Department of Accountancy

AC Research Newsletter

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CityU Accountancy Research Newsletter is designed to disseminate the research findings and policy implications of recent top-tier accounting publications by faculty of Accountancy Department, City University of Hong Kong to accounting professionals, professional accounting bodies and regulators, and the business community. It provides fresh perspectives on important accounting issues and links up research findings to policy implications on existing accounting practices and regulations.

In the global ranking of accounting schools, The City University of Hong Kong's Department of Accountancy is ranked 24th worldwide according to BYU (Brigham Young University) Worldwide Research Ranking based on the publications in the top five accounting Journals. (www.byuaccounting.net/rankings).

Tax Collector or Tax Avoider? An Investigation of Intergovernmental Agency Conflicts

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Why government-controlled firms avoid taxes has long been an unresolved puzzle. Using a unique setting to examine the effect of intergovernmental agency conflicts between local and central governments on tax avoidance by government-controlled firms, we are the first to provide direct empirical evidence to help resolve this puzzle. Research has documented that tax avoidance activities are associated with firm characteristics, ownership concentration, compensation contracts and agency problems. However, little is known about the role that governments play in tax avoidance by government-controlled firms.

A distinct characteristic of China's capital markets is that the majority of listed firms are government-controlled, either directly through government bodies such as state asset management agencies, or through institutions authorized to hold shares on behalf of the state, such as state-owned enterprises (SOEs). Thus, local governments serve dual but conflicting roles as controlling shareholders of firms from which they also collect taxes. As tax collectors, local governments aim to increase local fiscal revenue by collecting more taxes. If the firms in a locality avoid taxes, the local government's tax revenue is reduced. Hence, the local government has a strong incentive to discourage the firms it controls from engaging in tax avoidance. However, as the controlling shareholder of those same firms, the local government is the largest beneficiary of a high after-tax return and thus has a great incentive to direct its firms toward tax avoidance to maximize the after-tax profit (and thus the resources) under its control. This incentive exists as long as the tax revenue collected from the local government-controlled firms does not completely belong to the local government.

In 1994, as part of a fundamental reform of fiscal resource allocation, China introduced a system in which tax revenue was shared between the central and local governments. Under this tax sharing system, the income taxes collected from local government-controlled firms (LG firms) are exclusively assigned to the local governments, whereas those collected from central government-controlled firms (CG firms) are assigned exclusively to the central government. Under this system, there is no intergovernmental agency conflict, as local governments retain 100 percent of the taxes they collect. Thus, local governments, as the controlling shareholders of LG firms (normally owning less than 100 percent of shares), can direct their firms to maximize tax payments and thus minimize the need to share profits with minority (outside) shareholders. We expect that under this system, local governments' tax collection incentive surpasses their tax avoidance incentive.

In 2002, to further enhance the central government's ability to allocate fiscal resources to national programs such as infrastructure, defense and social welfare projects, the central government amended the sharing system. The new system requires that the income taxes of LG firms be shared equally with the central government. Thus, since 2002, local governments have acted as tax collection agents for the central government and must make trade-offs between the cost of sharing taxes with the central government and the cost of sharing after-tax profits with minority shareholders. We expect that when local governments' ownership percentage in LG firms is higher than the tax sharing ratio, they will steer the firms to minimize tax payments through tax avoidance, as the shared tax revenue will be less than the shared after-tax profit. In such circumstances, the intergovernmental agency cost is higher than the corporate agency cost. Using a sample of government-controlled listed firms from 1999 to 2006, we find evidence supporting the hypothesis that LG firms engage in more tax avoidance in the post-2002 period.

Our study makes several contributions. First, we add to the tax literature by documenting how intergovernmental agency conflicts affect tax avoidance activities. Specifically, we provide evidence that when the share of taxes that revert back to the government is low enough, there are incentives for government-controlled firms to avoid taxes. While corporate agency theory normally explains conflicts of interests in firms, we demonstrate the general applicability of agency theory beyond the private business perspective.

Second, we contribute to the public finance literature. Fiscal decentralization through tax revenue sharing among national and subnational governments is a global phenomenon. Previous studies have investigated the efficiency of tax sharing systems from the economic and public finance perspectives. Using micro accounting data from Chinese listed firms and macro fiscal data from Chinese governments, we provide evidence that intergovernmental agency conflicts created by tax sharing systems have affected not only governments' tax enforcement but also the tax avoidance behavior of government-controlled firms.

Finally, our findings have policy implications for transitional economies in which corporate ownership and political power are highly intertwined in the political-economic system, such as Russia, India, Vietnam and some Central and Eastern European countries. Our study sheds light on how the dual roles played by local governments, as administrators of public affairs and controlling shareholders of listed firms, affect tax policy enforcement under fiscal decentralization.

Does the PCAOB international inspection program improve audit quality for non-US-listed foreign clients?

