

# Determinants of Audit Fees: A Conceptual View of Audit Quality Characteristics.

Azni Suhaily Binti Samsuri<sup>1</sup>, Tengku Rahimah Binti Tengku Arifin<sup>2</sup>

<sup>1</sup> Faculty of Business and Finance, Universiti Tunku Abdul Rahman, Kampar, 31900, Perak, Malaysia

<sup>2</sup> Faculty of Business and Finance, Universiti Tunku Abdul Rahman, Kampar, 31900, Perak, Malaysia

## Abstract

This study extends the previous researcher on the audit fees by examining the association between audit fees and audit quality characteristics. The study specifically investigates the impact on the audit quality characteristics namely audit tenure, auditor size and reputation, auditor industry classification and frequency of audit committee meeting. This study aims to provide further understanding on association between audit fees and audit quality characteristics so that it can be served as a basic decision making for companies in determining the audit fees indicators. This study contributes to the growing of literature to enhance the knowledge of stakeholders or company on designing the audit fees. The findings are also relevant to the policy-maker and to practitioners in term of determining the factors effecting to audit fees.

**Keywords:** *Audit fees, Audit quality, characteristics.*

efficient and effectively and the greater audit quality may give implication to the audit fees.

Previous studies highlighted the relationship of audit fees and firms characteristics as in Simunic (1980), Palmrose (1986), Rubin (1988). All researchers indicates that auditor size is one of the determinants having relationship with the audit fees. According to Rubin (1988), the municipal audit fee model was aimed to provide evidence on the determinants of audit fees paid by municipalities to their external auditors. The study concluded that there was a significant positive relationship of organization size and audit fee.

Motivated by that, the current study will explore the linkages between audit fees and the audit quality characteristics. Thus, there are several characteristics can be measured for audit quality to relates with the audit fees.

## 1. Introduction

The demand for audit quality has been arising in recent years. The presentation of true and fair view has also become one of the most important concepts of auditing in public's perception. Cases for audit failures are still being seen in these few years and a series of accounting scandals such as Enron, Xerox and Worldcom has flustered the market around. In Malaysia, Transmile company also involved in financial scandals with tenderly give some implication to the financial reporting quality.

Concerning to the financial reporting quality, the auditor must play the vital roles to ensure the reporting process and financial statement in high quality. Hence, the requirement of auditor and the audit procedures is highly demanded to be more

### 1.2 Problem statement

In exchange for performing an audit related work, companies will be charged an amount of fees to the external auditor. The fees charged by the auditor are normally vary depending on the companies under auditing. Palmrose (1986) and Francis and Simon (1987) documented that there is an association between audit quality and a fees premium paid to the auditor. Their studies in the past decades had used Big 6 auditors in private sector to test the relationship. Determinants of audit fees are also vary among different audit firms. Past researchers indicate that fees paid to auditors can affect audit quality and when the auditors were paid large fees, the effort utilized by auditors may increase (Hoitash, Markelevich, & Barragato, 2007).

From Simunic's model, there are various variables control audit fees, which affected audit quantity and price. Simunic explains that the complexity of auditee companies and their risk influence the audit fees. It is supported by other researchers among others Francis (1984) to the Australian market; Firth (1985) to the New Zealand market; and Low, Tan & Koh (1990) to the Singapore market, and to different sizes of firm ( Francis & Stokes, 1986; Francis & Simon, 1987). However, there are also deficiencies in previous literatures. For example, little published work was compared on UK audit fees (Taylor & Baker, 1981; Taffler & Ramalingam, 1982, Chan, Ezzamel & Gwilliam, 1993).

To date, limited studies conducted regarding audit fees and audit quality characteristics. To shed light on this issue, an extensive conceptual view study will be explored the variables associates with audit fees. Audit quality may influence audit fees downwards because the quality of the financial reporting may strengthen the internal control in the company. To add, one of the audit committee characteristics namely frequency of audit committee meeting also will explain in details. Moreover, it may give significance to the company by having effective audit procedures may increase the quality of reporting. Thus, it may directly give impact on the audit fees.

