PRACTICE NOTE

The effect of mandatory fee disclosure on subsequent audit pricing and audit quality

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EXECUTIVE SUMMARY

In line with the EU Statutory Audit Directive (2006/43/EC), the Dutch legislation has required large companies to disclose audit and non-audit fees in their financial statements since 2008. The objective of this mandatory fee disclosure was to safeguard the independence of auditors and to ensure the quality of their audits. By making information about the level of fees and scope of work performed publicly available, stakeholders have a better understanding of the company-auditor relationship and, hence, are better able to assess whether auditor's independence is impaired. However, practitioners and professional bodies have raised concerns that fee disclosure may also result in downward pressure on fees, as clients gain more bargaining power. This could potentially lead to a decrease in the quality of audit services as the auditor might no longer be able to perform sufficient and/or adequate audit procedures. Despite these concerns, there is only limited research available on the effects of mandatory fee disclosure. The limited research, moreover, mainly focuses on listed firms in Asia and the US. The effect of fee disclosure in European markets which are dominated by *private firms*, like the Netherlands, remains however largely unknown. As part of the FAR Replication Program, our project aims to address this research gap: by replicating existing studies that investigate the impact of mandatory fee disclosure in the context of listed companies (i.e., Francis and Wang (2005) and Chen et al. (2019)), our FAR replication project explores the actual consequences of the mandatory disclosure of fees on audit pricing and audit quality in the Dutch audit market, which is predominantly composed of private firms. Our goal is to uncover the benefits as well as the potential drawbacks of mandatory fee disclosure.

RESEARCH SYNTHESIS

Introduction

Research topic

In the aftermath of some major accounting scandals (e.g., Waste Management 1999, Enron 2001, WorldCom 2002), it was recognized that the magnitude of audit and non-audit fees charged by auditors posed a potential threat to auditor independence. After all, if total fees from a single audit client constitute a significant portion of the audit firm's total fees, this could lead to economic dependence on the client thereby creating a self-interest threat, as auditors may be concerned about losing the client. By looking for ways to strengthen auditor's independence, regulators around the world deemed it therefore crucial to enhance transparency in the relationship between companies and auditors. This led to audit clients being mandated to disclose audit and non-audit fees charged by the auditor in the financial statements (European Commission 2006; SEC 2000). By having more information about the fees and scope of work performed, stakeholders have a better understanding of the company-auditor relationship. In this way, they also are better able to assess whether auditor's independence is impaired (European Commission 2006).

Research problem

Over the years, audit practitioners and professional bodies have, however, expressed their concerns on the mandatory disclosure of fees. They argue that while fee disclosure can provide stakeholders with insights into the relationship between the auditor and client, it can also lead to unintended consequences, such as increased price competition in the audit market as clients gain more bargaining power (IBR 2016; Dopuch et al. 2003; Averhals et al. 2020). Fee disclosure might then result in downward fee pressure, which could prompt auditors to compromise the quality of their services.

Research purpose

While there has been limited research on the impact of regulatory interventions on audit quality in a European context and more specifically in the Netherlands, there are, however, studies in the literature that have examined similar interventions in other countries. To address this gap, the FAR therefore initiated a Replication Program in 2020, inviting researchers to replicate the best existing research on regulatory interventions from other studies in the literature.
As part of the FAR Replication Program, the goal of our project is to contribute to the regulatory debate on the implementation of public fee disclosure mid 2008 in the Netherlands. By replicating the studies by Francis and Wang (2005) and Chen et al. (2019) we aim to (1) provide evidence of the effect of publicly available fee information on subsequent audit pricing and (2) examine whether potential fee adjustments affect subsequent audit quality. Additionally, we will study the over-time evolution of audit fees in periods subsequent to the regulatory implementation of mandatory fee disclosure.

Practical relevance of our project

Our results will allow to provide suggestions and recommendations relevant to regulators, audit firms and client companies, not only active in the Dutch audit market, but also in similar settings such as continental EU countries.

For ***regulators***, this study may help to reconsider their focus on mandatory fee disclosure. Should it turn out that our study brings to light potential unintended consequences of mandatory fee disclosure other than safeguarding auditor independence, our results may cast doubts on the effectiveness of the regulatory intervention. In that case, our results could trigger discussions regarding potential modifications to auditing regulations and identify factors that could potentially mitigate any unfavorable outcomes.

Our study is relevant to ***practitioners*** and ***audited companies*** as well. An analysis on the potential increased bargaining power after the regulatory implementation of mandatory fee disclosure, could be of interest in benchmarking audit fees during fee negotiations. Should our study confirm the concerns raised by practitioners and professional bodies that fee disclosure creates downward pressure leading to potential compromise on audit quality, we would recommend audit firms to act as a profession and never save on audit quality when setting fees. Specifically, we would advise audit firms to set fees and audited companies to accept fees at a level that can guarantee an ISA-compliant audit, particularly in situations in which they experience fierce competition for clients. Delivering high-quality audits is, after all, essential to serve the public interest.

