



## **Audit fee and auditor independence**

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### **ABSTRACT**

The growing number of corporate scandals continue to raise countless questions on auditors' independence. Therefore, this paper seeks to examine the impact of audit fees on auditors' independence. The study employs logistic regression model on a sample of 295 unlisted Kenyan firms between 2011 and 2018. The findings indicate that high audit fee increases the probability of auditors' independence. In addition, we find evidence that the provision of non-audit service lowers the likelihood of auditors' independence. The findings have managerial and policy implications.

**Keywords:** *Audit fee, auditor independence, unlisted firms*

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## **1. Introduction**

Auditor independence promotes public confidence in financial reports and safeguards the status of the auditing profession. Independence in auditing entails taking an unbiased viewpoint in the performance of audit tests, the evaluations of the results and the issuance of audit reports (Arens, Loebbecke, Takiah, Susela, & Shaari, 1999). It has been argued in literature that auditor independence has a significant impact on the credibility of accounting information. Besides, accounting information is central to the effective functioning of firms since it influences managerial decisions such as financing, mergers and acquisitions and earnings managements (McNichols, & Stubben, 2015; Sun, Zhao, He, & Zhang, 2019). Furthermore, auditor's independence is considered a key attribute of external auditors (Hay, Knechel, & Wong, 2006). Similarly, the growing number of corporate scandals continue to raise countless questions on auditors' independence and the role of the audit practitioners in alerting investors, employees, suppliers, customers and the general public to the realities of corporate wrongdoing and weakness (Cooper & Neu, 2006; Octavia, & Widodo, 2015). Thus, auditor independence has not gone unnoticed in the groves of academia and policy-makers in an effort to address the danger of financial scandals. What determines auditor's independence has been subject to extensive empirical scrutiny. Some of the factors cited in literature include audit fee (Ghosh, Kallapur, & Moon, 2009; Craswell, Stokes, & Laughton, 2002), partners tenure (Chen, Lin, & Lin, 2008), firm tenure (Garcia-Blandon & Argiles, 2015; Azizkhani, Daghani, & Shailer, 2018), firm size (Al-Thuneibat, Al Issa, & Baker, 2011), non-audit services (Ye, Carson, & Simnett, 2006), and audit firm rotation (Daniels, & Booker, 2011). Researchers have singled out audit fee is a key determinant of auditors' independence it not only reflects auditors' effort, but also reduces estimation errors; thus, improving auditors' independence (Suseno, 2013; Craswell *et al.*, 2002). Also, managers are more likely to influence auditors by including excessive rents in the audit fee (Srinidhi & Gul, 2007). In the same line of argument, research studies have shown that huge audit fee impairs auditor's independence as the auditors become complacent to oppose the client or get compromised by the abnormally high fee (Choi, Kim, & Zang, 2010). Despite the numerous studies seeking to explore the relationship between audit fee and auditor independence, empirical literature shows mixed findings. On one hand a stream of studies suggest a positive relationship between audit fee and auditor independence (Salau, Abdulmalik & Ahmad, 2016; Rahmina, & Agoes, 2014; Suseno, 2013), while on the other hand a some researchers posit a negative association (Salehi & Moradi, 2010; Hoitash, 2007; Malek & Saidin, 2013). Given the contradictory results this study contributes to the audit fee literature by providing additional evidence from a developing economy, since most of the previous studies focused on developed economies (Krauß, Pronobis, & Zülch, 2015; Choi *et al.*, 2010), which might shed more light on the audit fee-auditor independence association. To achieve the research objective, this paper is organized as follows: Section 1 presents the introduction. In section 2 shows the literature review of previous studies related to the present study. Section 3 sets up the research methodology while section 4 discusses the findings of the study. Section 5 contains the conclusions, limitations and suggestion for further research.

## **2. Literature review**

Audit fees are considered to be one of the crucial issues within the literature in recent years due to its correlation with auditor independence. It has been suggested that the auditor's independence is damaged when they 'lowball' by providing services to clients at a low fee. An early study by De Angelo (1981: p113) defined lowballing as "setting audit fees below total current costs on initial audit engagements".

