

# 1 INTRODUCTION

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This section will discuss the background of this study, problem statement, research questions and research objectives, motivation of the study, scope of the research and finally organization of research in the following order:

## 1.1 BACKGROUND OF STUDY

*Audit*, by definition, is an examination and verification of a company's financial information and accounting source documents. The entire auditing process will be done according to Generally Accepted Auditing Standards (GAAS). It provides assurance on the reality and fairness of an organisation's financial information; offer recommendation on controls and processing system weaknesses; and confirming accounting treatments on complex transactions. *Auditors* are professionals who have technical competence in accounting and independence in performing audit works and reporting their opinions to the public. They are expected to reduce agency cost between shareholders (principle) and management (agent). *Audit fees* refer to a fee that a company pays to external or independent auditors in exchange for performing audit. This fees also comprise services that generally an independent accountant reasonably may provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of

documents filed with the SEC (Cheffers M. et al., 2010). Generally, when auditors receive fees from their auditees as their compensation, a question may arise whether they compromise their independence and work for management instead of shareholders. This is because, auditors may want to maintain high payout auditees portfolio, in such context they may allow auditees to dominate the audit process. On the contrary, high fees could also represent high audit quality because it implies that auditors provide increased monitoring service to their clients such as performing systematic audit procedures (Carcello et al., 2002).

***Audit History*** - The rise of professional audit has started way back in 1970s. In the beginning, auditing mainstay was to uphold accuracy of governmental accountancy. The situation wasn't same until the advent of the Industrial Revolution. More businesses have gone through a period of expansion during the Industrial Revolution, creating more job opportunity between owners to customers. Due to extensive growth, in year 1750 to 1850, management was hired to monitor the operations in absence of the owners'. Auditing then began its evolution into fraud detection and financial accountability. Up to 1929, there was only a little regulation that prevailed at securities market in the US. Bad consequences follow due to insufficient rules and regulation, the stock market crashed. The fall and the depression that followed caused public to lose their confidence and trust in financial markets. In order to regain and rebuild a sound and strong market, Congress have passed two regulator bodies;

- i) the Securities Act of 1933 and
- ii) the Securities Exchange Act of 1934.

This law is established and it is now recognized as Securities and Exchange Commission (SEC). SEC was given the authority to ensure all publicly traded firms to lodge its financial reports and urged that these reports be reviewed by independent auditors. In the early 20th century, the reporting practice of auditors, which involved submitting reports of their duties and findings, was standardized as the "Independent Auditor's Report." The increase in demand for auditors leads to the development of the testing process. Auditors developed a way to strategically select key cases as representative of the company's overall performance. This was an affordable alternative to examining every case in detail, and it required less time than the standard audit.

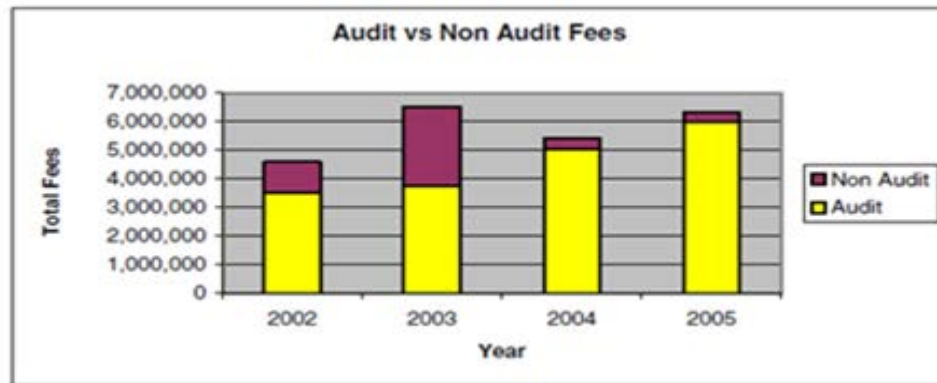
*Audit failures* still in existence despite of auditing regulation, a series of high profile financial scandals have shocked the public over past several years. This includes the ever Biggest corporate failure in the world like, Enron and WorldCom. The fall of Enron and WorldCom called for high quality and transparent financial reporting in capital markets (Swanson, 2008). As consequences of these corporate failures, regulators have become the dominant players in addressing financial issues. New regulations and legislation were enacted to expand the quality and accuracy of financial reporting for public companies. A transparent financial reporting refers to financial statements with zero material misstatements, omissions or biases that can avoid wrong investment decisions making by investors. In response to these matters, the US Senate amended existing requirements of the Securities Act 1934 by implementing Sarbanes Oxley Act (SOX) (US 70<sup>th</sup> Congress, 2002). SOX of 2002 thereafter developed Public Company Accounting Oversight Board (PCAOB) to ensure financial information is fairly presented to investors and the auditors

to comply with all applicable auditing standards. One of the steps taken by SEC to protect the investors is to mandate fee disclosures in financial reporting. From the Year 2001 onwards, companies registered under SEC must disclose the fees paid to their auditors in the financial reporting. This move was appreciated by the public and investors because publicly available fee is used to assess the credibility of financial reporting and corporate governance. Dickins and Higgs (2005), explain open disclosure has resulted services billed by auditors to be classified into one of the following categories (paraphrased):

1. under the caption of "Audit Fees," the aggregate fees billed for professional services rendered by an external auditor for the statutory audit and review of the financial reporting and regulatory filings or engagements;
2. under the caption of "Audit-Related Fees," comprise fees for services that are reasonably related to the performance of the audit or review of the Company's financial statements other than subjected under the "Audit Fees" caption.

Subsequently many countries mandated public disclosure of audit fees, such as the Australian authority under AASB 101 (Craswell and Francis,1999) and in Belgium, audit fees is made more transparent in the post-Enron disclosure regime (Caneghem, 2009).

*The effect of SOX* on audit fees not only change the workload carried by the auditors, but it has also increased the number of employees in public accounting firms to keep up with the challenges. Figure 1 represents the movement of audit fees and non audit services fees after post-SOX period using a sample of 51 companies out of Fortune 500.

**Figure 1 : Audit remuneration post-SOX period**

(Source : Beck, 2006)

Figure 1 explains audit fees and non-audit fees have been increasing at higher rate after SOX. In relation to this, finding of Francis and Wang (2005) conclude that audit fees paid before SOX saw a decline in their fees paid in year 2001, and auditee who were undercharged initially, paying higher fees in the subsequent period. However, the upward adjustment to the undercharged auditees was less than the downward adjustment of overcharged auditees.

