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Will the Quality of Internal Audit Affect Corporate Debt Financing?

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Abstract: *We explore the impact of internal audit quality on corporate debt financing behavior. The study finds the higher the quality of internal audit, the larger the scale of debt financing available to enterprises, and the lower the cost of debt financing. Further analysis finds that improving internal audit quality can expand the scale of debt financing and reduce the cost of debt financing by alleviating information asymmetry. This study enriches the research on the economic consequences of internal audit and the influencing factors of corporate debt financing behavior, contributes to a more comprehensive and objective evaluation of the implementation effect of the internal audit system, and provides empirical evidence for optimizing the internal audit system.*

Keywords: *Internal Audit Quality; Debt Financing Scale; Debt Financing Costs; Information Asymmetry*

1. Introduction

Together with national audit and social audit, internal audit constitutes the audit supervision system of China and has become an essential part of the supervision system of the party and the state. In January 2018, the National Audit Office of the People's Republic of China revised the provisions of "*the National Audit Office on internal audit* "(Order No. 11 of the National Audit Office, from now on referred to as the "provisions") to give a new definition to internal audit. Internal audit is defined as an activity that carries out independent and objective supervision, evaluation, and suggestions on the financial revenue and expenditure, economic activities, internal control, and risk management of the unit and its affiliated units, to promote the team to improve governance and achieve objectives. The regulation expands the function of internal audit, no longer regards internal audit as a simple control means but gradually becomes a valuable source for achieving high-quality development, that is, based on emphasizing "supervision and evaluation", it highlights the value of "advice and consultation", and emphasizes the rectification and implementation of problems. Previous studies have shown that internal audits can help enterprises improve their ability to identify, reveal and respond to risks, strengthen their internal control and risk management, and alleviate information asymmetry. Ogundana and Ojeka(2017)[1] found that improving internal audit quality can effectively improve the quality of enterprise accounting information. Then, Can internal audit's control of enterprise risks enhances the level of information asymmetry between the enterprise and the external capital market, to assist with external enterprise financing?

As China's economic development enters the process of structural adjustment and accelerated transformation, the external environment faced by enterprises is becoming more and more complex. How to achieve sustainable growth in a challenging market environment has become a vital issue that enterprises urgently need to solve. The strong financing ability is an essential guarantee for the safety of the enterprise's capital chain. The development of enterprises is inseparable from financial support. High-level financial support not only affects the business decision-making of enterprises to a certain extent, but also relates to the flow and distribution efficiency of social capital, which plays an essential role in economic development. Enterprise financing includes many forms, and debt financing is the most critical financing channel for Chinese listed companies, playing an essential role in China's economic development. Therefore, enterprises need to constantly optimize debt financing management and improve the overall efficiency of enterprises. Based on the above background, this study explores the impact of internal audit quality on corporate debt financing and the mechanism of their relationship from a new perspective of corporate debt financing.

This paper takes Chinese A-share listed companies from 2007 to 2020 as the research sample to explore the impact of internal audit quality on corporate debt financing behavior and its mechanism. The research finds that improving the quality of internal audits of enterprises will help expand the scale of debt financing and reduce the cost of debt financing. Further analysis finds that improving internal audit quality can expand the scale of debt financing and reduce the cost of debt financing by alleviating information asymmetry. The above conclusions are still valid in the robustness tests, such as replacing explanatory variables, changing explained variables, and adjusting sample periods.

The main contributions of this paper are as follows: first, it enriches the research on corporate debt financing. Existing studies on the influencing factors of corporate debt financing mainly focus on the impact of macroeconomic policies or institutional environment on corporate debt financing(Qian et al., 2021[2];Allen et al., 2005[3]). In terms of micro-level corporate governance, the current research only focuses on the cultural background of senior executives(Francis et al., 2013[4]) and the relationship between banks and enterprises(Winstein and Yafeh, 1998[5]). There is no literature to study the impact of the internal audit quality of enterprises on debt financing. The article finds that the improvement of the quality of internal audit is conducive to improving the scale of enterprise debt financing and reducing the cost of debt financing. Second, it raises the research on the economic consequences of internal audits. The article explores the impact path of the internal audit quality of enterprises on their debt financing, opens the "black box" of the path of the internal audit quality affecting the debt financing ability of enterprises, expands the mechanism of the research on the economic consequences of internal audit, and provides a reference for further optimizing the internal audit system.

