

# Financial Statement Frauds and Auditor Sanctions: An Analysis of Enforcement Actions in China

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**ABSTRACT.** The rising tide of corporate scandals and audit failures has shocked the public, and the integrity of auditors is being increasingly questioned. It is crucial for auditors and regulators to understand the main causes of audit failure and devise preventive measures accordingly. This study analyzes enforcement actions issued by the China Securities Regulatory Commission against auditors in respect of fraudulent financial reporting committed by listed companies in China. We find that auditors are more likely to be sanctioned by the regulators for failing to detect and report material misstatement frauds rather than disclosure frauds. Further analysis of the material misstatements indicates that auditors are more likely to be sanctioned for failing to detect and report revenue-related frauds rather than assets-related frauds. In sum, our results suggest that regulators believe auditors have the responsibility to detect and report frauds that are egregious, transaction-based, and related to accounting earnings. The results contribute to our knowledge of auditors' responsibilities for detecting frauds as perceived by regulators.

**KEY WORDS:** audit failure, audit quality, auditor responsibility, auditor sanction, fraud type

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## **Introduction**

An independent audit has historically been viewed as necessary and essential for the effective functioning of capital markets by providing reasonable assurance on the integrity of the financial statements and related disclosures. Due to the presence of information asymmetries between inside managers and outside owners and creditors of enterprises, auditors play an important role in alleviating agency problems and in adding credibility to financial statements. Auditors are expected to exercise due care which includes professional skepticism and judgment in adhering to professional standards in their audit engagements. However, the rising tide of fraudulent financial reporting in major corporations has shocked the public and tarnished the reputation of the auditing profession.

Audit failures are serious problems that investors cannot tolerate (Stabus, 2005). Andersen's failure on the Enron audits led to a big increase in concern about auditor integrity and independence in the eyes of regulatory authorities as well as in the eyes of investors and the public. Although many accounting professionals insisted that finding fraud is not part of their job, Brewster (2003, p. 295) stated that '... the truth is that fraud detection (by auditors) is exactly what most members of U.S. Congress, the Securities and Exchange Commission (SEC), and the public believe it should be about'. This implies that the regulators and financial statement users expect auditors to detect and report frauds. Historically, it was assumed that auditors' traditional audit planning and clients' internal control procedures would be sufficient to assess the fraud risks in clients' financial statements. After the promulgation of the new Statement on Auditing Standards (SAS) No. 99

(AICPA, 2005), which supersedes the old SAS No. 82 in December 2002, auditors are responsible for gathering and analyzing much more information with which to assess fraud risks than they have in the past. Specifically, auditors are required to discuss among the audit team members the potential for material misstatement due to fraud, to make expanded inquiries of management and others within the entity regarding their knowledge of actual or alleged fraud at the entity, and to expand their use of analytical procedures to identify risks of the material misstatement. These changes in the auditing standards imply that the regulators and policy makers are expecting auditors to perform more work in their audit procedures with the aim of increasing the detection of fraud.

While much of the focus in the accounting literature has been on frauds found in the U.S., corporate scandals and audit failures are not the sole preserve of the U.S. Given the rapid globalization of business and investment, it behooves us to examine audit failures in other countries. In this paper, we provide detailed analyses of different types of financial reporting fraud as disclosed in the enforcement actions issued by the China Securities Regulatory Commission (CSRC). We examine whether the likelihood of auditor sanctions varies with the types of fraud. In other words, we provide empirical evidence on auditors' responsibilities to detect and report frauds from the regulator's perspective.

Given the growing importance of China in the world economy, we choose to study the government regulators' behavior in respect of audit failures in China. According to the IMF (2005), the ten-year average growth in Gross Domestic Products (GDP) for China is 8.3%, which significantly outweighs the growth of the United States (3.4%), Euro area (2.0%), Japan (0.9%), and India (5.9%); and is double that of the world average (3.9%). Some analysts are predicting that China's GDP will surpass that of Germany by 2010 and Japan by 2015, and equal the U.S. GDP by around 2040 (e.g. see Kren, 2005). Since the establishments of the two stock exchanges in the early 1990s<sup>1</sup>, China's domestic stock market has grown rapidly. In 1991, there were 13 firms listed in the two stock exchanges (8 firms listed on the Shanghai Stock Exchange; and 5 firms listed on the Shenzhen Stock Exchange). By the end of 2004, there are totally 1373 firms listed in the Chinese

stock markets, and the total market capitalization of listed firms reach *Renminbi* (RMB)<sup>2</sup> 3706 billion, which is equivalent to approximately U.S. 440 billion dollars. China is increasingly seen as an interesting country in which foreigners want to make portfolio investments. To facilitate this demand, the authorities have opened up avenues for foreigners to invest in China's firms. For example, the recent Qualified Foreign Institutional Investors (QFII) initiative allows foreigners to directly invest in China's domestic equity stocks and many U.S., European, and other international funds have taken advantage of this opportunity. As another example, the authorities have given more firms the necessary permission to raise funds from abroad and to list their securities in Hong Kong and foreign markets. China's firms have taken up these opportunities.

China is undergoing a transition from a planned economy to a market economy where various market segments including insurance, banking, auditing markets are opening to foreign investors. Although lower economic costs of production attract significant capital inflows to the economy, the quality of financial statements is a potential impediment for foreign investments in, and transactions with, Chinese firms. In the absence of efficient legal environments and corporate governance regimes which are characteristics of many transitional and developing economies, the quality of audit services plays an important role in ensuring the proper functioning of financial reporting systems and it helps safeguard the assets of investors (Fan and Wong, 2005). It is therefore important to learn more about the quality of financial statements, and how the regulators help ensure audit quality in such a fast growing emerging economy.