***Audit fee study is important*** for the purpose of increase transparency, auditees should be learning the basis of fees structured by external auditors and understands the extent of auditors' role in corporate world. It is important to value this because for the past few years Malaysia have experience some companies stepped into financial scandals. It obviously damaged the essence of the auditing profession. Barker (2002) claimed that society's trust is the core element in a group of professional persons. Hence, if such trust is betrayed, the confidence held by public auditing professional will destroyed, and it would become useless. Among the scandals that have shocked the corporate circle in Malaysia were;

**Table 1 : List of Financial Scandals In Malaysia**

<b>NAME OF THE COMPANY</b>	<b>CASES</b>
i) Transmile	Amount of deviation; RM150m (FY 2005) and RM260(FY2006)
ii) Energo	RM64m fictitious export sales (FY2003)
iii) Welli Multi	Misleading statement to Bursa and reported fictitious revenue RM68 (3Q06)
iv) Megan Media	False revenue of RM1b in financial statements (FY2006)
v) GP Ocean	RM25.7m fictitious sales made to 4 customers (FY2006)

(Source :<http://www.sc.com.my>)

In regard to the increasing number of corporate collapses and fraud, investors and shareholders' lost trust towards Malaysia's capital market. Generally, public have doubt on auditors' judgments and they perceived auditors' services are not credible and not worth of the amount money paid (Teck et al., 2009). In addition, low-balling issue has been a key concern in Malaysia for many years that tarnish the prestige of audit profession (Md Ali et al., 2008) and could be a possible reason of accounting scandal occurrences. "Low balling" is a practice where some auditors get into competitive market with the willingness to accommodate auditees' demand. Researchers have found some evidence on low-balling which increases auditors' readiness to keep to client's needs (Maher, 1992; DeAngelo, 1981).

In order to regain public trust, Malaysian Institute of Accountants (MIA) has implemented some practice and review guide in auditing profession to turn the profession into one of the highly regulated industry. One of the steps which MIA has looked into was a guideline on audit fees calculation. Recommended Practice Guide 7 (Revised)

which is aimed at ensuring consistent and harmonized fee levels across the industry was issued (Salleh et al., 2006). MIA recommend audit fees computation based on either turnover or total assets or based on operating expenses (exhibit in Table 2 and Table 3). It is up to the auditees to choose as it very much depends on the nature of industry. For example, trading companies may use turnover as audit fees, whereas an asset based company may prefer the total assets method. However in actual scenario, most of the companies in Malaysia are not using these methods as a basis to charge the fees (Teck et al., 2009). Hence, audit fees charged come from the negotiation between auditors and their auditees. Therefore, the researcher is interested in the determinants of the fees charged in Malaysia.

**Table 2: Audit fee computation using Gross Turnover or Total Assets Basis**

<b>Gross Assets or Turnover (RM)</b>	<b>Cumulative Amounts(RM)</b>	<b>Rate (%)</b>	<b>Fees (RM)</b>	<b>Cumulative Fees (RM)</b>
The first 100,000	100,000	1.000%	1,000	1,000
The next 150,000	250,000	0.438%	657	1,657
The next 250,000	500,000	0.313%	783	2,440
The next 500,000	1,000,000	0.188%	940	3,380
The next 1,500,000	2,500,000	0.125%	1,875	5,255
The next 2,500,000	5,000,000	0.100%	2,500	7,755
The next 5,000,000	10,000,000	0.094%	4,700	12,455
10,000,000 to 20,000,000	1,000 for every RM1,000,000 increase of a fraction thereof up to RM20,000,000			
Above 20,000,000	Negotiable (but should not be less than RM20,000 per assignment)			

(Source : <http://www.mia.org.my>)

**Table 3: Audit fee computation using Total Operating Expenditure**

Total Operating Expenditure for every ringgit of		
RM		Rate(%)
The next	50,000	2
The next	150,000	1
The next	800,000	0.5
The next	1,000,000	0.2
Above	2,000,000	0.1

(Source: <http://www.mia.org.my>)

It also mentioned in MIA Handbook 05, that audit fees varies depending on the reliance of internal control, complication of business transactions, volume of transactions, degree of accountability and risk, expertise of staffs and audit hours. ([www.mia.org.my](http://www.mia.org.my)). In relation to that, the Practice Guide mentioned audit fees for a inactive company shall be a minimum of RM800 ([www.klmanagement.com.my](http://www.klmanagement.com.my))

Amongst others, The MIA issued this Practice Guide because of the following reasons:-

- i. to strengthen the compliance in order to meet higher auditing standards requirements
- ii. to increase in operating costs
- iii. to ascertain auditors' responsibility and accountability is not affected by "price wars" among auditors

Salleh et al., 2006 further added that audit profession in Malaysia is likely to be more stringently regulated in the coming years. Table 2 and Table 3 used to further analyzed in Chapter 4.



## 1.2 PROBLEM STATEMENT

Even though MIA has developed a guide as exhibited in Table 2 and Table 3, auditors still have not adopted the pricing strategy yet (Teck et al., 2008). Having various governance steps in place by these reforms is not solving the issue because it is very lamenting to note that the audit fees in Malaysia are on the low side as compared to other nation (Teck et al., 2009). Continuous complains were made by audit firms due to the low audit fees in Malaysia as this became a big challenge for auditors to secure adequate resources for audit engagement. (adapt from Star dated 2/4/2011).

High quality and reliability of audited financial reporting in Malaysia is being questioned due to the mismatch of audit fees with nature of work required from auditors. According to Audit Oversight Board (AOB) investigation, the board has requested audit fee should be price based on their services to ensure auditors' compliance with the requirements and ethical standard (<http://www.mia.org.my>). Otherwise, low audit fee will fail to retain good quality of reporting which may result in more financial scandals. In regard of this, AOB executive Chairman Mohamed Nik Hasyudeen Yusoff, urged Malaysian companies for transition of mind to adopt higher audit fee. Moreover, he also urged companies to take audit fees as an investment rather than as a cost, because audit task supports the enhancement of a company's value (adapt from Star dated 2/4/2011, <http://biz.thestar.com.my>). A reasonable audit fee is essential to create good quality of audit, which in turn would generate more value to a customer of that service (Anderson and Zeghal, 1994). Researchers have studied numerous variables such as auditees size, physical existence and inventories, receivables, and its effect on audit fees

in various countries. This paper will further provide evidence of determinants' of audit fee in Public Listed Companies in Malaysia.

### 1.3 RESEARCH QUESTIONS & RESEARCH OBJECTIVES

The overall objective of the research is to analyze the factors influencing audit fees in public listed companies. The guiding research question for this is: **What are the factors influencing the amount of audit fees paid?**

#### **Specific objectives:**

To address the general objectives of the research, the researcher formulated the following specific objectives based on review of previous literatures:

- i) Analysis of **auditees size** affecting the fees, consider the relationship between the audit fees and total assets.
- ii) Analysis of **auditees complexity** affecting the fees, consider the relationship between the audit fees and number of subsidiaries held by company.
- iii) Analysis of **auditees risk** affecting the fees, consider the relationship between the audit fees and leverage and sum of inventory and receivables over total assets.
- iv) Analysis of **auditor's opinion** affecting the fees, consider the relationship between the audit fees and qualified/unqualified opinion by auditor.

