

Client Demand and Audit Quality: Evidence from A-Share Firms in China

Wang Yuanyuan^{1*} Chaiyot Sumritsakun² Arunee Yodbutr³ Thatphong Awirothananon³

Abstract

This study examines the relationship between client demand attributes and audit quality in the Chinese capital market. Drawing on 2,878 firm-year observations of A-share listed companies from 2021–2023, audit quality is proxied by discretionary accruals estimated using the Modified Jones Model. Client demand is operationalized through incentive factors (dividend policy and firm value) and competency factors (board independence and directors' remuneration). The baseline results reveal that client-demand attributes exert only a limited influence on audit outcomes. The heterogeneity analysis further indicates that these attributes remain largely insignificant among state-owned enterprises (SOEs), whereas board independence plays a modest role in constraining earnings management in non-SOEs. Robustness tests using signed discretionary accruals confirm the stability of the findings and additionally suggest that dividend policy may mitigate managerial discretion when the direction of accruals is considered. This study contributes to the auditing literature by delineating the boundary conditions under which client demand affects audit quality and offers practical implications for regulators and investors in emerging markets.

Keywords: Agency theory, Audit quality, Reputation theory

Introduction

The importance of audit quality in China's capital markets cannot be overstated. As the Shanghai and Shenzhen stock exchanges have expanded rapidly, with increased complexity and greater international integration, high-quality audits have become foundational to reliable financial reporting. Robust audits directly shape investor confidence, promote efficient capital allocation, and safeguard market stability by mitigating the risks of financial misstatements and fraud (DeFond & Zhang, 2014; Francis, 2011). Conversely, weak audit quality erodes trust, raises the cost of capital for firms, and threatens both corporate governance and financial market integrity (Carcello, Hollingsworth, & Mastroliia, 2011). Sustaining rigorous audit standards is therefore critical to the transparency and credibility of China's evolving capital markets.

¹ Graduate student, Faculty of Business Administration, Maejo University, Thailand

² Associate Professor, Faculty of Business Administration, Maejo University, Thailand

³ Assistant Professor, Faculty of Business Administration, Maejo University, Thailand

* Corresponding Author e-mail: h20190912@csuoft.edu.cn

China's regulatory environment has undergone substantial reforms in the past two decades. Initiatives by the Ministry of Finance and the China Securities Regulatory Commission (CSRC) have targeted auditor independence, market discipline, and alignment with international norms. Such reforms include the post-2000 restructuring of audit firms, tightened inspections between 2014 and 2016, and, most recently, the expansion of cross-border oversight following renewed Public Company Accounting Oversight Board (PCAOB) access in 2022 (He, Pittman, Rui, & Wu, 2017; Lennox & Wu, 2022). Despite progress, persistent challenges—such as uneven enforcement, historically weak litigation risk, and governance practices that often emphasize formal compliance over substantive independence—limit the deterrent effect of regulation (Firth, Mo, & Wong, 2012). Unlike the US or EU, where litigation and strong investor protections reinforce auditor accountability (Christensen, Hail, & Leuz, 2016), China relies more heavily on regulatory oversight and reputational mechanisms. These institutional differences highlight the need to examine the demand-side drivers of audit quality, rather than focusing exclusively on auditor-side supply factors.

This study contributes to the previous literature in several ways. Firstly, it shifts attention from the auditor's supply of quality (e.g., Big 4 expertise, auditor size) to client demand for quality, an underexplored but theoretically significant determinant. Agency theory posits that managers face incentives to expropriate shareholder wealth, and high-quality audits serve to mitigate such agency costs by constraining earnings management and improving transparency (Jensen & Meckling, 1976; Watts & Zimmerman, 1986). Reputation theory further suggests that firms with higher growth opportunities or market visibility (proxied by Tobin's Q) are motivated to demand rigorous audits to sustain external credibility (DeAngelo, 1981). Quasi-rent theory highlights that long-term relationships between clients and auditors create incentives for both sides to protect future rents, reinforcing the demand for higher-quality audits (Klein & Leffler, 1981). By integrating these theoretical perspectives, this study explores how internal corporate governance mechanisms—dividend payout, firm value, board independence, and executive remuneration—generate managerial incentives to demand audit quality in China.

Secondly, this paper places the Chinese experience in an international context. Evidence from developed and emerging markets shows that client-side incentives play a critical role in shaping audit outcomes. Persakis and Iatridis (2016) report that during and after the global financial crisis, countries with stronger investor protection experienced higher audit quality, which in turn enhanced earnings quality. This underscores how institutional environments reinforce the governance role of auditing. Similarly, Trinh (2022), using panel data from 76 countries, shows that firms operating in high-quality financial reporting environments are more likely to increase dividend payouts, suggesting that governance mechanisms such as dividend policies interact closely with reporting quality on a global scale. Furthermore, Bakri (2021) demonstrates that audit quality strengthens the positive relationship between dividend payouts and firm value, highlighting the audit function as a governance lever that links corporate financial policies with

market outcomes. By drawing on such recent international evidence, this study highlights both the convergence and divergence of China's audit quality dynamics relative to global norms.

Thirdly, using firm-level panel data from 2021–2023, this study captures audit quality determinants during a period of heightened regulatory tightening, economic uncertainty, and post-COVID capital-market volatility. Focusing on firms listed on the Shanghai Stock Exchange (SSE) A-share market, the analysis controls for a consistent domestic regulatory framework and avoids the confounding effects of cross-listings. Additionally, by restricting the sample to audits conducted by China's top 20 audit firms, this study ensures that audit outcomes reflect interactions between client-side demand and reputable auditors with strong technical and reputational capacity (Chen, Sun, & Wu, 2010; He et al., 2016; Chen, Jiang, & Xu, 2022).

