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Audit mode change, corporate governance and audit effort☆

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ABSTRACT

This study investigates changes in audit strategy in China following the introduction of risk-based auditing standards rather than an internal control-based audit mode. Specifically, we examine whether auditors are implementing the risk-based audit mode to evaluate corporate governance before distributing audit resources. The results show that under the internal control-based audit mode, the relationship between audit effort and corporate governance was weak. However, implementation of the risk-based mode required by the new auditing standards has significantly enhanced the relationship between audit effort and corporate governance. Since the change in audit mode, the Big Ten have demonstrated a significantly better grasp of governance risk and allocated their audit effort accordingly, relative to smaller firms. The empirical evidence indicates that auditors have adjusted their audit strategy to meet the regulations, risk-based auditing is being achieved to a degree, reasonable and effective corporate governance helps to optimize audit resource allocation, and smaller auditing firms in particular should urgently strengthen their risk-based auditing capability. Overall, our findings imply that the mandatory switch to risk-based auditing has optimized audit effort in China.

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1. Introduction

The information asymmetry between a principal (shareholder) and agent (management) may lead to adverse selection and moral hazard. When an enterprise constitutes a series of linked contracts (Jensen and Meckling, 1976), managers are motivated to manipulate accounting policies and accounting choices to meet contract demands (Dechow et al., 2010). The question is how to effectively alleviate and control such managerial behavior. Theoretically, effective and reasonable internal controls can suppress management's manipulation of financial information to some extent because one of the functions of internal controls is to provide reasonable assurance of the reliability of financial reporting. Of course, auditing is also an external mechanism designed to mitigate agency problems, and, when applied using the internal control-based audit mode, the auditor must thoroughly understand the internal controls related to the financial statements in question to be able to identify material misstatements by the company.

Unfortunately, the frequent cases of financial and management fraud and false accounting information seen in recent years have raised awareness that internal controls are not effective in preventing these practices (Cao and Qian, 2011). Internal controls fail to reduce audit risk to an acceptable level because corporate governance is the main factor in audit risk, with effective controls depending on the rationality of corporate governance mechanisms. Reflective and reasonable corporate governance mechanisms are effective in mitigating and controlling the manipulation of financial information and adverse selection by management. Regular and effective mechanisms can also monitor, motivate and evaluate management, thereby reducing the probability of managers failing to meet their contractual obligations (and thus manipulating financial information) and increasing the reliability of that information.

As a key principle, the financial reporting and behavior of auditors is directly related to the reliability of accounting information (Watts and Zimmerman, 1983). External auditing, as an important part of external monitoring, provides reasonable assurance that financial reporting is fair and lawful in all material respects (Choi and Wong, 2007). Effective corporate governance can provide reasonable assurance of the quality of financial information and reduce audit risk, thus influencing auditor resources and effort. The revised auditing standards introduced by the U.S. Sarbanes–Oxley Act require the implementation of risk-based auditing, necessitating that auditors become thoroughly familiar with corporate governance mechanisms. The new audit guidelines implemented in China from 1 January 2007 also require such familiarity of auditors to enable them to assess the risk of material misstatements and configure their auditing efforts accordingly.

Because the audit mode in China did not change as a spontaneous response of auditors to fraud risk, but rather was mandated by the government, this study investigates whether auditors have actually changed to the risk-based mode and now evaluate corporate governance before they configure their audit effort. The results show that under the old regulations, when auditors applied the internal control-based audit mode, the relationship between audit effort and corporate governance was weak. Since implementation of the new risk-based mode required by the new auditing standards, that relationship has become significantly stronger. Further analysis reveals that the Big Ten auditing firms have demonstrated a significantly better grasp of governance risk, and allocate their auditing resources accordingly, in the wake of the changes relative to their smaller counterparts. The empirical evidence suggests that the higher the degree of corporate governance in a firm, the greater the assurance of its financial statements, which can save audit effort. Our findings also indicate that auditors have adjusted their audit strategies to meet the new regulations, that risk-based auditing is being achieved to a certain degree, that reasonable and effective corporate governance helps to optimize audit resource allocation and that smaller auditing firms, in particular, need to strengthen their risk-based auditing capability as a matter of urgency. In sum, the risk-based audit mode has helped considerably to optimize auditing effort in China.

The main contributions of this study are as follows. First, audit quality refers to the joint probability of an auditor finding and reporting a client's material misstatements. Appropriate audit effort is not only important to the auditor fulfilling the audit contract, but also to the allocation of infrastructure to identify material misstatements. Despite the requirement for auditors to report such misstatements, research in this area is rare in China, and this study thus provides important empirical evidence.