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Commentary

Agency costs and product market competition: The case of audit pricing in Greece

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A R T I C L E I N F O

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A B S T R A C T

Jensen and Meckling (1976) argue that agency costs are not dependent on product market competition. However, elsewhere in the economics literature, theoretical analysis and empirical research have indicated that product market competition reduces agency costs by reducing the marginal cost of eliciting effort from agents. We investigate the relationship between product market competition and audit fee, as an example of agency cost. Taking advantage of a proprietary data set for Greek audit firms, we find that the audit fee and audit hours are inversely associated with client firm product market competition. We conclude that audit effort, as an agency cost, is reduced where competitive forces reduce the need for shareholders to bear the costs of monitoring agents.

1. Introduction

This research note is motivated by an assertion in Jensen and Meckling (1976, p. 329) that the existence of competition in product markets will not eliminate agency costs:

> 'Furthermore the existence of competition in product and factor markets will not eliminate the agency costs due to managerial control problems as has often been asserted [cf. Friedman (1970)].[3] If my competitors all incur agency costs equal to or greater than mine I will not be eliminated from the market by their competition.
> 'The existence and size of the agency costs depends on the nature of the monitoring costs, the tastes of managers for non-pecuniary benefits and the supply of potential managers who are capable of financing the entire venture out of their personal wealth. If monitoring costs are zero, agency costs will be zero or if there are enough 100 percent owner-managers available to own and run all the firms in an industry (competitive or not) then agency costs in that industry will also be zero.'

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[3] The reference to Friedman (1970) relates to his discussion of whether corporate executives can make 'social responsibility' decisions on behalf of their corporation's proprietors. He argues that managerial actions such as wage restraint or price control, carried out for a political or social motive, are a form of agency cost which cannot be sustained in a competitive market enterprise because the customers, employees and proprietors will take action to favour managers in other firms who do not use their agency position to impose costs of social responsibility. A discussion of social responsibility might take a different direction in today's society but the general direction of the argument remains valid in relation to the choices that exist in competitive product markets.

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Testing for total elimination of agency costs would require ideal conditions that are not observable in practice. However the extract quoted also implies that there is no relationship between product market competition and monitoring costs due to managerial control. In contrast, other authors have identified a potential relationship between product market competition and agency costs, as explained further in the literature review (Baggs & De Bettignies, 2007; Gal-Or, 1997; Jagannathan & Srinivasan, 1999; Nickell, 1996). In this paper, we regard the audit fee as a specific and measurable agency cost and we investigate the extent to which the agency cost is reduced, recognising that total elimination is an unlikely observable. We ask whether increased competition in the product market is associated with reduced audit fee and also whether the reduction in audit fee is accompanied by a reduction in audit effort, measured by audit hours. We provide evidence to answer these questions using a proprietary data set available for the audit market in Greece, containing both audit hours and audit fees. Having access to data on audit time allows this paper to distinguish between a reduction in audit fee matched by a reduction in audit effort and a reduction in audit fee caused by pressure on the fee rate ('low balling').

The motivation for our study is to test the competing claims regarding the existence or absence of an association between agency cost and product market competition. The contribution is to provide new insight into a determinant of audit fees and hence to point to policy implications for a regulator which seeks to monitor audit fees. The motivation for focussing on Greece is firstly our access to proprietary data on both audit fees and audit hours, all collected from the audit firms. Secondly, the Greek auditing profession has come under increased scrutiny over several years as a result of corporate scandals and issues related to the audit function, particularly following the collapse of the Athens Stock Exchange (ASE) in 2000–01 (Spathis, 2002). The effectiveness of the external audit function in Greece has been questioned on a number of occasions by various parties (e.g. finance institutions, investors, journalists, and politicians). In an apparent attempt to boost public trust and confidence and, at the same time, protect audit revenue, the Hellenic Institute of Certified Auditors (abbreviated in Greek as SOEL) has issued a series of regulatory guidelines on audit time. Hence issues related to audit fees have become particularly important and are on the agenda of many market participants (Leventis & Caramanis, 2005). Finally, this paper responds to calls for empirical testing of audit fees in capital markets that are not under a strong Anglo-American influence (e.g. Karim & Moizer, 1996; Walker & Johnson, 1996).

We report a significant inverse relationship between market competition and both audit fee and audit hours. We conclude that at higher levels of product market competition the monitoring costs of audit scrutiny are reduced because owners can place some reliance on product market scrutiny of management by competitors. Where there is relatively low product market competition there is less scrutiny of managers by competitors and consequently owners incur a higher monitoring cost through the audit fee.

The regulation of audit in Greece is outlined in Sec. 2. Relevant prior literature is reviewed and hypotheses are developed in Sec. 3. The model and data are specified in Sec. 4. Results are reported and discussed in Sec. 5, leading to the conclusions in Sec. 6.

2. Auditing in Greece

Corporate auditing in Greece was liberalised from state control in 1992 with the intention of introducing competition among auditors in the market for statutory audits (Caramanis, 1999). Legislative reform established the SOEL as a new professional institute. Since 1992, the audit market has grown significantly and competitive pressure in the market for audit services has intensified (Caramanis, 1997, 1998, 1999 and 2002). Accordingly we expect that, where auditors are under pressure from clients to control or reduce costs, there is likely to be a response in terms of reducing the fee for the audit engagement. Product market competition could create such cost pressures from client companies because where there is competition it will make managers more sensitive to cost structures. They might seek to control costs, by appointing an auditor who charges lower fees, or to restrict the scope of the audit.

The Athens Stock Exchange (ASE) was included in Morgan Stanley's MSCI Developed Market Indices from May 2001, having previously been categorised as an emerging market.[4] This change of status enhanced the importance of issues related to regulation and investor protection when compared to prior years. The ASE compositae index fell continuously from 3388 in 2000 to 1748 in 2002 with annual returns of −8% in 2000, −23% in 2001 and −32% in 2002 (Koulakiotis, Dasilas, & Tolikas, 2008). Linking the enhanced status and the downturn in the market, auditing issues became particularly important for investors and regulatory committees in 2001 (Koulakiotis et al., 2008; Spathis, 2002). In an apparent attempt to boost public trust and confidence and, at the same time, protect audit revenue, the SOEL has issued a series of regulatory guidelines on audit time (Leventis & Caramanis, 2005).

3. Prior literature and hypothesis development

3.1. Hypothesis development–audit fees

Audit fees, as a monitoring cost incurred by the principal, represent one aspect of agency costs.[5] Our null hypothesis is based on the assertion of Jensen and Meckling (1976, p. 329), quoted in the Introduction to the paper, that the existence of competition in product markets will not eliminate agency costs (with the implication that there is no association).

[4] http://www.msci.com/pressreleases/archive/20010410_pr.pdf.

[5] Defined by Jensen and Meckling (1976, p. 308) as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.