



# The reform of accounting standards and audit pricing

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## ABSTRACT

This paper focuses on the reform of accounting standards in China in 2007 and investigates its impact on equilibrium pricing in the audit market. We find that the concentration of the audit market and the probability of issuing modified audit opinions do not significantly change, but that audit fees increase significantly after the adoption of the new accounting standards in China. Deeper analysis suggests that (1) the implementation of the new IFRS-based Chinese Accounting Standards (CASs) has increased the market risk faced by listed firms and thus auditors' expected audit risk, causing an increase in audit fees, and (2) the degree of the increase in audit fees is positively related to the adjusted difference between net income according to the old CAS before 2007 and the new CAS after 2007. We thus conclude that the reform has had a significant impact on audit pricing in China.

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## 1. Introduction

This study investigates the impact of the adoption of the new accounting standards in China in 2007 on audit pricing. Adopting or widely drawing on International Financial Reporting Standards (IFRSs) has become the trend in accounting standards in the current global capital market (Daske et al., 2008; Barth et al., 2008, Barth and Taylor, 2009; IFRS). However, there is some controversy about whether or not the

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adoption of new accounting standards based on the measurement attribute of fair value improves accounting information quality or the resource allocation efficiency of the capital market (Dechow et al., 2009; Barth and Taylor, 2009; Xianjie, 2009; Kai et al., 2009). As a result, it is necessary to comprehensively test the impact of the change in accounting standards on the use of accounting information.

Accounting standards are an important basis that auditors use to issue audit opinions, so any change in accounting standards will affect the working base of auditors directly and thus the structure of the entire audit industry. We investigate how a change in accounting standards affects audit pricing from three dimensions: the concentration of the audit market, the attributes of the audit product and audit risk. Summary statistics show that audit fees clearly increased following the adoption of the new accounting standards. However, the concentration of the audit market has not changed. Product heterogeneity, measured as the proportion of modified audit opinions (MAOs), decreased. We thus conclude that the impact of the adoption of the new accounting standards on audit pricing has mainly occurred due to a change in expected audit risk.

We also discuss how the adoption of the new accounting standards in China has affected audit market pricing strategy according to economic theory. Based on previous relevant research, we argue that the adoption of fair value measurement in the new accounting standards makes firms disclose more information about their market risk, which increases the expected audit risk of auditors and also audit fees. The original sample that we select includes all listed firms in the A share market in China between 2004 and 2008. We use the same method as Kai et al. (2009) and employ the difference between net income under the old accounting standards and net income under the new accounting standards to measure the degree of the impact on earnings information. The results suggest that the larger the difference in net income between the old and new accounting standards, the larger the change in audit fees. That is to say, the adoption of the new CAS has had a significant impact on equilibrium pricing in the audit market and has increased audit fees.

The remainder of this paper is arranged as follows. Section 2 describes characteristics of the industry structure of the audit market before and after the reform of the accounting standards in 2007. Section 3 reviews the relevant literature and develops the hypothesis. Section 4 discusses the research design. Section 5 presents the empirical results and Section 6 concludes the paper.

## 2. Audit market structure: Summary analysis

The independent audit opinions offered by auditors are based on the legitimacy, rationality and consistency of the accounting information disclosed by firms. Accounting standards are the main benchmark used to assess the quality of accounting information. Changes in accounting standards not only lead to changes in the recording, measuring and reporting of financial statements, but also directly influence auditors' work and the competitive behavior of auditors. This can lead to certain problems. For example, the adoption of IFRS may create more space for auditors to express a reasonable professional judgment, but this may confer a competitive advantage on high-quality auditors. Further, changes in standards may influence the differences between the audit products provided by auditors, which may cause the type and structure of audit opinions to change. The reform of Chinese accounting standards, in particular, may have affected the expected audit risk of auditors and in turn increase the audit fees paid by firms.

If the adoption of new accounting standards has affected the equilibrium in audit pricing, it is necessary to evaluate the characteristics both of the supply side and demand side of audit services. This study assumes the main characteristics of the supply side to be audit market concentration and audit product differentiation, and the main characteristic of the demand side to be audit risk. If audit prices increase due to the increased concentration of the audit market and differentiation of audit products, then we can conclude that it may lead to market monopoly or market segmentation. Thus, the adoption of new accounting standards may decrease the resource allocation efficiency of the audit market. Conversely, if an increase in audit risk leads to an increase in the marginal cost of audit services, that is, if audit fees increase as compensation for the additional risk assumed by auditors, then the equilibrium price of audit services will remain effective, which suggests that the adoption of new accounting standards does not change the resource allocation efficiency of the audit market.

At the beginning of 2006, the Ministry of Finance issued the new Chinese Accounting Standards (CASs), comprising one basic standard and 38 specific standards, which listed firms were required to fully follow from

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