- v) Analysis of **auditor's size** affecting the fees, consider the relationship between the audit fees and Big 4/non Big 4.
- vi) To understand of **non audit services (NAS)** affecting the fees, consider the relationship between the audit fees and amount of NAS paid.

Besides knowing the factors influencing the audit fees, the researcher also intended to understand the perception of auditees and auditors on the amount of fees paid. The guiding research question for this is : **What is the perception of auditees and auditors on the amount of audit fees charged in Malaysia?**

**Specific objectives:**

To review the opinion, experience and suggestions shared by auditors and auditees on the factors influencing audit fees in Malaysia. In summary, Table 4 illustrates the research questions and research objectives used by researcher in this study.

**Table 4: Research Questions and Research Objectives**

<b>RESEARCH QUESTIONS</b>	<b>RESEARCH OBJECTIVES</b>
<p>RQ 1: What are the factors influencing the amount of audit fees paid?</p>	<p>RO1: To review auditees size (total assets); auditees complexity (number of subsidiaries); auditees risk (leverage &amp; the ratio of 'inventory and receivables over total assets') and its pattern towards audit fees</p> <p>RO 2 : To investigate relationship between auditor's opinion (qualified and unqualified) and audit fees</p> <p>RO 3: To investigate relationship between auditor's size (Big 4 or non Big 4) and audit fees</p> <p>RO 4: To investigate the relationship between non audit services paid and audit fees.</p>
<p>RQ 2: What is the perception of auditees and auditors on the amount of audit fees charged in Malaysia?</p>	<p>RO 5: To review auditors and auditees' perception towards factors influencing audit fees.</p>

#### **1.4 MOTIVATION OF STUDY**

As can be seen from the literature review in Chapter 2, audit fee is mainly influenced by auditees size, complexity, and auditees risk (Maher et al., 1992; Simunic, 1980; Taylor and Baker, 1981). There are also many other variables affecting the fees such as industry specialization (Chen, 2001), ownership structure, CEO duality (Desender et al., 2009), board members (Carcello et al., 2002), internal audit committee (Felix et al., 2001) and many more.

Results from the Western research namely, US, Australia, UK and etc may not necessarily be applicable to all other countries. Therefore, the aim of this study is to examine the underpinning variables which explain the audit fee charged in Public Listed Companies in Malaysia. In addition to that, this study will investigate auditees perception towards audit fees paid in Malaysia. Not only that, the output of this study may initiate more transparency and reliable audit fee computation in Malaysia.

#### **1.5 SCOPE OF RESEARCH**

A sample of 100 companies is drawn from Bursa Malaysia website. The entire samples are extracted from Industrial Product Sector in the year 2010. Firstly, secondary data (annual report) is analyzed then the results are compared with multiple regressions output. In the attempt to provide qualitative evidence, interviews with accountants and auditors have been carried out. The mixed method of both qualitative and quantitative are used to enhance further understanding on audit fees charged in Malaysia. As a result, it is expected to have a positive relationship between audit fees and

- i) auditees size; total assets

- ii) auditees complexity; number of subsidiaries
- iii) auditees risk; leverage (long term debt exclude deferred taxation over total equity) and ratio of (sum inventories and receivables over total assets)
- iv) auditor's size; if audited by Big 4

And expecting negative results on variables below;

- v) Non Audit Services; total acquisition of non audit services
- vi) Auditor's opinion; qualified/unqualified opinion

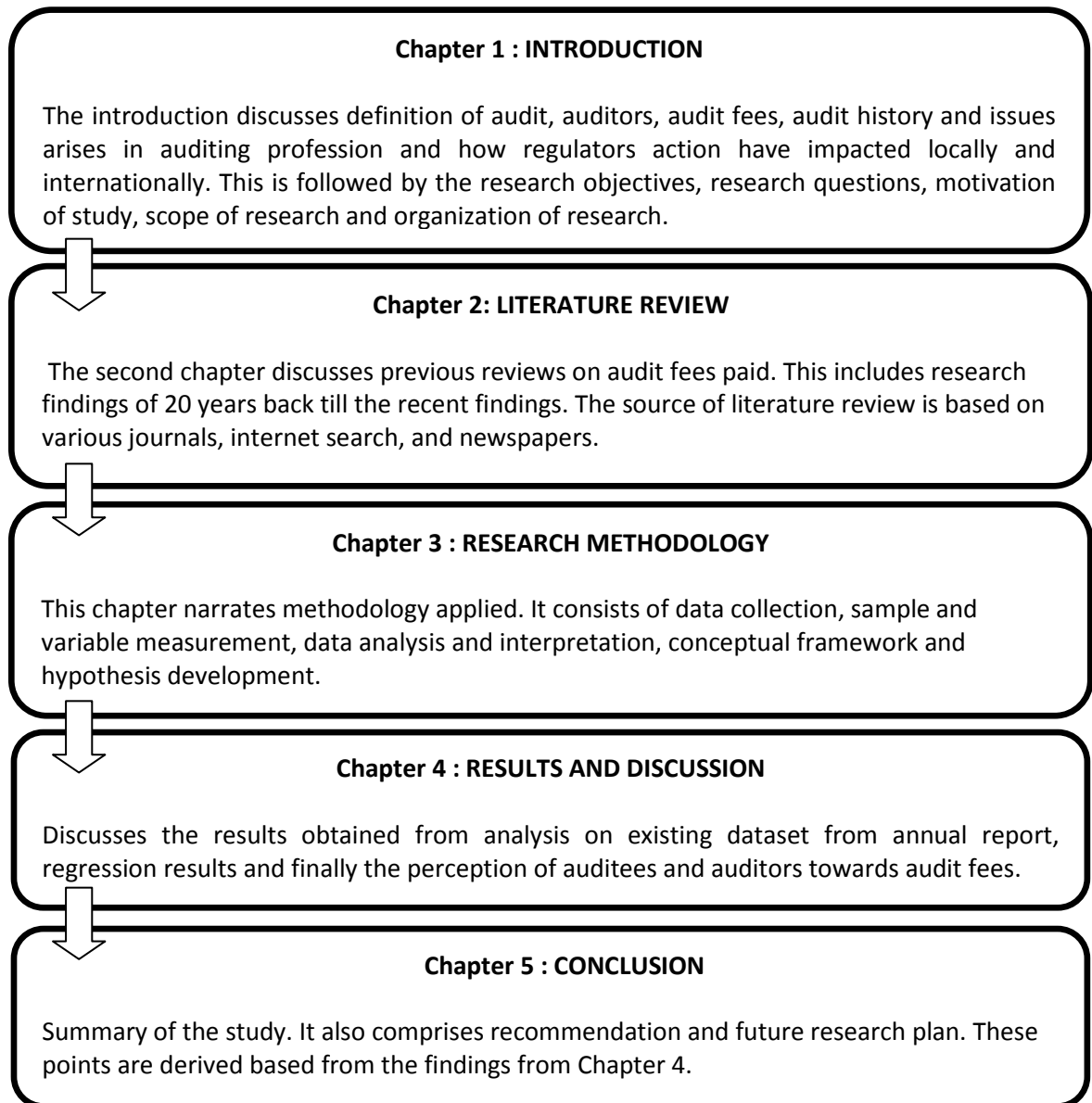
Table 5 exhibit the expected results of this study;

