The Relationship between Audit Fees, Auditor Independence and Audit Quality in the Audit Organization

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ABSTRACT

It is a while that, high quality audit is significantly considered by regulations developers and their partners and academics. Studies on the audit in the U.S. show that, the four largest international accountancy firm, provides high quality audit services that increase credibility and awareness of financial statements. These studies show the effect on audit quality on the reported financial statements of the U.S. companies as the same. This normally leads to audit quality assurance to creditors and investors, and decreases their information risk, and interest payments will be affected. The statistical population is certified accountants employed by the audit organization. Questionnaire and Cochran formula were used to collect information by simple random sampling. Data analysis in this research was conducted using Kolmogorov Smirnov test, Pearson correlation and regression testing, and by SPSS and EVIEWS software. The achieved results show that, significance level of (NGS) is 0.000 and this value for variable (INVREC) is 0.561, for variable (EMPLOY) IS 0.006, therefore, at confidence level of 95%, the obtained coefficients for the variable above is not significant in the regression model above.

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INTRODUCTION

Demand for External auditing services is due to the agency issues which are resulted from companies’ control. Companies are always owned by various stakeholders but, day to day operations of the company are controlled by professional managers who can be or not among the stakeholders. This means that, the shareholders of a company's claims about outstanding of the company's resources, and the managers should inform the stakeholders about their control over resource company shareholders typically through the periodic issuance of a notice to the financial statements [9, 14]. In order to guarantee the reliability of financial information published by the company for the members, it is normally required that, financial statements to be confirmed by an audit – a third objective and serious person who carries out an independent check and who consequently provides credibility of financial statements for the operators. Anyways, the recent financial crisis and the failure of audit have suggested the ability of auditors and their independence. This task has caused numerous researches about the nature of the auditor's independence and its relation to the quantity of audit reports on financial statements. These studied have focused on Impact on audit fees against fees received from the NAS (An alternative measure for auditor independence) in exchange with limiting both of them and the importance of revenue management (alternative measure for audit quality) [8].

Therefore, the researcher is sought to examine the question: “What is the relationship between audit fees, auditor independence and audit quality audit in the audit organization?”

2. Literature review:
   - Internal literature:

[2] Conducted a study on the effect of the independent audit report on creditors’ decisions. The findings of this study are based on survey results collected from 76 questionnaires from decision makers and administrators to pay the credit in the banking system. Statistical analysis indicates no strong and effective relationship...
between the audit report and the credit decision making. However, if other loan payment conditions are stable, audit reports will have relative involvement in decision making. On the other hand, the creditors’ behaviors follow a certain pattern and a relative model. Also, type of the recipient’s personality and the type of loan are effective in decision making, and various creditors groups in terms of organizational position or education level and work background have the same view about the role of independent audit in decision making of credit.

[4] Studied four increasing factors of the auditors’ dependence in a thesis entitled “Enhancing factors of the independence of independent auditor”. These factors include competition among audit firms, the audited audit committee, extent of audit firm and extent of the auditor’s firm. The results showed that, in the view of independent auditors, audited audit committee, extent and experience of audit of the auditee’s firm are considered as factors enhancing auditor independence, and professional competition is considered as the factor decreasing the auditor’s independence.

[5] Investigated the factors affecting the audit quality of auditors who are members of the auditor's certified public accountants. They determined that, there is a significant relation between the factors affecting the competence of auditors and auditor independence indicators and audit quality.

[3] Studied the effect of the amount of non-audit services and fees on audits independence in the view of audits, accountants, investors and creditors (the banks). The results of this study show that, non-audit services do not violate auditor independence but, not disclosed ratio of audit fees in the financial statements of the audited, and high non-audit fees against audit fees violate the auditors’ independence.

[6] Investigated the relationship between non-audit services and auditors independence in the view of Iranian Association of Certified Public Accountants members. The results demonstrate that, simultaneously providing of bookkeeping services, design services, and implementation of accounting information systems has negative effect on the auditors’ independence.

-Foreign literature:

[7] Studied the audit quality and extent of audit firm, and concluded that, audit services quality has a correlation with the extent of audit firm, and in other words, the extent of audit firms has positive effect on their competence and independence.

[8] Showed that, changing the auditors can be a sign for failures or distortions imposed by companies. By sampling of bankrupt firms, he concluded that, the companies with unrealistic sale, have tendency to change their auditors who provide credible reports. This indicates that, these companies tend to have lower accuracy in audit reports which shows their audit disorders. This researcher emphasizes that, the audits’ policies which affect their findings, cause to periodic change of the auditor.

[9] In Malaysia found that, the auditor independence has a positive relationship with audit committee meetings, audit committee report along with annual report, the role of audit committee in determination of audit fee and composition of the audit committee.

