

Fees—December 2016 Summary of Research Briefing Paper*Note to Meeting Participants*

This paper is the final report summarizing the Prof. David Hay's review of literature, including regulatory inspection findings relating to fees for the period January 1, 2006 – November 2016.

Audit fee research on issues related to ethics

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Overview of findings

There is now an extensive resource of published research on audit fees, some of which explores potential ethical risks regarding audit fees. This paper reviews research on four issues related to audit fees – fee level, dependence, non-audit fees and firms that provide non-audit services. Two related issues (the perspectives of stakeholders and processes adopted by firms) are also considered. In most cases research has not shown these risks to be significant practical problems.

The potential risks include the high level of market concentration in the market for audit services; auditors reducing fees to attract audit engagements; auditors being dependent on audit fees; auditors providing non-audit services to their audit clients and audit firms that providing extensive non-audit services. Most research studies do not find substantial concerns in these areas. There are a few recent studies which show some concerns, however. There is consistent evidence that audit fees for new engagements are lower and that non-audit services affect independence in appearance. There are occasional studies reporting evidence that non-audit services provided by an auditor are associated with a loss of independence indicated by lower audit quality. There has been recent concern about growth in non-audit services to non-audit clients and there is some evidence that audit quality is lower in firms with more extensive non-audit businesses. I concentrate on discussing areas where there are greater risks.¹

Issues examined

The main issues that I examined are:

- Issue 1: Level of audit fees for individual audit engagements;
- Issue 2: Relative size of fees to the partner, office or firm and the extent to which partner remuneration is dependent upon fees from a particular client;
- Issue 3: Ratio of non-audit services (NAS) fees to audit fees;
- Issue 4: Provision of audit services by a firm that also has a significant non-audit services business.

Research procedures

I conducted a search in May 2016, using the Accounting & Tax database (part of ProQuest). I added further papers including official and commercial reports, and relevant recent unpublished papers.² I reported preliminary findings in September 2016. Since then, I have consulted with academic colleagues and revised the paper and presentation to report the results more clearly. The present version concentrates on the primary, generally accepted findings of the research, and less on exceptional problem areas found in some studies.

However, I have highlighted indications of problems where these are evident as these are the results that are most likely to be of concern.

The research results reported are in most cases published in leading academic journals and can be regarded as rigorous. (The exception is the unpublished studies referred to at some points, especially under Issue 4, which is a fast-moving current issue for which the only studies available are as yet unpublished). The research articles use multivariate statistical techniques to take account of differences among the audits being examined. The papers have been through a rigorous process of peer review and are subject to extensive tests of issues such as endogeneity and sensitivity tests for issues such as the measures used for the variables. For example, where there are underlying issues such as greater risk or complexity that could affect results, the researchers have controlled for those effects. Nevertheless, the issue of whether the studies show causation or simply correlation can never be entirely eliminated. There are also numerous issues for which the outcome is simply not known. The significant results reported represent warning signals about problems that ought to be of concern.

Scope

The review is restricted to studies of audit fees; covers a limited period of time (2006-16); is intended to be brief; does not include quantitative meta-analysis of the underlying studies; and does not examine primary data. I have tried to avoid making conclusions based on counting the number of papers because that approach can be misleading – in many cases, some research papers need to be given more weight than others, because they use larger samples or are higher quality.

Context: The Code of Ethics

The review is within the context of the IESBA Code of Ethics (International Federation of Accountants, 2015). The relevant issues that I could identify are:

Self-interest (which includes Dependence); Intimidation: Pressure to reduce work and fees; Fee too low to perform engagement with professional competence and due care; Overdue fees.³

I also considered the relationship of audit fees to the Fundamental principles: Integrity, objectivity, professional competence and due care, confidentiality and professional behavior.⁴

Issue 1: Level of audit fees, market share and lowballing

Publications on the issue of the level of audit fees for individual audit engagements include the overall level of fees or fee increases in a country. I also include in this category, market share of audit firms; and ‘lowballing’ of audit fees. The ethical issues concerned with audit fees are whether overall fees are adequate to perform a proper audit; whether audit firms are providing a competitive market; and whether there is ‘low-balling’ of new audit engagements.

1.1 Level

The first issue is the level of fees, which I took to mean whether fees for individual engagements are too high, or too low. There are papers that provide relatively raw data which does not take into account of changes in the underlying population of companies, nor changes in the extent of audit work required. There are also research studies of the level of fees that examine fee changes after significant events in some countries.

In the US, audit fees increased substantially in 2004, and have continued to increase slowly, or decrease, after that (Whalen, Hannen, & Lussier, 2015a). Research studies confirm an

increase in audit fees in the US subsequent to SOX (e.g., Griffin & Lont, 2007; Ghosh & Pawlewicz, 2009). Since then, increases, if any, have been smaller. There are recent studies reporting fee pressure including fee cuts for many clients in the US in the period 2006-2009 (Ettredge, Fuerherm, & Li, 2014; G. V. Krishnan & Zhang, 2014). Fee pressure was associated with lower audit quality (Ettredge et al., 2014). A study of bank audits also found lower quality but only when the auditor was non-Big 4, the client was exempt from internal control audit and the fee cut was more than 25% (G. V. Krishnan & Zhang, 2014).

