Company Performance, CEO Legal Background, and Auditor Independence

Yuzhou Su[1,a], Jinyuan Zhang[1,b,*]

[1]Macau University of Science and Technology, Macau, China

[a]jycso@must.edu.mo, [b]MizuharaZhang@foxmail.com

*Corresponding author

Keywords: Legal Background, Auditor Independence, Corporate Performance, Corporate Governance

Abstract: In this study, we examined how CEOs with a legal background influence auditor independence and corporate performance, drawing insights from the Evergrande and PwC auditing cases. We employed empirical methods, explored whether legal expertise among executives enhances audit quality and strengthens corporate governance. Through three distinct model analyses, our findings indicate that CEOs with legal training may promote greater auditor independence, while elevated audit fees often signal higher corporate risk or operational complexity. These results contribute to a deeper understanding of the interplay between executive background characteristics, audit integrity, and firm performance, offering valuable implications for both academia and corporate governance practices.

1. Introduction

In contemporary corporate management, the potential link between a CEO's legal background and auditor independence has attracted growing attention from both scholars and practitioners. Understanding this relationship is essential for analyzing corporate governance dynamics. The Evergrande Group crisis and PwC's auditing controversy highlight the real-world implications of audit oversight failures. In response, China's Ministry of Finance imposed penalties on auditors who failed to identify significant misstatements in financial reports, reinforcing the critical role of audit quality in ensuring corporate transparency and maintaining stakeholder trust (Francis, 2004)[1].

A CEO with a legal background may contribute to stronger audit quality and independence by shaping corporate governance practices and risk management strategies. Prior studies indicate that an executive's professional experience, educational attainment, and ethical orientation play a crucial role in corporate oversight, which in turn influences audit quality (Puspitosari, 2019)[2].

Building on this context, this study explores the following key research questions:

- To what extent does a CEO's legal background contribute to improved audit quality?
- How does auditor independence affect corporate performance?
- In what ways do a CEO's legal expertise and auditor independence interact to shape corporate performance?

By examining the interaction between a CEO's legal background and auditor independence, this study provides new insights into strengthening corporate governance. It expands the existing literature on the influence of executive background characteristics on governance structures and explores the potential mechanisms through which legal expertise enhances audit quality. The findings offer practical implications for policymakers and corporate leaders, informing strategies to improve audit integrity and independence, thereby mitigating the risks of financial fraud and governance failures[3].

  DOI: 10.25236/icssem.2025.078

2. Literature Review

2.1 CEO Background and Corporate Governance

A CEO’s personal attributes play a critical role in shaping corporate governance and strategic decision-making. Legal expertise, in particular, may strengthen a firm's risk management capabilities and regulatory compliance, thereby lowering the likelihood of corporate misconduct (Dikolli et al., 2019)[4][5]. Empirical studies have identified a negative correlation between certain executive backgrounds—such as military or legal training—and financial misconduct, suggesting that these backgrounds contribute to stronger internal controls and enhanced governance structures (Koch-Bayram & Wernicke, 2018)[6].

2.2 Auditor Independence and Audit Quality

Auditor independence is fundamental to maintaining high audit quality. Research indicates that factors such as close client relationships, the provision of non-audit services, and extended auditor tenure may undermine independence, potentially compromising audit effectiveness (Tepalagul & Lin, 2015)[7]. The presence of independent audit committees and experienced auditors plays a critical role in mitigating financial fraud risks, thereby strengthening the credibility and reliability of financial reporting (Romano & Guerrini, 2012)[8].

2.3 Interaction Between CEO Background and Auditor Independence

The dynamic relationship between CEOs and auditors can significantly impact audit quality. Studies suggest that CEOs demonstrating high behavioral integrity foster greater professional skepticism among auditors, ultimately enhancing audit effectiveness. In contrast, lower CEO integrity may lead to increased audit costs due to heightened risk perceptions (Dikolli et al., 2019)[4]. Additionally, while social ties between CEOs and audit committees may facilitate more efficient information exchange, they can also compromise auditor independence, potentially creating conflicts of interest (Westphal, 1999)[9].