**Table 5 : Scope of research and expected results**

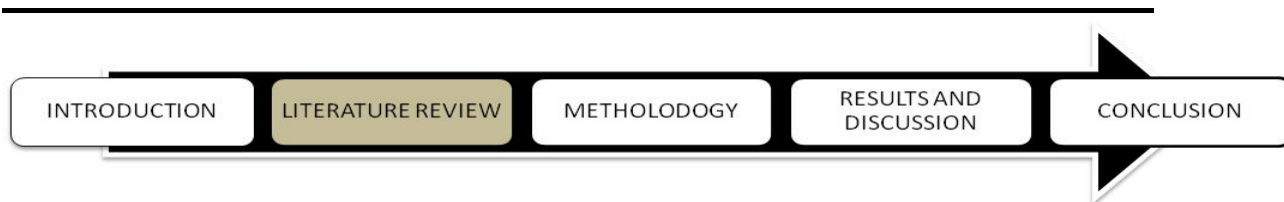
<b>No</b>	<b>Variables / Scope of research</b>	<b>Expected results</b>
1	Total Assets	Positive
2	Number of subsidiaries	Positive
3	Leverage	Positive
4	The ratio inventory and receivables over total assets	Positive
5	Opinion	Positive
6	Auditor's size (If Big 4)	Positive
7	Non Audit Services	Negative

## 1.6 ORGANIZATION OF THE RESEARCH

With the aim to provide a flow and continuation in the presentation, the chapters in this report are organized as follows;



## 2 LITERATURE REVIEW



### INTRODUCTION

The purpose of this chapter is to provide a general overview on various relevant literatures that explains the determinants of audit fees paid. The first part of this chapter gives a brief description of past and current work of researchers on examining the factors influence audit fees and next it focuses on audit fees in different context such as Kuwait, Jordan, Greece, Ireland, Australia, China and Malaysia through empirical studies.

### PRIOR STUDY ON FACTOR INFLUENCING AUDIT FEES

#### 2.1 AUDITEES SIZE



According to prior research, it was found that the first researcher on audit pricing was Simunic (1980) in US. His research has been the main underpinning studies for most of the future researchers on audit pricing determinants. He has argued on the main variables such as auditees size, auditees complexity and auditees risk which became main contributor to audit fee charged. Simunic's seminal study model explains audit fee as a cost of company. This cost consists of audit engagement cost, cost of internal controls



and expected losses derived from defects of audited financial statements. Therefore, auditor sets a fee which is equivalent to the incremental expected total costs.

As auditee size expands, level of audit fee charge increased. The rationale argument was, when the size increases, assuming all other things are being constant, auditors have to devote more hours to conduct substantive test to assure adequate compliance and which translate into higher audit fees. Researchers have found a positive relationship between audit fees and auditees size (Simunic, 1984; Francis and Stokes, 1986; Palmrose, 1986; Taylor and Baker, 1981; Craswell and Francis, 1999). However, some authors found an inverse relationship between audit fees and auditees size in a competitive market. This is supported by Gerrard et al., (1994) who argued auditors will lessen the amount of audit work performed to maximize its economies of scale in a competitive market by charge higher fees.

Swanson (2008) measure auditees size using sales revenue. The sample was based on the revenue earned in the fiscal year 2006. He has reported that increased revenue will increase volume of transactions. Thus, amount of audit testing and effort will increase and build up cost of audit. This was also supported by few other researchers namely, Palmrose, 1986; and Pong and Whittington, 1994; and Che Ahmad and Derashid, 1996. Based on the prior literature review, total assets or total revenue are used as a proxy for auditees size (Simunic, 1980; Hay et al., 2006).

## 2.2 AUDITEES COMPLEXITY

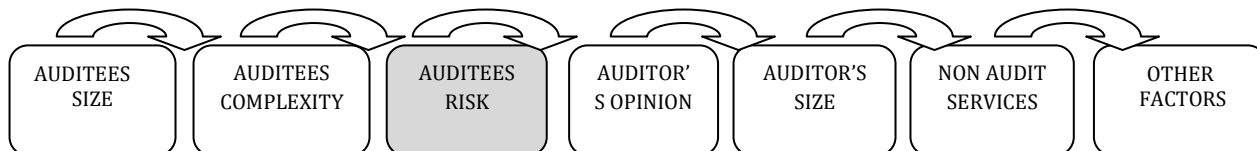


Generally, auditees complexity refers to difficulties experience by external auditors in auditing process. Companies with poor reporting discipline, for example, omission of data needed to complete the process, or lack of standardized systems, creates a need for external auditors services to offer their recommendation to fixed the problems. The amount of audit efforts expended can be expected to increase with the increased complexity of the audit task which in turn would lead to increased audit fees. Besides auditees size, prior research would also suggest audit fees positively and significantly related to auditees complexity. The greater the complexity of auditees transactions, the greater the complexity of audit functions would be, so does the audit fees. This is due to more hours spent by auditors to execute the audit function (Taylor and Baker, 1981). Auditees level of complexity can be assessed by examining organizational charts, for example by studying diversity of products, number of transactions and number of subsidiaries within the country of operation and overseas (Gerrard et al., 1994).

Sori and Mohammad (2007) argued that audit work tend to be more complex when it involves foreign subsidiaries. Generally, the requirements to comply with various rules and regulations imposed by home country complicates the audit procedure which potentially affect audit hours and audit fees. This is factual because complex audit is expected for more diverse organizational structure which harder to review. This argument

was similar with Bamber and Schoderbek, (1993) who argued size and complexity of auditee has a positive impact on the auditing fees. The complexity of the auditing process increases the level of auditor effort, thereby raising the auditing fee.

### 2.3 AUDITEES RISK



Many prior studies on auditing business are exposed to risk of an uncertain rate of returns. Consequently, auditees risk has become one of the audit fee determinations (Simunic and Stein, 1987). As to support this argument Menon and Williams (2001) have argued that a litigation risk is often included in the audit pricing models. As for this study, two types of risk measures are used in the audit pricing models, those are leverage and sum of receivables and inventory.

