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Low-cost trends in audit fees and their impact on service quality

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ABSTRACT

The 2008 financial crisis has transformed the business environment. The number of audited firms has fallen considerably since the crisis, leading to a reduction in the cost of auditing services as a result of fierce competition among auditors. This drop in audit fees is of great concern for audited firms because it may be correlated with a fall in audit service quality. Such a fall in quality ultimately harms the prestige of audited firms and therefore negatively affects their profits. Based on an application of fuzzy-set qualitative comparative analysis (fsQCA), this paper analyzes the quality of audit services following a drop in the fees charged by auditors. The factors analyzed in the empirical study were audit fees, other fees charged by the auditor, and the inclusion of explanatory paragraphs, qualified opinions, and emphasis of matter in audit reports. The EBITDA of the audited firms was chosen as an indicator of the quality of the service. The results of the analysis reveal that the quality of the auditing service has remained steady despite the fall in audit fees, as confirmed by the fact that the EBITDA has evolved positively without being affected by the fall in fees.

1. Introduction

The 2008 economic crisis has drastically reduced the number of large firms. In Spain, for example, the number of large firms fell from 36,763 in 2008 to 26,210 in 2015.¹ This 28.7% reduction reflects the fact that many affected firms are no longer considered large. Such firms might not necessarily have had to close, but their sales income might have dropped below the 6,000,000 Euro threshold above which firms are considered large.

Understandably, this reduction in the number of large firms has had a major negative impact on auditors. According to data from the Instituto de Contabilidad y Auditoría de Cuentas (ICAC), the Spanish equivalent of the Public Company Accounting Oversight Board (PCAOB) in the USA, audit firms experienced a 13.15% drop in the volume of audits performed between 2009 and 2015. The reason for this drop is that many firms are no longer obliged to audit their annual accounts as a result of the 2008 financial crisis.

These reductions in both the number of large firms and the volume of audits have intensified the competition among audit firms, which has caused these firms to cut the price of audits to capture as large a share of the market as possible. The fall in audit fees has been so drastic that it is even reasonable to use the concept of low-cost to refer to current audit fees.

This research explores whether the drop in the price of audits has affected the quality of these audits. This issue is important because a decline in the quality of auditing services not only harms auditors, but also negatively affects audited firms and, as a result, their image and prestige, ultimately damaging their market value and financial and asset structure. Note that the credibility of annual accounts depends on the auditor's report, which is especially important among listed companies because these firms must convey a spotless image to investors.

Fuzzy-set qualitative comparative analysis (fsQCA) was used in this study because it offers a causally complex perspective, addressing asymmetric relationships among observations, and because it enables analysis of a small number of cases (Fiss, 2007). In this study, the dataset consisted of data on 37 audited firms that were listed on the IBEX 35 between 2004 and 2015. These firms provide accessible, reliable data on auditor's reports because these firms are regulated by the Comisión Nacional del Mercado de Valores (CNMV), the government agency responsible for the financial regulation of the Spanish securities markets.

This paper makes a valuable contribution to the literature. Although numerous studies have examined audit fees (Alexeyeva & Svanström, 2015; Charrakh & Sharifi, 2016; Evans & Schwartz, 2014; Huang, Chang, & Chiou, 2016; Stewart, Kent, & Routledge, 2015), they have all focused on high fees. This study, in contrast, is one of the very few

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¹ According to the report *Ventas, Empleo y Salarios en las Grandes Empresas* from November 2016, published by the Spanish Inland Revenue (Agencia Tributaria). Available at: http://www.agenciatributaria.es/static_files/AEAT/Estudios/Estadisticas/Informes_Estadisticos/Informe_VESGE/VESGE.pdf.

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studies to examine low-cost audits (Kuo & Lee, 2016).

This paper is organized as follows. Section 2 presents the literature review. Section 3 describes the fsQCA method and explains its suitability for this study. Section 4 discusses the results of the analysis. Finally, Section 5 presents the conclusions of the study.

2. Theoretical framework

2.1. Audit fees and audit quality

DeAngelo (1981) showed that large auditors receive higher fees than their smaller counterparts do because the customers of these large firms perceive a higher level of quality. In contrast, Jones and Sasser (1995) found that, in competitive environments, customer satisfaction was more important than service quality when choosing an auditor. Similarly, Ribeiro Soriano (2001) highlights a customer preference for satisfaction over quality and low audit fees.

For Evans and Schwartz (2014), the concentration of the audit market, which essentially comprises the Big Four accounting firms, has had a non-appreciable effect on major customers. Huang et al. (2016), however, studied the relationships among market concentration in the audit sector, audit fees, and audit quality, reporting that market concentration has increased audit fees and indirectly improved audit quality. Huang et al. (2016) conclude that legal constraints regarding the price of this service may reduce its quality, although they did not confirm that this was the case.

