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Can Mandatory Dividend Policy Improve Audit Quality?

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Abstract

As an important external supervision force of listed companies, the behavior of CSRC and accounting firms may be compensatory. Taking A-share listed companies in 2009-2017 as samples, taking the mandatory dividend policy implemented by China Securities Regulatory Commission in 2013 as a "quasi-natural experiment", this paper uses double difference method to investigate the impact of mandatory dividend policy on audit fees. The research results show that the implementation of mandatory dividend policy significantly reduces audit fees. Further research shows that the above-mentioned effects are more significant in enterprises in areas with low marketization process and domestic non-"Top Ten" audit firms. The mechanism test results show that the mandatory dividend policy significantly reduces the agency cost, thus reducing the corresponding audit risk and audit cost. The research results not only support the theory of dividend agency cost, but also enrich the related literature of mandatory dividend policy and audit fees, and have reference significance for listed companies, auditors and regulatory authorities to fully understand the dividend policy reform and protect minority shareholders.

Keywords

Compulsory Dividend Policy; Audit Expenses; DID.

1. Introduction

Financial reform is an important part of supply-side reform. To protect individual investors in the capital market, the CSRC has promulgated a series of policies to guide listed companies to pay dividends since 2001. Since 2013, the Securities and Futures Commission promulgated regulations to stipulate the dividend behavior of all listed companies for the first time, and its promulgation and implementation has brought the dividend system of China's capital market into a new stage.

Audit cost has always been an important research topic in audit field. There are many influencing factors, and the related literature is too numerous to mention [4]. However, few scholars pay attention to the impact of mandatory dividend policy on audit fees. Based on the implementation of the mandatory dividend policy in 2013, this paper explains the information and governance effect of the CSRC's market supervision from the perspective of audit fees. The reason is that, in theory, the CSRC and external audit, as two reliable and powerful external supervision and restraint mechanisms, can effectively supervise and restrain the complex and opaque behaviors of enterprises, such as on-the-job consumption, earnings manipulation and dividend hollowing out. Their supervision functions are complementary to a certain extent. Specifically, the mandatory dividend policy directly reduces the free cash flow that the controlling shareholder can control, while the cash dividend payment indirectly inhibits the company's second-class agency costs [5][18], reducing the possibility of earnings manipulation, and thus reducing the audit risk. Auditors usually conduct audits in accordance with applicable auditing standards, correct the phenomenon of possible material misstatement risk, and reduce the audit risk. Therefore, the policies implemented by CSRC and their effects and the audit report information issued by accounting firms can be used for mutual reference. In addition, in

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practice, the CSRC's policies and regulations are related to the auditor's judgment opinions. The CSRC's policies and regulations usually reflect the stubborn problems existing in enterprises, and the implementation of policies will affect the auditor's risk perception, which will eventually be reflected in the audit fees. Thus, in theory, the mandatory dividend policy will indeed affect the audit fees. In view of this, this paper, based on the implementation of mandatory dividend policy, reveals the impact of mandatory dividend policy on audit fees and its mechanism, thus revealing the information and governance functions of mandatory dividend policy.

The contributions of this paper are as follows: Firstly, the policy effect of mandatory dividend policy is systematically tested. The dividend policy construction is very important to the construction of China's capital market. This paper supplements the research on the policy effect of the mandatory dividend policy from the perspective of audit fees, and provides a new perspective for assisting the market reform of regulatory authorities. Secondly, it expands the empirical research on the economic consequences of the mandatory dividend policy. With the help of the exogenous event of the implementation of the strong dividend policy in 2013, this paper reveals the spillover effect of the mandatory dividend policy on the audit field. Thirdly, it enriches the literature of influencing factors of audit fees. This paper tries to explore the influence of dividend policy on audit fees, and provides the path explanation of the influence of mandatory dividend policy on audit fees based on audit risks, which provides empirical evidence for clarifying how dividend policy causes the economic consequences of audit.

2. Theoretical Analysis and Research Hypothesis

China's capital market dividend policy has experienced a gradual process. In order to protect the interests of minority shareholders, this paper takes the 2013 policy as the research background, and studies the impact of mandatory dividend policy and audit fees.