Several studies have examined the extent audit fee influences auditor's independence, however the findings are largely contentious. Using a sample of 73 public accountant offices which are the members of the Indonesian Forum of Capital Market Accountants, a study by Suseno (2013)

investigated the influence of audit fees on auditor independence and found that audit fee had a positive and significant impact on auditors' independence. The two dimension of auditor's independence that the study considered were integrity and objectivity, while the amount of audit fee was further analysed based on the client's: size, complexity and risk. Considering a sample of 2,334 firm-year observations over the period 2005 -2010, Krauß *et al.*, (2015) found that abnormally high audit fees is negatively associated with audit quality (auditors' independence) in Germany. The study concluded that audit fee premium is a significant indicator of compromised auditor independence; due to the economic auditor-client bonding relationship. In the same line of research, Craswell *et al.*, (2002) examined whether fee dependence jeopardises auditor independence. The authors used the logistic regression estimation model and samples of 1062 and 1045 Australian companies and data for 1994 and 1996, respectively. The findings of the study suggest that the level of auditor fee dependence does not affect auditor propensity to issue unqualified audit opinions. A paper by Deis Jr and Giroux (1996) that sought to examine the relationship between auditor changes on audit fees, audit hours, and audit quality, and data from 232 working paper reviews -quality control reviews(QCRs) of public accounting firm audits of Texas ISDs which was obtained through an analysis of the Texas Education Agency (TEA) found that audits with high quality had higher fees and more audit effort. Additionally, the study reported that CAFR (comprehensive annual financial reports) engagements entail more audit effort which is reflected in both higher fees and additional audithours. Basioudis, Papakonstantinou and Geiger (2008), assessed the effect of audit fees, non-audit fees and auditor going-concern reporting decisions in the United Kingdom. A sample of 643 non-financial companies listed on the London Stock Exchange and data for the 2003 financial reporting year was used. The study found that audit service fees had a positive association with going concern modified opinions. Additionally, the study found that non-audit fee had a negative effect on going concern modified reporting decisions, which reinforce the necessity to examine both types of audit fees simultaneously when assessing the association of auditor fees and reporting decision. Salau *et al.*, (2016) investigated the relationship between audit fees, corporate governance mechanisms, and financial reporting quality in Nigeria. The study employed the Generalized Methods of Moment (GMM) as the regression estimation model. The authors used annual reports of 89 listed companies in the Nigerian Stock Exchange (NSE) for 2008 - 2013. The findings indicated that abnormal audit fees had a negative and significant relationship with earnings management, implying that the excessive fees charged by auditors improve financial reporting quality. The study concluded that the high fees charged by auditors reflect additional efforts expended during the audit process.

Conversely, a good number of studies show that audit fees have a negative impact on auditors' independence. Salehi and Moradi (2010) study examined the reaction of auditors, and shareholders regarding audit services and non-audit services provided by the auditors to the same clients in Iran. Qualitative data was collected from a sample of 1339 respondents using questionnaires. The study found that a large amount of audit fees had a negative effect on audit independence. Similarly, the findings indicated that provision of non-audit services by auditors to the same clients had a negative effect on audit independence.

Similarly, a paper of Hoitash(2007) which examined the relation between fees paid to auditors and audit quality, and used 13,860 firm-year observations during the period of 2000-2003. The author found a statistically significant negative association between total fees and both audit quality proxies' overall years. Malek and Saidin (2013) examined the association between audit services fee, non-audit services and the reliability of Earnings. The authors used a sample of 270 listed companies on the Bursa Malaysia in 2011, and ordinary least square (OLS) regression model. The study found that investors place lower reliability on earnings audited by highly paid auditors, since investors view high fees as a form of compensation to the auditors.

A paper by Meidawati and Assidiqi (2019) that sought to examine the relation between audit fees, auditor's competence, auditor's independence, auditor ethics, and time budget pressure on audit, the authors used a sample of 50 auditors of accounting firm at Semarang city, Indonesia, as the respondents. The findings of the study indicate that audit fee negatively affected audit quality, and independence had no effect on audit quality. Yet, some studies have reported that audit fee has no effect on auditors' independence. A study by Oladipupo and Monye-Emina (2016) that examined the effect of abnormal audit fees on audit quality in audit market in Nigeria using probit binary regression technique on 350 firm observations data; obtained from companies quoted on the Nigeria Stock Exchange, it was observed that both positive and negative abnormal audit fees had insignificant positive impacts on audit quality. This shows that abnormal audit fee Yanti and Wijaya (2020), assessed the effect of auditor switching, audit fees, audit tenure and company size on audit quality in food and beverage companies listed on the Indonesia Stock Exchange, and panel data for 2015-2018. The findings of the study show that audit fee had no effect on audit quality (auditors' independence). From the aforesaid, it evident that the effect of audit fees on auditors' independence is contentious and requires further scrutiny.