### 1.3 Research Question

The purpose of the study is to investigate the factors that associates between audit fees and audit quality characteristics. Thus, the study poses the following research questions:

1. What is the association between audit tenure and audit fees?
2. What is the association between auditor size and reputation and audit fees?
3. What is the association between auditor industry-specialisation and audit fees?
4. What is the association between frequency of audit committee meetings and audit fees?

### 1.4 Research Objectives

Therefore, the main purpose of this study is to answer the followings:

1. To examine the association between audit tenure and audit fees.
2. To examine the association between auditor size and reputation and audit fees.
3. To examine the association between auditor industry-classification and audit fees.
4. To examine the association between frequency of audit committee meetings and audit fees.

### 1.5 Purpose of the Study

This research aims to provide further understanding on association between audit fees and audit quality characteristics. It can also be served as a basic of decision making companies to determine the level of audit fees pay to auditor.

This research specifically estimates and develops a model for the relation of audit fees determinants and audit quality characteristics that is relevant to the firm. The exact and specific results for this relationship remain unclear and the research will test the result and enhance the value of previous result. In addition, it allows a more significant test of whether audit fees is influenced by those characteristics of audit quality. It may possibly enhance the knowledge of stakeholders or company on the design of audit fees. Finally, it may be useful for future researchers in developing countries to identify factors that are specific to their countries.

This research is said to provide a deeper insight that some new phenomena may also be responsible for variations in audit fees because there still have some deviations in past studies.

## 2.0 Literature Review

This section will discuss the theoretical foundation for the Agency theory, followed by the detailed discussions of audit tenure, auditor size, auditor industry-specialisation, frequency of audit committee meetings and selection of the past studies. Subsequently, the proposed conceptual model are developed and 5 hypotheses are established.

### 2.1 Theoretical/Conceptual foundation

Agency theory used in many accounting scholars such as management behavior (Jensen & Meckling, 1976), finance (Fama, 1980) and organizational behavior (Eisenhardt, 1985). The basis of agency theory was founded based on the insight that the separation of ownership and management companies may lead to costs related conflict that resolved between them. While Morris (1987) highlighted if individuals act self-interestedly, these separations produce conflicts. The conflict may arise when there are separation of risk bearing, decision making and control functions in companies (Fama & Jensen, 1983). In addition, Eisenhardt (1989) stated the agency theory is concerned with resolving two problems that can occur in agency relationships.

First, the agency problem occur when the principal and agent have conflict about desires or goals. This may lead to difficulty for the principal to verify what the agent is actually doing. The problem may occur when the principal cannot verify that the agent has behaved appropriately. Second, the problem of risk sharing occur when the principal (ownership) and agent (management companies) have different attitudes toward risk. The problem here is that the principal and the agent may prefer different actions because of the different risk preferences (Eisenhardt, 1989). To conclude, agency theory is an ideal theory that refers to the principal and agent to act independently and cooperate each other's.

Motivated by that, it is expected that the auditor may put a lot of audit efforts in order to reduce the audit risk seems the manipulation of accruals by managers may give effect to the audit quality. Thus, the audit risk may have significance impact to the audit quality of the firms and as auditor they might need to work with more audit procedures and audit efforts. Thus, it is expected the higher audit fees has positive association with the audit quality. Moreover, variables affecting the audit fees, specifically audit tenure, auditor size and reputation, auditor industry specialization and frequency of audit committee meetings should be incorporated into a model in order to test the relationship between them.

### **2.1 Audit fees and audit quality**

An audit provides an independent assurance on the financial statements provided by a company, which help to maintain the integrity and public confidence (Duits, 2012). Based on study by Palmrose (1988), audit quality is defined in relative to the level of assurance and accredited auditors. On the other hand, Riyatno (2007) defined audit quality as something that is intangible, hard to measure and can only be perceived by the users of audit services while Chen, Hsu, Huang, and Yang (2013) defined audit quality in terms of human capital of the audit firm. Besides, Pham, Amaria, Bui, and Tran (2014) determined audit quality based on auditor competence and auditor independence. However until today, there is no identical and absolute definition of audit quality although audit quality plays a vital role in ensuring the reliability of financial information to the users of financial statements especially to the shareholders of the companies. An auditor can be viewed as a watchdog for the shareholders and higher quality of audit is needed to ensure that the interests of the shareholders and other users of financial statements are being cared.

