The Impact of Controlling Shareholders' Equity Pledge on Abnormal Audit Fees: Empirical Evidence from Chinese Listed Companies

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Abstract

In recent years, equity pledge has become an important way of financing for the controlling shareholders of listed companies. Through equity pledge, the controlling shareholder not only retains its controlling rights to the company, but also obtains the required funds, which leads to the "separation of control rights and cash flow rights". However, the value of the equity pledged by the controlling shareholder is closely related to the stock price. In order to stabilize the stock price, the controlling shareholder tends to whitewash financial statements to meet external performance expectations. However, the financial statements of listed companies need to be audited by accounting firms, and companies often pay high audit fees to obtain the CPA's connivance to the company's earnings management behavior. This paper takes China's A-share listed companies from 2012 to 2019 as a research sample, and studies the impact of controlling shareholders' equity pledge behavior on abnormal audit fees. The study found that the abnormal audit fees of companies with equity pledge by controlling shareholders are higher than those of companies with no equity pledge by controlling shareholders, and the higher the pledge ratio, the higher the abnormal audit fees.

Keywords

Equity pledge abnormal audit fee "hollowing out" behavior.

1. INTRODUCTION

The establishment and development of China's capital market has provided a place for participants in economic activities to adjust the surplus and shortage of funds and realize the optimal allocation of funds, and also laid a solid foundation for the development of my country's market economy. But at the same time, we should not ignore that there are still many defects in my country's capital market. Due to the separation of ownership and management rights, shareholders no longer directly manage the company's daily operations, but entrust professional managers to take charge of the company's daily operations to maximize their own interests. However, there are often inconsistent interests between shareholders and management, and management may deviate from the goal of maximizing shareholder wealth in pursuit of personal interests. Shareholders do not directly participate in the company's operation and management, and it is difficult to objectively evaluate the performance of the management's entrusted responsibilities, so auditing comes into being. The main purpose of auditing is to improve the quality of financial information, enhance the degree of confidence of the expected users in the financial statements, and make the financial information provided by the audited entity more reliable and relevant. With the continuous development of my country's market economy, CPA auditing is playing a more and more prominent role. However, in recent years, many listed companies such as Enron, Yinguangxia, Lantian, and Ruixing Coffee have had financial scandals one after another, causing the public to question the quality of the audit

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reports issued by certified public accountants. These situations have attracted the attention of domestic and foreign academic circles, and a large number of studies have proved that audit quality is affected by audit fees. The certified public accountants and their accounting firms failed to maintain economic independence, and their incomes depended on the audited units, which affected the quality of the audit reports issued by them. Reasonable audit fees should be determined by the market. However, with the development of the financial market, more and more potential investors have become potential users of the company's financial reports, and audit reports have gradually become quasi-public goods, resulting in the inability of market laws to deal with agency problems in auditing. The agency problem in auditing makes the audit fee deviate from its reasonable level, which leads to the appearance of abnormal audit fee. Regarding abnormal audit fees, there are two viewpoints: "cost theory" and "rent theory". The "cost theory" thinks that the abnormal audit fee is the compensation for the CPA's unexpected audit fee. The "rent theory" believes that abnormal audit fees are actually a kind of rent, which will have a serious adverse effect on the independence of the certified public accountant.

Abnormal audit fees mainly have the following two specific manifestations: First, attract customers at low prices. As the competition in the audit market intensifies, many accounting firms regard reducing audit fees as their magic weapon to maintain and expand their market share, even at the expense of reducing audit fees below audit costs, which leaves CPAs without sufficient funds to perform necessary audits Procedures, audit quality is naturally difficult to guarantee. Second: purchase of audit opinion. When the management is under great performance pressure, it tends to make the company's performance meet external expectations through earnings management. At the same time, in order to improve the CPA's connivance to the management's earnings management behavior, the management tends to pay high audit fees. When the controlling shareholder has equity pledge, the value of its pledged equity is closely related to the company's stock price. In order to maintain the stability of the company's stock price, the controlling shareholders tend to manipulate the company's profits through earnings management to maintain the stability of the stock price, and at the same time pay the accounting firm high audit fees in exchange for the CPA's connivance of earnings management.