In Canada, audit fees have increased very little since 2007, by a steady amount of approx. 3.2% per year over the period (Whalen, Hannen, & Lussier, 2015b). In the UK, trends appear to be similar to the US. In annual reviews of fees in 2005, 2006 and 2007 audit fees were reported to have “surged”, had “double-digit” increases and a “huge” increase. Research studies on New Zealand data by Griffin et al. (2009) and Higgins et al. (2016) reported an increase in audit fees, which they attributed to introducing IFRS.

There is at least one study warning that fees could be too low. Behn et al. (2009) found evidence in Korea of the discounting of initial fee engagements and that audit fees per hour were decreasing. They reported “the regulatory and legislative authorities became concerned that price-based competition could cause deterioration in audit quality” and that “public agencies and the popular press suspected that increasing competition for audit services could lead to underpricing” (Behn et al., 2009, pp. 132–133). Their data was from 1999-2004.

Ethical issues: Low fees could impair professional competency and due care.

Research findings: Audit fees increased in the early part of the twenty-first century; some evidence in some circumstances shows associations between low fees and low quality.⁵

1.2 Market share

There is a concern about audit fees and monopolistic pricing, given that in most countries the market for audit services is highly concentrated, with a few audit firms auditing most clients. Concentration of the market for audit services has been controversial since the 1970s and 1980s (Simunic, 1980). It is argued that reduced competition lowers the auditor’s incentives to provide high quality (DeFond & Zhang, 2014, p. 311).⁶ Competition is not referred to in the Code of Ethics, although it could be seen as an issue that might bring the profession into disrepute.

1.3 Low-balling

A concern that relates to an ethical issue is whether auditors charge a fee that is too low in order to attract clients. Low-balling is a term used for auditors charging a fee below cost in the early years of an audit engagement in order to win the client. Since the auditor’s cost is not usually observable, researchers examine fee-cutting, i.e., charging a lower fee after a switch of auditor. Fee-cutting is not an issue to the same extent as low-balling. Related issues include rotation of auditors, and long tenure (when clients do not change auditors, generating a risk of familiarity).⁷

There is evidence of fee-cutting. A recent study by Griffin & Lont (2011) found lower fees both before and after switches in the US; Huang et al. (2015) found evidence of lower fees and lower quality after switches in China; and Stanley et al. (2015) evidence of fee discounting and lower quality after switches in the US. Both studies examined initial audit engagements. Huang et al. (2015) found lower audit fees and associated sanctions for problem audits and greater earnings management (controlling for variables related to client and audit firm). Stanley et al. (2015) reported lower fees, and a greater tendency for clients to use discretionary accruals to meet analyst forecasts.

A recent unpublished paper on UK data reports a very large study, of 792,905 company-year observations (Kácer & Wilson, 2016). They report initial fee discounting.⁸ On the other hand, there is contrary evidence (but not from audit fee studies) showing higher audit quality after a switch (Kim, Lee, & Lee, 2015; Lennox, Wu, & Zhang, 2014).⁹

A recent study by Bell et al. (2015) was able to examine both fees and audit firm records of effort. They found that a change in auditor was followed by low fees at first, but not by low effort.¹⁰

Overall, there are concerns that auditors might lowball, and that the quality of initial engagements might be low; but that on the other hand that audit quality might reduce after long tenure. There is evidence that fees are lower after a change of auditors, and mixed evidence about whether quality is lower.

Ethical Issues: Lowballing (professional competency and due care).

Research Findings: Fees are lower after a change of auditor. Mixed results on whether quality is lower.

Issue 2: Relative size of fees and dependence

The issue concerned is whether high audit fees or dependence by the auditor on one client for a high proportion of their revenue constitute a self-interest threat. The research studies tend to show that this is not the case, although there are a few that show high client importance or dependence is associated with reduced independence indicated by lower audit quality.¹¹

Higher fees and dependence (measured by higher fees) are not usually found to be associated with reduced auditor independence. There is evidence that higher audit quality is associated with more important clients, measured by fees (Blankley, Hurtt, & MacGregor, 2012; Gaver & Paterson, 2007; Hunt & Lulseged, 2007). In China, Chen et al. (2010) report lower quality where there is fee dependence before 2000, but higher quality after 2000 (measured by modified opinions). In Italy, Ianniello (2012) found some positive associations between NAS and qualified opinions, suggesting higher non-audit services led to higher audit quality. Li (2009) found that dependence at firm level in the US had no effect on going concern opinions before SOX; however, in 2003 dependence did make a difference. Later studies by Feldmann & Read (2010; and Kao et al. (2014) show that this change was only a temporary effect and that there is no effect in the longer term.

