

# Top Management Overhaul and the Audit Quality of Chinese State-Owned Enterprises

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**Abstract:** As the opening and reform of Chinese economic going further, more state-owned enterprises went on listing and went under the supervision under independent auditors. The thesis is bound for evaluating the effect of state-owned top management on the audit quality of state-owned listing firms. We found support for the theory that top management overhaul can negatively affects the audit quality through the path of a series of perspectives. This research is made through the case study of HengXin Estate chosen from the SOE audit quality relative cases within 2010 to 2020.

## 1. Introduction

Audit quality had been an important topic since independent audit was set by regulatory and the law. The target of independent audit is to make sure the financial report of the listing firm truly and fairly reflects the actual statement of business. Therefore, the audit quality is important as the target is important. Basically, the criteria of audit quality could be concluded as below: 1) the ability to discover the default and violation of the firm. 2) The ability to satisfy the acquirement of the regulatory and the other users of financial report, say, helping the decision making of the users. 3) Perform the two points above with efficiency, both in time and other costs. Based on the theory existed, we can analysis the audit quality of Chinese state-owned enterprises.

Top management overhaul is also another topic that worth discussing, especially in those firms that specific managers have superior power over the board and the other management. This situation usually happens in family-owned business, which the “creator” or “elders” can have absolute power, or the “official manager” that assigned by the state in SOEs and lack of regulation. The cases of Chen Tonghai, former chairman of SINOPEC, and Zhong Xincai of Foshan Lighting, had shown us that the top management overhaul could do great harm to the business of the firm (in the way of corruption, or taking advantages from the state-owned asset like selling the shares to foreign capital and lead to a loss of state-owned assets). Given the possible outcome of top management overhaul, audit quality as one of the important standards that translate the performance of the firm could be influenced (usually negative, which I will be discussing in the following paragraphs).

In this research, I chose Hengxin Estate as a typical case of top management overhaul on audit quality of state-owned enterprises. The case was took place in 2011, after years of independent audit as a subsidiary of CNPC, the long existing violation of the chairman Chen Zhihua, was finally exposed by the internal audit by National Audit Office. This case can provide us data for using a framework to analysis the effect of top management overhaul on audit quality.

## 2. Literature Review

First of all, we should defy the concept of audit quality before discussing any question about it. The lowest level of audit quality is limited by legal standards, and audit reports that are lower than the legal standards are worthless. Due to the high cost of the audit process, the high quality of audit results is not the only goal pursued by investors. They will measure the cost of audit and the cost-effectiveness of audit quality. (Jere R. Francis, 1981). Customer environment is also considered an important factor that can to some extent, decide the audit quality of the firm (Steve G. Sutton, 1993). The state-owned enterprises in China, and the institution/information environment of China,

had been discussed by academics for long time. The lack of local independent auditors is an important factor that constructed the business environment of China (Joseph. D. Pitroski, T.J. Wong, 2013), which needs to be considered when we are discussing audit quality.

### **3. Under Special Environments: SOEs in China**

It had long been considered that the SOEs in China are in some perspectives different from other firms even though they are listing in developed markets like the US and Hong Kong SAR. The management systems of SOEs, although had been improved and constructed under the standard of “modernized enterprises”, still have remaining of “controlled economics”. Therefore, top management overhaul could have effects on the daily business of the firm, also when having annual audit, on the audit quality. The head managers of the SOEs are usually former governmental officers, or even military officers, they might be experienced in their profession, but they do not have experience in managing firms and making business decisions. Also, the managerial environment that they experienced were not the same as normal firms (under a more centralized circumstance), top management overhaul would be more likely to take place.

### **4. Case Background: HengXin Estate**

HengXin Estate is a state-owned enterprise mainly owned by the CNPC, China National Petroleum Cooperation which is a leading SOE in China. Listing in Shanghai Stock Exchange of mainland China, the HengXin Estate is currently under a typical legal and political system of China. The manager of the firm, Chen Zhihua, had been working in CNPC system for years and turned into enterprises manager after the change of CNPC from a governmental department into a state-owned firm. The story of Chen Zhihua is also a typical story of managers in SOEs. Given the background, top management overhaul could easily appear and influence the business outcome including the audit quality.

In 2011, internal audit by the National Audit Office found a series of corruption and violation within the recent actions of the firm, and without finding by the independent auditor which was PwC China. The company started their development by manufacturing bricks, then caught the chance of residential area construction in 2000. Since then HengXin turned their main business in real estates and developed into the largest real estate company in Daqing. According to the published information, under Chen Zhihua’s command the firm transfer three areas of land at a price of three years ago, caused lost to state-owned assets. He was also found to embezzle and forge the official seals for illegal transactions and seek his own benefits. As his behaviors were illegal and proven, he was sentenced for 66 months and all the legal income was confiscated.