Ultimately, this paper contributes to the international auditing literature by demonstrating how client demand-side incentives—embedded in corporate governance and financial policies—serve as crucial drivers of audit quality in an emerging market context. Beyond extending the existing theory to China, the findings provide practical implications for regulators, boards, and investors, underscoring the importance of strengthening internal governance mechanisms to complement external regulatory oversight in sustaining credible financial reporting.

Research Objectives

This study seeks to deepen understanding of the demand-side determinants of audit quality in China's A-share market by pursuing the following objectives:

1. To evaluate whether client incentives—as captured by dividend payout ratios and firm value (Tobin's Q)—effectively constrain earnings management and improve audit quality.
2. To examine how client competencies—including board independence (percentage of non-executive directors) and directors' remuneration—influence firms' capacity to demand and benefit from high-quality audits.

These objectives establish the foundation for the empirical analysis that follows, providing a structured approach to exploring how corporate governance and market incentives shape audit quality in China's dynamic capital-market environment.

Literature Review and Hypotheses Development

Audit Quality and Client Demand

Audit quality is widely regarded as a cornerstone of capital-market integrity, particularly in emerging economies such as China, where the rapid expansion and complexity of market activities often outpace the development of effective enforcement mechanisms. While prior research has predominantly emphasized auditor-side attributes—such as firm size, industry specialization, and professional reputation—recent studies increasingly recognize that clients are not passive recipients of audit services. Instead, they actively co-produce audit quality through governance

structures, incentive mechanisms, and reputational considerations. In institutional environments characterized by weak investor protection and limited litigation risk, understanding client demand becomes especially critical for sustaining credible financial reporting.

Defining Client Demand: Incentives and Competencies

Client demand for audit quality is conceptualized in this study as a two-dimensional construct, comprising the motivation to demand higher quality (incentives) and the capacity to realize that demand (competencies). This distinction reflects the idea that while some firms may have strong reasons for seeking credible audits, only those with sufficient governance capabilities can effectively ensure that such demand is met.

Incentives (Why Firms Demand Quality)

Monetary incentives. Dividend policy restricts managerial discretion over free cash flow and signals financial discipline, thereby increasing the marginal benefits of rigorous external audits. Firms with higher dividend payout ratios are more accountable to shareholders, which strengthens their incentives to ensure the credibility of reported earnings. In line with prior research, this dimension is measured here using the log of the dividend payout ratio (Farinha & Moreira, 2017).

Reputation incentives. Firms with greater market value and visibility face heightened scrutiny from analysts, investors, and regulators. The reputational costs of financial reporting failures are disproportionately higher for these firms, motivating them to secure high-quality audits to safeguard market credibility. This dimension is proxied with Tobin's Q, consistent with prior governance and auditing studies (Masulis et al., 2012; He et al., 2017).

Together, monetary and reputation incentives explain why firms are motivated to demand higher-quality audits.

Competencies (How Firms Realize That Demand)

Board monitoring capacity. Even if firms have strong incentives, their ability to enforce higher audit quality depends on governance capacity. A higher proportion of non-executive directors (NED%) strengthens the board's independence and monitoring effectiveness, enabling directors to challenge management and demand more rigorous audit processes. This study follows Carcello et al. (2011) and Li and Xu (2020) in using NED% as a proxy for monitoring capacity.

Director incentive alignment. Effective oversight also requires directors to be sufficiently motivated. Competitive and performance-based remuneration packages can attract capable directors and incentivize them to engage actively in monitoring activities, including audit oversight. This capacity is captured here using the log of total directors' remuneration, consistent with Bryan and Mason (2020) and Lin and Hwang (2023), who document that director compensation enhances monitoring intensity.

Thus, competencies reflect how firms convert their underlying motivation into effective demand for audit quality.

Theoretical Underpinnings

Agency theory emphasizes conflicts of interest and information asymmetry between principals and agents. External auditing functions as a monitoring mechanism that reduces residual losses by disciplining managerial reporting choices. Dividend policy and board oversight both shape the strength of such monitoring demand.

Reputation theory highlights the disciplining effect of market scrutiny. High-reputation firms face stronger pressures to maintain credibility, while auditors safeguard their own reputational capital by resisting compromises in audit quality. Accordingly, the interaction of client incentives and competencies with auditor supply generates observable cross-sectional variation in audit outcomes.

Hypotheses Development

Based on the above conceptualization and empirical design—in which higher audit quality corresponds to lower absolute discretionary accruals ($|DA|$)—the following hypotheses are proposed:

H1 (Monetary incentives). Firms with higher dividend payout ratios exhibit lower $|DA|$, reflecting stronger demand for audit quality.

H2 (Reputation incentives). Firms with higher Tobin's Q exhibit lower $|DA|$, consistent with reputational motivations for credible reporting.

H3 (Board monitoring capacity). A higher proportion of NED% is associated with lower $|DA|$, consistent with stronger board monitoring capacity.

H4 (Director incentive alignment). Higher total directors' remuneration is associated with lower $|DA|$, reflecting stronger incentives for active oversight.

Conceptual Framework

Figure 1 illustrates the framework. Client Incentives (dividends; firm value) and Client Competencies (NED%; director remuneration) jointly determine client demand for audit quality, which in turn reduces opportunistic accruals (lower $|DA|$). Standard firm-level controls (size, leverage, auditor tenure, SOE status, firm and year fixed effects) and auditor-side attributes (e.g., Big 4/top-20 capacity) are included to isolate demand-side variation. The Chinese A-share market provides a particularly suitable context: rapid market deepening, evolving regulatory oversight, and heterogeneous governance practices create meaningful variation in both incentives and competencies.

