DETERMINANTS OF AUDIT FEES AND FINANCIAL CRISIS

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Abstract- Recent literature on audit fee reveals that auditors are under pressure to reduce audit fees during crisis. This paper investigates a new aspect of auditor behavior during crisis: how the downward pressure on audit fees influences the determinants of audit fees during crisis. The results, using Korean data for the period 2005-2010, reveal the following: First, consistent with prior studies, audit fees dropped significantly during the financial crisis period, supporting the existence of downward pressure on audit fees. Second, among the determinants of audit fees, the coefficients on firm size decreased significantly while those on firm risk increased during crisis. These findings suggest that auditors respond differently to small firms and risky firms when facing downward pressure on audit fees. Collectively, the above results provide useful insights into how auditors behave when they are under pressure to reduce audit fees.

Index Terms- Audit fee, crisis, size, risk

I. INTRODUCTION

The world financial crisis ignited from the subprime mortgage crisis in 2008 has greatly influenced world economy. Several large multinational firms, such as Lehman Brothers and General Motors, suffered huge losses and were acquired or went bankrupt during the financial crisis. Others also had to cut various expenses to survive or to avoid substantial deterioration of their operating performance. Audit fee was not an exception of such cost-saving efforts. Companies requested auditors to share the economic pain and exerted significant pressure on auditors to reduce audit fees in the periods (Goelz 2010; Ettredge et al. 2014). Given the downward audit fee pressure during the crisis period, the purpose of this study is to examine how the audit fee structure is changed during the financial crisis. Focusing on the periods surrounding the financial crisis gives a significant advantage in examining the impact of crisis on audit fee structure. The crisis represents an exogenous shock that do not related to the audit fee or auditor choice decision directly. Thus, we are able to focus on the audit fee structure changes due to an exogenous shock, while avoiding any potential endogeneity issue related to auditors.

The downward fee pressure is a great concern for the regulators. Public Company Accounting Oversight Board commented that the board is “aware that as a result of the economic crisis and other factors, auditors might be pressured to significantly reduce their audit fees.” Subsequently, PCAOB expressed its concern on the potential detrimental effect of the downward fee pressure on auditor’s behaviors. Specifically, PCAOB worried about the effect of downward fee pressure on potential audit quality impairment that could be caused by reduced audit efforts or inappropriate operation of audit firm-level quality control programs. Consistent with these arguments, studies in general document that lower than normal level of audit fees leads to poor audit quality measured by the frequency of financial statement restatement, firms’ tendencies to meet or beat earning benchmarks, or the magnitude of discretionary accruals (Asthana and Boone 2012). However, studies rarely look into the issue of how auditors respond to the downward fee pressure during the financial crisis periods in adjusting their audit fees. This study focuses on the important but yet unsolved issue.

II. HYPOTHESIS DEVELOPMENT

Audit fee is determined by various factors, including the size, complexity, and audit risk of the firm (Choi et al. 2008). Auditors need to exert greater audit effort to audit client firms with large size, complex operations, and high audit risk. In sum, these determinants of audit fees are expected to have a positive relationship with audit fees. Ettredge et al. (2014) demonstrate that downward fee pressure in the financial crisis periods reduced the level of general audit fees. However, they do not specifically examine how the coefficients on individual determinants of audit fees (i.e., the coefficient on variables representing the size, complexity, and audit risk) change in the crisis versus pre-crisis periods. We focus on this issue.

Prior studies suggest the adverse effect of economic recession on auditors’ behaviors. For instance, financial distress, firm failures, frauds lead to higher risk of financial statement misstatement, which increases audit risks. Auditors are likely to charge higher fees in the recession periods to compensate for increased audit risk. However, it is also possible that a financial crisis plays a role to press audit fees downward. As explained before, Ettredge et al. (2014) document that due to recession-induced fee pressure, audit fee dropped significantly in 2008, compared with 2007 level. The decreased audit fee may lead to poor audit quality. Prior studies document that low audit fees are associated with greater likelihood of meeting or beating earnings benchmarks, higher magnitude of discretionary accruals, and greater likelihood of financial statement misstatements (Asthana and Boone 2012).

