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# Audit fees: IFRS adoption and the recent financial crisis.

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# Audit Fees: IFRS adoption and the recent financial crisis

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# Prior UK Studies on the Determinants of Audit Fees

- UK Audit Market
  - structure
  - organisational and social context
  - conflicts of independence
  - EU developments to regulate the market
- UK Audit Fees and total fee income
  - Big 4
  - audit fees v's non-audit fees
- Abidin et al. (2010)

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

- Auditors (and accountants) operate at the cusp between the guardian and commerce function
  - Guardian function – Skill and competence and judgement to issue a formal true and fair opinion based on evidence
  - Commerce 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
  - 1<sup>st</sup> 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)

# Gap in the literature - UK Studies on the Determinants of Audit Fees

- No recent investigators; 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?
- 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

- Data over a long, recent time frame:
  - 2003 to 2011
- A large sample of 7958 firm-year observations.
- Data analysed for BIG4, and Small firms.
- Panel data regression model employed.
- A large number of explanatory variable considered.

# Method

- Descriptive Analysis
  - Typical firm has assets of £525m, operated 33 subsidiaries, paid audit fees of £0.234m and incurred £0.226m for non-audit services.
- Univariate Analysis
  - look at the correlation between audit fees and
    - 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 every variable.
- Relationship between audit fees and the following 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
  - Non-Big4 – charge less for auditing a financial company
- Regression equations for audit fee had R-squared values of between 0.61 and 0.86.

# Audit fees 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]; Vieru et al., 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 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 would welcome questions and feedback to enable  
us to develop this paper further***