Evidence of the impact of fees on lower audit quality is provided by Choi et al. (2010), showing that higher abnormal audit fees in the US are associated with lower quality (measured by discretionary accruals). A study in Taiwan showed economically important clients at partner level are associated with lower quality (measured by accruals) for small firms but not for Big N firms (Chi, Douthett, & Lisic, 2012). More evidence is reported by Blay & Geiger (2013) who show that distressed firms are less likely to get going concern opinions if future total fees and NAF fees are higher. However, there is a question of interpretation. Some studies such as Choi et al. (2010) interpret higher fees as abnormal profits to the auditor; but there are others which interpret higher fees as indicating greater risk and more audit work (Hribar, Kravet, & Wilson, 2014). Doogar, Sivadasan, & Solomon, (2015) conclude, by showing that these higher fees continue after a switch of auditor, that they represent audit costs, and that they do not represent an adverse impact of auditor independence (Doogar et al., 2015, p. 1278).

Partner income generally is examined by Knechel et al. (2013), who show that, for some firms, individual partner income is affected by gaining clients, losing clients and audit

failures. Their data was from Sweden. They conclude that this depends on the firm's remuneration policy.

Evidence that higher fees affect independence in appearance is shown in Ghosh et al. (2009). They show that earnings response coefficients are less – suggesting that analysts find the announcements less convincing – when there are higher audit fees (measured by relative client importance), but not when there are high non-audit fees.¹²

Dependence as defined in the Code of Ethics has not been widely examined. There are few studies that examine the 15% threshold for fee dependence. More research on what the appropriate threshold should be at the level of firm, office and partner could be useful.¹³

Overall, there is some evidence of concerns from high fees as a measure of dependence, but there are also studies showing high fees are beneficial (in the US in most periods and Italy), and others showing that high levels of fees make no difference.

Ethical Issue: Dependence.

Research Findings: Evidence generally that auditor independence is not reduced when there are high relative fees; but there is also some opposing evidence.

Issue 3: Ratio of non-audit to audit fees

Since the scandals of the early 2000s, the issue of high non-audit fees in relation to audit fees has been topical and has been widely researched. The concern is potential loss of independence. NAS to audit clients declined quickly after 2002, and then continued to decline slowly (e.g., Whalen et al., 2015a). This is not surprising. It is partly due to new regulations in many countries, but also because directors and auditors responded to public concerns about non-audit services (e.g., Abidin, Beattie, & Goodacre, 2010; DeFond & Zhang, 2014, p. 312). There has been extensive audit fee research on the impact of high non-audit fees in relation to audit fees. There is no strong evidence that NAS are a problem, but occasionally studies showing apparent loss of independence are appearing.

While some observers expect to see that auditors reduce their audit fee as a “loss-leader,” this effect has not been found. Instead, high non-audit fees are usually associated with high audit fees as well.

Research prior to the period of this review is important so far as this issue is concerned. Frankel et al. (2002) reported that there was evidence of auditors losing their independence when there were high non-audit fees in proportion to audit fees, using data from soon after when US companies were first required to disclose audit fees. That study was controversial, and was challenged by further research (Ashbaugh, Lafond, & Mayhew, 2003; Chung & Kallapur, 2003; Larcker & Richardson, 2004). It became generally accepted that non-audit fees did not impair independence (Sharma, 2014, p. 68). As a result, there is less motivation for researchers to examine this issue again.

More recent evidence suggests there may be problems in some circumstances. In the period under review, Bell et al. (2015, p.465) find that NAS is associated with higher audit quality and higher fees for public companies, but lower quality and lower fees for private companies. This is due to “market and regulatory mechanisms” that keep watch on public clients.¹⁴ Some of the studies that find results suggesting loss of independence use US data from before SOX (Causholli, Chambers, & Payne, 2014; Dickins, 2008; Gul, Jaggi, & Krishnan, 2007; J. Krishnan, Su, & Zhang, 2011; Omer, Bedard, & Falsetta, 2006; Srinidhi & Gul, 2007). However, there are others that find evidence of loss of independence and that use more recent US data (Bell et al., 2015; Causholli et al., 2014; Rice & Weber, 2012; C. Ye, 2012) or data

from Australia (P. Ye, Carson, & Simnett, 2011) or New Zealand (S. W. S. Wang & Hay, 2013). More details of these studies is provided in the table attached.

Independence in appearance is also important. Numerous studies show that higher non-audit fees impact share price, or related measures such as earnings response coefficient.¹⁵ Sharma (2014) sums up by stating: “investors see a problem even if audit quality studies don’t”.¹⁶ DeFond & Zhang (2014) propose that these results may mean that investors have ways of detecting the effects of reduced independence that are not captured by research (DeFond & Zhang, 2014, p. 309).

Overall, non-audit fees to audit clients are low and not decreasing or increasing much. There is mixed evidence about the effect of NAS on auditor independence of mind, but consistent evidence that NAS reduces the appearance of independence.

Ethical Issue: Objectivity including independence of mind and independence in appearance.

Research Findings: Numerous studies find evidence of loss of independence in appearance. There is some evidence in some circumstances of reduced independence of mind.

Issue 4: Audit services by firms that have non-audit business

Firms providing NAS to non-audit clients is an issue of increasing concern (Beardsley, Lassila, & Omer, 2016; Chi et al., 2012; Dey, Robin, & Tesson, 2012; Hermanson, 2009; Lisic, Myers, Pawlewicz, & Seidel, 2016; United States Treasury, 2008). The concern is that if audit firms become predominantly focused on consulting services, then they will allocate resources and talent to their non-audit businesses, and their culture will place less focus on auditing.

