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Do Big-Four affiliates earn audit fee premiums in emerging markets?

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ABSTRACT

The paper investigates whether Big-Four affiliated (B4A) firms earn audit premiums in an emerging economy context, using Bangladesh as a case. The joint determination of audit and non-audit service fees is also examined using a sample of 122 companies listed in the Dhaka Stock Exchange. Our findings reveal that although the B4A firms do not generally earn a fee premium in Bangladesh, they charge higher audit fees for clients not purchasing non-audit services. This suggests that the B4A firms may actually lower audit fees to attract non-audit services, and cross subsidizes audit fees through non-audit-services fees. The lack of a B4A premium implies that there is lack of quality audit in emerging markets. We also document that audit and non-audit service fees are jointly determined in Bangladesh. Thus, we provide evidence of joint determination of audit and non-audit service fees in an emerging economy context.

1. Introduction

The paper investigates the existence of audit fee premiums for Big-Four affiliated (hereafter, B4A) audit firms in an emerging economy, using the case of Bangladesh. Like many other emerging economies, the audit market in Bangladesh is characterized by low levels of audit fees, concentrated ownership structure, and lack of demand for quality audit services. However, one distinctive aspect of the Bangladesh audit market relates to the way Big-Four audit firms operate in Bangladesh. The absence of Big-Four audit firms is not uncommon in many countries, particularly in emerging economies. In such cases, Big-Four firms tend to operate through the formation of a partnership with a local audit firm.[3] However, despite no such legal restrictions, Big-Four firms do not operate in Bangladesh through their member firms. Rather, they carry out their operations in Bangladesh through 'correspondent' or 'cooperating' local firms. Another interesting aspect of the audit market in Bangladesh is the lack of market power of the B4A firms. Unlike in many other countries, Big-Four affiliate firms in Bangladesh do not enjoy a substantial market share, and only 17% of the listed companies are audited by the B4A.

The absence of Big-Four firms in Bangladesh gives us the opportunity to investigate B4A audit fee premiums. We argue that Big-Four firms will choose quality local audit firms to represent them in Bangladesh, although these firms may not have the same quality control standards such as the Big 4. If the market differentiates quality of audit services, the B4A firms will earn substantial audit fee premiums. In line with Willekens and Achmadi (2003), we also argue that in the case of Bangladesh, where large audit firms do not have significant market share, presence of any such premiums will be due to product differentiation rather than market power.

Our investigation of whether B4A earns audit fee premiums in Bangladesh is based on a sample of 122 companies listed in the Dhaka Stock Exchange during 2005 when Big-Four firms were absent in Bangladesh. We also investigate the joint provision of audit and non-audit services (NAS) in Bangladesh. Although a recent stream of research has investigated the determinants of audit fees in emerging economies, the use of NAS fees as an explanatory variable has been a notable omission (Joshi & Al-Bastaki, 2000). We explore this gap in the auditing literature by examining the joint provision of audit and NAS in an emerging audit market.[4]

The particular characteristics of the auditing market provide important context for our study. The World Bank (2002) has identified the lack of properly trained auditors in Bangladesh. This is a possible explanation for lack of demand for audit in Bangladesh (BEI, 2003). Given the circumstances it is interesting to investigate whether the Bangladeshi audit market differentiates between the B4A and other audit firms. Prior literature has acknowledged that audit firms, especially the Big 4, may charge lower audit fees to attract NAS. This tendency to cross subsidize audit services through NAS may be even more tempting in a country like Bangladesh, where demand for NAS is low. Unlike in developed econo-

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[3] For example, Douthett and Jung (2001) report that the Big-Four firms are only allowed to operate in Israel through formation of a partnership with a local audit firm.

[4] The classification of an 'emerging economy' is debatable. However, for the purpose of this paper, we use the term 'emerging economies' to refer to countries listed as 'emerging and developing countries' in the International Monetary Fund's World Economic Outlook Report (IMF, 2008).

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mies, many listed companies in Bangladesh do not purchase NAS from their incumbent auditors. We argue that this lack of demand for NAS, coupled with prevailing low audit fees, may make audit firms even more dependent on their clients. This, in turn, may have serious implications for auditor independence, and consequently, for audit quality. Of the 122 sample companies used in this research, only 66 purchased NAS from their incumbent auditors. This gives us an opportunity to investigate whether the B4A adopts a different audit fee structure for clients that purchase NAS compared with clients that do not.

2. Audit markets in emerging economies

Following the seminal work by Simunic (1980), a large body of research has investigated the determinants of audit fees. Hay, Knechel, and Wong (2006) identify a number of client-specific and auditor-specific attributes that play a significant role in determining the levels of audit fees. The client specific attributes include size, profitability, complexity, risk, internal controls, governance, form of ownership, and industry specification. On the other hand, the auditor-specific attributes relate to auditor quality, audit tenure, location of the audit office, audit lag, audit complexity, and busy season. Also, the provision of NAS was identified as an important determinant of audit fees. A few studies have also studied the effects of NAS on perceptions regarding auditor independence. Although results are inconclusive, most studies find that the provision of audit and NAS creates a negative perception among investors with regard to auditor independence (Quick & Warming-Rasmussen, 2009). Hay et al.'s (2006) meta analysis of audit fees is based on an analysis of 88 published academic papers investigating determinants of audit fees in 20 different countries over a 25 year period (1977 to 2002). Their findings reveal that only 13 of these 88 papers are based on emerging economy context, whereas 42 papers use US data.

