



## **Management Demography and Auditor Choice: The Case of China**

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**Abstract:** We examine whether management demographic characteristics would influence the choice of auditor. Auditors play an important role in controlling management reporting discretion. By examining the impact of management demography on the effect of auditor quality, we provide insight on the implementation of monitoring mechanism of firms in China. Our findings show that the upper echelons influence corporate governance commitment through auditor choice.

**JEL classification:** G30, G32.

**Keywords:** Keywords: audit quality, management demography, titles, upper echelons theory

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### **1. Introduction**

**I**n this study, we employ strategic management concepts (upper echelons theory and resource-based view of the firm) to explain the possible relation between management demography and corporate governance. The upper echelons theory shows that top executives can influence corporate outcomes in terms of performance and strategies (Hambrick and Mason, 1984; Barker and Mueller, 2002). On the other hand, the resource-based view of firm stresses the significance of human resources to achieve organizational effectiveness (Hitt,

Bierman, Shimizu and Kochhar, 2001). Recently, Hambrick (2007) further conjectures that the demographic characteristics (such as experience, gender, educational level, and professional background) of top executives are proxies of their cognitive frames and strategic actions.

While strategic management concepts have been used mainly to explain how top executives with different personal attributes and demography would result in differences in firm performance, no research has applied these theories on accounting issues such as the relation between management demography and choice of auditor. Furthermore, the empirical investigations of these theories have also been confined to the more developed economies. The validity of these theories in emerging economies (e.g., China) remains unexplored. Therefore, we aim to examine if there exists a relation between the demographic characteristics of chairman (experience, age, gender, education level and title) and corporate decisions such as choice of auditor for Mainland Chinese firms. More specifically, we test whether the personal attributes of top executives matter in affecting audit quality and hence the corporate governance of the firms.

The value of audit quality in improving the credibility and informativeness of financial reports has been documented in the audit literature (Teoh and Wong 1993; Becker, DeFond, Jiambalvo and Subramanyan 1998). Auditors help reduce agency costs between management and shareholders. As the choice of auditor is an important one, we hypothesize that different types of top executives may have preference on audit quality.

We choose the Chinese market for our study for several reasons. China has rapid economic growth and is one of the fastest-growing emerging markets. The growing economic significance of the Chinese market in the global economy arouses the attention of the local and international investors to the issue about the right type of top executives for effective management and corporate governance practice. The level of audit quality is also a factor affecting the investor confidence in audited financial statements.

Despite the rapid economic growth in China, the development of the financial infrastructure and regulatory system are still not mature, leading to inadequate investor protection (La Porta, Lopez-De-Silanes and Shleifer 1999). DeFond, Wong and Li (2000) suggest that poorer corporate governance system may lead to lower demand of audit quality. In China, the government is the controlling shareholders of many listed SOEs in the market. In addition, a large number of

local CPA firms are related to the government directly or indirectly. There is a question whether the auditors in China can perform their monitoring function. Therefore, it is important to explore the factors which determine the choice of auditors in China.

The management structure and characteristics of the board are different between the US or Europe and China. In China, the chairmen are full-time rather than part-time executives (as usually as the case in the US and Europe). In many cases, the chairmen, general managers, other board members and top executives of the firms are appointed by the state or the controlling shareholders of the quasi-state institutions. In addition, these top executives with a dual role of being Chinese government bureaucrats may also aim at achieving the political and social objectives rather than the firm objectives of maximizing shareholders' interest. Based on these unique features of the Chinese corporate environment, the Chinese market provides a different research setting for us to explore how far the strategic management concepts (upper echelons theory, resource-based view of firm) which are developed in the more mature western markets can be used to explain the impact of management demography on corporate strategies such as choice of auditor.

Based on a sample 3,881 firm-year observations between 2001 and 2005, we find that audit quality is related to management demography of chairmen. In particular, we find that the possession of professional accountant title exerts negative effect while other titles show positive effect on the choice of audit quality. In addition, we also show that auditor choice is related to board governance characteristics (board size and percentage of independent directors).