[11] During a study, observed some evidences about the existence of a potential relation between non-audit services fee and earnings management criteria. Therefore, providing non-audit services for audited has negative effect on the auditor’s independence.

In another research, [6] studied the effect of challenging situations on the auditor's judgment. True but irrelevant information about the relationships between the customer and auditor were given the participants in this study. The researchers found higher risk of the customer in negative challenging situation resulted from audit-customer relationship than positive challenging situation. This study shows that, challenging situations resulted from individual irrelevant but dominant relationships affect the auditor’s judgment.

[10] Found that, audit managers in positive challenging situations, probably make decisions which increase the audit risk because, in positive challenging situations, it is unlikely that the audit evidence to be examined closely by the audit managers. Positive challenging situations seek to tarnish the good decisions. Therefore, positive challenging situations not only affect the information processing, but also change the results of decision making [10].

3. Research hypotheses:

In order to achieve the research objectives, the following hypotheses are examined:

Hypothesis 1: The effect of non-audit fees on the audit quality is different in different customers.

Hypothesis 2: The effect of non-audit fees on the audit quality about “important customers” is less than unimportant customers.

Hypothesis 3: The effect of non-audit fees on the audit quality about the customers who have corporative governance is less than other customers.
MATERIALS AND METHODS

The present research in terms of objective is a practical research and in terms of data collection and analysis method is a descriptive and non-experimental research, and based on the kind of performance, is a survey. In this research, Cronbach’s alpha method was used to determine the reliability of the test. In order to determine the reliability, Cronbach’s alpha method was used using SPSS 18. Statistical population is Certified Public Accountants members.

Minimum required sample volume is 160 people. Also, financial statements and needed information are obtained from the organization documents of the period 2006-2011.

4.1. Data collection method:

In this research, Cochran formula, abnormal changes in audit fees and discretionary accruals were used. Data analysis was conducted using descriptive statistics and frequency table and bar graph. For better description of the data, central indices such as mean, and distribution indices such as standard deviation and variance. For data collection, randomized sampling method is used. The used inferential statistics are Pearson correlation coefficient, regression and Kolmogorov-Smirnov tests.

4.2. Research model and variables measurement method:

In order to study the effect of NAS on audit quality (Hypothesis 1), model (Frankel et al., 2002) was used.

\[
\text{AbsoluteDAC} = \beta_0 + \beta_1 \text{RFEES} + \beta_2 X + \beta_3 \text{FEES'}X + \beta_4 \text{BIGFOUR} + \beta_5 \text{ROA} + \beta_6
\]

\[
\text{Losses} + \beta_7 \text{CFO} + \beta_8 \text{ANNRET} + \beta_9 \% \text{INST} + \beta_{10} \text{LEVERAGE} + \beta_{11} \text{INVREC} + \beta_{12} \text{FIN} \div \text{ACQ} + \beta_{13} \text{M} \div \text{B} + \epsilon
\]

Where:

Absolute DAC= Absolute DAC on company i which is measured by modified Johns model (1991).

RFEES= Ratio of audit fee to the total fees received from audit customer.

X= Customer importance level or corporative governance traits.

The customer importance is measured through the ratio of audit fees received from the customer to total audit fees received from the audit customers.

Corporative governance is recognized by three traits including: Number of board members, the number of independent directors on the audit committee of the company and the number of the number of audit committee members with accounting expertise.

BIGFOUR=1 if the company audit is from Big 4 company, otherwise 0;

ROA= Net income divided by average total assets;

CFO= Cash from operations, adjusted for inflation by the average total assets;

ANNRET= Percentage of compound monthly stocks return;

INST%= Percentage of stocks held by institutions;

LEVERAGE= Ratio of total debt to total assets;

INVREC= Inventory plus receivable accounts as a percentage of total assets;

FIN/ACQ= 1 if the company issues securities or occupies another company and otherwise 0;

LOGMV= Logarithm of the capital market value; and

M/B= Ratio of office to the market.

In order to study the relationship between the rate of change of abnormal audit fees and audit quality (Hypothesis 2). Following models are considered which ties the importance of discretionary accruals to the test variables; it means the rate of change of abnormal audit fees and other control variables.

\[
\text{AbsoluteDAC'} = \beta_{0'} + \beta_1 \text{LNAACFR} + \beta_2 \text{ABSTAccurals'} + \beta_3 \text{FSIZE',} + \beta_4 \text{Leverage'} + \beta_5 \text{ROI'} + \beta_6
\]

\[
\text{Losses}_{t} + \beta_7 \text{CashFlowOp}_{t} + \beta_8 \text{OwnCon}_{t} + \beta_9 \text{GLC}_{t} + \beta_{10} \text{IndMan}_{t} + \beta_{11} \text{MV'}_{t} + \epsilon_{t}
\]

Where:

4.2.1. Dependent variable:

Absolute DAC: Absolute DAC of the company i for the year t measured by Johns model (1991).

