Related Party Transactions and Opinion Shopping

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Abstract

This paper examines the association between related party transactions (RPTs) and partner-level audit opinion shopping. The use of RPTs, generally diverse and complex, associates with an increased audit risk and the probability of receiving modified audit opinions (MAOs). In China, the audit market is dispersed and audit firms' internal control mechanisms are weak. This enables firms to shop for a more lenient audit partner within the same audit firm to obtain a favorable opinion. I argue that firms with more RPTs have greater incentives to press audit firms to switch engagement partners to obtain more favorable opinions. Based on a large sample of Chinese listed firms, I find that successful partner-level opinion shopping increases as the amounts of RPTs rises. I also find that the positive relationship between RPTs and successful opinion shopping is more pronounced in non-operating RPTs. Policymakers may consider RPTs to have a significant effect on auditor independence and design monitoring mechanisms to prevent partner-level opinion shopping.

1. Introduction

Related party transactions (RPTs) involve a company transacting with its related entities (e.g., subsidiaries, affiliates, principal owners, directors, or officers). Companies often use RPTs as a mechanism for financial fraud and for minority shareholder expropriation despite its potential to support genuine business

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transactions (Kohlbeck and Mayhew, 2010; Ryngaert and Thomas, 2012). Auditors play an essential role in the reporting of RPTs and monitoring and curbing abusive transactions with related parties (Bennouri et al., 2015). In China, where RPTs are particularly prevalent (Jiang and Wong, 2010), and auditors perceive RPTs as an audit risk factor (Habib et al., 2015) which is associated with the issuance of modified audit opinions (MAOs) (DeFond et al., 1999; Francis and Krishnam, 1999). Firms engage in partner-level audit opinion shopping when they successfully pressuring their audit firms to substitute an engagement partner with a more lenient one to obtain a more favorable audit opinion. Chinese listed firms are particularly successful in partner-level opinion shopping (Chen et al., 2016). Such MAOs associate with severe penalties against Chinese listed firms; such as, delisting, suspension of trading, and negative market reaction (Chen et al., 2000; Haw et al., 2003). While there is a growing body of research on the consequences of RPTs from the firm performance, earnings, and auditing quality perspectives[2], there is scant evidence as to whether RPTs result in partner-level opinion shopping. In this study, I investigate whether firms conduct significant amounts of RPTs are incentivized to compel their audit firm to switch its engagement partner to obtain more favorable opinions.

RPTs can be value-destroying if they are used as a means for managerial opportunism. There is a widely reported negative association between the use of RPTs and firm value.[3] Controlling owners of listed companies frequently engage in RPTs to gain private benefits at the expense of minority shareholders (Chen et al., 2009; Cheung et al., 2009; Aharony et al., 2010). Such transactions are frequently pertinent to earnings manipulation (Jian and Wong, 2004; Aharony et al., 2010). In addition, the disclosure of RPTs relates to a persistent negative risk-adjusted return for up to 12 months (Jiang et al., 2010; Kohlbeck and Mayhew, 2010) and an increased probability the firm will become financial distressed or deregister its securities (Ryngaert and Thomas, 2012).[4] While this represents the downside of RPTs, their upside include fulfilling normal business activities; such as, optimizing internal resource allocation, reducing transaction costs (Khanna and Palepu, 1997; Shin and Park, 1999), and improving performance (Khanna and Palepu, 2000; Wong et al., 2015). Empirical evidence regarding such efficiency-enhancing RPTs is, however, relatively rare.

Auditors in China are responsible for identifying, assessing, and handling the risks associating with their clients' misreporting of activities relating to RPTs (MOF, 2010). While Chinese listed companies that were originally stated-owned enterprises (SOEs) are technically independent they still retain strong political-

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[2] See for instance, Cheung et al. (2006), Jiang et al. (2010), Jian and Wong (2010), Bennouri et al. (2015), Habib et al. (2015), Lee et al. (2016).

[3] Such an association exists in, for instance, Hong Kong (Cheung et al., 2006), China (Berkman et al., 2009), the U.S. (Kohlbeck and Mayhew, 2010), and France (Nekhili and Cherif, 2011).

[4] Other studies also demonstrate that the magnitude of RPTs is positively associated with audit fees (Habib et al., 2015) and negatively associated with financial reporting comparability (Lee et al., 2016).

economic ties with the parent group (Liu, 2006). Firms, therefore, frequently construct complex RPTs with their related entities (Lo et al., 2010). Untangling these complex transactions is a significant audit risk that requires significant effort in the auditing process (Habib et al., 2015). An increase in audit risk also leads to an increase in the proportion of firms that receive MAOs (DeFond et al., 1999; Francis and Krishnan, 1999).

A number of factors within the Chinese setting make the existence of opinion-shopping at the partner-level especially likely. First, firms are under significant pressures to avoid modified reports, as these may weight in the delisting decisions of the stock market regulator (Chan et al., 2012). Second, the market for audit partners is dispersed. Firms, generally, have few formal quality control mechanisms. There is competition for clients among partners within the same firm (Wang et al., 2008; Gu et al., 2013; Yang, 2013). Third, the legal system in China is weak, and investor protection and litigation risk for auditors is low (Chen et al., 2013; He et al., 2013; Dhaliwal et al., 2017). Overall, the audit quality in the China market varies greatly both across firms and partners. This enables client firms to identify partners who are liable to be more lenient partners and to switch firm or partner.

If RPTs increase the probability of receiving an MAO then such firms have an incentive to engage in partner-level opinion shopping. In China, receiving an MAO imposes costs on a firm; such as, delisting risk and equity financing supervision, which can curb managerial opportunistic behavior. In addition, fierce competition for clients among audit firms and among partners of the same audit firm, along with weak internal control mechanisms of audit firms, make it easier for client firms to seek an audit partner with a more acquiescent attitude if the incumbent partner is likely to issue an unfavorable audit opinions. Therefore, I expect to observe a positive association between RPTs and partner-level opinion shopping.

In addition, prior research has documented that operating (i.e., purchases and sales of good and service) and non-operating (i.e., intercorporate loans) RPTs are both associated with opportunistic earnings management and tunneling (Berkman et al., 2009; Jiang et al., 2010; Kohlbeck and Mayhew, 2010; Lee et al., 2016). Nevertheless, prior research shows that firms using operating RPTs can maximize the operational efficiency and competitiveness of group companies (Liu and Liu, 2007), and increase firm value (Wong et al., 2015). Habib et al. (2015) also find that firms conducting operating RPTs have lower audit risk than non-operating RPTs. Therefore, it is not clear whether auditors are more likely to issue modified opinions for firms conducting operating or non-operating RPTs. Accordingly, I further examine whether operating and non-operating RPTs have different impacts on partner-level opinion shopping.

This study uses a sample of A-share firms listed on the Shanghai and Shenzhen Stock Exchanges from 2002 to 2015. The results show that RPTs are positively associated with partner-level opinion shopping. This finding suggests that RPTs provide insiders with incentives to influence an audit firm's decision to switch its engagement partner to obtain more favorable audit opinions. This is in line with the argument that RPTs can be indicative of weaknesses in corporate governance. The

additional analysis indicates that the positive association between RPTs and successful opinion shopping is more pronounced for firms engaging in more non-operating RPTs. This is consistent with the opportunistic use of non-operating RPTs. Finally, the results are robust to the use of change specification and alternative measures of audit opinion shopping and RPTs.