In the 1980s, Danos and Eichenseher (1986) and Kinney (1986) confirmed the existence of increasing competition in the audit sector. Studying the same period, Maher, Tiessen, Colson, and Broman (1992) found a significant reduction in audit fees during the 1980s. The same effect has been observed in Spain as a result of the 2008 financial crisis. The consequences of the crisis have caused substantial changes in the size of Spanish businesses and, consequently, an increase in competition among auditors. These changes in the business environment have led to a drop in audit fees, giving rise to the emergence of low-cost audits. The aim of these low-cost audits is to capture market share, foster customer loyalty, and build client portfolio.

According to the annual reports published by ICAC, the hourly rate charged by auditors in Spain fell from 67.52 Euros in 2008 to 64.53 Euros in 2015. This reduction in the hourly rate corresponds to a price drop of 4.43% in the major auditing firms. Likewise, small auditing firms have been forced to reduce their hourly rates from 56.93 Euros in 2008 to 55.08 Euros in 2015, which corresponds to a 3.25% price drop. Note that in Spain, the financial crisis effectively began 2009, intensifying from 2010 onwards. This clear decline in the hourly rate charged by auditors can be extrapolated to the Spanish economic environment because the root of this price drop lies in the 2008 financial crisis, which affected countries around the world.

Nevertheless, the literature discussing these price drops following the 2008 financial crisis is scarce. For example, Mande and Son (2015) examined the association between auditor fees and accrual quality. Kuo and Lee (2016) also studied the reduction in audit fees, albeit exclusively in the domain of increasing book-tax conformity.

We must therefore consider the following questions: Has the fall in prices due to the intensification in competition been accompanied by a reduction in the time spent performing these audits? Are auditors employing a high proportion of interns to conduct these audits as a means of offsetting lower profits? And, ultimately, is this situation leading to a fall in the quality of the auditing service?

We must also consider whether the converse is true: Were audit prices before the financial crisis (i.e., during the period of economic prosperity) excessive? And, although the hourly rate has reduced the profit margin considerably, has this reduction merely aligned the fees with the cost of the service rather than jeopardizing the quality of the auditing service?

2.2. Impact of the auditor's report on business structures

Firth (1980) studied the impact of the auditor's report on lending and credit decisions by banks. The author examined how lending institutions responded to applications for financing depending on the auditor's report on the applying firm. The analysis showed that a negative audit qualification led to a significant drop in the audited firm's credit rating and hence the firm's ability to get credit. Similar findings are reported by Duréndez Gómez-Guillamón and Sánchez Vidal (2008), who found that auditor's reports with a qualified opinion, whether adverse opinion or disclaimer of opinion, undermine lenders' confidence in the firm and therefore negatively affect lending institutions' decisions. Dedman and Kausar (2012) and Duréndez Gómez-Guillamón (2003) have also linked credit ratings to audited financial reports. Similarly, Nicholls (2016) found that an unfavorable auditor's report causes an increase in the audited firm's cost of capital because that firm's future cash flows are considered higher risk.

An audit's effect on the financial structure of the firm can be so great that, according to Piñeiro Sánchez, de Llano Monelos, and Rodríguez López (2012), reports with adverse or qualified opinions can offer reliable measures of credit risk and can predict the likelihood of insolvency. Piñeiro Sánchez et al. (2012) designed an econometric model with a predictive capability of 87%. Schroeder (2015) observed that unqualified audit reports positively affect profit reporting and, accordingly, the share price of the audited firm, hence the importance of the auditor's report in stock market behavior.

In this study, we examined whether a reduction in audit fees negatively affects the quality of the audit service. Furthermore, we assessed whether this decline in quality is captured by the market and, accordingly, whether this decline negatively affects audited firms, tarnishing their prestige and harming their financial and asset structure. Consistent with the aim of this study, the following hypotheses were tested:

Hypothesis 1. The reduction in audit fees does not affect the quality of the audit service and, therefore, does not negatively affect the prestige of audited firms.

Hypothesis 2. The reduction in audit fees does not affect the quality of the service and, therefore, does not negatively affect the financial and asset structure of audited firms.

3. Data and method

3.1. Sample

The dataset was built using financial data collected from the SABI database and audit reports and fees gathered from the official website of the Comisión Nacional del Mercado de Valores (CNMV), the government agency responsible for the financial regulation of the Spanish securities markets. Of the initial 45 Spanish firms, which corresponded to all companies that were listed on the IBEX 35 at some time between 2004 and 2015, any firm missing some of the data necessary for the empirical analysis was eliminated from the dataset. Accordingly, the final sample comprised 37 firms, from across all sectors, whose accounting data were considered fully reliable not only because they had been audited, but also because they were tightly regulated by the CNMV.

All firms in the sample had been audited throughout the study period by one of the Big Four. We thereby ensured that the prestige and size were similar for all auditors. Likewise, the drop in the price of the auditing service by these auditors was also similar, according to the data in the reports of the audited firms.

Despite the small number of firms in the dataset, use of the fsQCA method meant that the sample was representative and therefore that the empirical study would yield reliable results. In addition, because the

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