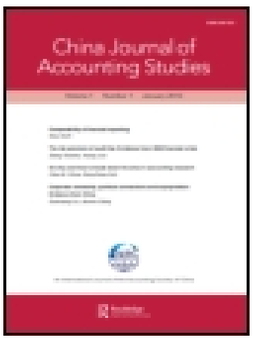

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Hospitality and auditor independence: do gifts blind the eyes?*

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ABSTRACT

In the Chinese audit market, some firms provide hospitality to their auditors. There is a well-known saying in China: 'Gifts blind the eyes and there is no such thing as a free lunch'. The phenomenon provides researchers with a unique setting to examine whether hospitality (proxied by free food and drink) can impair actual auditor independence. Using a sample of Chinese listed firms during the period of 2001–2010, my findings show that hospitality is significantly positively associated with discretionary accruals, and further hospitality is significantly negatively associated with auditors' propensity to issue modified audit opinions. These findings, taken together, imply that some Chinese listed firms compromise auditor independence and establish bonding relations with their auditors via hospitality. This study validates the impairment of hospitality on actual auditor independence, lending important support to the existing ethical standards about hospitality in the auditing profession.

KEYWORDS

Auditor independence; hospitality; free food and drink; discretionary accruals; modified audit opinions

1. Introduction

Conflicts of interest inherent in the audit market cause the erosion of auditor independence (Chu, Du, & Jiang, 2011). Prior studies validate that two major sources impair auditor independence: (1) audit fees dependence (Craswell, Stokes, & Laughton, 2002; DeAngelo, 1981; Ghosh, Kallapur, & Moon, 2009); and (2) the provision of non-audit services (NAS) (Antle, 1984; Antle, Gordon, Narayanamoorthy, & Zhou, 2006; Ashbaugh, LaFond, & Mayhew, 2003; Frankel, Johnson, & Nelson, 2002; Gunz, McCutcheon, & Reynolds, 2009; Weil & Tannenbaum, 2001). However, the impact of bonding relations between auditors and clients established by hospitality on auditor independence is rarely addressed in extant studies. In fact, some firms provide their auditors with free food and drink (referred to hereafter as 'hospitality'), which impair auditor independence. Although a variety of ethical statements (CAJEC, 1996; IFAC, 2001; CICA, 2003; APB, 2004) address the effects of 'hospitality' on auditor independence, the extant literature rarely provides empirical evidence on this issue. As a result, the public know little about whether hospitality can impair auditor independence.

Wang, Su, and Fang (2011) focus on the Chinese context and address whether hospitality (proxied by free food, drink and travel expenses) impairs audit quality. However, owing to

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the potential bias about the measure of hospitality, Wang et al. (2011) do not provide consistent evidence on the negative impacts of hospitality on audit quality. The study by Wang et al. (2011), showing no significant outcome, motivates this study to further address the 'puzzle' about: (1) whether hospitality includes 'free food, drink, and travel expenses' or only covers 'free food and drink'; and (2) whether hospitality proxied by 'free food and drink' impairs audit quality. This study focuses on the Chinese setting to argue that 'free food and drink' is a more appropriate measure of hospitality than 'travel expenses' or 'free food, drink, and travel expenses', and then employs 'free food and drink' as the proxy for hospitality to examine its effects on audit quality.

To assess the influence of hospitality on auditor independence, researchers must obtain a similar case, in which clients provide hospitality to their auditors, as the benchmark of comparison. However, it is difficult for researchers to obtain such a case because there is no statutory requirement for firms or auditors to disclose such information in most countries. Fortunately, the Chinese stock market can provide such a unique setting. Specifically, in China, there is no prohibition in ethical standards on auditors accepting hospitality from clients (Chinese Audit Standards), but the China's Securities Regulatory Commission requires firms to disclose the components of remuneration for audit firms in notes to financial statements. As a result, researchers can investigate the differences in both audit opinions and discretionary accruals between firms with hospitality and their counterparts. Specifically, this study constructs an indicator variable by judging whether a firm provides hospitality to its auditor. If my conjecture that hospitality does impair auditor independence can be supported by empirical evidence on the basis of this indicator variable, then the findings can suggest a tentative conclusion that even a minimal amount of hospitality will cause the impairment of auditor independence at least.

For empirical tests, this study hand-collects data on hospitality in Chinese listed firms over the period of 2001–2010, and then employs the 'propensity score matching' approach to examine whether hospitality impacts discretionary accruals and auditors' propensity to issue modified audit opinions. Briefly, my findings reveal the following aspects: first, hospitality is significantly positively related with discretionary accruals. Second, hospitality is significantly inversely related with auditors' propensity to issue modified audit opinions. These results, taken together, suggest that some firms compromise auditor independence via hospitality to establish bonding relations with auditors.

This study contributes to the existing literature in several ways. First, to my knowledge and the literature in hand, this paper is one of very few, if it is not the first, to use archival data and investigate the influence of hospitality on auditor independence, surrogated by discretionary accruals and audit opinions. Because of data limitations, this issue has been much neglected in previous studies. My study can evoke close attention from scholars to hospitality's influence on auditor independence. My study distinguishes itself from Wang et al. (2011), who investigate the impacts of hospitality, defined as free food, drink and travel expenses, on audit quality. Wang et al. (2011) provide weak evidence about hospitality's positive effect on discretionary accruals, but they find no significant relation between hospitality and modified audit opinions. As a comparison, in this study only 'free food and drink' is included to address the impacts of hospitality on audit quality and auditor independence. The findings show that: (1) hospitality is significantly positively related with discretionary accruals; (2) hospitality is significantly negatively related with auditors' propensity to issue modified audit opinions; and (3) hospitality significantly reduces accounting conservatism.

Second, this study focuses on the influence of auditors' acceptance of hospitality from clients on actual auditor independence. Using the survey and quantitative analysis, Law (2010) finds that the client's provision of hospitality to its auditor has no negative effects on perceived auditor independence. Perceived auditor independence is very important (Pearson, 2005), but actual auditor independence shall never be neglected. In this regard, my study distinguishes itself from Law (2010) by constructing a proxy for hospitality and examining its effects on audit quality.[1]

Finally, extant literature (Law, 2010; Pany & Reckers, 1980) focuses on the contexts of rule-based economies, but little is known about hospitality's influence on auditor independence in the contexts of relation-based economies.[2] This study argues that the familiarity effect or/and the bribe effect between the client and the auditor through hospitality may influence actual auditor independence, adding to the existing literature on auditor independence.

In the second section, this study reviews related literature and develops the research hypothesis. In the third section, this study discusses model specification and variables. In the fourth section, this study reports sample and descriptive statistics. The fifth section reports empirical results and conducts robustness checks. Finally, this study summarises conclusions.

2. Literature review and hypothesis development

2.1. Hospitality in ethical standards and previous literature

Independence is the cornerstone of the auditing profession. Most extant studies focus on the influence of audit fees and financial dependence on auditor independence (Chu et al., 2011; Craswell et al., 2002; DeAngelo, 1981; Ghosh et al., 2009; Gunz et al., 2009). Moreover, most ethical statements such as CAJEC (1996), IFAC (2001), CICA (2003) and APB (2004) address the impacts of hospitality on auditor independence.

APB ethical standard No. 4 (2004) argues that 'where gifts or hospitality are accepted from an audit client, self-interest and familiarity threats to the auditors' objectivity and independence are created' (Par. 44). However, APB ethical standard No. 4 (2004) also emphasises that

> hospitality is a component of many business relationships and can provide valuable opportunities for developing an understanding of the client's business and for gaining the insight on which an effective and successful working relationship depends. Therefore, the auditors' objectivity and independence is not necessarily impaired as a result of accepting hospitality from the audit client, provided it is reasonable in terms its frequency, its nature and its costs. (Par. 46)

[1] Alternatively, the survey method is universal in extant studies (Beattie, Fearnley, & Brandt, 1999; Gendron & Suddaby, 2004), but they rarely focus on the influence of hospitality on actual auditor independence.

[2] Under a relation-based economy, individual behaviour and corporate decisions are largely shaped by personal relations and most transactions are conducted based on personal and implicit agreements, rather than formal contracts (Li, 2003; Li, Park, & Li, 2004). That is, a central feature of relation-based economy is that information is largely local and private, and thus cannot be verified by a third party (Dixit, 2003; Li, 2003; Li et al., 2004). In contrast, a rule-based economy largely relies on public information, namely, publicly verifiable information (Li et al., 2004). Li et al. (2004, p. 66) summarise the differences between relation-based and rule-based economies as follows:

> relation-based economy relies on private and local information, non-verifiable agreements, and person-specific and non-transferable contracts, results in high entry and exit barriers, requires minimum social order, need low fixed costs to set up the system but high and increasing marginal costs to maintain, and roots in small and emerging economies. However, rule-based economy relies on public information, observable agreements, and explicit and third-party verifiable agreements, brings out low entry/exit barriers, requires well-developed legal infrastructure, need high fixed costs to set up the system but low and decreasing marginal costs to maintain this system, and roots in large and developed economies.

Therefore, APB ethical standard No. 4 suggests that

> the audit firm should establish policies on the nature and value of gifts and hospitality that may be accepted from and offered to audit clients, their directors, officers and employees, and should issue guidance to assist partners and staff to comply with such policies. (Par. 47)

In addition, according to the ICANZ Code of Ethics (2003), to maintain independence of mind and independence in appearance, accountants 'must neither accept nor offer hospitality that is reasonably believed to have a significant and improper influence on their professional judgment'. Rules of professional conduct of CICA note that 'accountants shall not accept a gift or hospitality, including a product or service discount, from the client or a related entity, unless the gift or hospitality is clearly insignificant'. IFAC (2001) also requires auditors 'should not accept undue hospitality from the client' (Section 8). CAJEC (1996) prohibits auditors' acceptance of hospitality from the clients unless it is modest. In general, most ethical code statements address hospitality's impacts on the impairment of auditor independence.