### **3. Methodology**

#### **Data and Sample**

The study targeted 3200 audited companies as per ICPAK database 2019. [www.icpak.com/cpa-members-directory](http://www.icpak.com/cpa-members-directory). With four sectors to be covered namely; professional service firms, medical and hospitality industries, agriculture and construction companies, the four sectors to be covered are generated from ICPAK database 2019, based on the table of the general scientific guideline for sample size decisions provided by Sekaran (1992). A stratified sampling approach was then used to derive the size of each stratum. A cross-sectional review of audit reports of a sample of audited companies in north rift region in Kenya as from (2011 to 2018) was undertaken. The study was conducted in Kenya, North Rift Region. North rift region in Kenya as per the instituted of certified public accountants of Kenya (ICPAK) comprises of the following counties; Uasin Gishu County, Nandi County, Trans Zoia County, Elgeyo Marekwet County and Turkana County).

#### **Definition and measurement of variables**

##### ***Dependent variable- Auditors independence***

Going concern opinion has been widely employed as a measure of auditor independence (Barnes, & Renart, 2013). The dependent variable is coded 1 when a going-concern uncertainty is disclosed in the audit report and 0 otherwise. Given this, we paid close attention to the nature of the explanatory paragraph. If the paragraph mentioned either going concern, or doubt regarding ability to continue, or if it was a going-concern disclaimer then the dependent variable takes value 1.

##### ***Independent variable – audit fee***

Audit fee is fees paid to a company's auditors, for auditing services offered to the company which is approved by the stockholders at an annual general meeting. Many scholars have measured audit fees has the audit fees received in that financial year over the total fees received in that particular year. To measure audit fee, the study employs the natural logarithm of actual fees paid to the auditors in a financial year (Wysocki, 2010; Wysocki, 2010; Boo, & Sharma, 2008).

##### ***Control variables***

The study incorporates several control variables, as suggest in empirical literature, to isolate the effect of audit fee on auditor independence. First, provision of non-audit service lowers the likelihood of a qualification. We control for non-audit service, which is the natural logarithm of the sum total of all non-audit fees paid to the incumbent auditor. Second, researchers have argued that managers may be motivated to opportunistically manipulate earnings using discretionary accruals choices to cover poor firm performance (Xu, Fernando, Tam, & Zhang, 2019). Also, studies have also reported that audit risk increases with poor firm performance (Xu, Dao, &

Petkevich, 2019). Therefore, the study controls for client’s firm performance as measure by the return on assets (ROA). Third, in line the fraud triangle theory, a firm’s lower liquidity conditions may motivate managers to engage in financial reporting fraud. Also, liquidity probability of bankruptcy (Hossain, 2013); thus, the study controls for client’s firm liquidity, which illustrate a company’s ability to meet its short-term obligations that are due soon (Handoko, Armand, Marpaung, & Yohana, 2019). Fourth, high financial leverage is an indicator of high financial risks, which increases the chance of qualification. Leverage is measured as the ratio of long-term debt to total assets (Craswell *et al.*, 2002). Fifth, client firm size affects the propensity of an auditor to be independent. Small clients are more likely to fail and face going concern problems, and this increases the likelihood of auditors qualifying small clients. On the other hand, the costs associated with litigation when a large client fails have the potential to condition auditors to be total assets (TA) variable is included in the model to control for the impact client size can have on the propensity to be independent. Small clients are more likely to fail and face going concern problems, which increases the possibility of auditors qualifying small clients. Conversely, the costs linked with litigation when a large client fails have the potential to force auditors to be conservative in their opinions, thus enhance their independence (Craswell *et al.*, 2002). The proxy for client firm size is the natural logarithm of total assets (Hossain, 2013).