Our study adds to the audit and management literature in several ways. Previous studies on auditor choice in audit literature focus on the relation between agency cost issues (Francis and Wilson 1988; DeFond 1992) or institutional (legal, political or economic) factors (Francis, Khurana and Pereira 2003; Choi and Wong 2007; Wang, Wong and Xia 2008) and demand for auditor. These studies have documented that the macro factors such as legal institutional environment and foreign investors' activities and micro factors such as firm size and leverage. After controlling for these factors, we provide further evidence that auditor choice may also be related to the personal attributes and demography of the chairmen. We use the choice of quality auditor as a proxy of good corporate governance of the top executives and the board to address the unexplored issue on the relation between management demography and corporate governance. Since information

asymmetry exists in the market, top executives can reflect their pursuit of good corporate governance practice to the market by hiring auditor with high level of quality. Consequently, the appointment of auditor with different qualities can be used as an external signal to reveal the fact that the upper echelons' demography is important in affecting corporate governance. We find that management demography (such as possession of accountant title or other professional titles, gender) and board composition characteristics (such as board size and number of independent directors) play an important part in choosing auditor. By linking management demography and choice of auditors, we connect the type of demography with the quality of corporate governance. Our study provides evidence that top executives do matter in influencing corporate strategies and corporate governance of the firms through the appointment of auditors with different levels of quality.

Following this introduction is a brief review of the management literature on management demography and audit literature on audit quality. The data and methodology are described in Section 3. We present empirical results in Section 4 and conclude our study in Section 5.

## **2. Literature Review and Hypothesis**

The early management literature suggests that organizational outcomes (e.g., firm performance, corporate strategies) are affected predominately by bureaucratic rules and environmental selection (Hall 1977; Hannan and Freeman 1977). Recently, the upper echelons theory of the management literature (Hambrick and Mason 1984; Hambrick 2007) argues that the demographic characteristics of top executives are important elements in shaping organizational outcomes. In addition, the resource-based view of firm (Barney 1991; Hitt, Bierman, Shimizu, and Kochhar 2001) also proposes that human capital is an essential intangible asset for business operation and decisions. Combining the assertions of upper echelons theory and resource-based view of firm, "top executives" do matter to influence organizational outcomes for better or worse. Based on the upper echelons theory, the demographic characteristics include educational level (Wailderdsak and Suehiro 2004; Boyatzis 2004), gender (Kalleberg and Leicht 1991), age and tenure (Hambrick and Mason 1984; Hambrick and Fukuomi 1991; Barker and Mueller 2002).

In the audit literature, there are three major explanations for the demand of audit quality. As there are always conflicts of interests between shareholders and

management in the agency relation, Jensen and Meckling (1976) argue that the information asymmetry between the agent and the principal creates moral hazard problem and increases agency costs. An independent auditor can function as monitors or bonding mechanisms to mitigate agency problems and lower agency costs. It is expected that auditors with higher quality can reduce information asymmetry than those with lower quality. Fan and Wong (2005) show that in emerging markets where the agency problems are embedded in the ownership structure, firms are more likely to hire Big-N auditors. Besides relieving the moral hazard problem, high audit quality can also solve another agency problem of adverse selection. High quality audit can serve as a credible signal to add value to the firm by enhancing the credibility and informativeness of financial reports (Datar, Feltham and Hughes 1991). In addition, audit service performs an insurance role to function as a potential indemnifier against investment losses in the capital markets (Menon and William 1994). In their study, Francis, Khurana and Pereira (2003) report that the demand for high quality auditor is lower for countries with weaker legal environment than for countries with stronger legal environment. Choi and Wong (2007) find that auditors play a more important role in corporate governance in countries with weak rather than strong legal institutions.

The Chinese audit market has undergone drastic changes in the last century. The CPA profession was first established in 1918 and was suspended in 1962 due to the cultural revolution. (Gensler and Yang 1996) The Chinese Institute of Certified Public Accountant (CICPA) was later set up by the National Ministry of Audit in 1992. Nevertheless, a majority of the local CPA firms are controlled by the government or government-related entities directly or indirectly. Since then, several audit market reforms have been implemented with the aim to open up the Chinese market to international CPA firms and to promote higher quality and more independent audits. However, the Chinese audit market is still dominated by government-affiliated CPA firms and hence by government.