In previous studies, Pany and Reckers (1980) find that auditors' acceptance of gifts and discount arrangement (even minimal) brings out the impairment of perceived auditor independence, and thus conclude that the auditing profession should prohibit auditors' acceptance of gifts and discount from clients. Pearson (2005) emphasises the importance of perceived auditor independence. Fern (1985) argues that auditors' accepting gifts from clients always gives the public an impression of bias on auditors. Ramsay (2001) argues that hospitality or gifts on a scale which are not commensurate with normal courtesies of social life, must not be accepted. Strohm (2006) verifies that the acceptance of gifts or hospitality from the client, its directors, or officers results in familiarity threat to auditor independence. Salehi, Mansoury, and Azary (2009) argue that any behaviour in which the auditor receives any gifts and presentations from the client or managers impairs auditor independence. However, using data from both face-to-face interviews and extensive survey, Law (2010) finds that receiving gift or hospitality from clients has no influence on perceived auditor independence.

Overall, in codes of ethics and prior studies, conclusions about whether hospitality influences auditor independence are mixed at best. On the one hand, hospitality is a component of business relationship, which can provide valuable opportunity for auditors to better understand the client's business. In this regard, auditor independence is not necessarily impaired due to auditors' acceptance of hospitality from the audit client. On the other hand, hospitality may lead to the impairment of auditor independence because auditors accepting hospitality from their clients may induce self-interest and familiarity threats to the auditors' objectivity and independence. Therefore, EC7 of Public Company Accounting Oversight Board (PCAOB, 2003) notes that

> no board member or professional staff shall, directly or indirectly, solicit or accept any gift, reimbursement, honoraria or anything of monetary value from any source, which might reasonably be viewed as: (1) interfering with his/her independence, objectivity or responsibilities to the board; or (2) hindering the interest or reputation of the board.

As a result, codes of ethics in the auditing profession do not prohibit auditors' acceptance of hospitality from their clients, provided it is reasonable, clearly insignificant, or commensurate with normal courtesies of social life.

2.2. Hospitality in the Chinese audit market

Hospitality is normal in business life and Chinese culture. However, for the auditing profession, there is no clear prohibition in ethical standards or Chinese Audit Standards (CAS) on auditors accepting hospitality from clients, but hospitality may lead to the impairment of auditor independence.

First, the reputation effect and the litigation effect mitigate the likelihood of auditors accepting hospitality from clients. During the sample period, auditors are confronted with more and more rigorous punishments in China. The Ministry of Finance, China's Securities Regulatory Commission (CSRC), and the Chinese Institute of Certified Public Accountants (CICPA) have promulgated a variety of regulations to discipline audit firms and auditors. Once audit firm and auditors violate laws or regulations, punishments on them will be reported to the public via official websites. For example, the CICPA reports results of year-in-inspection on audit firms on its official websites, and the punishment ratios from 2006 to 2010 are 22%, 24%, 25%, 24% and 23%, respectively (23.6% on average).

Second, in Article No. 3 of 'Disclosure of Remuneration for Audit Firms' of 'the Interlocution about Criteria of Information Disclosure of Companies that Make Initial Public Offering of Stocks' No. 6, CSRC requires listed firms to disclose specific components of remuneration for audit firms in notes to financial statements, including whether a firm provides free food, drink and entertainment.

To sum up, some firms do provide hospitality to their auditor because there is no clear restriction on such behaviour. Moreover, the CSRC requires the disclosure of hospitality, so this study can obtain data on hospitality from notes to financial statements. As a result, hospitality is not widespread in the auditing profession, so only a limited number of cases of hospitality can be observed.

2.3. The component of hospitality in the Chinese context

Hospitality refers to 'generous and friendly treatment of visitors and guests' and specifically, 'the activity of providing food and drinks for people who are the guests or customers of an organisation' (see: https://www.merriam-webster.com/dictionary/hospitality). In this regard, hospitality is composed of free food and drink from its fundamental meanings, although Wang et al.'s (2011) study argues that hospitality covers 'free food, drink and travel expenses'.

Free food and drink are very different from travel expenses (e.g., airfares, hotel/accommodation expenses). In essence, travel expenses belong to explicit contracts, which are individual-specific expenses and thus can be traced to individual auditors or/and audit firms. In addition, travel expenses can be calculated and disclosed in books of accounts separately, and thus are clear and less ambiguous. In other words, it is less likely for client firms to use travel expenses to bribe auditors for the purpose of favourable audit opinions. Comparatively, expenses related with free food and drink can be dominated by implicit contracts, and thus they are always embedded and submerged in a firm's books of accounts. For most cases, it is relatively difficult for researchers to trace expenses related with 'free food and drink'; at least it was before *an 'Eight-Point' Guideline for Fighting Bureaucracy and Formalism and Rejecting Extravagance among Party Members*.[3] Therefore, it can be inferred that, compared

[3]Please refer to the website: http://old.moe.gov.cn//publicfiles/business/htmlfiles/moe/s7469/201307/154479.html.

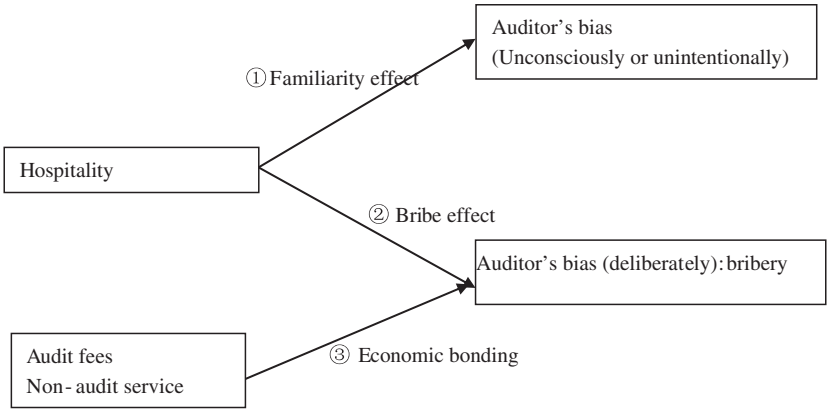

Figure 1. The relation between bias and hospitality.

with travel expenses, 'free food and drink' in China is more likely to elicit the collusion between client firms and auditors, and eventually impairs auditor independence (audit quality).

2.4. The familiarity effect and the bribe effect of hospitality: an analysis framework

The economic consequences of hospitality include both the familiarity effect and the bribe effect. Figure 1 displays the influencing conduits of hospitality on the familiarity effect and the bribe effect, respectively. Next, this study discusses the effects of hospitality on the familiarity and bribe effects.

Hospitality may result in familiarity between the client and the auditor (see in Figure 1), and the acceptance of hospitality from the client or directors brings out the familiarity threat unless the value is clearly insignificant (Strohm, 2006). Familiarity induces auditor's bias unconsciously or unintentionally (Antle et al., 2006; Bazerman, Loewenstein, & Moore, 2002; Moore, Loewenstein, Tanlu, & Bazerman, 2003). In fact, close relations between auditors and clients can generate bias in the auditing process, even in ways of which auditors themselves are unaware (Moore et al., 2003).

People are more inclined to harm strangers than acquaintances, and, analogously, auditors are less likely to act in opposition to clients with whom they have ongoing relationships or familiarity by hospitality (Bazerman et al., 2002). An auditor who suspects questionable accounting numbers has to balance between potential harm towards clients by challenging their earnings and harming faceless investors by letting possibly skewed numbers go (Bazerman et al., 2002). In most cases, unconsciously or unintentionally, an auditor may take his clients' part and 'lean toward approving the client's dubious accounting numbers' (Bazerman et al., 2002). Moreover, an auditor's biases become stronger along with personal ties with the clients deepen, and the social ties between auditors and clients negatively impact auditor independence more seriously than their financial incentives per se (Moore et al., 2003).

Second, even worse, as Steidlmeier (1997, p. 124) notes, gift giving or hospitality, which seeks to elicit 'behaviour that is not an integral or legitimate part of the set of transactions

at hand', may be associated with bribery when the receiver is invited to pursue personal interests at the expense of the legitimate aims and objectives of other stakeholders (see in Figure 1). Relevant to hospitality, it may result in the auditor's deliberate bias and further the client's bribery towards the auditor.

Deliberate bias towards a client, which is usually viewed as bribery, is consistent with economic bonding between an auditor and a client (Antle et al., 2006). The issue about whether bribery through fees as a common conduit is likely to lead to a positive relation between abnormal accruals and audit fees has been discussed in prior studies (Ashbaugh et al., 2003; Frankel et al., 2002). In addition, the existing literature focuses on the implicit hypothesis that clients employ non-audit services to get favourable treatment from their auditors. However, non-audit services in the Chinese audit market are not widespread, and thus this study cannot borrow direct support from the findings in previous studies.

Moore et al. (2003) imply that the client could simply provide hospitality to bribe the auditor, which has not been taken very seriously by scholars to date. As the supportive evidence, Antle and Gitenstein (2000) find that it is less effective to bribe an accounting firm or auditor through non-audit services. Also, Warin, Diamant, and Pfenning (2010) argue that *guanxi* presents a tangible corruption risk. In China, *guanxi* is a general term for social networking and is often translated as 'relationship' (Yeung & Tung, 1996). Moreover, *guanxi* is strengthened via this process of give-and-take of favours and nourished through reciprocity such as 'to respond' and 'to repay' (Yau et al., 2000). Analogously, the client may bribe the auditor by providing hospitality (and gifts).

Overall, it is very difficult for researchers to empirically differentiate the familiarity effects from the bribe effects, but both of them may bring out the impairment of auditor independence.

Finally, audit fees and non-audit services may bring out economic bonding between auditors and clients (see in Figure 1) (Antle et al., 2006; Ashbaugh et al., 2003; Chung & Kallapur, 2001; Frankel et al., 2002), which may induce the client's bribery towards its auditor.[4]

2.5. Hypothesis development

Guanxi is one of the key factors governing business success, and thus people try to establish *guanxi* for instrumental purposes (Yang, 1994). In China, the culture of *guanxi* remains unshakable and becomes even firmer as time goes by. In fact, the establishment, preservation, and strengthening of *guanxi* are related to hospitality. Cai, Fang, and Xu (2011) disclose the entertainment and travel costs as grease or protection money in Chinese companies' accounts reach 3% of sales revenue.