2.4 The Impact of Auditor Independence on Corporate Performance.

Research highlights the intricate relationship between auditor independence and corporate performance. The provision of non-audit services by auditors may undermine their independence, potentially reducing audit quality and adversely affecting a company's long-term financial stability (Beaulieu & Reinstein, 2010)[10]. Conversely, a robust and independent audit process strengthens stakeholder confidence in financial disclosures, ultimately contributing to improved corporate performance (Francis, 2004)[1].

3. Theoretical Analysis and Hypotheses

Empirical research suggests that a CEO’s professional background, including legal expertise, plays a pivotal role in shaping corporate governance and risk management. CEOs with legal training often uphold higher ethical standards and recognize the professional risks associated with governance failures, making them more likely to strengthen corporate compliance and audit quality. These executives tend to prioritize auditor independence and professionalism as a safeguard against corporate misconduct (Dikolli et al., 2019)[4]. Furthermore, their legal expertise equips them with the ability to detect deficiencies in audit processes and recommend effective improvements (Francis, 2004)[1].

Hypothesis 1: CEOs with a legal background significantly enhance audit quality.

Auditor independence is essential for ensuring high audit quality and mitigating financial risks[5]. The provision of non-audit services and prolonged auditor-client relationships can undermine independence, potentially weakening the transparency and reliability of financial reporting (Tepalagul & Lin, 2015). Conversely, independent auditors are more adept at identifying and disclosing financial irregularities, thereby strengthening corporate accountability and contributing to overall firm performance (Romano & Guerrini, 2012).

Hypothesis 2: Auditor independence significantly impacts corporate performance.

The interplay between a CEO's legal background and auditor independence may have a significant impact on corporate performance. Highly independent auditors, in collaboration with legally trained CEOs, can foster stronger oversight and governance frameworks, thereby mitigating the risk of managerial fraud (Beaulieu & Reinstein, 2010). Furthermore, CEOs with legal expertise may demonstrate a greater preference for independent auditors, recognizing their role in enhancing financial transparency and optimizing firm performance (Francis, 2004)[1].

Hypothesis 3: CEOs with a legal background and auditor independence jointly impact corporate performance.

4. Data and Methodology

4.1 Data Sources and Sample Selection

This study selects Chinese A-share listed companies as the research sample, covering the period from 2015 to 2023. To ensure data accuracy and completeness, financial firms, ST and *ST companies, and firms with missing key data were excluded. The required data include:

• CEO characteristics: Collected manually from annual reports, corporate websites, and other public sources.

• Auditor independence: Measured using audit firm tenure, firm size, and non-audit service fees.

• Corporate performance: ROA and ROE obtained from the Wind database.

4.2 Variable Definitions and Measurements

Independent Variables:

- CEO Legal Background (Law_CEO): A dummy variable, coded as 1 if the CEO has a legal background, and 0 otherwise.
- Auditor Independence (Aud_Indep): Measured using auditor tenure and the proportion of non-audit service fees.

Dependent variables:

- Corporate performance (Firm_Perf): Mainly measured using ROA (Return on Assets) and ROE (Return on Equity) as indicators.

Control variables:

- Company size (Size), debt-to-equity ratio (Leverage), board size (Board_Size), industry and year dummy variables, etc.

4.3 Empirical Models

To test the hypotheses, the following multiple regression models are established:

- Model 1: Effect of CEO Legal Background on Auditor Independence

$$Aud\_Indep = \beta 0 + \beta 1 * Law\_CEO + \Sigma\beta * Controls + \varepsilon \quad (1)$$

- Model 2: Effect of Auditor Independence on Corporate Performance

$$Firm\_Perf = \beta 0 + \beta 1 * Aud\_Indep + \Sigma\beta * Controls + \varepsilon \quad (2)$$

- Model 3: Interaction of CEO Legal Background and Auditor Independence on Performance

$$Firm\_Perf = \beta 0 + \beta 1 * Law\_CEO + \beta 2 * Aud\_Indep + \beta 3 * Law\_CEO * Aud\_Indep + \Sigma\beta * Controls + \varepsilon \quad (3)$$

Where β0 is the constant term, β1, β2, and β3 are the coefficients to be estimated, Σβ represents the coefficients of the control variables, and ε is the random error term.