#### **The ratio of receivables and Inventory over total assets**

Auditors recognize inventories and receivables as huge coverage of risk and loss exposure. The valuation of these items requires a forecast of future events and an analysis of auditees' management (Simon and Taylor, 1997). Fees will increase depending on the risk exposed by auditors. Based on study carried out by O'Sullivan (1999), the author used the proportion on receivables and inventory over total assets to measure risk of a company. The reason for this is because, more receivables and inventory a company holds; the more risky it will become due to bad debt occurrences and inventory written

off. Since these are risk areas which need more concentration, more test will be performed which lead to higher fee. Besides Sullivan, others like Firth (1997), Kamran and Goyal (2005) used the same ratio to test the impact on audit fees.

### **Leverage**

Leverage (long term debt excludes deferred tax/ total equity) is used as a proxy to measure risk because high level of leverage increases contracting costs between the company and lenders. If a company has been aggressively finance its growth with its debt, the risk of financial distress and bankruptcy increases. In relation to this, auditors have to investigate in depth to identify omission or mistakes within the accounting systems. More time used to minimize auditors own risk from being sued for negligence or lack of professionalism. This develops the fees.

Francis and Stokes (1986) found a significant relationship between audit fees and debt ratio. The lower the reliance on company's debt, the less the company risk is. On the contrary, Che Ahmad et al., (2006) found an inverse relationship between leverage and audit fees. The impact of a company exposed to higher leverage resulted in extensive debt repayment and high interest payout. Therefore, leverage is the most suitable proxy of a company risk. Che Ahmad et al., (2006) further explain that the negative relationship was due to Malaysian local business environment which likely is supported by the government, and therefore leverage excludes from audit pricing.

## 2.4 AUDITOR'S OPINION



Defond et al. (2002), argue that the final output of an audit process is an Audit report; it is also known as an external statement that concludes opinion during the course of audit. In that case, audit opinion may classified into two types; unqualified or clean report and modified reports, as mentioned in the International Standard on Auditing (ISA) 700 by the IAASB (2004).

### *(1) Emphasis of matter or unqualified opinion with explanatory language*

Auditors modify the auditor's report when there is a substance matter arising from a going concern. They emphasize of matter paragraph after the opinion paragraph to draw attention to matters affecting the financial statements and the addition does not affect the auditor's opinion. In other words, clean opinion still remains unchanged.

### *(2) Qualified opinion.*

Auditors express a qualified opinion when they disagree with management on the application of accounting.

The judgment on what type of audit report is to deliver to auditees is subject to a considerable amount of professional opinion on audited accounts and negotiation with the auditees, so, auditor's opinion affects audit fees in two ways; first, auditees may request auditors to issue unqualified or clean auditor's opinion as the stakeholders will be unaware of any problems or unsolved issues in the operations and the same time show a good performance. This will turn into an expensive audit . Secondly, qualifying a

financial reporting will expose auditors to face any litigation issues thereafter by auditee collapse (Ettredge and Greenberg, 1990). Therefore, auditors take up extra audit task to support their qualified opinion. The cost of extra hours and test taken will be shifted back to auditee in high audit fee. Palmrose too agreed that qualifications require greater evidence to achieve the auditor's desired level of assurance.

Pornupatham (2009) examines audit fees and auditor's opinion of 1,409 listed companies in Thailand from year 2004 to year 2008. Interestingly, the research results show that firms with unqualified or clean auditor's opinion have lower audit fee than those with modified auditor's opinion. Generally, the results obtained from various researchers are mixed. DeFond et al., (2002) found no relationship between going concern opinions and audit fees. Similarly, Raghunandan et al. (2003) discover no relation between total fees and audit opinion. On the other hand, Geiger and Rama (2003) found positive association between the audit fees and the going-concern modified audit opinion for stressed companies. This is consistent with prior research that modified audit opinions require additional audit work and lead to higher audit fees (Bell et al. 2001; Palmrose, 1986; Francis and Simon, 1987; Simunic, 1980).

## 2.5 AUDITOR'S SIZE



The world's Biggest auditing firms are Deloitte and Touche, Ernst & Young, KPMG, and Pricewaterhouse Coopers. They are highly likely to deliver more attention to confirm the

accuracy and reliability of auditees accounts as compared to non Big 4. These firms own their offices in most Big cities in the world. Alternatively, these firms have affiliated or linkage with local Big audit firms when it is not economically feasible to establish a branch office, for example, in Bangladesh (Ahmed & Hossain, 2000). Somehow, a Big 4 always associates with high quality of audit and became a label of trust among the auditees. A research in UK by Chan et al., (1993) evidenced Big 5 firms use greater proficiency, skills, and superiority in commanding higher audit fees. Big 4 audit opinion serves as an effective label quality; whereas the non-Big 4 firms are claim to be inexperience in dealing with large accounts due to their limited expertise, geographic pressure, and etc (Frieswick, 2003).

In contrast to Chan's finding, Weber and Willenborg (2003) examine the opinions of Big 4 auditors are often a reliable source for making investment decisions. Their finding concluded that Big 4 audit firms issue going-concern modified audit reports more frequent than non-Big 4 firms. In such cases, the quality and fees paid to auditors are being questioned whether auditors' compromise their independency. Simunic and Stein (1996) found Big 6 charge higher fees due to greater amount of risk involved during the course of audit. More wealth at risk associate to more effort at auditors end to ensure a sound audit services. That, in turn, increases audit fees.

Another possible reason Big 4 charged higher audit fee is because they want maintain a certain level of reputation capital and the professional competence and independence, both in perception and in reality (DeAngelo, 1981 and Watkins et al., 2004). Another implication of high fee charged by the Big 4 auditors are companies that tend to appoint a

non-Big 4 as their auditor. Warren (1980) found that smaller companies in US prefer to be audited by non-Big 4 auditors not only for the reason of cost saving, but it is a lot easier for them to change auditors if they received qualified audit report. Moreover, according to Dye (1993) large auditors tend have 'deeper pockets' than small ones, therefore, they are accountable to disclose problems due to greater risk exposure. This factor has positive connection with audit fees paid.