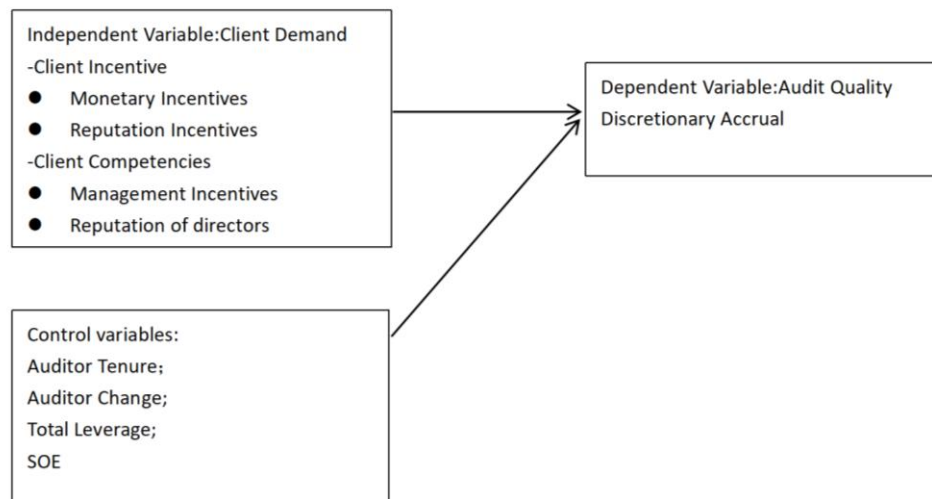


Figure 1. Conceptual framework

Methodology

Data Collection and Sample

This study uses panel data covering A-share companies listed on the SSE from 2021–2023. The SSE offers a consistent regulatory environment with standardized financial reporting requirements, ensuring comparability across firms.

Data are primarily sourced from the China Stock Market and Accounting Research (CSMAR) database, providing detailed financial statement data, corporate governance disclosures, and market valuation indicators. Additional information on audit firm rankings, size, and staffing characteristics is obtained from the Chinese Institute of Certified Public Accountants (CICPA), which publishes authoritative statistics on audit firm performance and reputation.

Consistent with prior auditing research, financial firms and companies designated as Special Treatment or Particular Transfer (ST/PT) are excluded due to their distinct regulatory requirements and abnormal reporting incentives.

Sample scope and justification. The analysis is restricted to audits conducted by the top-20 audit firms ranked by the CICPA. These firms dominate the listed-company audit market and are characterized by greater technical capacity, stronger reputational stakes, and more reliable disclosure practices. Small firms often lack consistent quality or scale, confounding audit-quality measurement. To address potential selection concerns, sensitivity tests are implemented: (i) re-estimating models including all auditors, (ii) adding a Big 4 dummy and auditor fixed effects, and (iii) comparing the observable characteristics of included versus excluded firms. Results are robust across specifications.

Period justification. The study period (2021–2023) corresponds to a phase of regulatory tightening and post-COVID market volatility, when investor scrutiny of reporting credibility was

particularly heightened. This homogeneous regulatory environment minimizes confounding from earlier institutional transitions while retaining meaningful cross-sectional variation.

Measurement of Audit Quality

Audit quality is proxied by $|DA|$, estimated using the Modified Jones Model (Dechow et al., 1995; Kothari et al., 2005). Total accruals are adjusted for expected normal components—based on changes in revenues and property, plant, and equipment—leaving the abnormal portion subject to managerial discretion. The absolute value captures both income-increasing and income-decreasing earnings management, with higher $|DA|$ values indicating lower audit quality.

All accrual measures are standardized and winsorized at the 1st and 99th percentiles to mitigate the influence of outliers and ensure normality for regression analysis.

Robustness of audit-quality measurement. To ensure inferences are not driven by a single proxy, robustness checks include: (i) signed DA, (ii) modified audit opinion incidence, and (iii) real earnings management indicators (abnormal CFO, production costs, discretionary expenses). These complementary measures strengthen the validity of the findings.

Measurement of Client Demand Attributes

To operationalize client demand for audit quality as a multidimensional construct, this study distinguishes between incentives (motivation to demand) and competencies (capacity to realize this demand).

Client Incentives (Motivation)

Log Dividend Payout Ratio ($\log_dividend_ratio$). Natural logarithm of dividends/net income (offset for zeros). Firms that commit to higher dividend payouts constrain managerial discretion over free cash flow and signal credible demand for transparent reporting (La Porta et al., 2000).

Log Firm Value ($\log_Tobin's\ Q$). Natural logarithm of Tobin's Q, calculated as (market value of equity + book value of debt)/book value of assets. Higher values indicate reputational incentives and greater sensitivity to stakeholder scrutiny.

Client Competencies (Capacity)

Percentage of Non-Executive Directors ($percentage_NEDs$). Proportion of board seats held by NED, reflecting monitoring capacity and governance oversight (Bae et al., 2021). This study emphasizes that NED% is a proxy for board monitoring capacity, not a full measure of “board independence.”

Log Directors' Remuneration ($\log_remuneration$). Natural logarithm of total directors' cash compensation. Higher remuneration, particularly if performance-linked, reflects stronger incentive alignment with shareholders and greater ability to demand credible audit outcomes (Krishnan, 2005; Bryan & Mason, 2020).

Data for these variables are collected from the CSMAR governance modules and annual reports. All continuous variables are log-transformed to address skewness and align with econometric practice.

Control Variables

To address omitted-variable concerns and enhance explanatory power, the set of control variables is extended beyond leverage, auditor change, auditor tenure, and SOE ownership. Specifically adding: log total assets (firm size), ROA (profitability), PE ratio (market valuation), and revenue growth rate (growth opportunities). These variables are widely used in prior auditing and earnings management research and help capture the firm fundamentals associated with accrual behavior.

