Research on the Influence of Executive Incentive on Audit Fees of Listed Companies

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Abstract. Since the listed companies were required to disclose audit fees in 2001, executive incentive is considered to be an important measure to improve corporate performance and reduce audit fees. There are different conclusions on the correlation between the two. In this paper, the mechanism of the impact of executive incentive on audit fees in listed companies is reviewed. It is found that under the influence of audit cost and risk premium, executive compensation and equity incentive have an impact on audit fees through audit risk. This paper selects A-share listed companies in Shanghai and Shenzhen of guotai’an database from 2013 to 2017 as research samples, and makes an empirical analysis on the relationship between executive incentive and audit fees. The results show that: there is a significant positive correlation between executive compensation level and audit fees; there is a significant negative correlation between executive equity incentive level and audit fees. According to this, this paper puts forward some suggestions, such as improving the company's salary system, improving the level of equity incentive, adopting a variety of equity incentive combinations, giving full play to the supervision role of internal governance institutions, etc., to provide reference suggestions for improving the incentive mechanism of senior executives and reducing audit fees.

Introduction

Executive incentive, which is composed of salary incentive and equity incentive, is a kind of incentive behavior adopted by shareholders in order to stimulate senior managers to work harder and achieve greater profits. The audit fee is the remuneration paid by the certified public accountant after providing audit services for the company. As a third party independent of operators and shareholders, certified public accountants audit the annual reports of listed companies. In the face of executive compensation incentive, it may promote the occurrence of fraud such as modifying financial information, and improve the audit risk. Certified public accountants can control the audit risk by adjusting audit pricing, expand the scope of audit supervision, conduct more strict statement audit, and spend more time and energy to reduce the risk of audit failure. However, the equity incentive of the company's executives may effectively restrict the behavior of the managers, prevent them from sacrificing the long-term interests of the company and shareholders in order to pursue the short-term interests of individuals, thus reducing the level of audit risk faced by the certified public accountants, and thus the audit fees required by the accounting firms will be reduced. Therefore, executive incentive will have an impact on audit fees.

Since 2010, executive compensation has been increasing year by year. Although the development of equity incentive in China is relatively short, the effect of equity incentive on executives has also caused extensive discussion in academia. The research heat of the impact of executive incentive on audit costs is rising. Scholars have made a lot of empirical analysis on the impact of executive incentive on audit fees, mainly focusing on three aspects of discussion: there is a significant positive correlation between executive incentive and audit fees\textsuperscript{1,2}; there is a significant negative correlation.
between executive incentive and audit fees; there is no correlation between executive incentive and audit fees. Different from foreign countries, most of the domestic researches think that executive incentive will affect audit cost, but how does executive incentive affect audit cost? Domestic scholars have studied it from multiple perspectives, but the research results are different. Most of the research focuses on the impact of equity structure and board characteristics on audit fees, while the research involving the impact of management and board of supervisors on audit fees is less, and the research methods are mostly empirical, lack of in-depth combing and demonstration from the theoretical aspect.

The existing research focuses on the overall impact of executive incentive on audit fees, and the detailed research is not enough. How to realize the influence of salary incentive and equity incentive on audit fee? How does the relationship and bridge work? What is the deep relationship among the three? These problems need to be studied. Starting from the mechanism of the effect of executive compensation and equity incentive on audit fees, this paper analyzes the logical relationship between the three, analyzes the impact of executive incentive on audit fees, and takes A-share listed companies in Shanghai and Shenzhen of guotai'an database from 2013 to 2017 as the research sample, and empirically analyzes the impact of executive incentive on audit fees, In order to provide effective enlightenment for the improvement of executive incentive mechanism, the improvement of audit fee market and the protection of investors' interests.

Analysis on the Mechanism of the Influence of Executive Incentive on Audit Cost

The owner of the enterprise will hire a certified public accountant to audit the enterprise, and evaluate the performance of the senior management through the audit report. Because of the information asymmetry, the incomplete internal information of the company owned by the certified public accountant, and the behaviors of some senior executives that are not conducive to the development of the enterprise, in order to maintain the audit prudence, more investment will be made in the investigation and audit to prevent the risk of audit failure, so the certified public accountant will pay more labor costs to control the audit risk at an acceptable level, Naturally, it increases the audit cost. In order to reduce audit cost through executive incentive, listed companies need to reduce audit risk. It is mainly to reduce the audit cost and risk premium in the audit risk through executive incentive, so as to reduce the audit cost. The specific description is shown in Figure 1.

