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Audit Pricing In Australia In 2000s

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This paper examines the change in audit fee in Australia in 2000s. Corporate collapses occurred in the audit service market during this period, leading to the spate of reforms proposed by the government and the accounting bodies. (word count: 3,113)

Field of Research: Auditing

1. Introduction

In the market for audit services in Australia in 2000s, internal control problems and the negligence of auditors, which contributed to the incident of the corporate collapses, caused a major credibility crisis in the accounting and auditing profession. Changes were introduced to address the issue, including the revision of the financial reporting rules and auditing requirements governing the conduct of audit.

2. Literature Review

Research has been done on the audit services market in countries like USA and UK. Menon et al. (2000) analyzed trends in audit fees from 1980 through 1997 adjusting for changes in wage rates and the general price-level. An audit fee regression model was used in investigating the relationship between audit fees and variables including audit firm's size, auditee's size, complexity, risk, financial year end and profitability. Their sample was confined to clients of the then Big 6 firms. Evidence was found that audit fees increased in the 1980s but stayed flat in the 1990s. A significant increase was discovered in 1988 when the 'expectation gap' standards were issued, suggesting an increase of auditing effort. The expectation gap existed because of the perception of inadequate performance of auditors. These standards were meant to bridge the gap of expectation of the standard of service offered by auditors. No evidence was found on price premium from industry specialization by auditors. The 1989 Big 8 mergers seemed to have a short-term, but not a long-term, effect on audit fees. The magnitude of the audit fee model coefficient for accounts receivables and inventory, an indicator of the complexity of an audit, has declined over the period, possibly due to productivity improvements in audit.

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Pong (2003) examined changes in the audit fees of listed public limited companies in the UK from 1991 to 1995. He found a 9.7% reduction in inflation-adjusted fees over the period for each of the Big 6. He further discovered a mixture of fee increases, decreases and no changes for the Big 6, medium-sized and small firms investigated. He concluded that the changes were due to an increase in dominance by a few large audit firms. Craswell (1992) conducted research on audit pricing in Australia from 1980 to 1989. The result showed a decline in audit fees due to price competition among audit firms and an increase in efficiency despite the fact that auditor's costs increased in this period. More research was required to determine whether the explanation lied with such cost savings or in a decline in audit quality.

DeFond (2000) examined the audit fees of Big 6 and non-Big 6 accounting firms for 348 publicly listed Hong Kong companies. They found evidence of Big 6 premiums for both general brand name and for industry specialization. They further found that the large local firm Kwan Wong Tan & Fong, which was the market leader in the property sector, had significantly lower fees than both Big 6 and other non-Big 6 auditors in that industry. This might be due to the firm achieving production economies that allowed them to charge lower fees and increase market share. Ferguson (2006) reported that audit industry fee premium primarily resided with joint national and city-specific industry leadership as opposed to merely firm-wide (national) industry expertise, suggesting auditor choice among the Big 5 was best conceptualised on joint industry specialisation in city-specific markets and nationally. He further examined whether the prior results could be confounded by the presence of city-specific overall market leadership effects. The findings reaffirmed that prior local and national auditor industry expertise was valued by audit clients. Furthermore, overall city-specific leadership, by itself, also mattered in fee determination and resulted in higher fees, although at a slightly weaker level of statistical significance.

Simon (1992) studied the audit services markets in Hong Kong, Malaysia and Singapore. A large audit firm fee premium was found to exist in Hong Kong and Singapore, but not in Malaysia. Some institutional and legal factors were suggested as possible explanations for the result. Francis (1984) investigated the effects of audit firm size on audit prices in Australia. He discovered that the relationship between audit prices and accounting firm size depended on competition in the market, the extent to which audit services were differentiated and potential scale economies to large accounting firms. One approach to measure competition in the market uses market concentration by suppliers. Big 8 accounting firms dominate the supply of audits to companies listed on the New York and American stock exchanges. Big 8 concentration led to allegations that the auditing services market for publicly traded companies was an oligopoly with insufficient competition. Thus, the Big 8 accounting firms had significantly higher audit prices than non-Big 8 firms. Audits were not homogeneous and product differentiation occurred with respect to audit quality.

DeAngelo(1981b) argued that the audit quality is directly related to the size of accounting firm. It was posited that accounting firms earned client-specific quasi-economic rents due to technological advantages of incumbency. Large firms stood to lose more client-specific quasi-economic rents if a loss in reputation occurred because they had more clients. For this reason large firms had a greater incentive to supply higher quality audits in order to avoid a loss in reputation, and thus accounting firm size served as a proxy for audit quality. Large accounting firms might experience scale economies in the audits of large companies (Simunic 1980). Technological considerations required an appropriate matchup of auditee size and auditor quality to conduct the audit. Large accounting firms would be able to spread the cost of the necessary infrastructure over more audits, giving them a cost advantage. Scale economies would result in lower prices by large accounting firms for large auditees.