2. Hypothesis development

Strengthening internal audit is a need to promote the modernization of the country's governance system and governance capacity, as well as to promote high-quality economic development. Internal audit has been promoted to the strategic level of the company. The existing research on the economic consequences of an internal audit mainly focuses on improving the enterprise value(Liu, 2014[6]) and improving the corporate governance effect(Prawitt et al., 2009[7]; Kumar, 2012[8]; Wang et al., 2014[9]; Gros et al., 2017[10]; Bajra and cadez, 2018[11]). Internal audit participates in corporate governance, risk management, and strategic management in the form of reasonable assurance and consultation to achieve a benign interaction with other governance mechanisms and help give full play to the promotion role of internal audit on the company's value(Gramling et al., 2004[12]; Liu, 2014[6]). In corporate governance, internal audit plays a supporting and supervisory role in internal control(Kumar, 2012[8]). Internal audit activities are forward-looking and advisory, it emphasizes the importance of enterprise internal risk management(Zhang and Hou, 2015[13]), and can effectively identify, evaluate and prevent enterprise operational risks, and plan and implement corresponding audit activities to deal with adverse factors in enterprise operation and eliminate potential risks. Therefore, the improvement of the quality of internal audits helps to improve the quality of the company's financial report(Prawitt et al., 2009[7]; Gros et al., 2017[10]; Bajra and cadez, 2018[11]) and inhibits the earnings management behavior of listed companies(Wang et al., 2014[9]). From the perspective of information disclosure, high-quality financial information disclosure can provide creditors with more valuable financial information, enable creditors to better understand the company's risk situation, and facilitate the company to obtain larger scale debt financing.

At the same time, improving the internal audit quality of the company not only means that the information disclosure quality of the enterprise is high but also can release a good signal to creditors. From the perspective of signal transmission, the signal released by the enterprise can eliminate the difference between creditors in information acquisition cost and information processing capacity, and reduce the possibility that creditors can not fully and effectively capture the high-quality financial information disclosed by the company, Improve creditors' understanding and positive evaluation of the company, and help the company obtain more debt financing. Therefore, the first hypothesis 1 of this paper is proposed:

Hypothesis 1: Under the same conditions, internal audit quality is conducive to expanding the scale of enterprise debt financing.

Compared with the scale of debt financing, the cost of debt financing is a market-oriented indicator that reflects the risk management and control of enterprises more finely. It is generally believed that the higher the quality of internal audit of an enterprise, not only the higher the level of corporate

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governance, but also the higher the quality of accounting information of the enterprise, which can effectively improve the information asymmetry between the enterprise and creditors, increase the credit limit of creditors to the enterprise, and thus reduce the debt financing cost of the enterprise (Winstein and Yafeh, 1998[5]). It can also release positive signals to the outside world, help creditors to identify high-quality enterprises more efficiently and demand lower return on investment, thus reducing the cost of corporate debt financing.

In addition, Graham et al.(2008)[14] believe that the cost of a creditor's supervision over the debtor is closely related to the cost of debt financing, and the related debt contract terms are also more strict. The internal audit mainly supervises the economic activities related to fiscal revenue and expenditure to ensure their authenticity, legitimacy, and effectiveness. The higher the quality of an enterprise's internal audit, the more active the supervision function it plays, the more it can ensure that the enterprise manages its finances according to law, improve its business management, reduce the supervision cost of creditors, and thus reduce the debt financing cost of the enterprise. Therefore, the second hypothesis 2 in this paper is proposed:

Hypothesis 2: Under the same conditions, internal audit quality is conducive to decreasing the cost of enterprise debt financing.

