

Yang, Daoguang; Han, Hongling; Mao, Yidan; Liu, Siyi

Article

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Special representative actions, the insurance value of audits, and investor protection: an empirical study based on the ruling against Kangmei Pharmaceutical Co. Ltd

Daoguang Yang^a, Hongling Han^b, Yidan Mao^b and Siyi Liu ^a

^aBusiness School, University of International Business and Economics, Beijing, China; ^bSchool of Management, Zhejiang University, Hangzhou, China

ABSTRACT

The ruling against the Kangmei Pharmaceutical Co., Ltd's financial fraud was the first special representative action under China's new Securities Law, serving as a milestone in investor protection in China. Exploiting the natural experiment provided by the ruling, we empirically test the insurance value of audits and find a negative market reaction of the client firms audited by the accounting firms that were still being sued as of the date of Kangmei ruling (i.e., the sued accounting firms). Further, this reaction is weakened when the solvency of the sued accounting firms or the client firms is high, and is intensified when the client firms have high litigation risk. The ruling also eroded investors' trust in the financial statements for the year 2020 that were audited by the sued accounting firms. Overall, we provide important evidence on the effect of special representative actions from the perspective of audit insurance hypothesis.

KEYWORDS

Special representative actions; investor protection; insurance hypothesis; new Securities Law

1. Introduction

Since the 18th National Congress of the Communist Party of China in 2012, General Secretary Xi Jinping has given a series of important directives concerning the capital market, showing the way ahead for its reform and development. Investors are the foundation of this development, and thus protecting and encouraging investors is fundamental to the development of the capital market; accordingly, it has become the fundamental regulatory mission of securities regulators (Yi, 2020). Since La Porta, Lopez-de-Silanes, Shleifer, and Vishny initiated the study of law and finance in the 1990s, the impact of the legal system on the formation of national financial systems, the efficiency of resource allocation in the financial markets, and the level of investor protection have been topics of major interest in this field. One key conclusion is that strong investor protection is essential for an efficient and active capital market (F. Jiang et al., 2008; G. Jiang et al., 2006; Xin & Xu, 2007).¹

CONTACT Siyi Liu  liusiyi@uibe.edu.cn  Business School, University of International Business and Economics, Beijing, China

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Investor protection in China's stock market has until recently mainly relied on administrative regulation. The judicial mechanism (especially civil litigation) has provided very limited protection for investors (Xia, 2014). Driven by the requirements of capital market's high-quality development, China implemented the new *Securities Law of the People's Republic of China* (hereafter, the new Securities Law) effective from 1 March 2020. This law made a series of institutional changes to improve existing laws and regulations of investor protection.² Its most innovative feature in terms of investor protection was the introduction of a system of representative (or class) actions with Chinese characteristics, i.e. special representative actions. The system specifies that an investor protection agency acting with the entrust by at least 50 investors can initiate a class action as a representative and register with the People's Court for investors confirmed by the Securities Registration and Settlement Agency, at which point it represents all investors in the class action unless they explicitly express unwillingness to be represented. This institutional arrangement of 'tacitly joining and explicitly withdrawing' resolves the problems with the previous 'explicitly joining and tacitly withdrawing' arrangement under China's old system of securities civil litigation, and will make it much easier for investors to file civil lawsuits and increase the amount of compensation claimed, thereby increasing the willingness of investors and law firms to initiate litigation. For example, in July 2006, investors won China's first civil compensation case against an accounting firm; however, although Hualun CPAs, an accounting firm that did not detect or disclose the financial fraud of its client, Lantian Co. Ltd., was found jointly and severally liable for the plaintiffs' economic loss, the amount claimed was only 6.17 million yuan (of which about 5.4 million yuan was finally awarded) because there were only 83 plaintiffs. Under a special representative action, the number of plaintiffs would increase to 20,000, and the claims amount would increase to a much more substantial 1 billion yuan. Overall, under representative actions, if the accounting firm involved is found to have joint and several liability, it would be forced to pay huge damages, which would have an unprecedented deterrent effect.

When the government embarks on major institutional reform and legal changes, the public, including direct stakeholders, generally takes a wait-and-see approach until the first applicable case works its way through the courts. For example, Leone et al. (2021) find no significant market reaction to the announcement of the 2010 *Enforcement Cooperation Program*, but a significant positive market reaction to disclosure of the first case, suggesting that firms were sceptical and waited for an actual resolved case to set a precedent (p. 1). In terms of whether accounting firms will really face the prospect of paying huge amounts of compensation under the new Securities Law, many studies have focused on clarifying accounting liability and legal liability, defining supplementary liability and joint liability, estimating the compensation capacity of accounting firms, and measuring the impact on the development of the audit market and CPA profession. In practice, determining the proportion of joint and several liability has always been a sticking point, and inconsistencies may occur even in the same case. For example, in December 2019, the court ruled that Ruihua CPAs (hereinafter, Ruihua) was jointly and severally liable for 60%

²The existing laws and regulations of investor protection include but don't limit to Opinions of the General Office of the State Council on Further Strengthening the Protection of the Legal Rights and Interests of Small and Medium Investors in the Capital Market in 2013 (Release of General Office of the State Council [2013] No. 110).

of the compensation to be paid by the defendant Chengdu Huaze Cobalt and Nickel Materials Co., Ltd. (hereinafter, Huaze). In May 2020, the sentence was commuted, and Ruihua was found jointly and severally liable for paying the compensation of the defendant Huaze. Since then, arguments about the responsibility of accounting firms under the new Securities Law has intensified. However, in the civil lawsuit of the listed company Zhonganke, the legal liability of Ruihua changed from 100% in the first ruling at the end of 2020 to 15% in the appeal ruling in May 2021.

On 12 November 2021, the Guangzhou Intermediate People's Court made a ruling on the Kangmei securities class action case, ordering the main auditor of Kangmei in the year of the financial fraud, Guangdong Zhengzhong Zhujiang CPAs (hereinafter, Zhengzhong Zhujiang) and its partners and signing CPAs, to bear 100% joint and several liability for the 2.459 billion yuan that Kangmei was required to pay investors. On 21 July 2022, the certification of Zhengzhong Zhujiang was cancelled, leading to its demise. This is the first case since special representative actions with Chinese characteristics were created by the new Securities Law. The Kangmei ruling is so far the civil compensation case for financial fraud of a listed company with the largest number of plaintiffs and the highest compensation amount. The Securities Regulatory Authority highlighted the benchmark nature of the ruling, and expressed determination to normalise special representative actions. In this way, the previous wait-and-see attitude about the special representative litigation system will dissipate. In addition, prior to the ruling, information about Zhengzhong Zhujiang and the sued accounting firms' audit responsibilities and litigation have already been released (as shown in [Table 1](#)). The incremental information of the Kangmei ruling lies in the huge compensation awarded under the special representative litigation system. Therefore, this ruling provides an excellent natural experiment for examining a fundamental audit theory, namely, the audit insurance hypothesis.

In this study, we take the Kangmei ruling as an event. We examine the abnormal stock price reaction of the client companies audited by the sued accounting firms as of the date of Kangmei ruling³ to verify the audit insurance hypothesis. The empirical results indicate that: (1) Investors of enterprises audited by sued accounting firms have a significantly negative response to the Kangmei ruling, which is confirmed by a series of robustness tests. Thus, we verify the audit insurance hypothesis from a negative perspective. (2) The market did not respond significantly to the date on which the Kangmei case was officially handled by the court, or to the date that the first special representative lawsuit was successfully converted, indicating that the market will form stable expectations only when the first applicable case occurs. (3) The negative market response differs depending on the compensation capacity of sued accounting firms, the compensation capacity and litigation risks of client firms. The stronger the compensation capacity of the sued accounting firm, the stronger the compensation capacity of the client company and the weaker the negative market response. The higher the litigation risk of the client company (including being involved in other lawsuits, being punished by the Exchange authorities, being the subject of an Exchange inquiry, and having higher earnings management), the

³The sample in our main analysis includes client companies of Zhengzhong Zhujiang. Considering that the market reaction of such client companies is mixed with expectations of the accounting firm's reputation and compensation ability, it is hard to separate the signal value and insurance value of the audit. Thus, we remove them to enhance the robustness of findings.

Table 1. Timeline of the key stages of the Kangmei Pharmaceutical fraud case.

