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Articles

Audit fee pressure and audit risk: evidence from the financial crisis of 2008*

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Abstra

This pap g crisis affects t rst, audit fees dro s respond different on audit fees. client is unde vide useful insights audit fees.

Keywords

Audit fee

Notes

* Accepted by Hong Hwang. We have received helpful comments from seminar participants at Seoul National University and the Korean Accounting Association's annual conference. All remaining errors and omissions are our own.

1. See Reason (2010) for audit-firm level statistics on audit fee changes in year 2008 and various anecdotal evidences on the downward audit fee pressure exerted to auditors. According to the statistics reported in Reason (2010), audit fee dropped by an average 5–8% in 2008.

2. Given that crisis is an exogenous shock which affects all firms, the reduced audit fees may not unilaterally lead to reduced audit effort. It is possible that, despite the reduced audit fees, auditors may still exert adequate audit effort to maintain reputation and more effectively allocate resources during crisis for a subset of firms.

3. Watts and Zuo (2011) explain that the financial crisis is an exogenous shock that is not related to most individual firms. However, we acknowledge that it may be related to country-level economic situation, which may affect firm performance.

4. For example, in year 2008 alone, audit fee dropped by an average of 11.4, 11.2, 3.3, and 9.0% G, respecti

5. The fi the Korean won fell price index also coll ean economy experienced a similar downward trend

6. Consi f identified deficien n report.

7. In a si onically as the cour lit risk in each cou

8. Prior studies show the positive relation between audit fee and audit effort, which may not hold true in crisis case. Since crisis affects all firms to reduce expenses, including audit fees, auditors may have incentives to exert adequate audit effort despite the reduced audit fees because of the potential idle audit hours.

9. Another possibility is that auditors absorb the fee pressure by reducing engagement profitability. However, such reasoning is based on a conjecture as Beck and Mauldin (2014) explain that it is not likely to be a widespread phenomenon.

10. It is documented that large clients pay greater audit fees and purchase more non-audit services from auditors (e.g. Ashbaugh, LaFond, and Mayhew 2003; DeFond, Raghunandan, and Subramanyam 2002; Frankel, Johnson, and Nelson 2002).

11. The determinants of audit fees can be broadly summarized as the following three factors: size, complexity, and audit risk of the firm (Choi et al. 2008; Simunic 1984). In H1, we include only firm size and audit risk. We do not include complexity in the hypothesis because we are not able to delineate the effect of downward fee pressure on the coefficients on the variables related to complexity. It is possible that auditors may charge higher fees for clients with more complex operations due to the increased audit hours required to obtain a certain level of confidence in the riskier period. However, it is also possible that auditors absorb the increased level of effort related to complex
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E is 1.318.

Thus, a one-standard deviation increase in SIZE is computed as 0.361 × 1.318 = 0.476. The marginal effect of a one-standard deviation increase in SIZE on audit fees during pre-crisis is estimated as exp(11.285 + 0.476) – exp(11.285) = US$ 128,130 – 79,619 = US$ 48,511. In a similar way, the marginal effect of a one-standard deviation increase in SIZE on audit fees during crisis period is estimated as exp(11.340 + 0.440) – exp(11.340) = US$ 130,669 - 84,120 = US$ 46,549. Thus, there is a US$ 48,511 - US$ 46,549 = US$ 1962 difference in the effect of SIZE on audit fees between pre-crisis and crisis period.

15. Other coefficients do not show any significant differences between the pre-crisis period and the crisis period with the exception of LIQ. However, we do not provide additional explanation on the significance of the coefficient on LIQ because subsequent analyses show that the change of coefficient on LIQ is not significant.

16. We additionally assess the statistical difference in the regression coefficients between the two periods using the Wald test. Following the methodology used in Haw, Lee, and Lee (2014), we employ a seemingly unrelated regression system combining the two periods. The (untabulated) results suggest that the differences in the coefficient on SIZE, ZSCORE, and NONCL between the two periods are statistically significant.

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18. Whil and good-performi formance, lending

19. Asse seemingly unrel efficient on SIZE 0.01 and at p < 0.01 cients on ZSCORE

20. Whil esults upon request.

21. We a onstraints. When we run Equation (1) using each subsample, the coefficient on CRISIS is −0.021

and is statistically significant at $p < 0.10$ for firms with financial constraints, while it is insignificant for firms without financial constraints. That is, the general level of audit fees is lower during the crisis period than the pre-crisis period only for firms with financial constraints.

22. During the crisis period in Korea, the government temporarily allowed firms to adopt the asset revaluation model as a way out of crisis (Kim and Kim and Kim 2012). In the revaluation model, an asset is initially recorded at cost but subsequently its carrying amount is increased (or decreased) to account for any changes in the market value. The revaluation model enabled many firms to write up their fixed assets to reflect the increased market value. However, even though the carrying amount is increased to the market value through asset revaluation, the intrinsic value of the asset remains the same. Thus, for such cases, measuring firm size using total asset may not be a proper representation. To avoid the confounding effect of asset revaluation on the changes in audit fees, we measure firm size using total sales instead of total assets and find that our previous results remain unchanged when measuring size with total sales.