This study contributes to the literature in several ways. First, previous studies focus on opinion shopping at the audit firm level (e.g., Krishnan and Stephens, 1995; Lennox, 2000; Carcello and Neal, 2003; Davidson et al., 2006). Chen et al.'s (2016) empirical work in China provides preliminary evidence of opinion-shopping at the partner level. This study extends their findings by showing that RPTs provide firms with incentives to engage in partner-level opinion shopping. Second, archival studies (e.g., Chen et al., 2008; Chi et al., 2009; Carcello and Li, 2013; Gul et al., 2013) using audit partner data examine determinants that explain variation in audit quality across audit partners. This work adds to this stream of literature by showing that RPTs can result in a more heterogeneous audit quality across partners within the same audit firm. Third, this study contributes to the literature on corporate governance and RPTs in China. Prior research largely concludes that Chinese firms engage in RPTs to expropriate firm resources which reduces performance and earnings quality (Gordon and Henry, 2005; Zhu and Zhu, 2012) while also increasing audit fees (Habib et al., 2015). There is a lack of research that examines whether client firms influence an audit firm's partner assignment to avoid unfavorable opinions regarding RPTs. This study addresses this gap in the literature. Finally, this study may have policy implications for auditor independence. Although external auditors typically are responsible for disclosure of fraud, inefficiency, or irregularities in audit reports to reduce their risk exposure, the existing legal and enforcement systems in China appear to foster partner-level opinion shopping. Policymakers may attempt to formulate effective discipline mechanisms to moderate the perceived ability of auditors to resist client management pressure for opinion shopping, which may in turn improve auditor independence.

The remainder of this paper is organized as follows. Section 2 reviews prior literature and develops testable hypothesis. Section 3 describes the methodology and sample selection. Section 4 presents empirical results, and section 5 concludes the paper.

2. Literature Review and Hypothesis Development

2.1   Literature on RPTs

Increasingly RPTs are a significant method for financial fraud and tunneling. A long list of accounting scandals (e.g., Adelphia, Enron, Tyco, and WorldCom) are a reminder of the extent to which RPTs impact on firm's valuation and on the entire capital market. There are two competing theoretical perspectives on RPTs. The efficiency-enhancing theory contends that the weak legal enforcement and inefficient market mechanisms fundamentally increase transaction costs for independent companies. Firms can form corporate groups and use RPTs to optimize

internal resource allocation, lower transaction costs, and improve return on assets (Shin and Park, 1999; Khanna and Palepu, 2000). The conflict of interest theory views RPTs as value-destroying activities that can be abused to expropriate shareholders' wealth (Chang and Hong, 2000).

Empirical research on how RPTs reduce transaction costs and facilitate internal resource allocation is relatively sparse. Chen et al. (2012), in the context of China, show that firms in more competitive industries tend to increase RPTs to diminish transaction costs, which can potentially alleviate their bankruptcy risk. Similarly, Wong et al. (2015) report that RPTs are a tool for improving resource allocation efficiency among affiliating firms within the same business group.

There is substantial support for the conflict of interest theory. Gordan et al. (2004), using a sample of U.S. firms, provide evidence that firms with more RPT activity have lower subsequent stock returns. Similarly, Kohlbeck and Mayhew (2010) show that S&P 500 firms with RPT experience significantly lower valuations and marginally lower subsequent return than firms without RPTs. Ryngaert and Thomas (2012) observe a sample of U.S. small and mid-sized firms and distinguish between the impacts of ex-ante RPTs (transactions that predate a counterparty becoming a related party) and ex-post RPTs (transactions initiated after a counterparty becomes a related party) on firms. They find that ex-post RPTs reduce shareholder wealth and the firm's profitability.

Studies of RPTs in emerging countries flourish, because expropriation via RPTs is more likely in the context of poor law enforcement and prevailing rent-seeking environment. For example, Jian and Wong (2004) find that Chinese group firms are more likely to use RPTs to manipulate earnings and tunnel firm value. Cheung et al. (2006) report that Hong Kong-listed firms experience negative excess returns both at the initial announcement and during the 12-month period following the announcement of connected transactions. Jiang et al. (2010) demonstrate that Chinese firms that grant loans to related parties experience poorer subsequent operating performance. Chen et al. (2011) provide evidence that Chinese IPO firms engaging in RPTs have poorer post-IPO long term performance. Kang et al. (2014) report that the RPTs of Korean chaebol firms, on average, diminish firm value, and this value destruction is most pronounced when the control-ownership wedge is high.

In addition, several studies investigate the association between RPTs and financial reporting quality. For example, Gordon and Henry (2005) show that transactions involving fixed-rate financing from related parties are positively pertinent to absolute abnormal accruals. Jian and Wong (2010) find that firms with group affiliation tend to engage in related party sales with their parent firms to manipulate earnings. Lee et al. (2016) report evidence that firms with more RPTs are associated with lower financial statement comparability. Moreover, Habib et al. (2015) find that the presence of RPTs increase audit fees because auditors are exposed to significant risk.[5]

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[5] Habib et al. (2015) sampled Chinese listed firms. Kohlbeck and Mayhew (2017) do not find this

2.2   Literature on opinion shopping

Research shows that MAOs influence investors' perceptions of the firm value. The way firms' share prices begin to fall on receipt of non-clean audit opinions illustrates the effect.[6] A MAO can lead to serious ramifications against the firm; such as, suspension of securities trading or higher cost of capital (Chow and Rice, 1982; Dopuch et al., 1986; Jones, 1996; Haw et al., 2003).[7] Firms may then press auditors for clean opinions when MAOs are warranted.

In the U.S., the Securities and Exchange Commission (SEC) defines opinion shopping as the practice of seeking an auditor willing to support a proposed accounting treatment that helps a company accomplish its reporting objectives even though doing so might impair reliable reporting. Chow and Rice (1982), Krishnan (1994), and Krishnan and Stephens (1995) conclude that opinion shopping is not successful in the U.S. setting as post-switch audit opinions are not more favorable than pre-switch opinions.

Lennox's (2000) findings are particular significant. Using an audit opinion forecasting model and U.K. data, he finds that audit opinions do not generally improve after firms switch aauditors. However, Lennox's results indicate that switching firms minimize the probability of receiving modified reports, and so have successfully engage in opinion shopping. Other studies also find evidence that firms switch audit firms as a means of opinion shopping. For instance, Carcello and Neal (2003) find that U.S. firms with less independent audit committees are likely to dismiss the auditor following the receipt of a first-time going concern report. Davidson et al. (2006), using U.S. data, report that firms tend to switch from Big N auditors to non-Big N auditors following a modified prior audit opinion, and also exhibit greater abnormal accruals. Using a sample of U.S. firms, Newton et al. (2015) show that firms are successful at shopping for clean internal control opinions, and that this effect is more likely to occur in competitive audit markets.

