

# Legal Awareness Level of the Board of Directors and Audit Fees

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**Abstract:** This paper takes all the listed companies in the Shanghai Stock Exchange of the A-shares that have disclosed annual reports and board reports from 2005 to 2020 as a sample, and selects control variables from the three levels of corporate financial characteristics, corporate governance and audit firms to study the impact of the board of directors' legal awareness level upon audit fees. The results show that there is a significant positive correlation between the legal awareness level of the board of directors and the audit fees, and the higher legal awareness level the board of directors own, the higher audit fees they might pay for. The finding provides a new interpretation of the factors influencing audit fees, a higher audit fee may be the board's voluntary choice.

**Keywords:** Audit Fees; Board Oversight; Legal Awareness; Corporate Governance Structure

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## 1. Introduction

Factors affecting corporate audit fees have been a non-negligible part of the audit research field. In recent years, in addition to the traditional research on the impact of factors such as audit cost hypothesis and audit insurance hypothesis on audit fees, more research on the impact of internal corporate governance mechanisms as well as individual characteristics on audit fees has emerged. However, the board of directors, as the most important decision-making and management body of the company, has the responsibility of supervising and managing the company's operation on behalf of shareholders and other stakeholders. Therefore, it is necessary to explore the factors affecting audit fees based on the characteristics of the board of directors.

In the existing corporate governance system, the board of directors is entrusted with two basic functions: directing the management of the company's strategy and effectively supervising the management in charge of the operation to ensure the interests of shareholders. In order to give full play to the role of the board of directors and to effectively carry out these functions, the board of directors needs to supervise the company in multiple ways in accordance with the existing laws, regulations and rules. Furthermore, the board members need to comply with the relevant laws, rules and regulations to ensure that they are able to perform their duties, fulfill their duties of diligence and loyalty, maintain a high level of ethical standards, be responsible to the company and its shareholders, and treat the interests of all parties fairly. Therefore, this paper chooses to study the relationship between the level of legal awareness of the board of directors and audit fees.

## 2. Research background and hypothesis

There are relatively few domestic and international studies on the impact of the level of legal awareness of the board of directors on audit fees. As early as the last century Lipton and Lorsch (1992) and Jensen (1993) showed that the board of directors to better ensure the credibility of financial reports will be more likely to choose accounting firms that charge high audit fees and can provide more quality audit services. More recent studies by Bozec and Dia (2017), Jizi and Nehme (2018) and Karim (2015) also concluded that the board of directors has a direct impact on audit fees and concluded that the level of governance of the board of directors positively affects the audit fees as the board of directors may have a greater need to improve audit quality in order to maintain its high level of governance[1][2]. Carcello and Neal (2000) also express this point, in order to exercise diligence, choose accounting firms that can guarantee high quality audit services in order to obtain a high level of assurance, even if this means paying higher audit fees to the accounting firm. Furthermore[3], Goddard and

Schmidt (2021) believed that some board members may even be concerned that too low audit fees may lead to auditors cutting back on the amount of work they are supposed to do, thus negatively affecting the quality of the audit and thus the level of board supervision[4]. Meanwhile, Custdio et al. (2014) argue that managers who have a higher level of legal awareness will have a deeper understanding of the laws, rules, and regulations related to the company's operations, and will supervise the company more strictly and perform their duties better according to the requirements of the laws, rules, and regulations[5].

In view of this, in order to make up for the lack of research on the impact of the level of legal awareness of the board of directors on audit fees, this paper will make an empirical analysis of the content of the annual reports of listed companies on SSE A shares and their board of directors' reports by putting forward the following hypotheses.

H1: The level of legal awareness of the board of directors is positively related to audit fees.

H2: The level of legal awareness of the board of directors is negatively correlated with audit fees.

## **2. Research design**

### **2.1 Definition of variables**

The explanatory variable is audit fees (Infee). The difference between the audit fees of different companies is large and the amount is positive, which will not affect the nature of the original data and linear correlation after taking the logarithm, and at the same time, it is convenient to calculate, which can weaken the possible co-linearity of the model to a certain extent and eliminate the scale effect.

