The Impact of Enhanced Communication Requirement and other Determinants on Audit Fees

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ABSTRACT

Studies generally suggest the audit report is not an effective communication tool to inform the users of Financial Statements about the audit and its process. In a move to enhance the informative value of the auditor's report, the International Auditing and Assurance Standard Board has approved a standard called for an enhanced auditors' report. While the introduction of the new report is expected to result in better financial reporting and audit quality, it may also cause auditors to incur additional audit costs due to increased audit efforts as well as reporting cost. The present study examines this possibility and based on the analysis of 261 listed companies, our results suggest that the new reporting requirement does not cause auditors to increase audit fees. Additional, the study suggests that size of the company, poor performance and ability to meet short term obligation are important determinants of audit fees. Two highly reputable audit firms namely, PWC and KPMG, are found to charge higher fees than others. The present study provides knowledge to regulators on how the auditors respond to regulatory change in the term of production cost and subsequently, would provide insight on how the change would alter the quality of audit reporting.

Keywords: Key audit matters, audit fees, audit quality.

I INTRODUCTION

Interest in audit fees is at all-time high. In Malaysia, all companies are required to appoint qualified auditor to audit the Financial Statements. The requirement is made mandatory by the Companies Acts 2016 and the now defunct, Companies Acts 1965. Meanwhile, auditors are bound by accepted auditing standards and requirements (Abdul Wahab et al., 2011). Such requirements include the International Auditing Standards, International Standard on Quality Control (ISQC) 1 and By-Laws (On Professional Ethics, Conduct and Practice).

It is reported that public listed companies in Malaysia, spend on average a sum of RM274,000 with a total of RM257 millions paid in 2010, as fee payment to their auditors. Despite the high amount of audit cost paid, Ali et al. (2006) claim that auditing practice in Malaysia is only to fulfil legal requirements and also to attract foreign capital investment. Many business do not value the statutory audit work accordingly, and in fact, many still consider auditing as additional cost to business with less benefit.

The fundamental purpose of the audit is to provide independent assurance that management has, in its financial statements, presented a "true and fair" view of a company's financial performance and position. Thus, the audit is to provide assurance to the users of Financial Statements and to add credibility to it. The auditor's opinion is conveyed in the auditor's report, which is the end product of an audit. However, studies (e.g. Gray et al., 2011 & Vanstraelen et al., 2012) suggest that it is generally accepted that the audit report is not an effective communication tool to inform the users of Financial Statements about the audit and its process. Mock et al. (2013) argue that the report has little informative value. The issue, however, is not new. For instance, in 1978, the study by the Commission on Auditor's Responsibilities suggested that the auditor's report as 'a single symbol that is no longer read'.

Recently, in a move to enhance the informative value of the auditor's report, the International Auditing and Assurance Standard Board, which is the international body for setting auditing standards, has approved an auditing standard calling for an enhanced auditors' report. As the result of the move, the Malaysian Institute of Accountants (MIA) has issued the same set of auditing standards, which were affective for audits of financial statements for financial periods ending on or after December 15, 2016. Thus, since 2017 the auditor's report needs to be presented in a revamped format which deemed 'a game-changing and insightful' (Oh, 2017).

The key changes in the enhanced auditor's report include the restructuring of the audit report for readability, specific paragraph to describe 'Going Concern'-i.e. the assumption that an entity will remain in business for the foreseeable future, and any material uncertainty. The new report also requires auditor to provide positive statement about the auditors' independence and fulfilment of other ethical responsibilities. The most significant change, however, is the inclusion of a paragraph on Key Audit Matters (KAM). KAM is a commentary on matters that were of most significance during the audit of Malaysian public listed companies (PLCs). Arguably, the inclusion of KAM would give investors more clarity or at least an idea of what were the risk areas for company.