### **5. Case Analyst**

We start from the path that the top management overhaul affecting the audit quality. Here I introduced an analyst framework that includes three perspectives:

1) The information basic of audit. This means that even if the auditor exercised their process strictly following all the requirements, the information they could reach might not be the truth and had been “handled” by top management. In this case, as the official seal was embezzled, some violation with normally deal process could possibly seems to be legal (in some way, seems like “following the normal steps” and could easily be mess up with the daily business). Also, the top management, which is Chen Zhihua, used he power to negotiate with specific clients to arrange transaction.

2) Exercising the audit process. Through the cooperation with outsiders, the auditors usually do not have the power to audit or check out how the transaction was made, whether it is illegal or could be defined as internal transaction. Due to the limit of audit process, and the relative regulatory requirements are currently not perfect, exercising the normal audit process at many times could not find the violation, therefore the audit quality might be damaged.

3) Ability for auditors to get the necessary information. In specific times, the resources and time given to independent auditors can decide the audit quality they can provide. Hengxin Estate is a subsidiary of CNPC, which was audited by PwC China as a group company, the resources and time invested in auditing Hengxin Estate were limited. Also, the location of the firm is far from CNPC headquarter and PwC office, which means it could be costly to get the information. Therefore, the audit quality could receive negative effects. Another point that could be noticed is that the violation was not exposed by the independent auditor but the internal audit from the state, which was exercised by the National Audit Office. The ability of independent auditor to have accurate information of state-owned enterprises, under the institution and information environment of China, is weaker than the relative governmental departments.

Based on the framework, the influence of top management overhaul on audit quality could be understood. The violation of Chen Zhihua had been existed for few years, but independent auditors did not expose until the NAO involved. Given the circumstance, we can say that the audit quality of Hengxin Estate was not satisfying.

To improve the audit quality, experience from the internal audit exercised by NAO could be learned from. The extended audit is necessary in most of the time, and with the help of information technology and big data this can be more costless in this time. Also, the regulatory requirements are needed to be consummate, raise restrictions to push the firms cooperating with the independent auditor, and to push the auditors exercise the process with efforts. Another improvement could be considered is to modernize the cooperate management of Chinese state-owned enterprises, to provide better institution and information environment for business. If this can be realized, not only the audit quality could be improved but can also improve the performance of SOEs, and the ability of them in handling public responsibilities.

## **6. Quantitative Methods to Evaluate Audit Quality: Research on Regression Models**

Some existing research had been trying to use quantitative methods to evaluate audit quality. Tian GaoLiang, Zhang Rui, Si Yi, Li Xing (2019) set a regression model that contains 17 variables to evaluate the audit quality of cross-listing Chinese firms, and lead to a result that shows a correlation between the audit quality in Hong Kong SAR and mainland China. This is a beneficial frontline research as it could be better to use a quantitative regression model which includes multiple variables that set from theories.

## **7. Other Possible Factors Effecting Audit Quality**

Overhaul of the top management is one of the multiple factors that have effect on audit quality. Other possible factors could be concluded as below: The relative requirements of the principles and the law; this is because the contains and process of independent audit are actually designed by the regulatory, and if the regulatory do not have requirements on some specific business, the audit might not take any action on it and the default or violation. Other factors like the firm size, which decides the working load of audit, and the identification of auditor, were also carried into consideration. The larger the firm size, the more work that the auditor needs to carry, then the cost and efficiency would be influence and mistakes could happen, then the overall audit quality could possibly be lower the expectation. Also, if the auditor is qualified or be one of the “Big Four” accounting firms, the audit quality could be higher as they have more strict process control and quality/risk management

## **8. Conclusion**

This research had analyzed the case of Huishan Dairy. The top management overhaul could have negative effect on audit quality through a series of perspectives including information basics, exercising audit process, and the ability for auditors to get the information. At the highest level the top management overhaul influences the information that the auditors can finally have and giving

opinions based on. If the auditors could only have untrue or “corrected” data, it is impossible to give appropriate and objective opinions. Secondly the top management could influence how the firm as a client to cooperate with the auditor, to exercise the necessary process that needed to provide high quality audit report. Finally, the management could persuade or to bribe the auditor, to limit the ability or motivation to perform high quality audit process. This concluded structure could be use in analyzing other firms with top management overhaul, not only about audit quality but also could be used on discussing other things relative to the behaviors of managers.

Further discussion could be made on how to improve the audit quality of state-owned listing firms, and also about building a modernized cooperate management system in these firms. The top management overhaul is not only a problem about how the outsiders evaluate their performance, but also relative to how the firm reach their target and satisfy the interest of shareholders. Therefore, the framework of top management overhaul on audit quality could be used on other business-related areas. Also, future research can focus on improving the framework into a quantitative regression model that can describe the relationship between management behavior and performance outcome of the firm.

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