Gul, Sun and Tsui (2003) find that the market reaction to earnings increase is stronger when the firms are audited by high quality auditors. Chan, Lin and Mo (2006) show that after receiving qualified opinions, local government-owned-firms switch from non-local to local auditors to achieve opinion shopping. Recently, Wang, Wong and Xia (2008) conclude that the extent of state ownership, level of market and legal development, and degree of government power over auditors affect auditor choice.

Management literature suggests that management demography of upper echelons can influence organizational outcomes. Appointment of auditor is a major decision to be made by the top executives. Therefore, we hypothesize that the demographic characteristics (experience, age, gender, education level and title) of chairman should be significantly related to the choice of auditor. We formulate the following “non-directional” hypotheses for testing H1:

*H1: The demography of chairman is related to audit quality.*

We include five demographic characteristics to test this relation. They are title ownership, gender, work experience, age, and education. In particular, we focus on the impact of title (other professional titles (e.g., economists, engineers) and accountant title) held by the chairman on the choice of audit quality. We expect that there is an association of the choice of auditor and education/certification of chairman. We have two explanations, substitution effect and displacement effect, for this association. According to the substitution effect, the chairmen without professional certification in accounting field would tend to use Big N auditors as the chairmen with qualification believe in the importance of certification. Thus they put additional value on the perceived professional expertise and the brand value affiliated with Big N auditors. According to displacement effect, for the chairmen who themselves own accounting qualification, they believe that their accounting expertise is good enough to monitor the firm. Thus, the additional value of hiring Big N auditors would be relatively limited.

### **3. Data and Methodology**

Our data is obtained from China Securities Markets and Accounting Research Database (CSMAR) and Wind. This study covers a sample period of five years from 2001 to 2005. In our sample, we include all firms listed on the Shanghai Stock Exchange and Shenzhen Stock Exchange (except for those in the finance, banking and insurance sectors). In total, we have 3,881 firm-year observations.

#### **3.1 Regression Model**

We examine the relation between management demography and the choice of auditor through a binary regression model (1). We use different versions of model (1) to examine if there is a difference in auditor choice for firms led by chairmen with titles vs without titles; with accountant title vs without accountant title; and with other professional titles vs without other professional titles:

$$\begin{aligned}
 \text{Top10D} = & \alpha_0 + \beta_1 \text{CHTitleVar} + \beta_2 \text{CHGender} + \beta_3 \text{CHYear} + \beta_4 \text{CHAge} + \beta_5 \text{CHEdu} \\
 & + \beta_6 \text{BoardSize} + \beta_7 \text{IndDirRatio} + \beta_8 \text{DirHolding} + \beta_9 \text{DirectorMeet} \\
 & + \beta_{10} \text{AdvisorMeet} + \beta_{11} \text{ShareholderMeet} + \beta_{12} |\text{PMDACC}| + \beta_{13} \text{EPS} \\
 & + \beta_{14} \text{DA} + \beta_{15} \text{MB} + \beta_{16} \text{LnAsset} + \beta_{17} \text{ForeignD} + \beta_{18} \text{NonSOED} \\
 & + \beta_{19} \text{Develop} + \beta_t \sum_t \text{Year}_t + \beta_j \sum_j \text{Industry}_j
 \end{aligned} \tag{1}$$

### 3.2 Key Variables

Top10D is a dummy variable coded 1 if the audit firm is in the Top 10 category and 0 otherwise. Audit quality or reputation is important to auditors as it affects the value of audit service, and enhances the ability of quality auditor to resist management pressure. The audit firms in the Top-10 category are expected to have higher audit quality and those in the non-Top-10 category have lower audit quality. We use two steps to differentiate firms into Top-10 category and Non-Top-10 category. First, based on the fact that the international CPA firms occupy the largest market share in the global market and rank highest in terms of revenue in the Chinese audit market, the international CPA firms would be included as one of the Top 10 firms with high audit quality. Second, following the methodology of Defond, Wong and Li (2000), we use market share of an audit firm, which is measured in terms of total asset value of the clients of the audit firms on a national basis to group firms into Top-10 and non-Top-10 categories. For each year during the sample period between 2001 and 2005, we rank the audit firms according to the total asset values of their clients. After including the international CPA firms in the Top 10 category, the remaining quota would be occupied by the domestic CPA firms which rank among the highest in terms of total asset value of the client firms in the audit market. The rest of the domestic CPA would be in the Non-Top 10 category.