While, the introduction of both the enhanced auditor is expected to result in better financial reporting and audit quality, it may also cause auditors to incur additional audit costs due to increased audit efforts as well as reporting cost. The implementation of KAM, for example, would require auditors to involve in discussion of the matters with audit committee and management in term of form and content. In addition, there is also some possibilities that auditors may increase audit procedures to respond to higher legal liability and reputation loss risk. Given the wider legal exposure and possible incremental audit efforts, it is expected the audit fees will also increase. However, given the audit process is unobservable to clients, auditors might take this opportunity to charge abnormal fees. Excessive increase in audit fees is of concern since it can create incentives for auditors to comply with client pressure for substandard reporting and thus erode audit quality.

Thus, it is the objective of the present study to examine the impact of the enhanced auditors' reporting on audit fees charged by auditors to their clients after the introduction of the requirement. The present study also seeks to identify the determinants of audit fee during the period surrounding the implementation of the requirement.

Given the introduction of the enhanced auditors' report requirement in December 2016, the investigation on how the new regulation potentially change the audit cost can be considered timely. Excessive audit fees can create incentives for auditors to comply with client pressure for substandard reporting and thus erode audit quality. The present study might also provide knowledge to regulators on how the auditors respond to regulatory change in the term of production cost and subsequently, would provide insight on how the change would alter the quality of audit.

The rest of this paper is organized as follows. Sections II describes the background and presents the research questions. Section III describes the research design and defines variables. Section IV provides statistics and presents the regression results. Section V concludes and suggests future works.

II BACKGROUND AND RESEARCH QUESTIONS

A. Enhanced auditors' report and Key Audit Matter Reporting (KAM)

In 2015, the International Auditing and Assurance Standards Board (IAASB) approved a suite of auditing reporting standards effective for audits of financial statements. These standards, which come to effect for financial periods ending on or after 15 December 2016, were set to enhance the information value of the auditors' report by providing greater insights into the audit of the financial statements of an entity. In the same year, the MIA issued the same set of auditing standards that fully adopted the IAASB equivalents, with the same effective date. The implications of these standards are significant and impact all those involved in the financial reporting ecosystem (investors, regulators, management, those charged with governance- such as the Board of Directors and other relevant parties) and not just the auditors.

Bursa Malaysia Securities Berhad has in March 2016 issued amendments to the Main Market and ACE Market listing requirements to complement these enhanced auditor reporting requirements. As the Board of Directors have a statutory responsibility for the preparation of the financial statements including the oversight of the financial reporting process of an entity, the Board should proactively engage its auditors on these standards to deliberate on the implications of the changes so as to ensure a smooth transition to the enhanced auditors' report.

A particular area of focus within the new standards is the requirements as set out in the new ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report. For audits of listed entities, a new section in the auditor's report called Key Audit Matters (KAM) will highlight those matters that, in the auditor's professional judgment, were of most significance in the audit. KAM are included in a separate section of the auditor's report explaining the nature and intent of KAM. The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.

KAM provide information to users of the financial statements on areas the auditor spent the most effort in the audit of the financial statements of the current period. Areas where the auditor spent the most effort are often difficult and complex areas in the financial statements and areas involving the use of significant judgement by the directors. Understanding the critical areas the auditor focused on doing the audit should help users in understanding the financial statements better.

KAM are selected from matters communicated by the auditors to the Board of Directors. From these matters, the auditor selects those matters that required significant auditor attention in performing the audit. Finally, the auditor selects those matters of most significance in the audit. The description of each key audit matter will be tailored to the entity and will:

(a) Explain why the matter was considered to be one of most significance in the audit;

(b) Describe how the matter was addressed in the audit; and

(c) Provide a reference to where this matter was disclosed in the financial statements.

Other key changes in the enhanced auditors' report include the restructuring of the audit report for readability – in particular, the 'Opinion' section is required to be presented first, followed by the Basis for Opinion section, description of the directors' and auditors' responsibilities for Going Concern and enhanced descriptions of the auditors' responsibilities and key features of an audit.

Arguably, the new requirement would cause auditors to incur additional audit costs due to increased audit efforts as well as reporting cost. However, given that the proposal for the requirement had been discussed by the professions as early as in 2010, the implementation of the new requirement were very much well anticipated and might not send a shockwave to the audit community. Thus, it is interesting to know the impact of requirement on audit production cost.