The research shows that the cash dividend payment tendency of listed companies is positively correlated with the quality of independent audit [7]. The implementation of the mandatory dividend policy has significantly increased the cash dividend ratio of listed companies, which can produce a "shocking" effect on the perennial non-dividend behavior of enterprises, which may play an important role in auditors' audit risks and audit fees. Specifically, the mandatory dividend policy may alleviate agency conflicts within enterprises, improve the quality of accounting information, and then reduce the level of risk compensation required by auditors, and reduce audit costs. Therefore, based on the perspective of agency risk, this paper explores the impact mechanism of the mandatory dividend policy on audit fees.

Generally speaking, audit fees are affected by customer risk, audit time and audit investment. When the risk of clients is high, the risk of material misstatement assessed by auditors is higher, so more audit time and investment are needed to implement substantive procedures. At this time, they will charge higher audit fees as risk compensation [6]. For example, this paper focuses on the agency problem within the enterprise when studying the path that the mandatory dividend policy affects audit fees. It is found that in listed companies with more serious agency problems and higher degree of information asymmetry, auditors will face a higher probability of audit failure, so they need to spend more audit time and investment [4][10], and at the same time, they will charge higher audit fees.

First of all, from the perspective of agency risk, the risk of material misstatement of financial report is the key factor to determine audit expenses, and agency conflict is an important inducement to cause the risk of material misstatement. Managers sometimes make decisions at the expense of shareholders' interests, which will lead to agency costs. In the case of high agency cost, managers may go against shareholders' wishes to manipulate earnings, consume on the job, over-invest and hollow out dividends for the purpose of maximizing private interests [1], which will lead to higher risk of material misstatement, and then enhance audit risk. Therefore, when the agency cost is high, auditors will need to pay more audit time and investment, pay more attention to the risk assessment of material misstatement in financial reports, and charge higher audit fees [10]. The research shows that cash dividends can improve the efficiency of capital use by reducing the disposable free cash flow of executives, thus effectively reducing agency costs [18]. Obviously, by directly changing the company's profit distribution form and proportion, mandatory cash dividends will reduce the discretionary cash flow of enterprises and reduce agency costs [18].

Secondly, one of the causes of agency problem is information asymmetry. The mandatory dividend policy can re-establish the incentive and restraint mechanism between shareholders and executives, forcing executives to reduce earnings manipulation, on-the-job consumption, over-investment and dividend hollowing out, so as to achieve the purpose of reducing agency costs. If an enterprise supplements the cash flow lost by paying cash dividends and prepares for the next dividend in the future, the listed company must consciously and actively improve its internal performance level to meet the self-interest behavior of executives and the dividend policy requirements promulgated by CSRC. In addition, according to the dividend signal theory, the expected cash dividend is a positive signal, which means that the company is in good financial condition [8][18]. This is not only conducive to the investment and financing behavior of enterprises in the capital market, but also enhances the overall value of enterprises, making executives more active and confident in realizing the unity of personal value and enterprise value. In order to establish a consistent and sustained good market image for external investors, dividends will also force the company to improve its corporate performance and reduce the short-sighted behavior of company executives in investment decisions [18]. So as to form a virtuous circle, reduce the internal risks of enterprises, improve accounting information, improve audit efficiency, reduce audit risks and reduce expenses accordingly.

Generally speaking, the implementation of the mandatory dividend policy and the reduction of agency costs will reduce audit risks and audit expenses.Based on the above analysis, this paper puts forward the following assumptions.

H1: Implement the mandatory dividend policy to reduce the audit fees of listed companies.

H2: Mandatory dividend policy reduces audit fees by affecting agency costs.

3. Research Design

3.1. Research Design

This paper selects A-share listed companies in Shanghai and Shenzhen stock markets from 2009 to 2017 as the research samples, and processes them as follows: (1) Eliminate financial industry companies; (2) Eliminate ST and *ST companies; (3) Eliminate companies with negative owner's equity; (4) Eliminate the data before listing and companies with missing data. A total of 20920 valid samples were obtained in this paper. 1% and 99% of all continuous variables are processed by Winsorize, and the financial data come from national Taian and Wind databases.