In this study, we explore if the management demography of chairman exerts influence on the auditor choice. Five demographic characteristics of chairman, CHTitleVar, CHGender, CHYear, CHAge and CHEdu are examined. Adler and Kwon (2002) and Shipilov and Danis (2006) suggest that social capital of top management is important operative mechanism to influence organizational outcomes. We use three versions of title (CHTitleVar) to examine if title would

be related to the choice of auditor. CHTitle is a dummy variable for title coded 1 if the chairman holds a title and 0 otherwise. CHAccTitle is a dummy variable for accountant title coded 1 if the chairman holds a professional accountant title and 0 otherwise. CHOtherTitle is a dummy variable coded 1 if the chairman holds other professional title (such as engineer, lawyer) except accountant title and 0 otherwise.

We use CHGender, which is a dummy variable coded 1 if the chairman is a female and 0 otherwise, to examine if there is relation between gender and choice of auditor. There are a number of studies examining the success and management style of male and female executives (Maier 1970; Day and Stogdill 1972; Schein 1973; Schein 1975; Kalleberg and Leicht 1991; Carter, Simkins and Simpson 2003). To examine if gender makes a difference in corporate strategies in a culturally masculine society like China, we include CHGender in our model to test if male or female executives have different choices of auditor.

CHYear is a measure of tenure and experience, which is the number of years the chairman stays in office. CHAge is the age of chairman. In the management literature, tenure and age of managers is related to the propensity to accept new changes and risk (Grimm and Smith 1991; Hambrick and Fukutomi 1991; Hambrick and Mason 1984). We use CHYear and CHAge to examine if the choice of auditor is different when tenure or age increases.

CHedu is a dummy variable coded 1 if the chairman has a four-year university degree or above and 0 otherwise. Education level is related to open mindedness and top executives with less education are more conservative in the decision-making process (Wally and Baum 1994; Herrmann and Datta 2002). In this study, we use CHedu to examine if education level would be related to the choice of auditor.

### **3.3 Control Variables**

We include some corporate governance factors (BoardSize, IndDirRatio, DirectMeet, AdvisorMeet, ShareholderMeet and |PMDACC |) in our model. BoardSize is the number of directors on board. IndDirRatio is the ratio of number of independent directors to total number of directors. We use the proportion of independent directors (IndDirRatio) on the board as proxies for board independence to monitor the firms. DirectorMeet is the number of director meeting in a year. AdvisorMeet is the number of advisory meeting in a year. ShareholderMeet is the number of audit committee meetings during the year. Xie, Davidson and DaDalt (2003) find that an active board performs the monitoring

function better than an inactive board. In this study, we use the number of directors and independent directors and number of meetings to proxy the activeness of the monitoring function of the board.  $|PMDACC|$  is the absolute value of performance-matched discretionary accrual (Kothari, Leone and Wasley 2005), which is our proxy of earnings management (DeFond and Jiambalvo 1994; Teoh, Welch and Wong 1998). Auditing literature has shown that auditors with high quality can constrain the earnings management activity of firms (e.g., Becker, DeFond, Jiambalvo and Subramanyam 1998). We expect a negative relation between audit quality and magnitude of discretionary accrual.

Several financial measures (EPS, DA, MB and LnAsset) are included as control variables. EPS is earnings per share. DA is debt to asset ratio which is a measure of firm risk. Information asymmetry is positively related to firm risk and hence high risk firms have a higher signaling demand for audit quality (Datar, Feltham and Hughes 1991). MB is ratio of market value to book value of equity. LnAsset is log of total assets which is a measure of firm size.