Based on the 72 enforcement releases that relate to fraudulent financial reporting issued by the CSRC during the period 1996–2002, we find that auditors are more likely to be sanctioned if they fail to detect and report material misstatement frauds such as overstatement of assets or income, understatement of liabilities or expenses, and fictitious transactions rather than detect and report inadequate disclosure of material contracts and potential litigation. Further analysis of the material misstatement frauds indicates that revenue-related misstatements are more likely to lead to auditor sanctions than asset-related misstatements. Overall, our results provide some useful

information for the profession and this will help them to develop various auditing procedures for detecting egregious frauds. For example, CPA firms may design more comprehensive audit procedures in verifying earnings-related items. Our analysis also gives some insights into the regulator's views on auditors' responsibilities for detecting frauds. This knowledge will be helpful to the accounting profession and policy makers when they devise new accounting and auditing standards that will help uncover these specific types of frauds.

### **Institutional background**

#### *Overview of the development of China's accounting profession*

Before the economic reforms, auditing played a very limited role in China and the profession had a low status (Chen et al., 2001; Li and He, 2000; Lin and Chan, 2000; Tang et al., 1999; Xiao et al., 2000; Yang et al., 2001). Economic reforms resulted in corporatization of the state-owned enterprises and a fast-growing foreign investment that created a high demand of external audits (DeFond et al., 2000). Since then, the accounting profession in China has experienced rapid development driven by an increasing demand for independent and high-quality audits. The establishment of the Chinese Institute of Certified Public Accountants (CICPA) in 1988, the disaffiliation program, where the CPA firms were severed from their sponsoring government agencies in early 1997, and the adoption of international accounting and auditing standards in recent years have all contributed to the improvement of audit quality in China (Lin and Chan, 2000; Yang et al., 2001).

Recent studies focusing on audit quality and auditor independence in China provide evidence that supports the above observations. For example, DeFond et al. (2000) investigate the impact of adopting new auditing standards on auditor independence. Their results reveal a nine-fold increase in modified audit opinions (MAOs), which proxy for auditor independence, after the adoption of the new standards in 1996. However, the increase is followed by a decline in audit market share among large auditors, as those clients with qualified opinions tend to shop for unqualified opinions from smaller

auditors and this flight from audit quality results from the lack of incentives to demand independent audits. Yang et al. (2001) examine whether the disaffiliation between China's CPA firms and their sponsoring government agencies improves auditor independence. They find that the number and percentage of MAOs issued have increased dramatically since the implementation of the program in 1997. Chen et al. (2001) also examine auditor independence and link it with earnings management by investigating whether auditors can detect discretionary earnings manipulation by management. Their results show that managers engage in significant earnings management in order to meet the regulatory target profitability level and their opportunistic accounting choices are associated with an increased frequency of MAOs.

Prior studies, as discussed above, examine the impact of *external* changes (i.e. environmental or institutional changes) on audit quality and auditor independence in China, and their results generally report an improvement in audit quality in the past decade (Chen et al., 2001; DeFond et al., 2000; Yang et al., 2001). Despite these improvements in audit quality, there are still a substantial number of fraudulent financial statements reported (Li, 2002; Wu, 2002; Xuan, 2002).

#### *CSRC enforcement actions*

The China Securities Regulatory Commission (CSRC) serves as the main monitoring authority in China's capital markets. It regulates the financial reporting and share trading of listed companies according to the *Temporary Rules and Regulations on the Management of Share Issues and Trade* (promulgated by the State Council in April 1993, "Temporary Rules" in the following paragraphs). Legal entities under the supervision of the CSRC include listed companies and market intermediaries such as auditors, securities brokers, chartered valuers, and lawyers. If there are any violations of the rules as specified in the *Temporary Rules* by a legal entity, a corresponding enforcement action will be issued by the CSRC. The punishments for auditors or other intermediaries include a warning, monetary fine, suspension or termination of practice, while the punishments for listed companies include a warning, monetary fine, termination of share issuance

qualification, suspension or termination of securities trading.

When a financial statement fraud is discovered, the CSRC will issue an enforcement action to sanction the listed company and its management. The auditor of the company will be sanctioned if the CSRC believes that the fraudulent financial reporting should have been detected by auditor but the auditor failed to do so. If the CSRC believes that the accounts or transactions were intentionally falsified or masked by management and the fraud was viewed as being almost impossible for the auditor to detect, then the auditor will not be sanctioned. Hence, an in-depth study of frauds committed by listed companies that resulted in auditors being sanctioned versus auditors not being sanctioned provide an excellent setting for examining how the regulators perceive the auditor's responsibility for detecting frauds.