3.2. Empirical Model Design

The implementation of the mandatory dividend policy is not a one-time comprehensive spread, but a continuous development and improvement, thus meeting the basic requirements of the double difference model in policy evaluation. Referring to Beck et al. (2010) [11], this paper constructs a standard double difference model (DID) to test the impact of the mandatory dividend policy on audit fees:

$$LnFee_{i,t} = \alpha + \alpha_1 Treat_{i,t} \times Law_{i,t} + \alpha_2 Law_{i,t} + \alpha_3 Treat_{i,t} + \sum Control + Year_{i,t} + Industury_{i,t} + \varepsilon_1 \quad (1)$$

Among them, $LnFee_{i,t}$ is the explanatory variable, indicating the logarithm of the audit expenses of listed company i in the t year. Treat is the dummy variable of the experimental group (the company that did not pay dividends for three consecutive years before the policy of the experimental group was introduced, and the value of Treat is 1, indicating that the listed company is affected by the policy impact; Otherwise, take 0), Law is a policy variable.

This paper takes the implementation of mandatory dividend policy in 2013 as a quasi-natural experiment. After 2013, Law takes 1, otherwise, it takes 0. TreatLaw is the core explanatory variable of this paper. It refers to the product of treat value and Law value, which reflects the state change of the company impacted by the mandatory dividend policy. This paper focuses on the coefficient α3 and its significance. If α3 is significantly negative, the implementation of the mandatory dividend policy is significantly negatively related to audit fees. Year represents the year effect, Instury represents the industry effect, and ε is the residual term. In addition, refer to the existing literature, control other variables that affect the audit expenses, and see Table 1 for the definition of specific variables.

Table 1. Variable Definition

VariableType	Variable Name	Code	Meaning
Independent Variable	Compulsory Dividend Policy	TreatLaw	Product of Treat value and Law value
Dependent Variable	Audit Expenses	LnFee	The audit fee of the current period is logarithmic.
Control Variable	Experimental Group	Treat	Listed companies that have not paid dividends for three consecutive years take 1, otherwise take 0.
	Policy Variables	Law	Dumb variable, take 1 in 2013 and after, otherwise take 0.
	Company Size	Size	Natural logarithm of total assets at the end of the year
	Loan Ability	Lev	Asset-liability ratio
	Profitability	Roa	Ratio of current net profit to total assets
	Firm Size	Big10	The value of audit institutions for the top ten firms is 1, otherwise it is 0.
	Growth	Growth	Income growth rate
	Cash Flow Ratio	CF	The ratio of cash flow generated by current operating activities to total assets
	Audit Opinion	Opinion	If the audit opinion is non-standard, the value is 1, otherwise it is 0.
	Business Complexity	Arinv	The ratio of current period (accounts receivable+inventory) to total assets
	Liquidity Ratio	CR	The ratio of current liabilities to current assets
	Ownership Concentration	OWN	The shareholding ratio of the largest shareholder in the current period
	Institutional Environment	Market	Marketization index of the province where the company is located in that year
	Annual Dummy Variable	Year	Set 11 annual dummy variables.
	Virtual Industry Variable	Industry	According to the industry classification of CSRC in 2012, industry dummy variables are set.

4. Empirical Test

4.1. Descriptive Statistics

Table 2 is descriptive statistics of main variables. According to the data in the table, the average audit fee (LnFee) is 13.1453, indicating that the average audit fee paid by the sample company is 1,269,131 yuan per year. The average value of the key variable TreatLaw is 0.2253. It can be seen that about 22.5% of the samples are affected by the mandatory dividend policy. With the continuous improvement of the capital market, this proportion will gradually increase. In terms of control variables, the average value of firm size (BIG10) is 0.5533, which indicates that more than half of the samples have hired domestic "Top 10" firms to audit statements, and the average value of audit Opinion is 0.9731, which means that 97.31% of the sample companies have obtained standard unqualified audit reports, and the results of other variables are similar to those of existing literature reports.