Table1 presents all variable definitions and measurements

Table 1. Variable definitions and measurement

Variable	Definition and Measurement	Reference(s)
Abs_DA	Absolute discretionary accruals, estimated using the Modified Jones Model with Kothari performance adjustment, winsorized at 1% and 99%. Higher values indicate lower audit quality.	DeFond and Zhang (2014); Chen, Hribar, and Melessa (2018)
Signed_DA (robustness)	Discretionary accruals without absolute transformation. Positive values indicate income-increasing accruals, negative values indicate income-decreasing accruals.	Chen, Hribar, and Melessa (2018)
Log Dividend Payout Ratio	Natural log of (cash dividends/net income). Proxy for monetary incentives, constraining free cash flow, and signaling transparent reporting.	Farinha and Moreira (2017); Chen, Kim, and Yao (2021)
Log Firm Value (Tobin's Q)	Natural log of (market value of equity + book value of debt)/book value of assets. Proxy for reputation incentives, capturing market scrutiny and reputational costs of low-quality reporting.	Masulis, Wang, and Xie (2012); He, Pittman, Rui, and Wu (2017)

Table 1. Variable definitions and measurement (Cont.)

Variable	Definition and Measurement	Reference(s)
Percentage of Non-Executive Directors (NED%)	Proportion of board seats held by non-executive directors. Proxy for board monitoring capacity, indicating governance oversight strength.	Bae, Kang, and Wang (2021); García-Ramos and Díaz (2021)
Log Directors' Remuneration	Natural log of total directors' annual cash compensation. Proxy for incentive alignment, reflecting the ability to attract and motivate directors.	Bryan and Mason (2020); Conyon, He, and Zhou (2015)
Log Total Assets (Firm Size)	Natural log of total assets. Controls for firm scale and visibility, which may constrain earnings management.	Francis, Hasan, and Wu (2013); Chen, Li, and Zou (2021)
ROA (Profitability)	Net income/total assets. Captures firm performance incentives related to accrual behavior.	Huang, Rose, and You (2021); Yu and Zhang (2023)
PE Ratio (Valuation)	Price-to-earnings ratio, measured as share price/EPS (or market value/net income). Controls for market expectations and reputational costs of poor reporting.	Chen, Kim, and Yao (2021); Lin and Hwang (2023)
Revenue Growth	Year-over-year percentage change in operating revenue. Controls for growth opportunities and financing-related reporting incentives.	Li and Xu (2020); Zhou, Chen, and Xu (2022)
Log Total Leverage	Natural log of total liabilities/total assets. Captures financial risk and incentives for earnings management.	Francis, Hasan, and Wu (2013); Chen, Li, and Zou (2021)

Table 1. Variable definitions and measurement (Cont.)

Variable	Definition and Measurement	Reference(s)
Auditor Change	Dummy = 1 if the client switches auditors in year t. Controls for opinion shopping and disruption in engagement.	Lennox and Wu (2018); Li, Qi, Tian, and Zhang (2021)
Log Auditor Tenure	Natural log of consecutive years with the same auditor. Reflects learning benefits but also potential independence concerns.	Chi, Huang, Liao, and Xie (2018); Knechel and Sharma (2020)
SOE Ownership	Dummy = 1 if the firm is state-owned. Captures institutional and political influences on governance and audit demand.	Gul, Ma, and Lai (2017); Hu, Tam, and Tan (2022)

Econometric Model Specification

The empirical analysis employs fixed-effects panel regression to control for unobserved, time-invariant firm-specific heterogeneity. Year fixed effects are also included to account for macroeconomic and regulatory changes over time.

Two nested models are estimated:

- Model (0) includes only controls and fixed effects.
- Model (1) adds the four client-demand variables.

Changes in adjusted R², AIC, and BIC indicate the incremental explanatory power of client demand.

Model (0): Controls only + Firm and Year Fixed Effects

$$|DA|_{it} = \beta_0 + \beta_5 \cdot \text{Size}_{it} + \beta_6 \cdot \text{ROA}_{it} + \beta_7 \cdot \text{PE}_{it} + \beta_8 \cdot \text{Growth}_{it} + \beta_9 \cdot \text{Leverage}_{it} + \beta_{10} \cdot \text{AuditorChange}_{it} + \beta_{11} \cdot \text{AuditorTenure}_{it} + \beta_{12} \cdot \text{SOE}_{it} + \mu_i + \lambda_t + \epsilon_{it}$$

Model (1): Controls + Client-Demand Variables + Firm and Year Fixed Effects

$$|DA|_{it} = \beta_0 + \beta_1 \cdot \text{DividendRatio}_{it} + \beta_2 \cdot \text{TobinsQ}_{it} + \beta_3 \cdot \text{DirectorsRemuneration}_{it} + \beta_4 \cdot \text{NEDs}_{it} + \beta_5 \cdot \text{Size}_{it} + \beta_6 \cdot \text{ROA}_{it} + \beta_7 \cdot \text{PE}_{it} + \beta_8 \cdot \text{Growth}_{it} + \beta_9 \cdot \text{Leverage}_{it} + \beta_{10} \cdot \text{AuditorChange}_{it} + \beta_{11} \cdot \text{AuditorTenure}_{it} + \beta_{12} \cdot \text{SOE}_{it} + \mu_i + \lambda_t + \epsilon_{it}$$

Symbols and Variable Notes

β_k : Regression coefficient (k denotes the parameter index)

μ_i : Firm fixed effects (time-invariant firm-specific heterogeneity)

λ_t : Year fixed effects (macro and regulatory shocks)

ϵ_{it} : Error term

DividendRatio_{it}: log_dividend_ratio (natural log of dividend payout ratio)