## Hypotheses development

### *Material misstatement frauds versus disclosure frauds*

In general, auditors are responsible for exercising due care which includes professional skepticism and auditor judgment in adhering to professional standards. This due care will lead to the detection of fraud and the reporting of material misstatements. Material misstatements include income/assets overstatement, expenses/liabilities understatement, and fictitious transactions. Fictitious transactions include client's falsification of accounting transactions, provision of fictitious documents to support fictitious transactions, falsely claiming revenue (or loan) transactions with a made-up firms, etc. Studies in the U.S. reveal that frauds involving income/assets overstatement and expenses/liabilities understatement are considered more common than other types of fraud and thus attract more attentions from regulators. For example, Feroz et al. (1991) find that over 50% of the reporting violations in their SEC enforcement actions sample involved premature revenue recognition and overstatement of receivables. Bonner et al. (1998) examine the determinants of auditor litigation based on the SEC enforcement releases and report that the presence of frequently occurring frauds that include premature revenue recognition, overvalued assets,

and undervalued expenses/liabilities, are likely to lead to litigation against auditors. Bonner et al. (1998) also find a positive relationship between fictitious events and auditor sanctions. They argue that the disproportionate attention given by the media to fictitious events makes people believe that these frauds occur more frequently than they actually do. Their study shows that due to the seriousness of these frauds, auditors' failure to detect them increases the probability of litigation against the auditors.

While the threat of litigation in China is relatively low as compared to the U.S., material misstatements, in particular fictitious transactions, are considered to be egregious and draw enormous attention from the regulators, professionals, and the media. For example, the former Chinese Premier Zhu Rongji in his speech at the Inauguration Ceremony of Shanghai National Accounting Institute in 2001 named a phase of 'No Fictitious Records (不造假賬)' as a motto for the Institute (NAI United Research Program, 2003; Yang, 2002). Zhou and Lin (2003) from the Shanghai Stock Exchange find that the significant increase in loss reporting by listed firms in 2002 is mainly due to firms taking a 'big bath' to decrease the value of fictitious assets that accumulated in previous years. In addition, the official Chinese professional accounting bulletin, the *CIC-PA Journal*, provides descriptions of various fictitious transaction frauds committed by listed companies and managements in China. For example, Wu (2002) examines some common techniques employed by listed companies for fictitious reporting purposes. Xuan (2002) investigates the reasons why auditors get involved in the falsification whirlpool. He suggests that deficiencies in regulations, lack of auditor independence and integrity, government affiliation with clients and auditors, and poor corporate governance systems are the main causes of audit failure in respect of clients' falsifications. Therefore, the seriousness of fictitious transaction frauds, and the adverse publicity that accompanies it, draws the regulatory authority's attention and leads to more enforcement actions against auditors.

In summary, a firm that overstates its net assets and income misleads investors about the firm's true value and its earning capacity (Feroz et al., 2000). Because of its significant impact on financial statements users, material misstatement frauds are considered more

egregious by the monitoring authority, and we predict that auditors are held responsible for their failure to detect and report such kind of frauds and are therefore more likely to be sanctioned.

On the other hand, according to Articles 58 and 59 of the *Temporary Rules*, listed companies are required to disclose information relating to company operations, financial status, material contracts, substantial shareholders, directors' remunerations, potential litigation and some other specific contents in the interim and annual financial statements. It is the listed companies' responsibility to ensure the completeness of accounting information submitted for verification. If the listed companies intentionally cover up financial information (i.e. inadequate disclosure of material contracts, loan guarantees, or potential litigation, etc.), it is hard, in most cases, for auditors to detect and report the hidden information. For example, it is difficult for auditors to identify purposely undisclosed loan guarantees made to third parties. Therefore, the regulator is more likely to hold the listed companies, rather than the auditors, responsible for the disclosure problems.

Accordingly, we hypothesize that:

H1: Auditors are more likely to be sanctioned if they fail to detect and report material misstatement frauds than disclosure frauds

#### *Revenue-related frauds versus asset-related frauds*

Material misstatement of revenues (or the income effect) is more prevalent than misstatement of assets, as accounting earnings are used by investors to evaluate a company's financial performance and, in particular, to project the future earning capacity. For example, Feroz et al. (1991) find that information about errors on accounting earnings affects the market's expectations about the future earnings of the fraud firm. Loebbecke et al. (1989) find that auditors experienced more revenue-related irregularities than asset-related irregularities during the audit processes. In their study, auditors experienced more management frauds that involve the audit areas of revenue cycle (40 cases) and expenses cycle (24 cases) than for property plant and equipment (13 cases) and cash (9 cases). In addition, financially distressed firms are more likely to conceal their distress prior to bankruptcy by inflating the accounting earnings. For

example, Rosner (2003) finds that the financial statements of bankruptcy firms reflect significantly greater material income-increasing earnings management in pre-bankruptcy years than those for non-bankruptcy firms, and these bankruptcy firms had been sanctioned by the SEC regarding the income overstatement frauds before the bankruptcy. Beneish (1999) and Feroz et al. (2000) find that most SEC sanctioned firms are involved in earnings manipulations. Palmrose and Scholz (2004) also report that companies with core earnings restatements—driven primarily by misstatements of revenue—have higher frequencies of intentional misstatements frauds (as revealed by the SEC enforcement releases) and subsequently enter into bankruptcy or are delisted.

In China, the level of accounting earnings is an important criterion for initial public offerings, raising additional capital, and maintaining trading status. Specifically, companies must have operating profits for two consecutive years in order to apply for listing (Aharony et al., 2000), and must maintain a minimum return on equity for three consecutive years in order to raise additional capital (Chen et al., 2001; Chen and Yuan, 2004). Companies will be suspended from trading if they experience losses for three consecutive years. Hence, companies have incentives to manipulate earnings in order to raise capital and to avoid trading suspensions.

Due to the specific profitability regulations and the prominent nature of accounting earnings in the capital market, we hypothesize that frauds related to misstatement of accounting earnings are perceived to be more important than frauds related to misstatement of assets. Therefore, the regulators will hold auditors responsible for their failures to detect and report revenue-related frauds rather than asset-related frauds.