Equity pledge refers to a kind of debt financing behavior in which shareholders (pledgers) use the equity they hold as the subject of pledge to obtain funds. After the pledge, the shareholders obtain the required funds, and the control rights represented by the pledged shares are still owned by the shareholders, so the shareholders can realize the purpose of supporting a large number of voting rights with a small amount of funds through equity pledge. Equity pledge will increase the audit risk faced by certified public accountants, accounting firms will charge higher audit fees to compensate for the risks they face, and some accounting firms will even charge high prices and express false audit opinions. This paper conducts an empirical study using the relevant financial data of listed companies in my country from 2012 to 2019 as the research sample. The conclusion of this paper is: when the controlling shareholder has equity pledge, the abnormal audit fee of the company is often higher, and the level of abnormal audit fee is positively correlated with the pledge ratio. In addition to this section, this paper also includes 6 sections, the second section is the article review and research hypothesis, the third section is the empirical design, the fourth section is the empirical result analysis, the fifth section is the robustness test, and the sixth section is the mechanism analysis. , and finally the conclusions and recommendations.

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2. LITERATURE REVIEW AND RESEARCH HYPOTHESES

2.1. Literature Review

The controlling shareholder's equity pledge has widely existed in our country's listed companies, and has been studied in many literatures. At present, the research interests of the academic community in this field are mainly in the following aspects:

The first is the "hollowing out" effect. Due to the separation of the company's cash flow rights and control rights after the equity pledge, when the private income generated by the "hollowing out" behavior of the controlling shareholder is greater than the company's loss that should be shared by it, the controlling shareholder considers its own interests. It is possible to carry out "hollowing out" behavior. In addition, after the equity pledge, the risk of falling stock price is also transferred to the pledgee, which further reduces the cost of "hollowing out" for controlling shareholders. (Jiang Guohua and Yue Heng, 2005) research found that when the company's cash flow rights and control rights are separated, controlling shareholders are more likely to carry out "hollowing out" behavior.

The second is the transfer of control. (Li Changqing et al., 2018) believe that since the value of the pledged equity depends on the stock price, and the stock price has great volatility, when the price of the pledged stock falls sharply, the pledgee will suffer losses. Therefore, in order to reduce their own risks, the pledgee often sets the pledge benchmark rate and the early warning line and the liquidation line. If the stock price falls below the liquidation line, the pledgee has the right to sell the pledged equity, which may cause the controlling shareholder to lose control. right.

The third is the impact of the controlling shareholder's equity pledge on the company's value. Many studies now support that the controlling shareholder's equity pledge damages the company's value. The equity pledge of the controlling shareholder increases the risks faced by the company, intensifies the conflict between the controlling shareholder and the minority shareholders, makes the internal governance of the company chaotic, and reduces the value of the company. Wang Bin et al. (2013) do hold the opposite view. When the controlling shareholder has equity pledge, in order to avoid forced liquidation due to the drop in stock price, it may strive to improve the company's operation and management and improve the company's performance, which will obviously increase the company's value.

The current academic literature on abnormal audit fees mainly focuses on the relationship between abnormal audit fees and audit quality. Hribar (2014) believes that positive abnormal audit fees often mean financial fraud; Higgs (2006) believes that negative abnormal audit fees Fees mean price competition among accounting firms. In order to seize the market, many accounting firms have reduced audit fees, or even lowered audit fees below audit costs. In order to achieve profit goals, these accounting firms can only reduce audit quality. The audit procedure is omitted; it can be seen that academic opinions on this issue are not uniform. Closer to the research in this paper, Lou Yuanyuan (2019) studied the relationship between the controlling shareholder's equity pledge, earnings management, and audit fees, proving that the controlling shareholder's equity pledge will increase audit fees.

This paper studies the consequences of controlling shareholders' equity pledge from the perspective of abnormal audit fees, and provides a new idea for this research.

2.2. Research Hypothesis

According to the principal-agent theory, the shareholding of listed companies is relatively scattered. Due to the low shareholding ratio of small and medium shareholders, it is difficult for small and medium shareholders to meet the requirements of attending the general meeting of shareholders. In fact, they rarely participate in the general meeting of shareholders, and often

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entrust their voting rights to the controlling shareholders. The controlling shareholder has control rights beyond the scope of the cash flow rights it has. For auditors, when the audited unit is in financial distress, the possibility of its financial fraud is greatly increased, and its ability to continue to operate usually has serious doubts. If the company fails to operate in the future, the accounting firm will often face severe penalties. In order to reduce audit risks, accounting firms often perform more audit procedures, which will lead to higher audit costs. In order to compensate for audit costs and audit risks faced by accounting firms, accounting firms often charge higher audit fees.