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The Public Company Accounting Oversight Board (PCAOB) was established by the Sarbanes–Oxley Act of 2002 with the objective of improving audit quality for companies listed in U.S. public securities markets. All auditors (both U.S. and foreign) who audit U.S.-listed companies are required to register with the PCAOB and be subject to PCAOB inspections. A number of studies demonstrate that PCAOB-inspected auditors' U.S. clients experience an increase in audit quality. We examine whether PCAOB inspection improves audit quality for a sample of non-U.S.-listed client companies from 55 countries audited by non-U.S. auditors.

The impact of the PCAOB international inspection program on audit quality abroad is ambiguous. Given the PCAOB's reputation for actively seeking out auditor misconduct and taking follow-up disciplinary actions against deficient auditors, the very act of registering with the PCAOB may exacerbate foreign auditors' exposure to reputational loss and provide them with an ex-ante incentive to strengthen their firm-level quality controls and increase audit quality. To the extent that audit deficiencies are discovered during the initial inspection, the auditor may have an additional incentive to take appropriate remedial action and strengthen firm-level quality controls to avoid further embarrassment on subsequent inspections. The improvements in the foreign auditor's firm-level quality controls could increase audit quality for all of the firm's foreign clients, U.S.-listed or otherwise. However, there are reasons to doubt the efficacy of PCAOB inspections in improving audit quality. Research indicates that PCAOB inspection reports are not useful for assessing audit quality because they merely list audit deficiencies and do not provide a summary opinion about the auditor's quality. Moreover, the effectiveness of the PCAOB's international inspections may be limited by geographic distance from the U.S., potential language differences or cultural barriers. Finally, foreign auditors may follow an asymmetric approach to their U.S.-listed and non-U.S.-listed clients.

Our findings suggest that initial inspections have an incremental effect on the audit quality of the foreign auditor over and above the effect of the threat of such inspections. Our paper contributes to the literature in several ways. First, to our knowledge, it is the first study to examine whether the PCAOB's international inspection program (which is intended to improve audit quality for foreign auditors' U.S.-listed clients) has a positive externality effect, i.e., whether it also improves audit quality for foreign auditors' non-U.S.-listed clients. Second, we contribute to the literature on auditor incentives and reputational concerns outside the U.S. With respect to incentives, research suggests that litigation exposure rather than reputational protection drives audit quality outside the U.S. Our findings are consistent with the notion that auditor reputation matters outside the U.S., in that the initial PCAOB inspection has an incremental salutary effect on the foreign auditor's audit quality over and above the effect of the threat of an inspection itself. Finally, our study contributes to efforts to assess the efficacy of the PCAOB international inspection program in improving audit quality. Our findings potentially allow foreign countries and regulators to better assess the desirability (in terms of the favorable audit quality impact for their own domestic investors in non-U.S.-listed public companies) of allowing the PCAOB to conduct inspections in their home countries.

The Oversight Role of Regulators: Evidence from SEC Comment Letters in the IPO Process

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Companies often use an initial public offering (IPO) to raise the capital needed for the expansion and development of the firm. It is also a common investment channel for institutional investors and retail investors. Regulators such as the U.S. Securities and Exchange Commission (SEC) serve an important role in monitoring IPOs. For example, on the eve of the very large IPO of Chinese e-commerce giant Alibaba Group, Senator Robert P. Casey wrote to SEC Chair Mary Jo White, calling upon regulators to redouble their efforts to determine whether companies structured like Alibaba were making proper disclosures and complying with securities regulations. Despite great interest in regulators' role in monitoring and influencing company disclosures, there is little evidence on regulators' role in disciplining the pricing of IPOs, in which a transparent and fair disclosure environment is critical to protecting less informed outside investors. In this study, we examine whether and how the SEC affects IPO firms' price formation.

When a company undertakes its IPO, it is required to file a registration statement with the SEC. Then, after a review of documents, the SEC issues a comment letter that may request the company to provide supplemental information, modify its disclosure or restate the financial statements to correct an error. The SEC may comment at any time during the entire IPO process, which typically consists of several iterations of SEC letters and filing company responses. The process is complete when all issues relating to the filing review are resolved. In the IPO setting, information asymmetry is high, and issuers have strong incentives to draw an overly rosy picture of their stocks (e.g., through inadequate or inappropriate disclosures) to obtain more capital upon issue. Therefore, we examine the role of comment letters in the IPO setting to investigate the

SEC's effects on IPOs. Specifically, we evaluate whether comment letters help to improve the information environment and mitigate hyping during the period from the initial filing date to the final offer date (the IPO waiting period). In other words, we examine whether and how comment letters affect IPO firms' pricing decisions.

