



Research on the Influence Path of Internal Control Quality on Audit Fees

—Based on the Intermediary Effect of Disclosure of Key Audit Matters

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Abstract

China's new audit standards issued in 2016 increased the disclosure of key audit matters, which aims to improve audit quality and standardize audit fees. Because the quality of enterprise internal control is closely related to the risk of material misstatement and special risk of financial reports assessed by auditors, it is necessary to study the impact of enterprise internal control quality on auditors' disclosure of key audit matters. This paper selects A-share listed companies that disclosed key audit matters in 2016 A + H shares and 2017-2019 annual reports as the research object, and studies the impact path of internal control quality on audit fees from the perspective of the number of key audit matters disclosed. It is found that when the quality of internal control is lower, auditors will choose to disclose more key audit matters, which will lead to the increase of audit fees; Further study found that in the non four audit classification groups, the number of key audit matters disclosed plays a partial intermediary effect between the quality of internal control and audit fees. This study aims to reveal the impact of unreasonable audit fees on audit quality. It is necessary to improve the adequacy and effectiveness of the disclosure of key audit matters, so as to standardize the rationality of audit fees.

Keywords: *Internal control quality; Audit fees; Key audit matters*

1. Introduction

As a third party, auditors provide audit services for customers and issue audit reports, which plays a role of external supervision on enterprises and avoids certain economic losses to investors caused by enterprises issuing false financial reports. In the traditional audit report, except that the name of the auditee is different from the audit opinion, other contents are almost standardized wording, especially in the standard unqualified audit report. Due to different basis, the auditee will make some personalized descriptions. On the one hand, the investors cannot learn the key information related to the auditee through the audit report, so they can obtain limited incremental information, resulting in the low utility of investors' decision-making by using the traditional audit report; On the other hand, for auditors, the traditional requirements related to the disclosure of audit reports lead to the low transparency of audit work, which provides auditors with the space to collude with

enterprises to provide false reports to a certain extent. A very important process for audit is to identify and evaluate the risk of material misstatement and special risks. However, the traditional audit report does not need to disclose the identified risks, but only records them in the audit working paper and does not need to be published. As a result, some auditors do not comply with the requirements of the standards in the audit process, and the risk identification and evaluation in the audit only stay in the form, which reduces the audit quality and may even lead to very serious audit failure. More and more scholars believe that the audit report should provide more valuable incremental information, which shows that the capital market has lower and lower confidence in the audit function ^[1]. In this context, the Ministry of Finance approved and issued 12 new standards for audit reports (hereinafter referred to as the new standards) in December 2016, which were first implemented in A + H-share companies in 2017 and fully implemented in 2018. The most important content of the audit work

specification is to require auditors to disclose key audit matters in the audit report, and give special consideration to identifying and evaluating areas with high risk of material misstatement. The above disclosure functions reflect the following characteristics: first, the work pressure on auditors is increased; second, to a certain extent, auditors are urged to pay attention to the assessment and identification of the risk of material misstatement, and can respond to the corresponding changes in audit matters; Third, the main purpose of the disclosure of key audit matters required by the new standards is to improve audit quality and reduce audit failure. However, due to the implementation time of the new standards, some auditors lack experience in judging key audit matters, affect the corresponding professional ability to a certain extent, and lack audit independence. In particular, they do not judge key audit matters in accordance with the requirements of the new standards, so that many information disclosed in the key audit matters section do not meet the corresponding requirements, Many of the contents disclosed are similar, stay in form, can not improve the audit quality to a great extent, and there will be audit failure. Just as the failure case of Zhengzhong Zhujiang certified public accountants' audit on Kangmei pharmaceutical exposed in 2019. Therefore, improving the quality of disclosure of key audit matters has become a very important aspect of improving audit quality.