TobinsQ_{it}: log_company_value (natural log of Tobin's Q)

DirectorsRemuneration_{it}: log_remuneration (natural log of directors' cash compensation)

NEDs_{it}: percentage_NEDs (proportion of non-executive directors)

Size_{it}: log_total_assets (natural log of total assets)

ROA_{it}: roa(return on assets)

PE_{it}: pe_ratio(price-to-earnings ratio)

Growth_{it}: revenue_growth(year-over-year revenue growth)

Leverage_{it}: total_leverage or log_total_leverage (financial leverage)

AuditorChange_{it}: change_firm (dummy = 1 if the firm switched auditors)

AuditorTenure_{it}: auditor_tenure or log_auditor_tenure (length of the auditor-client relationship)

SOE_{it}: soe (dummy = 1 if the firm is state-owned)

Heterogeneity Analysis

Subsample analyses are further conducted on state-owned enterprises (SOEs) versus non-SOEs. Prior studies suggest that SOEs face weaker capital-market discipline but stronger political oversight, while non-SOEs are more reliant on investor trust and external financing. Client-demand effects are therefore expected to be more pronounced among non-SOEs. The results confirm this pattern: demand-side attributes such as board monitoring capacity and dividend payouts are more strongly associated with audit quality in non-SOEs, whereas effects are attenuated or insignificant among SOEs.

Robustness Checks

To justify the measurement choice, this study follows the auditing literature that uses abnormal (discretionary) accruals as an outcome-based, inverse proxy for audit quality. The idea is that higher-quality audits constrain opportunistic accruals and thus reduce the magnitude of discretionary accruals (DeFond & Zhang, 2014; Francis, 2011). This proxy is widely adopted when direct inspection scores or restatement data are unavailable or incomplete, including recent studies in China and other markets (He, Pittman, Rui, & Wu, 2016). Consistent with best practice, discretionary accruals are estimated using the Modified Jones Model with performance adjustment, taking the absolute value ($|DA|$) as the primary measure (capturing both income-increasing and income-decreasing discretion), winsorizing variables at the 1st/99th percentiles, and including firm and year fixed effects with firm-clustered errors.

It is acknowledged that accruals-based proxies are noisy and affected by fundamentals, so they should be interpreted cautiously (DeFond & Zhang, 2014). To mitigate this concern, two sets of robustness checks are conducted. The $|DA|$ is replaced with a signed DA to preserve the direction of earnings management; the inferences are unchanged. This step aligns with calls in

recent reviews to corroborate accrual-based results with multiple measures and careful research design (Lennox & Wu, 2022).

Results

Descriptive Statistics and Correlation Analysis

Table 2 presents the descriptive statistics and VIFs of the study variables, while Table 3 reports the pairwise correlations. The mean $|DA|$ is 0.049, with a maximum of 0.533, suggesting notable variation in earnings management across firms. On average, firms pay relatively low dividends (mean log dividend ratio = -1.105), maintain moderate firm value (mean log company value = 0.516), and allocate limited but stable remuneration to directors (mean = 2.763). The proportion of NED averages 38%, while firms are generally large in scale (mean log assets = 22.93). Profitability and market valuation also vary considerably (mean ROA = 5.7%, mean PE ratio = 43.3).

The correlation results in Table 3 show that $|DA|$ is negatively correlated with dividend ratio and firm size, and positively correlated with ROA and firm value, broadly consistent with theoretical expectations. Correlations among explanatory variables are moderate, with the strongest between ROA and firm value ($r = 0.49$). Importantly, the VIF values reported in Table 2 are all below 2.5 (mean VIF = 1.50), well under the conventional threshold of 10, indicating no serious multicollinearity concerns.

Table 2. Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max	VIF
abs_DA	2878	.049	.049	0	.533	
log dividend ratio	2878	-1.105	.699	-10.68	2.218	1.10
log company value	2878	.516	.526	-.492	2.702	2.31
log remuneration	2878	2.763	.041	2.625	2.933	1.46
percentage NEDs	2878	.38	.056	.143	.8	1.02
log_total_assets	2878	22.926	1.446	20.589	27.192	2.11
ROA	2878	.057	.043	.002	.223	1.92
PE ratio	2878	43.319	53.949	3.414	368.487	1.95
revenue growth	2839	.246	.657	-.605	4.069	1.02
total leverage	2878	1.903	2.75	.433	98.634	1.28
change firm	2878	.07	.256	0	1	1.16
auditor tenure	2878	8.813	6.471	1	33	1.15
SOE	2878	.397	.489	0	1	1.49

Table 3. Pairwise correlations

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
(1) abs_DA	1.000										
(2) log_dividend_ratio	-0.091* (0.000)	1.000									
(3) log_company_value	0.169* (0.000)	0.027 (0.147)	1.000								
(4) log_remuneration	-0.015 (0.415)	-0.118* (0.000)	0.001 (0.944)	1.000							
(5) percentage_NEDs	0.026 (0.165)	-0.018 (0.333)	-0.001 (0.968)	-0.079* (0.000)	1.000						
(6) log_total_asset	-0.088* (0.000)	-0.173* (0.000)	-0.459* (0.000)	0.425* (0.000)	0.023 (0.213)	1.000					
(7) ROA	0.198* (0.000)	-0.072* (0.000)	0.486* (0.000)	0.155* (0.000)	0.004 (0.848)	-0.145* (0.000)	1.000				
(8) pe_ratio	0.010 (0.574)	0.231* (0.000)	0.301* (0.000)	-0.141* (0.000)	0.008 (0.667)	-0.239* (0.000)	-0.314* (0.000)	1.000			
(9) revenue_growth	0.078* (0.000)	-0.050* (0.008)	0.003 (0.886)	-0.013 (0.505)	0.034* (0.066)	-0.013 (0.473)	-0.051* (0.007)	0.047* (0.012)	1.000		
(10) total_leverage	-0.063* (0.001)	0.112* (0.000)	-0.122* (0.000)	-0.055* (0.003)	-0.017 (0.357)	0.050* (0.007)	-0.259* (0.000)	0.386* (0.000)	-0.033* (0.075)	1.000	
(11) auditor_tenure	-0.028 (0.135)	0.050* (0.007)	-0.034* (0.066)	0.083* (0.000)	-0.089* (0.000)	0.005 (0.787)	0.004 (0.829)	-0.033* (0.080)	-0.050* (0.007)	0.028 (0.127)	1