H2: Auditors are more likely to be sanctioned if they fail to detect and report revenue-related misstatement frauds rather than asset-related misstatement frauds

## **Research method**

### *Sample selection*

Table I summarizes our sample selection procedures. We collect all the enforcement releases posted on the

TABLE I  
Sample collection procedure

	Total number
CSRC enforcement releases issued during 1996–2002	479
Exclusion of cases not pertaining to financial reporting frauds	(337)
Exclusion of cases with missing data <sup>a</sup>	(43)
Exclusion of duplicated cases	(18)
Exclusion of cases with no auditor data <sup>b</sup>	(9)
Final sample	72

Notes:

<sup>a</sup>Missing data means there are no specific addressees, no date of issuance, or the companies sanctioned cannot be traced to their security code. There is also one case that has not yet been finalized so no actions have been taken by the CSRC while twelve cases were grouped together in an announcement and the nature of frauds committed by those firms cannot be reasonably separated.

<sup>b</sup>Cases with no auditor information include enforcement actions against unaudited interim statements and audited statements with missing auditor information.

CSRC Bulletin during the period 1996–2002. Of the 479 releases published in the CSRC Bulletin, we identify 142 releases that relate to fraudulent financial reporting. Excluding 43 cases with missing data, 18 duplicated cases, and 9 cases with no auditor information, the final sample consists of 72 enforcement releases.

Table II provides descriptive statistics of the selected enforcement releases. We classify the sample into two groups, namely the auditor-sanctioned group and the auditor-not-sanctioned group. The auditor-not-sanctioned group includes cases against the listed firms and managers *only*, while the auditor-sanctioned group consists of enforcement actions against both the listed companies and auditors, and cases against auditors only. As shown in Table II, 27 enforcement actions relate to auditor-sanctioned cases while 45 enforcement actions relate to auditor-not-sanctioned cases (item(i)). There is no discernable time trend in the number of enforcement cases. However within the total number of cases there is a decline in the number of enforcement releases issued for the auditor-sanctioned group whereas there is an

increase in the number of enforcement releases issued for the auditor-not-sanctioned group (item (ii)). The decline in auditor-sanctioned cases may relate to the continuous accounting reform in recent years, which helps to improve audit quality and auditor independence in China (DeFond et al., 2000; Lin and Chan, 2000). The clustering of fraudulent reporting year observations for the auditor-sanctioned group from 1996 to 1998 gives support to this argument. Note that the number of observations for fraudulent reporting year (item (iii)) is not equal to the total number of enforcement releases (items (i), (ii),(iv),and(v)), because some sample firms have multiple year violations in a single enforcement release.

About 90% of the enforcement releases for the auditor-sanctioned group have at least two years' delay in issuance from the fraudulent reporting year, while about 50% of the releases have one-year or no delay in issuance for the auditor-not-sanctioned group. Over 55% of the companies are listed on the Shenzhen Stock Exchange, while the other companies are listed on the Shanghai Stock Exchange.

*Logistic model*

We use two logistic regression models to examine whether the types of fraud are associated with the likelihood of enforcement actions against auditors. The two models used are as follows:

$$\begin{aligned} \text{AUD\_ENF} = & \alpha + \beta_1 \text{MIS} + \beta_2 \text{MAO} \\ & + \beta_3 \text{ASIZE} + \beta_4 \text{TA} + \beta_5 \text{ROA} \\ & + \beta_6 \text{DE} + \beta_7 \text{AGE} + \varepsilon \end{aligned} \quad (1)$$

$$\begin{aligned} \text{AUD\_ENF} = & \alpha + \beta_1 \text{REV} + \beta_2 \text{MAO} \\ & + \beta_3 \text{ASIZE} + \beta_4 \text{TA} + \beta_5 \text{ROA} \\ & + \beta_6 \text{DE} + \beta_7 \text{AGE} + \varepsilon \end{aligned} \quad (2)$$

The dependent variable for the two models is AUD\_ENF, and it has a value of one if auditors are sanctioned by the CSRC; and zero otherwise. We include the full sample of 72 fraud firms in Model (1)

TABLE II  
Descriptive statistics of enforcement releases

	Number (Percentage) of observations					
	Auditor-sanctioned group		Auditor-not-sanctioned group		Total sample	
(i) Total number of sanctions	27		45		72	
(ii) Date of issuance						
2002	3	(11.1%)	19	(42.2%)	22	(30.6%)
2001	5	(18.5%)	15	(33.3%)	20	(27.8%)
2000	8	(29.7%)	4	(8.9%)	12	(16.6%)
1999	4	(14.8%)	4	(8.9%)	8	(11.1%)
1998	6	(22.2%)	2	(4.5%)	8	(11.1%)
1997	0	(0.0%)	1	(2.2%)	1	(1.4%)
1996	1	(3.7%)	0	(0.0%)	1	(1.4%)
Total	27	(100%)	45	(100%)	72	(100%)
(iii) Fraudulent reporting year						
2001	0	(0.0%)	16	(26.7%)	16	(16.7%)
2000	1	(2.8%)	16	(26.7%)	17	(17.7%)
1999	2	(5.6%)	9	(15.0%)	11	(11.5%)
1998	7	(19.4%)	6	(10.0%)	13	(13.5%)
1997	12	(33.3%)	8	(13.3%)	20	(20.8%)
1996	14	(38.9%)	5	(8.3%)	19	(19.8%)
Total <sup>a</sup>	36	(100%)	60	(100%)	96	(100%)
(iv) Delay in issuance of enforcement releases						
No delay	1	(3.7%)	3	(6.7%)	4	(5.6%)
Lag 1 year	2	(7.4%)	21	(46.7%)	23	(31.9%)
Lag 2 years	10	(37.0%)	11	(24.4%)	21	(29.2%)
Lag more than 2 years	14	(51.9%)	10	(22.2%)	24	(33.3%)
Total	27	(100%)	45	(100%)	72	(100%)
(v) Client listing origin						
Shenzhen Stock Exchange	15	(55.6%)	25	(55.6%)	40	(55.6%)
Shanghai Stock Exchange	12	(44.4%)	20	(44.4%)	32	(44.4%)
Total	27	(100%)	45	(100%)	72	(100%)