Figure 1. Schematic diagram of the mechanism of the impact of executive incentive on audit fees.

Audit Cost

In order to complete the audit work better, the accounting firm will invest a certain amount of human, material and other resources and time cost to help it complete. In this process, there will be audit cost. For example, the current audit fees in our country are mostly charged by time. When the
financial risk, business complexity and operational risk of the audited unit are at a high level, the higher the audit risk is. In order to reduce the audit risk, firms need to carry out more audit procedures, spend more time to obtain sufficient evidence, and naturally charge more audit fees. Therefore, the level of audit cost depends to a certain extent on the CPA's strict degree of audit, that is, how much time and labor are invested to complete the audit.

From the perspective of signaling theory, the degree of executive incentive is a signal to CPA. Executive compensation is closely related to the company's financial situation, that is to say, personal income can be increased and private interest can be increased by adjusting financial information. Therefore, when the incentive level of executive compensation is high, the CPA can draw a conclusion from this signal that the possibility of executives' self-interest behavior increases, which will improve the audit risk, so as to conduct a more strict audit, and it is necessary to increase the audit cost to make up for their own cost loss; on the contrary, the CPA may reduce the audit cost appropriately and relax the audit intensity. However, the equity incentive of senior executives will restrain the private interest of senior executives to some extent, and the senior executives who obtain the equity will become the owners and beneficiaries of the company. They will consider the long-term interests of the company, not because of their personal interests, but because of the company's financial and operating conditions, in addition to the high risk level, to a certain extent, they will reduce the audit risk, so the certified public accountants need to invest less resources and costs To complete the audit work and reduce the audit cost.

**Risk Premiumt**

Because of the "deep pocket" responsibility of the certified public accountant ["deep pocket" responsibility refers to the untrue audit report issued by the certified public accountant, once the investor suffers losses due to the trust of the audit report for investment, he can file a lawsuit to the court to apply for the compensation of the accounting firm, regardless of the wrong party.] In order to make up for the possible losses in the future, accounting firms will require higher audit fees to reduce the risk of compensation. Similarly, because the remuneration of senior executives is linked to the financial situation of the company, when the remuneration of senior executives is high, there may be falsification of the financial statements of the company, and the risk of major misstatement, which transmits a high-risk signal to the certified public accountant: the management of the audited unit is likely to collude with fraud, disturb the vision of the certified public accountant, and can not find all the major misstatements, which greatly increases the possibility High, it will increase the risk that accounting firms will face compensation litigation in the future. In order to protect their honor and prevent the compensation risk of the firm in the future, certified public accountants must increase the scope of audit and increase the audit cost and expense. The listed companies that give equity incentive to the executives, to a certain extent, link the earnings of the executives with the long-term interests of the company, prevent the executives from damaging the company's collusion and fraud for their own interests, reduce the audit risk of the company, and also reduce the "risk premium" of the certified public accountant.

**Theoretical Analysis and Research Hypothesis**

**The Impact of Executive Compensation on Audit Fees**

According to the hypothesis analysis of rational economic man, the salary incentive mechanism only meets the goal of maximizing the personal interests of senior managers, and is not directly related to the enterprise goal of maximizing the value of the company. In order to achieve the expected performance, senior managers may make short-sighted behaviors such as falsely increasing performance and providing false financial statements, regardless of the long-term development of the enterprise. Therefore, the salary incentive mechanism tends to short-term effect. According to the theory of fraud triangle, salary incentive will increase motivation, which is a fraud factor. Personal interests drive the occurrence of senior executives' fraud, and the audit risk will increase accordingly.
According to the risk oriented audit, in order to keep cautious and prevent the risk of audit failure, CPA will invest more human, material and information resources to control the audit risk at an acceptable level. From the perspective of audit insurance theory, the increase of audit risk caused by executive compensation incentive will increase the audit cost, that is, the risk premium will be charged to the company, and the audit fee paid by the company will increase. Therefore, hypothesis H1 is proposed.

H1: the higher the compensation incentive of the management, the higher the audit cost of the company.