The level of legal awareness of the board of directors (Freq). The frequency of mentioning key words such as "law", "statute", "regulation", "system" in the board meeting is used as the basis for counting. The frequency of mentioning key words such as "laws", "regulations", "rules" and "systems" in the board meeting is used as the basis for counting in order to quantify the level of legal awareness of the board.

In order to further analyze and verify the relationship between the explanatory variable audit fees (Infee) and the explanatory variable board of directors' legal awareness level (Freq), this paper refers to the research approach of Yang Suchang and Ma Yahong (2020) and selects appropriate variables as control variables from three levels: company financial characteristics, corporate governance, and firm.

Control variables such as gearing ratio (Lev), inventory share (Inv), receivable-type assets share (Rec), and net sales margin (NPM) are selected at the firm financial level; control variables such as board size (Board) and number of board meetings (Times) are selected at the firm governance level; audit opinion type (Op) and firm size (Big4) are selected at the firm level. The control variables are selected at the firm level.

### **2.2 Data sources**

This paper selects the annual reports and board of directors' reports of all listed companies on the SSE A-share from 2005 to 2020 as the research samples, and screens the samples according to the following basic criteria: (1) exclude the samples of companies with missing board of directors' reports; (2) exclude the samples of financial companies such as banks without inventory information; (3) exclude the companies that have been delisted or specially treated in the ST category due to abnormal business conditions and other reasons (4) excluding the sample of companies with missing data in each of the other variables. In addition, in order to exclude the possible adverse effects of the extreme and extreme small values of each variable on the final conclusion, the tailing process was performed at the 1% level of winsorize in turn. The final valid sample of 9350 was obtained. Among them, the data on the frequency of words about laws, rules, regulations and systems in the board of directors' reports were obtained from the text database of listed companies in Wingo text data platform, and all other data were obtained from CSMAR Guotaian database. This paper processed and analyzed each data by Stata15.0.

### **2.3 Model constructs**

To further investigate the relationship between audit fees and the level of legal awareness of the board of directors, this paper constructs a model as follows:  $Infee = \beta_0 + \beta_1 Freq + \beta_2 Lev + \beta_3 Inv + \beta_4 Rec + \beta_5 NPM + \beta_6 Board + \beta_7 Times + \beta_8 Op + \beta_9 Big4$

+ε

## 4. Correlation Analysis

The correlation analysis of the main variables shows that the control variables *Inv* and *Rec* are both significantly negatively correlated with audit fees at the 1% level; the correlations between *Lev* *NPM* *Board* *Times* *Op* *Big4* and *Infee* is significantly positive at the 1% level. The correlation between the explanatory variable *Freq* and *Infee* is significantly positive at the 5% level, supporting hypothesis H1: audit fees are positively correlated with the level of legal awareness of the board of directors.

## 5. Regression analysis

The OLS regression results show that, the regression coefficient of *Freq* is 0.002 and significantly positively correlated at the 1% level, and each unit increase in *Freq* will be followed by a 0.002 unit increase in *Infee*. units. The results show that the level of legal awareness of the board of directors is significantly and positively correlated with audit fees, whether or not controlling for the influence of other factors, in line with hypothesis H1.

## 6. Conclusion and Implications

This paper specifically analyzes and verifies the effect and causes of the effect of the level of legal awareness of the board of directors on audit fees from the characteristic point of the level of legal awareness of the board of directors, using the SSE A-share listed companies from 2005 to 2020 as the research sample. The results of the study significantly show that the higher the level of legal awareness of the board of directors, the higher the audit fees they are willing to pay, and the level of legal awareness of the board of directors has a positive relationship with audit fees.

The implication of this study is that the factors affecting audit fees are not only the traditional audit cost hypothesis and audit insurance hypothesis based on the accounting firm's perspective, but also the factors of the board's active choice. A board of directors with a higher level of legal awareness will prefer a high quality audit service that balances the interests of the company, its shareholders and other stakeholders. Therefore, in order to ensure the board's due diligence, the board will tend to pay more for a high quality audit service.

As studied in this paper, the higher the level of legal awareness of the board of directors, the more likely it is to pay higher audit fees to obtain a high quality audit. On the other hand, it can complement its own supervisory function to protect shareholders' interests from the opportunistic behavior of the management, protect shareholders' interests and effectively fulfill its duty of diligence and loyalty, the high cost of the audit and the active choice of the Board of Directors are inseparable.

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