Out of the thirteen papers using emerging economies, four are based in Hong Kong (DeFond, Francis, & Wong, 2000; Gul, 1999; Gul & Tsui, 1997; Tsui, Jaggi, & Gul, 2001), two studies are based in Singapore (Killough & Koh, 1991; Low, Tan, & Koh, 1990), and one study each is based in South Korea (Taylor, Simon, & Burton, 1999), Malaysia (Eichenseher, 1995), India (Simon, Ramanan, & Dugar, 1986), South Africa (Simon, 1995), Pakistan (Simon & Taylor, 1997), and Bangladesh (Karim & Moizer, 1996). The other paper (Simon, Teo, & Trompeter, 1992) compares audit fee determinants among three emerging economies: Hong Kong, Malaysia, and Singapore.

Hay et al.'s (2006) meta-analysis, therefore, provides evidence that research investigating audit markets has largely been confined to developed economies and that our understanding of the market for audit services in other regulatory/national contexts is very limited. Cobbin (2002) summarizes the international dimensions of audit fee literature, covering studies relating to determinants of audit fees drawn from 17 countries between the period 1980 and 2000. In addition to developed countries like the USA, the UK, Australia, Canada, New Zealand, and Ireland, the paper also reports the findings of studies relating to determinants of audit fees in emerging economies, such as Pakistan, Bangladesh, Malaysia, and India.

Typically, studies attempting to identify determinants of audit fees tend to use OLS regression models. The independent variables used in such models include agency variables such as size, profitability, risk, complexity, auditor size, and industry affiliation. Some studies have also attempted to test variables that may be relevant for a particular country or for emerging economies as a whole. Al-Harshani (2008) uses CPA firms; Ahmed and Goyal (2005) use multi-national (MNC) affiliation and big audit firms; Karim and Moizer (1996) use language of annual reports and banking sector as independent variables. These variables are consistent with audit fee studies conducted in developed economy context.

Many of the audit fee studies mentioned above have investigated whether auditor size has an impact on levels of audit fees. Basioudis and Fifi (2004) summarize the research investigating audit fee premiums received by large audit firms. The paper reports that while research in developed economy generally suggests the existence of Big-Four (or Big-Eight) premiums (for example, Craswell, Francis, and Taylor (1995) in Australia; Simon and Taylor (2002) in Ireland; Basioudis (2002) in the UK; and Simon and Francis (1988) in the USA), findings in emerging economy context have been inconclusive. While some studies (for example, Basioudis and Fifi (2004) in Indonesia; Ahmed and Goyal (2005) in India, Pakistan, and Bangladesh; Dugar, Ramanan, and Simon (1995) in India) have reported the presence of such premiums, other studies (for example, Simon, Teo and Trompeter (1992) in Malaysia and Simon (1995) in South Africa) do not find any such quality differentiations. Although Simon and Taylor (1997) report a Big 6 audit fee premium in Pakistan, the premium was interpreted in large part to PWC. Willekens and Achmadi (2003), investigating audit pricing in Belgium, argue that in markets where the large audit firms do not have significant market share, audit fee premiums are likely driven by product differentiation rather than market power. Following Willekens and Achmadi (2003), Basioudis and Fifi (2004) report that the most commonly used hypothesis for studies investing impact of auditor size on audit fees is that large audit firms can demand higher audit fees either because of their brand name, or their market power.

One notable omission in audit fees related to research in emerging economies, compared to those in the developed world, has been the use of NAS fees as an explanatory variable. Although the joint provision of audit and NAS has long been at the center of attention of audit fee related research set in developed economies, there is a paucity of research in emerging market context. The joint provision of audit and NAS creates economic bonding between the auditor and the client (Beck, Frecka, & Solomon, 1988). The problem of economic dependence occurs when the fees from one client or one group of associated clients make up an 'unduly heavy proportion of the firm's gross fees' (Woolf, 1990). Such economic bondage is regarded as a threat to auditor independence (APB, 2004). The provision of NAS may also have serious implications for audit quality in cases where audit firms tend to use NAS fees to subsidize audit fees (ABI, 2002). Williams (2007) mentions that that there is a risk that large firms, which can afford to sustain such subsidies (in terms of lower audit fees), can use this device to create a barrier to entry for smaller firms. Studies investigating joint provision of audit and NAS use audit fees as the dependent variable, and NAS fees as an explanatory variable. Most of these studies document a strong positive relationship between audit and NAS fees (for example, Beattie, Goodacre, Pratt, and Stevenson, 2001; Craswell, 1999; Ezzamel, Gwilliam, and Holland, 1996; McMeeking, Pope, and Peasnell, 2006; O'Sullivan and Diacon, 1994), indicating that audit and NAS fees are jointly determined. However, as mentioned before, none of these studies are based on an emerging economy setting. In an emerging economy characterized by low levels of audit fees, the self interest threat created by joint provision of audit and NAS may be compounded by the fact that audit firms operating in emerging economies are likely to be economically more dependent on clients that purchase both audit and NAS. To obtain NAS work, audit firms may lower their audit fees, and subsequently compromise audit quality. Also, because of a lack of demand for quality audit, clients may prefer to retain the 'economically dependent' auditors. This may have serious implications for audit independence.

The objective of this paper is to investigate the determinants of audit fees in emerging economy setting, using Bangladesh as a case. We aim to investigate the presence of audit fee premiums for Big-Four affiliate firms, and the joint provision of audit and NAS in Bangladesh. Earlier, Joshi and Al-Bastaki (2000) acknowledged the need to accommodate NASF as an independent variable in an emerging economy setting. The next section provides an outline of the nature of the audit market in Bangladesh.

2.1. The audit market in Bangladesh

The auditing market in Bangladesh is characterized by very low levels of audit fees reflecting poor demand for audited financial statements