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Main Regression Results

Table 4 reports the results of the baseline and extended regression models. Model 1 includes only firm and year fixed effects, serving as a benchmark for assessing explanatory power. This parsimonious specification explains 54.97% of the variation in |DA| ($R^2 = 0.550$; Adj. $R^2 = 0.290$), indicating that unobserved heterogeneity across firms and years already captures a large share of variation in earnings management.

Model 0, which adds standard control variables, shows an improvement in model fit ($R^2 = 0.571$; Adj. $R^2 = 0.318$). The reduction in AIC and BIC values (from -10806.47 and -10800.57 in Model -1 to -10716.85 and -10658.04 in Model 0) indicates a better trade-off between explanatory power and parsimony, confirming the value of including firm-level controls. Among these controls, firm ROA is strongly positive and significant ($\beta = 0.357$, $p < 0.01$), implying that more profitable firms exhibit higher |DA|. Other controls—including leverage, auditor tenure, and auditor change—remain insignificant. Year fixed effects reveal a significant decline in |DA| in 2022 and 2023, consistent with post-pandemic regulatory tightening.

Model 1 further incorporates the four client-demand attributes. The proportion of non-executive directors (percentage_NEDs) is negatively associated with |DA| ($\beta = -0.066$, $p < 0.1$), suggesting that stronger board monitoring constrains earnings management. In contrast, dividend payout ratio, firm value, and directors' remuneration do not exhibit statistically significant associations with |DA|. ROA remains robustly positive and significant ($\beta = 0.366$, $p < 0.01$), while revenue growth attains significance at the 5% level.

Comparing the three models demonstrates the incremental explanatory contribution of client-demand attributes. The inclusion of these variables in Model 1 yields a slight increase in R^2 (from 0.571 in Model 0 to 0.572 in Model 1). Although the magnitude of this improvement is modest, the consistent significance of board monitoring capacity (NED%) highlights that competency-based governance mechanisms matter more for curbing earnings management than incentive-based factors such as dividend policy or firm valuation. This finding aligns with the theoretical view that incentives alone are insufficient unless supported by governance structures capable of enforcing higher audit quality.

Table 4. Main regression results

Variables	Model -1 (Baseline FE only)	Model 0 (Controls only)	Model 1 (Full model)
log_dividend_ratio			-0.0010 (0.79)
log_company_value			-0.0012 (0.85)
percentage_NEDs			-0.0656* (0.068)
log_remuneration			-0.0707 (0.339)
log_total_assets		0.0134 (0.259)	0.0137 (0.238)
ROA		0.3566*** (0.000)	0.3659*** (0.000)
pe_ratio		0.00005 (0.339)	0.00005 (0.292)
revenue_growth		0.0051 (0.054)	0.0052** (0.049)
total_leverage		0.00018 (0.614)	0.00016 (0.652)
change_firm		0.0052 (0.277)	0.0054 (0.253)
auditor_tenure		0.00003 (0.950)	0.00009 (0.865)
SOE		Omitted	Omitted
year 2022		-0.0057** (0.011)	-0.0057** (0.014)
year 2023		-0.0098*** (0.000)	-0.0094*** (0.000)
constant	0.0485(0.000)	-0.278 (0.305)	-0.069 (0.813)
observations	2646	2,646	2,646
R-squared	0.5497	0.571	0.572
Adj. R-squared	0.2896	0.318	0.318
AIC	-10806.47	-10716.85	-10715.25
BIC	-10800.57	-10658.04	-10632.92

Note: Table 4 reports the regression results for Models -1, 0, and 1. The dependent variable is the absolute value of |DA|. Model -1 includes only firm and year fixed effects. Model 0 adds control variables, while Model 1 further includes client demand attributes. Robust

standard errors are clustered at the firm level. ***, *, and * denote significance at the 1%, 5%, and 10% levels, respectively.

Heterogeneity Analysis: SOE vs. Non-SOE

To explore whether ownership type moderates the impact of client demand attributes on audit quality, separate regressions are conducted for SOEs (Columns 1–2) and non-SOEs (Columns 3–4).

For SOEs, the results (Table 5, Columns 1–2) indicate that none of the client-demand variables—dividend ratio, firm value, directors’ remuneration, or board independence—are statistically significant. The only variable consistently associated with $|DA|$ is firm ROA, which remains positive and significant ($\beta = 0.447$, $p < 0.01$). This suggests that in state-owned firms, profitability pressures are more influential in shaping earnings management, while governance and incentive mechanisms play a limited role.

In contrast, for non-SOEs (Columns 3–4), the results show that ROA is again significantly positive ($\beta = 0.321$, $p < 0.01$), but board independence (percentage of NEDs) becomes negatively associated with $|DA|$ ($\beta = -0.104$, $p < 0.1$). This finding implies that external monitoring mechanisms are more effective in constraining earnings management in privately controlled firms, where governance incentives are stronger. Dividend ratio, firm value, and remuneration remain insignificant.