Date	Related progress of the case
October 15, 2018	Articles on we-media challenged the authenticity of funds, operating cash and questioned other fraudulent behaviours in Kangmei Pharmaceutical's financial statements
May 9, 2019	Kangmei Pharmaceutical issued an announcement on the correction of accounting errors, claiming that through self-examination, it found there were major errors in its 2017 financial statements
May 17, 2019	The China Securities Regulatory Commission preliminarily ascertained that Kangmei Pharmaceutical's financial reports from 2016 to 2018 were materially false
May 28, 2019	Zhengzhong Zhujiang responded to the inquiry letter from the Shanghai Stock Exchange, clarifying that there were no errors or faults in the audit process of Kangmei Pharmaceutical
August 16, 2019	The China Securities Regulatory Commission issued an administrative penalty decision on Kangmei Pharmaceutical, and characterised it as a premeditated, organised, long-term and systematically implemented financial fraud
May 4, 2020	The China Securities Regulatory Commission issued a top 600,000-yuan administrative penalty and a no-entry ban on Kangmei Pharmaceutical
December 31, 2020	Kangmei Pharmaceutical announced that it had received the <i>Notice of Responding to Action</i> issued by the Guangzhou Intermediate People's Court, which was filed as an ordinary representative lawsuit for a dispute over securities misrepresentation
February 20, 2021	The China Securities Regulatory Commission issued an administrative penalty decision on Zhengzhong Zhujiang Exchange and its four signatory certified public accountants
March 26, 2021	The Guangzhou Intermediate People's Court issued an announcement on the rights registration of an ordinary representative litigation; the China Securities Investor Services Centre publicly accepted the entrustment of investors
April 8, 2021	The China Securities Investor Services Centre submitted evidence of 56 investors to Guangzhou Intermediate People's Court, and applied for conversion to a special representative lawsuit
April 16, 2021	The Guangzhou Intermediate People's Court issued an announcement on the rights registration of a special representative's litigation, and thus successfully converted to the first case of special representative litigation
April 23, 2021	China Securities Investor Services Centre obtained the list of rights holders in the Kangmei case from China Securities Depository and Clearing Co., Ltd.
April 30, 2021	The China Securities Investor Services Centre registered with the Guangzhou Intermediate People's Court
June 5, 2021	The Jieyang Intermediate People's Court handled and ruled on Kangmei's application for bankruptcy and reorganisation
July 22, 2021	On behalf of all of the plaintiffs, the China Securities Investor Services Centre referred the claims to the bankruptcy administrator with the amount claimed in the representative lawsuit
August 10, 2021	The China Securities Investor Services Centre was voted as a member of the creditors committee at the first creditors' meeting of Kangmei's bankruptcy and reorganisation case, and was confirmed by Jieyang Intermediate People's Court to exercise such functions and powers as supervising the management and disposal of the debtor's property, supervising the performance of administrator, and proposing to convene a creditors' meeting

Source: China Securities Regulatory Commission and *Twelve Questions and Answers* of China Securities Investor Services Center in *Securities Times*.

greater the negative market reaction. (4) The Kangmei ruling weakened investors' trust in the financial statements for year 2020 that were audited by the sued accounting firms.

The main contributions of this paper are as follows. First, we supplement the empirical evidence that the insurance function of audits protects investors in practice, whether in the domestic or foreign capital markets. The classic foreign literature on the audit insurance hypothesis has focused substantially on the existence of audit insurance value by studying the market reaction to the bankruptcy of L&H and the dissolution of KPMG (Brown et al., 2013; Menon & Williams, 1994). Still, the signal (assurance) mechanism and the insurance mechanism of audits overlap and are difficult to separate (Baber et al., 1995). Compared with previous research, our study has two advantages. First, we better separate the insurance value from the information or signal value, because the audit responsibility of Zhengzhong Zhujiang and the sued accounting firms is clearly defined, and the litigated information was released before Kangmei's ruling date (see Table 1). The

incremental information of this ruling lies in the huge award resulting from the adoption of the special representative litigation system. Second, we make it possible to test two different views concerning audit insurance value. The bankruptcy of L&H and the dissolution of KPMG were definite outcomes, while in the Kangmei ruling, it remains unclear whether the huge award will lead to the bankruptcy of the sued accounting firms. In China, some scholars have used exogenous events in the evolution of China's securities law, such as the promulgation of key judicial interpretations, the transformation of accounting firms from LLC to LLP, and the replacement of government officials, to test the existence of audit insurance value (Li & Li, 2017; Ni & Shi, 2014; C. Wang & Lu, 2014; Wu et al., 2010). However, there is a lack of empirical evidence from the civil litigation rulings of accounting firms to directly test audit insurance value. We bridge these gaps in this paper.

Second, we deepen the understanding of the market reaction to major securities misrepresentation rulings and investor protection effects after the promulgation of the new litigation system. The significance of the Kangmei case to China's capital market is almost equivalent to the impact of Arthur Andersen's audit failure in the 2001 Enron collapse in the U.S. securities market. Scholars have studied the economic consequences and spill-over effects of auditors' reputation damage. They found that other clients of Arthur Andersen experienced significant negative market reactions when the U.S. Justice Department brought criminal charges against Arthur Andersen and when Arthur Andersen itself admitted that Enron-related audit documents were destroyed (Chaney & Philipich, 2002; Krishnamurthy et al., 2006). Unlike the above studies, we directly verify the applicability of the audit insurance hypothesis under the new Securities Law – in particular, how the solvency of accounting firms affects investor protection – and thereby enrich audit insurance theory.

In addition, together with Zheng et al. (2020) we demonstrate China's continuous efforts to promote investor protection as part of audit market reform, and refute Simunic et al. (2017) perspective on institutional development. The theoretical study by Simunic et al. (2017) argues that even if China adopts (convergent) international auditing standards, it cannot achieve high audit quality because it is difficult for investors to recover losses from accounting firms and CPAs (p. 7). However, the legal system in China is continuously improving, and thus this conclusion may no longer be valid. Zheng et al. (2020) use the stock market reaction to the joint and several liability of BDO China Shu Lun Pan Certified Public Accountants LLP (hereafter BDO) for the amount claimed by the investors in the first ruling in September 2017, confirming investors' increased expectations that the accounting firm would bear joint and several liability after the ruling. It can be shown that after the first ruling, joint and several lawsuits against BDO increased significantly. By January 2018, the cumulative number of lawsuits by investors reached more than 380 million yuan. What we examine in this article is another major institutional improvement in China's audit market following the increase in joint and several liability cases – the special representative litigation system. This system has made it much easier for investors to sue, and increased the enthusiasm of lawyers for undertaking civil lawsuits. Once judged to be jointly and severally liable, accounting firms face the possibility of paying astronomically high awards, which was impossible under the previous litigation system. For example, in the BDO and Kangmei cases, both accounting firms were judged to be jointly and

severally liable. However, the penalty for the former was 380 million yuan, while in the latter case it was 2.459 billion yuan.

Lastly, the conclusions of this paper have strong policy and practical implications. On one hand, it reveals the positive impact of the new Securities Law on investor protection in China's capital market and provide an analysis of class actions under China's legal environment. For a long time, investor protection in China has been relatively weak. In judicial practice, there is no precedent for a class action in civil tort disputes over false statements in the securities market. The judicial department in China does not advocate a trial in the form of a class action.⁴ Hence, the substantial reform in the new Securities Law is of far-reaching significance for promoting a positive interaction between certified public accountants and investors and improving the efficiency of the capital market. On the other hand, it contributes to critical thinking on the definition of audit responsibilities and the severity of punishment, which is helpful for the audit institutions to play a better role in the capital market. It is undoubtedly a step in the right direction to consolidate the responsibility of audit institutions by strengthening civil liability and making litigation more feasible, but it remains unclear whether increasing the responsibility of audit institutions is desirable. In general, our conclusions provide important implications for the implementation of the new Securities Law and improving the legal system of the capital market. Our paper provides a reference for the protection of investors' interests and high-quality capital market development, which expands the research on China's capital market in the field of law and finance.

The remainder of our paper is structured as follows. The second part provides the institutional background and hypothesis. The third part presents the research design, introducing the data sources, samples, and research models. The fourth part presents the empirical results and analysis, including descriptive statistics, main regression results, and robustness tests. The fifth part provides further analysis. The last part reports our conclusions.

2. Institutional background and research hypothesis

2.1. Institutional background

Since 1 March 2020, China has implemented the *Securities Law of the People's Republic of China* (referred to as the new Securities Law) revised by the Standing Committee of the National People's Congress in December 2019. Its most innovative feature is the establishment of the securities class action system with Chinese characteristics in the third paragraph of Article 95; this is known as the special representative litigation system. An investor protection agency acting with the entrust by at least 50 investors can initiate a class action as a representative and register with the People's Court for investors confirmed by the Securities Registration and Settlement Agency in accordance with preceding regulations, at which point it represents all investors in the class action unless they explicitly express unwillingness to be represented. Securities class action, also known as securities group action, refers to a litigation mechanism in which multiple plaintiffs

⁴In 2002, Article 4 of the Notice of the Supreme People's Court on Accepting Cases of Civil Tort Disputes Caused by False Statements in the Securities Market: 'For a case of civil compensation for false statements, the people's court shall handle it in the form of an individual or a joint lawsuit, rather than a class action'.

aggregate their claims collectively and require the defendant to compensate them for the losses caused by its securities violations (Z. Wang, 2021).

