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Social trust and the client-auditor mismatch relationship

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Abstract: This paper examines the relationship between social trust and the demand for high-quality audits of listed companies from the perspective of informal system, taking A-share listed companies in China as a sample from 2010 to 2019. The findings social trust level is higher when the client company and auditor are more inclined to show an upward mismatch relationship. The above findings remain robust after replacing key variables and overcoming endogeneity issues. This paper enriches the research on the economic consequences of social trust and the factors influencing auditor choice, and is instructive in revealing the role of informal institutions in corporate governance and in improving audit oversight governance.

1. Preface

Trust, as an informal system, is one of the important social capitals that can play the role of "lubricant" for social systems[1]. Current research shows that informal institutions play an important role in promoting China's economic development [2], and trust is also considered to be the main social capital that determines a country's economic growth and social progress, in addition to physical and human capital [3]. Existing studies have shown that trust has a facilitating effect on the economic growth and financial development of a region at the macro level[4] . Also at the micro level, trust can have an impact on aspects such as corporate governance and investment decisions [5].

As a formal institutional arrangement, independent auditing is an important bridge between internal companies and external investors, and audit quality is widely concerned in both academic and practical circles[6]. Independent auditing is an external self-restraint mechanism chosen by companies to reduce information asymmetry with investors and creditors, while social trust is a self-restraint formed spontaneously by both parties to a debt contract. The former can be viewed as a formal system based on legal mandatory requirements, while the latter is an informal system formed by society over time. Previous studies have mainly examined auditor selection from the perspective of formal institutions such as policies and laws or the characteristics of business managers, and there is not much literature that examines auditor selection and its consequences from the perspective of informal institutions.

Against this background, this paper examines the relationship between social trust and the demand for high-quality audits of listed companies from the perspective of informal institutions, and examines the impact of the absence of a firm's beneficial owner on the relationship between the two.

2. Theoretical Analysis and Research Hypothesis

2.1 Social Trust and the Client-auditor Mismatch Relationship

Bills states that auditor-client mismatch relationship significantly affects audit quality[7]. This paper argues that the higher the level of social trust in a firm's region, the higher the firm's preference for higher quality auditors, i.e., a matching or upward mismatch in the client-auditor relationship. The rationale for this is that social trust reduces firms' information asymmetry and thus increases the demand for audit quality. Trust, as an informal system, is one of the important social capital, which can play the role of "lubricant" for the social system.Granovetter found that social trust can effectively reduce the information asymmetry between the principal and the agent, constrain the moral hazard behavior of managers, and reduce the cost of supervision[8]. At the same time, trust can enhance the tendency of people in a region to cooperate with each other, thus shrinking negotiation costs and enhancing efficiency instead of the Prisoner's Dilemma-type results caused by mutual suspicion[9] .At the same time, social trust, as a social environmental factor, guides people in a society to follow the behavioral norms that are accepted by the majority in such an environment[10].

Based on the above analysis, the hypothesis is proposed: H1 Other things being equal, the higher the level of social trust in the region where the enterprise is located, the higher the demand for high-quality audits of the enterprise will be.

2.2 Social Trust, No Actual Controller and Client-auditor Mismatch

As the actual dominator and decision maker of the company's business activities, the characteristics and behavior of the actual controller have been emphasized by the regulatory authorities. However, in recent years, it has been found from corporate disclosure information that some companies appear to have no actual controller. The actual control of such companies is in the hands of professional managers or executives, and in the environment of no actual controller, the executives as rational economic beings will pay more attention to their own self-interests, which leads to a gradual increase in agency costs[11]. External auditing as an effective internal governance alternative reduces the agency cost to a certain extent and alleviates the agency problem. Enterprises without real controllers have a higher demand for auditing services in order to send positive signals to the outside world due to more serious agency problems, so they are more inclined to select and hire large firm auditors, and this situation is more obvious in regions with high social trust.The reason is that in areas with higher levels of social trust, people's moral concepts will be subtly influenced, social integrity and moral awareness will be stronger, they will be more inclined to abide by the values of honesty and trustworthiness, and will be more inclined to fulfill their obligations.Therefore, based on the above analysis, the hypothesis is proposed:

H2: Other things being equal, the absence of actual control of a firm increases the effect of social trust on the client-auditor mismatch relationship.

3. Study Design

3.1 Sample and Data Sources

This paper selects China's A-share listed companies from 2010 to 2019 as the research object. On this basis, this paper made the following treatments in the initial sample selection: (1) in order to avoid the influence of the financial industry and other special industries, excluding the financial industry companies; (2) excluding the ST or ST* companies in the current year; (3) excluding some of the enterprises with serious missing data; (4) in order to eliminate the impact of the extreme values of this paper, all the continuous data using the upper and lower 1% Winsorize shrinkage treatment, and finally The final number of observations is 19790. The financial data in this paper are from CSMAR database, and the social trust data are from "China Urban Business Credit Environment Index (CEI) Blue Book", which are processed and empirically analyzed by Stata15.0.

3.2 Model Setting and Variable Definition

3.2.1 Measurement of the Client-auditor Mismatch Relationship

This paper draws on the relevant indicators and models of existing studies to measure the mismatch relationship between clients and auditors. The measurement result mismatch_big10 indicates that there is a mismatch relationship between clients and auditors, which is defined as a value of 1 when the client-auditor relationship is upward mismatch, and a value of -1 when the client-auditor relationship is downward mismatch, or 0 otherwise.

