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The Impact of Director Executive Liability Insurance on Audit Pricing

-- Take Yanzhou Coal Industry as An Example

Sha Lan, Songmin Li

Northwest University of Political Science and Law, China

Abstract: On April 3,2020, the news that Ping An Insurance of China responded to Luckin Coffee's claim for director liability insurance triggered a discussion about director liability insurance. Since 2002, more and more enterprises in China buy director liability insurance. So what is the impact of director liability insurance on enterprises? Can director liability insurance play its role, reduce the risk of enterprise fraud, and then reduce audit costs? Many scholars have studied this, but they have not reached a unified conclusion. This paper analyzes the case companies and studies the impact path of director liability insurance, and finds that director liability insurance can reduce the audit pricing.

Keywords: Director executive liability insurance, Audit pricing.

1. Foreword

Director executive liability insurance (hereinafter referred to as director liability insurance) is a kind of insurance purchased by the insurance company to bear the relevant civil compensation expenses when the directors and senior managers are investigated for negligence or misconduct in the process of performing their duties.After the collapse of the US stock market in the 1930s, the securities regulatory law suddenly increased the liability risk of directors and senior executives, resulting in the director liability insurance.

Director liability insurance was introduced late in China. In the Governance Standards of Listed Companies issued by the CSRC in 2002, it was mentioned that "approved by the general meeting of shareholders, listed companies can purchase liability insurance for directors", which introduced the director liability insurance system into the document for the first time.After more than ten years of development, director liability insurance gradually occupies a place in China's capital market, and many scholars have carried out a series of studies on the economic consequences of director liability insurance.But a unified conclusion has not been reached yet.The public understands director liability insurance began on April 3,2020, when Ping An Insurance of China responded to Luckin Coffee's claim for director liability insurance.Luckin Coffee purchased director liability insurance for its senior executives. According to the underwriting company Ping An Insurance, the senior management who intentionally caused losses to investors was not covered by the insurance. This incident triggered a discussion of director liability insurance.Whether director Liability Insurance can improve the corporate governance mechanism according to its original intention, or provide the bottom line for the company executives, increase the maximization of personal interests and increase the internal control risk of the enterprise, and ultimately increase the audit risk and pay higher audit costs.Through data collection, it is found that the premium of director liability insurance is far lower than the financial statement audit fee paid by the enterprise.If the fourth party supervision mechanism is introduced by insured director liability insurance, it can replace the external supervision effect of some audit to some extent, so as to reduce the expenditure of audit expense. Therefore, the exploration of the audit expense mechanism of director liability insurance will be of practical significance.

2. Literature References

Some scholars have conducted relevant studies on the impact of director liability insurance on audit pricing, but no unified conclusion.

Some scholars believe that director liability insurance will increase the audit pricing. Zhang Yueling et al. (2022) took China's A-share listed companies in 2015-2019 as the research sample, and added internal control quality as the adjustment variable.The study found that the companies that bought director liability insurance paid higher audit fees, and the quality of internal control significantly promoted the positive relationship between director liability insurance and audit costs. Yao Hui and Gao Kai (2022) The introduction of directors' liability insurance by listed companies can significantly increase the audit costs.At the same time, the study found that under a lower level of internal control, the positive relationship between directors 'liability insurance and the company's audit costs is more significant. Whether Li Qiyang (2022) insured director liability insurance has a significant promotion effect on the audit pricing, and the longer the insurance time, the larger the amount of insurance, the higher the fees charged by the audit activities. Ling Shi show (2020) based on the Shanghai and Shenzhen stock exchange listed companies in 2003-2017 data found that the introduction of director liability risks will significantly increase the audit expenses of listed companies, and the increase of the audit expenses because the insurer active supervision behavior, the pursuit of higher audit quality, rather than the resulting opportunistic behavior. The study found that buying board liability insurance would increase the company's audit costs . Zeng Chunhua and Li Yuan found that buying board liability insurance would increase the company's audit costs. Yuan Rongli et al. (2018) found that the purchase of directors 'liability insurance would increase the audit cost, and the purchase of directors' liability insurance may transfer the personal responsibility of the management, which to a certain extent is excessive protection, induce and aggravate moral hazard, increase agency conflict, and then increase the audit cost. Wu Ziyuan (2018) The board liability insurance policy will significantly increase the audit costs. Li Yuan (2018) and Jin Xiu (2019) also got the same conclusion that director liability insurance and audit costs were significantly positive correlation.