<sup>a</sup>The number of observations for fraudulent reporting year does not equal the total number of enforcement releases because some sample firms had multiple year violations.

and use material misstatement frauds versus disclosure frauds (MIS) as the test variable to test hypothesis H1. MIS has a value of one if the fraud involves material misstatements (including overstatement frauds and fictitious transaction frauds); and zero if the fraud involves inadequate disclosure of financial information. The second model focuses on material misstatement frauds and we exclude those fraud firms with inadequate disclosure violations. Model (2) uses the revenue-related fraud

versus asset-related fraud (REV) as the test variable for testing hypothesis H2. REV has a value of one if the fraud is revenue-related; and zero if the fraud is asset-related.

Besides the test variables, we include six control variables that may have potential effects on the dependent variable. The control variables include four client attributes, namely log of total assets (TA), return on assets (ROA), debt-equity ratio (DE), and the age of the client (AGE), and two audit

characteristics, the presence of a modified audit opinion (MAO) and auditor size (ASIZE).

Generally, we expect that the poorer the financial position a firm has in the year immediately before the fraudulent financial reporting the higher the motivation for the firm to engage in earnings manipulation (Chen et al., 2001; DeChow et al., 1996). Therefore auditors are more likely to be held responsible for their failure to detect fraud in cases where companies are more prone to distort financial statements. Low TA, low ROA, and high DE are indicators of poor financial performance or financial distress. Thus we expect that TA and ROA are negatively associated with enforcement actions against auditors while DE is positively associated with enforcement actions against auditors.

Another control factor is the auditor's quality and independence. Audit firms with a higher audit quality should have a lower probability of enforcement actions against them. We include MAO and ASIZE as the control variables in our models as proxies for audit quality. MAO measures the existence of a modified audit opinion issued by the auditor in the year of observation. Recent research reveals a defensive role played by modified audit reports for protecting auditors from subsequent litigation about their audit failures (Carcello and Palmrose, 1994; Gaeremynck and Willekens, 2003). In addition, a high quality and more independent auditor generally issues more modified audit opinions (Chen et al., 2001; DeFond et al., 2000). Hence, we expect a negative association between auditor sanction and the issuance of modified audit opinions. ASIZE measures the size of a CPA firm, which is given by the logarithm of total clients' assets of the CPA firm. Larger auditors are more competent and independent than smaller auditors, and they have more to lose when an audit failure occurs (DeAngelo, 1981). Therefore, we expect that ASIZE is negatively associated with enforcement actions against auditors.

## Empirical results

### *Sanctions on CPA firms and audit partners*

Table III summarizes the details of the enforcement actions based on the punishments meted out to the

CPA firms and individual audit partners. More than 80% of the punishments (for the two groups) are in the form of admonishments, appropriations, and monetary fines. According to the *Temporary Rules* promulgated by the CSRC, these three types of punishments are considered less severe, while suspension or terminations of practices, and market restrictions are more severe punishments. The findings are quite similar to those in the U.S. where the market regulator wants to deliver a message of the need for improvement in fraud companies and auditors rather than impose draconian sanctions (Sack et al., 1988).

### *Fraud characteristics and univariate tests*

Table IV provides the detailed description of frauds as cited in the CSRC Bulletin. Panel A classifies the frauds under two major categories, namely, material misstatements versus inadequate disclosure, while Panel B provides a further breakdown of material misstatements as revenue-related versus asset-related frauds. As shown in Panel A, for the auditor-sanctioned group, nearly all of the frauds are material misstatements. The most frequently occurring material misstatement frauds are misstatement for IPO purposes (10 cases), overstatement of income/assets (6 cases), understatement of expense/liabilities (5 cases), and premature revenue recognition (4 cases). For the auditor-not-sanctioned group, over 70% of the frauds are inadequate disclosure. The most common disclosure frauds are inadequate disclosure of related party transactions and external loan guarantees, which account for over 50% of the inadequate disclosure frauds.

Panel B shows that for the auditor-sanctioned group, about 90% of the material misstatements are revenue-related misstatements. The most frequently occurring revenue-related misstatement frauds are income overstatement for IPO purposes (7 cases), overvalued income (5 cases), and undervalued expenses (5 cases). For the auditor-not-sanctioned group, the material misstatements are quite balanced between revenue-related frauds (8 cases) and asset-related frauds (7 cases).

Table V summarizes the types of frauds as reported in Table IV and the average monetary



TABLE III  
Analysis of the punishments enforced in the enforcement actions

Types of punishments	On CPA firms		On audit partners	
	Number	Percentage	Number	Percentage
Admonishment <sup>a</sup>	11	50.0	22	50.0
Appropriation <sup>b</sup>	3	13.7	0	0.0
Monetary fine				
<RMB 100,000	0	0.0	16	36.4
RMB 100,000 to RMB 1 million	7	31.8	0	0.0
Suspension of practice	0	0.0	4	9.1
Others <sup>c</sup>	1	4.5	2	4.5
Total <sup>d</sup>	22	100.0	44	100.0

## Notes:

<sup>a</sup>Admonishment was a form of warning sentences appearing in the Enforcement Bulletin or a critique appearing in newspapers.