We have three firm characteristics (ForeignD, NonSOED and Develop) in our model. ForeignD is a dummy variable coded 1 if the firm issues domestic A-shares and B-shares or H-shares and 0 otherwise. NonSOED is a dummy variable coded 1 if the firm is a non-state-owned enterprise and 0 otherwise<sup>1</sup>. Develop is the index score of marketization for each province in China (Fan, Wang and Zhang 2001) to capture the development disparity of different regions.

#### 4. Empirical Results

We report the descriptive statistics (mean, median, maximum, minimum, and standard deviation) of audit quality, management demographic characteristics and other control variables for our sample firms in Table 1. Of our 3,881 observations, there are 934 and 2,947 firms employing high quality audit firms and low quality audit firms, respectively. There are 3,112 chairmen holding titles, of which 2,970 are holding titles other than accountant title. There are only 142 (3.66%) chairmen (CHAccTitle) holding accountant title.

Among our 3,881 chairmen, the mean of years of chairmen (CHYear) staying in office is 3.78 years. The number of females holding positions of chairmen is

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<sup>1</sup> By non-state-owned firms, we refer to those firms with the ultimate owners which are not government or government-related entities (e.g., the Bureau of State Assets Management, Finance Bureau, Ministry of Finance).

very few. In our sample, there are only 164 female chairmen (CHGender). A majority of chairmen (CHEdu = 79.34%) have university degrees.

**Table 1**  
**Descriptive Statistics**

Top10D is a dummy variable coded 1 if the audit firm is in the Top 10 category and 0 otherwise. CHTitle is a dummy variable for title which is coded 1 if the chairman holds a title and 0 otherwise. CHAccTitle is a dummy variable for professional accountant title which is coded 1 if the chairman holds a professional accountant title and 0 otherwise. CHOtherTitle is a dummy variable for title which is coded 1 if the chairman holds other title except professional accountant title and 0 otherwise. CHGender is a dummy variable coded 1 if the chairman is a female and 0 otherwise. CHYear is the number of years the chairman stays in office. CHAge is the age of chairman. CHEdu is a dummy variable coded 1 if the chairman has a four-year university degree or above and 0 otherwise. BoardSize is the number of directors on board. IndDirRatio is the ratio of number of independent directors to total directors on board. DirHolding is the total shareholding percentage of all directors on board. DirectorMeet is the number of director meeting in a year. AdvisorMeet is the number of advisory meeting in a year. ShareholderMeet is the number of audit committee meetings during the year. |PMDACC| is the absolute value of performance matched discretionary accruals. EPS is earnings per share. DA is debt to asset ratio. MB is ratio of market value to book value of equity. LnAsset is log of total assets. ForeignD is a dummy variable coded 1 if the firm issues domestic A-shares and B-shares or H-shares and 0 otherwise. NonSOED is a dummy variable coded 1 if the firm is a non-state-owned enterprise and 0 otherwise. Develop is index score of marketization for each province in China. DevelopD is a dummy variable coded 1 if the firm is located in a more developed region (using 5.7 of the index score as a cut-off) according to the index score of marketization for each province in China and 0 otherwise.

	Dummy <u>Code = 1</u>	Dummy <u>Code = 0</u>	<u>Mean</u>	<u>Median</u>	<u>Maximum</u>	<u>Minimum</u>	<u>Standard Deviation</u>
Top10D	934	2947					
CHTitle	3112	769					
CHAccTitle	142	3739					
CHOtherTitle	2970	911					
CHGender	164	3717					
CHYear			3.7789	3.0000	16.0000	1.0000	2.4493
CHAge							
CHEdu	3079	802					
BoardSize			9.7910	9.0000	19.0000	4.0000	2.2567
IndDirRatio			0.2771	0.3333	0.6667	0.0000	0.1189
DirHolding							
DirectorMeet							
AdvisorMeet			3.5416	3.0000	25.0000	1.0000	1.7231
ShareholderMeet							
PMDACC			0.0599	0.0416	1.0577	0.00002	0.0647
EPS			0.1620	0.1376	2.3703	-2.1392	0.2869
DA			0.4760	0.4854	0.9338	0.0081	0.1722
MB			2.9450	2.3882	10.9984	0.5651	1.8573
LnAsset			21.2473	21.1668	26.9782	18.3224	0.8835
ForeignD	349	3532					
NonSOED	991	2890					
Develop			6.4723	6.4000	8.4100	3.4000	1.3008
DevelopD	2727	1154					