Some scholars also believe that director liability insurance will lower the audit pricing.Chai Xishuai (2021) director and executive liability insurance has a positive impact on the quality of accounting information of enterprises. The purchase of this insurance by listed companies is conducive to improving the quality of their accounting information.Director Liability Insurance leads to the improvement of the quality of accounting information by reducing the agency costs.Yang Ruiming (2021) found that the audit expenses of the case company showed a downward trend during the period of case analysis.

There is no unified conclusion on the relationship between director liability insurance and audit pricing in the existing literature, and most scholars have adopted the method of empirical test to study. Only one scholar has analyzed the existing enterprises and drawn the conclusion that director liability insurance will reduce the audit pricing through specific practice.Therefore, this paper will analyze the enterprises that buy director liability insurance through the method of case analysis, and conclude the relationship between director liability insurance and audit pricing, so as to provide suggestions for other enterprises to choose insured director liability insurance to improve corporate governance.

3. Analysis of the Impact of Yanzhou Coal Industry to Purchase Director Liability Insurance on Audit Pricing

3.1. Case Company Overview

Yanzhou coal company is the national economic system reform commission of the People's Republic of China body reform [1997] no. 154 documents approval, by yankuang group co company.as the main sponsor co., LTD.Yanzhou Coal Industry was established in September 1997, registered in Zoucheng City, Shandirector Province, the headquarters office address is No.298, Fushan South Road, Zoucheng City, Shandirector Province.

The business scope of Yankuang Group is mainly coal mining and beneficiation and sales (the export shall be represented by the enterprises with coal export rights according to the current national regulations); Foreign investment and investment consultation with its own funds; entrusted operation; Mining area's own railway cargo transportation; Road cargo transport; Port operation; Manufacturing, sales, leasing, maintenance, installation and removal of mining machinery and equipment; Production and sales of other mining materials; Sales, leasing of electrical equipment and sales of related accessories; Construction machinery and equipment leasing; Sales of metal materials, mechanical and electrical products, building materials, wood and rubber products; Manufacturing and sales of cold tonic glue, soap, agent and coating; Comprehensive scientific and technical services for coal mines; Mine rescue technical service; Real estate development in the mining area, House rental, And provide catering, accommodation and other related services; Production and sales of coal gangue series of building materials products; Sales of coke, iron ore and non-ferrous metals; Import and export of goods and technologies; Storage (excluding hazardous chemicals); motor repair; labor dispatch; Property management services; landscaping; sewage disposal; heat addition; Industrial tourism; Internal personnel training (rescue team skills training, production technology training, safety training); Metrological verification, physical and chemical testing, nondestructive testing, analytical laboratory testing, safety production testing and inspection; business administration; management consulting; Enterprise planning, design; market research; Economic and trade consultation; Technology promotion and technical services; Lubricating oil, grease, chemical raw materials and chemical products (excluding hazardous chemicals), coatings, labor protective articles, textile products, cultural and educational supplies, plastic products, instruments and meters, cement, refractory materials and products sales.General contracting of mine engineering construction and construction contract of mechanical and electrical engineering; sales of coal water slurry.

The main operating indicators of Yanzhou Coal industry in 10 years are shown in the following chart.

Table 1. Yanzhou coal industry main operating indicators

Year	Total assets (one thousand yuan)	Total operating revenue (one thousand yuan)	Net profit (one thousand yuan)
2013	13,938,598.16	58,726,589.00	299,202.00
2014	133,680,126.00	65,326,133.00	1,768,450.00
2015	139,061,962.00	69,007,382.00	831,210.00
2016	153,046,361.00	102,282,148.00	2,404,863.00
2017	194,887,291.00	151,227,775.00	7,861,863.00
2018	203,679,900.00	163,008,472.00	10,655,936.00
2019	236,224,771.00	214,688,079.00	12,933,594.00
2020	258,910,041.00	214,991,818.00	6,837,681.00
2021	288,695,542.00	151,990,797.00	18,566,775.00
2022	295,795,524.00	200,829,269.00	39,438,346.00

This paper, Yanzhou Coal Industry is selected as a case company because it spent 15 years in the industry and is representative; The audit cost and the liability insurance premiums are comprehensive and continuous, which can provide a data basis for the research.