The discussion on the relationship between audit fees and audit quality have been in the literature since

years ago. That includes a study by Hoitash, Markelevich, and Barragato (2007) which documented that audit fees are negatively related to audit quality. They had investigated a data set comprises of 13,860 observations for firms that reported total fee data for year 2000 until 2003 using multiple regression model within the context that auditor profitability will better exhibit the relation between audit quality and auditor independence. Furthermore, to proxy for unobservable auditor risk and effort, Hoitash et al. (2007) had used client size and estimates of expected fees paid to auditors in their study. Similarly, Ettredge, Fuerherm and Li (2014) also showed that there is negative association between audit fee pressure and audit quality. Their study measured audit quality by using inverse method, which is misstatements in audited data. Their sample included 3,039 public listed companies and logistic regression revealed that there is negative association between audit fee pressure and audit quality.

On the contrary, Yuniarti (2011) found that audit fees has positive relationship with audit quality when audit fee was tested as independent variable individually. The study used a population of auditor in public accounting firm who registered by Indonesian Institute of Accountants in 2009 with the final sample size of 27 firms and using primary data to analyze the results. Multiple regression model was employed in Yuniarti (2014) to analyze the data collected. However, when the researcher tested audit firm size and audit fee as independent variable simultaneously, the result showed that audit fees do not have any effect on audit quality.

### **2.2 Audit tenure**

Prior studies indicated that the relationship between audit fee and audit tenure is high. Through audit tenure and greater expertise, it is believed that the audit fees and audit quality will be higher. This literature goes back to the study by Palmrose (1986) when the Big 8 audit firms exhibited both higher audit fees and audit hours. It was found that audit hours declined with audit firm tenure while audit fees remained stable. Moreover, during initial audit processes higher audit hours naturally may reflect lower fees per hour. This may lead to lower audit fees (Deis & Giroux, 1996).

Other study by Stanley and Todd Dezoort (2007) indicated a negative relationship between audit fees and likelihood of client's financial restatements in short tenure engagements. Due to a lack of client-specific knowledge and low audit fees on new audit engagements, this result is consistent with concerns about reduced audit quality.

However, study by Liu & Wang (2008) do not support the argument that long auditor tenure has adverse effects on audit quality. Using a sample of 1,981 company-year observations of potentially, financially stressed companies over an eight-year period from 1995 to 2002, the authors defined audit tenure as CPA tenure and CPA-firm tenure and found that there is no evidence that the going-concern opinion has negative significant relationship with auditor tenure. However, their empirical results indicate that there is a significantly positive relationship between auditor tenure and audit quality if there were some changes made to the samples. They limit the samples to the period after the effective date of SAS No. 33: *The Auditor's Report on Financial Statements* which were from 1999 to 2002, changed the definition of auditor tenure which based on short, medium and long tenures (rather than the number of years) and include samples from electronic industry only. The authors also restricted the going concern variable to three different categories based on the firm-year with a standard unqualified opinion and the firm-year with either a standard unqualified opinion or an unqualified opinion modified for mandatory change in accounting principle. Nevertheless, there is no conclusion from the authors as whether the mandatory auditor rotation will decrease audit quality as the motivation and behaviour of an auditor under mandatory auditor rotation may be different.

Apart from that, Suprpto and Suwardi (2013) studied the association between audit partner tenure, audit fees and audit quality and documented that there is no significant relationship between audit partner tenure and audit quality. The target respondent was selected based on purposive sampling and the sample period was from year 2007 to year 2011. The researchers used Binary logistic regression model in examining the relationship between audit partner tenure and audit quality and found no significant relationship.

### 2.3 Auditor size and reputation

In this research, the indicator variables for audit firm size and reputation are Big 4 and non-Big 4. Audit fees and audit firm size depends on market competition (Jere, 1984). In a competitive audit market, a fee differential between audit firms represents a return to higher quality. In order to assess the quality differential between large and small auditors the test should be conducted to examine the fees charged by audit firms (Ireland and Yennox, 2000). Ironically, it is assumption believes that high quality companies are more likely to hire large audit firms and are more likely to pay low fees.