ABSTAccurals: Absolute value of TAC for the company i divided by total assets of the company i for the year t-1;

FSIZE: Natural logarithm of total assets book value of the company i for the year t;

Leverage: Ratio of long-term debt book value of the company i for the year t to the book value of total assets of the company i for the year t-1;
ROI: The rate of income before extraordinary items of the company i for the year t to the book value of total assets of the company i for the year t-1;

Losses: Variable indexed by the company i with score 1 if the financial loss consequences at least once before three financial years; otherwise 0;

CashFlowOp: Cash current from operations for the company i during the year t which has been adjusted with inflation at the end of year t-1;

OwnCon: Percentage of the outstanding common stocks owned by the first 20 stockholders of the company i for the year t.

GLC: Variable indexed by the company i with score 1 if there is an issue in relation to the government; otherwise 0;

IndMan: Variable indexed by the company i with score 1 if it is active in construction industry; otherwise 0; and

MV: The rate of market value of the company i at the end of year t to the book value of total assets of company i at the end of year t.

4.2.2. Independent variable:

\( \text{LnAFEE}_t = \beta_0 + \beta_1 \text{AbsoluteDAC}_{t-1} + \beta_2 X_t + \epsilon_t \)

Where:

- \( \text{LnAFEE}_t \) is natural logarithm of audit fee in the year t.
- \( \text{AbsoluteDAC}_t \): Absolute level of DAC in the last year (t-1).
- \( X_t \): Fee potential stimulus (including the extent of company, complexity of auditee operations, financial risk, audit factors, and governance structures).

5. Statistical population, sampling method and sample volume:

Statistical population includes certified public accountants employed by the Audit Organization and randomized sampling method for data collection; so that, among accountants audit employed in audit organization, some people are selected randomly and the questionnaire is given them. Therefore, for sampling, Cochran equation is used which is defined as below:

\[
n = \frac{Nz_{\alpha/2}^2 \pi \left(1 - \pi \right)}{(N - 1)dz^2 + z_{\alpha/2}^2 \pi \left(1 - \pi \right)}
\]

Therefore the minimum required sample volume is:

\[
n = \frac{(276 \times 0.96 \times 0.5 \times 0.5) \times (1 - 0.5)^2}{(276 - 1) \times 0.95 \times 0.5 \times 0.5} \approx 160
\]

Therefore, the minimum required sample volume is 160 people. Also, for required financial statements and information, documents of the organization of period 2006-2011 are used.

6. Results:

For data analysis, descriptive statistics, inferential statistics, and drawing tables are used. Descriptive statistics has been used to summarize the collected data and more understanding of the studied population; since, the purpose of descriptive statistics is to describe and extracting the basic tips and combining the information using the numbers language. The purpose of inferential statistics is to perform inferences about population parameters by analyzing the information in the data sample and also, assessment of the uncertainty existent in these inferences.

Result of the first hypothesis test: according to the table, significance level of variable NGS is 0.000, these values have been considered less than significance level which is (5%) in this study. Therefore, the obtained coefficient for the variable above is significant at confidence level of 95% so, the first hypothesis is confirmed.

Result of the second hypothesis test: According to the table, significance level of variable INVREC is 0.561, these values have been considered higher than significance level which is (5%) in this study. Therefore, the obtained coefficient for the variable above is not significant at confidence level of 95%; so, the second hypothesis is not confirmed.

Result of the third hypothesis test: According to the table, significance level of variable EMPLOY is 0.006, these values have been considered higher than significance level which is (5%) in this study. Therefore, the
obtained coefficient for the variable above is not significant at confidence level of 95%; so, the third hypothesis is not confirmed.

Table 1: Results of regression equation fitting.

<table>
<thead>
<tr>
<th>Significance level</th>
<th>T statistic</th>
<th>Coefficient value</th>
<th>Variable coefficient</th>
<th>Variable name</th>
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<tbody>
<tr>
<td>0.006</td>
<td>3.091</td>
<td>6.961</td>
<td>β₁</td>
<td>Constant number</td>
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<td>4.878</td>
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<td>β₃</td>
<td>NGS</td>
</tr>
<tr>
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<td>β₄</td>
<td>INVREC</td>
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<td>-3.091</td>
<td>-2.451</td>
<td>β₅</td>
<td>EMPLOY</td>
</tr>
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<td>β₆</td>
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<td>LOSS</td>
</tr>
<tr>
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<td>2.635</td>
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<td>BTM</td>
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REFERENCES