Hence, we pose the following research question: "*Does the implementation of enhanced auditors' report affects the audit fees paid by clients?"*

B. **Prior Audit Fees studies**

The literature on determinants factors of audit fee could be dated back to Simunic (1980). In his seminal paper, he models audit fee as an element of the cost of the auditee's accounting system, where a profit maximizing auditee seeks to minimize the expected cost of the financial reporting system. The cost is made up of three components: (i) the cost of operating the internal accounting system, (ii) the cost of external auditing, and (iii) the auditee's share of expected losses from defects in the audited financial statements. Prior studies, such as Pratt and Stice (1994), use this model to predict the impact of increased auditee litigation risk on audit fees. Seetharaman et al. (2002) also use this model to predict the impact on audit fees of differences in the litigation environment of the country in which an auditor operates, and the reason is that in a more litigious situation the auditor will assess higher levels of the auditor's share of expected losses from defects in the audited financial statements, and this leads to an increase in audit fees.

Following the introduction of the enhanced auditors' report, where auditors are now subjected to increased scrutiny by authorities and public, the pricing behavior of the audit service might also change. Thus, this period of regulation change provides a valuable setting within which to test the audit fees models, and thereby extending our understanding of pricing issues. Our curiosity then leads to the following research question: *"What are the determinants of audit fees during the period surrounding the implementation of the new reporting?"*

III RESEARCH DESIGN AND METHODS

This section discusses the sample selection and describes the model employed.

A. **Sample Selection**

We obtain the latest initial annual listings of all companies from the official list of companies listed on Bursa Malaysia as at 31 Dec 2016. This source contains comprehensive entries of all companies and securities listed on the Main Market and ACE Market on that particular date. The compilation represents the most up-to-date and authoritative reference source available at every year-end. Given that the enhanced auditors' report was first mandated on the audit of companies with the fiscal year end post 15 December 2016, we then selected all companies with financial year end from 15 December 2016 onwards. In order to allow us to make comparison with the prior year's audit (prior to the enhanced auditors' report requirement), all selected companies should also have the prior year Annual Report available or else, dropped from the selection. All the required information were retrieved from the Worldscope Database. Our full sample, which has all the data required for our main analysis, consists of 291 companies or 582 firm-years over the two-year sample period. .

B. **Model Estimation**

After comprehensive process of review and synthesizing the theoretical foundations and the pertinent literature, a research framework was developed to capture the factors that influence auditor fees. We adopt the multivariate regression analysis to estimate the influence of regulation change on audit fees. The determinants of audit fees are identified from the variables used by previous studies. For simplicity, the potential variables included in the present study are classified into three categories – change in regulation, client attributes and auditor attributes.

We conducted OLS regressions as a corroborative analysis of the effect of the enhanced auditors' report (we refer as KAM) on audit fees. First, to examine the effect on fees, we adopted a regression equation similar to that used by many previous studies. The model is as follows:

$$Fees = ß_0 + ß1kam + ß_2 lnAssets + ß_3 loss + ß_4 roa + ß_5 current + ß_6 liquidity + ß_7\ sector + ß_8 pwc + ß_9 kpmg + ß_{10} ey + ß_{11} del + \mathcal{E}$$

Consistent with prior studies (e.g. Abdul-Wahab et al. 2011) we use the logarithmic transformation of audit fee (lgAUDFEE) to capture the level of audit effort in the audit fee model. According to Abdul-Wahab et al. (2011), it is reasonable to assume that auditor requires more audit hours and use more specialized audit staff in order to complete audit investigation. This in turn will result in higher audit fees (O'Sullivan, 2000; Abdul-Wahab 2011). Given that audit quality is unobservable, thus prior studies suggest the use of, amongst others, audit fees to proxy for audit effort.