This is due to that there is less audit work requirement in high quality companies if compared to low quality companies (Titman and Trueman, 1986; Thornton and Moore, 1993). The result previously showed that there is a negative relationship between auditor firm size and audit fees. However, this is not always true based on other researches.

Choi, Kim, Kim, & Zang (2010) found a different result. They examined the relationship between size of audit firm and audit fees and audit quality. The focus of their study was beyond national-level audit firm size and office-level industry leadership but on examining whether the office size is an additional, engagement-specific factor determining audit quality and audit pricing. Their results show that audit firm size is significantly and positively related to both audit quality and audit fees. The significant positive relationship support the view that larger and reputable audit firms provide higher quality audits compared with smaller audit firms. Differences in quality are priced in the market for audit services to the companies. In addition, Aronmwan, Ashafoke, and Mgbame (2013) investigated the relationship between audit firm reputation and audit quality by choosing the listed trading companies trading on the Nigerian Stock exchange as a sample. Their data consists of audited annual report as at 2010 of 35 sample companies. The Ordinary Least Square Model estimation technique was used and the results revealed that the audit firm reputation is significantly and positively affect audit quality. Therefore, it can be said that when the auditor is a reputable auditor and rendering a higher quality audit, the fees charged to audit clients will be higher if compared to smaller audit firms.

In contrast, Han (2012) had examined whether Big 4 audit firms will provide high audit quality and found that Big 4 audit firms will provide high audit quality. The sample covered 132 companies for the period from 2007 to 2010. The data was categorized in few ways to execute a market analysis by auditor size and industry in terms of the amounts of clients and the total assets. The findings showed that there is no difference impact on audit quality whether it is performed by Big 4 audit firms or non-big 4 audit firms. Hence, since there is no difference in the quality of audit services provided, it will not affect the fees charged by the auditor.

### 2.4 Auditor industry specialization

*"Auditor specialization is auditor as having deep understanding (refer to the knowledge) and have long experiences of the client's specific business and industry, having knowledge about the company's*

*nature, and specific accounting and auditing guidance which are essential for doing a high quality audit.*" (Arens, Best, Shailer, Fidler, Elder, & Beasley, 2011). Many literatures also discussed that auditor's industry specialization is auditor as applied long experiences and deep understandings of on general and specific accounting guidance to the specific client's industry, and includes an understanding of operational challenges and the degrees of such industry (Tuanakotta, 2011; Cohan, Jeter, & Naiker, 2010). Addition, the companies engage with the auditor specialization in the audit process of their particular clients industry, will be able to implement the audit procedures more effectively compared to non-specialization (Rittenberg, Johnston, & Gramling, 2010; and Balsam, Krishnan, & Yang, 2003). It is said that the competence and expertness are obtain from the repetitive tasks on the audit procedures in specific industries (Sarwoko & Agoes, 2014).

Based on the previous discussion, it is conclude that the auditor specialization may have significant impact on audit quality. Higher audit quality are likely to have higher audit fees (Palmrose, 1986). It suggests that the auditor do more extensive audit procedures to ensure the sufficient works and effectiveness. Thus, the relationship between audit fees can be highlighted when the audit fees relates to the degree of auditor specialization. Existing result find mix result between audit fees and auditor specialization. Palmrose (1986) did not find any relationship between audit fees and auditor industry specialization. However, other study find that higher audit fees associates with auditor specialization (Hay, 2010). It is supported by previous studies such Ward, Elder and Kattelus (1994), find higher fees for one specialized auditor, and contradict result by Chase (1999) finds lower fees for a specialized auditor. Based on the mixed empirical evidence and conceptual view arguments for either positive or negative effect, it is proposed that the following hypothesis in next section.