<sup>b</sup>Appropriation of service income as a result of fraudulent reporting. The amounts range from RMB 30,000 to RMB 1 million.

<sup>c</sup>Others refer to an enforced provision of a correction plan to the CSRC by sanctioned auditors within a time period. There is one case each for the CPA firm enforcement action and the audit partner enforcement action. Another case for other punishments for audit partners involves the CSRC's suggested action for the Ministry of Finance to warn and suspend the audit partner's practice.

<sup>d</sup>The total number of punishments for CPA firms is not equal to the total number of enforcement releases (i.e. 27) because in 5 cases only audit partners were sanctioned. Because not all audit partners were sanctioned, the total number of punishments for audit partners is less than 54 (as each audit report in China should have two audit partners who sign off).

amount of the frauds. Overall, 37 enforcement actions involve material misstatements and the average amount of the fraud is RMB 50 million while 35 enforcement actions involve inadequate disclosure and the average amount of the fraud is RMB 474 million. More than 96% of the auditor-sanctioned cases involve material misstatement frauds while around 76% of the auditor-not-sanctioned cases involve inadequate disclosure frauds. The average dollar amounts involved for frauds committed by the auditor-not-sanctioned cases are generally greater than those committed by the auditor-sanctioned cases.

Of the 37 material misstatement fraud cases, 29 cases (78%) relate to revenue misstatements while 8 cases (22%) relate to asset misstatements. Eighty five percent of the auditor-sanctioned cases involve revenue-related frauds while only 45% of the auditor-not-sanctioned cases involve revenue-related frauds. Overall, the average dollar amounts involved in asset-related frauds (RMB 90 million) are greater than that for the revenue-related frauds (RMB 34 million).

The univariate tests in Table V reveal that the number and percentage of occurrences of material misstatement frauds in the auditor-sanctioned group are statistically higher (at the 1% level) than for the auditor-not-sanctioned group. In addition, the number and percentage of occurrences of revenue-related frauds in the auditor-sanctioned group are statistically higher (at the 5% level) than for the auditor-not-sanctioned group.

In sum, the results suggest that the high occurrence of material misstatement frauds and revenue-related frauds are associated with a higher possibility of enforcement actions against auditors rather than disclosure frauds and asset-related frauds, respectively. The results are consistent with our hypotheses.

#### Multivariate tests

Table VI reports the results of the logistic regression models. Results for Model 1 and Model 2 indicate that material misstatement frauds (MIS) and

TABLE IV  
Detailed description of frauds

	Number (Percentage) of observations			
	Auditor-sanctioned group		Auditor-not-sanctioned group	
<i>Panel A: Material misstatement frauds versus inadequate disclosure frauds</i>				
(A) Material misstatement fraud				
(A1) Misstatement for IPO purposes	10	(27.1%)	1	(6.7%)
(A2) Income and/or assets overstatement	6	(16.2%)	3	(20.0%)
(A3) Expenses and/or liabilities understatement	5	(13.5%)	4	(26.6%)
(A4) Premature revenue recognition	4	(10.8%)	0	(0.0%)
(A5) Fictitious assets and/or reductions of expenses/liabilities	3	(8.1%)	0	(0.0%)
(A6) Fictitious revenue	3	(8.1%)	1	(6.7%)
(A7) Fictitious supporting documents	3	(8.1%)	3	(20.0%)
(A8) Delayed expenditure recognition	1	(2.7%)	0	(0.0%)
(A9) Equity frauds	1	(2.7%)	1	(6.7%)
(A10) Misclassification	1	(2.7%)	2	(13.3%)
<i>Total violations</i>	37	(100%)	15	(100%)
(B) Inadequate disclosure fraud				
(B1) Related party transactions	0	(0.0%)	11	(27.5%)
(B2) External loan guarantees	0	(0.0%)	11	(27.5%)
(B3) Litigation and/or potential litigation cases	0	(0.0%)	5	(12.5%)
(B4) Significant contracts or events	0	(0.0%)	4	(10.0%)
(B5) Miscellaneous	0	(0.0%)	2	(5.0%)
(B6) Fictitious announcement	1	(100%)	7	(17.5%)
<i>Total violations</i>	1	(100%)	40	(100%)
<i>Panel B: Material misstatement frauds: revenue-related frauds versus asset-related frauds</i>				
(C) Revenue-related frauds				
(C1) Income overstatement for IPO purposes	7	(21.2%)	0	(0.0%)
(C2) Overvalued income	5	(15.2%)	1	(12.5%)
(C3) Undervalued expenses	5	(15.2%)	3	(37.5%)
(C4) Premature revenue recognition	4	(12.1%)	0	(0.0%)
(C5) Fictitious revenue	3	(9.1%)	1	(12.5%)
(C6) Fictitious expenses	3	(9.1%)	0	(0.0%)
(C7) Fictitious supporting documents	3	(9.1%)	2	(25.0%)
(C8) Delayed expenditure recognition	1	(3.0%)	0	(0.0%)
(C9) Misclassification	1	(3.0%)	0	(0.0%)
(C10) Equity frauds	1	(3.0%)	1	(12.5%)
Sub-total	33	(100%)	8	(100%)
(D) Asset-related frauds				
(D1) Asset overstatement for IPO purposes	3	(75.0%)	1	(14.3%)
(D2) Overvalued assets	1	(25.0%)	2	(28.5%)
(D3) Undervalued liabilities	0	(0.0%)	1	(14.3%)
(D4) Equity frauds	0	(0.0%)	1	(14.3%)
(D5) Misclassification	0	(0.0%)	1	(14.3%)
(D6) Fictitious supporting documents	0	(0.0%)	1	(14.3%)
Sub-total	4	(100%)	7	(100%)
<i>Total violations</i>	37		15	

Note: The total number of observations in Panel A and Panel B do not equal the total number of enforcement actions because some sample firms had multiple violations in the enforcement action.