## 2.6 NON AUDIT SERVICES FEES (NAS)



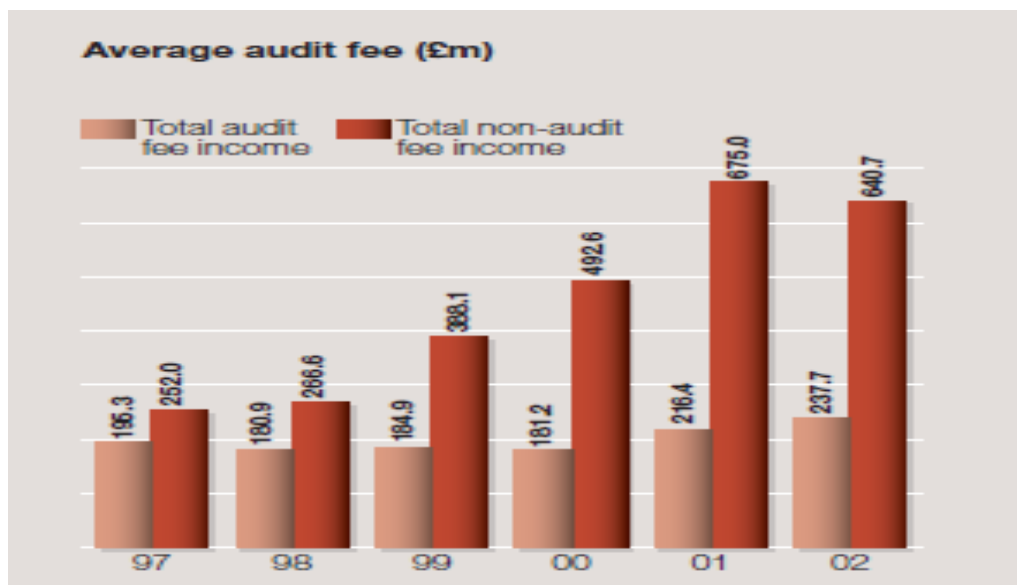
Non audit fees (NAS) refers to fees paid to auditor that are not considered as an audit. Such payment is for services rendered neither to improve financial statement, nor to the review services that are customary under generally accepted auditing standards (GAAS). NAS fees may comprise payment for consultancy, tax assistance, SEC filing services, and mergers and acquisitions support, and others (<http://www.sec.gov/info/accountants/audindep/audinfaq.htm>). In general, NAS is acquire to increase the operations' transparency. Despite the potential objectivity to increase the effectiveness, it is claimed NAS impair auditors' independence (Firth, 2002). Due to the fact, the Securities and Exchange Commission (SEC) outlines of the new rule that prohibit auditors from providing certain NAS and require auditor fee disclosure. In addition, SEC further argues that acquiring non audit services may deteriorate auditor independence (Dhaliwal et al., 2008). In the line to this a lot of



dispute about the role of auditors in the NAS has arise at the time of post-Enron's collapse.

Figure 2 exhibits 100 companies in The Financial Times Stock Exchange, FTSE, which acquire NAS in year 2001-02 financial periods. The movement of audit fees and NAS on the way up, reveals more extra services are being purchased from audit firms to increase the transparency of financial reporting. This also evidence many companies are concern on the fees than ever before to ensure auditors independence.

**Figure 2 : Relation between Audit fee and Non Audit Services Fee (NAS)**



(Source : Andrew Sawers, Financial Director, Jan 2003)

Study by Firth (2002) has been proven that in United Kigdom, NAS has been a catchy services offered by the auditors over past years. This is supported by Sterling rise since 1997 from 226m to Streling 636m, at the same time ordinary audit remuneration has gone up from Streling 186m to Streling 212m (Cliff, 2002). This trends confirms that the auditees were purchasing NAS at an increasing rate along with audit service. This has

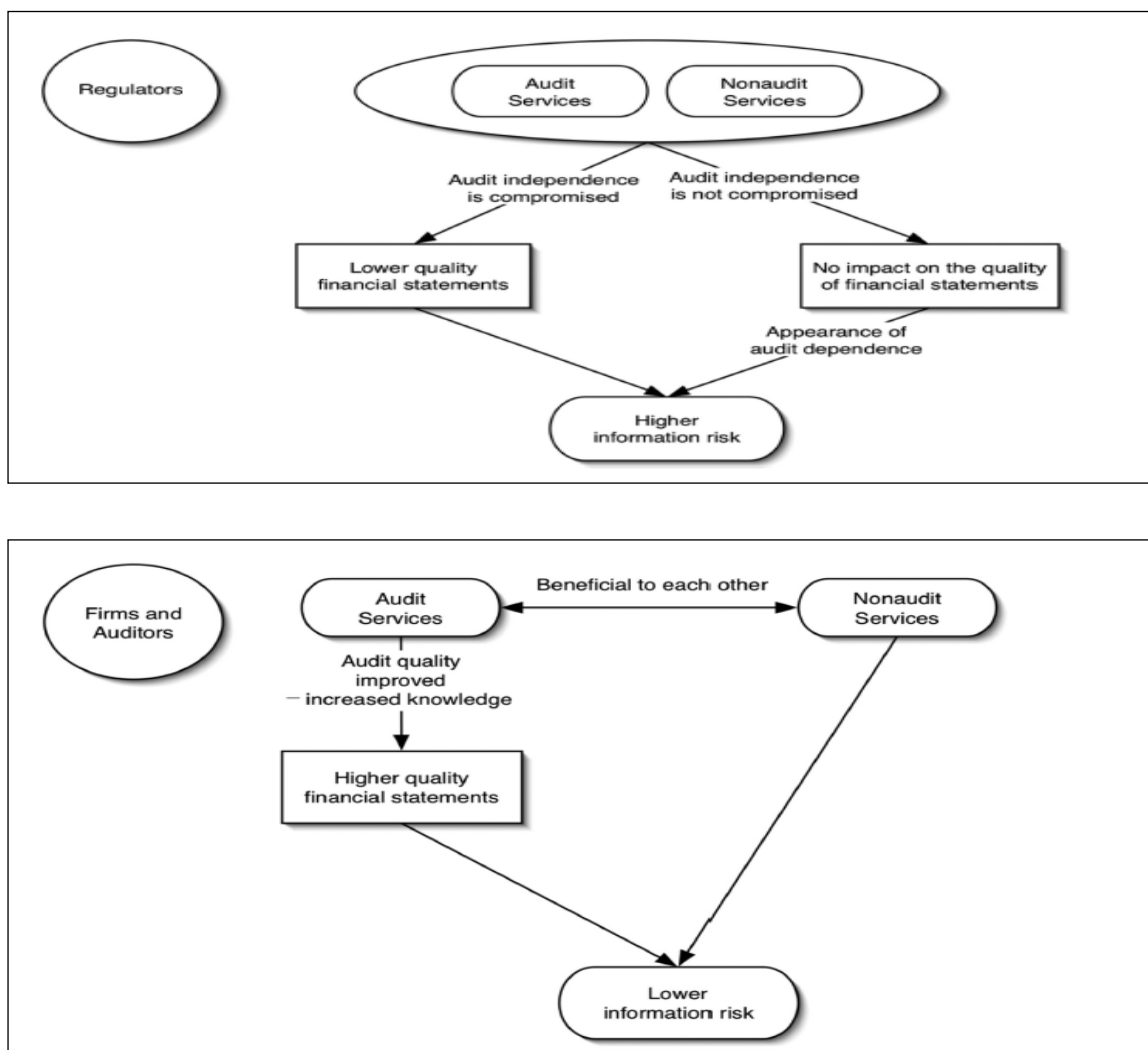
revealed that while the NAS increased, the audit fees also marginally increased. Therefore, a positive relationship between audit fees and non-audit fees would be seen. Conversely, Simunic (1984) argued a negative relationship exists due to exchange between audit fee and NAS. This is known as knowledge spillover effects where it flows from non-audit to the statutory audit side and vice versa. Krishnan and Yu (2011) concluded that non audit services; tax services fees found 1 percent increase in audit fees is associated with a 0.33 percent decrease in non-audit fees.