Table 2. Descriptive Statistics

Variable	Observation	Average Value	Standard deviation	Median
lnFee	20920	13.1453	2.6681	13.487
TreatLaw	20920	0.2253	0.4178	0
Size	20920	9.5469	0.5813	9.4707
Lev	20920	0.4266	0.2157	0.4182
Roa	20920	0.0514	0.7769	0.0397
Big10	20920	0.5533	0.4972	1
CF	20920	0.0416	0.1407	0.0427
Opinion	20920	0.9731	0.1617	1
Arinv	20920	0.2675	0.1721	0.2441
CR	20920	0.7528	0.9473	0.6021
Growth	20920	7.8072	936.4499	0.1075
OWN	20920	36.3262	15.5065	34.6576
Market	20920	7.8458	1.8216	8.08

4.2. Benchmark Regression Test

Table 3 reports the suppression of the mandatory dividend policy on the audit fees of "Iron Rooster" listed companies. Column (1) is a simple double difference model, and its multiplicative TreatLaw coefficient is -0.3683, which is significant at the level of 1%. This shows that the mandatory dividend policy significantly reduces the audit fees of "Iron Rooster" companies. On this basis, this paper continues to introduce other control variables at the company level. The regression results in column (2) show that the significance of the cross-product TreatLaw has not changed, which indicates that the introduction of the mandatory dividend policy in 2013 has indeed reduced the audit cost of the "Iron Rooster" company. Hypothesis 1 in this paper has been verified.

Table 3. Regression Result

Variable	LnFee			LnFee	
	Model (1)	Model (2)		Model (1)	Model (2)
TreatLaw	-0.3683*** (-5.21)	-0.3233*** (-3.657)	CR		0.0209 (0.959)
Treat		0.3332*** (3.777)	Growth		-0.0000* (-1.819)
Law		1.9096***	OWN		-0.0023*

		(16.155)			(-1.911)
Size		1.0324*** (26.228)	Market		0.0305*** (3.292)
Lev		0.6794*** (5.510)	Constant	10.3778*** (16.68)	1.7757*** (4.48)
Roa		0.1293*** (7.722)	Adi_R2	0.0140	0.1840
Big10		0.0797** (2.320)	Year	Yes	Yes
CF		1.1559*** (6.198)	Instury	Yes	Yes
Opinion		-0.1903* (-1.778)	N	20920	20920
Arinv		0.0143 (0.110)			

Note:()isn't value; ***is p<0.01, ** is p<0.05, * is p<0.1.

4.3. Mechanism Inspection

In order to test whether agency cost is an intermediary indicator of the impact of mandatory dividend policy on audit fees, this paper uses the following model to test:

$$LnFee_{i,t} = \alpha + \alpha_1 Treat_{i,t} \times Law_{i,t} + \alpha_2 Law_{i,t} + \alpha_3 Treat_{i,t} + \sum Control + Year_{i,t} + Industury_{i,t} + \varepsilon_1 \quad (2)$$

$$Agent_{i,t} = \beta + \beta_1 Treat_{i,t} \times Law_{i,t} + \beta_2 Law_{i,t} + \beta_3 Treat_{i,t} + \sum Control + Year_{i,t} + Industury_{i,t} + \varepsilon_2 \quad (3)$$

$$LnFee_{i,t} = \gamma + \gamma_1 Treat_{i,t} \times Law_{i,t} + \gamma_2 Agent_{i,t} + \gamma_3 Law_{i,t} + \gamma_4 Treat_{i,t} + \sum Control + Year_{i,t} + Industury_{i,t} + \varepsilon_3 \quad (4)$$

Table 4. Agency Cost Intermediary Effect

	Model (1)	Model (2)	Model (3)
Variable	lnFee	Agent	lnFee
Agent			0.0353***
			(2.76)
TreatLaw	-0.3233***	-0.0699*	-0.3191***
	(-3.66)	(-1.92)	(-3.61)
Treat	0.3332***	0.0561*	0.3345***
	(3.78)	(1.93)	(3.79)
Law	1.9096***	0.0880	1.9066***
	(16.15)	(1.46)	(16.10)
Control	Yes	Yes	Yes
Year Insdury	Yes Yes	Yes Yes	Yes Yes
N	20885	20885	20885
Adi_R2	0.1840	0.0278	0.1830

Note:()isn't value; ***is p<0.01, ** is p<0.05, * is p<0.1.