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2012). Specifically for the effect of 2008 world financial crisis, Ettredge et al. (2014) report that firms that successfully dropped audit fees significantly in 2008 are more likely to experience financial statement restatements in later years. In sum, these lines of studies suggest that auditors are likely to charge lower fees in the crisis periods than in pre-crisis periods to respond to the fee pressure. Given the two countervailing forces that influence audit fees in the crisis periods, prior studies find that the latter force dominates the former, resulting in decreased audit fees during the crisis periods. There might be strong incentives for firms to reduce audit fees as a way to survive in the crisis. But then again, decreases in audit fee is opposed to some prior literatures. For example, audit fee is an increasing function of audit risk (Choi et al. 2008). Since the probability of material misstatement and the probability of an audit failure is increased during the crisis periods (Ettredge et al. 2014), audit fee is likely to increase in the crisis periods, especially for risky clients. However, it is noteworthy that none of abovementioned prior studies have investigated the audit fee structure changes directly in the crisis periods. Thus, we look into how the crisis influences each determinants of audit fees.

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We expect that client size is significantly related to the fee pressure. Large client firms have superior negotiating power to auditors than small client firms have (Castella et al. 2004). Auditors may be afraid of losing large clients which generate greater audit or non-audit revenue than small clients. Thus, it is possible that if there exists downward audit fee pressure in the crisis period, it is more likely that auditors yield to the pressure from large clients. As a result, we expect that, among the determinants of audit fees, the coefficients on firm size become smaller in the crisis periods than in the pre-crisis periods.

Next, we focus on the audit risk as a key determinants of audit fees. A recent work of Doogar et al. (2010) provide an important implication for the pricing of risk in audit fees. They find that high risk clients pay about 11% higher audit fees than low risk clients after the implementation of AS5 in 2007. The AS5 was adopted by U.S. regulators to relieve skyrocketed audit fees after the introduction of SOX. SOX implemented various mechanisms to strengthen governance mechanism and audit quality. As a result of SOX, audit fees increased dramatically (Ghosh and Pawlewicz 2009). Because firms comply a lot on the increased fees, U.S. regulators adopted AS5 to decrease audit fees. Thus, the implementation of AS5 works similarly as a fee pressure induced by financial crisis. Based on the findings of Doogar et al. (2010), we expect that auditors charge higher fees for risky clients. Thus, among the determinants of audit fees, it is expected that the coefficients for variables representing audit risk should increase in the crisis periods than pre-crisis periods.

III. DATA AND EMPIRICAL RESULTS

We use Korean audit fee and financial data collected over the periods from 2005 to 2010. We define pre-crisis periods until 2007 and post-crisis periods from 2008. Korea is one of the countries that are believed to have weak legal liability for auditors (Brown et al. 2014). In weak legal countries, audit fee is more likely to be influenced by the negotiation between auditors and client firm. Thus, we can more clearly observe the internal negotiation process between auditors and client firms in a Korea setting than other developed countries. These advantages will enable us to reveal a clearer effect of financial crisis on the audit fee structure.

Our empirical results are summarized as follows. First, we find that audit fee dropped significantly in the Korean audit market during the crisis periods. This finding supports that the general audit market condition in Korea is not much different from that in the other countries. Second, we find that, among the determinants of audit fees, the importance of client firm size decreased while that on audit risk increased during the crisis periods. The latter finding is consistent with what happened in the U.S. when risk-based audit approach was adopted (Doogar et al. 2010). It implies that auditors start to focus on risky clients with more attention but pay less attention to large clients in the periods.

CONCLUSION

This study has various contributions to related parties. First, this study is the first to show the macro-level financial crisis can affects audit fee structure. The findings answer to regulatory concerns on how auditors respond to the fee pressure during the crisis periods. Second, the findings in this study are also beneficial for academicians. There are several papers that examine the cross-sectional determinants of audit fees, but relatively few papers investigate the inter-temporal variation in audit fee. This paper complements the existing audit fee literature by showing the structural change of audit fee determinants in the crisis periods. Third, investors and practicing auditors can also learn lessons from this study to identify firms with potentially poor financial reporting quality.

REFERENCES

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