Qualified Opinions	13	7	10	10	6	46
Qualified with Explanatory Notes	18	16	13	10	7	64
Disclaimer Opinions	5	5	7	11	8	36
Adverse Opinions	1	1	0	0	0	2
Total of Modified Audit Opinions	101	89	71	69	56	386
Unqualified Opinions	370	470	562	633	707	2742
Total of Audit Opinions	471	559	633	702	763	3128

Notes:
The corresponding sample is the entire sample. Unqualified with Explanatory Notes, Qualified Opinions, Qualified with Explanatory Notes, Disclaimer Opinions and Adverse Opinions denote five types of modified audit opinions in the Chinese context, that is unqualified audit opinions with explanatory notes, qualified audit opinions, qualified audit opinions with explanatory notes, disclaimer audit opinions and adverse audit opinions respectively.

Hypothesis 1 is directed at the fundamental question of whether auditor switching actually occurs for ST companies on the Shanghai market. Table 9 reports a t-test on the switch variable, which is 1 for companies switching and 0 otherwise. The mean of the variable for each group is therefore the proportion of each category (ST, all) of companies changing auditor in any given year. From the results it is clear that ST company years have a higher incidence of auditor change (16.73%) than non-ST company years (6.76%).

TABLE 9: ASSOCIATION OF AUDITOR SWITCHING WITH ST STATUS

	ST companies	non-ST companies	t-stat. (1-tailed p)
n	245	2883	
switch – mean	0.1673	0.0676	-4.09 (<.0001)

switch is a dummy variable; 1 denotes that a company switched auditors from year t-1 to year t; 0 denotes that it did not

[3] Guo Tai An Information Technology Co. Ltd is a company engaged in the design and development of economic, financial and securities databases, and analysis software.

Hypothesis 2 postulates that switching can be motivated by the desire to avoid a loss.

Table 10 reports results for hypothesis 2. For switching and non-switching companies, the mean of the NLP variable is reported. This variable is 1 for companies which improved the sign of their profit (that is, moved from loss to profit) and 0 for those that did not (that is: continued making a loss, continued making a profit, or moved from profit to loss). Panel A reports the test for all companies that ST status in any year, while Panel B reports only ST1 companies: companies that had just received their initial ST designation.

TABLE 10: EFFECT OF SWITCHING AUDITORS ON IMPROVEMENT OF SIGN OF PROFIT

Panel A – All Special treatment companies in the sample			
	ST companies switching in year after ST status	ST companies not switching in the year after ST status	t-stat. (1-tailed p)
n	204	41	
NLP – mean	0.0392	0.0488	-0.28 (0.3894)
Panel B – Only companies that were ST1 in year t-1			
	ST companies switching in year after initial ST (ST1) status	ST companies switching in year after initial ST (ST1) status	t-stat. (p-value)
n	70	17	
NLP – mean	0.0143	0	0.49 (0.3125)

NLP is a dummy variable; 1 denotes that a company went from loss in year t-1 to a profit in year t; 0 denotes that the sign of profit did not change, or changed from profit to loss; **switchers** are companies that changed auditor from year t-1 to year t; non-switchers are companies that did not change their auditor.

Note from Panel A that there is no significant relation between switching auditor and moving from a loss to a profit: for all ST companies, the average value of the NLP for switchers is 0.0392, and for non-switchers 0.0488. If this were a significant effect, it would suggest that non-switching companies would be more likely to move from loss to profit in any given year than switchers. This, the result indicates that an auditor switch is no more likely to make a profit possible or palatable.

Panel B is indicative of the presence of an effect, but the effect is once more not significant. In our sample, an ST1 company changing auditor is never associated with a move from loss to profit (mean of NLP=0).

From these preliminary results, it is clear that changing auditor is not associated with a change in likelihood of a profit.

Hypotheses 3 and 4 postulate that an auditor switch can be associated with an improvement in the audit opinion ("opinion shopping"). Results are provided in Table 11 for three groups: all companies, whether or not they are designated ST; ST companies (having the designation, whether initially or still in ST status awarded in a previous year); and ST1 companies (having the ST designation for the first time). It is clear from the results that switching auditor is associated with both the presence (improved_opinion) and magnitude (opinion_change) of opinion improvement ($p<0.01$ in both cases, from Panel A). However, Panels B and C indicate that this effect must be confined to companies that do not have ST designation, as the effect does not hold in the two subgroups of ST designated companies: all ST company-years (ST) and those only having the designation for the first time (ST1).