The quality of internal control is closely related to the quality of audit reports provided by auditors. Audit institutions improve economic benefits through audit services. When facing enterprises with poor internal control quality, it will increase the major risk of practice. Therefore, the audit activities of audit institutions should take the quality of internal control into account, increase the measurement of the ability of enterprise management (song Na, 2021)^[2], and pay more attention to the disclosure of key audit matters for enterprises with internal control defects and large business scale (Li Renhua, 2019)^[3]. The quality characteristics of enterprise internal control are the main influencing factors for the disclosure of key audit matters, which can provide some guidance for auditors to determine the audit work related to key audit matters according to professional judgment. At the same time, regulators can use key audit matters to supervise auditors. Therefore, how to improve the adequacy and effectiveness of the disclosure of key audit matters to improve the audit quality has become the top priority of the current audit work. In addition, according to the new standards, when disclosing key audit matters, auditors should pay special attention to identifying and evaluating areas with high risk of material misstatement, and their internal control quality is closely related to the risk of material misstatement and special risk of financial reports assessed by auditors. Therefore, it is necessary to study the impact of enterprise internal control quality on auditors' disclosure of key audit matters.

The unreasonable audit fees charged by accounting firms to customers will also have a certain impact on the audit quality (Ji Yafang, 2020)^[4]. In order to avoid affecting the audit quality due to the unreasonable audit fees, accounting firms and relevant regulatory authorities should formulate scientific and reasonable provisions related to audit prices. In this way, it is necessary to analyze which factors will affect audit fees. The more information provided in the general audit report, the higher the probability of errors in the disclosed information. When the more key audit matters are disclosed, the higher the probability of errors in the key audit matters in the issued report. In this way, the higher the probability of losses for investors to make investment decisions by using the audit report, and the higher the litigation risk borne by the accounting firm. Therefore, The litigation risk undertaken by accounting firms will have an impact on audit fees, so there is an extremely important link between the number of key audit matters disclosed and audit fees (Kan Jinghua, 2019)^[5].

The possible innovation of this paper is to take the number of key audit matters disclosed as an intermediate variable to study the impact path of internal control quality on audit fees, that is, to study how the quality of enterprise internal control affects the number of key audit matters disclosed by auditors, so as to affect audit fees. The main contributions are as follows: (1) this paper studies the impact path of internal control quality on audit fees. The results show that the lower the quality of internal control, the more the number of key audit matters disclosed by auditors, resulting in higher audit fees. This shows that certified public accountants fully consider the quality of internal control when determining key audit matters according to professional judgment. (2) By examining the impact of internal control quality on audit fees and the intermediary effect with key audit matters, this paper provides practical guidance for auditors to determine the audit work related to key audit matters to a certain extent, and provides research evidence and path ideas for regulators on how to use key audit matters to supervise auditors and further improve the disclosure system of key audit matters, It expands and enriches the research perspective of relevant literature.

2.Theoretical analysis and research hypothesis

2.1.Internal control quality and audit fees

According to the analysis of the impact mechanism of the correlation between the quality difference of internal control and audit cost on audit quality, the higher the quality of internal control of the client company, the more auditors will rely on control testing, and the substantive procedures will be reduced, so the audit cost will be reduced; When the internal control quality of the client company is worse, the auditor will tend to do more substantive procedures. Even when the internal control

quality of the client company is very poor, the auditor only depends on the substantive procedures. Compared with the control test, the cost of the substantive test is high. Existing literature shows that audit fees are negatively correlated with the quality of internal control (Li Baixing, 2019; Li Yuedong, 2014; Hong Lin, 2016)^[6-8]. Therefore, we believe that the higher the quality of the internal control of the client company and the higher the accuracy and reliability of the relevant information and data provided by the client company in the audit process, the more authentic and reliable the audit evidence obtained by the auditor, and the shorter the time spent by the auditor in obtaining the audit evidence. It also further shows that when the internal control quality of the client company is better, the cost of audit will be lower and the audit fee will be lower. On the other hand, the lower the quality of the internal control of the client company, the more opportunities are provided for the fraud of relevant personnel, and the higher the possibility of financial fraud. Once the interests of relevant personnel are damaged due to the financial fraud of the client company, these relevant personnel are unable to distinguish the responsibilities in the past, they will regard the accounting firm as the person jointly and severally liable and take it to court, In order to make up for the losses that may be borne due to being sued in the future, a certain litigation risk premium will be charged. At the same time, if auditors fail to find corresponding financial fraud, the reputation and reputation of accounting firms will be impacted to a certain extent, and regulators will punish them. In order to make up for reputation risk and regulatory risk, they will charge a certain reputation risk and regulatory risk premium.

Based on the above analysis, hypothesis H1 is put forward: there is a significant negative correlation between the quality of internal control and audit fees.

