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Corporate governance and audit fees: Evidence from companies listed on the Shanghai Stock Exchange

Xingze Wu

Research Institute of Accounting and Finance, Nanjing University, China

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ABSTRACT

This study uses data from companies listed on the Shanghai Stock Exchange to investigate the relationship between corporate governance and audit fees. Full sample results reveal a significant negative relationship between corporate governance and audit fees, and subsample results further show that corporate governance's influence on audit fees is affected by corporate growth. The negative relationship between corporate governance and audit fees is economically and statistically significant in sample companies that grew moderately during the sample period, and mixed or insignificant in companies that experienced overly fast or negative growth.

1. Introduction

China's special audit market has important theoretical and empirical implications for the determinants of audit fees (Zhu and Yu, 2004). Of the various determinants thus far proposed in the literature, corporate governance constitutes a relatively new research topic (Larcker and Richardson, 2004; Cai, 2007). Since the demise of Enron and WorldCom, however, the internal corporate governance of listed companies has become

E-mail address: wxz-005@163.com

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a topic of considerable research interest (Liu and Hu, 2006). Auditors themselves have also begun to attach greater importance to evaluations of internal corporate governance. On 15 February 2006, China's Ministry of Finance announced the issuance of new auditing standards. These standards implement a risk-oriented audit approach that attaches importance to the risks associated with a firm's governance structure. Auditing Standard No. 1211 states clearly that auditors must pay attention to the governance structure of the audited entity. However, it remains unclear whether corporate governance has any effect on audit fees and, if it does have such an effect, how it influences audit fees.

There are at least two arguments concerning the relationship between corporate governance and audit fees. The first is informed by substitution theory and the second by signaling theory, and the two lead to different conclusions. Substitution theory posits that the more perfect the internal corporate governance structure of a firm, and hence the lower the agency costs, the fewer risks the audit firm and auditor will encounter and thus the lower the audit fee that will be charged. In other words, an audit is seen as a form of external governance for which effective internal corporate governance may substitute to some degree. Signaling theory argues that managers signal high-level corporate governance to external stakeholders[1] by inviting a more rigorous external audit, which inevitably leads to higher audit fees, i.e., companies with strong corporate governance pay higher audit fees to accounting firms. The mixed empirical evidence reported to date leaves unanswered the question of which theory better explains corporate practice.

Most of the literature on the relationship between corporate governance and audit fees concentrates on one or more aspects of corporate governance, such as ownership, board of director or management characteristics, as proxy variables for corporate governance (Pan, 2008). Although the use of such proxies renders it easy to collect and treat data, it has a number of disadvantages. For example, it introduces the possibility of omitted variables in the models because all corporate governance characteristics are not included. In addition, different characteristics may interact with one another in a manner too complex to identify, thus producing possibly biased results. Finally, as the influence of single characteristics on the level of corporate governance is uncertain, it is doubtful whether a proper corporate governance proxy exists. For example, some scholars believe that CEO duality impairs corporate governance, whereas others take the opposite view. It is thus clear that identifying the relationship between audit fees and corporate governance on the basis of such a proxy is problematic, although a more comprehensive corporate governance variable would mitigate or eliminate such problems to a considerable extent.

The Shanghai Stock Exchange (SSE) introduced the SSE Corporate Governance Sector in 2007, thus offering a good opportunity for a comprehensive investigation of the relationship between corporate governance and audit fees. The listed companies within this sector are subject to greater public scrutiny of their corporate governance structures. After preliminary examination of listed companies' application qualifications, the appraisal working group of the Corporate Governance Sector publishes the application materials of those that qualify on its official website for public appraisal. The overall aim is to involve public investors in the appraisal process and encourage all market participants to pay greater attention to the issue of corporate governance. The SSE also invites professional research institutions to appraise the SSE Corporate Governance Sector and to judge the governance structures of the companies submitting applications. These research institutions include CITIC Securities Co., Ltd., Guotai Junan Securities Co., Ltd., Shenyin & Wanguo Securities Co., Ltd. and Haitong Securities Co., Ltd., among others. Experts and scholars have also been invited to form an Expert Consultative Committee for Appraisal of the Corporate Governance Sector, which meets regularly to discuss the method, process and results of the appraisal process, thus ensuring its objectivity and standardization. This rigorous appraisal process ensures that listed companies undergo comprehensive assessment of their corporate governance level prior to inclusion in the SSE Corporate Governance Sector. As noted, it also makes possible a comprehensive investigation of the relationship between corporate governance and audit fees.

This study uses inclusion in the SSE Corporate Governance Sector as a proxy for corporate governance to empirically investigate the relationship between corporate governance and audit fees after controlling for the

[1] It is obvious that companies will not pay higher audit fees to convey a signal to the market merely for signaling purposes. Rather, such motives as obtaining financing from the market, boosting firm value or reducing financing costs generally explain signaling behavior.