Before the promulgation of the new Securities Law, if investors of small and medium-sized enterprises in China suffered damage to their interests because of securities misrepresentation, they faced practical difficulties in filing a securities class action lawsuit. The reason is that China's securities class action system is of only recent origin, and offered no clear route for participating in litigation (as shown in Table 2). In 1991, Articles 53 and 54 of the *Civil Procedure Law of the People's Republic of China* (hereafter, the Civil Procedure Law) stipulated two circumstances, namely, 'the representative system under a certain number of persons' and 'the representative system under an uncertain number of persons, who must explicitly join and may tacitly withdraw'. Similarly, in January 2003, the *Several Provisions on the Trial of Civil Compensation Cases Arising from Misrepresentation in the Securities Market* (hereafter, the Judicial Interpretation of Misrepresentation) promulgated by the Supreme People's Court clearly specified that the application scope of class actions is limited to situations arising from false statements in the securities market and for which the number of parties is already determined. In June 2019, although the *Opinions on Providing Judicial Guarantee for the Establishment of Science and Technology Innovation Board and the Pilot Reform of Registration System* issued by the Supreme People's Court introduced the situation when the number of parties has not yet been determined at the time of the lawsuit into the securities representative litigation system, it still required that investors participate in the litigation through registration. Therefore, despite various regulations and judicial interpretations, there was basically no precedent for class actions in judicial practice (Tang, 2019).

In addition, the old Securities Law failed to support class actions in terms of civil litigation conditions and civil liability definitions. The specific manifestations were as follows: (1) Administrative preconditions could hinder the exertion of the judicial mechanism. Many securities civil litigation laws and regulations set the preconditions for investors to sue, limiting the object of a lawsuit to listed companies already punished by administrative departments for misrepresentation, or that had already been criminally sentenced by People's Courts for false statements. See, for example, the *Notice of Civil Dispute and Tort Cases from Misrepresentations* in January 2002 and the *Civil Compensation Regulations for Misrepresentations* in January 2003. (2) The Law focused on criminal responsibility and neglected civil punishment. Past judicial practice concerning misrepresentation from listed companies emphasised using public power to enforce the law; however, post-event civil remedies were neglected. Substituting a penalty for compensation in the disciplinary mechanism for the responsible entity often occurred, yet the total amount was too small to cover investors' losses from financial fraud (Z. Wang, 2021).

To this end, the new Securities Law has greatly increased the penalties for accounting firms and other securities service institutions, and strengthened the civil compensation liability of auditors, which has increased the effectiveness of the special representative litigation system. As shown in Table 3, in terms of responsibility, the old Securities Law concerned 'professional institutions and personnel', while the new Securities Law further clarified these as 'securities service institutions'. In terms of determining responsibility, the old Securities Law only required defendants to 'be jointly and severally liable for the part for which they are responsible', but the new Securities Law further states that 'if causing losses to others, they shall be jointly and severally liable with the client for compensation'. At the

Table 2. The development of a securities class action system in China's capital market.

Time of Implementation	Related system and its content
October 1982	<i>Civil Procedure Law of the People's Republic of China (for Trial Implementation)</i> : No provision for group litigation
April 1991	<i>Civil Procedure Law of the People's Republic of China</i> : The earliest legal source of a securities class action system in China "Article 53: In the case of a large and certain number of parties, if a joint lawsuit is filed, a representative may be elected to conduct the lawsuit. Article 54: In the case of a large but uncertain number of parties, the relevant parties may register with the people's court within the statutory period before electing a litigation representative."
July 1999	<i>Securities Law of the People's Republic of China</i> : First promulgated by the Standing Committee of the National People's Congress, yet in the subsequent four revisions or amendments in 2004, 2005, 2013, and 2014, there was no relevant content related to representative litigation.
January 2002	<i>Notice of the Supreme People's Court on Issues Concerning Acceptance of Civil Tort and Disputes Arising from False Statements in the Securities Market</i> : 'For a case of civil compensation from misrepresentation, the people's court shall accept it in the form of an individual or a joint action, while it is not appropriate to accept it in the form of a class action'.
January 2003	<i>Several Provisions of the Supreme People's Court on Trial of Civil Compensation Cases Caused by False Statements in the Securities Market</i> (Judicial Explanation [2003] No. 2) provide the following three ways for investors to institute legal proceedings: separate lawsuits, joint lawsuits, or representative lawsuits with a certain number of parties at the time of prosecution
January 2015	<i>Interpretation of the Supreme People's Court on the Application of the Civil Procedure Law of the People's Republic of China</i> provides detailed explanations and judicial practice guidance for the representative litigation system
June 2019	<i>Several Opinions of the Supreme People's Court on Providing Judicial Guarantee for the Establishment of the Science and Technology Innovation Board and the Pilot Registration System Reform</i> (Judicial Release [2019] No. 17). Circumstances in which the number of parties involved at the time of the prosecution has not yet been determined are included in the securities representative litigation system, but investors need to register to join
March 2020	<i>Securities Law of the People's Republic of China</i> establishes a securities class action system with Chinese characteristics, namely, the special representative litigation system: 'Article 95, Paragraph 3: Investor protection institutions, entrusted by more than 50 investors, can participate in litigation as representatives, and register with the people's court in accordance with the provisions of the preceding paragraph for the rights holders confirmed by the securities registration and clearing institutions, unless the investors expressly state unwillingness to participate in the lawsuit. An investor protection agency acting with the entrust by at least 50 investors can initiate a class action as a representative and register with the People's Court for investors confirmed by the Securities Registration and Settlement Agency in accordance with preceding regulations, at which point it represents all investors in the class action unless they explicitly express unwillingness to be represented'.
July 2020	<i>Provisions of the Supreme People's Court on Several Issues Concerning Representative Litigation in Securities Disputes</i> (Judicial Explanation [2020] No. 5). The securities class action system in China has truly been implemented
January 2022	<i>Several Provisions of the Supreme People's Court on Handling Infringement Civil Compensation Cases for False Statement in the Securities Market</i> (Judicial Explanation [2022] No. 2) specifies the constituent elements of civil compensation liability for false securities statements

same time, the principle of presumption of fault is adopted; that is, if the CPA cannot prove that he (or she) is not at fault, then he (or she) will be legally presumed to be at fault and needs to bear the compensation liability correspondingly (Z. Wang, 2021). On the intensity of punishment for violations of laws, the new Securities Law raises the upper limit of fines for securities service institutions from 'five times' to 'ten times', and the fines for directly responsible supervisors and other directly responsible personnel from 'more than 30,000 yuan and not more than 100,000 yuan' to 'more than 200,000 yuan and not more than 2,000,000 yuan'.

Table 3. Comparison of amendments to administrative penalties for audit institutions under the new Securities Law and the old Securities Law.

Change of contents	Old Securities Law (amended in 2014)	New Securities Law (amended in 2019)
Responsibility identification	Article 161: Professional institutions and personnel that issue audit reports, asset appraisal reports or legal opinions for the issuance, listing or securities trading activities of securities, must issue reports in accordance with the working procedures stipulated in the practice rules, and check and inspect on the authenticity, accuracy and completeness of their report content, and are jointly and severally liable for their responsible part.	Article 163: “Securities service institutions producing and issuing documents such as audit reports and other attestation reports, asset appraisal reports, financial advisory reports, credit rating reports or legal opinions for the issuance, listing, trading and other securities business activities, should be diligent and responsible, and check and verify the authenticity, accuracy and completeness of the content of the documents and materials it relies on. If the documents they produced or issued have false records, misleading statements or major omissions, which cause losses to others , they should bear joint and several liability for compensation with the client , unless they themselves can be proved not at fault. “
Punishment for violations	Article 223: ‘If a securities service institution fails to perform its duties diligently, and the documents produced or issued contain false records, misleading statements or major omissions, it shall be ordered to correct, and its business income shall be confiscated, its securities service business licence shall be suspended or revoked, and a fine of more than one time but not more than five times of their business income shall be imposed. The directly responsible person in charge and other directly responsible personnel shall be given a warning, and their securities business qualifications will be revoked, together with a fine of not less than 30,000 yuan but not more than 100,000 yuan ’.	Article 213: ‘Securities service institutions that violate Article 163 of this Law, failing to perform their duties diligently, and the documents they produce or issue containing false records, misleading statements or major omissions, shall be ordered to correct, and their business income shall be confiscated. A fine of not less than one time but not more than ten times the business income shall be imposed; if there is no business income or the business income is less than 500,000 yuan, a fine of not less than 500,000 yuan but not more than 5,000,000 yuan shall be imposed; in serious circumstances, they shall be suspended or prohibited from engaging in securities service business. The directly responsible person in charge and other directly responsible personnel shall be warned, and a fine of not less than 200,000 yuan but not more than 2 million yuan shall be imposed’.

Source: Official website of the China Securities Regulatory Commission (CSRC).