Among them, Agent is the agent cost, which is measured by the ratio of management cost to total assets according to the existing literature. In this paper, Baron et al.' s step-by-step approach [14] is adopted to verify the intermediary effect. Model (2) is used to test whether the mandatory dividend policy can reduce the audit cost, and the foregoing has passed the test, so α1 must be significant; According to the model (3) (4), when both β1 and γ1 are significant, if γ2 is not significant, then the agency cost has a complete intermediary effect in the mandatory dividend policy to reduce the audit cost. If γ _ 2 is significant, then agency cost has a partial intermediary effect in the mandatory dividend policy to reduce audit fees.

Table 4 shows the results of the intermediary effect test. According to column (2), it can be found that the mandatory dividend policy does lead to the reduction of agency cost in the experimental group (Treat=1); At the same time, according to column (3), it can be seen that the results of regression after controlling the agency cost show that the mandatory dividend policy still reduces the audit cost of enterprises.

This paper also guarantees the effectiveness of intermediary effect by Bootstrap test. 1000 times will be selected at 95% confidence level, and the test results are shown in Table 5. The confidence intervals of both direct and indirect effects do not contain 0, and the intermediary effect is established, that is, the mandatory dividend policy reduces the audit cost by affecting the agency cost. The hypothesis 2 is verified.

Table 5. Intermediary Effect Test

Effect Classification	Interval Estimation
Direct effect	(-0.0041758, -0. 0004969)
Indirect effect	(-0.4608565, -0.1096415)

5. Robustness Test

5.1. PSM-DID

In the empirical research, PSM can solve the possible selection and mixed bias of samples to a certain extent. Therefore, in order to further control the influence of the mandatory dividend policy experimental group and other differences on audit fees, this paper uses the method of combining PSM with double difference model to re-evaluate the policy effect of mandatory dividend policy on audit fees. First, financial leverage, profitability, company size, accounts receivable and inventory ratio, current assets ratio, growth ratio, cash flow ratio, and whether the top ten are the characteristic variables. Then, Logit model is used for one-to-one matching, and finally 11,773 observations are obtained. Table 6 (1) has significant regression coefficient, indicating that the negative impact of mandatory dividend policy on audit fees is still valid.

5.2. Re-measure Variables

There may be some lag in the implementation effect of the mandatory dividend policy, that is, after the policy is promulgated, the companies affected by the policy may need a period to react, for example, internal meetings to discuss and formulate dividend policies will affect the dividend payment time. Therefore, in the year when the mandatory dividend policy is implemented, the audit fees for the next year may really play a role. Therefore, this paper redefines the policy variable of this paper, that is, the value of the t+1th year and the following years of company I is 1, otherwise it is 0. The results in column (2) of Table 6 show that the regression coefficient is still significantly negative, indicating that the conclusion of this paper is still stable after the possible lag.

5.3. Cluster Inspection of Controlled Areas and Companies

In order to eliminate the possible heteroscedasticity in the model, this paper re-examines the policy effect by regional and company double cluster analysis. The regression results in Table 6 (3) show that the conclusion of this paper is still stable.

Table 6. Robustness Test

	Model (1)	Model (2)	Model (3)
Variable	PSM-DID	Re-measure Variable	Double clustering of regional companies
TreatLaw	-0.2518*		-0.3529***
	(-1.83)		(-2.85)
TreatLaw+1		-0.2831***	
		(-4.01)	
	3.2097***	1.7993***	1.7411***
_cons	(6.13)	(4.56)	(3.13)
Control	Yes	Yes	Yes
Year	Yes	Yes	Yes
Instury	Yes	Yes	Yes
cluster			Region and Company
Adi_R2	0.1683	0.1838	0.1913
N	11773	20892	18778

Note:()isn't value; ***is p<0.01, ** is p<0.05, * is p<0.1.