**Econometric model**

We test our hypotheses by estimating the coefficients in the following logistic regression that models the relationship between audit fee and the likelihood of auditors’ independence (as measured by the going concern opinion). The regression model is shown below.

$$y_{it} = \alpha + \beta_1 x_{it} + \beta_2 Z_{it} + \varepsilon$$

Where;  $y_{it}$  = an indicator variable equal to 1 for firms with going concern audit opinions, and 0 otherwise;  $\alpha$  is the constant,  $\beta_1$  and  $\beta_2$  are beta coefficients,  $X_{it}$  is the predictor variable,  $Z_{it}$  denotes the control variables and  $\varepsilon$  is the idiosyncratic error term

**4. Findings and Discussions**

This section presents the findings of the study. Table I show the summary descriptive statistics. The mean auditors’ independence, measured by the presence or absence of the going concern opinion on the audited reports has a mean of 0.5 (standard deviation = 0.5 (minimum= 0.00 and maximum =1.00); this implies that on average 50% of the audited companies receive either a qualified or unqualified report. The mean audit fee, natural logarithm of audit fees, has a mean of 10.45 (standard deviation = 0.580, minimum= 8.788 and maximum = 12.326). Non audit fee mean is 10.191 (standard deviation =0.532, minimum= 8.537 and maximum =12.070. Client firm size had a mean of 15.3 (standard deviation = 0.99 minimum= 12.73 and maximum = 18.51). The mean client firm liquidity was 0.568 (standard deviation = 0.40, minimum= 0.03 and maximum = 2.17. The mean client firm leverage was 0.760 (standard deviation = 0.361, minimum= 0.017 and maximum = 2.31, finally the mean client firm profit was 0.022, (standard deviation = 0.035, minimum= 0.007 and maximum = 0.287).

**Table 1. Descriptive statistics**

Variable	Obs	Mean	Std. Dev.	Min	Max
AIN	960	0.500	0.500	0.000	1.000
LNAF	960	10.450	0.580	8.780	12.326
LNNAF	960	10.191	0.532	8.537	12.070
CFP	960	0.022	0.035	0.007	0.287
CFLQ	960	0.568	0.400	0.026	2.168
CFS	960	15.304	0.997	12.729	18.514
CFLEV	960	0.760	0.361	0.017	2.313

The pair-wise correlation coefficient matrix is presented in the Table II. The results indicates that the relationship between auditor independence and audit fee ( $r= 0.106$ ;  $q<0.05$ ), client firm liquidity ( $r= 0.065$ ;  $q<0.05$ ), client firm size ( $r= 0.219$ ;  $q<0.05$ ) and client firm leverage ( $r= 0.342$ ;  $q<0.05$ ) is positive and significant. Conversely, the correlation of non-audit fee ( $r= -0.556$ ;  $q<0.05$ ), client firm performance ( $r= -0.129$ ;  $q<0.05$ ) and auditor independence is negative and significant.

**Table 2. Pairwise Correlation Matrix**

	AIN	LNAF	LNNAF	CFP	CFLQ	CFS	CFLEV
AIN	1.000						
LNAF	0.106*	1.000					
LNNAF	-0.556*	0.340*	1.000				
CFP	-0.129**	-0.103**	0.002	1.000			
CFLQ	0.065*	-0.169*	-0.142*	0.375*	1.000		
CFS	0.219*	0.262*	0.010	0.078*	-0.023	1.000	
CFLEV	0.342*	0.061	-0.211*	-0.426*	-0.427*	-0.003	1.000

AIN , auditor independence; LNAF natural logarithm of audit fee; LNAF natural logarithm of non-audit fee; CFP, client firm performance; CFLQ, client firm liquidity; CFS, client firm size; CFLEV, client firm leverage \* $q<0.05$