Guanxi in China is a typical ethical phenomenon (Dunfee & Warren, 2001; Fei, 1948; Hui & Graen, 1997) and affects business ethics (Hwang, Golemon, Chen, Wang, & Hung, 2009; Luo, 2000). In fact, *guanxi* between auditors and clients also affects the auditing process

[4]Findings in previous studies suggest two competitive arguments on the relation between audit fees/non-audit services and auditor independence. On the one hand, non-audit services strengthen an auditor's economic bonding with the client and thus provide the auditor with incentives to allow earnings management (Beeler & Hunton, 2001; Frankel et al., 2002; Larcker & Richardson, 2004; Simunic, 1984; Srinidhi & Gul, 2007). On the other hand, non-audit services also increase an auditor's reputational capital, which reduces the likelihood of an auditor's agreement with the client's earnings management (Arruñada, 1999; Chung & Kallapur, 2001; Craswell et al., 2002; DeFond, Raghunandan, & Subramanyam, 2002; Ghosh et al., 2009; Reynolds, Deis, & Francis, 2004; Ruddock, Taylor, & Taylor, 2006).

(Au & Wong, 2000), and thus *guanxi* may impair auditor independence because the familiarity between auditors and clients can facilitate firms to receive preferential audit opinions. However, relevant to the Chinese audit market, the behaviour that clients provide hospitality to their auditors (vice versa), which may create familiarity between auditors and clients, is not a common phenomenon because of the reputation and litigation effects. Extant literature argues that auditors' accepting hospitality from clients may create familiarity threats (Ramsay, 2001; Par. 8.193). In this regard, hospitality may impair auditor independence.

MacLullich and Sucher (2004) argue that it is difficult for auditors to deny hospitality or gifts.[5] As the leadership theory notes (Kao, 1993), the businessman can better achieve the final objectives when he/she owns a widespread social network and *guanxi*. In Chinese culture, free food, drink, and entertainment are common in practice (Law, 2010). As a result, auditors view hospitality as the channel to communicate with each other to evaluate clients' potential risks and upgrade audit efficiency.

In the Chinese audit market, it could not be the case that hospitality helps improve audit efficiency. The Chinese audit market is highly competitive and has much lower concentration than other markets (Chu et al., 2011). For example, market shares of the Big 4 (listed firms) in China from 2003 to 2008 were 17%, 21%, 25%, 28%, 33% and 33%, respectively. However, according to Choi and Wong (2007), the market share of the Big 5 is 79.61% in Australia, 90.98% in Denmark, 82.05% in Finland, 87.02% in Hong Kong, 57.96% in Taiwan, 62.13% in Thailand, and 95.79% in the United States, respectively. Competition destroys ethical behaviour (Cai et al., 2011; Shleifer, 2004). Therefore, in this regard, unethical behaviour inevitably exists in the Chinese audit market.

High competitiveness forces auditors and CPA firms to keep familiarity with clients via various means and thus retain their important clients. This is only one aspect of the matter. On the other hand, clients also wish to establish close relation with auditors to increase the propensity to receive clean audit opinions. Therefore, both auditors and clients are not likely to deny familiarity in the Chinese audit market. As a result, *guanxi* is established between clients and auditors. In fact, firms can establish *guanxi* with their auditors in various ways in China's society, especially hospitality.

In essence, hospitality can be classified as one of implicit contracts. Under most circumstances, hospitality is hidden in firms' accounts, and it is hard for others to verify these fees.[6] Gifts blind the eyes, and there is no such thing as a free lunch. Therefore, the implicit characteristic of hospitality may not only create the familiarity between clients and auditors, but also prompt them to cooperate or unscrupulously conspire with an unspoken consensus (the bribe effect). If so, the familiarity effects or/and the bribe effects derived from hospitality will lead to a bonding relationship between clients and auditors, and then auditor independence will be impaired. Logically, I predict that hospitality firms report higher discretionary accruals than their counterparts. Thus, if hospitality is used by clients to compromise auditor independence, greater discretionary accrued earnings should be observed.

In addition, due to information asymmetry, it is very difficult for outside stakeholders to identify the channel and extent of earnings management. However, the recognition of earnings and their components must be approved by auditors (Chu et al., 2011; Elias, 2002). As

[5]MacLullich and Sucher (2004) note that "…given the fact that it is an emerging market there is a risk that beside all hospitality, there are incidents of accepting bribes or trying to bribe and so on. It is difficult to deny it…Often though we are not talking about big bribes…a box of chocolates or a bottle of alcohol".

[6]Compared with hospitality, travel expenses are clear and identifiable, so travel expenses are a part of explicit contracts.

a result, because of the familiarity effect or/and the bribe effect derived from auditors' accepting hospitality from clients, auditor independence may be impaired. And thus, logically, firms that provide hospitality to their auditors have a lower probability of receiving modified opinions than their counterparts. Based on the above discussions, Hypothesis 1 is developed in an alternative form as below:

H1: Ceteris paribus, hospitality is negatively associated with audit quality.

H1 predicts the negative association between hospitality and audit quality, which can be translated into: (1) hospitality is positively associated with discretionary accruals; and (2) hospitality is negatively related with auditors' propensity to issue modified audit opinions.

3. Empirical models specification and variables

3.1. The 'propensity score matching' approach

It is difficult to rule out the potential endogeneity (self-selection problem) between hospitality and discretionary accruals (audit opinions). In response, this study employs the 'propensity score matching' method to mitigate the potential endogeneity issue (Dehejia & Wahba, 2002), as well as the influence of unbalanced memberships between the subsample with hospitality and the subsample without hospitality on my findings (Kim, Simunic, Stein, & Yi, 2011).[7]

First, this study identifies a set of observable variables influencing a firm's providing hospitality to its auditor. Specifically, Equation (1) is used to conduct the 'propensity score matching' procedure:

$$HOSP = \theta_0 + \theta_{1-23}Control\ Variables + (Industry\ and\ Year\ Dummies) + \psi \quad (1)$$

In Equation (1), the dependent variable is hospitality with a label of *HOSP*. *HOSP* is a dummy variable, equalling 1 if a client firm provides free food and drink to its auditor and 0 otherwise. Following prior studies (DeFond et al., 2002; Lawrence et al., 2011; Lennox & Pittman, 2010; Murphy & Sandino, 2010; Omer, Sharp, & Wang, 2016), this study includes a set of determinants affecting a firm's providing hospitality to its auditor (*HOSP*). (1) In Equation (1), this study includes three geographic proximity-based variables that may impact a firm's providing hospitality to its auditor. *REG* is the average distance (in thousand kilometres) between a firm and three regulatory centres in China (Beijing, Shanghai and Shenzhen). *AUDIT_DIS* is the distance (in thousand kilometres) between a firm and its audit firm. *METRO* is a dummy variable, equalling 1 if a firm is located in one of the province-level municipalities, provincial capitals, or vice-provincial cities and 0 otherwise. (2) Auditor-specific features, including the time lag between fiscal year-end date and the date the auditor signs the audit report (*DELAY*), one-year-lagged audit opinions (*OPINION_LAG*), a dummy variable of *BIG10*, auditor switch (*SWITCH*), auditor tenure (*TENURE*) and audit fees (*AUD_FEE*), are included in Equation (1). (3) In Equation (1), this study also includes several variables about corporate governance mechanisms, such as the percentage of shares held by the controlling shareholder (*FIRST*),

[7]Chu et al. (2011), Farber (2005), Desai, Hogan, and Wilkins (2006) and Stanley and DeZoort (2007) directly adopt the matching sample based on firm-specific characteristics (firm size, financial leverage, accounting performance) to conduct their tests. Dehejia and Wahba (2002) and Rosenbaum and Rubin (1983, 1985) suggest the rationale of the 'propensity score matching' approach in mitigating the potential endogeneity problem. Lennox and Pittman (2010), Lawrence, Minutti-Meza, and Zhang (2011), and Murphy and Sandino (2010) employ the 'propensity score matching' method to conduct their studies.

Table 1. Variable definitions.