Accordingly, this paper proposes the following assumptions:

H1: After controlling for other factors, the abnormal audit fees of companies with equity pledge by controlling shareholders are higher than those of companies without pledge.

H2: After controlling for other factors, the higher the pledge ratio of the controlling shareholder of the company, the higher the abnormal audit fee.

3. RESEARCH DESIGN

3.1. Data Sources

The data of this paper comes from the Guotai'an database, and the sample data of my country's A-share listed companies from 2012 to 2019 is selected as the research object of this paper, and the following exclusions are done:

1. Exclude samples from the financial industry and real estate industry (mainly due to the obvious differences in their accounting policies and capital structure compared with other listed companies);

2. Eliminate ST and samples (because there are significant differences between such companies in terms of financial status and ability to continue operating and listed companies that operate normally);

3. In order to ensure the continuity of the data, the samples listed after 2011 were excluded.

4. Exclude comprehensive categories with unknown main business

5. Eliminate companies with missing data After the above elimination, the final retained effective sample size is 1539.

3.2. Variable Definition

3.2.1 Explanatory variables

This paper uses two different variables to measure the equity pledge behavior of controlling shareholders. First, a dummy variable is introduced, which is 1 if the controlling shareholder has equity pledge at the end of the year, and 0 otherwise. Secondly, the continuous variable pledge ratio is used to measure the degree to which the listed company's equity is pledged, which represents the proportion of the shares pledged by the controlling shareholder to the company's shares held by them.

3.2.2The explained variable

This paper argues that the abnormal audit fee of a company is the difference between its actual audit fee and its normal audit fee. In this paper, according to the existing literature, a regression model is established to estimate the normal audit fees of enterprises, then the residual is the abnormal audit fees. The model constructed in this paper for estimating normal audit fees is as follows:

$$\ln Fee_{it} = \beta_1 Op_{it} + \beta_2 \ln/ At_{it} + \beta_3 A\,\mathrm{Re}c / At_{it} + \beta_4 Big4_{it} + \beta_5 \mathrm{Re}\,vR_{it} + \beta_6 Lev_{it} + \beta_7 Change_{it}$$
$$+ \beta_8 \ln At_{it} + \mu_{it}$$

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Among them, ln Fee represents the logarithm of the actual audit fee of company i in year t, Op represents the audit opinion of company i in year t, if it is a standard audit opinion, its value is 1, if it is a non-standard audit opinion, its value is 0. Ln/At Indicates the proportion of company i's inventory in year t to total assets. ARec/At Indicates the proportion of accounts receivable of company i in year t to total assets. Big4 Indicates the type of firm, if it is the Big Four, its value is 1, otherwise, it is 0. RevR Indicates the revenue growth rate, Lev represents the company's debt-to-equity ratio.Change Indicates whether company i has changed its office in year t. If it does, its value is 1; otherwise, it is 0. Ln At Represents the logarithm of the company's total assets, which is the residual, that is, the abnormal audit fee.

3.2.3 Control variables

1.Logarithm of total assets ln At

The total assets logarithmically controls the size of the company. Usually, the larger the size of the company, the more complex its business is, the higher the audit risk faced by the certified public accountant, and the need to perform more audit procedures, so the higher the audit fee, which will affect the abnormal audit fee.

2 Return on net assets ROE

ROE is a core indicator to measure a company's profitability. The stronger the company's profitability, the weaker the motivation for earnings management.

3 Shareholding ratio of the largest shareholder Top1

The higher the shareholding ratio of the largest shareholder, the greater its influence on the company, and the higher its ability and possibility to damage the company's interests to meet personal interests, which will result in more abnormal audit fees.

4 Cash-to-asset ratioNCF/At

Due to the strong objectivity of cash flow, it is not easy to be manipulated. The higher the proportion of net cash flow from operating activities to the company's total assets, the stronger the objectivity of the company's financial statements, and the less room for profit manipulation.

5 Whether the company's financial statements have been audited by the Big Four Big4

The Big Four has a good reputation and pays more attention to its own reputation. The Big Four have strong professional competence, and the financial statements audited by the Big Four are often more authentic and credible.