The Influence of Equity Incentive on Audit Cost

Equity incentive is an agreement between the owner and the senior managers. If the senior managers meet the corresponding conditions, they can obtain part of the shareholders' equity of the company. Because the personal interests of senior executives are shareholders' rights and interests, this is actually a close combination of the objectives of senior executives and the company, forming a community of interests. Realize the maximization of enterprise value together. Executives can not only manage as managers, but also bear risks and share profits as owners. Under this mechanism, executives will serve the company's long-term development diligently and responsibly to maximize the value of the company in order to maximize their personal interests. Therefore, the risk of fraud caused by equity incentive is low.

According to the signaling theory, if the company implements a high degree of equity incentive, the CPA will receive the corresponding signal, the audit risk of the company is correspondingly low, and the scientific and reliable financial statements are relatively high. From the perspective of insurance theory, in this case, the certified public accountant will not increase the audit procedure and ask the company for additional risk premium, so the audit fee will be maintained or even reduced. Therefore, hypothesis H2 is proposed.

H2: the higher the equity incentive of the management, the lower the audit cost of the company.

Research Design

Sample Selection and Data Source

Five years' data of A-share listed companies in Shanghai and Shenzhen of guotai'an database are selected as the empirical analysis of the research samples, with the sample time interval of 2013-2017. The data of variables such as executive shareholding ratio and executive compensation are from guotai'an database; the "top ten" accounting firms in the control variables are classified according to the comprehensive evaluation ranking of accounting firms in 2013-2017 published on the website of China Institute of Certified Public Accountants (http://www.cicpa.org.cn). In order to ensure the validity of the sample, after downloading the data of 2013-2017, the listed companies with missing data and incomplete data are eliminated; for the consideration of the characteristics of financial and insurance listed companies, their asset liability ratio is quite different from that of other industries, so the data of financial and insurance companies are eliminated; finally, the data of A-share listed companies in Shanghai and Shenzhen in 2013-2017 are selected as 11492 Of them. SPSS software was used to process and analyze the data.

Variable Definition

(1) Interpreted variable

LNFEE: natural logarithm of audit cost. In order to maintain the normality of data, the natural logarithm of audit cost is selected as the explained variable (Table 1).

(2) Explanatory variable

LNPAY: the natural logarithm of executive compensation. This paper uses the level of executive compensation to measure executive compensation incentive. In order to ensure the representativeness, availability and statistics of the data, the total compensation of the top three
executives in the annual report of listed companies is selected, and their natural logarithm is selected as the measurement of executive compensation incentive.

**INCENT:** executive equity incentive. Bergstresser and Philippon (2006) are used to measure the equity incentive of the company[9], namely:

$$\text{INCENT} = \frac{0.01 \times \text{PRICE} \times (\text{SHARE} + \text{OPTIONS})}{0.01 \times \text{PRICE} \times (\text{SHARE} + \text{OPTIONS}) + \text{SALARY}}$$

Price is the closing price of the company's shares at the end of the year; share and options are the number of shares and options held by executives respectively. The definition of the management, including the chairman, the general manager and other senior executives, delete the double counting of part-time employees; salary is the total compensation of senior executives, and here we select the total compensation of the top three senior executives with the highest amount disclosed by the listed company.

(3) Control variable

Based on the research basis of scholars at home and abroad, this paper selects five factors that can affect audit fees as the control variables of this paper: the natural logarithm of total assets of listed companies, the asset liability ratio, the proportion of accounts receivable to total assets, the proportion of inventory to total assets, and the type of accounting firm.

**LNASSET:** natural logarithm of total assets of the audited unit. Generally speaking, the larger the total assets of the audited entity is, the larger the operation scale of the company is, the more complex the operation business is, and the accounting treatment is relatively complex. The greater the possibility of material misstatement of the company's financial report is, the higher the level of audit risk faced by the certified public accountant is. In order to reduce the audit risk to an acceptable low level, the accounting firm It is necessary to increase the investment of audit resources and require higher audit fees.

**SUBC:** asset liability ratio of the company. Represents the company's overall solvency. If the asset liability ratio is on the high side, the company's ability to repay debts is weak. In order to ensure the company's normal production and operation activities, the management may manipulate the accounting personnel and whitewash the financial statements, so the company is more likely to have business and financial fraud. Therefore, accounting firms need to invest more resources and bear more risks, which will inevitably require higher audit fees.