Chan et al. (2006), in the context of China, demonstrate that local state-owned enterprises (SOEs) with qualified opinions can shop for unqualified opinions by switching from non-local to local auditors. They also find that local SOEs obtain

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association in the U.S. setting. They attribute this finding to limited U.S. auditing standards concerning auditors' responsibilities toward RPTs.

[6] The market reaction to the information contained in the audit reports is well documented in, for instance, the U.S. (Dopuch et al., 1987), the U.K. (Lennox, 1999), Australia (Monroe and Teh, 1993), and China (Chen et al., 2001).

[7] In China, the receipt of an MAO can be quite costly to client management. The stock market reacts negatively to firms' receipt of MAOs (Chen et al., 2000). According to the regulation of China Securities Regulatory Commission (CSRC), firm managers must interpret the underlying reasons for an MAO in the annual report. They also forbid conducting seasoned equity offerings until the underlying matters that led to the issuance of MAOs are resolved. In addition, the stock exchanges also take into account the nature of audit opinions in their delisting decisions. Specifically, a listed firm that has suffered losses in the previous two years must report a profit with a clean audit opinion in the current year to avoid being delisted by the stock exchange.

more favorable audit opinions from local auditors in regions with a low level of institutional development (Chan et al., 2010) or when they face the need for new equity financing or the threat of delisting (Chan et al., 2012). Chen et al. (2016) analyze opinion shopping at the partner-level for Chinese listed firms and argue that because of the fierce competition audit market and the weak internal controls of audit firms, firms are able to dismiss incumbent auditors and appoint more acquiescent auditors to obtain more favorable audit opinions. They find that firms can succeed in partner-level opinion shopping after partner switching, and that incoming partners have a greater propensity to issue clean opinions than their outgoing partners.

2.3　Hypothesis development

Davidson et al. (2006) argue that auditor opinion shopping is an agency cost in that the firm's managers are searching for a lower quality audit which reduces the quality of information that reaches financial markets. From this perspective, managers desire to use the resulting increase in asymmetric information for their own benefit. China's auditing standards require engagement auditors (normally two) to sign their names on the audit reports. Typically one of the two signing auditors act as the lead auditor who is responsible for field work, and the other must be at least a deputy executive of the firm and act as the reviewer. Since individual engagement partners differ in expertise, capability, risk profile, cognitive style, and ethical standards, audit quality varies (Gul et al., 2013).

Chinese auditors are responsible for identifying, assessing, and handling the risks of their clients' misreporting of activities related to RPTs (MOF, 2010). Given the competing arguments regarding the financial reporting implications of RPTs, it is unclear as to whether firms with RPTs can influence their audit firm's decision to switch engagement partners in China. Compared with arm's length transactions in a competitive business environment, firms have abundant discretion over the timing, amount, and value of RPTs that may reduce firm value (e.g., Cheung et al., 2006; Kohlbeck and Mayhew, 2010). RPTs can be used by controlling owners to extract private benefits from minority shareholders through manipulating earnings or diverting resources away from their firms (i.e., tunneling) (Jian and Wong, 2004; Claessens et al., 2006; Aharony et al., 2010). The use of RPTs also includes sustaining affiliated firms that are new or are in financial difficulties (Chang and Hong, 2000; Friedman et al., 2003). Therefore RPTs epitomize a situation of extensive management discretion. It is for these reasons that external auditors generally consider RPTs to be a factor that increases inherent risk (Gordon et al., 2007).

A minority of studies report RPTs as fulfilling the underlying needs of the firm, primarily by promoting operating efficiency.[8] However, most listed firms in China

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[8] For instance, Gordon and Henry (2005) observe that when a related party has in-depth knowledge of firm-specific activities as well as an expertise (e.g., legal expertise) that the company demands, it can give services to the company more effectively than outsiders. Kohlbeck and Mayhew (2010)

are state controlled. Such firms often construct complex and frequent RPTs with their related parties for nefarious purposes (e.g., to hide losses). Auditors, to untangle these transactions, bear an increased risk and thus need put more time and effort into the auditing process (Habib et al., 2015). The literature on audit quality also indicates that an increase in audit risk accompanies increases in the proportion of firms receiving MAOs (DeFond et al., 1999; Francis and Krishnan, 1999). Receiving an MAO could depress the prices of a firm's securities and impair its ability to raise funds in future, and lead the firm to face greater regulatory scrutiny (Chen et al., 2010; Lin and Liu, 2010), which potentially constrain managerial opportunistic behavior. In addition, he salient features of the audit market in China are the presence of heterogeneous audit quality among audit partners within the same audit firm, fewer incentives towards mutual monitoring among audit partners, and a lower cost of audit failures for audit firm and their partners due to weak regulatory sanctions or penalties (Gul et al., 2013, He et al., 2013; Yang, 2013; Dhaliwal et al., 2017). Firms in China can successfully pressure audit firms into removing non-acquiescent partners in order to prevent the issuance of MAOs (Chen et al., 2016). Taken together, I argue that firms conducting more RPTs tend to affect their audit firms' partner assignment decision, towards more pliable partners who are liable to issues favorable audit opinions. The research hypothesis is as follows:

Hypothesis 1: Firms with more RPTs are more likely to succeed in partner-level audit opinion shopping.

3. Methodology

3.1   Measuring opinion shopping

Following previous research (e.g., Lennox, 2000; Chen et al., 2006), I define partner–level opinion shopping (*PSHOP*) as the difference between the client's predicted probability of receiving an MAO conditioned to the switching and the non-switching partner scenarios. Based on previous studies (e.g., Chen et al., 2000; Chan et al., 2006; Chan and Wu, 2011; Firth et al., 2012; Chen et al., 2016), I include a series of client firm characteristics that may affect the auditors' propensity to issue MAOs, including partner switch (*PSWITCH*), prior-year audit opinion (*L1MAO*), profitability (*ROA*, *LOSS*, *CFO*), financial risk (*LEV*, *OTHAR*, *CR*), client size and age (*SIZE*, *AGE*), accounts receivable and inventories intensiveness (*ARINV*), and stock performance (*MAR*). Following Lennox (2000), I also include interaction terms between *PSWITCH* and each of the other variables to capture the difference in coefficients of the explanatory variables between firms with and without a partner switch. The following probit model predicts the probability of receiving an MAO in a given year:

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also indicate that companies can benefit from RPTs by making strategic investments in joint ventures so that they can acquire and secure access to supplies or markets (e.g., vertical integration) and lower their business risk.

