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Internal control risk and audit fees: Evidence from China

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ABSTRACT

This study examines the association between internal control risk and audit fees under the voluntary adopting regime of the *Basic Standard of Enterprise Internal Control* in China. We find that audit fees are positively related to disclosed internal control weaknesses (ICWs). In particular, they are significantly associated with non-financial reporting-related, but not with financial reporting-related, ICWs.

Our results also indicate that voluntary assurance in internal control reports can mitigate higher audit fees associated with ICWs. Our study provides timely evidence relating to the debate on whether the scope of internal control should be expanded to non-financial reporting-related areas.

1. Introduction

With the increasing importance of risk management in business enterprises and auditors' roles in promoting effective risk management as part of the audit process, it is not surprising that the concept of risk management has become a focus in auditing and assurance research (Knechel, 2007). The number of academic studies devoted to investigating the relationship between enterprise risk management (ERM) and audit risk adjustments has increased (Desender and Lafuente, 2011; Knechel and Willekens, 2006). Internal control, as one of the essential elements of ERM, has attracted enormous attention in recent years, since the stipulation of the *Sarbanes–Oxley Act* (SOX) in the United States (US), which requires auditors to provide an assessment of clients' internal control quality and certify their internal control reports (ICRs). Studies examining the effect of the SOX regulation on audit fees—one of the main audit risk adjustment mechanisms—predominately adopt the supply view of auditing, suggesting that clients' internal control weaknesses (ICWs) in financial reporting represent audit risks that could have negative effects on clients, both currently (e.g., misstatement and error in financial statements) and in the future (e.g., potential litigation liability) (Bedard et al., 2008; Raghunandan and Rama, 2006; Elder et al., 2009; Foster et al., 2007; Hogan and Wilkins, 2008; Hoitash et al., 2008; Choi et al., 2010). Due to increased perceived audit risks and correspondingly increased audit hours and efforts as a result of the implementation of SOX regulation, prior studies provide conclusive evidence that clients' internal control risk leads to auditors' risk adjustment and resulting higher audit fees.

However, whether internal control assessment of the financial reporting area under the SOX regime can truly represent a complete and accurate internal control assessment of business entities has been questioned recently (Public Company Accounting Oversight Board [PCAOB], 2013, 2015). There is a concern that internal control assessment of operational control risks can also affect financial reporting quality and this issue has been largely ignored by prior studies. It has been argued that the literature on internal control

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focuses only on financial reporting in an isolated way, rather than as part of an integrative evaluation of overall internal controls in business (Habib et al., 2018; Lawrence et al., 2018). Thus, the limitation of prior studies on internal control risk and audit fees is that they narrow auditors' reactions to ICWs that exist in the financial reporting-related area only, mainly because the SOX is a financial reporting-focused internal control regulation. ERM, however, in the spirit of the *Internal Control-Integrated Framework* developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), advocates that auditors should adopt a broader view of risk management, examining clients' internal control at the management level, which might have a more direct and profound effect on the quality of the judgements and estimates made for financial statements rather than focusing solely on accounting errors (COSO, 2004, 2013; Knechel, 2007).

The auditing failures relating to financial scandals such as Enron, WorldCom and Parmalat in the early 2000s share a distinctive characteristic: the financial fraud was conspired and concealed by top management—a crucial area of internal control. These cases highlight the importance of auditors possessing good knowledge of clients' internal control problems beyond financial reporting. The information related to clients' internal control over both financial reporting-related areas and non-financial reporting-related areas is expected to play a complementary role in helping auditors to form the foundation for assessing a client's audit risk.

Disclosed ICWs in non-financial reporting areas could provide auditors with leading indicators for audit risks when determining auditing fees. This incremental value is derived from two sources. First, ICWs in non-financial reporting areas could imply clients' potential litigation risk, which would inevitably increase the perceived audit risk for auditors. Second, since a business entity functions as an integrated organ (Chen et al., 2016; Simnett et al., 2009), weaknesses in non-financial reporting areas can affect the quality and effectiveness of internal control over financial reporting areas. ICWs in non-financial reporting areas could have either a direct or indirect effect on the quality of financial statements. Thus, given that audit fee pricing is an important strategy for auditors to manage audit risks (Defond and Zhang, 2014; Simunic, 1980), the disclosure of non-financial reporting-related ICWs could assist auditors in determining an acceptable threshold of audit risk, audit hours and compensation for potential legal liability and reputation loss (Dechow et al., 2010).