**REC:** the proportion of accounts receivable to total assets. In the situation of modern product sale on credit, accounts receivable is a project with a large proportion of current assets. The larger the proportion of accounts receivable in total assets is, the better the product sale is, the better the company's profit situation may be. However, it may also be a false transaction or internal transaction conducted by the management of the audited unit in order to improve the company's performance. Therefore, it is necessary for the certified public accountant to verify the accounts receivable by letter, and comprehensively analyze the authenticity and reliability of its existence. Accounting firms need to invest more audit resources to carry out more strict audit work. As the audit cost increases, the relative audit fees will increase, and the company's audit fees will increase.

**INV:** the proportion of inventory in total assets. The audit of inventory items is more complex than other items, which requires certified public accountants to supervise the inventory stored in different places. Moreover, the accounting standards for inventory are relatively complex, and accountants are likely to make major misstatements in the daily accounting treatment of inventory. Therefore, more audit resources need to be invested to ensure that the project is recorded truthfully and accurately, which requires higher audit costs.

**BIG10:** transaction type. Most scholars' research results have shown that some accounting firms have reputation premium in the audit service market. Therefore, this paper takes whether accounting firms belong to the "top ten" dummy variable as the control variable to affect the related factors of audit fees. Select the top 100 information in the comprehensive evaluation of accounting firms issued by China Institute of Certified Public Accountants in 2017 as a reference to classify the accounting firms as "top 10".
Table 1. Variable definition table.

| Variable properties | Variable name | Variable definition | Expected symbol |
|---------------------|---------------|---------------------|-----------------|
| dependent variable  | LNFEE         | The natural logarithm of audit cost |                |
| independent variable| LNPAY         | The natural logarithm of executive compensation | +               |
|                     | INCENT        | Executive equity incentive | -               |
| control variable    | LNASSET       | The natural logarithm of total assets of the company | +               |
|                     | SUBC          | Asset liability ratio of the company | +               |
|                     | REC           | Proportion of accounts receivable to total assets | +               |
|                     | INV           | Proportion of inventory in total assets | +               |
|                     | BIG10         | Take 1 if the firm is "top 10", otherwise take 0 | +               |

Model Construction

According to the above theoretical analysis, in order to demonstrate the relationship between executive compensation incentive and equity incentive and audit cost, this paper constructs the following research model:

\[
\text{LNFEE} = \beta_0 + \beta_1 \times \text{PAY} + \beta_2 \times \text{INCENT} + \beta_3 \times \text{LNASSET} + \beta_4 \times \text{SUBC} + \beta_5 \times \text{REC} + \beta_6 \times \text{INV} + \beta_7 \times \text{BIG10} + \mu
\]

Where \(\beta_0\) is intercept items, \(\beta_1, \beta_2, \beta_3, \ldots\) are the regression coefficients, \(\mu\) is the random error term.

Empirical Analysis

Descriptive Statistics

From the descriptive analysis of variables in Table 2, it can be seen that in the selected samples of Shanghai and Shenzhen A-share listed companies, the audit fees differ significantly, with the maximum, average and minimum natural logarithms of 17.759, 13.840 and 12.346, respectively, and the size difference reaches about 5.41; for the natural logarithms of executive compensation, the differences among listed companies are also large; the maximum and minimum differences of equity incentive reach 0.99, the difference is very significant, but the average value is only 0.464, which has not reached 0.5, indicating that the overall level of equity incentive of listed companies is low. Most of the listed companies choose non top 10 accounting firms for audit; the average ratio of accounts receivable to total assets and inventory to total assets is 0.14 and 0.13, indicating that the overall liquidity is good, but the large difference between the maximum and minimum values indicates that there is a large deviation in the liquidity of different companies. The value difference of logarithm of total assets indicates that the total assets of listed companies are quite different.