Variable		Definitions	Data Source
Variables for main tests			
DAC	=	Discretionary accruals using modified Jones model (Dechow et al., 1995) deflated by total assets at the beginning of the period	Calculated
DAC_CF	=	Discretionary accruals based on augmented Jones model of Ball and Shivakumar (2006) considering cash flow from operation	Calculated
DAC_MP	=	Performance-matched discretionary accruals based on Kothari et al. (2005)	Calculated
OPINION	=	A dummy variable, equaling 1 if a firm is issued unqualified opinions and 0 otherwise (Chen et al., 2001; Gul et al., 2009; Wang et al., 2008)	CSMAR
HOSP	=	A dummy variable, equaling 1 if a firm clearly and definitely provides free food, drink, and entertainment to its auditors and 0 otherwise	Hand-collected
OPINION_LAG	=	A dummy variable of lagged auditing opinion, equaling 1 if a firm is issued unqualified opinions by its auditor in last calendar year and 0 otherwise	CSMAR
BIG10	=	A dummy variable, equaling 1 if a firm hires one of the ten largest accounting firms in the Chinese audit market and 0 otherwise	www.cicpa.org.cn
SWITCH	=	A dummy variable, equaling 1 if a firm switches its auditor during the year and 0 otherwise	Hand-collected
TENURE	=	Audit tenure, measured as the number of years since the auditors have been employed (Li, 2010)	Hand-collected
AUD_FEE	=	The natural logarithm of audit fees (Craswell et al., 2002; DeFond et al., 2002)	CSMAR
ROA	=	Returns on total assets, measured as earnings before interest and tax (EBIT) to total assets at the beginning of the period	CSMAR
LAGACCR	=	One-year-lagged total accruals (Choi et al., 2012)	Calculated
LOSS	=	A dummy variable, equaling 1 if a firm's net profit is negative and 0 otherwise	CSMAR
TINY	=	A dummy variable for tiny profit, equaling 1 if ROA is greater than zero and less than 0.01 and 0 otherwise	CSMAR
FIRST	=	The percentage of common shares owned by the controlling shareholder	CSMAR
MANSHR	=	The percentage of common shares owned by top managers	CSMAR
DUAL	=	A dummy variable, equaling 1 if the same person serves as the CEO and the Chairman of board simultaneously and 0 otherwise	CSMAR
INDR	=	The proportion of independent directors, measured as the number of independent directors scaled by the number of directors in the boardroom	CSMAR
BOARD	=	Board size, measured as the natural logarithm of the number of directors in the boardroom	CSMAR
LNBGS	=	The natural logarithm of the sum of business, product, and geographic segments minus 2 (Choi et al., 2012)	Hand-collected
SIZE	=	The natural logarithm of a firm's total assets	CSMAR
LEV	=	The ratio of total liabilities to total assets	CSMAR
CURR	=	Current ratio, measured as current assets scaled by current liabilities	CSMAR
ARTA	=	The ratio of accounts receivable to total assets	CSMAR
INVTA	=	The ratio of inventory to total assets	CSMAR
TURNOVER	=	Total assets turnover ratio, measured as sales revenue to total assets	CSMAR
CHGSALE	=	The change in sales deflated by lagged total assets (Choi et al., 2012)	CSMAR
BTM	=	Book-to-market ratio (Choi et al., 2012)	CSMAR
ZMIJ	=	Zmijewski's (1984) financial distress score, winsorized at five and minus five (Choi et al., 2012)	Calculated
ISSUE	=	A dummy variable, equaling 1 if the sum of debt and equity issued during the past three years is more than 5% of the total assets, and 0 otherwise (Choi et al., 2012)	Calculated
STOCKRET	=	A firm's stock return estimated using the market model over the calendar year	CSMAR
BETA	=	A firm's beta estimated using a market model over the calendar year	CSMAR

(*Continued*)

Table 1. (*Continued*).

Variable		Definitions	Data Source
INDSPEC	=	An indicator variable about auditor industry expertise, equaling 1 if the audit firm is the specific industry leader (based on the share of audit fees) for the audit year in the provincial audit market and 0 otherwise (Choi et al., 2012)	Hand-collected
CONCENT	=	Auditor concentration by province, measured as the Herfindahl index of the number of clients for each audit office (Choi et al., 2012)	Hand-collected
STATE	=	A dummy variable, equaling 1 when the ultimate controlling shareholder is a (central or local) government agency or SOEs and 0 otherwise	CSMAR
LISTAGE	=	The number of years since a firm's IPO	CSMAR
MKT	=	Fan et al.'s Marketization index, which measures the whole institution development of each province in China	Fan et al. (2011)
Variables for the first stage of the "propensity score matching" method and robustness checks			
DELAY	=	The natural logarithm of the number of days between fiscal year-end date and the date the auditor signs the audit report (DeFond et al., 2002; Omer et al., 2010)	Calculated
REG	=	The average distance (in thousand kilometers) between a firm and three regulatory centers (Beijing, Shanghai, and Shenzhen)	Calculated
AUDIT_DIS	=	The distance (in thousand kilometers) between a firm and its audit firm	Calculated
METRO	=	A dummy variable, equaling 1if a firm is located in one of province-level municipalities, provincial capitals, or vice-provincial cities and 0 otherwise	Calculated
DAC_CFADJ	=	Discretionary accruals based on augmented Jones model of Ball and Shivakumar (2006) considering industry-median-adjusted cash flow from operation	Calculated
DAC_ΔCF	=	Discretionary accruals based on augmented Jones model of Ball and Shivakumar (2006) considering the change of cash flow from operation	Calculated
DAC_RET	=	Discretionary accruals based on augmented Jones model of Ball and Shivakumar (2006) considering abnormal returns	Calculated
TRAV	=	An indicator variable, equaling 1 if a firm separately provides 'travel expenses' to the audit firm and 0 otherwise	Hand-collected
HOSP_TRAV	=	An indicator variable, equaling 1 if a firm separately provides 'free food and drink' or/and 'travel expenses' to its auditors and 0 otherwise	Hand-collected
RET	=	Excess stock returns over the period from May of year $t-1$ to April of year t	Calculated
DR	=	An indicator variable, equaling 1 if $RET<0$ and 0 otherwise	Calculated
EPS	=	Earnings per share at the end of the year	CSMAR
P_{t-1}	=	The closing price at the end of year $t-1$	CSMAR

the percentage of common shares owned by top managers (*MANSHR*), a dummy variable indicating whether the same person serves as the CEO and the Chairman simultaneously (*DUAL*), the proportion of independent directors (*INDR*), and the natural logarithm of the number of directors in the boardroom (*BOARD*). (4) In Equation (1), this study includes firm-specific characteristics including firm size (*SIZE*), financial leverage (*LEV*), accounting performance (*ROA*), a dummy variable of negative net income (*LOSS*), a dummy variable of meagre profit (*TINY*), and a dummy variable of re-financing (*ISSUE*) to control for their impacts on hospitality, respectively. (5) *STATE*, *LISTAGE*, and *MKT* are introduced into Equation (1) to control the impacts of the nature of the ultimate owner, the number of years since a firm's IPO, and the Marketization process on hospitality, respectively. (6) Finally, *YEAR* and *INDUSTRY* are included in Equation (1) to control for fixed effects of calendar years and industries. All the definitions of variables in Equation (1) are provided in Table 1.

Second, this study estimates propensity score for each firm using predicted probabilities in Equation (1).

Third, this study matches each treatment firm (the hospitality firm) to the closest control available (the control firm or the matched firm), which minimises the absolute value of the difference between the treatment firm's and the control firm's propensity scores, provided the propensity score of the closest match is within a distance of 0.05 from the treatment firm's propensity score.

Finally, this study compares differences in discretionary accruals and audit opinions between the treatment firms and the matched firms to examine the influence of hospitality on auditor independence.

3.2. Multivariate test models for the relation between hospitality and discretionary accruals

To test the relation between hospitality and discretionary accruals, Equation (2) is constructed as:

$$DA = \alpha_0 + \alpha_1 HOSP + \alpha_{2-26} Control\ Variables + (Industry\ and\ Year\ Dummies) + \varepsilon \quad (2)$$

In Equation (2), the dependent variable is discretionary accruals, labelled as *DA*. According to Ball and Shivakumar (2006), Dechow, Sloan, and Sweeney (1995), and Kothari, Leone, and Wasley (2005), three variables for discretionary accruals are calculated as below: *DAC* is discretionary accruals using the modified Jones model of Dechow et al. (1995), deflated by total assets at the beginning of the period. *DAC_CF* is discretionary accruals based on the augmented Jones model of Ball and Shivakumar (2006) considering cash flow from operation. *DAC_MP* is performance-matched discretionary accruals based on Kothari et al. (2005). In addition, the independent variable is *HOSP*, a dummy variable, equalling 1 when a firm provides hospitality (free food and drink) to its auditor and 0 otherwise. In Equation (2), if the coefficient on *HOSP* (i.e. α_1) is positive and significant, H1 is supported by empirical evidence.

Moreover, a set of control variables are included in Equation (2). First, following the existing literature (Choi, Kim, Qiu, & Zang, 2012; Craswell et al., 2002; DeFond et al., 2002; Li, 2010), a dummy variable of *BIG10*, auditor switch (*SWITCH*), auditor tenure (*TENURE*), audit fee (*AUD_FEE*), auditor industry expertise (*INDSPEC*), and auditor concentration by province (*CONCENT*) are controlled in Equation (2) to address the effects of auditor-specific variables

on discretionary accruals. Second, to control for the impacts of corporate governance on discretionary accruals, five variables are included: the percentage of shares held by controlling shareholder (*FIRST*), the percentage of shares owned by top managers (*MANSHR*), a dummy variable indicating whether the same person serves as the CEO and the Chairman of board simultaneously (*DUAL*), the proportion of independent directors (*INDR*), and the natural logarithm of the number of directors in the boardroom (*BOARD*). Third, referring to extant studies (Choi et al., 2012), the complexity of a firm's operation (*LNBGS*), firm size (*SIZE*), financial leverage (*LEV*), accounting performance (*ROA*), negative net income (*LOSS*), an indicator for meagre profit (*TINY*), one-year-lagged total accruals (*LAGACCR*), the change in sales revenues (*CHGSALE*), book-to-market ratio (*BTM*), financial distress index (*ZMIJ*), and a dummy variable of re-financing (*ISSUE*) are included into Equation (2) to control for the influence of firm-specific financial characteristics on discretionary accruals, respectively. Fourth, *STATE*, *LISTAGE* and *MKT* are introduced into Equation (2) to control the impacts of the nature of the ultimate owner, the number of years since a firm's IPO, and the marketisation process on discretionary accruals, respectively. Finally, *YEAR* and *INDUSTRY* are included to control for calendar year and industry fixed effects.

3.3. Multivariate test model for the relation between hospitality and audit opinions

To examine the relation between hospitality and modified audit opinions, this study refers to Wang, Wong, and Xia (2008) to conduct Equation (3) using the *Logistic* regression:

$$OPINION = \beta_0 + \beta_1 HOSP + \beta_{2-24} Control\ Variables + (Industry\ and\ Year\ Dummies) + \zeta \quad (3)$$

In Equation (3), the dependent variable is *OPINION*. According to previous literature (Chen, Chen, & Su, 2001; DeFond, Wong, & Li, 2000; Gul, Sami, & Zhou, 2009; Wang et al., 2008), *OPINION* is a dummy variable, equalling 1 if a firm is issued a modified audit opinion by its auditor and 0 otherwise. Modified audit opinions include unqualified opinion with explanatory notes, qualified opinion, disclaimed opinion, and adverse opinion, and thus only unqualified opinions without explanatory notes are classified as clean audit opinions (DeFond et al., 2000; Wang et al., 2008).