Raghunandan and Rama (2006), Hoitash et al. (2008) and Hogan and Wilkins (2008) attempt to differentiate top management, human resources (HR) and controlling environment-related ICWs from financial reporting-related ICWs, and find that risks existing in these areas affect auditors' perceptions of their clients. However, inconsistent definitions and classifications of non-financial reporting-related ICWs among prior studies imply that there is still a lack of evidence on whether auditors' assessments of clients' internal control in non-financial reporting areas—that is, in business management and operations-related areas—can assist them in carrying out their audit work more effectively and efficiently. In other words, whether and how business management-related internal control risks affect audit process remains unclear.

The internal control disclosure made by Chinese listed firms provides us with a unique opportunity to address this research gap. Aiming to improve operational efficiency and promote the strategic development of ERM, between 2008 and 2010, Chinese regulatory bodies established a regulatory framework for internal control—China SOX—by issuing the *Basic Standard of Enterprise Internal Control* and three implementation guidelines: the *Internal Control Application Guidelines*; *Internal Control Evaluation Guidelines*; and *Internal Control Audit Guidelines*. China SOX requires listed firms to strengthen their internal control over the internal operating environment; risk assessment and management; information disclosure and communication; and internal oversight/monitoring. Similar to the SOX in the US, both firms and their auditors are required to provide an evaluation of the effectiveness of their internal control. China SOX became effective on 1 January 2012. Prior to this date, firms possessed discretion in adopting it voluntarily.

Using the internal control disclosures made by Chinese listed firms enables us to overcome one of the limitations of prior studies. Compared with the US SOX regime, China SOX is more comprehensive, extending the scope of the internal control system to much broader business management and operation areas by specifically identifying 18 business management and operation areas where internal control risks could exist, from organisational structure, HR management, budget and corporate social responsibilities, to procurement and sales, outsourcing and contract management. The internal control directly related to the preparation of financial reporting is only one of the components of the overall internal control system articulated in the China SOX. Including risk assessment and management, internal oversight/monitoring and other unspecified weaknesses, firms are required to identify their ICWs in a total of 21 areas. Thus, under the Chinese internal control regime, the ICWs disclosed by firms constitute research data not only on financial reporting, but also on business management and operation areas. As the non-financial reporting-related internal control areas are clearly defined and articulated, this data set provides us with an opportunity to investigate whether much broader internal control risks can have a different effect on auditors' price adjustments, and particularly whether auditors incorporate clients' internal control risks—present in non-financial reporting areas—into their audit service.

More specifically, capitalising on the data available in China, our study examines: (1) the relationship between internal control risks—measured as ICWs disclosed by listed firms—and audit fees; (2) the association between internal control risks existing in financial reporting areas and in non-financial reporting-related areas, and audit fees respectively; and (3) whether the voluntary assurance of ICRs can mitigate the higher audit fees associated with internal control risks.

Using a sample of 2343 firms listed on the two Chinese stock exchanges over 2009–11, our results show that audit fees are positively associated with internal control risk—measured as ICWs disclosed in ICRs—indicating that auditors believe the existence of ICWs in firms increases audit risk and therefore charge higher audit fees as compensation for the greater auditing effort required (Hill et al., 1994; Morgan and Stocken, 1998). Our results also show that audit fees are significantly associated with business management and operations-related ICWs, meaning that auditors incorporate these non-financial reporting-related risks into their audit planning and audit fee adjustment. Further, we find that voluntary ICR assurance can mitigate audit risks caused by low internal control quality; that is, disclosure of ICWs. This can be explained as firms voluntarily engaged in ICR assurance have the desire to improve the credibility of the internal control information they disclose and these firms are assumed to be proactive in ERM. Consistent with

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