Overall, the heterogeneity analysis highlights that client demand for audit quality is more pronounced in non-SOEs, where board structures exert meaningful influence on constraining earnings management. Conversely, in SOEs, political and institutional factors may overshadow governance mechanisms, reducing the effectiveness of traditional demand-side attributes.

Table 5. Heterogeneity analysis: SOE vs. Non-SOE

Variables	SOE (Model 1)	Non-SOE (Model 2)
log_dividend_ratio	0.00087 (0.858)	-0.0020 (0.687)
log_company_value	-0.0122 (0.400)	0.0013 (0.862)
log_remuneration	-0.1625 (0.087)	0.0514 (0.657)
percentage_NEDs	-0.0845 (0.263)	-0.1035* (0.090)
log_total_assets	0.0245 (0.114)	0.0031 (0.868)
ROA	0.4466*** (0.000)	0.3210*** (0.005)
pe_ratio	0.00084 (0.229)	0.00037 (0.849)
revenue_growth	0.0032 (0.376)	0.0036 (0.074)
total_leverage	-0.00006 (0.808)	0.0010 (0.378)
change_firm	-0.0040 (0.741)	0.0136 (0.128)
auditor_tenure	-0.000001 (0.999)	0.0015 (0.435)
year 2022	-0.0057* (0.070)	-0.0070* (0.057)
year 2023	-0.0084** (0.010)	-0.0128** (0.018)

Table 5. Heterogeneity analysis: SOE vs. Non-SOE (Cont.)

Variables	SOE (Model 1)	Non-SOE (Model 2)
Constant	-0.0894 (0.818)	-0.1544 (0.721)
observations	1,060	1,586
R-squared	0.552	0.576
Adj. R-squared	0.283	0.320

Note: Table 5 presents the heterogeneity analysis results by ownership type. Model 1 includes only SOEs, while Model 2 includes only non-SOEs. The dependent variable is the absolute value of |DA|. Robust standard errors are clustered at the firm level. Year and firm fixed effects are included in all specifications. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Robustness Analysis

To validate the robustness of the main findings, the models are re-estimated by replacing the dependent variable with signed DA, preserving the direction of earnings management. Table 6 presents the results.

In Model 0, which includes only control variables, ROA remains positively and significantly associated with DA ($\beta = 0.422$, $p < 0.01$), while auditor tenure is negatively significant ($\beta = -0.0017$, $p < 0.05$). These results suggest that more profitable firms are prone to greater earnings management, whereas longer auditor tenure helps constrain such practices.

In Model 1, after introducing client-demand variables, the results remain broadly consistent with the baseline. The dividend payout ratio becomes negatively significant ($\beta = -0.0135$, $p < 0.05$), indicating that higher payout policies are associated with lower earnings management when the direction of accruals is considered. Other demand-side proxies, such as firm value, remuneration, and board independence, remain statistically insignificant. ROA continues to be strongly positive and significant, while auditor tenure retains its negative association with DA.

Overall, the robustness analysis confirms that the main conclusions are not driven by the use of absolute accruals. The consistent significance of ROA and auditor tenure across specifications underscores the central role of profitability pressures and auditor experience, while dividend policy shows additional explanatory power when the direction of earnings management is explicitly considered.

Table 6. Robustness test using signed DA

Variables	Model 0 (Controls only)	Model 1 (Full model)
log_dividend_ratio		-0.0135** (0.009)
log_company_value		0.0020 (0.815)
log_remuneration		-0.0906 (0.394)
percentage_NEDs		-0.0754 (0.180)
log_total_assets	-0.0028 (0.841)	-0.0007 (0.960)
ROA	0.4219*** (0.000)	0.3777*** (0.000)
pe_ratio	-0.00012 (0.128)	-0.00076 (0.280)
revenue_growth	0.0044 (0.223)	0.0044 (0.221)
total_leverage	0.00073 (0.203)	0.00079 (0.203)
change_firm	-0.0111* (0.089)	-0.0103 (0.106)
auditor_tenure	-0.0017** (0.033)	-0.0016** (0.046)
year 2022	-0.0115*** (0.000)	-0.0112*** (0.000)
year 2023	-0.0051 (0.194)	-0.0032 (0.397)
constant	0.0804 (0.802)	0.2940 (0.438)
observations	2,646	2,646
R-squared	0.541	0.545
Adj. R-squared	0.271	0.276

Note: Table 6 presents the robustness regressions using signed DA instead of $|DA|$. Robust standard errors are clustered at the firm level. Year and firm fixed effects are included in all specifications. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Discussion and Conclusion

Discussion

This study examines whether client demand—captured by incentive-type attributes (dividend payout, firm value) and competency-type attributes (board monitoring capacity via NED%, and directors' remuneration)—is associated with audit quality for SSE firms from 2021—2023. Across specifications, evidence of a systematic, direct effect of client demand on audit quality is partial and context-dependent. The incremental fit of models that add demand-side variables over controls is small, and most coefficients are economically modest. An interpretation of the main patterns and their plausibility in China's post-COVID, tightening-regulation environment is presented below.

Incentive-Type Attributes

Dividend payout. In robustness models that use signed DA, a higher dividend payout ratio is linked to lower earnings management. This is consistent with Agency Theory: dividends reduce free cash flow, lowering managers' ability to fund opportunistic actions. It also aligns with

reputation theory: a stable payout policy signals credible commitment to transparent reporting. The absence of strong significance in the $|DA|$ baseline likely reflects the short three-year window (limited within-firm payout variation) and the fact that $|DA|$ masks direction, whereas dividends mainly discipline income-increasing manipulation.