3.2. Case of the Company's Purchase of Directors Liability Insurance and Audit Expenses Changes

The main purpose of this paper is to explore the influence mechanism of enterprises on corporate audit pricing after purchasing board liability insurance.So this article access to public information collection case company insurance directors, supervisors and senior management liability insurance, due to data limited factors cannot obtain the annual financial statements audit costs, in addition due to the annual financial statements audit and internal control audit is the company this year all the most representative and the most comprehensive audit project.So this paper adopts the annual report audit and internal control expenses as the representative factor of audit costs, finally collected from the purchase of directors, supervisors and senior managers liability insurance after the company's annual statement audit expenses (because yanzhou in 2008 board of directors 16th meeting approved to buy the insurance, so the 2008 and after audit costs impact).See Table 2 for details.

Table 2. Yanzhou Coal industry director liability insurance purchase and audit fee payment table

Year	Insurance amount (ten thousand yuan)	Premium (ten thousand yuan)	Accounting firm	Type of audit report	Annual report audit fee (ten thousand yuan)	Internal control audit expenses (ten thousand yuan)	Operating income (ten thousand yuan)	Audit expense / operating revenue
2008	1500	21.70	Shinyong Zhonghe Accounting firm	Standard without reservations	-	696.00	2,612,355.17	-
2009	1500	20.60	Shinyong Zhonghe Accounting firm	Standard without reservations	-	696.00	2,150,035.22	-
2010	1500	22.20	Shinyong Zhonghe Accounting firm	Standard without reservations	-	730.00	3,484,438.76	-
2011	1500	-	Shinyong Zhonghe Accounting firm	Standard without reservations	468.00	312.00	4,876,834.49	0.10‰
2012	1500	26.80	Shinyong Zhonghe Accounting firm	Standard without reservations	468.00	312.00	5,967,354.64	0.08‰
2013	1500	25.50	Shinyong Zhonghe Accounting firm	Standard without reservations	468.00	312.00	5,872,658.90	0.08‰
2014	1500	25.50	Shinyong Zhonghe Accounting firm	Standard without reservations	468.00	312.00	6,532,613.30	0.07‰
2015	1500	24.50	Shinyong Zhonghe Accounting firm	Standard without reservations	415.00	50.00	6,900,738.20	0.06‰
2016	1500	24.50	Shinyong Zhonghe Accounting firm	Standard without reservations	415.00	50.00	10,228,214.80	0.04‰
2017	1500	22.05	Shinyong Zhonghe Accounting firm	Standard without reservations	415.00	50.00	15,122,777.50	0.03‰
2018	1500	20.90	Shinyong Zhonghe Accounting firm	Standard without reservations	459.00	150.00	16,300,847.20	0.03‰
2019	1500	19.86	Shinyong Zhonghe Accounting firm	Standard without reservations	495.00	190.00	21,468,807.90	0.02‰
2020	1500	22.06	Shinyong Zhonghe Accounting firm	Standard without reservations	570.00	220.00	21,499,181.80	0.03‰
2021	1500	22.06	Shinyong Zhonghe Accounting firm	Standard without reservations	570.00	220.00	15,199,079.70	0.04‰
2022	--	--	Shinyong Zhonghe Accounting firm	Standard without reservations	570	220	20,082,926.90	0.03‰

According to the above data, it can be seen that the annual audit fee and internal control audit fee paid by Yanzhou Coal Industry after the purchase of director liability insurance show a downward trend. From 2008 to 2010, no annual report audit expenses were generated, so the annual report audit expenses and director liability insurance premium of Yanzhou Coal Industry were analyzed. From 2011 to 2019, the ratio of annual audit fee and operating income paid by Yanzhou Coal after the purchase of director liability insurance showed a downward trend. Between 2020 and 2022, the annual report audit fee and operating income paid by Yanzhou Coal after the purchase of director liability insurance showed an upward trend. After consulting relevant materials and enterprise announcements, it is found that the increase in audit costs is due to the capital increase of Inner Mongolia Mining (Group) Co., Ltd. in the form of public delisting. In 2020, yanzhou acquisition controlling shareholder yankuang group co., LTD., holdings of shaanxi future energy chemical co., LTD. 49.315%