TABLE V  
Descriptive statistics and univariate tests for financial statement frauds and auditor sanctions

Types of fraud	Number (Percentage) of observations			$\chi^2$ -statistics	Average dollar amounts (in RMB millions)		
	Auditor-sanctioned group	Auditor-not-sanctioned group	Total		Auditor-sanctioned group	Auditor-not-sanctioned group	Total
Material misstatement frauds versus disclosure frauds							
(A) Material misstatement frauds	26(96.3%)	11(24.4%)	37	34.875***	31.69	97.47	49.90
(B) Inadequate disclosure frauds	1(3.7%)	34(75.6%)	35		3.34	487.45	473.62
<i>Total violations</i>	27(100.0%)	45(100.0%)	72				
Revenue-related frauds versus asset-related frauds							
(C) Revenue-related frauds	22(84.6%)	5(45.5%)	29	6.010**	37.37	33.97	34.21
(D) Asset-related frauds	4(15.4%)	6(54.5%)	8		0.43	150.01	90.18
<i>Total violations</i>	26(100.0%)	11(100.0%)	37				

Note: \*\*\* and \*\* indicate significance at the 1% and 5% level for two-tailed test.

Misstatement frauds represent material misstatement frauds that include income/assets overstatement, expense/liabilities understatement and fictitious events frauds.

Disclosure frauds represent inadequate disclosures of financial information.

revenue-related frauds (REV) are both statistically significant at the 1% level. The signs for both variables are positive as predicted in H1 and H2. Consistent with our expectation, auditor size (ASIZE) is negatively associated with the probability of auditor sanctions at the 5% level.

The overall results of the multivariate tests suggest that auditors are more likely to be sanctioned if they fail to detect and report frauds that relate to material misstatements and revenue-related frauds than inadequate disclosure of information and asset-related frauds, respectively.

## Conclusions and implications

This paper investigates whether certain types of fraud increase the likelihood of enforcement actions against auditors in China. In particular, we examine how the regulatory body perceives the auditors' responsibilities in respect of detecting frauds in listed companies. By focusing on the CSRC enforcement releases, our results suggest that auditors are *more* likely to be sanctioned if they fail to detect and report frequently occurring and

transaction-based frauds such as income or assets overstatement and fictitious transactions rather than disclosure frauds. In addition, auditors are *more* likely to be sanctioned if they fail to detect and report frauds that involve revenue overstatements and/or falsifications rather than asset-related misstatements.

This study makes several contributions. We contribute to the extant fraud type literature (e.g. Bonner et al., 1998; Feroz et al., 1991; Rollins and Bremser, 1997) by providing direct evidence on the specific characteristics of fraud that are related to enforcement actions against auditors in China. The analysis of specific financial statement frauds provides additional information on auditors' responsibilities. Our study reveals that revenue-related frauds are viewed as more important than asset-related frauds from the regulator's standpoint. The positive association between the occurrence of auditors' sanctions and revenue-related frauds underscores the significant role auditing plays as a check on the earnings manipulation of the listed companies. Consistent with prior earnings management literature (e.g. Chen et al., 2001) and error types research (e.g. Chan and Mo, 1998;

TABLE VI  
Multivariate analysis result

Dependent variable: (1) auditor-sanctioned vs. (0) auditor-not-sanctioned							
Model 1 (Full Sample, $n = 72$ )				Model 2 (reduced sample, $n = 37$ )			
Material misstatement frauds versus inadequate disclosure frauds				Revenue-related frauds versus asset-related frauds			
Variable	Expected sign	Coefficient	$p$ -value	Variable	Expected sign	Coefficient	$p$ -value
Intercept	?	22.418	0.073*	Intercept	?	22.032	0.210
REV	+	4.353	0.001***	REV	+	4.254	0.010***
MAO	-	-2.190	0.176	MAO	-	-1.845	0.328
ASIZE	-	-0.877	0.032**	ASIZE	-	-1.260	0.036**
TA	-	-0.282	0.580	TA	-	0.253	0.748
ROA	-	1.085	0.923	ROA	-	22.448	0.283
DE	+	0.150	0.832	DE	+	-0.583	0.548
AGE	?	0.040	0.857	AGE	?	-0.067	0.816
$\chi^2$		54.038	0.000***	$\chi^2$		19.892	0.006***

\*\*\*, \*\*, \* indicate significance at the 1%, 5%, and an 10% level for two-tailed test.