3. Sample and reserch design

3.1 Sample selection

This study selects A-share listed companies from 2007 to 2020 as the initial research sample. The internal audit data is obtained by sorting out the company's internal audit system, internal control evaluation report, enterprise annual report, and other materials. Other data are from the CSMAR (the guotai'an) database. The industry classification guidelines for listed companies are based on the industry classification standards revised by China Securities Regulatory Commission in 2012 as the basis for industry classification. To ensure the effectiveness of the sample, the sample is processed as follows:(1) to prevent the particularity of the financial industry from affecting the research results, the sample of the financial sector was removed. (2) Eliminate samples with missing data. (3) To prevent extreme values from affecting the research results, continuous variables are winsorized and tailed. Finally, 6986 observations were obtained as research samples.

3.2 Models

3.2.1 Model for tests the impact of internal audit quality on enterprise's debt financing scale

We employ model(1) to examine the hypotheses 1, namely whether firms that with high internal audit quality are more likely to obtain more debt financing:

$$Debt\_size_{i,t}=\alpha_0+\alpha_1 lnIAQ+\alpha_2 Growth+\alpha_3 Size+\alpha_4 Roa+\alpha_5 Cfo+\alpha_6 Lev+\sum Industry+\sum Year+\varepsilon_{i,t} \quad (1)$$

Where Debt_size represents the scale of enterprise's debt financing, and lnIAQ is a firm's internal audit quality. We include the net operating incomes by the operating incomes of last year(Growth), the natural logarithm of total assets(Size), operating cash flows(Cfo), the ratio of total debt to total assets(Lev), year indicators(Year), and industry indicators(Industry) defined on the basis of the China Securities Regulatory Commission(CSRC) industry classifications in the regression model. Our variable of interest is the interaction between lnIAQ. A positive coefficient on this interaction(α_1) indicates greater debt financing scale via the improvment on the firm's internal audit quality.

3.2.2 Model for tests the impact of internal audit quality on enterprise's debt financing cost

The hypotheses 2 to be tested are that the debt financing cost is a function of the internal audit quilty and other control variables. we employ model(2) to examine whether firms that with high internal audit quality are more likely to obtain lower cost of debt financing:

$$Debt\_cost_{i,t}=\beta_0+\beta_1 lnIAQ+\beta_2 Debt\_size+\beta_3 Growth+\beta_4 Size+\beta_5 Roa+\beta_6 Cfo+\beta_7 Lev+\beta_8 Ta+\beta_9 Se+\beta_{10} Dfa$$
$$+\sum Industry+\sum Year+\varepsilon_{i,t} \quad (2)$$

Where Debt_cost represents enterprise's debt financing cost, and the definition of other variables is seminar to model(1). Our variable of interest is the interaction between lnIAQ. A positive coefficient on this interaction(β_1) indicates greater debt financing scale via the improvment on the firm's internal audit

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quality.

3.3 Variables

3.3.1 Dependent variable: Debt financing scale

This paper uses the ratio of cash received from borrowing to total assets of the enterprise to measure the debt financing scale of the enterprise. Among them, the cash received from obtaining loans is the sum of the enterprise's long-term loans and short-term loans.

3.3.2 Dependent variable: Debt financing cost

This paper uses the proportion of net financial expenses to measure the debt financing cost of an enterprise, and the proportion of net financial expenses is equal to the ratio of net financial expenses to total liabilities at the end of the period.

3.3.3 Test variable: Internal audit quality

The internal audit quality was calculated through the following model. Among them, the IAModel is the affiliation mode of the internal audit department. When the affiliation mode of the company's internal audit department is the dual leadership of the board of directors and the management, subordinate to the board of supervisors, subordinate to the board of directors, or the audit committee, the IAModel is assigned a value of 1. When the internal audit department is subordinate to the management or the finance department, the IAModel is assigned a value of 0. IADduty is the scope of responsibility of the internal audit department. The total number of the special audit, financial audit, internal control evaluation, and consultation responsibilities of the internal audit department is divided by three as the assignment of IADuty. Dual refers to whether the chairman and the general manager were concurrently held. When the chairman and the general manager are separated, dual is assigned a value of 1. Otherwise, it is 0. Finally, The Big10 is whether to audit by the top ten accounting firms. If the company hires the top ten accounting firms to audit, Big10 is assigned a value of 1. Otherwise, it is 0. When the value of lnIAQ in the model is more significant, it means that the internal audit quality of the company is higher.