Moreover, in Equation (3), the main independent variable is *HOSP*. The coefficient on *HOSP* (i.e. β_1) captures the difference in audit opinions between *HOSP* firms and non-*HOSP* firms. If the coefficient on *HOSP* is negative (i.e. $\beta_1<0$) and significant, H1 is supported by empirical evidence.

Following extant studies (Chen, Su, & Zhao, 2000; Chen et al., 2001; DeFond et al., 2000; Gul et al., 2009; Haw, Park, Qi, & Wu, 2003; Wang et al., 2008), a set of control variables is controlled in Equations (3). First, one-year-lagged audit opinions (*OPINION_LAG*), a dummy variable of *BIG10*, auditor switch (*SWITCH*), auditor tenure (*TENURE*), and audit fee (*AUD_FEE*) are included in Equation (3) to control for the impacts of auditor-specific features on auditors' propensity to issue modified audit opinions. Second, following Wang et al. (2008) and DeFond et al. (2000), firm-specific variables that affect audit opinions are also included: accounting performance (*ROA*), a dummy variable indicating whether the profit of a firm is below 0 (*LOSS*), a dummy variable indicating whether the profit is rare (*TINY*), firm size (*SIZE*), financial leverage level (*LEV*), current ratio (*CURR*), the percentage of accounts receivable to total assets (*ARTA*), the percentage of inventory to total assets (*INVTA*), total assets turnover ratio

(*TURNOVER*), one-year-lagged total accruals (*LAGACCR*), book-to-market ratio (*BTM*), financial distress index (*ZMIJ*), and a dummy variable of re-financing (*ISSUE*). Third, following previous literature (Chen et al., 2001; DeFond et al., 2000; Haw et al., 2003; Wang et al., 2008), annual stock return (*STOCKRET*) and risk factor (*BETA*) are included into Equation (3). Fourth, *STATE* is introduced in Equation (3) to address the influence of ownership nature on audit opinions. To address the concern about whether the number of years since a firm's IPO influences audit opinions, *LISTAGE* is included into Equation (3). Moreover, following Wang et al. (2008), *MKT* is controlled into Equation (3) to address the effect of marketisation on audit opinions. Finally, *YEAR* and *INDUSTRY* are included in Equation (3) to control for calendar year and industry fixed effects.

4. Sample, descriptive statistics and univariate tests

4.1. Identification of sample

The sample period of my study covers 2001–2010. 'Notes to financial statements' in the *WIND* database report the potential components of audit fees, which facilitates the data collection process and results in reliable data on hospitality. This study judges case by case whether firms provide 'travel expenses' and 'free food and drink' (hospitality) to their auditors. In addition, the research sample is selected in the light of the following criteria: first, firms pertaining to the banking, insurance, and other financial industries are deleted. Second, this study excludes firms that issue shares to foreign investors (B-/H-shares) because of different regulatory environments (Chu et al., 2011). Third, this study deletes firm-years whose data on firm-specific control variables are unavailable. Finally, this study obtains 11,636 firm-years, including: (1) 242 firm-year observations that clearly and definitely provide hospitality to their auditors to constitute the *HOSP* (hospitality) sample; (2) 3745 firm-year observations that clearly and definitely provide no hospitality to their auditors; (3) 7649 firm-year observations that disclose inadequate information so that it is difficult for this study to judge whether or not they provide hospitality to their auditors because of data and information limitations.

If the auditor and the client are located in the same city or the distance between the auditor and the client is very close, then the auditor needs not travel to other locations to carry out field audits. Therefore, if the client provides free food and drink (as well as accommodation) to the auditor, then such behaviour is more likely to be attributed to 'hospitality'. In particular, the behaviour that the client discretionally provides free food and drink to the auditor in different years can further verify hospitality.

In addition, if the auditor and the client are located in different cities or the distance between the auditor and the client is relatively far, and then auditors may need to travel to another location to perform field audits such as stock taking. In such cases, expenses – including food and accommodation for auditors – are costs to auditors and should be covered by clients. Instead of auditors paying such expenses and then claiming reimbursement, the client may provide free food and accommodation. As such, one should observe that, in these cases, the clients should uninterruptedly provide free food and accommodation to their auditors when audit fees are kept unchanged for several years. If not, one can deduce that free food and accommodation are likely to be associated with 'hospitality'.

Table 2. Descriptive statistics and univariate tests for differences between the HOSP subsample and the matching subsample.

		(1)		(2)		(3)
		Firms with HOSP		Firms without HOSP		t-tests
Variables		Mean	S. D	Mean	S. D	(1) v. s (2)
DAC	(1)	0.0032	0.0936	−0.0283	0.0802	3.98***
DAC_CF	(2)	0.0092	0.0560	−0.0048	0.0535	2.82***
DAC_MP	(3)	0.0029	0.1151	−0.0378	0.1054	4.06***
OPINION	(4)	0.0413	0.1994	0.1405	0.3482	−3.84***
OPINION_LAG	(5)	0.0579	0.2339	0.0826	0.2759	−1.07
BIG10	(6)	0.3264	0.4699	0.3099	0.4634	0.39
SWITCH	(7)	0.0661	0.2651	0.0496	0.2358	0.72
TENURE	(8)	6.7851	4.0355	6.7273	3.8326	0.16
AUD_FEE	(9)	13.3091	0.7507	13.3234	0.7987	−0.20
INDSPEC	(10)	0.4008	0.4911	0.3347	0.4729	1.51
CONCENT	(11)	0.2035	0.1144	0.1973	0.1085	0.61
ROA	(12)	0.0391	0.0737	0.0341	0.0811	0.72
LAGACCR	(13)	−0.0236	0.0934	−0.0322	0.1045	0.96
LOSS	(14)	0.1074	0.3103	0.1116	0.3155	−0.15
TINY	(15)	0.1033	0.3050	0.1033	0.3050	0.00
FIRST	(16)	0.3871	0.1650	0.3976	0.1540	−0.72
MANSHR	(17)	0.0046	0.0474	0.0092	0.0571	−0.97
DUAL	(18)	0.0950	0.2939	0.1033	0.3050	−0.30
INDR	(19)	0.3356	0.0900	0.3362	0.0973	−0.07
BOARD	(20)	2.1895	0.2136	2.1890	0.2114	0.03
LNBGS	(21)	1.7820	0.5761	1.8161	0.6305	−0.62
SIZE	(22)	21.6430	1.1822	21.6286	1.1209	0.14
LEV	(23)	0.4687	0.1754	0.4627	0.1733	0.38
CURR	(24)	1.5865	1.0956	1.5129	1.4030	0.64
ARTA	(25)	0.1065	0.0978	0.0951	0.1017	1.26
INVTA	(26)	0.1571	0.1072	0.1403	0.1264	1.47
TURNOVER	(27)	0.8061	0.5680	0.7856	0.4861	1.09
CHGSALE	(28)	0.1459	0.3157	0.1248	0.2537	0.81
BTM	(29)	0.5489	0.2619	0.5474	0.2603	0.07
ZMIJ	(30)	−1.8388	1.1500	−1.8460	1.1773	0.07
ISSUE	(31)	0.3306	0.4714	0.3099	0.4634	0.49
STOCKRET	(32)	0.0197	0.8458	0.0763	0.8918	−0.72
BETA	(33)	1.0228	0.2369	1.0337	0.2111	−0.53
STATE	(34)	0.6983	0.4599	0.7397	0.4397	−1.01
LISTAGE	(35)	9.7975	3.7633	9.5455	4.0679	0.71
MKT	(36)	7.5996	2.0850	8.0818	2.2961	−0.36
DELAY	(37)	87.3430	23.6027	87.6446	24.2084	−0.14
REG	(38)	0.4825	0.4361	0.4454	0.5213	0.84
AUDIT_DIS	(39)	0.6664	0.6722	0.7269	0.7905	−0.91
METRO	(40)	0.5463	0.4981	0.5372	0.4996	0.32

Notes: ***,** and * represent the 1%, 5% and 10% levels of significance (two-tailed). All the variables are defined in Table 1.

Using the 'propensity score matching' method and Equation (1), this study re-assembles the research sample based on 3987 firm-year observations including the hospitality subsample (242 observations) and the non-hospitality subsample (3745 observations). Finally, the matched sample consists of 484 observations, including 242 observations with hospitality (the *HOSP* subsample) and 242 observations without hospitality. In addition, the top and bottom 1% of each continuous variable are winsorised to control for the influence of some extreme observations.

4.2. Data source

The data sources are as follows. (1) Referring to Wang et al. (2011), data on *HOSP* is hand-collected based on 'notes to financial statements' in the *WIND* database (http://www.wind.com.cn). Specifically, the data on *HOSP* are hand-collected on the basis of the following procedures: first, this study checks the specific components of audit fees from 'notes to financial statements' in the *WIND* database. Second, this study judges and identifies case by case whether audit fees include 'free food and drink' that client firms provide to their auditors. Finally, this study defines *HOSP* as a dummy variable, equalling 1 if a firm clearly provides 'free food and drink' to its auditor and 0 otherwise. (2) Data on *SWITCH*, *TENURE*, *LNBGS*, *INDSPEC* and *CONCENT* are hand-collected based on China Stock Market and Accounting Research (*CSMAR*), see http://www.gtafe.com. (3) Data on *OPINION* and *OPINION_LAG* are collected from *CSMAR* database. (4) *DAC*, *DAC_CF* and *DAC_MP* are computed following Dechow et al. (1995), Ball and Shivakumar (2006), and Kothari et al. (2005), respectively. (5) Data on *MKT* are obtained from Fan, Wang, and Zhu (2011). (6) Other data are collected from *CSMAR*. Please refer to Table 1 for data sources in detail.