Notes:

Regression Model 1:

$$AUD\_NF = \alpha + \beta_1 MIS + \beta_2 MAO + \beta_3 ASIZE + \beta_4 TA + \beta_5 ROA + \beta_6 DE + \beta_7 AGE + \varepsilon$$

Regression Model 2:

$$AUD\_NF = \alpha + \beta_1 MIS + \beta_2 MAO + \beta_3 ASIZE + \beta_4 TA + \beta_5 ROA + \beta_6 DE + \beta_7 AGE + \varepsilon$$

Where:

AUD\_ENF = 1 if auditors are sanctioned by the CSRC; 0 otherwise.

MIS = 1 if material misstatement frauds revealed by the CSRC; 0 if inadequate disclosure frauds revealed by the CSRC;

REV = 1 if revenue-related frauds revealed by the CSRC; 0 if asset-related frauds revealed by the CSRC;

MAO = 1 if a modified audit opinion (i.e. unqualified opinion with explanatory notes, qualified opinion, disclaimer opinion, and adverse opinion) was issued by the auditor in the year of observation; 0 otherwise;

ASIZE=Auditor size; denoted by the log of total clients' assets of the CPA firm;

TA=Log of client's total assets;

ROA = Client's return on assets (Net income divided by total assets);

DE = Client's debt equity ratio (Total long-term liabilities divided by shareholder's equity);

AGE =Client's, age; denoted by number of years since it was incorporated.

Kinney and Martin, 1994), our findings reaffirm the important role of auditors in detecting and reporting financial statement frauds. Auditors are perceived to be responsible for safeguarding clients' assets and reducing biases in financial reporting through detecting and reporting prominent income-statement related frauds.

Our results are consistent with the findings in the U.S. that material misstatement frauds that involve fictitious transactions are more likely to lead to formal sanctions against auditors. As argued by Bonner et al. (1998), fictitious transactions are unambiguously fraudulent and it would be more

difficult for auditors who fail to detect these frauds to argue convincingly that their audits complied with generally accepted auditing standards. Therefore, the Chinese regulators believe the auditors should be able to detect material misstatement frauds. Our findings show strong support for the regulators' belief in auditors' capabilities and responsibilities to detect these types of frauds. Furthermore, as mentioned earlier, the accounting earning numbers are crucial for listed companies to raise capital, or maintain trading status, and so managements may have strong motivations to manipulate the earnings numbers. From the regulators' perspective, auditors

should pay more attention to clients' earnings numbers and they will be more likely to be held responsible if they fail to detect and report the revenue-related frauds.

We believe the regulators' unequal treatments on auditors' responsibilities in detecting certain types of frauds are consistent with the regulators' anticipation of emerging problems. As revealed by Feroz et al. (1991), many of the views as expressed by the SEC in the enforcement releases are precursors of future auditing standards. We hope our findings are helpful for the Chinese regulators and policy makers in promulgating new auditing standards in respect of detailed guidelines for auditors to detect material misstatement frauds and revenue-related frauds. Furthermore, given the rising tide of fraudulent reporting in the U.S. and in China, we believe our research contributes to the current debate on whether auditors should be responsible for detecting frauds or be mere a watchdog for clients' financial statements (Brewster, 2003; Zhang and Wang, 2003). In particular, we find that related party transactions are one of the most frequently occurring disclosure frauds in China; nevertheless, the Chinese regulators apparently place more emphasis on material misstatement frauds than disclosure frauds. Given that the major problem of Andersen's audit was the inadequate disclosure of Enron's related party transactions with its special purpose entities (Brewster, 2003), we propose that more stringent and frequent checks on related party-transactions should be made and we believe this will help improve the integrity of financial statements.

In conclusion, our study shows a significant relationship between various types of frauds and enforcement actions against auditors. Importantly, the evidence may assist the accounting profession and regulators in better assessing the underlying causes of the audit failures. From this, the auditors can devise preventive measures so as to improve audit quality in the future. For example, auditors may focus more on audit procedures to detect certain earnings-related frauds, or provide technical training for staff to identify various types of prominent frauds. Recent research like Beneish (1999) reports some red-flags that are associated with earnings overstatements. CPA firms may therefore consider devising practice manuals in assisting their staff accountants to examine an abnormal increase in

sales growth or accounting accruals and particularly, to detect earnings-related misstatements frauds.

One limitation of our study is the small number of observations of fraudulent reporting cases in the Chinese securities markets, and hence the results may not be generalizable to other economies or other time periods. Nevertheless, the results add to our knowledge about fraudulent financial reporting in a developing economy and they provide a good benchmark for the accounting profession in considering their responsibilities for detecting frauds. Future research could investigate the economic consequences for auditors that were subject to the enforcement actions. Since regulatory sanctions have education effect on sanctioned and non-sanctioned auditors (Sack et al., 1988), research questions such as whether the sanctioned auditors supply high audit quality after the enforcement actions, and whether clients whose auditors are sanctioned experience more negative market reactions than clients whose auditors are not sanctioned, seem to be fruitful. Such studies will contribute to our understanding of the effects of enforcement actions.

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### Notes

<sup>1</sup> There are two stock exchanges in China, namely the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The Shanghai Stock Exchange was officially opened in December 1990, followed by the Shenzhen Stock Exchange in July 1991 (Aharony et al., 2000). There are two types of shares, namely A-Shares and B-Shares, traded on the markets and they have the same rights and obligations. The only difference is that A-Shares are listed on the domestic exchanges and traded in *Renminbi* (RMB), while B-Shares are traded in U.S. dollars in Shanghai or Hong Kong dollars in Shenzhen, and only foreign investors may hold them.

<sup>2</sup> *Renminbi* (RMB) is the Chinese monetary unit. Hereafter, we use the abbreviation RMB for *Renminbi*.

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