5. Empirical testing

5.1 Descriptive statistics

To ensure data accuracy and completeness, Stata software was used to remove outliers, samples with missing key data, and apply a 1% to 99% trimming process. This resulted in a dataset of 31,892 observations, as shown in Table 1.

Table 1: Descriptive Statistics of Data

Variable	Obs	Mean	Std. Dev.	Min	Max
Size	31892	22.23674	1.338733	15.97917	28.69688
Auditfee	31892	13.9276	0.6828335	10.59663	21.41701
Loss	31892	0.1345478	0.3412453	0	1
AssetLiabiratio	31892	0.4056393	0.2038783	0.0098	1.6869
MarketValuation	31892	22.82124	1.187106	19.32674	28.5993
AuditorTenure	31892	7.770507	5.749676	1	33
DirectorNumber	31892	9.958673	2.666826	4	30
IncomeLn	31891	21.48021	1.52524	10.16951	28.81194
ROA	31892	0.0340115	0.1094668	-3.164378	7.446082
ROE	31892	-0.0039781	2.044618	-235.096	64.05638
OtherCost	31892	0.4916594	0.4999383	0	1
Degree	26872	3.668577	1.251821	1	7
TMTP	31892	1.022137	0.2092504	1	3
Funback	31892	0.0152703	0.1226278	0	1

5.2 Correlation analysis

Table 2: Correlation Analysis Matrix

Variable	**Size**	**Auditfee**	**ROA**	**ROE**	**Funback**
Size	1.0000	0.7512 (p=0.7476)	0.0220 (p=0.1835)	0.0150 (p=0.2191)	0.0199 (p=0.7222)
Auditfee	0.7512 (p=0.7476)	1	-0.0528 (p=0.3278)	-0.0127 (p=0.5513)	0.0314 (p=0.8851)
ROA	0.0220 (p=0.1835)	-0.0528 (p=0.3278)	1.0000	0.3705 (p=0.6466)	-0.0299 (p=0.1951)
ROE	0.0150 (p=0.2191)	-0.0127 (p=0.5513)	0.3705 (p=0.6466)	1	-0.0004 (p=0.3191)
Funback	0.0199 (p=0.7222)	0.0314 (p=0.8851)	-0.0299 (p=0.1951)	-0.0004 (p=0.3191)	1.0000

After conducting correlation analysis on individual continuous variables using Stata software, the correlation matrix shown in Table 2 and the heatmap in Figure 1 were obtained.

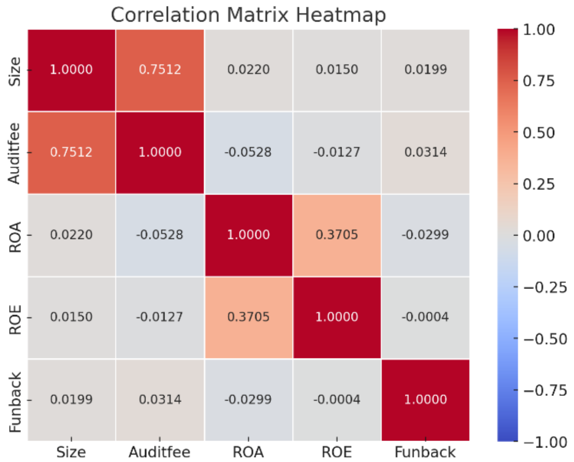

Figure 1: Correlation Analysis Heatmap

From the heatmap and correlation matrix, we can visually observe the degree of correlation between the variables.

The correlation between CEO legal background (Funback) and company size (Size), audit fees (Auditfee), and debt-to-equity ratio (AssetLiabilityRatio) is low (all less than 0.05), indicating that the direct relationship between CEO legal background and these variables is weak. Its correlation with corporate performance (ROA, ROE) is almost nonexistent (close to zero), suggesting that the CEO's legal background has a weak direct impact on these variables.