6. Further Analysis

Firstly, the analysis of the heterogeneity of the marketization process shows that when the degree of marketization is high, the legal system is sounder, the information transmission is more effective, and the company faces stricter external supervision. Therefore, the transmission speed of the policy issued by the CSRC is faster and the market response sensitivity is higher, so the incremental effect on corporate governance and operation is not obvious. In this paper, we use the "General Marketization Index" in the Report of Marketization Index of China's Provinces (2008) compiled by Wang Xiaolu et al. [2] to measure the degree of marketization. In this paper, according to the annual industry median of "Total Marketization Index", the samples are divided into groups with high degree of marketization and groups with low degree of marketization, and the regression results are shown in columns (1) and (2) of Table 7. The negative effect of mandatory dividend policy on audit fees is significant in the environment with low marketization process, but not significant in the environment with high marketization process.

Secondly, the analysis of the heterogeneity of firm size shows that firm size can reflect the audit quality to some extent, and it is the main factor that affects the audit cost [6][15]. Among many domestic firms, the former "Top Ten" firms have higher professional ability and reputation, and have stronger ability to control audit risks, so they charge higher audit fees. The empirical results show that in columns (3) and (4) of Table 7, the negative effect of mandatory dividend policy on audit fees in domestic non-"Top Ten" firms is more significant. The possible reason is that the implementation of mandatory dividend policy will inevitably be negatively resisted by managers, and may also stimulate unexpected large-scale earnings management behavior [16]. Therefore, in order to eliminate doubts, obtain more reliable audit reports, and understand the real business situation of the business operators, the business owners hire more authoritative accounting firms.

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Table 7. Heterogeneity Test

	Model (1)	Model (2)	Model (3)	Model (4)
Variable	Top ten in China	Non-top ten in China	High degree of marketization	Low marketization degree
TreatLaw	0.0023	-0.5816***	-0.2185	-0.3354***
	(0.02)	(-4.74)	(-1.50)	(-2.95)
_cons	1.9203***	2.0754***	2.0180***	1.6893***
	(3.87)	(3.07)	(3.73)	(2.70)
control	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes
Instury	Yes	Yes	Yes	Yes
Adi_R2	0.1900	0.1681	0.2148	0.1590
N	11566	9326	10635	10257

Note:() isn’t value; ***is p<0.01, ** is p<0.05, * is p<0.1.

7. Conclusion

Based on the sample of listed companies in Shanghai and Shenzhen stock markets from 2009 to 2017, and the event of implementing mandatory dividend policy in 2013, this paper empirically finds that this policy can indeed reduce the audit cost of enterprises. The specific conclusions are as follows: Firstly, the mandatory dividend policy has indeed increased the dividend ratio in the capital market because of its policy effect, and it can significantly inhibit the audit expenses of enterprises. Moreover, the mandatory dividend policy can reduce the agency cost of enterprises, thus restraining the audit cost. Secondly, this paper finds that the mandatory dividend policy has a significant inhibitory effect on audit fees in areas with low marketization process and listed companies audited by domestic non-top ten accounting firms, while it has no significant inhibitory effect on areas with high marketization process and listed companies audited by domestic top ten accounting firms.

Based on the research conclusion, this paper puts forward the following suggestions. First, auditors need to fully emphasize the policy effects of various policies implemented by CSRC on enterprises, to strengthen tracking and risk assessment, and thus exert the supervision and governance function of external audit. Second, when the CSRC formulates and implements the mandatory dividend policy, it should improve the mechanism of the whole process of policy implementation. When faced with stubborn resistance to laws and regulations, it needs to implement certain punishment measures. Thirdly, the policies and regulations of the CSRC are popular in the capital market, but for policy makers, they should also deal with the negative effects and pertinence of policies when formulating policies, and consider different market environments and the situation of different enterprises when improving the dividend reform mechanism, so as to consider the affordability of enterprises on the one hand, and better protect the interests of minority shareholders on the other, improve the efficiency of resource allocation in the capital market, and help the high-quality development of China's economy.

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