2.2. Internal control quality and disclosure quantity of key audit matters

The new standards require auditors to give special consideration to the areas with high risk of material misstatement when disclosing key audit matters. Therefore, the quality of internal control is closely related to the risk of material misstatement and special risks of financial reports assessed by auditors. Existing studies have proved that the lower the quality of internal control of a client company, the higher the frequency of fraud in its financial reports and the worse the quality of accounting information (Liu Qiliang, 2013; Dai Xian, 2021)^[9-10]; When the internal control quality of the customer company is lower, the financial risk will be higher (yuan Xiaobo, 2010)^[11]. The worse the quality of accounting information and the higher the financial risk of the client company, the higher the risk of material misstatement and special risk in the corresponding field. Therefore, the lower the quality of internal control of the

client company, the higher the risk of material misstatement and special risks in the corresponding field. For risk oriented auditors, these risks will be the focus of audit work, and the users of financial reports will be reminded to pay attention to the relevant risk information of the enterprise through key audit matters. Therefore, auditors need to consider disclosing more key audit matters related to the risk of material misstatement and special risks of the client company.

Based on the above analysis, this paper puts forward the hypothesis H2: the quality of internal control is significantly negatively correlated with the number of key audit matters disclosed by auditors.

2.3. Internal control quality, disclosure quantity of key audit matters and audit fees

The quality of internal control of general customer companies will affect the level of financial risk and the quality of accounting information of customer companies, especially the greater the risk of major misstatement and special risks in corresponding fields. From the perspective of key audit matters, auditors need to disclose more key audit matters related to the risk of material misstatement and special risk of the client company. The existing literature believes that the disclosure of key audit matters will increase the information content of audit reports and improve the audit quality (Yang Xin, 2018; Wang Yanyan, 2018)^[12-13]; There are also views that the disclosure of key audit matters has little effect on increasing information content (Chen Bo, 2017)^[14]. Therefore, the more information the client company provides in the audit report, the greater the probability of information error, especially the information involving professional judgment, and the disclosure of key audit matters just involves greater professional judgment. Firstly, the determination of key audit matters requires high professional judgment ability of auditors. The more key audit matters generally disclosed, the higher the possibility of errors in the information disclosed in the audit report; Secondly, from the perspective of investors, the higher the probability of loss caused by investment decision-making using the audit report and the probability that the regulatory authorities find errors in the audit report, the higher the litigation risk borne by the accounting firm, and the possibility of being criticized and punished by the regulatory authorities will be greatly increased, and the probability of compensation and fine payment by the accounting firm will be higher in the future, It will have a great impact on the reputation of accounting firms: on the one hand, it will affect their future business performance. In order to safeguard their own interests, accounting firms will inevitably increase corresponding audit fees to make up for their possible material losses and reputation losses in the future. On the other hand, the new standards require certified public accountants to determine the most important matters in

the audit process according to their professional judgment and disclose them in the audit report as key audit matters, and the corresponding measures taken for each key audit matter in the audit process must also be disclosed. Taking corresponding countermeasures for the most important matters in the audit process is what auditors must do. At the same time, it can be said that even without the requirements of the new standards, auditors need to take corresponding countermeasures for each of the most important matters. However, due to the need to disclose these most important matters as key audit matters in the audit report, this disclosure requirement makes the auditors need to ensure the accuracy of their judgment, and the auditors will take more audit countermeasures for each key audit matter to ensure their correct judgment. To sum up, the more the number of key audit matters, the higher the cost of audit investment and the higher the audit fee.

Based on the above analysis, hypothesis H3 is put forward: the quality of internal control affects the audit fees by affecting the number of key audit matters disclosed by auditors.

3. Research design and model construction

3.1. Data source and sample selection

Select 2016 A + H shares and A-share listed companies with key audit matters disclosed in 2017-2019 annual reports as the research object. In order to ensure the reliability of the research results, the samples are screened as follows: first, eliminate the financial enterprises, ST and * ST enterprises, then eliminate the samples with missing financial data, and finally the remaining 8955 samples. The financial data in this paper mainly comes from CSMAR database. For the data that cannot be directly passed through CSMAR database, the relevant data of key audit matters can be downloaded from the official websites of Shanghai Stock Exchange and Shenzhen Stock Exchange, collected manually and processed through Excel. In order to avoid the influence of outliers on the results, continuous variables are windorized up and down by 1%. Use stata15 to process data and empirical analysis.