5.3 Multiple regression

5.3.1 The Impact of CEOs with a Legal Background on Auditor Independence

To test whether CEOs with a legal background are more inclined to choose auditors with stronger independence, thereby improving the company's audit quality, Model (1) mentioned above is used for testing (See Table 3).

$$Aud\_Indep = \beta0 + \beta1 * Law\_CEO + \Sigma\beta * Controls + \varepsilon \quad (4)$$

Table 3: t-values of Model 1 Regression Results

VARIABLES	Auditfee
Funback	0.0705***
	(3.4786)
Size	0.3760***
	(170.8147)
AssetLiabilityRatio	0.1137***
	(7.8880)
Loss	0.1728***
	(22.6083)
DirectorNumber	0.0025**
	(2.5529)
2016.Year	0.0368***
	(2.8959)
2017.Year	0.0975***
	(7.9432)
2018.Year	0.1234***
	(10.1731)
2019.Year	0.1418***
	(11.8478)
2020.Year	0.1389***
	(11.8109)
2021.Year	0.1523***
	(13.3008)
2022.Year	0.1584***
	(13.9952)
2023.Year	0.1543***
	(13.7692)
Constant	5.3481***
	(116.1846)
Observations	31,892
R-squared	0.5799

t-statistics in parentheses *** p<0.01, ** p<0.05, * p<0.1

After the regression test, the adjusted R-squared indicating that the model explains approximately 58% of the variation in audit fees (Auditfee). The F-value and Prob>F = 0.0000, indicating that the overall model is significant, with the independent variables such as Funback and Size having a significant impact on the dependent variable, Auditfee.

Funback indicating that companies employing CEOs with a legal background significantly increase audit fees, with audit fees rising compared to companies with CEOs without a legal background. This result supports Hypothesis 1, which suggests that CEOs with a legal background significantly enhance auditor independence.

Size indicating that company size has a significant positive effect on audit fees. Larger companies tend to have increased audit complexity, thus requiring higher audit fees. AssetLiabilityRatio suggesting that companies with a higher debt ratio may require more stringent audit services, leading to higher audit fees.

Year variable are significant, indicating that audit fees have gradually increased over time. This reflects the impact of changes in the economic environment, improvements in audit standards, or inflation. Loss indicating that companies with losses in the current year paid more in audit fees than non-loss companies. Loss-making companies may require additional audit procedures to assess their going concern ability, which increases audit costs.

DirectorNumber meaning that the impact of board size on audit fees is small but significant. This may be because larger companies have larger boards, making the audit work more complex and requiring more coordination.

5.3.2 The Impact of Auditor Independence on Corporate Performance

To test the impact of auditor independence on corporate performance, we use the above Model (2) for testing.

$$Firm\_Perf = \beta 0 + \beta 1 * Aud\_Indep + \Sigma\beta * Controls + \varepsilon \tag{5}$$

Table 4: t-values of Model 2 Regression Results

VARIABLES	ROA
Auditfee	0.0087***
	(-7.3446)
Size	0.0098***
	(-8.3342)
MarketValueLn	0.0230***
	(18.6357)
Loss	0.1449***
	(-89.3362)
2016.Year	0.0016
	(0.5870)
2017.Year	0.0084***
	(3.2004)
2018.Year	0.0046*
	(1.7265)
2019.Year	0.0022
	(0.8589)
2020.Year	0.0107***
	(4.2471)
2021.Year	0.0161***
	(6.5645)
2022.Year	0.0162***
	(6.5673)
2023.Year	0.0103***
	(4.2398)
Funback	0.0150***
	(-3.5148)
AssetLiabilityRatio	0.0850***
	(-27.8952)
DirectorNumber	0.0013***
	(-6.3833)
Constant	0.0939***
	(-7.4358)
Observations	31,892
R-squared	0.2758

t-statistics in parentheses

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

After the regression test, the results, as shown in Table 4, indicate that the model is significant overall, the joint effect of all independent variables on ROA is significant.

