



Contents lists available at [SciVerse ScienceDirect](http://SciVerse.Sciencedirect.com)

China Journal of Accounting Research

journal homepage: www.elsevier.com/locate/cjar



Board independence, internal information environment and voluntary disclosure of auditors' reports on internal controls

Ye Sun^{a,b,*}, Yang Yi^a, Bin Lin^{a,c}

^a School of Business, Sun Yat-sen University, China

^b Department of Accountancy, City University of Hong Kong, China

^c Center for Accounting, Finance and Institutions, Sun Yat-sen University, China

ARTICLE INFO

Article history:

Received 8 December 2011

Revised 20 May 2012

Accepted 29 May 2012

Available online 30 June 2012

JEL classification:

G30

K22

M41

D23

Keywords:

Voluntary disclosure

Auditors' reports on internal controls

Board independence

Internal information environment

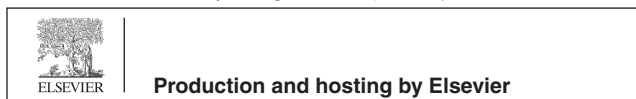
ABSTRACT

When there is high information asymmetry between directors and managers, independent directors do not have enough information to perform their functions. Only when faced with a good internal information environment can such directors acquire enough information to provide advice and monitor managers, and only under these conditions can increasing their proportion on the board effectively reduce agency problems, such as driving managers to disclose information to investors. Using a sample of Chinese listed firms that voluntarily disclose their auditors' reports on internal controls from 2007 to 2009, this study explores how the information acquisition costs of independent directors affect their monitoring effectiveness by investigating the disclosure decisions of their internal control audits. We find that when the information asymmetry between insiders and outside directors is low and the proportion of independent directors on a board is high, a firm is more likely to voluntarily disclose its internal control audit report.

© 2012 China Journal of Accounting Research. Founded by Sun Yat-sen University and City University of Hong Kong. Production and hosting by Elsevier B.V. All rights reserved.

* Corresponding author at: Department of Accountancy, City University of Hong Kong, China.

E-mail address: sunye_74@163.com (Y. Sun).



1. Introduction

Spurred by the seemingly ever-growing list of corporate scandals at the time, the United States passed the Sarbanes–Oxley Act (SOX) in 2002, which requires managers to evaluate the design and effectiveness of their internal control systems and report their overall conclusions, at which point they must employ an external auditor to audit their internal control systems and attest to the accuracy of the company management assertion that internal accounting controls are in place, operational and effective (SOX 302, 404). In China, investors and policymakers have also paid increasing attention to firms' internal controls. Since 2006, the China Securities Regulatory Commission (CSRC) and the Shanghai and Shenzhen Stock Exchanges have released a series of internal control-related regulations. In 2008, the Ministry of Finance released the Enterprise Internal Control Basic Standard, which is considered the Chinese SOX (C-SOX) and is aimed at standardizing the construction of internal controls in Chinese firms and strengthening the supervision and assessment of internal controls. Regarding internal control audits, unlike in the United States, there were no mandatory requirements for most Chinese listed firms before 2010. Since 2007, the Shanghai and Shenzhen Stock Exchanges have explicitly encouraged listed firms to report their internal control self-assessments and voluntarily hire CPA firms to conduct audits of internal controls. Hiring auditors to provide extra audit reports on internal controls produces additional costs. However, according to our statistics, from 2007 to 2009, there were 133, 161 and 210 listed firms that voluntarily disclosed their auditors' reports on internal controls (ARICs). What were the motives and incentives for those firms to voluntarily audit their internal control systems? What factors caused such differential disclosure decisions? These are still open questions. [Lin and Rao \(2009\)](#) show that firms with high internal control quality and those that want to refinance are more likely to audit their internal controls to send a positive signal to the market. This study investigates the motives behind the voluntary auditing of internal controls from a corporate governance perspective. In particular, we discuss the relationships among board independence, voluntary audit and disclosure decisions under different internal information environments.

As [Jensen and Meckling \(1976\)](#) note, the separation of property and management rights creates agency problems between principals and agents. The latter tend to hide information in the hope of maintaining their private control benefits ([Chen and Jaggi, 2000](#); [Eng and Mak, 2003](#); [Gul and Leung, 2004](#)). As a mechanism for solving agency problems, effective corporate governance is capable of increasing both the quantity and quality of disclosures in addition to enhancing voluntary disclosure. [Fama \(1980\)](#) believes that the board of directors is the core of an internal governance mechanism that monitors agents. Among all of the board characteristics, the proportion of independent directors is one of the most important factors because it reflects board independence and is considered an objective and professional monitoring mechanism. [Cheng et al. \(2009\)](#) show that the independent director system provides a more secure control mechanism for managing employment contracts, such that the independent directors' professional knowledge makes board decisions more scientific and capable of effectively preventing financial report distortion. We predict that a higher proportion of effective independent directors on a board will drive the firm to voluntarily audit its internal control system and disclose the related audit report.

Independent directors affect auditing and disclosure decisions regarding internal controls in the following ways. First, consistent with the literature, the monitoring role of independent directors will push the firm to disclose more information, including internal control information, to investors, which increases the likelihood that the internal control system will be audited to reduce information asymmetry and agency problems (direct effect). Second, under the requirements of C-SOX, the board of directors has the primary responsibility for establishing internal controls. The audit committee, under the control of the board, plays a core role in the detailed design and daily review of the internal control system. If the board is more independent, its monitoring function will be more pronounced, to the extent that the firm will pay more attention to the establishment of its internal control system. These firms are also more likely to send a signal of the effectiveness of their internal controls by disclosing their third-party verification reports (indirect effect).

We choose the voluntary disclosure of ARIC to test the monitoring effectiveness of independent directors for the following reasons. First, given the increased attention that internal control systems have been receiving in China and around the world, internal control information has become more important to investors' decision making. An internal control system plays an important role in ensuring the efficiency of daily operations

Download English Version:

<https://daneshyari.com/en/article/1004389>

Download Persian Version:

<https://daneshyari.com/article/1004389>

[Daneshyari.com](https://daneshyari.com)