2.2. Hypothesis development

The audit insurance hypothesis, which is based on risk transfer theory, can be traced back to the 1980s, when the number of lawsuits against auditors grew explosively in the United States. In essence, the accounting firm’s liability for compensation serves as a transfer payment to investors (Schwartz, 1997). The formation of audit insurance value must satisfy two preconditions. First, the information users have the right to file lawsuits against accounting firms. Second, accounting firms can afford to pay the corresponding compensation (Menon & Williams, 1994). Foreign research on audit insurance value can be traced back to the early 1980s, and so far, there is still no conclusion as to whether it exists (e.g. Baber et al., 1995; Menon & Williams, 1994; Willenborg, 1999). Chinese scholars have provided relevant evidence on the existence of audit insurance value through different events (e.g. accountant firm restructuring, civil litigation reform) or situations (e.g. government officials change), but no consensus has been reached (Li & Li, 2017; Ni & Shi,

2014; C. Wang & Lu, 2014; Wu et al., 2010). Given that audit insurance value is based on litigation rights and the extent of compensation, the Kangmei ruling provides a direct scenario for testing the audit insurance hypothesis.

First, from the perspective of the two necessary conditions for the existence of audit insurance value, whether and how to verify audit insurance value through the Kangmei ruling is uncertain. On the one hand, the Kangmei ruling is the first case to invoke the special representative litigation system. It is a civil compensation case that will play a benchmark role, because it is the case concerning listed companies' financial fraud with the largest number of plaintiffs and the highest amount of compensation handled by the court so far. The securities regulatory authorities also expressed their determination to encourage representative litigation.⁵ Therefore, it can be expected from the Kangmei ruling that the investor's right to sue the accounting firm will be guaranteed and the process will become easier, and the compensation expected will basically cover the losses suffered by investors. As a result, the value of audit insurance can actually be realised (e.g. Dye, 1993; Wallace, 2004). In this case, the clients of the sued accounting firms should have a significant positive reaction to the Kangmei ruling. On the other hand, if the 2.459 billion yuan awarded in the Kangmei ruling is paid by Zhengzhong Zhujiang, which is jointly and severally liable, it will cause Zhengzhong Zhujiang to go bankrupt because it is obviously unable to pay. This tendency to bankrupt accounting firms will directly lead to the failure to meet the second condition of the audit insurance hypothesis. The stock market will react negatively due to the loss of audit insurance value. For example, Menon and Williams (1994) found that the bankruptcy of the accounting firm Laventhol & Horwath (L&H) directly caused investors to lose their potential claims on the auditors, so the stock prices of the original L&H audit client companies fell. If the Kangmei ruling becomes the norm, it can be expected that the clients of similar sued accounting firms will react negatively to the Kangmei ruling. Of course, there is a third possibility – that the clients of the sued accounting firms will not react to the Kangmei ruling. There are at least two possible reasons. First, the accounting firm and the audited unit and few key individuals are jointly and severally liable. In addition, the solvency of the accounting firm is not stronger than the audited unit and those key individuals, which means that the accounting firm is unlikely to give 100% compensation. According to a report by CCTV.com on 23 December 2021, 2.459 billion yuan has been paid by Kangmei Pharmaceutical, and investors are satisfied with the speed of compensation.⁶ Therefore, whether accounting firms will be the compensation subject or not may remain unchanged. Second, the public is divided about whether the Kangmei ruling is an isolated warning and deterrent or whether it will become the norm, which will be reflected in the beliefs of investors in stock trading, and therefore leads to a weak or nonexistent market reaction to the Kangmei ruling.

Second, from the perspective of the expected consequences of audit insurance value, both the positive and negative market reaction triggered by Kangmei ruling may confirm the existence of audit insurance value. One view holds that the audit service purchased by the enterprise in the name of the shareholders is essentially an act of purchasing

⁵China Securities Journal: 'CSRC: Promoting the Normalization of Special Representative Litigation': https://www.cs.com.cn/xwzx/hg/202111/t20211113_6219769.html

⁶CCTV.com: 'Compensation for Kangmei Pharmaceutical's fraud case has been executed, and investor has received compensation one after another': <https://tv.cctv.com/2021/12/23/VIDEnXXqck4riRwnSpu3LXyR211223.shtml>

insurance, and it is reasonable for investors to ask accounting firms to compensate them for losses (Hope & Langli, 2010; Kothari et al., 1988). By increasing the civil liability of accounting firms, audit quality can be improved, and the interests of investors can be effectively protected (Dye, 1993; Palmrose, 1994), which further promotes capital market development. Thus, the stricter the civil liability, the better. Conversely, another view holds that if all investment losses can be recovered from the pockets of accounting firms, this may lead to a decline in investors' efficiency (Liao & Radhakrishnan, 2016; Lu & Sapa, 2009; Schwartz, 1997), a decline in the attractiveness of the audit profession, a decrease in supply from the audit market, or an increase in audit fees (Laux & Newman, 2010; Venkataraman et al., 2008), or CPAs will become more cautious yet not necessarily more diligent (Thoman, 1996). Thus, accounting firms should only be exposed to moderate civil liability (Radhakrishnan, 1999). Although these two viewpoints both support the insurance hypothesis of auditing, their implications for future institutional orientation and policy evolution are entirely different. The former points towards increasing the civil liability of accounting firms, while the latter advocates only a moderate degree of civil liability. Therefore, according to these two opposing viewpoints, different expectations can be formed: according to the former, the clients of the sued accounting firms will react positively to the Kangmei ruling; according to the latter, they will have a negative reaction to the verdict.

Based on the above analysis, we propose the following null hypothesis:

H0: *Ceteris paribus*, the stock price of companies that are audited by the sued accounting firms did not fluctuate abnormally during the short window after the Kangmei ruling.

3. Research design

3.1. Samples and data sources

In this paper, we use the A-share listed companies on the Shanghai, Shenzhen, and Beijing Stock Exchanges as of 13 November 2021, as our initial research sample, and obtain a total of 4,782 firm-year observations. The reason for choosing this specific time is that the date of the Kangmei ruling was Friday, 12 November 2021, which was immediately followed by a weekend. We then remove the following observations from our initial sample: (1) financial listed companies; (2) ST or *ST companies; (3) companies that experienced other significant events affecting stock prices during the estimation period and event period (mergers and acquisitions, equity transfer, stock repurchase, additional issuance, allotment, administrative investigation, litigation and arbitration ruling, violation announcement, equity pledge freezing, etc.); (4) companies with no transactions during the estimation period or event period; (5) companies missing other financial or transaction data. After the above sample selection, we finally obtain 3,245 observations. Next, based on the latest announcements of listed companies on the Cninfo website (www.cninfo.com.cn), and civil judgements or rulings published on the China Judicial Opinions Website (<https://wenshu.court.gov.cn/>), we retrieve and manually collect

the prosecutions of accounting firms and the information on the listed companies involved in the lawsuits. We get a total of 5 accounting firms listed as co-defendants because of the securities misrepresentation of their audit clients, which have yet to be settled as of 13 November 2021. The specific information of these cases and the key parties are given in Table 4. Other data used in this paper are mainly from the CSMAR database. To eliminate the impact of outliers, we winsorise all continuous variables at the 1% and 99% levels.

3.2. Research model

We design and set up model (1) for regression analysis as follows.

$$CAR[-3, 3] = \beta_0 + \beta_1 SuedAudClint + \beta_2 Size + \beta_3 Momentum + \beta_4 BM + \beta_5 SOE + \beta_6 Age + \beta_7 ROA + \beta_8 CFO + \varepsilon \quad (1)$$

where $CAR [-3,3]$ is the dependent variable, which is the cumulative excess return calculated with the market model in the three days both before and after the event day (i.e. 13 November 2021). The main explanatory variable, *SuedAudClint*, is a dummy variable that represents whether a listed company is one of the audit clients of the sued accounting firms. If a company has been audited by one of the five sued accounting firms within the past two fiscal years (i.e. fiscal years 2019 and 2020), then *SuedAudClint* is assigned a value of 1, and otherwise it equals 0. In this definition, the two fiscal years of 2019 and 2020 are used because the new Securities Law has been implemented since 1 March 2020 (in the following, we also conduct robustness tests according to the application principles of China's laws and regulations). After the Kangmei ruling, the insurance value of accounting firms is reflected in two aspects: for listed companies involved in related lawsuits, it is reflected in liability for compensation after the ruling; for

Table 4. Progress of judgements in related events.

