

RGC Ref. No.: <b>UGC/FDS14/B07/15</b> (please insert ref. above)
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**RESEARCH GRANTS COUNCIL  
COMPETITIVE RESEARCH FUNDING SCHEMES FOR  
THE LOCAL SELF-FINANCING DEGREE SECTOR**

**FACULTY DEVELOPMENT SCHEME (FDS)**

**Completion Report**  
(for completed projects only)

<p><b><u>Submission Deadlines:</u></b></p> <ol style="list-style-type: none"> <li>1. Auditor's report with unspent balance, if any: within <b><u>six</u></b> months of the approved project completion date.</li> <li>2. Completion report: within <b><u>12</u></b> months of the approved project completion date.</li> </ol>
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**Part A: The Project and Investigator(s)**

**1. Project Title**

The Emergence of Second-Tier Auditors in China: An Analysis of Audit Quality

**2. Investigator(s) And Academic Department(s) / Unit(s) Involved**

Research Team	Name / Post	Unit / Department / Institution
Principal Investigator	LIU Junxia / Assistant Professor	Department of Accountancy / The Hang Seng University of Hong Kong
Co-Investigator(s)		
Others		

**3. Project Duration**

	Original	Revised	Date of RGC / Institution Approval (must be quoted)
Project Start Date	January 1, 2016		
Project Completion Date	December 31, 2017	June 30, 2018	July 27, 2017
Duration (in month)	24	30	July 27, 2017
Deadline for Submission of Completion Report	December 31, 2018	June 30, 2019	July 27, 2017

## **Part B: The Final Report**

### **5. Project Objectives**

#### 5.1 Objectives as per original application

Using data on Chinese listed firms from 2003 to 2013 and employing propensity scores and attributes-based matching samples, we aim:

1. to examine the association between auditor type (namely, Big 4, Second-tier, and Other local firms) and audit quality, i.e., whether the Big 4 and the Second-tier local auditors provide audits of similar quality?
2. to examine changes in the association between auditor type and audit quality after 2007, i.e., whether the Second-tier auditors provide higher audit quality after 2007 than before?

#### 5.2 Revised objectives

Date of approval from the RGC: Nil

Reasons for the change:

- 1.
- 2.
3. ....

#### 5.3 Realisation of the objectives

*(Maximum 1 page; please state how and to what extent the project objectives have been achieved; give reasons for under-achievements and outline attempts to overcome problems, if any)*

The project objectives have been achieved, which is evident from the fact that:

1. The first part of the research outcomes was published in the *Asia-Pacific Journal of Accounting & Economics* (APJAE), a journal indexed by SSCI and ranked Type B by the RAE, local universities and our Department;
2. The second part of the research outcomes was accepted by and presented at a recognized international conference, the *Accounting and Business Research Special Issue Conference on "Auditing in China"*; and
3. The second part of the research outcomes has been under the second-round review at the *Accounting and Business Research* (ABR), a journal indexed by SSCI and ranked Type A by the RAE, local universities and our Department.

## 5.4 Summary of objectives addressed to date

<b>Objectives</b> <i>(as per 5.1/5.2 above)</i>	<b>Addressed</b> <i>(please tick)</i>	<b>Percentage Achieved</b> <i>(please estimate)</i>
1. To examine the association between auditor type (namely, Big 4, Second-tier, and Other local firms) and audit quality, i.e., whether the Big 4 and the Second-tier local auditors provide audits of similar quality?	√	100%
2. To examine changes in the association between auditor type and audit quality after 2007, i.e., whether the Second-tier auditors provide higher audit quality after 2007 than before?	√	100%
3.		
4.		

## 6. Research Outcome

### 6.1 Major findings and research outcome

*(Maximum 1 page; please make reference to Part C where necessary)*

In the published paper titled “*The Emergence of Second-tier Auditors in China: Analysis of Audit Fee Premium and Audit Quality*”, we examine audit fee and audit quality differences across the Big 4, second-tier auditors, and other small auditors.