TABLE 11: AUDIT QUALIFICATION IMPROVEMENT FOR COMPANIES SWITCHING AUDITOR

Panel A – Entire sample			
	All company years switching auditors	All companies years not switching auditors	t-stat. (1-tailed p)
n	41	3087	
improved_opinion – mean	0.3659	0.0703	-3.87 (0.0002)
opinion_change – mean	0.7317	0.0398	-3.05 (0.0020)
Panel B – Only companies that were ST in year t-1			
	ST companies that switched in year after any ST status	ST companies that did not switch in the year after any ST status	t-stat. (1-tailed p)
n	17	228	
improved_opinion – mean	0.4118	0.3509	-0.50 (0.3073)
opinion_change – mean	0.7647	0.6053	-0.50 (0.3089)
Panel C – Only companies that were ST1 in year t-1			
	ST companies that switched in year after initial ST (ST1) status	ST companies that did not switch in the year after initial ST (ST1) status	t-stat. (1-tailed p)
n	17	70	
improved_opinion – mean	0.4118	0.3429	-0.53 (0.2999)
opinion_change – mean	0.7647	0.5571	-0.59 (0.2787)

opinion_change is an ordering variable; 1 denotes that a company's audit opinion improved from year t-1 to year t; 0 denotes that it did not. For the purpose of measuring improvement, audit opinions are coded as follows: 5=unqualified (no modification); 4=unqualified with explanatory notes; 3=qualified; 2=adverse; and 1=disclaimer. Change is measured as the difference in codes between year t-1 and year t; **opinion_improvement** is a dummy variable, set to 1 where opinion_change is positive, and 0 otherwise.

Thus, opinion-shopping, if it happens, does not have any worthwhile or discernible outcome for any ST companies involved in it.

6. SUMMARY AND CONCLUSION

In this paper, we report preliminary results addressing the question of whether the ST designation applied in the Chinese market (and in particular to companies listed on the Shanghai stock exchange) causes opportunistic behaviour in terms of auditor selection. We find that ST companies are more likely to switch auditors than the population as a whole; that switching is not associated losses becoming profits after switches occur; and that audit opinions do improve for companies switching auditors across for all companies, but this result does not hold for companies that were designated ST before the switch.

Thus, we conclude that the evidence is consistent with a general pattern of opinion shopping, but that the general opinion shopping result does not apply to ST companies. So, even though ST companies are more likely to switch auditors than non-ST companies, the switch seems not to achieve any discernible outcome on either of the two financial reporting criteria for ST status: profitability and audit opinion.

Our results suggest that companies are willing to opinion shop but, if they do so in order to relieve themselves of ST status, then it seems that company management has not yet learned that such opinion shopping seems futile insofar as ST status is concerned.

Please note that these results are preliminary and incomplete. We expect to test their robustness in further development of this paper.

REFERENCE

[1] China Securities Regulatory Commission (CSRC), 1994, "*Listed Company Disclosure Standard No. 2: Content and Format of Annual Reports*", CSRC, Beijing.

[2] CSRC, 2001, "*Notice Regarding B-share Investment by Chinese Citizens*", CSRC, Beijing.

[3] CSRC, 2001, "*Implementation Measures for Suspending and Terminating the Listing of Loss-Incurring Listed Companies*", CSRC, Beijing.

[4] CSRC, 2001, "*Standards for Content and Format of Information Disclosure of Public Companies No. 14*", CSRC, Beijing.

[5] CSRC, 2001, "*The Guidelines on Industry Classification of Listed Companies*", CSRC, Beijing.

[6] Chinese Institute of Certified Public Accountants (CICPA), 1995, "*The Chinese Specific Independent Auditing Standard No. 7 - Audit Reports*", CICPA, Beijing.

[7] CICPA, 1999, "*Annual Report on Activities in 1999*", CICPA, Beijing.

[8] CICPA, 2000, "*Annual Report on Activities in 2000*", CICPA, Beijing.

[9] CICPA and CSRC, 2001, "*The Guidelines for the Annual Review of the Security Related Service License*", CICPA and CSRC, Beijing.

[10] CICPA, "The comments on 'the Information of Top 100 Accounting Firms in 2003' by the spokesman of CICPA [in Chinese]", *http://www.cicpa.org.cn/ReadNews*, 26th, December, 2003

[11] Xinhua News Agency, "Stock Exchanges Get Tougher Delisting System", *http://news.xinhuanet.com/stock/2001-12/06/content_150401.htm*, 6th, December, 2001.