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\begin{aligned}
\mathrm{Pr}\,ob\left(MAO_{it}\right) = {} & \beta_0 + \beta_1 PSWITCH_{it} + \beta_2 L1MAO_{it} + \beta_3 ROA_{it} + \beta_4 LOSS_{it} \\
& + \beta_5 CFO_{it} + \beta_6 LEV_{it} + \beta_7 OTHAR_{it} + \beta_8 CR_{it} + \beta_9 SIZE_{it} \\
& + \beta_{10} ARINV_{it} + \beta_{11} AGE_{it} + \beta_{12} MAR_{it} \\
& + \beta_{13} PSWITCH_{it} \times L1MAO_{it} + \beta_{14} PSWITCH_{it} \times ROA_{it} \\
& + \beta_{15} PSWITCH_{it} \times LOSS_{it} + \beta_{16} PSWITCH_{it} \times CFO_{it} \qquad (1) \\
& + \beta_{17} PSWITCH_{it} \times LEV_{it} + \beta_{18} PSWITCH_{it} \times OTHAR_{it} \\
& + \beta_{19} PSWITCH_{it} \times CR_{it} + \beta_{20} PSWITCH_{it} \times SIZE_{it} \\
& + \beta_{21} PSWITCH_{it} \times ARINV_{it} + \beta_{22} PSWITCH_{it} \times AGE_{it} \\
& + \beta_{23} PSWITCH_{it} \times MAR_{it} + \sum Years + \sum Industries + \varepsilon_{it}
\end{aligned}
$$

where for firm i in year t:

MAO	=	indicator variable that takes the value of 1 if the firm receives a modified audit opinion,[9] and 0 otherwise;
$PSWITCH$	=	indicator variable that takes the value of 1 if the firm is audited by a new partner, and 0 otherwise;
$L1MAO$	=	last year's MAO;
ROA	=	net income scaled by total assets;
$LOSS$	=	indicator variable that takes the value of 1 if the firm reports a loss for the year, and 0 otherwise;
CFO	=	cash flow from operations scaled by total assets;
LEV	=	total liabilities divided by total assets;
$OTHAR$	=	other accounts receivable scaled by total assets;
CR	=	current assets divided by current liabilities;
$SIZE$	=	natural log of total assets;
$ARINV$	=	sum of accounts receivable and inventory divided by total assets;
AGE	=	number of years since the firm's initial public offering;
MAR	=	market-adjusted stock return over the fiscal year;
$Years$	=	year dummies;
$Industries$	=	industry dummies (based on CSRC industry classification standard).

I use the coefficients obtained in equation (1) to calculate the probability of receiving an MAO if a firm switches its partner (MAO_S) and the probability of

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[9] Audit opinions in China include unqualified opinions (i.e., clean opinion), unqualified / qualified opinions with explanatory notes, and qualified, disclaimed, and adverse opinions. Following Wang et al. (2008) and Chen et al. (2010), except for unqualified opinions, I classify all the remaining audit opinions as modified audit opinions (MAOs).

receiving an MAO if a firm does not switch its partner (*MAO$_{NS}$*). The difference in the conditional probability of a firm's receiving an MAO between the two scenarios (i.e., *MAO$_S$* – *MAO$_{NS}$*) is defined as the opinion shopping variable, denoted by *POPSHOP*. A negative (positive) value of *POPSHOP* implies that firms engage in opinion shopping if there is a partner switch (no partner switch).

3.2   Model specification

I run the following probit model to test the association between RPTs and opinion shopping:

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\begin{aligned}
\Pr ob\left(PSWITCH_{it}\right) = {}& \gamma_0 + \gamma_1 POPSHOP_{it} + \gamma_2 RPT_{it} + \gamma_3 POPSHOP_{it} \times RPT_{it} \\
& + \gamma_4 TENURE_{it} + \gamma_5 L1PTENURE_{it} + \gamma_6 PSPEC_{it} + \gamma_7 CI_{it} \\
& + \gamma_8 ROA_{it} + \gamma_9 LOSS_{it} + \gamma_{10} MAR_{it} + \gamma_{11} GROWTH_{it} + \gamma_{12} LEV_{it} \quad (2) \\
& + \gamma_{13} CFO_{it} + \gamma_{14} ARINV_{it} + \gamma_{15} SEO_{it} + \gamma_{16} SIZE_{it} + \gamma_{17} AGE_{it} \\
& + \sum Years + \sum Industries + \varepsilon_{it}
\end{aligned}
$$

where for firm *i* in year *t*:

RPT	=	total annual PRTs scaled by total assets;
TENURE	=	number of consecutive years that the firm has retained the incumbent audit firm;
L1PTENURE	=	last year's average number of consecutive years that the engagement partners have signed the client's annual audit report;
PSPEC	=	indicator variable that takes the value of 1 if any of the engagement partners is the industry leader or has a market share of greater than 10 percent in terms of total assets audited in the industry, and 0 otherwise;
CI	=	natural log of the client's total assets scaled by the sum of the natural log of total assets of all clients audited by the same audit firm;
GROWTH	=	growth rate of sales;
SEO	=	indicator variable that takes the value of 1 if the firm has seasoned equity offering in the next year, and 0 otherwise.
All other variables are defined in Equation (1)		

In equation (2), the primary variable of interest is the coefficient (γ_3) on the interaction term, *POPSHOP×RPT*. A negative estimate indicates that firms conducting more RPTs are more likely to succeed in partner-level opinion shopping. I control for various factors that previously have been shown to affect the probability of auditor changes. First, longer auditor tenure indicates that the client is unlikely to change the auditor given the familiarity between them (Hennes et al., 2014; Chen et al., 2016). However, longevity of auditor engagement is associated

with perceptions of audit quality and could therefore affect the board's decision to change auditors (Williams, 1988; Ghosh and Moon, 2005). I thus control for both audit firm's and partner's tenures (*TENURE*, *L1PTENURE*) in the regression. Second, firms may experience higher switching costs if the incumbent partner is an industry specialist (Chi and Chin, 2011). Therefore, I include partner industry expertise (*PSPEC*) to control for this effect. Third, Chen et al. (2016) find a significantly negative relation between the client economic importance of a firm to its audit firm and auditor switching. Consequently, I control for client importance (*CI*) in the model. Fourth, previous studies suggest that auditor switching is influenced by profitability (Mande and Son, 2013; Bagherpour et al., 2014; Hennes et al., 2014; Brocard et al., 2018) this is also controlled for in the model using return on assets (*ROA*), a loss indicator (*LOSS*), stock performance (*MAR*), and sales growth rate (*GROWTH*). To further capture differences in firms' capital structure and financial risk, I add the debt ratio (*LEV*) and cash flow from operations (*CFO*) as measures of financial liquidity (Landsman et al., 2009; Boone et al., 2015). Fifth, research suggests that the probability of an auditor switch increases with audit risk (Dopuch et al., 1987; Krishnan, 1994). To control for audit risk and complexity of client companies I include the ratio of accounts receivable and inventory to total assets (*ARINV*). Sixth, I include an indicator for a seasoned equity offering (*SEO*) as Chan et al. (2006) indicate that a desire to raise equity capital creates incentives for firms to care more about audit quality, and these firms are less likely to change their auditor. Seventh, I control for firm size (*SIZE*) because large and complex firms are less likely to change their auditors (Hennes et al., 2014). Similarly, I control for firm age (*AGE*), as firms of different ages may differ in their decisions about switching auditors. Finally, I include year and industry dummies to control for year and industry effects.