NAS provided to non-audit clients by US audit firms have grown considerably in recent years and now represent substantial proportions of total revenue (Dey et al., 2012; Lisic et al., 2016). There is not very much research. Two unpublished studies show some evidence that audits are of lower quality when firms provide more NAS to non-audit clients, in some circumstances (Beardsley et al., 2016; Lisic et al., 2016) and that independence in appearance is reduced (Lisic et al., 2016).¹⁷

Beardsley et al. (2016) find that when offices of a firm are experiencing fee pressure, they are likely to increase non-audit services; when they do increase non-audit services, then there is an increase of misstatements. Fee pressure is measured by firm revenue dropping in decile category within the firm; misstatements by subsequent restatements.

Lisic et al. (2016, p. 28) reports a higher likelihood of misstatement among clients that have a lower litigation risk when their auditors generate more revenue from consulting. Misstatement is measured by subsequent restatements, litigation risk is measured using two models from previous studies, and revenues from consulting by non-audit services fees divided by audit fees for the whole firm. Independence in appearance is the earnings response coefficient.

Ethical issue: Professional competence and due care.

Research findings: Some evidence but not much.

Perspectives of stakeholders

There are studies that examine the perspectives of investors, measured through the impact on share market reactions. These studies, discussed under Issues 2 and 3, find that investors are concerned by high levels of audit fees and non-audit fees. There is a loss of independence in appearance.

Processes implemented by firms

The processes implemented by firms is another issue. Research on this issue has not been identified in research papers concerned with audit fees. It may be difficult to obtain information about the internal procedures of firms.

Other recent research reviews

Other recent literature reviews that are related to this area include Gramling et al. (2010); DeFond & Zhang (2014); Sharma (2014); Tepalagul & Lin (2015); and Simnett et al. (2016). Their conclusions are consistent with the comments in this paper, that while ethical issues are not strongly evident, there are nevertheless some concerns. They say:

- Gramling et al. (2010, p.547): “[research] does not provide strong evidence that the prohibitions and requirements embedded in the current independence rules for public company auditors are strongly correlated with independence in fact. However, some prohibitions and requirements do appear to improve perceived independence – at least in the pre-SOX era.”
- DeFond & Zhang (2014, p. 312): “evidence is persuasive that audit committee and Section 404 provisions, but not banning NAS, improves audit quality . . . evidence is limited on whether low-balling or opinion shopping improves audit quality”.
- Sharma (2014, p.80): “although this paradigm often concludes that NAS do not threaten auditor independence, the literature remains unclear.”
- Tepalagul & Lin (2015, p.112): “there is limited evidence that auditor independence is compromised in the presence of client importance and NAS.”
- Simnett et al. (2016, p.11): “findings support audit partner rotation . . . long audit firm tenure and audit firm rotation do not necessarily impact audit quality [and] . . . “further examination of the potential threat to auditor independence, both actual and in appearance, arising from the provision of NAS would be beneficial to justify the current restrictions on the provision of NAS.”

Limitations

This report is an overview. Studies before 2006 can be important, and research within the period is influenced by them. Conflicting results between papers are a further complication. Results also vary according to setting or period.

Publication bias can also be important – authors, reviewers for journals and editors are much more interested in papers that have significant or surprising results, and there may be studies that are never seen because they are abandoned by the authors or rejected by the journals for not providing significant results (Hay & Knechel, 2016; T. D. Stanley, Doucouliagos, & Jarrell, 2008). There are techniques for taking account of differences in setting and period, and weight studies according to size, control for publication bias and that can be used to resolve conflicting results. An example is meta-regression (Hay, 2013; Hay, Knechel, & Wong, 2006). This technique is time consuming and complex, but could be considered for future work to assess research on some of the questions arising.¹⁸

Summary

There is a mixture of risks to auditor independence that are confirmed by the research evidence; risks that are not confirmed; and risks where evidence is mixed. There is no evidence of auditors using the audit as a loss-leader to obtain more lucrative consulting work. There are few signs of audit fees being too low to be able to conduct an adequate audit.

Nevertheless, there is evidence of some issues of concern, including non-audit services associated with indications of reduced independence; and non-audit services leading to reduced independence in appearance. There is some concern about the audit services provided by firms that have substantial non-audit service businesses.¹⁹

In general, audit fee research does not convey a message that there are widespread ethical problems. Nevertheless, there are some risk areas.