Auditfee indicating that an increase in audit fees significantly lowers ROA. Higher audit fees may be related to the company’s operational risks, which are likely reflected in lower return on assets. Size suggesting that larger companies may have lower asset efficiency, as reflected in a lower ROA.

MarketValueLn indicating that companies with larger market values may enjoy higher market recognition or profit margins, which increases ROA. Loss showing that companies with losses have significantly lower ROA compared to non-loss companies. Loss-making companies typically have lower asset utilization, significantly reducing ROA.

The results for most Year variables are significant, though some year coefficients are not significant (such as for 2016 and 2019), suggesting that the changes in ROA during these years may have been small. The fluctuation in ROA across different years may be related to changes in the macroeconomic environment or industry cycles.

The coefficient for Funback indicating that CEOs with a legal background have a negative impact on ROA. These CEOs may focus more on business compliance and risk control rather than short-term profits, leading to slightly lower return on assets.

The coefficient for AssetLiabilityRatio indicating that a higher debt ratio may increase financial costs and reduce asset utilization efficiency.

The coefficient for DirectorNumber meaning that for every additional board member, ROA decreases. A larger board size may reduce decision-making efficiency, impacting company performance."

5.3.3 The Impact of the Interaction Between CEOs with a Legal Background and Auditor Independence on Corporate Performance

To test the impact of the interaction between CEOs with a legal background and auditor independence on corporate performance, we conducted a regression test using Model (3).

$$Firm\_Perf = \beta 0 + \beta 1 * Law\_CEO + \beta 2 * Aud\_Indep + \beta 3 * Law\_CEO * Aud\_Indep + \Sigma\beta * Controls + \varepsilon \quad (6)$$

Table 5: t-values of Model 3 Regression Results

VARIABLES	ROA
Funback	-0.1008
	(-1.2140)
Auditfee	-0.0107***
	(-8.8685)
FunbackAuditfee	0.0058
	(0.9788)
Size	-0.0184***
	(-15.9531)
MarketValueLn	0.0257***
	(20.5866)
Loss	-0.1574***
	(-99.4049)
2016.Year	0.0033
	(1.1987)
2017.Year	0.0114***
	(4.2931)
2018.Year	0.0078***
	(2.9131)
2019.Year	0.0054**
	(2.0741)
2020.Year	0.0148***
	(5.7998)
2021.Year	0.0203***
	(8.1862)
2022.Year	0.0223***
	(8.9814)
2023.Year	0.0167***
	(6.8114)
Constant	0.0140
	(1.1351)
Observations	31,892
R-squared	0.2568

t-statistics in parentheses

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

The results, as shown in Table 5, indicate that the model is significant overall, meaning that the joint effect of the independent variables and control variables on ROA is significant.

However, in the results obtained, the CEO’s legal background does not have a significant direct effect on ROA. The legal background may influence corporate performance through other mechanisms, rather than directly. The interaction between the CEO’s legal background and audit fees does not significantly affect ROA, suggesting that CEOs with a legal background may focus more on compliance when selecting audit services, rather than directly improving corporate performance.

5.4 Robustness check

5.4.1 The Impact of CEOs with a Legal Background on Auditor Independence

When the dependent variable in Model (1) is replaced from the natural logarithm of Auditfee to AuditorTenure, the results show a significant relationship with the variable Funback, with a coefficient of -0.8459 and P = 0.001. This indicates that, on average, each additional CEO with a legal background reduces the auditor tenure by 0.85 years. Shorter auditor tenures may reduce the formation of overly close relationships between auditors and the company, preventing auditors from becoming dependent on the company's management due to prolonged collaboration, thereby lowering the risk of auditor independence being compromised. This result still supports Hypothesis 1.