stake, yankuang Yulin fine chemical co., LTD. 100% stake, yankuang south chemical co., LTD., 100% stake, yankuang Jining chemical equipment co., LTD., 100% stake, yankuang coal supply and marketing co., LTD. 100% stake, Shandirector yankuang economic three power co., LTD., 99% stake in six companies. Due to the occurrence of Yanzhou Coal Industry in 2020, the audit scope and workload of Xinyonghe increased accordingly, so the audit expenses of Xinyonghe Accounting Firm were increased, which was not related to the purchase of directors' liability insurance.It can be concluded that the annual report audit fee paid by enterprises after the purchase of director liability insurance generally shows a downward trend, and the proportion of the operating income also shows a downward trend.

3.3. Case Company in the Industry to Buy Directors Liability Insurance

Because enterprises will not publicly buy director liability insurance insurance contract, so according to the existing research determine whether the enterprise buy director liability insurance method of statistics, namely the enterprise in the resolution of the board of directors disclosure agreed to buy directors, supervisors and senior management liability insurance, and the bill by the general meeting of shareholders, as buying director liability insurance.Statistics are shown in Table 3.

Table 3. Coal industry to buy director liability insurance situation

Year	Number of purchased enterprises	Year	Number of purchased enterprises
2008	2	2016	2
2009	2	2017	3
2010	2	2018	2
2011	2	2019	3
2012	2	2020	2
2013	3	2021	3
2014	2	2022	3
2015	2		

As can be seen from Table 3, the number of enterprises in the industry to buy director liability insurance is very rare, generally two, one of which is Yanzhou Coal Industry, the case company studied in this paper.In the past 15 years, only three companies have purchased director liability insurance in five years.In addition, it can be seen that since 2019, the number of enterprises deciding to buy director liability insurance has increased, indicating that director liability insurance has gradually entered the vision of the company's senior management, and the demand for director liability insurance is gradually increasing.

4. Analysis of the Influence of Case Company Purchasing Board Liability Insurance on Audit Pricing

4.1. Incentive Effect

If you follow the “checklist” your paper will conform to the requirements of the publisher and facilitate a problem-free publication process.

With the gradual improvement of the legal system, the awareness of rights protection of corporate investors and other stakeholders is gradually strengthened, and the litigation cases involving listed companies are also increasing. At the same time, the amount of compensation involved in the litigation cases is also increasing.The governance layer and the management layer of the listed companies are both faced with the risks caused by the mistakes.Under the structure of the separation of ownership and management right, the interests of corporate executives and shareholders and the company are not completely consistent, so the first type of agency problem will arise.

In order to solve the problem of divergent interests between corporate executives and companies, most companies today adopt the practice of giving stock or options to management companiesTo some extent, this approach binds the interests of the management with the interests of the company.But management is not as diverse in different companies as shareholders.Shareholders can resolve most of the risks by dispersing their investment, but the investment target of the management given the stock option incentive is relatively single and cannot resolve the risks.This results in a mismatch between management revenue and risk.So director liability risks to insurance company, the risks of the management risk, and benefit the gap between the company and investors in the interests, for directors and related senior management personnel to provide fully display management operation platform, fully encourage directors and related senior management personnel active in company operational decision-making, bold management to enhance the company's overall value, bring rich returns for investors.Don't worry about making mistakes.Company operating in good condition facing the business risk will reduce, and executives in order to cope with the performance pressure of fraud motivation will decrease, according to the audit risk theory, enterprise management risk reduction, auditors face the expected risk will be reduced, thus the risk premium will reduce, eventually audit fees will be reduced.

This is consistent with the conclusion of this paper that the purchase of board liability insurance will reduce the audit pricing.

4.2. Supervision Effect

According to existing studies, the risks related to the insurance executives will be transferred to the insurance company.In order to control risks and then reduce the compensation of insurance premiums, insurance companies will play the role of the fourth party supervisor of insurance companies to a certain extent, and play the role of external risk prevention mechanism.In order to control risks and reduce costs, the insurance company will carry out continuous in-process supervision and post-process control over the risk status of the insured enterprise during the duration of the insurance.In addition, as a professional risk evaluation and management organization, insurance companies can use professional measurement tools and measurement methods to accurately evaluate the prospects, development potential and corporate governance risks of listed companies.And can timely adjust the risk premium included in the premium according to the corporate governance level of the insured enterprise.Therefore, if the enterprise violates, the enterprise risk assessment conducted by the insurance company will greatly increase, leading to an increase in the premium, and then increase the financial cost of the enterprise.Therefore, the insurance companies will have an external governance effect on the insured enterprises.