$$lnIAQ_{i,t}=ln(IAModel_{i,t}+IADuty_{i,t}+Dual_{i,t}+Big10_{i,t})$$

3.3.4 Control variables

To explore the relationship between internal audit quality and enterprise debt financing scale and debt financing cost in a more in-depth and minimized way, this paper selects Size, Growth, Roa, Lev, Cfo, Ta, Se and Dfa are taken as control variables. In addition, the paper also controls the Year indicators and Industry indicators. See Table 1 for the definition of specific variables.

Table 1: Variables definitions.

Symbol	*Definitions*
Debt_size	*Debt financing scale, calculated by cash received from borrowings by the book value of total assets*
Debt_cost	*Debt financing cost, calculated by net financial expenses by the book value of total liabilities*
lnIAQ	*Internal audit quality, refer to Wei Xiaoquan and Yuan Zhenchao(2014), and calculate according to the model:* $lnIAQ_{i,t}=ln(IAModel_{i,t}+IADuty_{i,t}+Dual_{i,t}+Big10_{i,t})$
Size	*The natural logarithm of the book value of total assets*
Growth	*calculated by the net operating incomes by the operating incomes of last year*
Roa	*Return on assets, calculated by net profit divided by the book value of total assets*
Lev	*calculated by the book value of total liabilities by the book value of total assets*
Cfo	*calculated by annual net cash flow from operating activities by the book value of total assets*
Ta	*calculated by operating incomes by the book value of total assets*
Se	*calculated by operating incomes by the book value of shareholders' equity*
Dfa	*calculated by operating incomes by the net amount of fixed assets*
Industry	*industry dummies*
Year	*year dummies*

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4. Empirical analyses

4.1 Descriptive statistics

Table 2 provides descriptive statistics for the variables used in our analysis, and the sample observation value is 6986. Among them, we can see that the average value, standard deviation, minimum value, and maximum value of the debt financing scale (Debt_size) are 0.179, 0.140, 0, and 0.663, respectively, which indicates that the debt financing scale Listed Companies in China is quite different. The average value, standard deviation, minimum value, and maximum value of debt financing cost (Debt_cost) are 0.015, -0.031, -0.136, and 0.081, respectively, which indicates that the debt financing cost of Listed Companies in China is relatively high. In addition, the average value, standard deviation, minimum value, and maximum value of internal audit quality (lnIAQ) are 0.77, 0.473, 0, and 1.386, respectively, which indicates the internal audit level of listed companies is relatively high. In terms of control variables, the average value of enterprise size is 22.269, and the median value is 22.18, which is consistent with the average value and median value of enterprise size in existing internal audit related studies; There is a big difference between the minimum value and the maximum value of variables such as enterprise growth, fixed assets turnover rate and shareholders' equity turnover rate.

Table 2: Descriptive statistics.

Variable	*obs.*	*mean*	*median*	*sd*	*minimum*	*maximum*
Debt_size	*6 986*	*0.179*	*0.163*	*0.140*	*0*	*0.663*
Debt_cost	*6 986*	*0.015*	*0.019*	*0.031*	*-0.136*	*0.081*
lnIAQ	*6 986*	*0.770*	*0.847*	*0.473*	*0*	*1.386*
Growth	*6 986*	*0.405*	*0.072*	*2.020*	*-0.972*	*15.621*
Size	*6 986*	*22.269*	*22.180*	*1.336*	*18.871*	*25.871*
Roa	*6 986*	*0.031*	*0.031*	*0.068*	*-0.507*	*0.227*
Cfo	*6 986*	*0.041*	*0.042*	*0.077*	*-0.227*	*0.263*
Lev	*6 986*	*0.488*	*0.496*	*0.208*	*0.051*	*0.999*
Ta	*6 986*	*0.635*	*0.516*	*0.492*	*0.030*	*2.965*
Se	*6 986*	*1.631*	*1.053*	*1.987*	*0*	*14.216*
Dfa	*6 986*	*10.493*	*2.806*	*33.286*	*0.191*	*270.345*