3.2. Model design

Based on the intermediary effect test method proposed by Wen Zhonglin et al. [15-16], this paper constructs the following model to test whether the number of key audit matters disclosed plays an intermediary role in the impact of enterprise internal control quality on audit fees. That is, build model (1) - model (3). The steps of mediating effect test are as follows.

Step 1: build a regression model (1) according to hypothesis H1 to test whether the regression coefficient

between internal control quality and audit fees is significantly negative. If the coefficient A1 is significantly negative, it means that the internal control quality of the client company is significantly negatively correlated with the audit fees charged by the auditor to the client, then proceed to the next step. If the coefficient A1 is not significant, stop.

$$LNFE = a_0 + a_1.ICQ + a_2.KAM_NUM + a_3.Control + a_4.\sum Year + a_5.\sum Industry + \varepsilon \quad (1)$$

Step 2: build a regression model (2) according to hypothesis H2 to test whether the regression coefficient between the number of key audit matters disclosed by the intermediary variable and the quality of internal control is significantly negative. If the coefficient B1 is significantly negative, it means that the quality of internal control of the client company is significantly negatively correlated with the number of key audit matters disclosed in the report.

$$KAM_NUM = b_0 + b_1.ICQ + b_2.Control + b_3.\sum Year + b_4.\sum Industry + \varepsilon \quad (2)$$

Step 3: build the regression model (3) according to hypothesis H3. If C1 coefficient is significantly negative and C2 coefficient is significantly positive, it indicates that there is a partial intermediary effect between the quality of internal control of the client company and the audit fees charged by the accounting firm. If the C1 coefficient is not significant, but the regression coefficient C2 of the disclosure of key audit matters is significantly positive, it shows that the disclosure of key audit matters plays a complete intermediary role.

$$LNFE = c_0 + c_1.ICQ + c_2.KAM_NUM + c_3.Control + c_4.\sum Year + c_5.\sum Industry + \varepsilon \quad (3)$$

3.3. variable definition

1. Explained variable

Audit fees (lnfee). Referring to the research of Huang Li [17], we use the natural logarithm of the audit cost of the company's annual financial statements to measure it.

2. Explanatory variables

Internal control quality (ICQ). Referring to the research of Li Baixing [9] and others, the internal control index of Dibo database is divided by 100 to measure it.

3. Mediating variables

Number of key audit matters disclosed (kam_num). Referring to the research of Kan Jinghua [5], we use the number of key audit matters disclosed in the audit report to measure it.

4. Control variables

According to the relevant research of the existing literature, the following variables are selected as the control variables: enterprise size (size), financial leverage (Lev), net accounts receivable ratio (REC), net interest

rate (ROE), operating income growth rate (oigr), BIG4, big10, current audit opinion (OP), audit opinion of last year (OPL), number of subsidiaries (subsidiary), equity concentration (share5) Place of incorporation (West),

place of incorporation (MID), nature of enterprise (SOE). Considering the fixed effect of industry year, it is also controlled. The definitions of all relevant variables are shown in Table 1 below.