¹References and additional notes are available on request.²⁰

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Table 1: Audit fee research: summary of issues

Issue	Extent of research	Ethical issues	What is known	Unknown
1. Level of audit fees	Level (65 papers)	Low audit fees (professional competency and due care) High non-audit fees (objectivity)	Audit fees are high and non-audit fees low in the US, UK, New Zealand; Audit fees are low in Korea (one study)	Other markets; costs
	Competition (31)	Professional behavior	Some evidence that competition is lacking in the UK, Australia; not in the USA	Other markets
	Lowballing and rotation (12)	Low audit fees (professional competency and due care)	Low fees in early years of engagement; some evidence of lower independence	
2. Relative size of fees/dependence	17 (studies of relative size)	Dependence	Evidence of lower independence with high relative fees in some studies; but also some opposing evidence	
3. Non-audit fees to audit fees	53	Objectivity (independence in appearance)	Stock market reacts to high non-audit fees	Other stakeholders
		Objectivity (independence of mind)	High non-audit fees associated with reduced independence in some circumstances	Benefits versus costs;
4. Firm with NAS business	9	Objectivity	Firms that have more NAS business associated with more frequent restatements (unpublished studies)	
Perspectives of stakeholders	Included under Issue 3.			
Processes by firms	None found	Safeguards		Private information

Extended Table 2: Research studies reporting issues of concern

<i>Issue for investigation</i>	<i>Finding</i>	<i>Setting</i>	<i>Data period</i>	<i>Number of observations</i>	<i>Audit variable</i>	<i>Issue variable</i>
Level of fees	Fees had decreased and were too low (Behn et al. 2009)	Korea	1999-2004	1,195	Audit fee per hour*	Period 1999-2004
	Fee pressure in 2006-10 and lower quality associated with fee pressure (Ettredge et al. 2014)	US	2006-2009	3,039	Audit fees using pre-recession benchmark	Misstatements (subsequent restatements)*
	Fee reductions for banks in 2008-09 associated with less timely loan loss provisions but only in cases where auditor was a non-Big 4 firm and the bank was exempt from internal control audit (Krishnan & Zhang 2014)	US	2008-09	574	Cuts in audit fees	Loan loss recognition* where the auditor was non-Big 4, the bank was exempt from internal control audit and the fee cut was more than 25%
Competition	Lack of competition (Oxera 2006)	UK	1995-2004	6,623	Market share, Hirschman–Herfindahl index, audit fees*	Increased concentration
	Reduced competition (Ding & Jia 2012)	UK	1995-2001	5,820	Increased audit fees for Big N*	PwC merger
	Reduced competition in some market segments (Carson et al. 2012)	Australia	1996-2007	11,593	Increased premiums for Big N in some segments*	Reduction from Big 6 to Big 4
Lowballing	Lower fees in anticipation of and following for auditor dismissals (higher fees before and after resignation) (Griffin & Lont 2011)	US	2001-06	18,923	Dismissals and resignations	Residual audit fees from fee model*
	Lower fees and quality (Huang et al. 2015)	China	2002-11	9,684	Initial audit	Audit fee discount; sanctions for problem

<i>Issue for investigation</i>	<i>Finding</i>	<i>Setting</i>	<i>Data period</i>	<i>Number of observations</i>	<i>Audit variable</i>	<i>Issue variable</i>
	Lower fees and quality (Stanley et al. 2015)	US	2000-09	402	Initial audit engagements	audits; earnings management* Discretionary accruals around analyst forecasts*
	Lower fees (Kácer & Wilson 2016) (unpublished working paper)	UK	1998-2012	792,705	Initial audits	Lower fees*
	Lower fees (Bell et al. 2015)	US	2003	265	First-year audits*	Assessment by audit firm
Relative size	Higher fees, lower quality (Choi et al. 2010)	US	2000-03	9,815	Positive abnormal audit fees*	Discretionary accruals
	Higher fees, lower quality (Chi et al. 2012)	Taiwan	1990-2009	22,978	Economically important clients by partner* (of non-Big 4 firms)	Abnormal accruals, modified opinions, just meet or beat earnings target
	Higher future fees, lower quality (Blay & Geiger 2013)	US	2004-06	1,479	Higher subsequent total fees and NAS fees	Going concern opinions*
	Partner incomes related to clients gained or lost (Knechel et al. 2013)	Sweden	2007	287	Gaining or losing clients (for three of the Big 4 firms)	Partner income*
NAS and Independence of mind	Reduced tax NAS after disclosure (Omer et al. 2006)	US	2000-02	5,727	Association between tax NAS and audit fees pre-2002*	Reduced association between tax NAS and audit fees in 2002*
	Lower accrual quality with NAS (Srinidhi & Gul 2007)	US	2000-01	4,282	Non-audit fee ratio and level*	Accrual quality
	Discretionary accruals and NAS (Gul et al. 2007)	US	2000-01	4,720	Non-audit fees* for clients with auditor tenure < 3 years	Discretionary current accruals