Using 7,049 client-year observations of A-share listed companies from 2008 to 2013 and controlling for auditor choice bias, we find the Big 4 auditors to earn an audit fee premium relative to second-tier auditors, but no difference in audit quality between the two groups. In contrast, second-tier auditors are found to earn an audit fee premium relative to other small audit firms, but that premium is accompanied by superior audit quality.

In addition, using data from 2003 to 2013 and a pre- versus post-2007 design, we find that the audit fees and audit quality of second-tier clients have improved since 2008. In the post-2007 period, relative to other small auditors, second-tier auditors earn a fee premium and deliver higher quality audits. The quality differentiation between second-tier and other small auditors has widened post-2007. In contrast, relative to the Big 4, second-tier auditors provide audit quality that is indistinguishable from that of the Big 4 but charge their clients lower audit fees.

Overall, our findings show that second-tier auditors in China have emerged as an alternative to the Big 4 for A-share listed companies. They provide the same level of audit quality without charging an audit fee premium.

In the conference paper titled “*Does Access to Overseas Audit Markets Improve Home Audit Quality? Evidence from China*”, we examine whether an individual factor, the approval of the large mainland auditors to provide auditing services for H-share companies in Hong Kong, drives the increase in audit quality of the second-tier auditors in the post-2007 period.

Using a difference-in-differences (DID) design and 15,192 client-year observations of A-share listed companies from 2008 to 2016, we find that mainland auditors with H-share clients provide higher quality audits, as measured by more modified audit opinions, higher audit fees and less earnings management, relative to auditors without H-share clients. The positive effect is more pronounced when the auditors are second-tier audit firms and the clients are listed only in mainland China.

Further, to capture investors’ perceived audit quality, we examine the cumulative abnormal returns (CARs) around various announcement dates of policy change or auditor switches. We find that mainland investors react positively to the initial announcement that mainland auditors can conduct H-share audits, whereas the reaction is negative in Hong Kong. However, over time, the Hong Kong stock market reacts positively to H-share companies that switch from Hong Kong to mainland auditors.

Overall, the results are consistent with access to the overseas audit market being positively associated with audit quality in the mainland market. Our findings suggest that H-share audits have a positive spillover effect on the quality of A-share audits, and the quality effect is more pronounced for the second-tier auditors.

## 6.2 Potential for further development of the research and the proposed course of action (Maximum half a page)

When the working paper titled “Does Access to Overseas Audit Markets Improve Home Audit Quality? Evidence from China” was presented at the *Accounting and Business Research Special Issue Conference on “Auditing in China”*, Professor Mark DeFond, the keynote speaker, commented that it will be a much bigger contribution if we can trace the spillover effect from the audit firm level to the audit partner level.

Audits are conducted by engagement partners based in a specific office. Expertise is unlikely to be homogeneous across auditors within a given firm or office. Our study at the audit firm level presumes that partners provide a uniform level of quality across the audit firm as a whole. Because audit partners’ names are publicly identified in China, we should be able to conduct analysis at the partner level.

## 7. Layman’s Summary

(Describe in layman’s language the nature, significance and value of the research project, in no more than 200 words)

Chinese government has implemented multiple measures to help domestic auditors to grow bigger and stronger and move into overseas markets since 2007. Domestic auditors, especially the larger ones (i.e. second-tier auditors), have achieved significant growth in size and market share. The rapid growth of second-tier auditors has inevitably presented a challenge to the international Big 4 auditors, giving rise to significant questions concerning whether their audit fees and audit quality differ from the Big 4.

In December 2010, eight large domestic auditors, in addition to the Big 4, were accepted by Hong Kong regulators to audit mainland-incorporated companies listed in Hong Kong. This move is recognized as a milestone for domestic auditors in going overseas and competing internationally. Given the starting point for audit quality is lower in mainland than in Hong Kong, access to Hong Kong market could have had a positive impact on the audit quality of the second-tier auditors.

This project focuses on second-tier auditors separately because there is a lack of evidence specifically about them and because their emergence as “brand-name” firms necessitates a re-examination of the association between auditor size and audit quality and its changes over time.