Table 1 variable definition

Variable type	Variable name	Variable code	Variable description
Explained variable	Audit fees	LNFEF	Natural logarithm of audit fees of the company's annual report
Explanatory variable	Internal control quality	ICQ	Dibo database internal control index divided by 100
Intermediary variable	Number of key audit matters disclosed	KAM_NUM	Number of key audit matters disclosed in the audit report
control variable	Enterprise scale	SIZE	Logarithm of total assets
	financial leverage	LEV	Enterprise asset liability ratio
	Ratio of net accounts receivable	REC	Ratio of accounts receivable to total assets
	Net interest rate of equity	ROE	Ratio of net profit to net assets of listed companies
	Growth rate of operating revenue	OIGR	Ratio of the change of operating income in this year to the operating income at the end of last year
	Four major international	BIG4	"Big four" is 1, otherwise it is 0
	Ten major international	BIG10	Dummy variable, if it is the top ten domestic firms (Lixin, Ruihua, Tianjian, Dahua, Zhitong, xinyongzhong, Daxin, Tianzhi international and zhongshenzhong) in terms of revenue released by China injection Association Ring and ZTE (caiguanghua) is 1, otherwise it is 0
	Current audit opinion	OP	1 if it is a standard unqualified opinion, otherwise 0
	Audit opinion of last year	OPL	1 if it is a standard unqualified opinion, otherwise 0
	Number of subsidiaries	SUBSIDIARY	Square root of the number of subsidiaries of a listed company
	Ownership concentration	SHARE5	Total shareholding ratio of top five shareholders
	Place of incorporation	WEST	If the listed company is registered in Sichuan, Chongqing, Ningxia, Yunnan, Shaanxi, Gansu, Guizhou, Qinghai, Xinjiang, Tibet, etc., West is 1, otherwise it is 0
	Place of incorporation	MID	If the listed company is registered in Henan, Shanxi, Hubei, Anhui, Hunan, Jiangxi, etc., the mid is 1, otherwise it is 0
	Nature of enterprise	SOE	0 for state-owned enterprises and 1 for non-state-owned enterprises
	industry	Industry	Industry dummy variable
Annual fixed effect	Year	Annual fixed effect	

4. Analysis of empirical results

4.1. Descriptive statistics

Table 2 shows the descriptive statistical results of each variable. It can be seen from the table that the average value of the logarithm of audit fees is 13.8002, of which the minimum value of the logarithm of audit fees is 12.6115 and the maximum value is 16.0127, which shows that there are great differences in the audit fees paid by listed companies. The minimum value of the number of key audit matters (kam_num) disclosed is 1

and the maximum value is 4, indicating that the information content disclosed by certified public accountants varies greatly among different companies;

The average value is 2.0666, indicating that the number of key audit matters disclosed by most companies is concentrated in about 2, and the number of key audit matters disclosed as a whole is small. Observing the quality of internal control, although there is little difference between the median and the average, the standard deviation is high, indicating that the quality of internal control of Listed Companies in China is uneven.

Table 2 Descriptive Statistics

	sample size	mean value	median	standard deviation	minimum value	Maximum
LNFEF	8955	13.8002	13.7102	0.6392	12.6115	16.0127
ICQ	8955	6.2437	6.5986	1.4605	0	8.0069
KAM_NUM	8955	2.0666	2	0.6416	1	4
SIZE	8955	22.3399	22.1860	1.3008	19.9874	26.2313
LEV	8955	0.4236	0.4150	0.1981	0.0650	0.8939
ROE	8955	0.0564	0.0702	0.1472	-0.7652	0.3605
REC	8955	0.1302	0.1085	0.1085	0.0001	0.4927
OIGR	8955	0.1814	0.1148	0.3978	-0.5734	2.4993
BIG4	8955	0.0575	0	0.2328	0	1
BIG10	8955	0.6575	1	0.4746	0	1
OP	8955	0.9605	1	0.1946	0	1
OPL	8955	0.9759	1	0.1534	0	1
SHARE5	8955	0.5404	0.5403	0.1448	0.2262	0.8762
SUBSIDIARY	8955	4.3272	3.8730	2.4221	0	14.0357
WEST	8955	0.1165	0	0.3208	0	1
MID	8955	0.1330	0	0.3396	0	1
SOE	8955	0.3264	0	0.4689	0	1

4.2. Regression result analysis

Table 3 shows the test results that the quality of internal control affects audit fees through the intermediary role of the disclosure of key audit matters. Column (1) is the regression result of model (1). The relationship between the quality of internal control and audit fees is significantly negative at the level of 5%, and the coefficient is -0.0090, indicating that the lower the quality of internal control of the client company will lead to various risks faced by auditors and higher audit costs, In order to cover various risks and recover the cost of investment, auditors will charge higher fees to customers, thus verifying hypothesis H1. Column (2) is the regression result of model (2). The quality of internal control of the client company and the number of key audit

matters disclosed by the auditor are significantly negative at the level of 1%, indicating that the lower the quality of internal control will lead to the more number of key audit matters disclosed by the auditor. The hypothesis H2 is verified. Column (3) is the regression result of model (3). There is a significant positive correlation between the number of key audit matters disclosed by auditors and audit fees at the level of 1%, indicating that at least part of the impact of internal control quality on audit fees is realized through the number of key audit matters disclosed; At the same time, the internal control quality of the client company is also significantly negatively correlated with the audit fee at the level of 10%, indicating that there is a partial intermediary effect in the relationship between the internal control quality and the audit fee.