In the audit services market of the late 1980s, there was a concern about low-balling which was charging fees below cost to secure clients. Ettredge (1990) investigated audit fee cutting on initial audit engagements by 389 client firms which switched auditors from 1983 through 1987. Their results showed a positive relationship between reduction in audit fees with the change in the auditors' relative cost advantage or disadvantage in auditing a given client, the change in auditor class, the number of auditors bidding on the engagement and the change in auditor industry expertise. When a small client switched from a Big 8 to non-Big 8 auditor, the fee cut might reflect the saving of the fee charged as Big 8 premium. When the auditor with lower cost of operation was chosen, this cost advantage might be passed along to the client in lower fees. The new auditor's industry expertise might be a source of efficiency which led to lower audit fees. The number of auditors bidding on the engagement was positively associated with the percentage of fee cut. Simunic (1984) collected data from a sample of publicly held companies in USA to examine the client's decision to purchase non-audit services and audit services when the provision of these services was interdependent. The results showed that the audit fees of clients who purchased non-audit services from their auditors were significantly higher than audit fees of clients who did not do so. This could be explained by the efficiencies from joint production of the two services.

3. Theoretical Framework

The demand for audit arises from the separation of ownership from control in entities. Under the agency theory (Jensen and Meckling 1976), the auditor is employed to monitor the performance of the management (agent) on behalf of the owners (principal) because the agent may place his interest above that of the owners, giving rise to agency costs. The agency model (Institute of Chartered Accountants in England and Wales, 2005) suggests that, as a result of information asymmetries and self interest, principals lack reasons to trust their agents and will seek to resolve these concerns by putting in place mechanisms to align the interests of agents with principals and to reduce the scope for information asymmetries and opportunistic behaviour.

Agents are likely to have different motives to principals. They may be influenced by factors such as financial rewards, labour market opportunities, and relationships with other parties that are not directly relevant to principals. This can result in a tendency for agents to be more optimistic about the economic performance of an entity or their performance under a contract than the reality would suggest. Agents may also be more risk averse than principals. As a result of these differing interests, agents may have an incentive to bias information flows. Principals may also express concerns about information asymmetries where agents are in possession of information to which principals do not have access.

There are various mechanisms that may be used to try to align the interests of agents with principals and to allow principals to measure and control the behaviour of their agents and reinforce trust in agents. Monitoring costs are incurred to ask an external auditor to verify the financial statements prepared by management. However, the agency model would suggest that agents are untrustworthy. Like directors, auditors will have their own interests and motives to consider. Auditor independence from the board of directors is of great importance to shareholders and is seen as a key factor in helping to deliver audit quality. Bonding costs such as share options are the costs spent to ensure management works for the best interests of the shareholders. Residual loss is the loss arising from management's self-interested behaviour which cannot be prevented by monitoring and bonding costs.

4. Research Methodology

An analysis of the texts on the performance of the audit service market in Australia from 2000 to 2007 was undertaken. A summary of the factors affecting the pricing of audit in terms of the regulatory environment, litigation environment, concentration of market, efficiency of audit, increase in the risk of audit and the cost of operation of audit was presented.

5. Regulatory Environment

The Commonwealth Treasury of Australia issued the proposal for reform, Corporate Law Economic Reform Program Paper (CLERP) No. 9, which covered oversight of the auditing profession, the market for audit services, auditor liability and independence, accounting standards and disclosure requirements and shareholder participation. The paper was released as the CLERP Bill and was officially enacted in 2004 (Leung, 2007). The Financial Reporting Council has been significantly enhanced to include a broad oversight of the processes for setting accounting and auditing standards.

Auditor qualification requirements have been expanded to include the practical experience requirements for registration by satisfying all the components of auditing competency standards. With effect from 1 July 2004, the directors' report must include a statement whether the directors are satisfied that the provision of non-audit services by the auditor during the year is compatible with the general standard of independence for auditors. Division 3 of part 2M.4 of the Corporations Act states that the individual auditor or audit company must be aware of a conflict of interest when it arises and take reasonable steps to ensure that the conflict of interest ceases to exist.

An auditor conducting an audit must, within 28 days of awareness, notify ASIC regarding any person who attempts to unduly influence a person involved in the conduct of audit. Shareholders can now submit written questions to the auditor before the annual general meeting (AGM) relating to the auditor's report and the conduct of the audit and the auditor must attend the AGM to answer their queries. In 2002, the ICAA (Institute of Chartered Accountants in Australia) and CPA Australia adopted a new internationally harmonised standard for professional independence covering rotation of audit partners and a 2-year period before a retired auditor become a director of an audit client.