4.3. Descriptive statistics and univariate tests

This study examines the differences in discretionary accruals and audit opinions between the 'treatment' firms and 'matched' firms.[8] Columns (1)–(3) of Table 2 report the mean value (standard deviation) for firms with *HOSP*, firms without HOSP, and t-tests between two subsamples. First, in Rows (5)–(40), the differences in the mean values of all control variables are insignificant, suggesting that the 'propensity score matching process' is well conducted. Second, results in Rows (1)–(3) show that the differences in the mean values of *DAC*, *DAC_CF* and *DAC_MP* between the 'treatment' firms and 'matched' firms are all significantly positive at the 1% level. Also, Row (4) indicates that the difference in the mean values of *OPINION* is significantly negative. The above results, taken together, provide preliminary support to H1.[9]

5. Results

5.1. Multivariate test of H1

Panel A of Table 3 reports the OLS regression results of discretionary accruals on hospitality and other determinants. As shown in Columns (1)–(3) of Panel A, the coefficients on *HOSP* are positive and significant at the 1% level (0.0291 with $t = 3.95$, 0.0122 with $t = 5.70$, and 0.0383 with $t = 3.52$, respectively), implying that auditors' acceptance of hospitality from clients results in higher discretionary accruals. Moreover, the coefficient estimates suggest that *DAC, DAC_CF* and *DAC_MP* are about 2.91%, 1.22% and 3.83% higher for the *HOSP*

[8]For brevity, I report results of the logistic models used to estimate the propensity score in this footnote. The unabulated tables are available from the author upon request (similarly hereinafter). The first stage of *PSM* approach: *HOSP* = –1.0893 (–1.16) – 0.1070 (–0.91) × *REG* – 0.1155* (–1.87) × *AUDIT_DIS* – 0.4347*** (–5.49) × *METRO* +0.1704** (2.39) × *AUD_FEE* + 0.0191 (0.23) × *ISSUE* – 0.0018 (–1.13) × *DELAY* + 0.0113 (0.08) × *OPINION_LAG* + 0.0894 (1.06) × *BIG10* – 0.2089 (–1.43) × *SWITCH* – 0.0164 (–1.44) × *TENURE* – 0.0029 (–0.01) × *FIRST* – 0.8554 (–1.06) × *MANSHR* – 0.2182* (–1.90) × *DUAL* + 0.5068 (0.83) × *INDR* – 0.4723*** (–2.63) × *BOARD* – 0.0291 (–0.59) × *SIZE* – 0.3434 (–1.53) × *LEV* – 0.0426 (–0.06) × *ROA* – 0.0902 (–0.60) × *LOSS* – 0.2167 (–1.19) × *TINY* – 0.0204 (–0.24) × *STATE* + 0.0461*** (3.53) × *LISTAGE* – 0.1439*** (–5.19) × *MKT* +Industry and Year effects (3987 observations; Pseudo $R^2 = 0.1267$; LR-value = 228.21***).

[9]Results of *Pearson* correlation analyses (untabulated for brevity) reveal that *HOSP* displays significantly positive (negative) correlations with *DAC*, *DAC_CF*, and *DAC_MP* (*OPINION*), which are consistent with H1.

Table 3. The influence of Hospitality (HOSP) on audit quality.

Panel A: The influence of Hospitality (HOSP) on discretionary accruals

	(1)		(2)		(3)	
	DAC		DAC_CF		DAC_MP	
Variables	Coefficient	*t*-value	Coefficient	*t*-value	Coefficient	*t*-value
HOSP	0.0291***	3.95	0.0122***	5.70	0.0383***	3.52
BIG10	0.0031	0.52	0.0053*	1.96	0.0067	0.57
SWITCH	0.0126	0.61	−0.0098	−1.58	0.0367	1.16
TENURE	−0.0001	−0.04	−0.0001	−0.02	0.0004	0.17
AUD_FEE	−0.0140	−1.50	−0.0004	−0.09	−0.0176**	−2.34
INDSPEC	0.0073	0.96	0.0038	1.08	0.0232	1.22
CONCENT	0.0501	1.21	−0.0115	−0.73	−0.0106	−0.20
FIRST	0.0150	0.41	0.0069	0.53	−0.0139	−0.41
MANSHR	−0.0468	−1.32	−0.0266	−0.98	0.0761	0.64
DUAL	−0.0128	−1.13	−0.0001	−0.01	−0.0109	−0.46
INDR	0.1193	1.58	0.0317	0.96	0.2667**	2.12
BOARD	0.0037	0.20	−0.0073	−0.93	0.0586**	2.43
LNBGS	0.0052	0.97	0.0026	0.97	0.0023	0.26
SIZE	−0.0006	−0.05	−0.0008	−0.30	−0.0047	−0.39
LEV	0.4201	0.68	−0.5862***	−3.15	−0.2668	−0.61
ROA	0.1654	0.30	1.0657***	6.92	0.2516	0.58
LOSS	−0.0225	−0.99	−0.0113	−0.80	−0.0158	−0.52
TINY	0.0042	0.30	−0.0045	−1.17	0.0111	0.45
LAGACCR	0.0303	0.71	0.0302*	1.91	0.0832	1.49
CHGSALE	−0.0826***	−5.08	−0.0632***	−10.75	−0.0539**	−2.53
BTM	0.0233	0.85	0.0050	0.47	0.0428	1.52
ZMIJ	−0.0661	−0.59	0.1050***	3.13	0.0452	0.59
ISSUE	0.0039	0.49	−0.0018	−1.09	0.0027	0.18
STATE	0.0093	0.63	0.0038	0.87	0.0241	1.21
LISTAGE	0.0014	0.65	−0.0001	−0.04	0.0020	0.72
MKT	0.0007	0.38	−0.0008	−1.06	−0.0022	−0.60
Constant	−0.3286	−0.57	0.4507***	2.93	0.1975	0.58
Industry and Year effects	Control		Control		Control	
Observations	484		484		484	
Adjusted R^2	0.1945		0.6308		0.0492	
F (*p*-value)	4.37***(<0.0001)		12.67***(<0.0001)		1.74***(0.0015)	

Panel B: The influence of Hospitality (HOSP) on audit opinions

Variables	Coefficient	*t*-value	M. E.
HOSP	−2.0453***	−2.93	−0.0917
OPINION_LAG	2.6255**	2.40	0.1169
BIG10	0.3322	0.54	0.0151
SWITCH	−0.1141	−0.09	−0.0039
TENURE	−0.1718**	−2.13	−0.0075
AUD_FEE	−1.1591**	−2.14	−0.0504
ROA	−8.2802**	−2.33	−0.3844
LOSS	−0.2079	−0.23	−0.0097
TINY	2.0602*	1.91	0.0926
SIZE	0.1514	0.36	0.0060
LEV	8.2680**	2.29	0.3850
CURR	−0.0787	−0.24	−0.0032
ARTA	5.3450	1.52	0.2348
INVTA	−0.6009	−0.24	−0.0308
TURNOVER	−1.1875**	−2.17	−0.0550
LAGACCR	−1.7342	−0.55	−0.0818
BTM	3.3828***	2.67	0.1501
ZMIJ	−1.3915**	−2.17	−0.0648
ISSUE	−4.0805**	−2.41	−0.1822
STOCKRET	0.0067	0.02	0.0013
BETA	−3.4365***	−2.68	−0.1539

(*Continued*)

Table 3. (*Continued*).

Panel B: The influence of Hospitality (HOSP) on audit opinions			
STATE	−0.2977	−0.81	−0.0131
LISTAGE	−0.0654*	−1.75	−0.0032
MKT	0.2101	1.41	0.0095
Constant	−16.0227*	−1.73	
Industry effects		Control	
Year effects		Control	
Observations		484	
Pseudo R^2		0.5753	
LR (*p*-value)		168.10***(<0.0001)	

Notes: ***,** and * represent the 1%, 5% and 10% levels of significance, respectively, for two-tailed tests. All reported t-statistics are based on standard errors adjusted for clustering at the firm level and the year level (Petersen, 2009). All the variables are defined in Table 1.

subsample than for the matching subsample, which are economically significant, in addition to their statistical significances.

Panel B of Table 3 reports the results of audit opinions on hospitality and other determinations using the logistic regression procedure. Following Wooldridge (2009) and DeFond et al. (2002), this study also computes the marginal effect of each variable on audit opinions, which provides some additional evidence on the economic significance of each coefficient. As shown in Panel B, the coefficient on *HOSP* is negative and statistically significant at the 1% level (−2.0453 with −2.93), suggesting that accepting hospitality from clients is inversely related to auditors' propensity to issue modified audit opinions. Furthermore, the marginal effect of *HOSP* on audit opinions is −9.17%, revealing the economic significance of hospitality on audit opinions.

To sum up, results in Panels A and B of Table 3 provide strong and consistent support for H1. Please refer to Table 3 for the signs and significances of control variables.

5.2. Robustness checks

First, this study further calculates three additional discretionary accruals following Ball and Shivakumar (2006) – *DAC_CFADJ*, *DAC_ΔCF* and *DAC_RET* – to conduct robustness checks. *DAC_CFADJ*, *DAC_ΔCF* and *DAC_RET* are discretionary accruals based on the augmented Jones model of Ball and Shivakumar (2006) considering industry-median-adjusted cash flow from operation, the change of cash flow from operation, and abnormal returns, respectively. As shown in columns (1)–(3) of Table 4, *HOSP* has significantly positive coefficients across all cases, consistent with H1.

Second, there are five major types of audit opinions in the Chinese audit market: (1) unqualified opinion without explanatory notes; (2) unqualified opinion with explanatory notes; (3) qualified opinion; (4) disclaimed opinion; and (5) adverse opinion. Most of the prior studies such as DeFond et al. (2000), Haw et al. (2003), Wang et al. (2008) and Gul et al. (2009) classify unqualified opinions without explanatory notes as clean opinions, and thus the other four types are defined as modified opinions. In response, according to the severity extent of audit opinions, this study constructs an additional variable of *OPINION_RANK*, an ordered variable, equalling 0, 1, 2, 3 and 4 for unqualified opinion without explanatory notes, unqualified opinion with explanatory notes, qualified opinion, disclaimed opinion, and adverse opinion, respectively. As shown in columns (1) and (2) of Panel B in which the ordered logistic

regression approach and the Poisson regression procedure are used, respectively, the coefficients on *HOSP* are both negative and significant, providing additional support to H1.