Firm value (Tobin's Q). Tobin's Q is statistically weak in the main $|DA|$ model, but turns out to be positively related to signed DA. Rather than contradicting theory, this pattern is plausible in China's high-growth setting: high-valuation firms face intense market pressure to sustain performance narratives. Reputation incentives can therefore increase short-term reporting aggressiveness (income-increasing accruals) even while such firms invest in external assurance. The tension between reputational discipline and growth pressure helps explain why a simple, monotonic "higher Q $\rightarrow$ better audit outcomes" relationship does not emerge.

Competency-Type Attributes

Board monitoring capacity (NED%). The percentage of NED is marginally negative in the full model, and more pronounced among non-SOEs, suggesting that stronger board oversight can dampen earnings management where ownership is less politicized. Importantly, NED% is a proxy for monitoring capacity, not the same thing as "board independence." In China, minimum independence requirements, concentrated ownership, affiliated directors, or political appointments can weaken the link between a higher NED share and genuine independence. Measurement attenuation (count share vs. expertise, attendance, or committee clout) likely further mutes the coefficient.

Directors' remuneration. Total board pay is statistically insignificant. Two forces can offset a disciplinary effect: (i) remuneration is tightly tied to firm size/complexity (captured by controls), and (ii) pay structures may be level-heavy rather than incentive-heavy, limiting alignment with audit quality objectives. Disclosure granularity (e.g., lack of contract design details) also introduces noise.

Controls, Short Window, and Audit Tenure Results

ROA consistently exhibits a positive association with $|DA|$. This finding is consistent with prior evidence suggesting that more profitable firms have both stronger incentives to manage earnings and greater accrual-based opportunities to do so. The result highlights that profitability, while a signal of operational success, can simultaneously create pressures that increase the likelihood of earnings manipulation.

Audit tenure is close to zero or weakly negative across specifications. This outcome is not unexpected for two reasons. Firstly, the relatively short three-year sample period provides limited within-firm variation in auditor tenure once firm fixed effects are absorbed. Secondly, the effects of tenure are theoretically ambivalent: longer engagements may enhance audit quality through auditor learning and accumulated client-specific expertise, yet may simultaneously erode independence due to familiarity threats. These offsetting mechanisms plausibly converge into an

overall insignificant coefficient in the study sample. In the few instances where the coefficient is negative, the result is consistent with the dominance of the learning effect, particularly in engagements involving large, top-20 audit firms with greater technical capacity.

Ownership Heterogeneity

Splitting by ownership shows that demand-side proxies have a limited role in SOEs, whereas NED% becomes more (marginally) effective among non-SOEs. In SOEs, multiple objectives and political oversight can dominate market and governance incentives, attenuating the transmission from client demand to audit outcomes. In private firms, boards are relatively more responsive to reputational and contracting pressures, making monitoring capacity more relevant.

Robustness and What It Means

Replacing absolute $|DA|$ with signed DA preserves the main messages and clarifies mechanisms: dividend payout turns significantly negative (consistent with agency discipline when direction matters), while Tobin's Q becomes positive (consistent with growth pressure narratives). Results also remain stable across alternative fixed effects and clustering choices. Together, these checks indicate that conclusions are not an artifact of a single specification, but they also underscore that effects are modest in size.

What the Evidence Supports and What It Does Not

Overall, the data provide partial support for the role of client demand in enhancing audit quality. Governance competencies (board monitoring capacity) appear more reliably associated with lower earnings management than incentive proxies, and even that effect is contingent on ownership. This study, therefore, refrains from claiming a universal, strong demand-side effect. In China's institutional setting—with tightened regulation, disclosure standardization, and top-20 auditor dominance—auditor-side forces and system-level pressures may crowd out cross-sectional variation in client demand.

Implications for Theory and Practice

Theory. Findings align with Agency and Reputation theories but highlight boundary conditions: reputational incentives can raise manipulation pressure for high- Q firms, and formal independence (NED%) is not equivalent to effective monitoring. Future models should allow for competing reputational forces and measure board capacity beyond headcount.

Practice. For regulators, dividend policy can function as a credible commitment device; monitoring its interaction with performance-linked pay may strengthen governance. For boards, raising NED% is insufficient—expertise, committee authority, and meeting intensity are key. For investors, a high valuation should not be read as an audit-quality signal without corroborating governance indicators.

Conclusion

This study contributes to the literature on audit quality and corporate governance in several ways. Firstly, by disentangling client demand into incentive- and capacity-based

dimensions, this study provides nuanced evidence on the limited role of demand-side attributes in influencing audit outcomes in the Chinese setting. Secondly, by highlighting the consistent significance of profitability and auditor tenure, the findings of this study emphasize the primacy of financial performance pressures and auditor learning effects in determining audit quality. Thirdly, the heterogeneity analysis enriches the understanding of the ownership effect, showing that governance attributes matter more to non-SOEs, whereas institutional and political influences dominate in SOEs.

Despite these contributions, this study is subject to several limitations. The sample is restricted to 2,878 firm-year observations from 2021–2023, which may limit the generalizability of the findings beyond this period and context. Audit quality is primarily measured by $|DA|$, which, although widely used, may not capture its multidimensional nature. The proxies for client demand—dividend policy, firm value, directors’ remuneration, and board independence—are simplified and may omit other relevant governance or disclosure factors. In addition, despite robustness checks being conducted, potential endogeneity concerns cannot be fully eliminated.

These limitations provide opportunities for future research. Longer time horizons, alternative measures of audit quality (e.g., restatements, inspection outcomes, or audit opinions), and broader governance indicators could yield deeper insights. Comparative studies across emerging and developed markets may further clarify the institutional boundary conditions under which client demand shapes audit quality. Although the main analysis focuses on the top 20 firms dominating the Chinese audit market, future research could extend the scope to smaller auditors, who may experience different client demand pressures and governance environments.

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