In 2003, the Australian Stock Exchange Corporate Governance Council issued its Ten Corporate Governance Principles and their related Best Practice Recommendations which included audit committees being mandatory for the top 500 listed companies and certification by CEOs and CFOs of the adequacy of internal controls and financial statements. The change in the regulatory requirements was due to the major corporate collapses such as HIH, One.Tel and Harris Scarfe. The new financial reporting rules and auditing requirements have increased the amount of work done on audit and the audit fee.

6. Litigation Environment

The legal claims against auditors increased significantly in the 2000s due to the alleged audit failures. The report of the Australian Competition and Consumer Commission for the year 2004 stated that the average size of claims for professional indemnity insurance increased by 60%. The Treasury Legislation Amendment Bill 2003 proposed a scheme to adapt the professional standards legislation to limit civil liability for misleading and deceptive conduct under the Commonwealth's Trade Practices Act 1974. The effect of this was to reduce the legal claims against auditors for issuing misleading and deceptive opinions. The expected litigation costs were passed on to the risky clients in the form of specific fee adjustments.

7. Concentration Of Market

Arthur Anderson, one of the Big-5 audit firms, was engaged in auditing the problematic HIH Insurance Ltd. HIH was placed into provisional liquidation. Arthur Anderson was found negligent in compromising with management's fraudulent accounting issues, and failing to comply with the independence requirement with the former partners sitting on the board of HIH. The firm was indicted for obstructing justice by destroying the client's documents which led to its collapse. Following the failure of Arthur Anderson, the audit market became more concentrated. The few large audit firms increased the total market share and competition might be weakened which would have the positive effect on audit fee (Pong, 2004). On the other hand, they might, due to economies of scale, became more efficient and charged the clients at a lower fee. The research to date suggested that increasing market concentration has not been accompanied by increasing audit fees, rather fee reduction was seen over the period.

8. Efficiency Of Audit

Important changes occurred in the production technology of auditing and improved the efficiency of audit. Audit software was used in extracting data for testing, re-performing calculations, selecting and printing audit samples. Analytical procedures involving the study and comparison of relationships among data were applied to identify areas of potential misstatements in the financial statements. Auditors adopted more structure in their approach such as applying forensic testing in audit. In forensic audit, the auditor looked for the causes and effect of fraudulent activities by reviewing system documentations, log trailers, authorisation signatories and transaction reports. The improvement in audit efficiency reduced audit effort and audit fee.

9. Increase In Risk Of Audit

There was risk involved in audit as auditors faced the possibility of forming incorrect opinions on financial statements. This occurred when the financial statements were fraudulently prepared. The financial statement fraud included falsification of financial records, intentional omissions of transactions, misapplication of accounting principles and intentional omission of disclosures of financial information. Auditors had to buy insurance to cover for the claims for issuing wrong opinions. In the survey done by the Institute of Chartered Accountants in Australia in 2003, the average amount of premiums paid by audit firms were $4455 in 2001, $6474 in 2002 and $14035 in 2003. The gross fees increased by 8% between 2002 and 2003 and premiums increased by 117%, which meant that the profit of audit firms had been significantly affected. To compensate for the additional risks, auditors would increase the fee.

10. Increase In Cost Of Operation Of Audit

Cost of labour has increased over the years which might have a positive effect on audit fee. According to the information supplied by the Australian Bureau of Statistics, the total hourly rates of pay excluding bonuses increased by 4.0% from 2005-06 to 2006-07. The superannuation index in 2005 – 2006 showed the highest rate of change from the previous year (4.2% increase). Payroll tax index increased by a slightly smaller percentage of 4.1%. Financial year increases in the total hourly rates of pay excluding bonuses, by industry, showed the change from 2005-06 to 2006-7 to be 4.1% for the personal and other services including the auditing services. Professionals, including the auditors, recorded the highest growth of pay (4.3%) from 2006 – 2007 as compared to 2005 – 2006.

11. Conclusion

Audit fee fluctuated in the 2000s due to various factors such as increase in cost of operation of audit, efficiency of audit, risk of audit, concentration of the audit market, changes in the litigation and regulatory environment. Of these, the change in the regulatory environment was the most significant one as it reshaped the whole auditing profession. There is a tendency for audit fee to decrease which may affect the quality of audit as evidenced by the mounting claims against auditors for negligence in audit. Further research may be conducted to investigate other factors affecting the determination of audit fee in Australia.

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