The sued accounting firms	Relevant sued listed company in the litigation	Related litigation process
Zhonghuan Haihua (众环海华) Certified Public Accountants	Kaidi Ecological and Environmental Technology Co., Ltd (delisting) (stock code: 000939)	From May 2018 to November 2020, many lawsuits were filed, and some lawsuits have not yet opened for the first instance as of November 13, 2021
Ruihua Certified Public (瑞华) Accountants	Beijing Haohua Energy Resource Co., Ltd (stock code: 601101)	The <i>Notice of Response</i> and related legal documents were received between June 10, 2021, and July 5, 2021. As of November 13, 2021, the first trial has not yet opened
Zhonghua Certified (众华) Public Accountants LLP	*ST Shandong Yabo Technology Co., Ltd (stock code: 002323)	The <i>Notice of Response</i> and related legal documents were received in December 2020; the first trial had not yet opened as of November 13, 2021.
CAC CPA Limited (中审华) Liability Partnership	ST FUREN Group Pharmaceutical Co., Ltd. (stock code: 600781)	The case was filed by the Zhengzhou Intermediate People's Court from June 2 to 8, 2021, and the first trial had not yet opened as of November 13, 2021
Pan-China (天健) Certified Public Accountants	ST Jiangsu Huifeng Agrochemical Co., Ltd (stock code: 002496)	The <i>Notice of Response</i> and related legal documents in were received in March 2021. On July 30, 2021, appealed against the ruling of the first court. As of November 13, 2021, the second-instance trial had not yet opened.

other listed companies not involved in related lawsuits, it is reflected in potential liability in future lawsuits. Thus, both defendant companies in related cases with sued accounting firms and other non-defendant companies are included in the sample. Following the literature, we also add the following control variables to the model: enterprise size (*Size*), measured by the logarithm of total assets (million yuan) in the third quarter of 2021; stock momentum (*Momentum*), measured by the momentum index of the previous 30 trading days using the closing price on 12 November 2021, as the benchmark; book-to-market ratio (*BM*), measured by the book value of net assets in the third quarter of 2021 divided by the market value; the nature of property rights (*SOE*), which equals 1 if the enterprise is state-owned and 0 otherwise; listing age (*Age*), measured by the logarithm of the listing years as of the end of 2021; return on assets (ROA), measured by dividing net profit by the average balance of total assets; cash flows from operating activities (*CFO*), measured by the net cash flows from operating activities after normalisation of gross operating income. In addition, considering the heterogeneity of industries and regions, the model also controls for industry and city fixed effects.

4. Empirical results and analysis

4.1. Descriptive statistics

As shown in Table 5, the mean of *CAR* $[-3,3]$ is 0.002 and its median is 0.000, indicating that the dependent variable is normally distributed. The mean of *SuedAudClint* is 0.261, which means that 26.1% of listed companies have appointed sued accounting firms that are amid a litigation dispute over false statements and have yet to be settled.

4.2. Main regression results

4.2.1. Main test results

Table 6 reports the results of our main regression (model (1)). The results in column (1) show that *SuedAudClint* and *CAR* $[-3,3]$ are significantly and negatively correlated at the 5% level (the coefficient is -0.007), indicating that the Kangmei ruling led to a negative market reaction to the client companies of the sued accounting firms. Column (2) shows that after controlling for enterprise size (*Size*), book-to-market ratio (*BM*), stock momentum (*Momentum*), the nature of property rights (*SOE*), listing years (*Age*), return on assets (ROA), and cash flows from operating activities (*CFO*), the clients of the sued accounting firms also have a significant negative market reaction (with a coefficient of -0.006 , and *t*-value of -2.24) within the short window of the ruling event. The results imply that, *ceteris paribus*, the stock prices of the client companies audited by the sued accounting firms experienced a negative and abnormal change in the short window around the Kangmei ruling. This suggests that for the client companies of the sued accounting firms, investors rationally realise after the Kangmei ruling that they will lose their future possibility of protection by sued accounting firms through civil compensation (i.e. the audit insurance value), which consequently appears as a negative market reaction in the short window period.

Table 5. Descriptive statistics.

Variable	Obs.	Mean	SD	1/4 quantile	Median	3/4 quantile
<i>CAR</i> [-3,3]	3,245	0.002	0.066	-0.031	0.000	0.029
<i>SuedAudClint</i>	3,245	0.261	0.439	0.000	0.000	1.000
<i>Size</i>	3,245	8.593	1.314	7.625	8.371	9.351
<i>Momentum</i>	3,245	4.592	0.148	4.576	4.601	4.621
<i>BM</i>	3,245	0.626	0.264	0.431	0.616	0.812
<i>SOE</i>	3,245	0.271	0.444	0.000	0.000	1.000
<i>Age</i>	3,245	2.197	0.827	1.609	2.398	2.944
<i>ROA</i>	3,245	0.046	0.072	0.016	0.045	0.083
<i>CFO</i>	3,245	0.106	0.175	0.015	0.089	0.180

Table 6. Main test.

	(1)	(2)
Dep. Var. =	<i>CAR</i> [-3,3]	<i>CAR</i> [-3,3]
<i>SuedAudClint</i>	-0.007** (-2.26)	-0.006** (-2.24)
<i>Size</i>		-0.008*** (-7.38)
<i>Momentum</i>		-0.067*** (-6.50)
<i>BM</i>		0.044*** (7.40)
<i>SOE</i>		-0.006* (-1.84)
<i>Age</i>		0.001 (0.66)
<i>ROA</i>		0.013 (0.61)
<i>CFO</i>		-0.006 (-0.83)
<i>Constant</i>	0.003** (2.46)	0.352*** (7.49)
Industry	Yes	Yes
City	Yes	Yes
Adj. R ²	0.061	0.114
N	3,245	3,245

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

4.2.2. Robustness tests

To verify the robustness of our conclusion in the main analysis, we perform the following series of robustness tests.

- (1) Alternative event windows. In [Table 7](#), we adjust the event windows to [-1, 1], [-2, 2], [-4, 4], [-5, 5] and perform the regression of model (1) again. The results show that during the [-2, 2], [-5, 5] windows, the coefficients of *SuedAudClint* are both at least 10% significant, and the results in the [-4,4] period are very close to the 10% significance level, which is generally consistent with our main test results. The results in the window period [-1, 1] are not significant, which might be because the market requires the necessary reaction time to understand the Kangmei ruling.

Table 7. Robustness test: alternative event windows.

	(1)	(2)	(3)	(4)
Dep. Var. =	CAR [-1,1]	CAR [-2,2]	CAR [-4,4]	CAR [-5,5]
<i>SuedAudClint</i>	-0.001	-0.004*	-0.004	-0.005**
	(-0.59)	(-1.82)	(-1.58)	(-2.13)
Size	-0.006***	-0.011***	-0.015***	-0.017***
	(-10.35)	(-13.14)	(-17.76)	(-14.27)
Momentum	-0.058***	-0.056***	-0.074***	-0.054***
	(-6.60)	(-6.70)	(-5.84)	(-4.90)
BM	0.034***	0.054***	0.066***	0.070***
	(9.04)	(12.26)	(11.33)	(12.14)
SOE	-0.007***	-0.011***	-0.010**	-0.011**
	(-3.26)	(-3.51)	(-2.45)	(-2.42)
Age	0.002*	0.005**	0.004**	0.005**
	(1.88)	(2.51)	(2.51)	(2.51)
ROA	0.004	-0.013	-0.018	-0.062*
	(0.19)	(-0.40)	(-0.54)	(-1.94)
CFO	-0.001	-0.003	-0.013	-0.011
	(-0.15)	(-0.30)	(-1.45)	(-1.17)
Constant	0.307***	0.333***	0.459***	0.383***
	(7.71)	(8.27)	(7.79)	(7.32)
Industry	Yes	Yes	Yes	Yes
City	Yes	Yes	Yes	Yes
Adj. R ²	0.127	0.132	0.137	0.143
N	3,245	3,245	3,245	3,245

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

(2) Alternative research samples. Non-retroactivity is one of the fundamental principles in the P.R.C. Constitution. When new and old laws conflict, applying the older and the lighter law is generally the principle. If an illegal act occurred under the old law but was investigated and punished after the implementation of the new law, the new law prevails, rather than the old law being applied retroactively; the cases that have been judged and entered into force before the new law is promulgated have already taken effect, and the new law can no longer be applied.⁷ Therefore, the new Securities Law will be applied when the false statement of an audit report was issued after March 1, 2020, or a false statement in an audit report was issued before March 1, 2020 but was investigated after March 1, 2020. From the strictest point of view, audit reports issued after March 1, 2020, must be subject to the new Securities Law if they contain false statements. To this end, column (1) of Table 8 excludes observations whose audit reports were issued before March 1, 2020. Overall, the conclusions in our main test are consistent (coefficient of -0.005, t-value of -1.73).

Three days after the Kangmei ruling, i.e. on the morning of 15 November 2021, the Beijing Stock Exchange was officially unveiled. Because of this, investors may have had more positive expectation, which may have affected the normal fluctuation of stock prices. Thus, we exclude companies that were listed on the Beijing Stock Exchange in the same industry on 15 November 2021. The results in column (2) of Table 8 show that the coefficient of *SuedAudClint* is significantly negative at the 10% level, with a value of -0.008, the absolute value of which is slightly larger than the coefficient of -0.006 in the

⁷The new securities law was officially implemented on March 1, and the investigation was carried out according to the new law or the old law' <https://baijiahao.baidu.com/s?id=1659960589231810542&wfr=spider&for=pc>

full sample test, indicating that the negative market reaction of the subsample is more severe than that of the full sample.