3.3   Sample selection

Table 1 summarizes the sample selection process. The sample consists of A-share firms listed on the Shanghai and Shenzhen Stock Exchanges for the period 2002-2015.[10] I retrieve firms' RPTs, accounting, and stock return data mainly from the China Stock Market and Accounting Research (CSMAR) database, and auditor data from the Taiwan Economic Journal (TEJ) database. The sample starts in 2002 because this is the first year that data on the reasons for switching audit firms is officially and fully disclosed. From the 24,218 A-share firm-year observations available in CSMAR, I first exclude financial service and insurance firms (581 observations) and first-year IPO firms (1,229 observations). I also remove 3,891 observations due to missing data for auditor identities, related party transactions, and control variables in the regression models. I delete 3,221 observations of firms that switch signatory auditors who are not audit partners.[11] Since the research focus

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[10] These A-share firms are all domestic Chinese firms (i.e., they do not belong to foreign investment firms).

[11] In China, a signing auditor can be a partner, but may also be from the lower levels of the firm;

is on audit partner changes rather than audit firm switches, I delete 860 observations in which clients switch audit firms.[12] Furthermore, in the spirit of Lennox (2002), I identify and delete observations with audit partner switches that do not appear to relate to clients' opinion shopping motive. Specifically, I delete 96 observations in which an audit partner is rotated off due to reaching the upper limit of audit tenure for a company in the previous year.[13] Partner switching can also occur if the partner retires (20 observations), switches to another audit firm (287 observations), or suspends or terminates the audit practice (47 observations).[14] Furthermore, since temporary changes of engagement partner are not suggestive of opinion shopping, I delete 1,159 observations in which an audit partner is temporarily rotated off the current engagement in a given year but return to audit the same client after one or two years. This leaves a final sample of 12,827 firm-year observations.

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such as, a senior manager.

[12] I treat firms as not switching audit firms if they hire the post-merger audit firm.

[13] According to the mandatory audit partner rotation policy in China, firms are required to rotate out their signatory auditors who have signed the firm's audit reports for five consecutive years or who provide audit services during the IPO time and continue to provide services for two consecutive years after the IPO.

[14] As both companies and audit firms do not publicly explain the reasons for auditor switching, I thus presume that an audit partner retires if his/her age approaches 65 (retirement age). In addition, I presume an audit partner suspends or permanently stops the audit practice if the audit partner (1) provided audit services for at least three companies in the previous year but provides no audit services in the current year, or (2) provided audit services in the previous year but provides no audit services in the following two years.

Table 1: Sample selection

		Firm-years observations
A-share firms in Shanghai and Shenzhen Stock Exchanges from 2002 to 2015		24,218
Less:	Financial institutions	581
Less:	First year IPO firms	1,229
Less:	Firms-years with missing values on audit partner identities and control variables	3,891
Less:	Firm-years with signatory auditors who are not audit partners	3,221
Less:	Firm-years involving audit firm switches	860
Less:	Firm-years with partner switches owing to mandatory audit partner rotation	96
Less:	Firm-years with partner switches owing to audit partners reaching the retirement age	20
Less:	Firm-years with partner switches owing to audit partners changing to another audit firm	287
Less:	Firm-years with partner switches owing to audit partners suspending or terminating audit service	47
Less:	Firm-years involving temporary partner switches	1,159
Final sample		12,827

4. Results

4.1 Descriptive statistics

Table 2 provides descriptive statistics of the sample. The average *PSWITCH* is 0.43, suggesting that 43% of sample firms switch audit partners before they arrive at the tenure limit of mandatory rotation. This is consistent with prior work finding that audit partner switches are prevalent in the Chinese capital market (Firth et al., 2013; Lennox et al., 2014; Chen et al., 2016). The average *POPSHOP* is -0.002, indicating that firms can improve audit opinions if they replace the incumbent audit partners. The mean (median) RPTs normalized total assets (*RPT*) is 36.8% (20.8%).

The average audit firm tenure (*TENURE*) is 7.192 years, and the average audit partner tenure (*L1PTENURE*) is 1.531 years. On average, 4.1% of sample firms are audited by industry specialists (*SPEC*), and the mean of client importance (*CI*) is 4.4%. The average return on assets (*ROA*) is 3%, and about 12% of the sample observations report loss (*LOSS*) for the year. The average stock return (*MAR*) is 0.3%, and the average sales growth rate (*GROWTH*) about 19%. The typical firm has a debt to assets ratio (*LEV*) of 50%. The mean operating cash flows (*CFO*)

account for 4.6% of total assets. The ratio of the sum of accounts receivable plus inventory to total assets (*ARINV*) averages 27.5%. Only 1.2% of the firms conduct seasoned equity offering (*SEO*). The mean of firm size (*SIZE*) is 21,825, and the average listing age (*AGE*) is 9.966 years.

Table 2: Descriptive statistics

	Mean	Standard deviation	25th percentile	Median	75th percentile
PSWITCH	0.430	0.495	0.000	0.000	1.000
POPSHOP	-0.002	0.013	0.000	0.000	0.0004
RPT	0.368	0.530	0.065	0.208	0.455
TENURE	7.192	4.531	4.000	6.000	10.000
L1PTENURE	1.531	0.749	1.000	1.333	2.000
PSPEC	0.044	0.206	0.000	0.000	0.000
CI	0.029	0.029	0.007	0.021	0.039
ROA	0.030	0.065	0.010	0.030	0.058
LOSS	0.119	0.324	0.000	0.000	0.000
MAR	0.003	0.502	-0.250	-0.072	0.158
GROWTH	0.189	0.499	-0.034	0.114	0.287
LEV	0.497	0.211	0.343	0.498	0.642
CFO	0.046	0.078	0.004	0.045	0.091
ARINV	0.275	0.179	0.138	0.249	0.381
SEO	0.012	0.109	0.000	0.000	0.000
SIZE	21.825	1.267	20.942	21.692	22.551
AGE	9.966	5.832	5.000	9.000	14.000

Variable definitions: *PSWITCH* = indicator variable set to 1 if the firm is audited by a new partner, and 0 otherwise. *POPSHOP* = difference in the predicted probability between receiving a MAO conditioned to a firm switch its partner and receiving a MAO conditioned to not switching the partner. *RPT* = amount of RPTs scaled by total assets. *TENURE* = number of consecutive years that the firm has retained the incumbent audit firm. *L1PTENURE* = last year's average number of consecutive years that the engagement partners have signed the annual audit report of the client. *PSPEC* = indicator variable set to 1 if any of the engagement partners is the industry leader or has a market share of greater than 10 percent in terms of total assets audited in the industry, and 0 otherwise. *CI* = natural log of the client's total assets scaled by the sum of the natural log of total assets of all clients audited by the same audit firm. *ROA* = net income scaled by total assets. *LOSS* = indicator variable set to 1 if the firm reports a loss for the year, and 0 otherwise. *MAR* = annual return minus annual market return. *GROWTH* = change in sales scaled by lagged sales. *LEV* = total debt deflated by total assets. *CFO* = cash flow from operations scaled by total assets. *ARINV* = accounts receivable plus inventory scaled by total assets. *SEO* = indicator variable set to 1 if the firm has seasoned equity offering in the next year, and 0 otherwise. *SIZE* = natural log of total assets. *AGE* = number of years since the firm's initial public offering.