**Part C: Research Output****8. Peer-Reviewed Journal Publication(s) Arising Directly From This Research Project**

*(Please attach a copy of the publication and/or the letter of acceptance if not yet submitted in the previous progress report(s). All listed publications must acknowledge RGC's funding support by quoting the specific grant reference.)*

The Latest Status of Publications				Author(s) (denote the corresponding author with an asterisk*)	Title and Journal / Book (with the volume, pages and other necessary publishing details specified)	Submitted to RGC (indicate the year ending of the relevant progress report)	Attached to this Report (Yes or No)	Acknowledged the Support of RGC (Yes or No)	Accessible from the institutional repository (Yes or No)
Year of Publication	Year of Acceptance (For paper accepted but not yet published)	Under Review	Under Preparation (optional)						
2017				Leung, N.W. Liu, Junxia* Wong, Brossa	The emergence of second-tier auditors in China: analysis of audit fee premium and audit quality / Asia-Pacific Journal of Accounting & Economics, published online: 28 Nov 2017. <a href="https://doi.org/10.1080/16081625.2017.1404920">https://doi.org/10.1080/16081625.2017.1404920</a>	Yes (December 31, 2017)	Yes	Yes	Yes
		Second round review		Lam, Kevin Liu, Junxia* Yip, Rita	Does access to overseas audit markets improve home audit quality? Evidence from China / Accounting and Business Research Special Issue on "Auditing in China"	No	Yes	Yes	Yes

**9. Recognized International Conference(s) In Which Paper(s) Related To This Research Project Was / Were Delivered**

*(Please attach a copy of each conference abstract)*

<b>Month / Year / Place</b>	<b>Title</b>	<b>Conference Name</b>	<b>Submitted to RGC</b> <i>(indicate the year ending of the relevant progress report)</i>	<b>Attached to this Report</b> <i>(Yes or No)</i>	<b>Acknowledged the Support of RGC</b> <i>(Yes or No)</i>	<b>Accessible from the institutional repository</b> <i>(Yes or No)</i>
December / 2018 / Beijing, China	Does access to overseas audit markets improve home audit quality? Evidence from China	The Accounting and Business Research Special Issue Conference on “Auditing in China”	No	Yes	Yes	Yes

**10. Whether Research Experience And New Knowledge Has Been Transferred / Has Contributed To Teaching And Learning**

*(Please elaborate)*

I shared the research findings with BBA-Accounting and BBA-Corporate Governance students on various occasions, such as in PRC taxation classes and personal tutor-tutee networking sessions, to inform students of the recent development of Big 4 and second-tier auditors in mainland China and HK and to help students make an informed decision about their first job choices.

More importantly, the research experience I have gained in conducting this project makes me confident that I will be able to perform quality research and get my work published in quality journals.

**11. Student(s) Trained**

*(Please attach a copy of the title page of the thesis)*

<b>Name</b>	<b>Degree Registered for</b>	<b>Date of Registration</b>	<b>Date of Thesis Submission / Graduation</b>
Nil			

**12. Other Impact**

*(e.g. award of patents or prizes, collaboration with other research institutions, technology transfer, teaching enhancement, etc.)*

Nil

**13. Public Access Of Completion Report**

*(Please specify the information, if any, that cannot be provided for public access and give the reasons.)*

<b>Information that Cannot Be Provided for Public Access</b>	<b>Reasons</b>
Nil	



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COMPETITIVE RESEARCH FUNDING SCHEMES FOR  
THE LOCAL SELF-FINANCING DEGREE SECTOR**

**FACULTY DEVELOPMENT SCHEME (FDS)**

**Completion Report - Attachment**  
*(for completed projects only)*

**RGC Ref. No.:** UGC/FDS14/B07/15

**Principal Investigator:** LIU Junxia

**Project Title:** The Emergence of Second-Tier Auditors in China: An Analysis of Audit Quality

**Statistics on Research Outputs**

	Peer-reviewed Journal Publications	Conference Papers	Scholarly Books, Monographs and Chapters	Patents Awarded	Other Research Outputs (Please specify)
No. of outputs arising directly from this research project [or conference]	1	1			