To exclude the impact of the drop in the stock prices of client companies audited by Zhengzhong Zhujiang, which is at the centre of this incident, the client companies audited by Zhengzhong Zhujiang within the past two years are excluded in column (3) of Table 8. The results show that the coefficient of *SuedAudClint* is still significantly negative at the 10% level, with a value of -0.005 .

Column (4) of Table 8 excludes audit client companies whose accounting firms have been penalised within the past two years. The results show that the client companies that employ the litigated firm also have a significant negative market reaction (the coefficient is -0.009 , and the t-value is -2.51).

Column (5) of Table 8 excludes firms listed after 1 January 2020. The results indicate that the coefficient of *SuedAudClint* is still significantly negative at the 5% level (coefficient of -0.006) after excluding the observations of newly listed companies.

In summary, the sub-sample regression results in Table 8 robustly validate the research hypothesis of this paper.

(3) Excluding the influence of the Big Four and firm-level characteristics. First, we remove 230 observations whose auditors are one of the Big Four accounting firms. The regression results are recorded in columns (1) and (2) of Table 9. Second, after excluding the audit clients of the Big Four, we match these samples using the propensity score

Table 8. Robustness test: alternative research samples.

	(1)	(2)	(3)	(4)	(5)
	Excluding observations with audit reports issued before March 1, 2020	Excluding companies in the same industry listed on the Beijing Stock Exchange on November 15	Excluding client companies audited by Zhengzhong Zhujiang within 2 years	Excluding companies that have been audited by a penalised accounting firm within 2 years	Excluding firms listed after January 1, 2020
Dep. Var. = <i>SuedAudClint</i>	CAR [-3,3]	CAR [-3,3]	CAR [-3,3]	CAR [-3,3]	CAR [-3,3]
	-0.005*	-0.008*	-0.005*	-0.009**	-0.006**
	(-1.73)	(-1.66)	(-1.71)	(-2.51)	(-2.04)
Size	-0.008***	-0.005***	-0.009***	-0.008***	-0.008***
	(-7.17)	(-2.91)	(-7.31)	(-6.17)	(-7.01)
Momentum	-0.077***	-0.029	-0.079***	-0.068***	-0.096***
	(-5.98)	(-1.15)	(-6.19)	(-4.53)	(-6.42)
BM	0.045***	0.040***	0.045***	0.044***	0.045***
	(7.21)	(4.25)	(7.10)	(5.87)	(7.13)
SOE	-0.004	-0.010**	-0.004	-0.003	-0.005
	(-1.33)	(-2.11)	(-1.21)	(-0.80)	(-1.42)
Age	-0.002	0.002	-0.001	-0.002	-0.001
	(-0.66)	(0.55)	(-0.61)	(-0.75)	(-0.46)
ROA	0.002	-0.002	0.001	0.023	0.017
	(0.12)	(-0.09)	(0.06)	(1.12)	(0.81)
CFO	-0.004	-0.001	0.001	-0.001	-0.005
	(-0.45)	(-0.55)	(0.46)	(-0.48)	(-0.64)
Constant	0.404***	0.145	0.418***	0.364***	0.488***
	(6.84)	(1.25)	(7.06)	(5.27)	(7.15)
Industry	Yes	Yes	Yes	Yes	Yes
City	Yes	Yes	Yes	Yes	Yes
Adj. R ²	0.121	0.114	0.123	0.137	0.125
N	2,894	1,248	2,814	2,099	2,885

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

matching (PSM) method. The clients of the sued accounting firms are categorised as the intervention group, while those who are not clients of the sued accounting firms are the control group. We use all control variables in our main model (model (1)) as covariates, and employ the Logit model to estimate the possibility of a sample belonging to the intervention group, i.e. a propensity score. We use the nearest neighbour matching method and match the sample observations 1:1, with a maximum 0.01 difference in propensity scores. After matching, the covariate characteristics of the intervention group and the control group are quite similar, which reduces the imbalance in firm characteristics. Therefore, except for the main explanatory variable (*SuedAudClint*), the characteristics of other covariates are similar between samples in the matched groups. In this way, the impact of differences in company characteristics is eliminated as much as possible. Then, we regress model (1) with the matched samples and report the results in columns (3) and (4) of Table 9.

It can be seen that, compared with the results in our main test, after excluding the Big Four audit clients, the absolute values of the coefficient of *SuedAudClint* increased by 0.001, and are still significant at the levels of 1% and 5%, respectively. At the same time, compared with the main test, after excluding the Big Four audit clients and performing PSM matching, the absolute values of the coefficient of *SuedAudClint* change little and are both significant at the 5% level. These results suggest that, on the one hand, the Big Four have higher solvency than other accounting firms, which to a certain extent alleviates the negative market reaction caused by sued firms' liability for compensation. On the other hand, it further demonstrates the main point of this paper, that is, accounting firms have the value of audit insurance. In summary, results removing the Big Four and excluding firm-level heterogeneous characteristics further reinforce our main findings.

Table 9. Robustness test: excluding the influence of the Big 4 and firm-level characteristics.

	Excluding Big 4 clients		Excluding Big 4 clients and performing PSM	
	(1)	(2)	(3)	(4)
Dep. Var. = <i>SuedAudClint</i>	CAR [-3,3] -0.008*** (-2.63)	CAR [-3,3] -0.007** (-2.45)	CAR [-3,3] -0.008** (-2.15)	CAR [-3,3] -0.008** (-2.19)
Size		-0.008*** (-6.20)		-0.009*** (-4.90)
Momentum		-0.070*** (-6.17)		-0.071*** (-4.66)
BM		0.044*** (6.82)		0.048*** (5.24)
SOE		-0.006* (-1.74)		-0.008* (-1.71)
Age		0.001 (0.50)		0.002 (0.74)
ROA		0.007 (0.33)		0.020 (0.66)
CFO		-0.007 (-0.85)		0.005 (0.48)
Constant	0.005*** (3.40)	0.364*** (7.04)	0.007*** (2.86)	0.379*** (5.35)
Industry	Yes	Yes	Yes	Yes
City	Yes	Yes	Yes	Yes
Adj. R ²	0.054	0.105	0.035	0.094
N	3,015	3,015	1,676	1,676

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

5. Further analysis

5.1. Alternative time points in the Kangmei judgement process

In our main examination, we identify the date of the Kangmei ruling as the event day, but the market might react to this case at an earlier point before the verdict. Thus, we further examine it at two other important points in time before the ruling. The results are reported in Table 10.

First, we take the date when the court officially accepted the Kangmei case (31 December 2020) as the event date for a robustness test. Correspondingly, the dependent variable is replaced by the cumulative excess return based on the market model for three days both before and after the event date (i.e. 31 December 2020). We collected data by hand from the Cninfo website and China Judicial Opinions Website for accounting firms listed as co-defendants due to false representation of an audit client's securities, which have not been settled as of 31 December 2020. There are a total of five groups of sued accounting firms and related sued client companies: KPMG Huazhen LLP – GuoYuan Securities Co., Ltd (stock symbol: 000728), Zhonghuan Haihua Certified Public Accountants – Kaidi Ecological and Environmental Technology Co., Ltd (delisting) (stock symbol: 000939), Zhonghua Certified Public Accountants LLP – *ST Shandong Yabo Technology Co., Ltd (stock symbol: 002323), Ruihua Certified Public Accountants – ST China Security Co., Ltd (stock symbol: 600654), BDO China Shu Lun Pan Certified Public Accountants LLP – Shanghai DZH Limited (stock symbol: 601519). After filtering the data set as in the main test, 2,842 firm-year observations were obtained. The test results are shown in column (1). The coefficient of *SuedAudClint* is 0.001, but is not significant (t-value is 0.21), indicating that the

Table 10. Market reaction to alternative event days in the Kangmei judgement process.

	(1) Alternative event day: the date when the Kangmei case was officially taken on by the court	(2) Alternative event day: the date when the Kangmei case was successfully converted to the first special representative lawsuit
Dep. Var. = <i>SuedAudClint</i>	CAR [-3, 3] 0.001 (0.21)	CAR [-3, 3] -0.003 (-0.75)
<i>Size</i>	0.016*** (11.33)	-0.001 (-0.48)
<i>Momentum</i>	0.017 (1.22)	0.069*** (5.54)
<i>BM</i>	-0.051*** (-7.72)	-0.014** (-2.33)
<i>SOE</i>	0.003 (0.74)	-0.001 (-0.26)
<i>Age</i>	-0.003 (-1.17)	-0.001 (-0.65)
<i>ROA</i>	0.095*** (4.75)	0.020 (0.96)
<i>CFO</i>	-0.000* (-1.66)	-0.000 (-0.94)
<i>Constant</i>	-0.179*** (-2.76)	-0.297*** (-5.17)
Industry	Yes	Yes
City	Yes	Yes
Adj. R ²	0.183	0.153
N	2,842	2,863

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

Kangmei case induced no significant market reaction on the day the court formally accepted it.

