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Audit Fees: IFRS adoption and the recent financial crisis

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Auditors – competing demands of the Guardian and Commerce function (Molyneaux, 2008)

- Auditors (and accountants) operate at the cusp between the guardian and commercial functions
 - Guardian function – Skills, competence and judgement to issue a formal quasi-judicial opinion based on evidence
 - Commercial function –
 - add commercial value to the client and audit firm
 - Need to sustain a good working relationship (with shareholders, directors, stakeholders)
 - Commercial awareness of the impact of their ‘guardian’ role
- Need to balance public, client and personal interests

Developments impacting on the role of audit of UK listed companies

- IFRS adoption
 - 1st January 2005; EU endorsed
 - in pursuit of harmonising global financial reporting practice
 - to encourage global development of neoliberal capital markets; “globalisation”
- The role of the audit profession in developing IFRS
 - IFRS developed by IASB – audit profession plays a central role in the governance structure of the IASB (and other international standard setting NGOs)
 - development of international standards creates additional guardianship responsibilities for the audit profession
 - new compliance and audit market from which the profession can earn commercial audit fees ... and other...

Developments impacting on the role of audit of UK listed companies

- Financial crisis – 2007/8
 - market liquidity dried up; major banking collapses
 - fuelled by development of complex financial instruments
 - ownership and valuation not easy to account nor audit!
- The role of the audit profession
 - the audit profession had a ‘good crisis’; despite its role in the crisis!!!
 - but – passive; what did the audit opinion mean? ... evidently distressed companies received unqualified audit reports prior to the crisis (Sikka, 2009a)
 - critics argue this is evidence of a severely compromised audit profession operating in a social and business context that fundamentally compromises auditor independence (Humphrey et al.; Sikka, 2009b)

Gaps in the empirical literature- International studies

- IFRS and audit fees (De George et al., 2013 [Australia]; Griffin et al., 2009 [New Zealand]; Vieru and Schadewitz, 2010 [Finland]; Kim et al., 2012 [Europe]).
- The recent financial crisis and audit fees. Xu et al. (2013) [Australia] find evidence of increased audit fees during the period 2008–2009 compared with the period 2005–2007.

Gaps in the empirical literature - UK Studies on the Determinants of Audit Fees

- No recent investigations; most using data from 1982-2003.
- Many focus on non financial companies.
- Many do not include AIM firms.
- Data primarily examined using regression analysis.

Research Questions

- Question 1 – is there evidence that the adoption of IFRS had an impact on audit fees?
- Question 2 – is there evidence that the financial crisis impacted on the determination of audit fees?
- Question 3- what are the effects of these two events on audit fees of Big 4 clients and Non-Big 4 clients?
- Interpretation - what do our results suggest about audit profession and its evident willingness to balance the pursuit of guardianship (public) versus commercial (self) interests?

Contribution of the Current Investigation

- Firstly, it answers calls for research on the reasons for changes in audit fees (e.g., The Audit Quality Forum, 2009; P.22).
- Secondly, in contrast to prior UK studies (e.g., Abidin et al, 2010; Sikka, Humphrey ??); it concentrates on events that affected virtually all UK companies – the global financial crisis as well as the adoption of IFRS.
- Thirdly, in contrast to most UK prior studies, it investigates audit fees for all listed UK companies, including those operating in the financial sector.
- Fourthly, it provides evidence that, in relation to setting audit fees, institutionalised practices differ between Big4 and non-Big4 audit firms.
- Finally, it explains how the profession has reacted to key events affecting assurance activity during a volatile period of time using Molyneaux's (2008) ethical framework.

Research sample

- All domestic UK companies listed on both the main and AIM markets of the London Stock Exchange (LSE) for the period 2003 to 2011.
- Data were obtained from three datasets: FAME, Bloomberg and DataStream databases.
- The final sample therefore consisted of 7958 firm-year observations but due to missing observations on individual variables, the final common sample includes 2529 observations.

Method

- Descriptive Analysis
 - Typical firm has assets of £464m, operated 37 subsidiaries, paid audit fees of £0.283m and incurred £0.220m for non-audit services.
- Univariate Analysis
 - look at the correlation between audit fees and IFRS as well as a CRISIS dummy, while taking account of the following variables:
 - IFRS adoption dummy
 - Financial Crisis dummy
 - Client size (Total Assets, Sales)
 - Audit complexity (No. of Subsidiaries, Current Assets/Total Assets, Wage/Sales)
 - Audit risk (Profit Margin, Current Ratio, Hearing Ratio)
 - Peak period (dummy variable)
- Multivariate Analysis
 - Panel regression model seeking to explain audit fees.

Results from Correlation Analysis

- Some 116 of the 136 correlations were statistically significant.
- Audit fees were significantly correlated with IFRS and CRISIS dummies.
- Relationship between audit fees and the following control variables were positive and significant
 - Client size
 - Number of subsidiaries
 - Gearing
 - Listing location

Results from Regression Analysis

- Big4 firms charge higher audit fees.
- Most of the other variables has the expected sign of a relationship with audit fee.
- Audit fees were significantly higher post the introduction of IFRS GAAP and during the CRISIS
- There were differences in the determinants of audit fee between Big4 and Non-Big4.
 - Big 4 – Significant positive association with listing location
 - Big4 – charge LESSS for auditing a regulated company
- Regression equations for audit fee had Unweighted R-squared values of between 0.57 and 0.85.

Audit fees are significantly higher after IFRS introduction – why?

- compliance costs of transition to IFRS lead to increase audit fee in first year of compliance (De George et al., 2013 [Australia]; Griffin et al., 2009 [New Zealand]; Vieru and Schadewitz, 2010 [Finland]; Kim et al., 2012 [Europe])

or,

- International standard setters have been criticised for being “agents of the audit industry” (Loft et al., 2006; Humphrey et al., 2009)
- Enduring excessive audit costs beyond the year of transition (De George; Vieru; Kim, as above).

Thoughts....

- Has the audit profession created a guardianship role for itself by supporting IFRS development and globalisation
- cost of convergence is passed to the shareholder (lower dividends) and the public (lower tax)

Audit fees are significantly higher after crisis– why?

- the audit profession is still able to increase audit fees and retain their profit focus, despite their role in the financial crisis.
- The audit profession have been heavily criticised for the part they played in the financial crisis.
 - the wide spread practice of issuing unqualified audit reports to clients with adverse financial ratios indicating going concern problems (Auditing Practices Board, 2004)
 - the incapability of traditional audit techniques and methodologies to interrogate contemporary complex transactions (Sikka et al., 2009).
- Arguably, in such an environment, auditors are not able to execute their guardianship role to shareholders and wider society, however our evidence shows that they are able to pursue their entrepreneurial profit seeking behaviour.

Audit fees, guardians and entrepreneurs

So, what do our results suggest about audit profession and its ability, within contemporary practice, to balance the pursuit of guardianship (public) versus commercial (self) interests?

Our results show the audit profession increased its fee income from the introduction of IFRS, a set of standards it helped develop in pursuit of high quality international financial reporting.

However, the events of the financial crisis demonstrate the inadequacy of IFRS adoption to portray the economic reality of reporting entities and the incapability of current audit practice (and context) to report a meaningful audit opinion.

This implies the guardianship role of audit in the UK is threatened; however, audit fee increases show the commercial profit seeking behaviour of the audit profession continues.

Thank you for listening

***We welcome questions and feedback to enable us to
develop this paper further***