4.2   Regression results

Table 3 presents the estimation results for the partner switching model. The coefficient on *POPSHOP* is significantly negative (p < 0.01). This finding is consistent with evidence that firms can successfully press audit firms to switch (retain) incumbent partners when the new partners are more (less) likely to issue clean opinions (Chen et al., 2016; Osma et al., 2017). In addition, the coefficient on the interaction term, *POPSHOP×RPT* is significantly negative (p < 0.05), supporting the hypothesis that firms with more RPTs are more likely to succeed in partner-level opinion shopping. This finding also aligns with the perspective of weak governance for RPT usage.

With respect to the control variables, the coefficients on *TENURE* and *L1PTENURE* are significant with positive signs, which is consistent with longer tenure yielding weaker auditor independence that motivates firms to switch audit firms and engagement partners. Auditor industry expertise (*PSPEC*) is positively associated with a switch in audit partners in my tests.[15] However, previous empirical research regarding auditor industry expertise has also been mixed (e.g., Chen et al., 2016; Osma et al., 2017). In addition, Firms with higher return on assets (*ROA*) and absence of a loss (*LOSS*) are associated with a higher probability of switching audit partners. The signs of these coefficients are consistent with previous studies (e.g., Bagherpour et al., 2014; Hennes et al., 2014; Brocard et al., 2018). Finally, younger firms (*AGE*) are more likely to experience a partner switch.

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[15] One possible explanation is that the board's decisions regarding partner switching are less likely influenced by the switching cost stemming from partner industry expertise.

Table 3: Related party transactions and audit opinion shopping

		PSWITCH	
	Expected sign	**Coefficient**	**z-statistic**
Intercept		-0.509**	-1.98
POPSHOP	–	-37.961***	-17.14
RPT	+/–	0.010	0.42
POPSHOP×RPT	–	-9.254**	-2.48
TENURE	+/–	0.016***	5.58
L1PTENURE	+/–	0.137***	8.57
PSPEC	–	0.112**	2.03
CI	–	-0.665	-1.41
ROA	+/–	0.694**	2.57
LOSS	+/–	-0.424***	-9.24
MAR	+/–	-0.010	-0.43
GROWTH	+/–	0.002	0.07
LEV	+/–	0.024	0.32
CFO	+/–	-0.027	-0.17
ARINV	+	0.093	1.14
SEO	–	0.0002	0.00
SIZE	–	-0.011	-0.97
AGE	+/–	-0.013***	-5.09
Year fixed effects		Yes	
Industry fixed effects		Yes	
Pseudo R^2		0.051	
n		12,827	

Variable definitions: *PSWITCH* = indicator variable set to 1 if the firm is audited by a new partner, and 0 otherwise. *POPSHOP* = difference in the predicted probability between receiving a MAO conditioned to a firm switch its partner and receiving a MAO conditioned to not switching the partner. *RPT* = amount of RPTs scaled by total assets. *TENURE* = number of consecutive years that the firm has retained the incumbent audit firm. *L1PTENURE* = last year's average number of consecutive years that the engagement partners have signed the annual audit report of the client. *PSPEC* = indicator variable set to 1 if any of the engagement partners is the industry leader or has a market share of greater than 10 percent in terms of total assets audited in the industry, and 0 otherwise. *CI* = natural log of the client's total assets scaled by the sum of the natural log of total assets of all clients audited by the same audit firm. *ROA* = net income scaled by total assets. *LOSS* = indicator variable set to 1 if the firm reports a loss for the year, and 0 otherwise. *MAR* = annual return minus annual market return. *GROWTH* = change in sales scaled by lagged sales. *LEV* = total debt deflated by total assets. *CFO* = cash flow from operations scaled by total assets. *ARINV* = accounts receivable plus inventory scaled by total assets. *SEO* = indicator variable set to 1 if the firm has seasoned equity offering in the next year, and 0

otherwise. *SIZE* = natural log of total assets. *AGE* = number of years since the firm's initial public offering. z-statistics are based on standard errors clustered by firm. *, ** and *** indicate two-tailed significance at the 0.10, 0.05 and 0.01 levels, respectively.

4.3 Further analysis

4.3.1 Operating RPTs versus non-operating RPTs

The literature both theoretically and empirically documents that operating and non-operating transactions with related parties are subject to management discretion (Jiang et al., 2010; Wang and Yuan, 2012; Lee et al., 2016). I further investigate whether the positive association between RPTs and partner-level opinion shopping attributes to operating or non-operating RPTs. Following Habib et al. (2015), I define operating RPTs as purchases and sales of goods and service, and non-operating RPTs as intercorporate loans. From an efficiency-enhancing perspective, related party purchases and sales can encourage cooperation among entities and maximize the operational efficiency and competitiveness of group companies (Liu and Liu, 2007), facilitate firm value (Wong et al., 2015), and allow auditors to reduce audit effort and audit risk (Habib et al., 2015). Nevertheless, controlling owners can easily rely on related purchases / sales to expropriate minority shareholders' interests by propping up earnings or tunneling resources (Aharony et al., 2010; Jian and Wong, 2010). Thus, it is not clear whether operating RPTs are more likely to trigger modified opinions by auditors for client firms which in turn motivates firms to search for lenient audit partners and succeed in their attempts to obtain more favorable opinions. In addition, the literature commonly supports the value-destroying effects of non-operating RPTs. That is, intercorporate loans can be used by parent firms for tunneling or siphoning resources out of their listed subsidiaries. Hence, firms which conduct such transactions have poor future performance, higher probability of entering financial distress in the future (Berkman et al., 2009; Jiang et al., 2010; Kohlbeck and Mayhew, 2010), significant audit risk faced by auditors (Habib et al., 2015), and more importantly, higher probability of receiving an MAO (Jiang et al., 2010). Therefore, firms that have more non-operating RPTs may engage in opinion shopping by switching audit partners.

I start by replacing *RPT* with the following two variables: *OP_RPT* and *NOP_RPT*. The former is measure as the sum of sales and purchases of goods and services revenue and expenses, scaled by total assets. While the latter is the sum of related party intercorporate loans (include capital transfer, loans, guarantees, and collateral), scaled by total assets. The results of this analysis are shown in Table 4. The table shows that the coefficient on the *POPSHOP×NOP_RPT* interaction term is negative and significant (p < 0.05) while the coefficient on the *POPSHOP×OP_RPT* interaction term is negative but not significant. This indicates that firms utilize intercorporate loans to carry out value-destroying tunneling and this motivates them to replace incumbent partners to obtain more favorable audit opinions. It is also consistent with the explanation of self-dealing in relation to non-operating RPTs.

The results for control variables are similar to those in Table 3.