3.2.2 Social Trust

The main explanatory variable is social trust (GRADES). In this paper, the city-level indicator in the China Urban Business Credit Environment Index (CEI) is chosen as an indicator of social trust. The larger the value of this indicator, the higher the degree of social trust in the region. In order to eliminate the effect of magnitude, the original indicator is divided by 100 to get the indicator used in this paper.

3.2.3 Control Variables

As mentioned earlier, many firm financial characteristics and management characteristics can have an impact on the client-auditor mismatch relationship. Therefore drawing on existing research, this paper selects firm financial characteristics variables such as firm size (SIZE), return on total assets (ROA), gearing ratio (LEV), cash flow (LR), firm growth (GROWTH), the percentage of sole directors (INDR), two-employment (DUAL), and management shareholding (MSHR), and further controls for the corporate governance variables equity concentration (TOP10). In addition, this paper controls for the variables of the number of years the firm has been listed (LISTYEAR), industry (IND), year (YEAR), and region (AREA).

3.2.4 Multiple Regression Models

This paper utilizes model (1) to test the social trust client-auditor mismatch relationship.

$$Mismatch\_big10 = \beta_0 + \beta_1 GRADES + \beta_i CONTROLS + \sum IND + \sum YEAR + \sum AREA + \varepsilon \tag{1}$$

4. Analysis of Empirical Results

4.1 Descriptive Statistics

This article provides a simple statistical analysis of the required data for the study, but due to limited space, it will not be listed one by one. The results are reserved for future reference.The explanatory variable client-auditor mismatch relationship Mismatch _big10 has a mean value of

0.33, and this result suggests that in the phenomenon of client-auditor mismatch, the clients' willingness to seek high-quality audits is relatively stronger. The maximum value of the explanatory variable GRADES is 0.89, and the minimum value is 0.65, which is a large difference, indicating that there are large differences in the degree of social trust in different regions of China. The statistical results such as the control variable firm size (SIZE) are consistent with the results of most studies.

4.2 Social Trust and Quality Audits

This paper empirically tests the effect of social trust on client-auditor mismatch relationship according to hypothesis H1. Table 1 shows the results of the empirical test of the relationship between social trust and client-auditor mismatch, the first column is the regression results of social trust on client-auditor mismatch relationship without considering other factors, and the second column is the regression results after controlling the influence of relevant variables.The regression coefficients of GRADES are 1.596 and 2.154 respectively, which are significant at 1% level, indicating that the social trust has a positive and significant influence on client-auditor mismatch relationship. Matching relationship has a positive and significant effect, and the degree of positive correlation increases after adding control variables, i.e., the higher the level of social trust, the higher the client-auditor mismatch relationship, and hypothesis H1 is verified.

Table 1: Social trust and high-quality audits

VARIABLES	Mismatch_big10	Mismatch_big10
GRADES	1.596***[5.689]	2.154***[7.538]
CONTROLS	NO	YES
N	19790	19790
r2_p	0.0436	0.0613
chi2	1509	2125

*** p<0.01, ** p<0.05, * p<0.1 the following are the same

4.3 Social Trust, No Real Controller of the Firm and Client-auditor Mismatch Relationship

Table 2: Moderating effect test.

VARIABLES	mismatch_big10
GRADES	2.074***[7.220]
NONACTON_GRADES	3.399*[1.900]
NONACTON	-2.666*[-1.936]
CONTROLS	YES
N	19790
r2_p	0.0613
chi2	2125

To further examine whether the absence of a firm's beneficial owner can affect the relationship between social trust and the client-auditor mismatch relationship, this paper introduces NONACTON × GRADES (No Beneficial Owner and Social Trust Interaction Term). The regression results are shown in Table 2, and the results of the interaction term are significantly positive at the 10% level. It indicates that the relationship between social trust and client auditor mismatch is affected by the firm's no actual controller. In enterprises with relatively dispersed shareholdings or strong self-interested motives of major shareholders, the actual controller plays a supervisory and control effect, effectively stops insider hollowing out motives and self-interested behaviors, reduces collusion and short-sightedness between shareholders and managers, improves the corporate governance environment, and enhances the quality of internal control of the enterprise. Along with the phenomenon of no actual controller comes the exposure and deterioration of corporate internal control deficiencies, and this phenomenon will have a greater impact in areas with a high degree of social trust, so at this time the company needs to be more high-quality audits as a signal to the outside world to send a signal that the company is doing well. Hypothesis H2 is verified.

4.4 Robustness Tests

In this paper, we refer to the existing literature to re-measure the client-auditor mismatch relationship, and the results are significant at the 1% level, and the findings are robust.The regression coefficients of GRADES is 2.904. Due to limited space, the regression results are not presented in tabular form and are kept for future reference.

5. Conclusions and Implications

This paper examines the impact of social trust on the client-auditor mismatch relationship with a sample of China's A-share listed companies from 2010 to 2019, and explains the influencing factors of the client-auditor mismatch relationship from the perspective of social trust as an informal institutional arrangement. The main test uses the city business credit index as a measure of social trust, and the client-auditor mismatch relationship is stronger in places with high levels of social trust. Further tests reveal that the absence of actual control in the firm exacerbates the effect of local social trust on the client-auditor mismatch relationship.

The inspiration of this paper for regulatory policy is that while regulators continue to improve formal institutions such as laws, they should also pay more attention to the role of informal institutions such as trust in the regional community in facilitating high-quality audits.

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