Table 2. Descriptive analysis of variables.

| Variable | N   | Mean value | Minimum | Maximum | Standard deviation |
|----------|-----|------------|---------|---------|--------------------|
| LNFEE    | 11492 | 13.840     | 12.346  | 17.759  | 0.671              |
| LNPAY    | 11492 | 14.478     | 12.450  | 17.216  | 0.661              |
| INCENT   | 11492 | 0.464      | 0.000   | 0.994   | 0.374              |
| BIG10    | 11492 | 0.610      | 0.000   | 1.000   | 0.487              |
| REC      | 11492 | 0.141      | 0.000   | 0.660   | 0.108              |
| INV      | 11492 | 0.133      | 0.000   | 0.800   | 0.115              |
| SUBC     | 11492 | 0.391      | 0.028   | 1.037   | 0.195              |
| LNASSET  | 11492 | 22.116     | 19.410  | 28.098  | 1.284              |

Correlation Analysis

Before the regression analysis of the sample number, the correlation analysis of each variable in the model is carried out to check whether there is collinearity(Table 3). The correlation shows that the correlation coefficient of LNASSET and SUBC is greater than 0.5, and the value of Vif is large, which indicates that there is a strong collinearity. Considering the collinearity and the accuracy of
empirical results, the interaction between LNASSET and SUBC is processed, and the processed value is defined as the logarithm of debt (INDEBT).

In terms of correlation, the correlation between the dependent variable executive compensation and audit cost is significant under the condition of 1%, and the coefficient is positive. The preliminary verification hypothesis H1: the higher the management compensation is, the higher the audit cost is. While the executive equity incentive (INCENT) has a negative correlation impact on audit fees, and it is significant under the condition of 1%, which verifies the hypothesis H2: the higher the management equity incentive, the lower the audit fees.

### Table 3. Correlation analysis of variables in the model.

|        | LNFEE | LNPay | INCENT | LNASSET | SUBC | REC | INV | BIG10 |
|--------|-------|-------|--------|---------|------|-----|-----|-------|
| LNFEE  | 1     | 0.378 | -0.274 | 0.713   | 0.445| -0.172| 0.007| 0.114 |
| LNPay  | 0.407 | 1     | -0.200 | 0.426   | 0.179| -0.109| -0.015| 0.099 |
| INCENT | -0.277| -0.204| 1      | -0.357  | -0.308| 0.247| -0.030| 0.009 |
| LNASSET| 0.750 | 0.458 | -0.375 | 1       | 0.569| -0.238| 0.037 | 0.043 |
| SUBC   | 0.435 | 0.197 | -0.313 | 0.581   | 1   | 0.010| 0.231 | 0.031 |
| REC    | -0.152| -0.096| 0.200  | -0.209  | 0.048| 1   | 0.096 | -0.005|
| INV    | 0.082 | 0.070 | -0.093 | 0.171   | 0.315| -0.070| 1    | -0.011|
| BIG10  | 0.136 | 0.101 | 0.013  | 0.067   | 0.037| -0.001| -0.016| 1    |

**Note:** the lower triangle is Pearson correlation coefficient; the upper triangle is Spearman correlation coefficient; *, **, *** are significant at the level of 1%, 5%, and 10%, respectively, the same below.

### Regression Analysis

After adding interaction term to exclude the influence of collinearity and regression analysis of the above model, the conclusion is shown in Table 4. If the natural logarithm of executive compensation (INPAY) has a positive impact on audit fees (coefficient 0.292, t-value 16.641) and is significant at 1%, then assuming H1 is true, it indicates that the higher the executive compensation is, the higher the audit fees will be; if the investment has a negative impact on audit fees (coefficient-0.136, t-value-4.199) and is significant at 1%, then assuming H2 is true, it indicates that The higher the equity incentive, the lower the audit cost. In addition, whether it is BIG10, REC, INV and INDEBT also have a significant impact on audit cost.
### Table 4. Data regression analysis results.

| variable               | Ratio of audit expenses to total assets of the company (LNFEET) |
|------------------------|---------------------------------------------------------------|
|                        | Coefficient | T            |
| intercept \( (X_0) \)   | 8.933***     | 35.279       |
| LNPAY                  | 0.292***     | 16.641       |
| INCENT                 | -0.136***    | -4.199       |
| BIG10                  | 0.132***     | 5.750        |
| REC                    | -0.852***    | -8.032       |
| INV                    | -0.378***    | -3.733       |
| LNDEBT                 | 0.418***     | 21.117       |
| N                      | 11492        |              |
| Adjusted R²            | 0.343        |              |
| F test                 | 210.475      |              |

### Robustness Test

The LNFEET, INPAY and INCENT less than the median are assigned as 0, and those greater than the median are assigned as 1, so that they become dummy variables; 10% of the samples (the number of samples becomes 11378) are randomly deleted, and the original model is used for logistic regression, and the regression test results are shown in Table 5. The natural logarithm of executive compensation (INPAY) still has a positive impact on the audit fee at 1%, and the equity incentive (INCENT) still has a negative impact on the audit fee at 1%. It shows that the higher the executive compensation is, the lower the executive equity incentive is, and the higher the audit cost is. There is no significant difference in the other analysis results, which indicates that the conclusion of this study has passed the test and the conclusion has high reliability.