Table 4. Robustness checks using alternative dependent variables.

Panel A: Robustness checks using alternative discretionary accruals

	(1)		(2)		(3)	
	DAC_CFADJ		DAC_ΔCF		DAC_RET	
Variable	Coefficient	*t*-value	Coefficient	*t*-value	Coefficient	*t*-value
HOSP	0.0129***	6.66	0.0134**	2.33	0.0285***	5.50
Control variables	Control		Control		Control	
Constant	0.6268***	4.23	0.0860	0.40	−0.2513	−0.50
Industry and Year effects	Control		Control		Control	
Observations	484		484		484	
Adjusted R^2	0.6380		0.3926		0.1731	
F (*p*-value)	13.93***(<0.0001)		9.25***(<0.0001)		4.33***(<0.0001)	

Panel B: Robustness checks using alternative measure of audit opinions

	(1)		(2)	
	Ordered logistic regression		Poisson regression	
Variable	Coefficient	*t*-value	Coefficient	*t*-value
HOSP	−2.4563**	−2.44	−1.2756***	−3.34
Control variables	Control		Control	
Constant			−2.7947*	−1.70
Constant1	8.9292	1.12		
Constant2	6.7278	1.20		
Constant3	5.4140	1.28		
Constant4	7.2051	1.34		
Industry and Year effects	Control		Control	
Observations	484		484	
Pseudo R^2	0.5025		0.5674	
LR (*p*-value)	188.15***(<0.0001)		522.27***(<0.0001)	

Panel C: Robustness checks using accounting conservatism as the proxy for audit quality

	Dependent variable: EPS/P_{t-1}	
Variable	Coefficient	*t*-value
RET	−0.3972**	−2.08
DR	0.1682	1.14
RET×*DR*	1.7838***	3.80
HOSP	0.0067	0.72
HOSP×*RET*	−0.0038	−0.26
HOSP×*DR*	−0.0406***	−2.76
HOSP×*RET*×*DR*	−0.1362***	−3.10
Control variables	Control	
Constant	−0.1388	−1.38
Industry and Year effects	Control	
Observations	484	
Adjusted R^2	0.3352	
F (*p*-value)	5.35***(<.0001)	

Notes: ***,** and * represent the 1%, 5% and 10% levels of significance, respectively, for two-tailed tests. All reported *t*-statistics are based on standard errors adjusted for clustering at the firm level and the year level (Petersen, 2009). All the variables are defined in Table 1.

Variable definitions: RET denotes excess stock returns over the period from May of year *t*−1 to April of year *t*; DR is indicator variable, equaling 1 if *RET*<0 and 0 otherwise.

Finally, this study employs accounting conservatism (on the basis of Basu's (1997) model) to address the influence of hospitality on audit quality. As shown in Panel C of Table 4, the coefficient on *RET*×*DR* is positive and significant. More importantly, *HOSP*×*RET*×*DR* has a negative and significant coefficient, suggesting that hospitality reduces accounting conservatism. These findings provide supportive support to H1.

Overall, results in Table 4 are indistinguishable from those in Table 3, and thus my main findings are not qualitatively changed when other dependent variables are used.

5.3. Using Heckman's (1979) approach to address the self-selection problem of hospitality

In addition to the propensity score matching approach, this study further uses Heckman's (1979) two-stage regression procedure (approach) to address the self-selection problem of hospitality. Specifically, referring to Antle et al. (2006) and variables used in the 'propensity score matching' process (see Table 1 for variable definitions), this study constructs Equation (4) and conducts the first-stage regression of Heckman's (1979) approach, and then calculates the inverse Mills Ratio (*IMR*):

$$\begin{aligned} HOSP =& \gamma_0 + \gamma_1 BIG10 + \gamma_2 SWITCH + \gamma_3 TENURE + \gamma_4 SIZE + \gamma_5 LEV \\ &+ \gamma_6 OCF + \gamma_7 BTM + \gamma_8 STATE + \gamma_9 MKT + \gamma_{10} REG \\ &+ \gamma_{11} AUDIT\_DIS + \gamma_{12} METRO + \gamma_{13} AUD\_FEE \\ &+ \gamma_{14} DELAY + (Industry\ and\ Year\ Dummies) + \varepsilon \end{aligned} \tag{4}$$

Regression results about the first stage of Heckman's (1979) approach are reported in footnote 10.[10] This study then includes the inverse Mills Ratio (*IMR*) from the first stage into Equations (2) and (3) to re-test H1. As shown in Panel A of Table 5, *HOSP* has significantly positive coefficients in all cases accompanying a significant coefficient on *IMR*. In addition, in Panel B of Table 5 the coefficients on *HOSP* is negative and significant. These findings lend additional support for H1.

5.4. Other robustness checks

Although not tabulated for brevity, this study also conducts several robustness checks as below:

First, this study computes *DAC, DAC_CF* and *DAC_MP* based on operating income and re-tests H1. Untabulated results show statistically indistinguishable results compared with those in Table 3.

Second, this study conducts t-tests about the effects of hospitality on discretionary accruals and unclean audit opinions between different subsamples, and the findings show that discretionary accruals (the likelihood of unclean audit opinions) are significantly higher (lower) for firms with hospitality than for firms without hospitality:[11] (1) in both *TINY* and non-*TINY* subsamples; (2) in both *FIN_DIS* and non-*FIN_DIS* subsamples; (3) in both *ISSUE* and non-*ISSUE* subsamples; and (4) in both state-owned enterprises and non-state-owned enterprises. The foregoing findings provide supportive evidence to H1.

Finally, this study re-assembles the research sample (242 observations with hospitality and 242 observations without hospitality) based on 11,636 firm-year observations including

Table 5. Results of the second stage of Heckman's (1979) approach.

Panel A: Results of the second stage of Heckman (1979)'s approach—various discretionary accruals on hospitality and other determinants

	(1)		(2)		(3)	
	DAC		DAC_CF		DAC_MP	
Variables	Coefficient	*t*-value	Coefficient	*t*-value	Coefficient	*t*-value
HOSP	0.1924***	6.30	0.0574***	5.83	0.2008***	6.43
Control variables	Control		Control		Control	
IMR	0.1132***	5.56	0.0314***	4.05	0.1127***	5.95
Constant	−0.0740	−0.13	0.5121***	3.39	0.4387	1.23
Industry and Year effects	Control		Control		Control	
Adjusted R^2	0.2979		0.6507		0.1058	
F (p-value)	6.57***(<0.0001)		14.96***(<0.0001)		2.52***(<0.0001)	

Panel B: Results of the second stage of Heckman (1979)'s approach—audit opinions on hospitality and other determinants

Variables	Coefficient	*t*-value
HOSP	−4.2286**	−2.25
Control variables	Control	
IMR	−1.0601	−0.77
Constant	−50.5421	−1.63
Industry and Year effects	Control	
Observations	484	
Pseudo R^2	0.6310	
LR (*p*-value)	186.09***(<0.0001)	

Notes: ***,** and * represent the 1%, 5% and 10% levels of significance, respectively, for two-tailed tests. All reported *t*-statistics are based on standard errors adjusted for clustering at the firm level and the year level (Petersen, 2009). All the variables are defined in Table 1.

the hospitality subsample (242 observations), the non-hospitality subsample (3745 observations), and the uncertain subsample (7649 observations). The findings are qualitatively similar to those in Table 3.

6. Additional tests

6.1. Additional tests using 'travel expenses' and 'free food, drink, and travel expenses'

In main tests, this study excludes 'travel expenses' and defines hospitality on the basis of 'free food and drink'. Next, this study compares two sets of results excluding and including travelling expenses and examines whether these results differ significantly.

First, this study constructs an indicator variable of *TRAV*, equalling 1 if a firm separately provides 'travel expenses' to the audit firm and 0 otherwise. And then, *TRAV* is used as the

[10]The first stage of Heckman's (1979) approach: *HOSP* = −1.4896 (−0.78) + 0.1396 (0.89) × *BIG10* + 0.2425 (1.24) × *SWITCH* − 0.0145 (−0.92) × *TENURE* + 0.0220 (0.22) × *SIZE* + 0.0755 (0.15) × *LEV* − 2.3209** (−2.11) × *OCF* − 0.1058 (−0.35) × *BTM* − 0.2124 (−1.23) × *STATE* − 0.0993*** (−4.03) × *MKT* − 0.0350 (−0.17) × *REG* − 0.1862* (−1.75) × *AUDIT_DIS* − 0.2874* (−1.92) × *METRO* + 0.1246 (0.95) × *AUD_FEE* − 0.0014 (−0.42) × *DELAY* + Industry and Year effects (Pseudo R^2 = 0.1076; LR -value = 72.20***).

[11]*TINY* is a dummy variable for tiny profit, equalling 1 if *ROA* is greater than zero and less than 0.01 and 0 otherwise; *FIN_DIS* is an indicator variable on the basis of Altman's (1968) Z-score, equalling 1 if *Z_SCORE*<1.8 and 0 otherwise; *ISSUE* is a dummy variable, equalling 1 if the sum of debt and equity issued during the past three years is more than 5% of the total assets, and 0 otherwise (Choi et al., 2012).

Table 6. Additional tests using 'travel expenses' and 'free food, drink, and travel expenses'.