<i>Issue for investigation</i>	<i>Finding</i>	<i>Setting</i>	<i>Data period</i>	<i>Number of observations</i>	<i>Audit variable</i>	<i>Issue variable</i>
	NAS and financial report quality (Dickins 2008)	US	Pre-SOX	Not available	Reduction in non-audit fee ratio	Reduction in discretionary accruals
	NAS and earnings management (Krishnan et al. 2011)	US	2000-05	1,768	Reduction in NAS post SOX*	Discretionary accruals pre-SOX
	NAS and audit opinions (Ye et al. 2011)	Australia	2002	626	Non-audit fees together with alumni affiliation*	Going concern opinions
	NAS and earnings management (Ye 2012) (unpublished thesis, Boston U.)	US	2007-09	1,103	Tax services by auditor* (large clients)	Earnings smoothing
	NAS and disclosure of internal control weaknesses (Rice & Weber 2012)	US	2004-09	488	Non-audit fees*	Firms that restated due to control weakness but had not previously disclosed the weakness
	Higher future fees, lower quality (Blay & Geiger 2013)	US	2004-06	1,479	Higher subsequent total fees and NAS fees	Going concern opinions*
	NAS and audit opinions (Wang & Hay 2013)	New Zealand	2011	99	Non-audit fees ratio*	Going concern opinions
	Future NAS and earnings management (Causholli et al. 2014)	US	2000-01	4,078	Increased future NAS*	Discretionary accruals, shifting to special items
	NAS and quality assessed by audit firm (Bell et al. 2015)	US	2003	265	Non-audit fees divided by audit fees* for private companies	Assessment by audit firm
Appearance of Independence	Client importance and earnings response coefficient (Ghosh et al. 2009)	US	2001-06	21,797	Client importance (fees to total firm fees) (no relationship with NAS ratio)	Earnings response coefficient*

<i>Issue for investigation</i>	<i>Finding</i>	<i>Setting</i>	<i>Data period</i>	<i>Number of observations</i>	<i>Audit variable</i>	<i>Issue variable</i>
	Non-audit fees and earnings response coefficient (Higgs & Skantz 2006)	US	2001-02	1,313	Abnormal audit fees and (under some conditions) abnormal non-audit fees*	Earnings response coefficient
	Abnormal audit and non-audit fees and stock price synchronicity (Wang 2009) (unpublished thesis Hong Kong Poly U)	US	2004-06	9,188	Abnormal audit fees* (no relationship with abnormal non-audit fees)	Stock price synchronicity
	Non-audit fee ratio and asset-pricing inefficiencies (Davis & Hollie 2008)	US	Experiment, post-SOX	48	Non-audit fees and audit fees*	Investor perception of share value
	Non-audit and audit fees and cost of capital (Khurana & Raman 2006)	US	2000-01	2,163	NAS and total fees divided by audit firm revenue (office-level and firm-level)*	Cost of capital
	Non-audit fees and earnings response coefficients (Francis & Ke 2006)	US	2000-01	16,243	High relative NAS (75 th percentile by \$ and NAS ratio above median)	Earnings response coefficient*
	NAS and IPO underpricing (Chahine & Filatotchev 2011)	UK	1999-2003	375	Log of non-audit fee*	IPO underpricing
Firms providing non-audit services	Higher consulting fees associated with more restatements for lower litigation-risk clients (Lisic et al. 2016) (unpublished working paper)	US	1999-2013	13,534	NAS for total firm over total revenue*	Restatements of low-litigation clients
	Higher consulting fees associated with lower earnings	US	1999-2013	77,902	NAS for total firm over total revenue*	Earnings response coefficient

<i>Issue for investigation</i>	<i>Finding</i>	<i>Setting</i>	<i>Data period</i>	<i>Number of observations</i>	<i>Audit variable</i>	<i>Issue variable</i>
	response coefficients (Lisic et al. 2016) (unpublished working paper)					
	Non-audit services together with audit fee pressure at the office level and restatements (Beardsley et al. 2016) (unpublished working paper)	US	2003-2013	3,674	Increases in NAS at office level with Fee Pressure (= decreased fees for office)*	Restatements

NAS: non-audit services

* with control variables for size, risk and other factors

Notes

¹ Extended overview:

In summary, there are numerous studies on some issues, but few on others. The level of audit fees appears to have increased substantially until about 2007, but less so since. Non-audit fees have reduced since the early twenty-first century. The concentration of the market for audit services is high. While concentration has in the past been considered not to be a problem, some recent studies suggest that it is, at least in the UK and Australia. Research about the size of audit fees, and possible dependence of an auditor upon a client, shows that there are some cases where higher fees are associated with worse audits. There is also some evidence suggesting that higher non-audit fees reduce independence (indicated by audit quality) in some conditions. There is considerable evidence that higher non-audit fees reduce independence in appearance. There is not much research about audit services provided by firms that have non-audit services, but what there is suggests clients choose to get these services for economic reasons, not as a means of rewarding their auditor. The research shows that more complex clients are more likely to choose firms that offer these services, and that risk and governance are taken into account in making that choice.

² Of those papers, 325 relate to the level of fees, 8 to relative fees and dependence, 75 to the ratio of non-audit to audit fees and 5 to firms with a non-audit business.

³ In more detail, the following sections of the Code of Ethics refer to relevant issues:

Undue dependence (200.4)

Contingent fees (200.4)

Intimidation includes pressure to reduce work and fees (200.8)

Fee too low to perform engagement with professional competence and due care (240)

Fee dependence where fee is a large proportion of firm revenue (290.217)

Fee dependence where fee is a large proportion of partner or office revenue (290.218)

Fees from a public-interest entity > 15% of firm revenue: disclose to those charged with governance, pre or post issuance review (290.219)

Overdue fees (290.222)

⁴ Section 150 of the IESBA Code of Ethics (Professional Behavior) requires that there is an obligation for professional accountants to “comply with relevant laws and obligations” and avoid any action that may discredit the profession (International Federation of Accountants, 2015). It does not specifically mention competition.