6 Current ratio CR and asset-liability ratio Lev

Both the current ratio and the asset-liability ratio are indicators of a company's solvency and reflect the company's financial position.

7 Executive compensation

For the sake of self-interest, executives often have a strong incentive to whitewash financial statements to meet shareholders' expectations, thereby increasing their own compensation.

8 Whether there is a loss

1 if the company incurred a loss in a certain year; otherwise, 0.

9 Nature of property rights SOE

SOEs are less likely to whitewash their financial statements because they are subject to stricter regulation. When the company is a state-owned enterprise, take 1, otherwise take 0.

10 Audit time lag Delay

The audit time lag refers to the time interval from the date of the balance sheet to the date of the publication of the audit report.

11 Whether to change the office

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If the listed company changes the annual report auditing accounting firm in the current year, that is, there is a change in the accounting firm, CHANGE will be "1", and if no change has occurred, it will be "0".

3.3. Model Construction

This paper studies the impact of controlling shareholder's equity pledge on abnormal audit fees. Abnormal audit fees are based on the practice of previous literature, and the residual of the audit pricing model is used as the value of abnormal audit fees. Based on the research literature and research methods of previous scholars, the research model of this paper is constructed to test the impact of equity pledge on abnormal audit fees. To test hypotheses H1 and H2, this paper constructs the following models, as follows:

Model one:

$$\ln AbFee_{it} = \alpha_1 Pledge(dum)_{it} + \gamma x_{it} + \varepsilon_{it}$$

in the formula ， $\ln AbFee_{it}$ represents the logarithm of the abnormal audit fee for year t of company i, $Pledge(dum)_{it}$ Indicates the pledge of the controlling shareholder of company i in year t. If there is a pledge, take 1; otherwise, take 0. x_{it} represents the control variable . ε_{it} represents the residual term.

Model two:

$$\ln AbFee_{it} = \lambda_1 Pledge(rat)_{it} + \eta x_{it} + \sigma_{it}$$

In the formula, $LnAbFee_{it}$ represents the logarithm of abnormal audit fees of company i in year t, $Pledge(rat)_{it}$ represents the pledge ratio of controlling shareholders of company i at the end of year t, x_{it} represents the control variable, and σ_{it} represents residual.

4. ANALYSIS OF EMPIRICAL RESULTS

4.1. Descriptive Statistics

First perform descriptive statistics on the sample, as shown in Table 2, during the sample period, nearly half of the companies have equity pledges. The average value of the pledge ratio is 0.24, and the standard deviation is 0.35, and the distribution is relatively scattered. The minimum value of the logarithm of total assets is 18.29, and the maximum value is 28.64, which indicates that the size of the assets of the sample companies has a large difference and the standard deviation is small, indicating that the distribution of the size of the company's assets is relatively concentrated. The minimum value of ROE is -66.54 and the maximum value is 0.92, which shows that the profitability of different companies can vary greatly. Its mean value is 0.04, indicating that the average profit level of listed companies in my country is not high, but the distribution is relatively scattered. Other control variables are not described in detail.

4.2. Analysis of Empirical Results

4.2.1Estimated abnormal audit fees

In order to eliminate the influence of extreme values, all continuous variables have been shortened by 1% up and down. As shown in Table 3, the correlation coefficient reaches 0.621, indicating that the model is well constructed. Opinion, ARecAt, Big4, RevR, LnAt, Change were highly significant, and the other two control variables were not significant. On the basis of the regression results, the production residuals can be used to obtain abnormal audit fees.

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Table 1. Variable Descriptive Statistics Table

variable	N	mean	sd	min	max
Pledge(dum)	12456	0.41	0.49	0	1
Pledge(rat)	12456	0.24	0.35	0	1
lnAt	12456	22.39	1.33	18.29	28.64
ROE	12456	0.04	0.71	-66.54	0.92
Top1	12456	34.53	14.99	0.29	89.99
NCF/At	12456	0.05	0.07	-0.7	0.88
Big4	12456	0.07	0.25	0	1
CR	12456	2.33	3.78	0.07	144
lev	12456	0.44	0.20	0.008	1.35
lnMp	12456	15.39	0.71	9.99	26.07
Loss	12456	0.098	0.30	0	1
SOE	12456	0.39	0.49	0	1
Delay	12456	78.62	843.79	-43,465,602	128
Change	12456	0.24	0.43	0	1