Panel A: The impacts of "travel expenses" on modified audit opinions

	(1)		(2)	
	The full sample		The matched sample	
Variables	Coefficient	*t*-value	Coefficient	*t*-value
TRAV	0.1424	1.03	−0.1704	−0.34
Other controls	Control		Control	
Observations	3,987		484	
Pseudo R^2	0.4015		0.5825	
LR (*p*-value)	816.08***(<0.0001)		171.77***(<0.0001)	

Panel B: The impacts of 'free food, drink, and travel expenses' on modified audit opinions

	(1)		(2)	
	The full sample		The matched sample	
Variables	Coefficient	*t*-value	Coefficient	*t*-value
HOSP_TRAV	0.0847	0.62	−0.8612	−1.59
Other controls	Control		Control	
Observations	3,987		484	
Pseudo R^2	0.4014		0.5846	
LR (*p*-value)	815.78***(<0.0001)		172.39***(<0.0001)	

Panel C: The influence of travel expenses on discretionary accruals for the full sample

	(1)		(2)		(3)	
	DAC		DAC_CF		DAC_MP	
Variables	Coefficient	*t*-value	Coefficient	*t*-value	Coefficient	*t*-value
TRAV	−0.0016	−0.59	0.0039	1.30	−0.0026	−0.65
Other Controls	Control		Control		Control	
Adjusted R^2	0.1488		0.6507		0.0198	
Observations	3,987		3,987		3,987	
F (*p*-value)	356.18***(<0.0001)		75.64***(<0.0001)		292.44***(<0.0001)	

Panel D: The influence of travel expenses on discretionary accruals for the matched sample

	(1)		(2)		(3)	
	DAC		DAC_CF		DAC_MP	
Variables	Coefficient	*t*-value	Coefficient	*t*-value	Coefficient	*t*-value
TRAV	−0.0006	−0.06	0.0003	0.13	0.0013	0.20
Other Controls	Control		Control		Control	
Adjusted R^2	0.1690		0.6184		0.0143	
Observations	484		484		484	
F (*p*-value)	2.96***(<0.0001)		16.65***(<0.0001)		1.14(0.2468)	

Panel E: The effect of 'free food, drink, and travel expenses' on discretionary accruals for the full sample

	(1)		(2)		(3)	
	DAC		DAC_CF		DAC_MP	
Variables	Coefficient	*t*-value	Coefficient	*t*-value	Coefficient	*t*-value
HOSP_TRAV	0.0023	−0.72	0.0034**	1.99	−0.0007	−0.17
Other Controls	Control		Control		Control	
Adjusted R^2	0.1488		0.6505		0.0197	
Observations	3,987		3,987		3,987	
F (*p*-value)	355.50***(<0.0001)		75.72***(<0.0001)		292.93***(<0.0001)	

(*Continued*)

Table 6. (*Continued*).

Panel F: The effect of "free food, drink, and travel expenses" on discretionary accruals for the matched sample

	(1)		(2)		(3)	
	DAC		DAC_CF		DAC_MP	
Variables	Coefficient	*t*-value	Coefficient	*t*-value	Coefficient	*t*-value
HOSP_TRAV	0.0087	0.51	–0.0021	–0.31	0.0513***	3.12
Other Controls	Control		Control		Control	
Adjusted R^2	0.1696		0.6185		0.0263	
Observations	484		484		484	
F (*p*-value)	2.97***(<0.0001)		16.66***(<0.0001)		1.44**(0.0297)	

Notes: ***,** and * represent the 1%, 5% and 10% levels of significance, respectively, for two-tailed tests. All reported t-statistics are based on standard errors adjusted for clustering at the firm level and the year level (Petersen, 2009). All variables are defined in Table 1.

main independent variable to examine its influence on audit quality. Columns (1) and (2) of Panel A in Table 6 reveal insignificant effect of travel expenses on modified audit opinions, suggesting that travel expenses cannot significantly affect audit quality. In addition, in Panels C and D of Table 6, it can be observed that travel expenses (*TRAV*) have insignificant effects on discretionary accruals. The above results, compared with those in Table 3, suggest that: (1) it is 'free food and drink' rather than 'travel expenses' that negatively affects auditor independence and audit quality; (2) 'free food and drink' should be classified as hospitality, but 'travel expenses' should not be attributed as the component of hospitality.

Second, referring to Wang et al. (2011), this study constructs another indicator variable of *HOSP_TRAV*, equalling 1 if a firm separately provides 'free food and drink' and/or 'travel expenses' to its auditors and 0 otherwise. Using *HOSP_TRAV* as the main independent variables, the results show that: (1) in columns (1) and (2) of Panel B in Table 6, the coefficients on *HOSP_TRAV* are insignificant; and (2) in Panels E and F of Table 6, the coefficients on *HOSP_TRAV* are insignificant for most cases. The above results, taken together, suggest that: (1) a mixed measure including both 'free food and drink' and 'travel expenses' may result in inconsistent findings, which is similar to Wang et al. (2011); and (2) 'free food and drink' is an appropriate proxy for hospitality, but neither 'travel expenses' nor 'free food, drink and travel expenses' can serve as the appropriate proxy for hospitality.

6.2. Additional tests about the difference in audit fees between subsamples

As an observation of practice, some companies may pay an amount of audit fees including all traveling expenditures, while some others pay a smaller amount of audit fees with traveling expenditures not included. As a response, this study tests whether audit fees are significantly different between firms that separately provide travel fees to their auditors (the *TRAV* subsample) and their counterparts (the non-*TRAV* subsample). As Panel A of Table 7 shows, the amount of audit fees is significantly lower for firms that separately provide travel expenses to their auditors than for their counterparts. In other words, if the client firm separately provides travel expenses to the audit firm, then the amount of audit fees will be significantly lower than the case in which the agreement on audit fees between the client firm and the audit firm includes travel fees, and vice versa. These findings, combined with a proverb of 'like tree, like fruit', suggest that it's not the problem that 'travel expenses' are

Table 7. *t*-tests about the differences in audit fees between the *TRAV* (*HOSP*) subsample and the non-*TRAV* (non-*HOSP*) subsample.

Panel A: The difference in audit fees between the TRAV subsample and the non-TRAV subsample					
	The *TRAV* subsample		The Non-*TRAV* subsample		
Variable	Mean	S. D	Mean	S. D	t-test
AUD_FEE	13.2395	0.6814	13.3917	0.8505	–2.17**

Panel B: The difference in audit fees between the HOSP subsample and the non-HOSP subsample					
	The *HOSP* subsample		The Non-*HOSP* subsample		t-test
Variable	Mean	S. D	Mean	S. D	
AUD_FEE	13.3091	0.7507	13.3234	0.7987	–0.20

Notes: ***,** and * represent the 1%, 5% and 10% levels of significance, respectively, for two-tailed tests.

separately paid by the client firm to the audit firm or included in the total audit fees (as being part of audit fees). As a result, 'travel expenses' are less likely to be attributed to hospitality.

In addition, as a comparison, as shown in Panel B of Table 7, there is no difference in audit fees between firms with hospitality (free food and drink; the *HOSP* subsample) and those without hospitality (the non-*HOSP* subsample). The finding suggests that the amount of audit fees is indifferent about whether it covers free food and drink, which should be attributed to hospitality.

Furthermore, as extant studies validate, audit fee dependence is a major source to impair auditor independence (Craswell et al., 2002; DeAngelo, 1981; Ghosh et al., 2009). As a result, theoretically, it is less likely for 'travel expenses' to influence auditor independence and further affect my findings.

7. Conclusion

Auditor independence has drawn a lot of attention from scholars, regulators and the public. However, the issue about whether auditors' acceptance of hospitality from clients impairs actual auditor independence has been under inadequate research until now, although ethical standards and several extant studies have addressed hospitality's influence on perceived auditor independence. Using hand-collected data on hospitality from the Chinese stock market, this study examines the effect of hospitality on actual auditor independence. First, my findings suggest that firms that provide hospitality to auditors report significantly greater discretionary accrued earnings. Second, hospitality firms are less likely to receive modified audit opinions. My findings imply that some firms establish bonding relations with their auditors via hospitality, and thus compromise auditor independence.

This study contributes to existing literature on auditor independence. First, my study focuses on the influence of hospitality on actual auditor independence, rather than on perceived auditor independence. Specifically, my study documents systematic evidence to show that hospitality *does* impair *actual* auditor independence, which can be used for reference regarding the controversy on the influence of hospitality on auditor independence in *Rules of Professional Conduct*, *Ethical Standard* and *Code of Ethics for Professional Accountants*.

Second, my study is conducted based on the Chinese context, a typical relation-based economy, and thus my findings can provide supplementary evidence to findings in extant studies based on rule-based economies. Overall, 'slight negligence may lead to great disaster', and thus hospitality's influence on auditor independence should not be understated.

My study, of course, has its limitations. First, because of data limitations, this study only collects data on whether a firm provides hospitality to its auditor, but it is difficult to obtain adequate data on the amount of hospitality. Nevertheless, my findings suggest that the existence of hospitality impairs *actual* auditor independence. Second, in my study, 242 firm-year observations with 'free food and drink' are not enough, and thus more caution should be exercised during the process of generalising the findings in this study. Nevertheless, this study can motivate further research to pay close attention to the influence of Chinese traditional culture (i.e. 'free food and drink') on auditor independence. Third, a qualitative study undergoes censures of being subjective (Cavana, Delahaye, & Ching, 2001), but empirical studies are also open to criticism due to the risk of omitting other key explanatory variables (Yin, 2003). Therefore, the integrated method is more likely to be generally accepted. Third, compared with the sample period (2001–2010), from 2011 to 2015, there is a decreasing tendency on the number of firms that disclose information about 'free food and drink' due to an 'Eight-Point' Guideline for Fighting Bureaucracy and Formalism and Rejecting Extravagance among Party Members, which elicits a number of Chinese listed firms to cover their expenses of free food and drink. This change in institutional environment may hinder the generalization of my findings. Fourth, due to data limitation, this study does not include auditor–client relationship (e.g. school ties) in regression models, and thus future research can further address the impact of hospitality on auditor independence through isolating the suggested auditor–client social ties. Fifth, this study employs the propensity score matching approach and Heckman's two-stage procedure to address the endogeneity, but it is better to find a natural experiment setting to further mitigate the endogeneity. Finally, this study is conducted based on the Chinese context, a typical relation-based economy, and thus my findings may not fit in well with rule-based economies. Nevertheless, a firm's dependence on *guanxi* is just a matter of degree, so my conclusions may be applied to other relation-based economies.

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