DeFond et al., (2002) found no relation between NAS and going concern audit opinions. However, Frankel et.al., (2002) found NAS to be positively associated by a very small margin and on the other hand, Chung and Kallapur (2003) failed to find any evidence on NAS. Another explanation of this negative relationship is that when auditing firms offer a variety of financial and non financial planning to auditees, in some situation NAS became more costly than audit work in dollar volume. By acquiring consultancy work, auditees view audit as “loss leader”. These factors have tendency to perform audit task in shorter period which reduces the statutory audit fees. Subsequently, audit firms increase the NAS fees to capture the loss incurred in audit fee (Clatworthy et al., 2002). Likewise, studies that only found a negative relationship between audit fees and NAS fees were those Mellett and Peel (2002) and Fields et al., (2004). Clatworthy et al., (2002) investigated public sector organizations in the United Kingdom while Fields et al., (2004) examined banks in the United States.

As explained in Chapter One, post-SOX have primarily distorted the strength and weakness of both audit and non-audit services that can be rendered to audit clients.

Therefore, the empirical evidence from many researchers remains elusive and mixed. This mixed result is best explained in Table 3.

**Table 6: Two different views on the impact of non audit services on the ality of financial statements and capital markets**



(Source : Seunghan, N. and Joshua, R., 2011).

According to Koh et al., (1998), Malaysian Standard Board has set up rules and regulation to improve the audit system in Malaysia. Therefore, he also added to have full disclosure of statutory and non statutory audit fees to be assessed. He refers to

Companies Act 1965 subparagraph 1(q) of the 9<sup>th</sup> requirements in respect of disclosures in profit and loss accounts, should be extended to include disclosure of fees paid in respect of non-audit work.

## 2.7 OTHER FACTORS



### 2.7.1 Litigation risk

Simunic and Stein (1996) find an overview of the economics and consequences of litigation risk pricing on audits. The economic considerations contained in audit pricing are described as follows:

In a competitive market, fees will equal the economic costs including a normal profit incurred by efficient suppliers of the various service qualities. When considering auditors' costs, two issues need to be considered: the client specific nature of audit costs, and the fact that total audit costs include a resource cost and an expected liability loss component. (pp. 121)

To maintain a good reputation in auditing profession, auditors will try to avoid any litigation issues such as case of bankruptcy. Therefore, auditors will increase their effort to detect irregular transactions or compliance with a high probability of bankruptcy. As a consequence, the auditors convert the effort used to assess the risk into the pricing of audit fees. As to support this statement, when a foreign company publicly sells its securities in the US, auditors are liable under the US securities laws. Litigation risk drives the auditors to;

- (a) take up measures by increasing their efforts to secure the possibility of future litigation (Simunic, 1980; Simunic and Stein, 1996); and/or

(b) Charge a premium to cover possible future litigation losses (Pratt and Stice, 1994; Gramling et al., 1998). In any two scenarios above, the auditor fee should increase.

In addition, Setharaman et al., (2002) and Nikkinen and Sahlstrom (2005) reported that litigation risks influence the degree of audit fees very much depends on country of litigation environment that an auditor operates. They conclude that more litigious situation lead to higher audit fee. Their results in general tie with the theory underlying Simunic (1980) and Simunic and Stein (1996) which audit fees reflect risk differences across legal responsibility regimes.

Another influential study was carried out by Pratt and Stice, (1994) where he explains auditees financial position is the main element to measure on litigation risk, the face of balance sheet provides reliable information for auditors' plan and fees as well. The weaker the financial position, the higher the degree of litigation risk, seeking for more evidence, and ended in higher audit fees.

### **2.7.2 Internal Audit Committee**

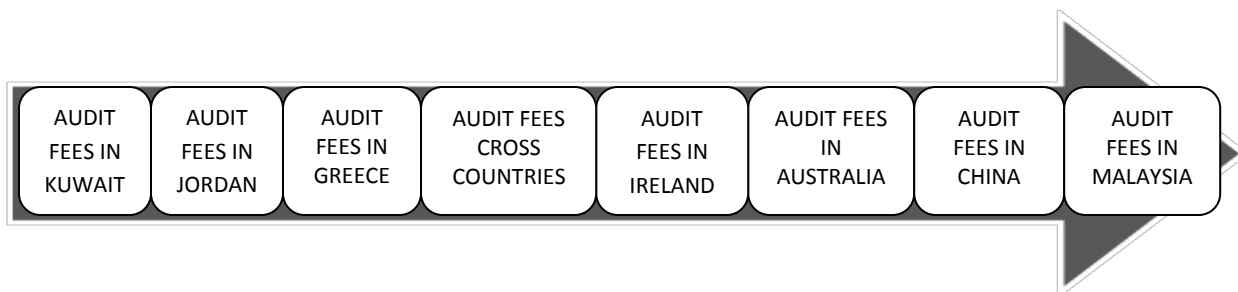
Some researchers argue that reliance on internal auditor's work may reduce audit fees. The reduction caused by a lower measurement of audit risk consequential from internal audit contribution in firming the internal control (Felix, 2001), but some researchers urge both, Internal and External auditors are complementary, with an increase in both when greater monitoring is required (Hay and Knechel, 2002). Results obtained have been mixed but it supports a positive relationship with audit fees.

Sharma (2003) concluded from the sample of top 500 listed companies in Australia, that a positive relation is found between audit fees and audit committee. This is followed by Coulton et al., (2001) who have similar opinion with Sharma. Coulton's sample derived to this statement using a sample of 61 industrial companies listed on the ASX in 1998.

Followed by Monroe et al., (1994) he found differences in quality of financial reporting within companies with Internal Audit Committee and those without audit committees. He argued higher quality of financial reporting can be produced with the presence of Internal Auditor, and this give rise to a lower assessment of audit risk and hence lower sample size and hence reduce statutory audit fees.

In addition, Kaplan (1985) argued that improved internal controls should result in fewer audit hours and lesser audit fee charged. Reason being, if the internal audit committee performs its function properly towards making sure that internal controls are in order, this should lead to a more effective system and eventually resulting in lower audit fees. This is also supported by Palmrose (1986) who argues that auditor's task can be reduced by the reliance of information provided by audit committee such as increase in internal audit functions and increase maintenance of internal control.

### **AUDIT FEES IN DIFFERENT CONTEXT**



**Kuwait**

The sample of research was picked from 49 audit appointments in Year 2005. A survey has been conducted in Kuwait by Meshari (2008) and the finding is consistent with other researches that audit fees in Kuwait is positively related to the auditees size. Auditees size was measured using total assets in this study. Furthermore, the finding also shows audit fees are positively related to the profitability of auditees. The results, however, did not offer significant relation between external audit fees debt-to-equity ratio, and the audit firm size. This is due to the fact that the audit services in Kuwait may be dissimilar than more developed countries. Waresul Karim and Moizer (1996) suggest that some findings obtained in Western countries need not be applicable in a less-developed country context.