Using 659 IPOs for the period 2005 to 2011 in the U.S. market, we find that IPOs with more comment letters are more likely to make price revisions. Our regression results reveal a significant negative relation between signed price changes and comment letters, suggesting that IPO issuers tend to reduce prices when they receive comment letters, and the price reduction is greater when the IPO firm has more comment letter correspondence with the SEC. This finding implies that investors may become less enthusiastic about buying IPO stocks after the IPO firms' disclosures are disciplined through SEC comment letters, and this decrease in investor demand incentivizes issuers to reduce their offering price. Our findings also suggest that SEC comment letters have a more pronounced effect in decreasing the IPO offering price for issuers that are more eager to manipulate the offering price upward through inappropriate disclosures. This finding corroborates our main conclusion.

We further examine IPO long-run performance following the issue date to assess the effectiveness of SEC oversight in constraining issuers' manipulation of IPO offerings. We find that IPOs with more comment letters have similar levels of underpricing and outperform those with fewer comment letters in the long run. This suggests that SEC monitoring constrains IPO issuers' overvaluation attempts and mitigates hyping.

Collectively, our findings indicate that the SEC mitigates IPO hyping through improving IPO firms' disclosure quality, thus providing investors with a more transparent information environment. Our study contributes to the literature on IPO price formation by providing evidence on the disciplining role of SEC comment letters in IPO pricing. In particular, it sheds light on the SEC's oversight role in prompting IPO firms to improve their compliance and disclosure quality in IPO price formation. Our study also contributes to the current debate on whether IPO issuers manage earnings to hype their stocks. Our findings suggest that IPO issuers indeed have strong incentives to mislead outside investors. However, the oversight of the SEC, through its comment letters, helps mitigate IPO hyping.

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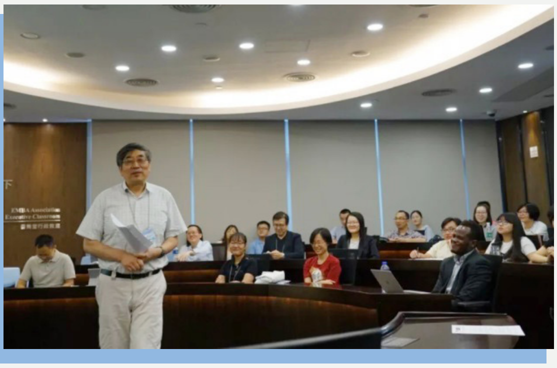

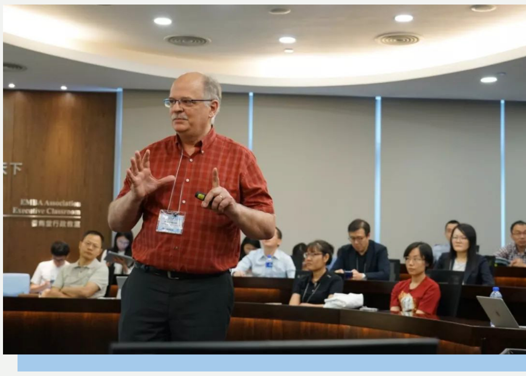

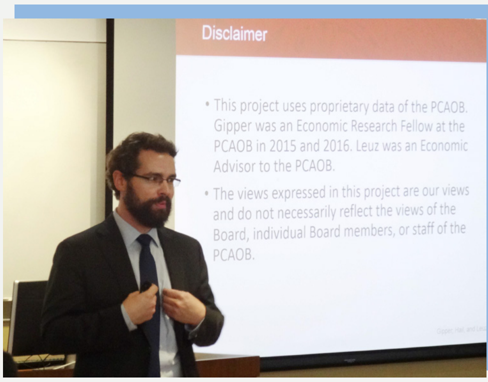

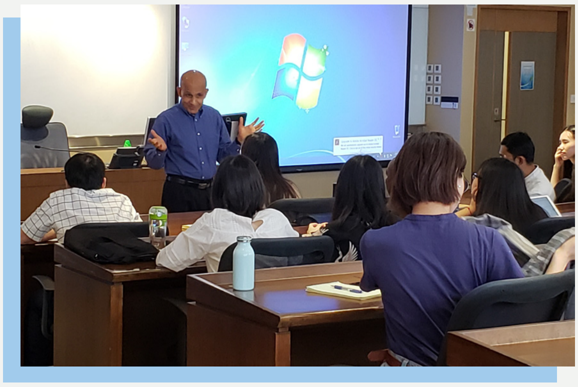

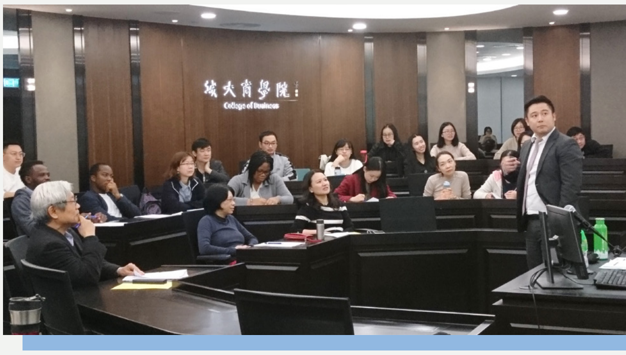

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