**Table 2**

## Two-sample T-test

Top10D is a dummy variable coded 1 if the audit firm is in the Top 10 category and 0 otherwise. CHTitle is a dummy variable for title which is coded 1 if the chairman holds a title and 0 otherwise. CHAccTitle is a dummy variable for professional accountant title which is coded 1 if the chairman holds a professional accountant title and 0 otherwise. CHOtherTitle is a dummy variable for title which is coded 1 if the chairman holds other title except professional accountant title and 0 otherwise. CHGender is a dummy variable coded 1 if the chairman is a female and 0 otherwise. CHYear is the number of years the chairman stays in office. CHAge is the age of chairman. CHEdu is a dummy variable coded 1 if the chairman has a four-year university degree or above and 0 otherwise. |PMAC| is the absolute value of performance matched discretionary accruals. ForeignD is a dummy variable coded 1 if the firm issues domestic A-shares and B-shares or H-shares and 0 otherwise. NonSOED is a dummy variable coded 1 if the firm is a non-state-owned enterprise and 0 otherwise. DevelopD is a dummy variable coded 1 if the firm is located in a more developed region (using 5.7 of the index score as a cut-off) according to the index score of marketization for each province in China and 0 otherwise.

	Dummy Code	Mean	Top10D N [1]	Top10D N [0]	Mean Difference	Chi-Square
CHTitle	1		781	2331		
	0		153	616		9.1256**
CHAccTitle	1		27	115		
	0		907	2832		2.0585
CHOtherTitle	1		754	2216		
	0		180	731		12.0867**
CHGender	1		54	110		
	0		880	2837		7.3572**
CHYear		4.0921	934			
		3.6897		2947	0.4124**	
CHAge		50.5953	934			
		49.2796		2947	1.3751**	
CHEdu	1		740	2339		
	0		194	608		0.0084
PMAC		0.0572	934			
		0.0608		2947	-0.0036	
ForeignD	1		217	132		
	0		717	2815		304.8071**
NonSOED	1		208	783		
	0		726	2164		6.8953**
DevelopD	1		836	1891		
	0		98	1056		217.9775**

\* 0.05 significance level

\*\* 0.01 significance level

#### 4.1 Two-sample Comparison

We use parametric (two-sample t-test) and non-parametric (Chi-square analysis) tests for measuring differences of subsamples with different levels of audit quality. The results are reported in Table 2. For chairmen with titles and other professional titles, they tend to hire auditors with higher quality (Top10D). There is a significant difference in the preference of higher audit quality between female chairmen and male chairmen. In addition, chairmen who are older in age and stay in office for longer time are more likely to use higher quality auditors.

It is expected that there is a smaller discretionary accruals reported by auditors of higher quality than by lower quality (Becker, DeFond, Jiambalvo and Subramanyam 1998). In Table 2, we find no significant difference for |PMAC| with high and low audit quality. For the other control variables, the results show that there are significant differences in audit quality between firms which also issue B-shares or H-shares and firms which issue only domestic A-shares (ForeignD), firms which are privately-owned (NonSOED) and state-owned, and firms are located in more and less developed regions of China (DevelopD).

#### 4.2 Regression Analysis

The results for logit analyses for equation (1) are reported in Table 3. We include year and industry dummies as additional control variables in our regression models<sup>2</sup>. We find the possession of title (CHTitle, CHAccTitle, CHOtherTitle) is significantly related to the choice of auditors. The coefficients on CHTitle and CHOtherTitle are positive, indicating that chairmen with titles other than accountant titles tend to use auditors with higher quality. However, our result shows that the relation between Top10D and CHAccTitle is negatively significant, which implies that the chairmen with accountant title are less likely to hire auditor with high audit quality. The preference of the chairmen with accounting background to lower audit quality may be due to the fact that these chairmen already have the training and sophistication to be familiar with and understand the corporate financial reporting process. Consequently, the need of these firms for high audit quality to detect and discover contract breach (competence) is reduced.