5.4.2 The Impact of Auditor Independence on Corporate Performance

When the dependent variable in Model (2) is replaced from ROA to ROE, the results show that an increase in audit fees is significantly negatively correlated with ROE. For every 1 unit increase in the natural logarithm, ROE decreases by 6.40%. When both ROA and the natural logarithm of Auditfee are replaced with ROE and OtherCost (whether additional audit fees occurred), the results remain significantly correlated. The increased other audit costs may indicate the company's demand for higher quality audit services, which could improve governance levels and enhance profitability. Therefore, after replacing the dependent variable, the related variables still show a significant negative correlation, indicating that the model results possess a certain level of robustness.

5.4.3 The Impact of the Interaction Between CEOs with a Legal Background and Auditor Independence on Corporate Performance

When the dependent variable in Model (3) is replaced from ROA to ROE, and Auditfee (the natural logarithm of audit fees) is replaced with OtherCost, neither Funback, OtherCost, nor the interaction term Funback*OtherCost significantly affects ROE. This indicates that the alternative model does not support the significant impact of the combined effect of CEO legal background and auditor independence on corporate profitability.

5.5 Further Test

Since the joint effect of CEO legal background and auditor independence is not statistically significant, it still has important implications for policy. For example, the negative news surrounding Evergrande Real Estate and its auditors is a typical outlier case, while most companies follow accounting and auditing rules and procedures. On the other hand, research on companies with poor financial conditions or undergoing bankruptcy might yield stronger results, as, in extreme cases, CEOs may take on excessive risks in hopes of improving business conditions. Evergrande Real Estate is a good example, where major shareholders hoped to turn the situation around and achieve huge returns.

Based on this, the author selected companies involved in bankruptcy liquidation or reorganization and empirically tested and conducted robustness checks using Model 3 mentioned earlier. The significance of the key indicators remained weak, indicating that the joint effect of CEOs with a legal background and auditor independence may not significantly impact corporate profitability.

5.6 Interpretation of Results

Model 1 shows that CEOs with a legal background significantly affect auditor independence. The results are significant when the natural logarithm of audit fees is used as an independent variable, but the significance weakens when variables such as auditor tenure are substituted, indicating that the impact of a legal background on auditor independence varies across different variables. Model 2 explores the effect of auditor independence on corporate performance. The results indicate a significant negative correlation between audit fees and performance, but the significance and direction change when replaced with auditor tenure or other audit fees, suggesting that the mechanism through which auditor independence affects corporate performance may vary depending on the proxy variables.

Model 3 examines the interaction effect between a CEO's legal background and auditor independence. The findings indicate that the interaction term lacks statistical significance across various proxy variables, providing limited evidence that the combination of legal expertise and auditor independence directly enhances corporate performance. However, the effects of key control variables, including company size, debt-to-equity ratio, and loss status—remain consistent and statistically significant, reinforcing the robustness of the model. Overall, these results suggest that the relationship between a legally trained CEO, auditor independence, and corporate performance warrants further investigation, particularly in specific contexts and with alternative proxy variables.

6. Conclusion

This study aims to explore the impact of CEOs with a legal background and auditor independence on corporate performance, and, using the context of the Evergrande and PwC auditing incidents, to examine whether CEOs with a legal background contribute to improving audit quality and corporate performance. The study conducts empirical analysis through three models and verifies the reliability of the results using various robustness tests. CEOs with a legal background significantly enhance auditor independence, which is reflected in the positive correlation with higher audit fees. Auditor independence has a significant negative correlation with corporate performance, suggesting that higher audit fees may reflect higher operational risks or complexity within the company, which negatively impacts performance.

The research still has certain limitations. The proxy variables for auditor independence may not fully capture its complex nature. Furthermore, the joint effect of legal background and auditor independence may operate through other indirect mechanisms, which require further investigation. Additionally, if data from companies undergoing bankruptcy proceedings were available, the results would be more robust, as agency problems are likely to be more severe during such periods. Lastly, the sample is limited to companies from specific periods and regions, meaning that the research findings may not fully apply to other contexts. Future research could consider more indicators of auditor independence, cross-national comparisons across multiple regions, and more refined subgroup analyses to further improve the research conclusions.

Acknowledgement

Macau University of Science and Technology, FRG-23-029-MSB.

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