

EFFECT OF AUDITOR FEE ON AUDIT QUALITY

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Abstract

The relation between auditor independence and an auditor's ability to conduct high-quality audits has been widely debated by regulators, legislators, financial statement users and researchers. Fees paid to auditors can affect audit quality in two ways: large fees paid to auditors may increase the effort exerted by auditors, hence, increasing audit quality. Alternatively, large fees paid to auditors, particularly those that are related to non-audit services, make auditors more economically dependent on their clients. Such financial reliance may induce a relationship whereby the auditor becomes reluctant to make appropriate inquiries during the audit for fear of losing highly profitable fees. Conversely, the potential for audit failure imposes significant economic costs on the auditor (DeAngelo, 1981; Simunic, 1984). Though a number of recent studies have examined the relationship between audit and non-audit fees and independence, they are ambiguous as to the relationship between audit fees and auditor behavior (Larcker and Richardson, 2004). They also differ on how fee composition and client importance affect auditor independence.

The paper aims to examine the relation between fees paid to auditors and audit quality during the period of 2010-2015. The paper constructs a measure of auditor profitability that is used as a proxy for auditor independence. The methodology is grounded in the notion that auditor independence is influenced by effort and risk-adjusted fees, rather than the level of fees received from clients. Since, risk and effort are unobservable, the paper uses proxies based on client size, complexity and risk to estimate abnormal fees. Abnormal fees are derived using a fee estimation model drawn from prior literature. The paper employs two metrics to assess audit quality – the standard deviation of residuals from regressions relating current accruals to cash flows and the absolute value of performance-adjusted discretionary accruals. **Key words:** Auditor's fees, Auditors, Quality