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<sup>2</sup> We use the industry definition of the CSRS's expanded list of industries, which includes agriculture (A), mining (B), food and beverage (C0), textile and apparel (C1), timber and furniture (C2), paper making and printing (C3), petroleum and chemicals and plastics (C4), electronics (C5), metal and non-metal (C6), machinery, equipment and instrument (C7), medicine and biological product (C8), other manufacturing industries (C9), power, gas and water (D), architecture (E), transportation (F), IT (G), retail (H), real estate (J), communication (L), and conglomerate (M). The year dummies represent the years for 2001, 2002, 2003, 2004 and 2005.

This may provide a plausible explanation to the lower need of high audit quality for firms chaired with a professional accountant. For the other demographic characteristics, only CHGender is significant, a result showing that female chairmen choose to use high quality auditors.

**Table 3****Logit Regression Analysis**

Top10D is a dummy variable coded 1 if the audit firm is in the Top 10 category and 0 otherwise. CHTitle is a dummy variable for title which is coded 1 if the chairman holds a title and 0 otherwise. CHAccTitle is a dummy variable for accountant title which is coded 1 if the chairman holds an accountant title and 0 otherwise. CHOtherTitle is a dummy variable for title which is coded 1 if the chairman holds other title except professional accountant title and 0 otherwise. CHGender is a dummy variable coded 1 if the chairman is a female and 0 otherwise. CHYear is the number of years the chairman stays in office. CHAge is the age of chairman. CHEdu is a dummy variable coded 1 if the chairman has a four-year university degree or above and 0 otherwise. BoardSize is the number of directors on board. IndDirRatio is the ratio of number of independent directors to total directors on board. Dirholding is the total shareholding percentage of all directors on board. DirectorMeet is the number of director meeting in a year. AdvisorMeet is the number of advisory meeting in a year. ShareholderMeet is the number of audit committee meetings during the year. |PMAC| is the absolute value of performance matched discretionary accruals. EPS is earnings per share. DA is debt to asset ratio. MB is ratio of market value to book value of equity. LnAsset is log of total assets. ForeignD is a dummy variable coded 1 if the firm issues domestic A-shares and B-shares or H-shares and 0 otherwise. NonSOED is a dummy variable coded 1 if the firm is a non-state-owned enterprise and 0 otherwise. Develop is index score of marketization for each province in China. z-values are adjusted for heteroskedasticity using White's procedure (1980).

	Coefficient	z-value	Coefficient	z-value	Coefficient	z-value	Coefficient	z-value
Intercept	-23.0144	-16.56	-22.8537	-16.52	-23.0105	-16.56	-22.9611	-16.53
CHTitle	0.2410	2.06*						
CHAccTitle			-0.5156	-2.01*			-0.3057	-1.13
CHOtherTitle					0.3283	2.91**	0.2771	2.34*
CHGender	0.4156	2.21*	0.4661	2.48*	0.4363	2.34*	0.4568	2.44*
CHYear	-0.0073	-0.39	-0.0085	-0.45	-0.0094	-0.50	-0.0104	-0.54
CHAge	0.0028	0.45	0.0036	0.57	0.0013	0.21	0.0012	0.19
CHEdu	-0.0642	-0.60	-0.0719	-0.67	-0.0781	-0.73	-0.0837	-0.78
BoardSize	0.0465	2.40*	0.0466	2.41*	0.0449	2.32*	0.0444	2.30*
IndDirRatio	2.0961	3.30**	2.0891	3.30**	2.0799	3.28**	2.0726	3.27**
DirHoldng	1.3800	1.24	1.4507	1.30	1.3140	1.18	1.3180	1.19
DirectorMeet	0.0107	0.73	0.0067	0.46	0.0109	0.75	0.0098	0.67
AdvisorMeet	-0.0085	-0.34	-0.0054	-0.21	-0.0087	-0.34	-0.0078	-0.31
ShareholderMeet	-0.1187	-2.70**	-0.1221	-2.76**	-0.1200	-2.72**	-0.1214	-2.74**
PMAC	-1.0878	-1.66	-1.1397	-1.75	-1.0757	-1.64	-1.0868	-1.66
EPS	0.0447	0.29	0.0609	0.39	0.0417	0.27	0.0451	0.29
DA	-1.6207	-5.68**	-1.6150	-5.68**	-1.6201	-5.67**	-1.6196	-5.67**
MB	0.2168	7.66**	0.2159	7.60**	0.2175	7.67**	0.2175	7.66**
LnAsset	0.8781	13.74**	0.8797	13.80**	0.8781	13.76**	0.8786	13.77**
ForeignD	1.1128	7.75**	1.1141	7.79**	1.1152	7.77**	1.1163	7.78**
NonSOED	0.1188	1.09	0.0798	0.74	0.1193	1.10	0.1080	0.99
Develop	0.3445	9.34**	0.3482	9.36**	0.3498	9.38**	0.3522	9.40**
Year Dummies Included								
Industry Dummies Included								
LR Statistic	710.00		710.51		714.74		716.20	
p-value	0.00		0.00		0.00		0.00	
N	3881		3881		3881		3881	