Table 2. Estimated table of abnormal audit fees

lnfee	coef	t
Opinion	-0.2317688***	-8.34
ln/At	0.0492147	1.19
ARecAt	0.1167938***	2.82
Big4	0.5353371***	30.78
RevR	-0.0359048***	-2.88
Lev	-0.0243903	-0.99
LnAt	0.3944709***	97.5
Change	-0.0937087***	-10.1
_cons	5.248817***	58.87
N	12456	
AdjR2	0.621	
F	2296.16	

4.2.2Benchmark model regression results

Based on the estimation of abnormal audit fees, this paper tests Hypothesis 1 and Hypothesis 2. As shown in Table 4, whether the dummy variable is pledged or not, or the pledge ratio has a significant impact on abnormal audit fees. The regression analysis results verify Hypothesis 1 and Hypothesis 2. Under the control of other factors, companies with equity pledge by controlling shareholders have more abnormal audit fees, and companies with higher pledge ratios have higher abnormal audit fees. This is because, when the controlling shareholder has an equity pledge, its own interests are often closely related to the value of the pledged equity, and the value of the pledged equity is in turn related to the company's stock price. The company's financial statements have the function of information transmission. If the company's performance is poor, its stock price will inevitably decline. In order to maintain the stability of the company's equity, the controlling shareholders often use their influence to manipulate the company's financial statements. While financial statements must be independently audited

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before they can be submitted, companies often choose to pay more audit fees to purchase an audit opinion, resulting in an increase in abnormal audit fees. Other control variables are not described in detail.

Table 3. Benchmark Model Regression Results

	Assumption one	Assumption two
Pledge	0.0224811**	0.0771645***
LnAt	0.0049661***	-0.0134719***
ROE	0.0617458**	-0.1486322**
top1	0.0002988***	-0.0008951***
lnAt	0.0446898	0.0644631
Big4	0.0180781	-0.0038813
CR	0.0031915***	-0.0152092***
Lev	0.034144**	-0.0938298***
lnMP	0.0076687***	0.0654011***
LOSS	0.0187456	0.0253247
SOE	0.009436	0.001134
Delay	0.000235***	0.0018089***
Change	0.0106447***	0.0275677***
_cons	-0.6894121***	-0.7526743***
Industry	Yes	Yes
Year	Yes	Yes
N	10387	10387
AdjR	0.0679	0.0705
F	22.02	22.89

5. ROBUSTNESS TEST

5.1. The Hysteresis of the Impact of Equity Pledge

Considering that the impact of equity pledge on abnormal audit fees may have a lag, this paper uses the data of one period of equity pledge lag to conduct a robustness test. The regression results are similar to the benchmark regression model, that is, the research conclusion of this paper is robust.

5.2. Heterogeneity Test

Considering the heterogeneity among different enterprises, this paper conducts a heterogeneity test on the results of the paper. Tested whether there are differences between state-owned enterprises and non-state-owned enterprises, large-scale enterprises and small-scale enterprises (whether the assets are greater than the average), and found that the equity pledge of the controlling shareholders of state-owned enterprises and large-scale enterprises can more affect abnormal audit fees.

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5.3. Endogenous Test

Considering the possible endogeneity, this paper uses the average value of the equity pledge ratio of other companies in the same industry as an instrumental variable to conduct an endogeneity analysis. The results show that there is no endogeneity problem in this study.

6. MECHANISM ANALYSIS

This paper conjectures that the main impact of equity pledge on abnormal audit fees may be to increase the CPA's connivance to earnings management by paying high audit fees. Therefore, based on the revised Jones model, this paper conducts a mediation test on accounting earnings management. The results show that earnings management is indeed the path through which the controlling shareholder's equity pledge affects the company's abnormal audit fees.

7. CONCLUSIONS AND TESTS

The research results of this paper show that the controlling shareholder's equity pledge will increase abnormal audit fees. This is primarily because of audit opinion purchases. And the higher the pledge ratio, the higher the abnormal audit fee. Therefore this paper recommends the following: The company should strive to improve its governance structure, play the role of external supervision mechanism and internal control system, ensure the smooth realization of the goal of maximizing shareholders' wealth, and reduce the phenomenon of "hollowing out" of small and medium shareholders by controlling shareholders.

Certified public accountants should maintain independence, implement necessary audit procedures, abide by professional ethics, and issue true audit reports.

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