Second, we take the date of the successful conversion of the first special representative lawsuit as the event date (16 April 2021) for a robustness test. Correspondingly, the dependent variable is replaced by the cumulative excess returns for three days both before and after the event date (i.e. 16 April 2021) calculated based on the market model. Data from a total of four accounting firms listed as co-defendants due to misrepresentation of securities and which had not been settled as of 16 April 2021, were collected manually. The sued accounting firms and the listed companies involved are as follows: Zhonghuan Haihua Certified Public Accountants – Kaidi Ecological and Environmental Technology Co., Ltd (delisting) (stock code: 000939), Zhonghua Certified Public Accountants LLP – *ST Shandong Yabo Technology Co., Ltd (stock code: 002323), Ruihua Certified Public Accountants – ST China Security Co., Ltd (stock code: 600654), Shangkuai Certified Public Accountants – ST China Security Co., Ltd (stock code: 600654). After screening samples as in the main test, 2,863 observations were obtained. The test results are shown in column (2). The coefficient of *SuedAudClint* is -0.003 , but is not significant (t value is -0.75), indicating that the Kangmei case failed to elicit a significant negative market reaction on the date of successful conversion to the first special representative lawsuit.

To sum up, the results indicate that although the dates of formal acceptance and conversion of the Kangmei case attracted market attention to Zhengzhong Zhujiang's audit quality, the market reaction was not significant because the punishment and compensation liability of the final verdict were not yet determined. This is consistent with the U.S.-based findings of Leone et al. (2021) that public doubts about major institutional changes or legal revisions are only resolved when the first case emerges from the legal system.

5.2. Heterogeneity tests

5.2.1. The solvency of accounting firms

Whether accounting firms can indemnify is an important condition for the existence of audit insurance value. Thus, the stronger the compensation capacity of the sued accounting firm, the weaker the negative reaction of its clients to the Kangmei ruling. To verify this hypothesis, we use the accounting firms' total revenue (*Revenue*) and the audit fees (*Fee*) of A-share clients as proxy variables for the solvency of accounting firms and construct two interaction terms with *SuedAudClint*. The results in Table 11 suggest that the coefficients of the interaction between *SuedAudClint* and the solvency of accounting firms are all significantly positive at least at the 10% level (the coefficients are 0.014 and 0.010, and the t -values are 2.38 and 1.68, respectively), which confirms our main findings and further demonstrates that more solvent accounting firms experience less negative market reaction to the Kangmei ruling.

5.2.2. The solvency of client companies

As accounting firms are a third party independent of the client company, the insurance value they provide varies according to the indemnity ability of the litigated company and

Table 11. Heterogeneity test: the solvency of accounting firms.

	(1) X = Revenue	(2) X = Fee
Dep. Var. =	CAR [-3,3]	CAR [-3,3]
<i>SuedAudClint</i>	-0.015*** (-3.40)	-0.013*** (-2.90)
<i>SuedAudClint*X</i>	0.014** (2.38)	0.010* (1.68)
X	-0.002 (-0.63)	-0.001 (-0.34)
Size	-0.008*** (-7.24)	-0.008*** (-7.35)
Momentum	-0.066*** (-6.45)	-0.067*** (-6.50)
BM	0.044*** (7.29)	0.044*** (7.38)
SOE	-0.006** (-1.98)	-0.006* (-1.93)
Age	0.002 (0.83)	0.001 (0.76)
ROA	0.012 (0.61)	0.012 (0.58)
CFO	-0.006 (-0.84)	-0.006 (-0.82)
Constant	0.351*** (7.45)	0.352*** (7.49)
Industry	Yes	Yes
City	Yes	Yes
Adj. R ²	0.116	0.115
N	3,245	3,245

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

its personnel who are jointly and severally liable. The Kangmei ruling states: ‘Kangmei Pharmaceutical shall be liable for a total of 2,458,928,544 yuan to investor losses. Xingtian Ma, Dongjin Xu, Xiwei Qiu, Yiqing Zhuang, Shaosheng Wen, Huanzhou Ma, and Kangmei Pharmaceutical shall be jointly and severally liable for compensation’. We speculate that if the sued company’s solvency is above the median level, its investors will pay less attention to the solvency of the sued accounting firms, which may weaken the negative market reaction brought about by the Kangmei ruling.

Therefore, first, we examine the impact of the client company’s solvency at the personal level, i.e. from the perspective of the salaries of directors, supervisors, and senior executives. We define *Salary* as a dummy variable that equals 1 if the salaries of directors, supervisors, and senior executives are higher than the median level, and 0 otherwise. Second, we examine solvency at the firm level, i.e. from the perspective of the cash flows from the enterprise’s operations. We define *Cashflow* as a dummy variable that equals 1 if the net cash flows from operating activities normalised by the total operating income of the enterprise is greater than the median level of the same industry in the current year, and 0 otherwise. The results are shown in columns (1) and (2) of Table 12. The coefficients of *SuedAudClint* are all significantly negative. However, the coefficient of its interaction with *Salary* is not significant (with

Table 12. Heterogeneity test: the solvency of client companies.

	(1) X = Salary	(2) X = Cashflow
Dep. Var. =	CAR [-3,3]	CAR [-3,3]
<i>SuedAudClint</i>	-0.006*	-0.010***
	(-1.79)	(-2.75)
<i>SuedAudClint*X</i>	0.001	0.009*
	(0.23)	(1.90)
<i>X</i>	0.004	-0.004*
	(1.50)	(-1.77)
<i>Size</i>	-0.010***	-0.007***
	(-10.05)	(-7.52)
<i>Momentum</i>	-0.050***	-0.057***
	(-6.09)	(-6.85)
<i>BM</i>	0.037***	0.038***
	(7.43)	(7.47)
<i>SOE</i>	-0.006**	-0.005*
	(-2.28)	(-1.83)
<i>Age</i>	0.002	0.001
	(1.17)	(0.55)
<i>ROA</i>	-0.020	0.008
	(-1.20)	(0.49)
<i>CFO</i>	-0.005	-0.000
	(-0.79)	(-0.47)
<i>Constant</i>	0.319***	0.304***
	(8.57)	(7.99)
<i>Industry</i>	Yes	Yes
<i>City</i>	Yes	Yes
Adj. R ²	0.143	0.134
N	3,245	3,245

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

a coefficient of 0.001, and t-value of 0.23), while the interaction with *Cashflow* is significantly positive at the 10% level (with a coefficient of 0.009 and t-value of 1.90). The results indicate that, rather than the financial ability of directors, supervisors and senior executives, the solvency of sued companies at the firm level significantly alleviates the negative market reaction to the Kangmei ruling, which is in line with our expectations and reality.

5.2.3. The impact of the client company's litigation risk

The insurance value provided by accounting firms varies with the litigation risk of the client company itself. Thus, we set four variables representing enterprise litigation risk in Table 13 to examine this heterogeneous impact. *Lawsuit* is defined as a dummy variable of whether the client company has been sued in the previous fiscal year, and equals 1 if it has been sued, and 0 otherwise. *Violation* is defined as a dummy variable indicating whether the company has been punished by the stock exchange in the last fiscal year, and equals 1 if it has been punished, and 0 otherwise. *CL* is defined as a dummy variable indicating whether the listed company received an inquiry letter from the stock exchange in the last fiscal year, and equals 1 if it has received, and 0 otherwise. *DA* is defined as the earnings management degree of the client company, measured by the absolute value of the

Table 13. Heterogeneity test: the impact of the client company's litigation risk.

	(1)	(2)	(3)	(4)
Dep. Var. =	X= <i>Lawsuit</i> CAR [-3,3]	X= <i>Violation</i> CAR [-3,3]	X= <i>CL</i> CAR [-3,3]	X= <i>DA</i> CAR [-3,3]
<i>SuedAudClint</i>	-0.006* (-1.93)	-0.006** (-2.03)	-0.006* (-1.87)	-0.007** (-2.60)
<i>SuedAudClint</i> *X	-0.182*** (-2.81)	-0.046* (-1.66)	-0.037* (-1.66)	-0.104** (-2.25)
X	0.048 (0.89)	-0.011 (-1.17)	0.006 (0.58)	0.066* (1.97)
Size	-0.009*** (-7.46)	-0.009*** (-7.47)	-0.009*** (-7.48)	-0.009*** (-12.10)
Momentum	-0.071*** (-6.34)	-0.071*** (-6.36)	-0.071*** (-6.34)	-0.071*** (-6.49)
BM	0.049*** (7.58)	0.048*** (7.39)	0.048*** (7.44)	0.048*** (9.42)
SOE	-0.006* (-1.86)	-0.006* (-1.86)	-0.006* (-1.85)	-0.006* (-1.89)
Age	0.002 (0.79)	0.002 (0.86)	0.002 (0.86)	0.002 (0.92)
ROA	0.008 (0.35)	0.003 (0.12)	0.005 (0.20)	0.004 (0.13)
CFO	-0.000 (-0.32)	-0.000 (-0.28)	-0.000 (-0.30)	-0.000 (-0.27)
Constant	0.374*** (7.29)	0.375*** (7.32)	0.373*** (7.29)	0.375*** (7.56)
Industry	Yes	Yes	Yes	Yes
City	Yes	Yes	Yes	Yes
Adj. R ²	0.102	0.100	0.100	0.100
N	3,245	3,245	3,245	3,245

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

manipulative accruals estimated with the Jones model. In regressions (1) – (4) of Table 13, we find that the interaction terms between *SuedAudClint* and each litigation risk proxy are significantly negative; that is, the higher the litigation risk of the client company, the greater the negative market response to Kangmei ruling.