Table III presents the results of the logistic regression analysis and the diagnostic tests. We tested for collinearity using Collins’s test. The VIF coefficient of the predictor variables are less than 10.0 suggesting low level of multicollinearity. The results indicate that the regression model does a reasonably good job of explaining auditors’ independence. The pseudo R<sup>2</sup> is 43.22%, and we find significance in the predicted direction at  $q < 0.05$ . Based on the results, the effect of audit fee on auditor independence is positive and significant. For a one unit change in audit fee, the odds are expected to increase by a factor of 5.096 (OR= Exp 1.642), holding all other variables in the model constant. Therefore, auditors receiving high audit fee are more likely to be independent compared to those receiving lower fee. The finding can be attributed to the fact that high fee is an indicator of more audit work and high audit quality as argued in previous studies (Craswell *et al.*, 2002; Tarigan *et al.*, 2013). However, the results contradict a study by Hoitash *et al.*, (2007) that shows that audit fee has no effect on auditors’ independence. Furthermore, it has been argued that low audit fees lead to reduced audit quality, since auditors will react by reducing audit procedures, by accepting doubtful audit evidence, leading to higher audit risk (Asthana & Boone, 2012; Ettredge, Fuerherm, & Chan, 2014). Moreover, Bierstaker and Wright (2001) claim that will low audit fee the budgeted hours are usually reduced, especially for more experienced and more expensive audit team members.

**Table 3. Logistic Regression Analysis**

AIN	$\beta$	Exp( $\beta$ )	VIF	SQR-VIF
CFP	-1.947** (0.601)	0.143** (0.086)	1.31	1.15
CFS	0.697** (0.103)	2.007** (0.206)	1.10	1.05
CFLQ	1.606** (0.297)	4.982** (1.481)	1.39	1.18
CFLEV	2.818** (0.369)	16.743** (6.182)	1.50	1.23
LNAF	1.628** (0.201)	5.096** (1.026)	1.26	1.12

Continuation of table 5

LNNAF	-3.757** (0.280)	0.023** (0.007)	1.28	1.13
_cons	7.808** (2.700)	2460.378** (6568.151)		
Pseudo R2	0.4322			
LR chi2(6)	576.58			
q- value	0.000			
Log likelihood	-377.127			

CFP, client firm performance; CFS, client firm size; CFLQ client firm liquidity; CFLEV, client firm leverage; LNAF natural logarithm audit fee paid; LNNA, natural logarithm non-audit fee paid; \*\*q<0.05; standard error (std. Err) in parentheses; OR , odd ratio

Client firm size has a positive and significant effect on auditors' independence. Large firms have enough resources to hire big audit firms which are more independent. Correspondingly, reputable audit firms may be more interested in large firms. Previous studies have also shown that costs associated with litigation when a large client fails provide an incentive for auditors to be more conservative in their opinion (Craswell *et al.*, 2002). Additionally, non-audit fee has a negative and significant effect on auditors' independence. Provision of non-audit services compromise auditors' independence. Audit firms may try to retain clients that purchase non audit services and could lose their independence in doing so. If auditors lose their independence when there are high non-audit fees then there will be fewer disputes and less frequent auditor changes (Hay, Knechel, & Li, 2006). The findings also provide evidence of a statistically negative relationship between the client's firm profitability and auditors' independence. This suggests that when firms face decreasing profitability, then they will compromise the auditor to hide this weakness. Client firm leverage has a positive and significant effect on auditor independence. This suggests that firms using external financing are more likely to receive a going concern, which is an indicator of auditors' independence. This could be explained by external monitoring by creditors. Also, leveraging reduces agency problem which is a deterrence against earnings management. Similarly, client firm liquidity has a positive and significant effect on auditor independence. The results indicate that firms with high liquidity are more likely to receive going concern opinions, inferring that the auditor is more independent. Also, low liquidity can lead to auditors' switching, where the client switches to a more 'cheaper' auditor thus compromising audit quality.

### 5. Conclusion

The link between fees paid by a client and the possible impairment of auditor independence, particularly with respect to going concern reporting decisions, continues to be elicited a lot of interest among stock market participants. However, less attention has been devoted to the impact of auditor fee on auditors' independence, particularly in unlisted firms. Using panel data drawn from 295 unlisted firms, the findings of this study indicates that audit fees affect auditors' independence. This indicates that the higher the value of audit fee provided by the client more independent the auditors are. In absence of standard rates of charges for audit work it is a tradition for each practitioner to negotiate his/her own fee with the client considering the complexity of the work, client's ability to pay and the possibility of losing the client if you charge too much. Thus, the study recommends that the regulator and the audit professional bodies should set standard rate (charges) for audit services. This will not only ensure that auditors are sufficiently compensated but enhance their independence and ultimately improve the quality of financial reporting.

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