Empirical research on mandatory fees disclosure

Studies have indeed shown that public fee disclosure influences subsequent audit pricing (Francis and Wang 2005; Mayhew 2005; Chen, Duh and Li 2019; Su and Wu 2017; Averhals et al. 2020). Evidence shows that audit fees of overcharged clients have been adjusted downward more than audit fees of undercharged clients have been adjusted upward (Averhals et al. 2020; Su and Wu 2017), which is consistent with increased price competition and clients gaining more bargaining power than auditors.[1] To the best of our knowledge, the study conducted by Averhals et al. (2020) is currently the only study that has investigated the impact of mandatory audit fee disclosure on audit pricing in a private audit market context. Using both proprietary and public audit fee data from private Belgian firms before and after public fee disclosure was mandated in 2007, the authors show that overcharged clients were able to secure downward fee adjustments, while undercharged clients faced upward fee adjustments. Upward fee adjustments were, however, dependent on the importance of the client in the auditor's portfolio and the competition that the auditor faced (measured by the auditor's market share) (Averhals et al. 2020). Specifically, undercharged clients were better able to mitigate upward fee adjustments if they were more important in the auditor's portfolio or if the auditor faced more intense competition. These findings suggest that increased transparency in audit fees enhances client bargaining power and/or increases competition among auditors.

[1] Over(under)charged clients refer to those companies that are being charged more (less) by their audit firm than is appropriate for the level of service supplied (Causholli and Knechel 2012).

The evidence on the impact of fee disclosure on audit quality remains mixed, with some studies finding that overall audit quality improves following fee disclosure (Chen 2016; Lai 2009) and others finding that downward fee adjustments are associated with decreased audit quality (Chen et al. 2019).

Research gap

Given that the limited number of studies considering the consequences of fee disclosure focused on listed firms in Asia and the US, a study in Belgium by Averhals et al. (2020) notwithstanding, the effect of fee disclosure in markets dominated by *private firms*, remains largely unknown. However, it is important to note that private companies constitute world-wide the majority of companies (Vanstraelen & Schelleman, 2017). Specifically, in continental-European countries, such as the Dutch audit market, private companies make up over 99 percent of audited companies (Willekens and Gaeremynck 2005). Because private firms differ from listed firms on a number of important dimensions (e.g., exposure to market forces, nature of agency conflicts, information environment) (Langli and Svanström 2014; Vanstraelen and Schelleman 2017), it is *ex ante* unclear whether results from listed firms are generalizable to private firms. In particular, the impact of fee disclosure could be greater for private firms as the private client segment of the audit market is characterized by lower concentration, leading to a higher level of price competition (Simunic 1980). Especially, since the cost price of an audit is considered to be a decisive factor for smaller companies when appointing auditors (Collis 2012).

Methodology

To achieve our research goals, we gratefully make use of the possibility offered by the FAR to conduct replication research in the Dutch audit market and to provide us with archival data from consolidated financial statements from Dutch non-financial companies (i.e. companies outside the financial sector)[2] for the period 2008-2019. The time-series perspective allows us to analyze several subsequent years after the implementation of the fee requirement and to focus on trends. We will investigate our research questions by replicating the studies by Francis and Wang (2005) and Chen et al. (2019). Particularly, we will make use of univariate tests of the variance of audit fees and several regression analyses.

The ongoing FAR research project

Regarding the project's present status, we were able to obtain financial data from the annual accounts of consolidated Dutch companies, which were compiled by Bureau van Dijck. Starting from this dataset, we collected a sample of 14,300 observations (13,818 observations from private firms and 482 observations from listed firms) covering the period from 2008 to 2019, for which sufficient data is available to calculate variables from our models. At present, FAR research

[2] Financial institutions are excluded because of their specific accounting requirements, which differ substantially from those of industrial and commercial companies.

assistants are collecting audit and non-audit fees, the audit opinion, the audit firm and the individual auditor.

Empirical expectations and concluding comments

With the aim to contribute to the regulatory debate on the impact of mandatory fee disclosure in the Netherlands, we answer the call from the FAR for academic replication research. Our objective is to provide key insights into how fee disclosure affects audit pricing and audit quality. It is crucial for the audit practice and regulators to gain a deep understanding of the impact of mandatory fee disclosure on both audit pricing and audit quality. This knowledge can help uncover and address any potential unintended consequences of the regulation.

Expanding upon prior research, particularly Averhals et al.'s (2020) study in which a comparable audit market was examined, we expect to find that clients who were previously overcharged are able to negotiate a reduction in audit fees, while those who were previously undercharged face an – albeit lower - increase in fees.[3] As there is limited empirical evidence and conflicting arguments on the influence of mandatory fee disclosure on audit quality, it is challenging to predict how fee disclosure will ultimately impact audit quality. This highlights the need for further research in this area, which is exactly why we conduct this study. By delving deeper into the issue, we aim to enhance the current understanding of the topic and provide valuable insights for academics, regulators, and practitioners interested in the effects of mandatory fee disclosure on audit quality.

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[3] In accordance with the study by Francis and Wang (2005) we proxy over(under)charged clients as those whose audit fee exceeds (falls below) the estimate predicted by the fee model.

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