\* 0.05 significance level

\*\* 0.01 significance level

We include BoardSize, IndDirRatio and DirectorMeet, AdvisorMeet and ShareholderMeet and |PMDACC| as the corporate governance factors. As we assume that the board members, the independent directors and the shareholders should have their “say” in the choice of auditor during the board meetings and shareholder meetings, we examine if these corporate governance factors would have impacts on audit quality. We expect that there should be a higher likelihood for higher quality auditors by better-governed firms which are characterized by greater number of directors and independent directors and higher frequency of board meetings, advisor meetings and shareholder meetings. Among these corporate governance factors, only BoardSize, IndDirRatio and ShareholderMeet are significant. Our results in Table 3 show that there are positive relations between Top10D with Board and IndDirRatio. However, the coefficient on ShareholderMeet is negative. Auditors with higher quality should have better ability to detect (competence) and to report contract breach (independence) (Watts and Zimmerman (1986)). As a result, we expect a negative relation between Top10D and |PMDACC|. In Table 3, the coefficient on |PMDACC| is negative but insignificant.

EPS, DA MB and LnAsset are control variables for firm performance. It is expected that firms which perform better, which is larger in size and which have more growth opportunities choose auditor with higher quality auditor to enhance the credibility of financial statements. Consistent with our expectation, the coefficients on LnAsset and MB are positively significant. Leverage is a proxy of firm financial risk. As the firms with higher leverage should have higher firm risk, these firms are less likely to appoint auditor with higher audit quality. We find that the coefficient on DA is negative, indicating that firms with high leverage are more likely to hire auditor with lower audit quality.

Among other firm characteristics, ForeignD and Develop are significant while NonSOED is not. From 1992 onwards, some Mainland Chinese firms can issue foreign shares (B-shares or H-shares) for foreign investors. However, these firms with foreign shares are required to prepare their financial statements according to International Accounting Standards and with the financial statement to be audited by international CPA firms. Since the international Big 4 CPA firms are usually included as the auditors in the Top-10 category and it is more likely for firms which issue foreign shares to hire international Big 4 CPA firms as their auditors, a positive relation between ForeignD and Top10D is found.

We use Develop to capture the development disparity of different regions in China. The larger the index score, the more advanced and sophisticated the economic development in the region should be. Wang, Wong and Xia (2008) suggest that in a less developed market where there is more local government intervention, there is a higher tendency for the SOEs to hire small local auditor, i.e., non-Top10D auditors. It is expected to have a positive relation between Develop and Top10D. In Table 3, the coefficient on Develop is positive.

## 5. Conclusion

In this study, we examine whether the management demographic characteristics of chairman would influence the firm in making choice of auditor (audit quality). Audit quality is an important issue relating to corporate governance of a firm. Auditors play a part in controlling management reporting discretion. By examining the impact of management demography on auditor choice, we provide evidence on the effectiveness of the monitoring mechanism on director behavior and corporate governance of the firms in China. The findings of the relation between management characteristics and audit quality can shed light on how important management demography is on corporate governance.

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