⁵ Research suggestion: is there an association between fee levels for an auditor and the outcome of inspection reports by regulators such as the PCAOB? (Research suggestion 3)

⁶ Although this issue has been studied, evidence that there is a lack of competition has not been found (according to Simunic 2014). That is the accepted view, although there are some studies showing evidence of lack of competition (Carson et al., 2012; Ding & Jia, 2012; Oxera, 2006).

Papers on the market share of audit firms commonly find a premium for the Big N firms, although this is mainly a US phenomenon according to a forthcoming study (Hay & Knechel, 2016). It is widely considered, based on earlier research, that the large market share held by the Big 4 firms in most countries is not inconsistent with competition and that higher fees represent a premium for higher quality.

Nevertheless, some recent papers show that there are concerns about competition. Notable official studies in the period were by Oxera for the UK Department of Trade and Industry and the Financial Reporting Council and by the Government Accountability Office (GAO) in the US. Oxera (2006) concluded that in the UK market, “higher concentration has led to higher audit fees” (Oxera, 2006, p. i). The GAO found that: “Continued concentration in [the] audit market for large public companies does not call for immediate action” (GAO, 2008). However, the report also acknowledges that the available data did not allow it to conclude that the auditing market is competitive (GAO, 2008).

There are other studies that find evidence of reduced competition. Ding & Jia (2012) report a significant increase in fees for Big N firms in the UK after the PW-Coopers merger in 1998 and conclude that there was increased market power. Carson et al. (2012) in a study of Australian data found an increase in the Big N firm premium over the years 1996 to 2007, during which the firms decreased from the Big 6 to the Big 4, although this increase did not apply to the largest client firms. A later paper comments “the decrease in the number of the largest audit firms from the Big 6 to the Big 4 has likely reduced the level of competition in the audit market for public companies as reflected by increases in audit fee premiums, but that this impact is not consistent across all client segments” (Carson, Botica Redmayne, & Liao, 2014, p. 302). There are many other settings for which there are no recent published studies.

⁷ Studies of audit fee determinants estimate the effect of various issues on audit fees. There are 220 papers that examine the determinants of audit fees. These are concerned with a wide range of issues, although in the period examined the issues of SOX (20 articles), internal control (20) and governance (16) were important. These studies also include a wide range of settings, including Belgium, France, Malaysia, New Zealand, the UK and the US.

The econometric models used are generally consistent from study to study, and generally show a high R-squared (indicating that they provide a good explanation of what determines audit fees).

⁸ They report that they found no evidence of the auditors “short-cutting” the engagement (Kácer & Wilson, 2016, p. 37). Their evidence that no short-cutting occurs has limitations, however. By short-cutting, they mean reducing the quality of the audit; they argue that as an audit fee discount persists for only two years, then that is evidence that short-cutting does not occur.

⁹ Lennox et al. (2014) found evidence that first year audits were higher quality in China and Kim et al. (2015) also found evidence of higher quality at first after auditor switches in Korea.

¹⁰ They also found that audit quality declines eventually with long tenure, but this effect applies only to private clients, not to listed companies where there is more regulation and greater risk (Bell et al., 2015, p. 465). The evidence in Bell et al. (2015) suggests that there is

a greater concern about long tenure when there are fewer other controls, such as in the market for private company audits. Among earlier studies, Myers et al. (2003) found longer tenure was associated with higher quality. There are a number of other studies of the auditor rotation issue which do not examine audit fees and so are not captured here. Review articles summarizing those studies include Casterella & Johnston (2013); Ewelt-Knauer et al. (2013); and Jenkins & Vermeer (2013).

¹¹ Earlier studies have mixed results but generally no evidence that high fees have any effect. (Craswell, Stokes, & Laughton, 2002): “the level of auditor fee dependence does not affect auditor propensity to issue unqualified audit opinions” p. 253

Barkess, Simnett, & Urquhart (2002) “for the top 25 audit firms, the level of fee dependence from any one client was substantially below the level suggested in auditing standards. In summary, the investigation was unable to identify any instances of fee dependence impairing the independence of auditors.” They examined a 15% threshold, but no firm had more than 10.2% gross fees from one client.

Other early studies: Giver and Paterson (2007) say “Reynolds and Francis (2000) report a negative coefficient on client influence, suggesting that auditors are less likely to approve large discretionary accruals by their influential clients. Chung & Kallapur (2003) find that the coefficient on client influence is insignificantly different from zero, meaning that auditors do not differentiate among clients according to their influence.”

¹² Higgs & Skantz (2006) find the opposite, abnormally high audit fees as a signal of a firm’s commitment to high earnings quality. Under certain conditions NAF associated with lower ERC.

¹³ Research suggestion: extent of fee dependence at the firm, office and partner level and impact of high dependence. The Code of Ethics says that (para 290.219) when audit fees from a single public interest audit client are more than 15% of the firm’s total revenue then special procedures are required. Why 15%? Have different thresholds been tested? And what should the threshold be for an individual office or partner? (Research suggestion 2).