Table 4: Operating versus non-operating RPTs

	Expected sign	PSWITCH	
		Coefficient	z-statistic
Intercept		-0.488*	-1.88
POPSHOP	–	-37.561***	-17.37
OP_RPT	+/–	0.011	0.20
NOP_RPT	+/–	-0.013	-0.28
POPSHOP×OP_RPT	+/–	-0.469	-0.06
POPSHOP×NOP_RPT	–	-18.299**	-2.17
TENURE	+/–	0.016***	5.55
L1PENURE	+/–	0.137***	8.55
PSPEC	–	0.114**	2.07
CI	–	-0.677	-1.42
ROA	+/–	0.675**	2.51
LOSS	+/–	-0.428***	-9.25
MAR	+/–	-0.010	-0.42
GROWTH	+/–	0.002	0.07
LEV	+/–	0.042	0.55
CFO	+/–	-0.039	-0.24
ARINV	+	0.090	1.11
SEO	–	0.002	0.02
SIZE	–	-0.012	-1.06
AGE	+/–	-0.013***	-5.10
Year fixed effects		Yes	
Industry fixed effects		Yes	
Pseudo R^2		0.051	
n		12,827	

Variable definitions: *PSWITCH* = indicator variable set to 1 if the firm is audited by a new partner, and 0 otherwise. *POPSHOP* = difference in the predicted probability between receiving a MAO conditioned to a firm switch its partner and receiving a MAO conditioned to not switching the partner. *OP_RPT* = amount of operating RPTs scaled by total assets. *NOP_RPT* = amount of non-operating RPTs scaled by total assets. *TENURE* = number of consecutive years that the firm has retained the incumbent audit firm. *L1PTENURE* = last year's average number of consecutive years that the engagement partners have signed the annual audit report of the client. *PSPEC* = indicator variable set to 1 if any of the engagement partners is the industry leader or has a market share of greater than 10 percent in terms of total assets audited in the industry, and 0 otherwise. *CI* = natural log of the client's total assets scaled by the sum of the natural log of total assets of all

clients audited by the same audit firm. *ROA* = net income scaled by total assets. *LOSS* = indicator variable set to 1 if the firm reports a loss for the year, and 0 otherwise. *MAR* = annual return minus annual market return. *GROWTH* = change in sales scaled by lagged sales. *LEV* = total debt deflated by total assets. *CFO* = cash flow from operations scaled by total assets. *ARINV* = accounts receivable plus inventory scaled by total assets. *SEO* = indicator variable set to 1 if the firm has seasoned equity offering in the next year, and 0 otherwise. *SIZE* = natural log of total assets. *AGE* = number of years since the firm's initial public offering. z-statistics are based on standard errors clustered by firm. *, ** and *** indicate two-tailed significance at the 0.10, 0.05 and 0.01 levels, respectively.

4.4 Sensitivity analyses

4.4.1 Severity of audit opinions

Since different types of modified opinions represent different levels of severity in accounting irregularities, they vary in terms of costs to audit clients (Chen et al., 2010). Firms are able to shop for clean opinions when modified opinions are warranted or for less-severe modified opinions (e.g., unqualified opinions with explanatory notes) when severe modified opinions (e.g., qualified or disclaimers/adverse opinions) are warranted. Therefore, to measure the different types of MAOs according to their levels of severity, I code the audit opinion variable *OPIN_Type* from 0 to 3 to represent clean opinions (0), unqualified opinions with explanatory notes (1), qualified opinions (2), and qualified opinions with explanatory notes/disclaimers opinions/adverse opinions (3).[16] I replace *MAO* with *OPIN_Type* in the audit reporting model (equation (1)) and adopt an ordered probit regression to estimate the predicted probability. I then replace the variable *POPSHOP* (equation (2)) with *POPSHOP_Sev*, which defines the difference in the predicted probability between receiving a non-clean opinion conditional on a firm switching its audit partner and receiving a non-clean opinion conditional on not switching the partner and rerun the regression. Table 5 shows that the coefficient for *POPSHOP_Sev×RPT* is negative and significant ($p < 0.05$), which is consistent with the result presented in Table 3. Thus, the main evidence is unaffected by this alternative estimation procedure.

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[16] I combine firms with qualified opinions with explanatory notes (23 observations), disclaimers opinions (70 observations), and adverse opinions (1 observations) into one group as the sample sizes are small.

Table 5: Severity of audit opinions

	Expected sign	PSWITCH	
		Coefficient	z-statistic
Intercept		0.244	0.95
POPSHOP_Sev	–	-26.680***	-8.30
RPT	+/–	-0.003	-0.12
POPSHOP_Sev×RPT	–	-11.536**	-2.26
TENURE	+/–	0.015***	5.03
L1PTENURE	+/–	0.142***	8.89
PSPEC	–	0.144***	2.60
CI	–	-0.683	-1.45
ROA	+/–	1.204***	4.23
LOSS	+/–	-0.384***	-6.88
MAR	+/–	-0.028	-1.21
GROWTH	+/–	-0.005	-0.21
LEV	+/–	0.399***	5.36
CFO	+/–	0.086	0.53
ARINV	+	-0.024	-0.29
SEO	–	0.001	0.01
SIZE	–	-0.056***	-4.76
AGE	+/–	-0.010***	-3.86
Year fixed effects		Yes	
Industry fixed effects		Yes	
Pseudo R^2		0.044	
n		12,827	

Variable definitions: *PSWITCH* = indicator variable set to 1 if the firm is audited by a new partner, and 0 otherwise. *POPSHOP_Sev* = difference in the predicted probability between receiving a non-clean opinion conditioned on a firm switch its audit partner and receiving a non-clean opinion conditioned on not switching the partner. *RPT* = amount of RPTs scaled by total assets. *TENURE* = number of consecutive years that the firm has retained the incumbent audit firm. *L1PTENURE* = last year's average number of consecutive years that the engagement partners have signed the annual audit report of the client. *PSPEC* = indicator variable set to 1 if any of the engagement partners is the industry leader or has a market share of greater than 10 percent in terms of total assets audited in the industry, and 0 otherwise. *CI* = natural log of the client's total assets scaled by the sum of the natural log of total assets of all clients audited by the same audit firm. *ROA* = net income scaled by total assets. *LOSS* = indicator variable set to 1 if the firm reports a loss for the year, and 0 otherwise. *MAR* = annual return minus annual market return. *GROWTH* = change in sales scaled by lagged sales. *LEV* = total debt deflated by total assets. *CFO* = cash flow from operations scaled by total assets. *ARINV* = accounts receivable plus inventory scaled by total assets.

SEO = indicator variable set to 1 if the firm has seasoned equity offering in the next year, and 0 otherwise. *SIZE* = natural log of total assets. *AGE* = number of years since the firm's initial public offering. z-statistics are based on standard errors clustered by firm. *, ** and *** indicate two-tailed significance at the 0.10, 0.05 and 0.01 levels, respectively.

4.4.2 Change analysis

I recognize that the findings could be affected by endogeneity. It is possible that successful opinion shopping and RPTs are influenced by an omitted variable such as, the quality of management. A firm with inferior directors / managers may prefer acquiescent engagement partners so as to manipulate audit opinions, and thus affect an audit firm's partner assignment decision. Furthermore, the quality of management is likely to affect the use of RPTs. Therefore, I estimate a change specification which is more capable of controlling for the endogeneity induced by omitted variables. Specifically, I take the year to year change for each variable in equation (2) so that each firm effectively serves as its own control. This alleviates the impact of omitted variables, particularly if those variables stay relatively constant across years. As seen in Table 6, the $\Delta POPSHOP \times \Delta RPT$ interaction variable is significantly negative ($p < 0.05$), which indicates that the main result in Table 3 is unlikely driven by endogeneity bias.