**2.5 Frequency of Audit Committee Meeting**

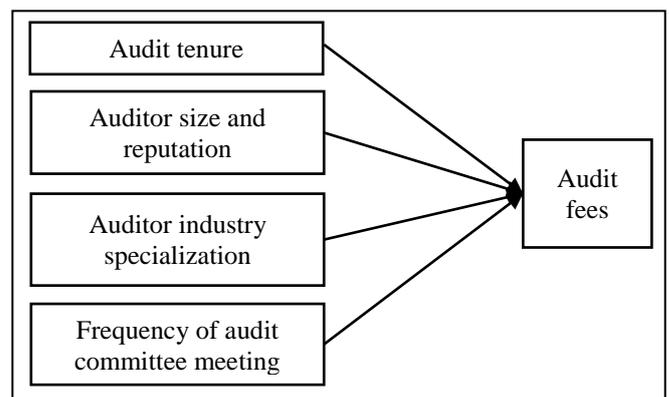
Many extensive studies incorporated the various relationship of audit committee characteristics with audit fees. According to Goddard and Masters (2000) and Goodwin-Steward and Kent (2006), there is positive relationship between audit committee characteristics and audit fees due to the functions of audit committee which is to review internal control and financial reporting process. Consequently, this will lower the audit fees. Therefore, it may reduce audit hours, substantive test and risk of the company and as a result may lower audit fees.

According to Yatim, Kent and Clarkson (2006), the audit fees are positively and significantly associated with the audit committee meeting frequency. With respect to the best corporate governance practices, audit committees should carry out their responsibilities (the Blue Ribbon Committee, 1999; Kalbers & Fogarty, 1993). Recent Malaysian Code on Corporate Governance 2017, highlighted the audit committee need appropriate communications insights, view and concerns about relevant transactions and events to internal and external auditors. Thus, the number of audit committee meetings need to held annually. It indicates that communications between audit committee is importance through the meeting pertaining to the financial reporting. Other study also suggests that an audit committee that meets frequently can reduce the financial reporting problems. This indicates that by having meeting regularly; the audit committee can alert the auditor on the auditing issues, which can give greater attention to the auditor itself (Scarbrough, Rama, & Raghunandan, 1998). Therefore, it is expected that a more frequent audit committee meeting is likely to reduce financial reporting problems, thus, it may lower the audit fees.

Nevertheless, previous studies indicate that there is no evidences on the relationship of audit fees and audit committee meeting frequency. (Abbott, Parker, Peters, & Raghunandan, 2003). Thus, this current study liase with the audit committee characteristic as one of the audit quality variables to test the significance impact on the audit fees. Thus, it is proposed that specific audit committee characteristic namely audit committee meeting frequency and audit fees are associated despite of the previous researchers' results are not consistent. Therefore, the aims of this study is to explore the possibility of interaction effects without predicting a direction.

**3.0 Conceptual Framework**

Based on the literature and the above discussion leads to the following theoretical framework:



**Figure 1:** Conceptual Framework of Audit Quality Characteristics and Audit Fees

Source: Developed for this study

This study proposes the following hypotheses based on the above past studies:

H1: There is a relationship between audit tenure and audit fees.

H2: There is a relationship between auditor size and reputation and audit fees.

H3: There is a relationship between auditor industry specialization and audit fees.

H4: There is a relationship between frequency of AC meeting and audit fees.

#### 4.0 Conclusion and Discussion

Based on the literature review, a conceptual model has been developed. This study proposes to test the above hypotheses with the effects of audit quality characteristics, namely audit tenure, auditor size and reputation, auditor industry specialization and frequency of audit committee meeting on audit fees. Further research should be carried out to test, validate and enhance the model especially in empirical evidence. The results obtained will be presented in a later article.

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#### Author Profile

**Azni Suhaily Binti Samsuri<sup>1</sup>** completed her degree in Bachelor of Accounting (Information Systems) in year 2008 and her Master of Business Administration (Accounting) 2010 from Universiti Utara Malaysia. She is currently working at Universiti Tunku Abdul Rahman (UTAR), Malaysia under Commerce & Accountancy, Faculty of Business & Finance (FBF).

**Tengku Rahimah Binti Tengku Arifin<sup>2</sup>** received her degree in Bachelor of Accountancy (Hons) in 2008 and her Master of Business Administration degree majoring in Accounting in 2011 from Universiti Utara Malaysia. She is currently a lecturer for the Faculty of Business & Finance, Universiti Tunku Abdul Rahman (UTAR), Malaysia.