Table 3 regression results

	Model 1	Model 2	Model 3
	LNFEF	KAM_NUM	LNFEF
ICQ	-0.0090***(-2.66)	-0.0208***(-3.83)	-0.0080**(-2.39)
KAM_NUM			0.0459***(6.99)
SIZE	0.2711***(52.06)	0.0800***(9.55)	0.2674***(51.23)
LEV	0.0098 (0.36)	0.1219***(2.77)	0.0042 (0.15)
ROE	-0.2994*** (-8.92)	-0.4791***(-8.88)	-0.2774***(-8.25)
REC	0.1855*** (4.36)	0.4788***(6.99)	0.1635***(3.84)
OIGR	0.0393*** (3.64)	0.0668***(3.85)	0.0363***(3.37)
BIG4	0.5832*** (29.11)	-0.0521(-1.62)	0.5855***(29.31)
BIG10	0.0583*** (6.39)	0.0655***(4.47)	0.0553***(6.07)
OP	-0.0348 (-1.31)	0.2581***(6.02)	-0.0466*(-1.75)
OPL	-0.1092*** (-3.64)	-0.0942*(-1.95)	-0.1048***(-3.50)
SHARE5	0.1816*** (6.06)	-0.1546***(-3.20)	0.1887***(6.31)
SUBSIDIARY	0.0750*** (32.40)	0.0216***(5.79)	0.0740***(32.00)
WEST	-0.0908*** (-6.97)	-0.0774***(-3.69)	-0.0873***(-6.71)
MID	-0.1248*** (-10.17)	-0.0454**(-2.30)	-0.1227***(-10.02)
SOE	-0.1184*** (-11.81)	-0.1051***(-6.51)	-0.1136***(-11.33)
_cons	7.5508***(63.54)	0.1013(0.53)	7.5462***(63.67)
Industry	Control	Control	Control
Year	Control	Control	Control
N	8,955	8,955	8,955
R2	0.6440	0.0854	0.6459

4.3. Robustness test

In order to ensure the reliability of the research results, the robustness test of alternative independent variables is carried out: if the enterprise internal control index (ICQ) is higher than the average value, the internal control quality (icq_high) is set to 1, otherwise it is 0, and the models (1) to (3) are run in turn. The results show that the number of key audit matters disclosed in the audit report still has some intermediary effects between the quality of internal control and audit fees.

5. Research conclusions and suggestions

It is found that the number of key audit matters disclosed by auditors has some intermediary effect before the quality of internal control and audit fees of the client company, that is, with the reduction of the quality of internal control of the client company, the more the number of key audit matters disclosed by auditors, resulting in the higher audit fees charged to customers. In addition, in further research, it is found that only in the non four major audit groups, the number of key audit matters disclosed in the audit report has a partial

intermediary effect before the quality of internal control and audit fees of the client company.

The research enlightenment is as follows: (1) enterprises should focus on their own internal control, find and improve problems in time, and avoid the risk of material misstatement caused by the problems of internal control, which can be transmitted by auditors to investors through the disclosure of key audit matters, so as to avoid investors' mistrust of the enterprise. (2) The disclosure of key audit matters by auditors should not only be superficial work. Auditors should strictly abide by the provisions of the new standards and strive to improve their professional ability. During the audit, they should pay attention to the quality of internal control of the client company, and focus on what areas of internal control problems will lead to major misstatement risks or special risks, In the process of determining key audit matters according to professional judgment, the internal control of the enterprise shall be fully considered to avoid omitting some key risk information or disclosing invalid information, which will cause damage to investors. (3) In the past, the regulatory authorities supervised the auditors through abnormal audit fees. The implementation of the new standards led to that the regulatory authorities can

also supervise the abnormal key audit matters. The more regulatory methods, the more auditors can maintain their independence and professional quality, so as to improve the audit quality. When the internal control quality of the enterprise is low and the auditors do not transmit relevant risk information to the report users through the disclosure of key audit matters, the regulatory authorities should pay full attention to the relevant auditors, and can require the auditors to give reasonable explanations on the disclosure of abnormal key audit matters in the form of inquiry or industry inspection.

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