In addition, in the underwriting stage, the insurance company will also make continuous assessment and supervision according to the information of the insured enterprises, which will also have an external supervision effect on the insured enterprises to some extent.After the insurance company plays the external governance effect, the corporate governance will develop in a good direction to reduce audit risks, and ultimately reduce audit fees.

From the perspective of litigation, the case company has a positive external governance effect on the audit cost.According to the company announcement data and the Taian database statistics made table 4.

Table 4. Yanzhou coal industry received the lawsuit situation

Year	Number of lawsuits received	Year	Number of lawsuits received
2008	0	2016	2
2009	0	2017	1
2010	0	2018	1
2011	0	2019	0
2012	0	2020	0
2013	0	2021	0
2014	1	2022	0
2015	3		

As can be seen from the above table, Yanzhou Coal Industry has received fewer lawsuits since the purchase of director liability insurance. Among them, received in 2014 is due to citic daxie fuel co., LTD. In yanzhou is not according to the coal sales contract delivery obligations, Sue yanzhou to Shandirector province higher people's court, request to remove the coal sales contract signed by the two sides, refund the payment for goods and compensation for economic losses total RMB 163.6 million.After the trial, the court found that Yanzhou Coal Industry to fulfill its obligations and rejected the appeal. In 2015, the three lawsuits were all banks requiring Yanzhou Coal Industry to repay the arrears, which Yanzhou Coal Industry has paid. The 2016 lawsuit was the 2015 bill discount appeal event, and the arrears were repaid. In 2017, Luxin Real Estate Co., Ltd. on the grounds of the dispute over the right of recourse, Yanzhou Coal Industry, Shandirector Hengfeng Electric Power Fuel Co., Ltd. were told to Jining Intermediate People's Court, requiring Yanzhou Coal Industry to pay receivables and interest. However, after verification, Hengfeng company is suspected of fictitious accounts receivable, forging the seal of Yanzhou Coal Industry, handling accounts receivable pledge financing in financial institutions, causing losses of Yanzhou Coal Industry, the court ruled that Yanzhou Coal Industry has no illegal behavior. The 2018 lawsuit was the appeal event of the 2017 case.As can be seen from the details of the above cases, only the three lawsuits in 2015 were caused by yanzhou Coal Industry's own problems.

This paper does not find that the claim for recovery of directors, supervisors and relevant senior managers in the above litigation cases, but the litigation case itself will consume a lot of human costs and resources of the company, and will have a negative impact on the market performance to a certain extent.So there is no major litigation for the company to reduce the actual loss and protect the company's brand value of the company.In addition, if the company has a major lawsuit and has a significant adverse impact on the production and operation, the risk of the company will increase, and the corresponding premium in the next year will increase, or even the insurance will not be renewed, so the improper behavior of the governance management is constrained in terms of cost.

According to the supervision effect of the board liability insurance, the insurance company has the right to conduct a comprehensive investigation of the litigation situation, and the relevant behavior of the company's senior executives will be considered as an important factor in insurance claims.At this time reflects the external governance effect of director Liability insurance.

According to the audit insurance theory, the pending litigation of the audited company will significantly increase the uncertainty risk of the audited company, resulting in an increased risk of civil liability for the auditor, so the auditor will charge a risk premium on this, thus increasing the audit fee.However, after the purchase of director liability insurance, the company's litigation risk will be reduced. For many years, there has been no significant adverse litigation against the operation, so the risk estimated by the auditor will be reduced, and the corresponding risk premium will be reduced, thus the audit fee will be reduced.

4.3. The Connivance Effect

From the perspective of the design of insurance clauses, Director liability insurance will not indulge the company's executives and thus increase the audit cost.