Table 6: Change analysis

	Expected sign	ΔPSWITCH	
		Coefficient	z-statistic
ΔPOPSHOP	–	-13.991***	-11.38
ΔRPT	+/–	0.044	1.47
ΔPOPSHOP×ΔRPT	–	-27.466**	-1.98
ΔTENURE	+/–	0.099***	3.75
ΔL1PTENURE	+/–	0.999***	30.37
ΔPSPEC	–	0.061	0.56
ΔCI	–	3.549**	2.38
ΔROA	+/–	0.292	0.95
ΔLOSS	+/–	-0.142***	-3.12
ΔMAR	+/–	-0.014	-0.70
ΔGROWTH	+/–	-0.034	-1.51
ΔLEV	+/–	0.236	1.43
ΔCFO	+/–	-0.020	-0.13
ΔARINV	+	-0.004	-0.02
ΔSEO	–	-0.130	-1.23
ΔSIZE	–	0.100*	1.87
ΔAGE	+/–	-0.098	-0.74
Pseudo R^2		0.158	
n		7,531	

Variable definitions: *PSWITCH* = indicator variable set to 1 if the firm is audited by a new partner, and 0 otherwise. *POPSHOP* = difference in the predicted probability between receiving a MAO conditioned to a firm switch its partner and receiving a MAO conditioned to not switching the partner. *RPT* = amount of RPTs scaled by total assets. *TENURE* = number of consecutive years that the firm has retained the incumbent audit firm. *L1PTENURE* = last year's average number of consecutive years that the engagement partners have signed the annual audit report of the client. *PSPEC* = indicator variable set to 1 if any of the engagement partners is the industry leader or has a market share of greater than 10 percent in terms of total assets audited in the industry, and 0 otherwise. *CI* = natural log of the client's total assets scaled by the sum of the natural log of total assets of all clients audited by the same audit firm. *ROA* = net income scaled by total assets. *LOSS* = indicator variable set to 1 if the firm reports a loss for the year, and 0 otherwise. *MAR* = annual return minus annual market return. *GROWTH* = change in sales scaled by lagged sales. *LEV* = total debt deflated by total assets. *CFO* = cash flow from operations scaled by total assets. *ARINV* = accounts receivable plus inventory scaled by total assets. *SEO* = indicator variable set to 1 if the firm has seasoned equity offering in the next year, and 0 otherwise. *SIZE* = natural log of total assets. *AGE* = number of years since the firm's initial public offering. The symbol Δ represents the change in the variable between the current and the

preceding year. z-statistics are based on standard errors clustered by firm. *, ** and *** indicate two-tailed significance at the 0.10, 0.05 and 0.01 levels, respectively.

4.4.3 Abnormal RPTs

Abnormal RPTs tend to be conducted on a discretionary basis with more arbitrary transactions than the predicted (normal) RPTs (Gordon et al., 2004). Consistent with this conjecture, Jian and Wong (2010) find evidence that controlling owners of Chinese listed firms are more likely to use abnormal RTPs to prop up earnings in order to meet earnings targets. Following Jian and Wong (2010), I decompose total RTPs into normal and abnormal parts. For this purpose, for each sample year, I regress *RPT* against *SIZE*, *LEV*, *MTB* (as measured by the market-to-book ratio), and industry dummies. I measure abnormal RPTs (*ABRPT*) using the residual of the above regression. I then use *ABRPT* to replace *RPT* in equation (2) and rerun the test. As shown in Table 7, the coefficient on *POPSHOP×ABRPT* is also significantly negative. This indicates that the main result remain insensitive after using this proxy for RPTs.

Table 7: Abnormal RPTs

	Expected sign	PSWITCH Coefficient	z-statistic
Intercept		-0.453*	-1.75
POPSHOP	–	-38.449***	-17.59
ABRPT	+/–	0.012	0.44
POPSHOP×ABRPT	–	-6.805*	-1.95
TENURE	+/–	0.016***	5.26
L1PTENURE	+/–	0.138***	8.47
PSPEC	–	0.107*	1.94
CI	–	-0.711	-1.44
ROA	+/–	0.769***	2.74
LOSS	+/–	-0.425***	-9.16
MAR	+/–	-0.012	-0.48
GROWTH	+/–	-0.001	-0.03
LEV	+/–	0.049	0.65
CFO	+/–	-0.035	-0.21
ARINV	+	0.053	0.64
SEO	–	0.022	0.20
SIZE	–	-0.013	-1.13
AGE	+/–	-0.013***	-5.05
Year fixed effects		Yes	
Industry fixed effects		Yes	
Pseudo R^2		0.049	
n		12,528	

Variable definitions: PSWITCH = indicator variable set to 1 if the firm is audited by a new partner, and 0 otherwise. POPSHOP = difference in the predicted probability between receiving a MAO conditioned to a firm switch its partner and receiving a MAO conditioned to not switching the partner. ABRPT = residual value of RPTs from yearly regressions. TENURE = number of consecutive years that the firm has retained the incumbent audit firm. L1PTENURE = last year's average number of consecutive years that the engagement partners have signed the annual audit report of the client. PSPEC = indicator variable set to 1 if any of the engagement partners is the industry leader or has a market share of greater than 10 percent in terms of total assets audited in the industry, and 0 otherwise. CI = natural log of the client's total assets scaled by the sum of the natural log of total assets of all clients audited by the same audit firm. ROA = net income scaled by total assets. LOSS = indicator variable set to 1 if the firm reports a loss for the year, and 0 otherwise. MAR = annual return minus annual market return. GROWTH = change in sales scaled by lagged sales. LEV = total debt deflated by total assets. CFO = cash flow from operations scaled by total assets. ARINV = accounts receivable plus inventory scaled by total assets. SEO = indicator variable set to 1 if the firm has seasoned equity offering in the next year, and 0 otherwise. SIZE = natural log of

total assets. AGE = number of years since the firm's initial public offering. z-statistics are based on standard errors clustered by firm. *, ** and *** indicate two-tailed significance at the 0.10, 0.05 and 0.01 levels, respectively.

5. Conclusion

This study examines how RPTs affect partner-level audit opinion shopping. Extant research and anecdotal evidence generally support the view that RPTs are more likely to reflect opportunistic insider behavior. Further, RPTs are often associated with an increased audit risk, which in turn, increases the probability of receiving MAOs. Moreover, for a firm, an MAO usually results in more stringent regulator supervision of managerial actions and a negative market reaction, constraining the ability of managers to behave opportunistically. Therefore, firms conducting more RPTs have incentives to influence their audit firms' partner assignment decisions for the sake of obtaining more favorable audit opinions. Using a sample from Chinese listed firms, I find that firms with more RPTs are more likely to successfully engage in opinion shopping. The finding is consistent with weak governance motivation for RPTs usage. In addition, this effect is more pronounced when firms conduct more non-operating RPTs.

This study responds to calls for research on the role of individual auditors in determining audit quality (e.g., DeFond and Francis, 2005; Francis, 2011; Gul et al., 2013). Several jurisdictions, such as Australia, China, Taiwan, and countries in the European Union already require disclosing the names of the engagement partners in audit reports, and others, such as the U.S., are proposing adoption of similar disclosure policies. This study adds to the debate on what factors motivate client firms to shop for opinions at the partner-level. Thus, it may have important policy implications for standard-setters in China.

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