In addition to the *lnAudfee* measure, we also measure the fees paid relative to company's total assets. This measure (*feeperassets*) indicates the amount of audit fees paid for every RM1,000 total assets and we refer it as a measure of fee expensiveness. The summary of the dependent and independent variables are as follows:

Dependent Variables (Fees)

lnAudfee = Absolute audit fees as measured by the natural logarithm of fees paid to external auditor for the fiscal year end

feeperassets = Audit fees expensiveness as measured by audit fees paid per RM1,000 total assets

Independent Variables

Enhanced Auditors' Report

kam = If the new enhanced auditors' report have been included in the annual report, i.e. '1' if the company's financial year end is 15 December 2016 or later and '0' if the financial year end is before the date.

Client Attributes

lnAssets = Size of company as measured by natural log transformation of total assets

loss = Dummy variable for companies that recorded a loss (LOSS) in the previous year

roa = Return on assets, business income (operating income plus financial revenue less financial expense)/total assets

current = Ratio of current assets to total assets

liquidity = Ratio of current assets to current liabilities

sector = Industry dummies that take a value of '1' for companies belonging to the industries that are more difficult and labour-intensive to audit, which are construction; consumer; technology sectors. Otherwise '0'

Auditor Attributes

pwc = A dummy variable for PWC auditing firms

kpmg = A dummy variable for KPMG auditing firms

ey = A dummy variable for Ernst & Young (EY) auditing firms

del = A dummy variable for Deloitte auditing firms

IV RESULTS

The section presents the descriptive analysis and the results of the multivariate estimations.

A. Descriptive Analysis

Table 1 presents descriptive statistics for the variables used in the study. Audit fees (lnAudfee) statistics indicates that the 582 companies have spent an average value of 6.239 with a maximum of 5.5974. In untransformed term (not reported in table), the average audit fees paid pre-KAM and post-KAM periods were RM1.163 million and RM1.199 million, respectively. The highest paid audit fees by a single company in the pre-KAM period was RM25 millions and, in the post-KAM period was RM33 millions. In term of audit fees paid per total assets, the statistics suggest that for every RM1000 assets, a company will spend RM0.45 to pay its auditor.

Table 1. Descriptive Statistics (n=582)

Variables	Mean	Std. Dev.	Min	Max
lnAudfee	6.239	1.137	2.303	10.413
feeperassets	0.454	0.510	0.003	5.598
kam	0.500	0.500	0.000	1.000
lnAsset	14.335	1.422	10.250	19.091
loss	0.132	0.339	0.000	1.000
roa	5.957	10.305	-116.500	75.320
current	0.495	0.357	0.009	5.268

liquidity	2.503	3.321	0.202	63.488
sector	0.247	0.432	0.000	1.000
pwc	0.103	0.304	0.000	1.000
kpmg	0.210	0.407	0.000	1.000
ey	0.254	0.436	0.000	1.000
del	0.086	0.280	0.000	1.000

Other interesting statistics are that 13% of the companies reported losses during the period under study and 24.7% of the companies sampled are operating in construction, consumer and technology sectors. The table also reveals market concentration (65.3%) of the Malaysian audit market by the four biggest audit firms in the world, known as the "Big 4" firms, i.e. PWC, KPMG, EY and Deloitte . This market share is much lower than in Taiwan (80% in Chi and Huang 2005) but slightly lower than Australia (64% in Carey and Simnett 2006). Looking at individual audit firms' market share, EY dominates 25.4% of the audit market (in term of audit fees) and is followed closely by KPMG with 21% market share. Another Big 4 firm, i.e. PWC captures around 10% of the market and Deloitte with merely 10% of the market's slice.

B. **Multivariate Results**

Table 2 and 3 present the results of the estimations of the audit fees equation. The dependent variables are audit fees (lnAudfee) and audit fee expensiveness (feeperassets) for Model 1 and Model 2, respectively.