According to the resolution announcement of the board of directors of Yanzhou Coal Industry, the company intends to continue to purchase a guarantee limit of $15 million of liability insurance for its directors, supervisors and officers.However, neither Yanzhou Coal Industry nor the insurance company will disclose the details of the relevant insurance contract.Therefore, this article did not find the original text of the relevant contracts, but the insurance contracts provided by the insurance institutions are mostly standard terms, and only a small amount of content will be negotiated with the insurance enterprises.Therefore, in this paper, we found the Liability Insurance of Huatai Property Insurance Company Limited for directors, Supervisors and Senior Managers on the official website of the Insurance Industry Association of China.Article 1 clarifies the insurance liability: “If the insured is asked for compensation for the first time during the insurance period and the incident is an improper behavior of this insurance contract, and the insured is liable for economic compensation according to law, the insured has the right to claim to Huatai to bear the liability for compensation.If the insured company must first pay or compensate for the loss of the insured according to the laws, regulations, rules or agreements concerning the company's compensation, Huatai Property Insurance shall also bear the corresponding responsibility to compensate for the insured company.”

The above provisions clearly point out that when the insured makes a claim for compensation due to misconduct, the insurer shall perform the liability for compensation according to law.

In accordance with Article 4, "Huatai shall not be liable for any compensation claim or investigation attributable to the following reasons; any dishonesty, fraud, fraudulent omission or any intentional violation of the Insured." According to the above provisions, the Insurer shall only indemnify the Insured for the loss caused by the negligence, and shall not compensate for the dishonest, fraud and illegal acts.Therefore, for the enterprise directors and relevant senior managers, the compensation caused by self-interest behavior is not unintentional to a large extent, but subjective and intentional behavior, which belongs to the exclusion in the insurance clause. The insurance company has the right not to bear the relevant responsibility and does not compensate for the loss.And the clause clearly states that the insured for the first time to claim compensation for misconduct, the insurance company will compensate.

Visible, to the insurance company will not do many times of compensation for improper behavior, only after a compensation of the insured lost the protection of insurance institutions.Therefore, the existence of director liability insurance does not necessarily cause opportunistic behavior, nor does it increase the frequency of opportunism.

Since the provision setting avoids some of the opportunistic behavior and reduces the impact of the connivance effect on the company's operation, according to the audit insurance theory, the risk compensation in the audit cost will not increase, and the audit cost will not increase.

5. Study Conclusions and Policy Recommendations

5.1. Study Conclusions

Through the literature summary and theoretical analysis of director liability insurance and audit pricing, taking the relevant data of Yanzhou Coal Industry from 2008 to 2022 as samples, and taking the average industry except the case company as a comparison, the mechanism of director liability insurance affecting audit pricing was explored by the case study method.

The research results are as follows: (1) enterprises with better rules and regulations and better internal governance mechanism than other enterprises are more motivated to buy directors' liability insurance.In this way, enterprises pay more attention to the construction of internal governance environment, so they are more inclined to purchase the director liability insurance; (2) the purchase of director liability insurance reduces the probability of the motivation of fraud and reduces the audit cost; (3) the director liability insurance supervises the enterprise and reduces the amount of audit cost; (4) the purchase of director liability insurance reduces the influence of the agency cost, thus reducing the operating risk, and thus the audit pricing.

5.2. Policy Recommendations

According to the research in this paper, enterprises with good internal control and corporate governance are more inclined to buy director liability insurance, and after the purchase of director liability insurance will have a positive impact on the company's internal control and governance mechanism, and eventually have an impact on the audit charges.The information asymmetry between shareholders, investors and enterprise managers is still a great risk of the enterprise. The third-party supervision mechanism of audit can not completely reduce the resulting audit risks, and the audit can only provide reasonable guarantee, which cannot avoid all major misstatements.After the enterprise buys the board liability insurance, the loss of investors' losses can be partially compensated by the insurance company to reduce the existing losses.Therefore, the risk of the enterprise can be transferred by introducing the method of director liability insurance.

In addition, enterprises can achieve high quality and rapid development with the dual supervision of director liability insurance and audit.Therefore, this paper suggests that the mainland regulators should learn from Hong Kong and guide and regulate listed enterprises to purchase director liability insurance at the institutional level, so as to expand the director liability insurance market.On the one hand, it can reduce the risk of senior company executives, on the other hand, it can help the insurance market to mature, improve the status of insurance companies in the transaction, so as to achieve a more efficient supervision system, and finally realize the virtuous cycle of internal governance of listed companies.

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