4.2 Multivariate results

The column (1) of table 3 shows the regression results of the impact of internal audit quality (lnIAQ) on the debt financing scale(Debt_size). The results show that the regression coefficient of lnIAQ is 0.005, significantly and positively related with lnIAQ at the 10% level, which indicates a significant positive correlation between the quality of internal audit and the scale of debt financing. It shows that firms with high internal audit quality are more likely help to reduce its level of information asymmetry, thus helping creditors understand the company and provide funds. Overall, the result indicates that with the improvement of internal audit quality, the scale of debt financing of enterprises will expand, which supports hypothesis 1.

The column(2) of table 3 shows the regression results of the impact of internal audit quality(lnIAQ) on debt financing cost(Debt_cost). The results show that the coefficients of lnIAQ is -0.002, and the relationship between them is significantly negative at the 5% level, indicating a significant negative correlation between the quality of internal audit and the cost of debt financing. It shows that firms with high internal audit quality are more likely help to reduce its level of information asymmetry, thus helping to reduce the risks that creditors need to bear, thus reducing the cost of debt financing. Overall, with the improvement of internal audit quality, the debt financing cost of enterprises will be reduced, which supports hypothesis 2.

To make the research conclusion more reliable, this paper uses the methods of changing the measurement of independent variables, changing the measurement of dependent variables and the period of study samples to test the robustness of the research results, again proving that hypothesis 1 and hypothesis 2 are tenable, which shows that the above conclusions are robust.

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Table 3: Internal audit quality and the enterprises' debt financing scale and financing cost.

	Debt_size	Debt_cost
	(1)	(2)
lnIAQ	0.005*	-0.002**
	(1.91)	(-2.41)
Debt_size		0.072***
		(24.04)
Growth	-0.001*	0.000
	(-1.76)	(0.39)
Size	0.008***	-0.002***
	(6.51)	(-8.23)
Roa	-0.131***	-0.034***
	(-6.41)	(-6.62)
Cfo	-0.132***	0.019***
	(-7.74)	(4.44)
Lev	0.418***	0.051***
	(57.43)	(19.79)
Ta		0.011***
		(11.07)
Se		-0.003***
		(-11.63)
Dfa		-0.000***
		(-2.94)
Constant	-0.085***	0.034***
	(-3.29)	(5.05)
Year	Yes	Yes
Industry	Yes	Yes
N	6,826	6,986
Adj. R^2	0.496	0.322

(*, **, and *** indicate significance at the 10%, 5% and 1% levels (two-tailed), respectively.)

5. Further analyses

In the process of corporate debt financing, there is information asymmetry between the fund provider and the fund user (Armstrong et al., 2010[15]), resulting in adverse selection and moral hazard when the listed company performs the debt contract. For risk prevention, rational creditors will certainly consider reducing the scale of lending funds or setting strict contractual conditions, raising the risk premium requirements, and demanding higher investment returns, making up for their information deterioration and investment risks. Pittman and Fortin (2004) [16] and Derrien et al.(2016)[17] and other studies have confirmed that the existence of asymmetric information will reduce the possibility of the company obtaining debt financing. Dennis and Mullineaux (2000)[18] also found that creditors would refuse to provide loan support to listed companies with low information transparency.

According to the above theoretical analysis, the improvement of internal audit quality can not only improve the governance level of enterprises but also help release positive signals to the external capital market, which can effectively improve the transparency of accounting information of enterprises, alleviate the information asymmetry in the financing market to a certain extent, and thus obtain more favorable loan support for the development of enterprises.

According to the hypothesis derivation, internal audit affects the debt financing ability of enterprises by improving information transparency. To test the intermediary effect of information transparency in the impact of internal audit on debt financing ability, this study uses the method of Yuan et al.(2016)[19] to test the intermediary effect to verify the relationship between internal audit quality(lnIAQ) and information transparency. Information transparency was measured by analyst tracking quantity (NUM).