Table 2. Multivariate (OLS) Results for Model 1

DV	Model 1 lnAudfee		
	Coef.	t statistic	P value
Intercept	-1.885	-5.300	0.000
kam	-0.009	-0.150	0.882
lnAsset	0.560	22.360	0.000
loss	0.213	1.980	0.048
roa	0.000	-0.110	0.915
current	0.060	0.680	0.500
liquidity	-0.032	-6.650	0.000
sector	-0.019	-0.260	0.792
pwc	0.591	4.800	0.000
kpmg	0.214	2.430	0.015
ey	0.064	0.790	0.430
del	0.117	1.390	0.164
Adj-R^2			0.625
F-stat			93.040
P value			0.000

The estimations for both models are globally significant (p-value < .00) and the proposed model shows high explanatory power in predicting audit fees (lnAudfee) and audit expensiveness (feeperassets). The independent variables explain 62.5% of the absolute audit fees and 25.1% of audit fee expensiveness. Finally, after estimation we calculate variance inflation factors (not reported here) in order to assess multicollinearity problems. The rather low values of these factors (a maximum value lower than 3.0) do not suggest serious multicollinearity problems.

Five variables are found to significantly determine the level of audit fees paid to auditor while four variables are significantly determined the audit fees expensiveness. Contrary to our expectation, the coefficients of KAM reporting in both models are not significantly different from zero, indicating that audit fees and expensiveness are not increased due to the introduction of KAM reporting in Malaysia. Meanwhile, lnAsset, loss and liquidity are significance at least at p<0.05 and consistent with our prediction. Interestingly, company's size is positive when dependent variable is audit fees (lnAudfee) and negative when the dependent variable is audit fee expensiveness (feeperassets). The results might suggest that bigger companies pay more in term of total audit fees, however, the fee rate, i.e. expensiveness is decreasing for bigger companies. This is to suggest the auditor of bigger companies are enjoying economies of scale in the production of audit work. This is consistent with the finding by Abidin et. al. (2010), who find evidence that large companies in UK, pay lower audit fees rate.

Table 3. Multivariate (OLS) Results for Model 2

DV	Model 2 feeperassets		
	Coef.	t stat	P value
Intercept	3.148	10.230	0.000
kam	0.019	0.510	0.612
lnAsset	-0.191	-8.860	0.000
loss	0.150	2.060	0.040
roa	0.002	0.550	0.583
current	-0.003	-0.060	0.953
liquidity	-0.010	-2.560	0.011
sector	-0.049	-0.950	0.344
pwc	0.295	2.750	0.006
kpmg	0.070	1.340	0.182
ey	-0.016	-0.400	0.692
del	-0.053	-1.170	0.244
Adj-R^2			0.251

F-stat	12.760
P value	0.000

Loss coefficient reported to be positive and significantly greater than zero. This findings is consistent with the fees paid and its expensiveness are increasing in perceived engagement risk. Meanwhile, the positive coefficient of liquidity suggests companies with higher liquidity are perceived as low in engagement risk and hence, the auditor will charge lower fees and cheaper than companies with low liquidity.

Amongst audit firms, it is evidenced that PWC and KPMG charge higher fee than the other firms. Predicted audit fees is approximately 59 percent higher when the auditor is PWC and 21.4 percent higher when the auditor is KPMG, holding other variables constant. Meanwhile, predicted fee expensiveness is approximately 29.5% higher when the auditor is PWC. None of other Big Four firms report significant relationship with audit expensiveness.

V CONCLUSION AND FUTURE WORK

The present paper examines the impact of the mandatory enhanced auditors' reporting on audit fees and identifies the determinants of audit fee and audit fees rate during the period surrounding the implementation of the requirement. The results of this paper lead us to draw several conclusions. Firstly, the newly introduced enhanced auditors' reporting do not seems to drive auditors to increase the audit fees. Thus, the results might suggest that the new requirement does not lead auditor to increase the audit efforts, possibly because the proposal for enhanced reporting has been made known to the profession long before its actual implementations. Secondly, the study also suggests four important determinant variables of the audit fees, i.e. size of the company (lnAsset), poor performance (loss), ability to meet short term obligation (liquidity) and if audited by two particular audit firms namely, PWC and KPMG.

This study is subject to various limitations. First is the relatively small sample size due to unavailability of complete dataset. Second is the comprehensiveness of the audit fees model. These shortcomings need to be taken into account when interpreting the reported results.

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