### Table 5. Analysis results of robustness test data.

|          | B     | S.E.  | Wald   | Sig    | Exp(B)  |
|----------|-------|-------|--------|--------|---------|
| Constant | -2.636| 0.211 | 156.696| 0.000  | 0.072   |
| LNPAY    | 0.872 | 0.093 | 88.505 | 0.000  | 2.391   |
| INCENT   | -0.412| 0.096 | 18.440 | 0.000  | 0.663   |
| BIG10    | 0.292 | 0.095 | 9.462  | 0.002  | 1.339   |
| REC      | -2.891| 0.438 | 43.637 | 0.000  | 0.055   |
| INV      | -1.424| 0.434 | 10.782 | 0.001  | 0.241   |
| LNDEBT   | 1.402 | 0.091 | 235.005| 0.000  | 4.062   |

#### Conclusions and Suggestions

#### Conclusions

Through literature review and theoretical research, this paper finds that the impact of executive compensation incentive and equity incentive on audit costs is generated under the mechanism of
audit risk. Taking the A-share listed companies in Shanghai and Shenzhen as research samples, this paper uses empirical analysis to explore the relationship between executive compensation incentive and equity incentive on audit fees, and draws the following conclusions:

(1) There is a significant positive correlation between executive compensation incentive level and audit cost. That is to say, with the improvement of executive compensation incentive level, the audit fee paid will increase. The main reason is that at this stage, the remuneration of senior executives of listed companies is linked with financial performance, which may cause the senior executives of the company to do harm to the interests of the company for their short-term interests. The auditors of accounting firms consider the audit cost and risk premium, and will increase the audit fees collected to prevent their own audit risks.

(2) There is a significant negative correlation between the level of executive equity incentive and audit fees. It shows that with the improvement of the level of equity incentive, the audit fees paid will decrease. The main reason is that the executive equity incentive changes the executive from manager to part owner, and the executive will work hard for the long-term interests of the company, and make the most scientific and reasonable decision, which will play a positive role in promoting the development of the company, avoid the management and financial fraud of the Executive, and save certain audit costs on the premise of reducing the audit risk of the company.

Suggestions

(1) Improve the company's salary system.
Due to the high level and great difference of executive compensation in China, the listed companies should not only reflect the incentive, but also reflect the principle of moderation in the design of compensation system. In order to ensure the enthusiasm of incentive executives, we should also consider the fraud risk caused by excessive compensation incentive. At the same time, the design of the listed company's salary system should be connected with the company's internal control system, reasonably control the audit risk, and create a positive and stable development enterprise environment.

(2) Improve the level of equity incentive.
Equity incentive mechanism can establish a longer-term incentive effect, and promote executives to associate their short-term interests with the long-term development of enterprises. Therefore, increasing the proportion of equity incentive and improving the level of equity incentive can not only mobilize the enthusiasm of senior executives, but also restrain the behavior of senior executives, reduce the occurrence of damaging the long-term interests of the company for their own interests, and reduce the audit costs.

(3) Adopt a variety of equity incentive combinations.
In order to ensure the full play of equity incentive, listed companies should change the single way of equity incentive, using a variety of different ways of equity incentive combination, such as cash incentive, futures incentive and option incentive. To promote executives and enterprises to share risks, avoid short-term behavior, promote executives to serve the enterprise for a longer term, and maximize the economic benefits of the enterprise.

(4) Give full play to the supervision role of internal governance institutions.
With the development of market economy in China, the supervision function of internal governance organizations such as compensation committee and audit committee is becoming more and more important. Listed companies should improve the degree of specialization and independence of internal governance institutions, promote the reform of compensation system of listed companies, promote the legal authenticity of financial accounting information, so as to supervise the behavior of senior executives and prevent the financial risks of enterprises.

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