5.1 Internal audit quality and analyst tracking quantity

According to the hypothesis derivation, internal audit affects the debt financing scale and debt financing cost of enterprises by improving information transparency. Since the higher the number of analysts tracked, the higher the reliability and transparency of financial information of listed companies,

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the clarity of information were measured by the number of analysts tracked (NUM). With the increase in the number of enterprise analysts following, it can effectively reduce the degree of information asymmetry in enterprises, thereby expanding the scale of debt financing and reducing the cost of debt financing. Therefore, internal audit plays a significant positive role in the transparency of accounting information. Further, improving internal audit quality makes enterprise accounting information more transparent. Therefore, internal audit quality affects the scale and cost of debt financing by enhancing the transparency of information (the number of analysts tracking).

The model (3) was constructed with the number of analysts tracking as the explained variable and the internal audit quality as the test variable. The number of analysts (NUM) refers to the cumulative number of forecast information given by securities analysts during the period from the disclosure of the financial report to the end of the current year. Num1 is the number of analysts tracked, and num2 is the number of analyst teams.

$$NUM_{i,t}=\gamma_0+\gamma_1 lnIAQ_{i,t}+\sum Control\ Variables_{i,t}+\sum Industry+\sum Year+\varepsilon_{i,t} \quad (3)$$

Table 4: Internal audit quality and the number of analysts.

	NUM1	*NUM2*
	(1)	*(2)*
lnIAQ	*2.230****	*0.414***
	(3.08)	*(2.04)*
Growth	*-0.226*	*-0.038*
	(-1.36)	*(-0.83)*
Size	*10.546****	*3.371****
	(32.57)	*(37.24)*
Roa	*71.440****	*21.290****
	(12.42)	*(13.24)*
Cfo	*26.875****	*7.236****
	(5.67)	*(5.46)*
Lev	*-15.566****	*-6.694****
	(-7.62)	*(-11.72)*
Constant	*-216.429****	*-66.885****
	(-30.37)	*(-33.57)*
Year	*Yes*	*Yes*
Industry	*Yes*	*Yes*
N	*6,415*	*6,415*
Adj. R^2	*0.249*	*0.289*

We can see from the column (1) of table 4 that the regression coefficient between lnIAQ and num1 is 2.23, which is significantly positive at the level of 1%. And the column(2) of table 4 shows that the regression coefficient between lnIAQ and num2 is 0.414, which is significantly positive at the level of 5%, indicateing that there is a significant positive correlation between the quality of internal audit and the number of analysts. That is, with the improvement of the quality of internal audit, more analysts will track. The more analysts track, the more attention they receive, which can alleviate the problem of information asymmetry to a certain extent, thereby expanding the scale of debt financing of enterprises and reducing the cost of debt financing of enterprises. Therefore, internal audit can expand the scale of enterprise debt financing and reduce the cost of enterprise debt financing by alleviating information asymmetry.

6. Conclusions

This paper takes Chinese A-share listed companies from 2007 to 2020 as the research sample to explore the impact of internal audit quality on the enterprises' debt financing scale and cost. It was found that the internal audit quality is positively related to the scale of debt financing and negatively associated with the cost of debt financing. Further research finds that internal audit can improve information transparency by alleviating information asymmetry, thus expanding the scale of debt financing and reducing the cost of debt financing.

Our study enriches the research on corporate debt financing and raises the research on the economic consequences of internal audits. The article finds that the improvement of the quality of internal audit is conducive to improving the scale of enterprise debt financing and reducing the cost of debt financing, expanding the research on the influencing factors of enterprise debt financing, and providing new ideas and perspectives for enterprise debt financing management. At the same time, the article explores the

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impact path of the internal audit quality of enterprises on their debt financing, opens the "black box" of the path of the internal audit quality affecting the debt financing ability of enterprises, expands the mechanism of the research on the economic consequences of internal audit, and provides a reference for further optimizing and improving the internal audit system. However, some limitations and further study should be noted. With the changes in the audit environment and audit needs of various enterprises brought about by digital transformation, which don't mentioned in this paper.

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