¹⁴ Note that the data is from 2003 (Bell et al., 2015, p. 463).

¹⁵ There are eight studies, all using US data, in the period 2006-16. At least one (Ghosh et al., 2009) uses data subsequent to SOX. Methodology: for example, Higgs & Skantz (2006) use an event study methodology with unexpected returns regressed on unexpected earnings. They add measures for unexpected audit and non-audit fees, with interaction terms to test whether ERCs are associated with audit and non-audit fee residuals (Higgs & Skantz, 2006, p. 7).

¹⁶ Some practitioners also do not see a problem. Beaulieu & Reinstein (2010) examined practitioner reactions to the issue of non-audit fees in relation to audit fees, and the impact of research on their reactions. They found that large firm practitioners were less likely to believe that NAS impairs independence (compared to practitioners from smaller firms); and less likely to change their minds when shown research on the issue.

¹⁷ This issue includes the topics of why companies purchase NAS (instead of using in-house management); why companies purchase NAS from their auditors; and why audit firms choose

a business model of offering non-audit services or not. These topics have not been widely examined. Very little data about these issues is available to researchers. Clients buy non-audit services from their auditors when the company is complex, or going through restructuring, or the environment is uncertain; they also take account of conflict of interest (such as minority shareholders) and the quality of governance. One study shows that clients prefer audit-only firms when the auditor is an industry specialist; and firms that offer both consulting and audit when they are going through growth, mergers and acquisitions (Gal-Or, 2011). This area has potential for future research. The Gal-Or (2013) study examined Deloitte (which retained its consulting business in the US after SOX) to the other Big firms. In most circumstances, audit firms that offer non-audit services are different from firms that do not in many other ways, especially size. Studies: Kent (2011) examines “the decision to purchase MAS from their external auditors and other consultants as opposed to assembling MAS internally within the company”. Associated with restructuring, management change, complexity (number of subsidiary companies) and number of geographic segments. (Christensen & Kent, 2015) – uncertainty; (Habib & Islam, 2007): larger firms, firms with international subs; (Gal-Or, 2011) (unpublished thesis): Clients prefer audit-only when auditor is an industry specialist; consulting and audit when growth, mergers and acquisitions. (Lassila, Omer, Shelley, & Smith, 2010) et al, JATA: audit firms for tax services when there is complexity and also when good governance. (Abbott, Parker, & Peters, 2012): less NAS when seeking financing, more when high managerial ownership.

¹⁸ Future research: meta-regression. (Research suggestion 1)

¹⁹ Practical implications. Some ways to deal with these issues that could be discussed might be as follows:

1. Auditors discontinue providing NAS.
2. Provide more guidance on new engagements (with lower fees)
3. More research.

²⁰ I appreciate helpful comments from colleagues in Australia (Keryn Chalmers, Robyn Moroney and Jenny Stewart), Finland (Lasse Niemi and Hannu Ojala), the Netherlands (Caren Schelleman), New Zealand (Debbie Alexander, Steven Cahan and David Emanuel), Tunisia (Hichem Khelif) and the US (Robert Knechel).

Audit fee research on issues related to ethics

Suggestions for future research

1. Meta-regression. Given the conflicting results in several areas, it would be useful to conduct a meta-regression to take stock of the overall results of research such as the effect of non-audit services. This might clarify some of the results that are discussed in more general terms in the paper. Areas where that might be useful include the low-balling issue and the issues of independence of mind and appearance when there are non-audit services.
2. Dependence: extent of fee dependence at the firm, office and partner level and impact of high dependence. The Code of Ethics says that (para 290.219) when audit fees from a single public interest audit client are more than 15% of the firm's total revenue then special procedures are required. Why 15%? Have different thresholds been tested? And what should the threshold be for an individual office or partner? Research could examine different thresholds for office and partners and whether there is an association with auditor independence.
3. Audit fees, audit quality and inspection reports. Is there an association between fee levels for an auditor and the outcome of inspection reports by regulators such as the PCAOB? Research on whether low fees are associated with inadequate audit quality (or whether high fees are associated with reduced independence) has used indirect proxy measures for quality and independence such as earnings management.
4. NAS and appearance of independence around the world. Research on the impact of auditors providing NAS on the appearance of independence has nearly all used evidence from the US. It would be useful to conduct research in different settings that have differing legal environments and less-developed financial markets.
5. Firm data. One recent study (Bell, Causholli, & Knechel, 2015) was able to obtain a much deeper understanding because the authors had access to internal data from a major firm, including the firm's assessment of audit quality, and records of time and cost as well as fees. They examined the issues of non-audit services, lowballing and long tenure. They were able to assess whether more or less effort was made. IESBA may be able to prevail on firms to allow researchers access to confidential data like this, subject to controls such as anonymity.
6. Editorial. I intend to write an editorial for the International Journal of Auditing about this project, and other recent initiatives by professional authorities. I will include links to the paper prepared for the IESBA. I'd like the Board's views on publishing the report itself, after a refereeing process. The PCAOB's synthesis projects were published in the journal *Auditing: A Journal of Practice & Theory* (Cohen & Knechel, 2013).

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