**Jordan**

Naser et al., (2007) had drawn his sample from Amman Stock Exchange (ASE) and the directory of ASE for the year 2000/2001. Auditee size is measured by number of employees and this variable turns out to be the strongest variable to determine level of audit fee charged. These results are consistent with other researchers like Chan et al., (1993) and Joshi and Al-Bastaki (2000). Al-Bastaki developed a fee model for 38 companies listed on the Bahrain Stock Exchange. Moreover, audit fee and auditor's size are found to have positive relationship. In Jordan, audit fees classified into national and national affiliated firms. Medium size audit firms which have affiliated to Big 4, charge higher than the local ones. This finding is consistent with Craswell and Francis (1999).

In addition, complexity is found to have positive relationship with audit fees, however, industry type, level of gearing, corporate year end and time lag between yearend appear to be insignificant to determinants of audit fees. The author studies the determinants of audit fee in a year after the Jordan companies started to disclose their fee, so this study would be inappropriate as it doesn't provide a clear picture.

### **Greece**

A sample of 145 companies was drawn from a population of 342 companies that were listed on the ASE as of December 2000. This study suggests that audit fees are positively influenced by auditee size, the number of hours spent by auditors, appointment of Big-5 and auditees financial position. On the other hand, it negatively influence by change in auditor and profitability of auditee. Furthermore, the Ansah and Leventis (2010) found no evidence to support public issuance shares in the variations of audit pricing in Greece.

### **Cross-Countries**

Chung and Narasimhan (2002) quoted Haskins and Williams (1988) in their paper. Haskins and Williams examined companies audited by Big 6 from five countries: Australia, New Zealand, Ireland, the UK, and the US and they have found that the pricing of audit services did not differ substantially across the five countries.

### **Ireland**

Simon and Taylor (2002) studied the factors influencing audit fees in a sample of 377 observations on 75 different Irish auditee during the years 1990-1999. Data were collected annual reports which were listed in Moody's International Manual or found in the Global Vantage database. The results exhibit that the auditee size, auditee risk, and



audit complexity important in explaining audit fees. Their finding is also proof that auditor size has an impact on the audit fees paid.

### **Australia**

Samples were drawn from 1995-1999 audit engagements in Australia for the years 1995 to 1999. As expected from previous research, audit fees shown positive direction towards client size, client complexity (square root of the number of subsidiaries and the number of foreign subsidiaries) and risk measured by quick ratio, current assets to total assets and leverage (Carson and Fargher, 2007). The data suggests that smaller clients purchase a relatively smaller proportion of non-audit services relative to audit fees. The finding has failed to find evidence of discounting audit fees to obtain non-audit service fees.

### **China**

Sample of this paper are listed companies in Shanghai and Shenzhen Securities. Financial firms are excluded in the study due to its nature of financial reporting. With the 1426 observations collected from China Stock Market Accounting Research (CSMAR) over the year 2009, it is interesting to note that audit fees are not significantly associated with auditee risk. Nevertheless, audit fees are not significantly associated with audit opinion or net profit. This result indicates that contingency fees do not exist in Chinese audit market (Xiaobo, 2011).

Similarly, Zhang Jixun (2005) conclude that the ratio of inventory in total asset was not related to audit fees meanwhile the study of Liu Bin (2003) urge that audit opinion, proxy of an audit risk was not related with audit fees. This exhibits that audit fees

influence by client size and takes little account of audit risks. In addition, Xin and Xiaobo (2011) stated larger audit firm lead to higher fees. These findings supports previous research finding by Choi et al., (2008).

### **Malaysia**

Che Ahmad et al.,(2006) found variables like auditee size, auditee complexity significantly related to audit fees, unlike audit risk (as measured by proportion of assets represent by inventory and receivables) and types of auditor (Big 5 vs non-Big 5).

Simon et al.,(1992) found a Big 6 in Hong Kong enjoys a fee premium, however Singapore found weak evidence, while no evidence in Malaysia. They concluded that the Malaysian market did not have the need for quality-differentiated audits mainly because the regulatory environment in Malaysia permitted little involvement by international investors in the operation of companies and most of the companies in Malaysia were family-owned and controlled even after going public.

Moreover, an empirical study investigated by Nessi (2003) pointed out some developed countries counted risk cost in audit fees. Based on this finding, companies such as in Denmark, Hong Kong, Malaysia, Norway, Singapore, South Africa, and the United Kingdom, the performance of the model seems to differ across countries, which may indicate that the risk is not taken into account when pricing auditing service.

Another result based in Malaysia by Hariri et al., (2007) shows Price Water House Coopers fees is not as high as it is used to be and the firm operates at lower cost by maintaining its efficiency. However, risk influence the audit fees charged, due to

auditors' exposure on greater responsibility auditing long term debt ratio. Similarly, Che Ahmad et al.,(2006) found no statistically significant relationships between non-audit fees and audit fees. His finding derived from the entire population of Public Listed Companies of Main Board, Second Board and Mesdaq, which totaled to 819 companies. Data are from 2002 annual reports.

## **SUMMARY**

This chapter identified all the likely factors affecting the level of audit fees paid by companies to their auditor through a prior study. Firstly, these factors were classified into size, complexity, risk, opinion, auditor's size and non audit services. The relative importance of these factors was determined empirically and statistically.

The data for the statistical analysis was obtained from published data Companies' Annual Reports. In carrying out the statistical analysis, Multiple Regression were used to assess the magnitude of the association between the factors and audit fees. The results of most authors revealed that the auditees size (in terms of auditee size), auditees complexity (in terms of number of subsidiaries, and number of countries in which the company operates), auditees risk (in terms of leverage, ratio of receivables and inventories), auditor's opinion (qualified or unqualified), auditor's size (Big 4 or non Big 4) and non audit services (in terms of dollar and value acquired by a company. The empirical study also revealed that the size of company, its complexity of transactions, the quality of the company's internal control system, competition in the audit market, and the risk involved in the audit work are the major subjective determinants of audit fees. In addition, the

statistical analysis revealed that the factors receivables, number of subsidiaries, and total employment costs are the most significant predictors of audit fees too.

In summary, audit efforts and audit hours are fully capture audit fees. A positive explanation is that if auditing function gets complicated and requires more evidence and hours then it will increase the fees paid. However, the results obtained from various researcher confirmed that different nation or country have different factors influencing audit pricing structure. In addition, despite the stated concerns of regulators, it is not clear that auditors would respond to fee pressure by reducing audit effort or to maintain or increase audit effort when faced with increased engagement risk.