5.3. Economic consequences test

The Kangmei ruling serves as a warning to the sued accounting firms. As a result, investors would have expected more diligence in their 2020 financial statement audit. Such an expectation should largely reflect the confidence that investors place in the audited reported earnings. Conversely, there is another possibility. Investors may develop strong distrust of the accused accounting firms because of Kangmei ruling, and do not expect them to be more diligent and conscientious in the future. Therefore, we set up the following model to examine the extent to which investors responded to the 2020 financial statements audited by the sued accounting firms.

$$\begin{aligned}
 CAR[-3, 3] = & \beta_0 + \beta_1 UE + \beta_2 SuedAudClint + \beta_3 UE \times SuedAudClint + \beta_4 Size + \beta_5 Size \\
 & \times SuedAudClint + \beta_6 Lev + \beta_7 Lev \times SuedAudClint + \beta_8 CFO + \beta_9 CFO \\
 & \times SuedAudClint + \beta_{10} BM + \beta_{11} BM \times SuedAudClint + \beta_{12} Big4 + \beta_{13} Big4 \\
 & \times SuedAudClint + \beta_{14} Grow + \beta_{15} Grow \times SuedAudClint + \beta_{16} ROA + \beta_{17} ROA \\
 & \times SuedAudClint + \varepsilon
 \end{aligned}$$

where the dependent variable, *CAR* $[-3,3]$, is the same as in the definition in our main test; it represents the cumulative excess return calculated with the market model for the three days both before and after the event day (i.e. 13 November 2021). *UE*, the explanatory variable, represents unexpected earnings for the current period, measured by subtracting third-quarter earnings per share (*EPS*) from fourth-quarter earnings per share in 2021 and then dividing by the closing price in the beginning of the fourth quarter in 2021. The model controls the enterprise size (*Size*), financial leverage (*Lev*), cash flows from operating activities (*CFO*), the book-to-market ratio (*BM*), whether the company is audited by the Big Four (*Big 4*) and growth capability (*Grow*, determined by the company's annual operating income growth rate), return on assets (*ROA*). The results in Table 14 report that the coefficient of $UE \times SuedAudClint$ is significantly negative (the coefficient is 0.159, with its t-value equals -1.70), which means that listed companies audited by the sued

Table 14. Earnings response of the sued accounting firms.

	(1)	(2)
	<i>CAR</i> $[-3,3]$	<i>CAR</i> $[-3,3]$
<i>UE</i>	0.288 (1.38)	0.321 (1.56)
$UE \times SuedAudClint$		-0.159* (-1.70)
<i>SuedAudClint</i>		-0.007** (-2.19)
<i>Size</i>	-0.010*** (-7.11)	-0.010*** (-7.05)
$UE \times Size$	0.015 (0.41)	0.016 (0.44)
<i>Lev</i>	-0.003 (-0.31)	-0.003 (-0.32)
$UE \times Lev$	-0.607*** (-2.61)	-0.615*** (-2.66)
<i>CFO</i>	-0.006 (-0.66)	-0.006 (-0.70)
$UE \times CFO$	-0.082 (-0.48)	-0.076 (-0.44)
<i>BM</i>	0.052*** (8.03)	0.052*** (8.11)
$UE \times BM$	-0.128 (-0.58)	-0.144 (-0.65)
<i>Big4</i>	-0.002 (-0.45)	-0.004 (-0.78)
$UE \times Big4$	0.181*** (2.91)	0.169*** (2.83)
<i>Grow</i>	0.007 (1.51)	0.007 (1.46)
$UE \times Grow$	0.006 (0.06)	0.006 (0.05)
<i>ROA</i>	0.018 (0.71)	0.020 (0.79)
$UE \times ROA$	0.238 (0.47)	0.287 (0.57)
<i>Constant</i>	0.053*** (5.74)	0.054*** (5.81)
<i>Industry</i>	Yes	Yes
<i>City</i>	Yes	Yes
Adj. R^2	0.108	0.110
<i>N</i>	2,854	2,854

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. The t-statistics reported in brackets are based on robust standard errors adjusted for firm-level clustering.

accounting firms have lower earnings response coefficients than firms audited by non-sued accounting firms. In sum, the results in Table 14 show that Kangmei ruling has to a certain extent weakened investors' trust in the financial statements of companies audited by the sued accounting firms.

6. Conclusions

The Kangmei ruling is the first case to be decided within the special representative litigation system for securities with Chinese characteristics under the new Securities Law. It is the civil compensation case involving listed companies' misrepresentation with the largest number of plaintiffs and highest amount of compensation heard by the court so far; thus, it has benchmarking and demonstrative significance. In addition, prior to the ruling, the definition of the audit responsibilities of Zhengzhong Zhujiang and other litigated firms and the information about the litigation have already been released. The incremental information of this ruling lies in the huge compensation awarded under the special representative litigation system. Therefore, this ruling provides an excellent scenario for directly examining audit insurance value. However, it is difficult to certainly expect whether and how the ruling will verify the insurable value of the audit, since the existence conditions or the expected consequences of the audit insurance value are unclear. We take China's A-share listed companies as a research sample and investigate the stock market responses to companies audited by the sued accounting firms as of the date of Kangmei ruling, to empirically test the insurance value of audits. The results indicate that investors in enterprises audited by the sued accounting firms had a significantly negative response to the Kangmei ruling; these results are confirmed by a series of robustness tests. In other words, investors perceive the new Securities Law as increasing the audit insurance value by safeguarding the investor's right to sue and increasing the compensation amount accounting firms must pay. Yet the huge size of the awards means that the accounting firm practically loses its ability to pay compensation to other clients; that is, the insurance value of the audit is lost.

Further, this effect differs depending on the compensation capacity of the sued accounting firms, and the compensation capacity and litigation risks of the client firms. Specifically: (1) The stronger the compensation ability of the sued accounting firms, the weaker the negative market response, which confirms the existence of audit insurance value; (2) The stronger the compensation ability of the client companies, the weaker the negative market response, which highlights the importance of the compensation ability of the client company in cases of joint and several liability. (3) The higher the litigation risk of the client company (including being involved in other lawsuits, being punished by the Exchange authorities, being the subject of an inquiry by the Exchange, and having higher earnings management), the greater the negative market reaction. Finally, the Kangmei ruling weakened investors' trust in the financial statements for 2020 that were audited by the sued accounting firms. In all, based on the audit insurance hypothesis, we provide important empirical evidence concerning the special representative litigation system, audit insurance, and investor protection under the new Securities Law, and expand the research on China's capital market in the field of law and finance.

In addition to the contributions to literature, our findings in this paper will improve the decision-making of accounting firms in sentencing adjudication under the new Securities

Law. The question of how to practically exert audit insurance value, which broadens investor protection, should be considered in civil compensation judgements.

As a fundamental law in the capital market, the new Securities Law strengthens auditors' civil compensation liability, which strengthens the audit insurance function in China's securities market. At the same time, the new Securities Law protects the interests of most small- and medium-sized investors. The special representative litigation system and the establishment of investor service agencies have provided investors with a powerful way to safeguard their rights, which will in return encourage certified public accountants to improve their professional and service quality. This will increase positive interactions with investors and build a strong engine for sustainable, high-quality development of China's capital market. However, this is only the first step in the development of China's capital market, as there is still a long way to go to implement investor protection and deepen reform. We have only conducted an event study of the market reaction to Kangmei ruling in a short window, while its deterrent effect and long-term deep impact on the securities market (such as the tide of resignations of independent directors in listed companies) requires a longer window to explore. The special representative litigation system is in the ascendant. Article 90 of the new Securities Law also leaves room for establishing other investor protection institutions and rights, which will reshape China's capital market. In addition, the audit insurance theory still needs further development. For example, after the implementation of the new Securities Law, the differences in the function of insurance for investors, such as the restructuring of accounting firms, auditors' subjective choice of clients, and their prudence in presenting opinions, are worthy of further exploration.

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ORCID

Siyi Liu  <http://orcid.org/0000-0001-8572-2333>

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