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The effects of advertising and solicitation on audit fees

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ABSTRACT

Leading academic and professional accountants have suggested that the crisis in auditing over the past few years may have had its origin in deregulation which allowed firms to advertise their services and solicit new clients, encouraging accounting firms to become more commercial. In this paper, we look at this issue in New Zealand which has the unique distinction of having separated two key forms of deregulation, namely advertising and solicitation, by 6 years. This allows us to separately examine the effect of each form of market competition on audit fees. We find that advertising is associated with increases in fees, not decreases, which suggests that quality-based advertising took place, and not price-based advertising. In contrast, solicitation corresponded with a general decrease in average fees for clients of the Big 8. We interpret this result as indicating an increase in competition among accounting firms. Our results suggest that there may be a much more complex relationship among market competition, advertising and solicitation, and fees than the arguments used to originally justify deregulation.

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1. Introduction

Problems in the auditing profession in the past few years have raised questions as to whether competition in the market for audit services has undermined auditor professionalism and objectivity. Numerous commentators have specifically observed that the deregulation of advertising and

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solicitation forced auditors to become more competitive, and suggest that this may have contributed to a loss of professionalism associated with the recent wave of audit failures around the world (Imhoff, 2003; Wyatt, 2004; Zeff, 2003a,b; Palepu and Healy, 2003; Healy and Palepu, 2003). For example, Imhoff (2003, p. 119) states: “In the mid-1970s, in response to pressures from the Federal Trade Commission, the rules of the AICPA changed to permit CPA firms to advertise. Aggressive open competition for audit clients soon became a new attribute of the accounting profession. Firms then cut costs, streamlined audits, went after internal audit work and ‘turned the audit into a commodity’.”¹ Palepu and Healy (2003) observe that regulatory changes “required the profession to change its standards to allow audit firms to advertise and compete” and that this “created substantial pressure for audit firms to cut costs and seek alternative revenue sources” (Palepu and Healy, 2003, pp. 19–20). There is some research evidence consistent with these views, as prior studies have shown that the deregulation of audit markets was followed by lower fees in the US (Maher et al., 1992, using data from 1977–1981) and Australia (Crawell, 1992, using data from 1980–1989).²

While most deregulation addressed advertising and solicitation simultaneously, the respective effects on competition, product promotion, pricing and audit quality might differ. Deregulation was based on the premise that advertising and solicitation would lead to increased competition and lower prices. However, more recent research in advertising (Klein and Leffler, 1981; Abela and Farris, 2000) suggests that an opposite effect might occur, because advertising facilitates branding and service differentiation that could lead to increased market power and higher prices when firms are successful in differentiating their services or developing brand value. Solicitation might also lead to higher prices if used to further differentiate a firm’s services. On the other hand, advertising and solicitation could make the negotiation and contracting of audit service levels and fees more efficient, resulting in lower fees. Advertising may reduce information asymmetries that favor sellers while solicitation may encourage auditors to search out and contact potential clients to whom they can offer better or more efficient service. The effect on the market would be similar to increasing the supply of service providers available to any given client since a competitor auditor can observe when current fees charged by an incumbent auditor appear to be unusually high, and permitting solicitation allows the competitor to act upon that knowledge by approaching the client.

We use the unique institutional setting provided by New Zealand to specifically examine the effects of advertising on audit fees separately from the effects of solicitation. New Zealand deregulated advertising effective January 1, 1986, 6 years earlier than solicitation was deregulated, effective January 1, 1992.³ The audit market in New Zealand has been examined in previous studies (e.g., Johnson et al., 1995; Hay and Davis, 2004; Baskerville and Hay, 2006; Hay et al., 2006a) and is very similar to those in the United States and other Western countries in many ways. Companies must be audited by a chartered accountant and make their financial statements publicly available if they are issuers or if there is 25% or more overseas shareholding. Becoming a chartered accountant requires 4 years of university study, three years of professional experience, and passing of professional competency exams. Audits of listed companies are dominated by the international firms (Hay et al., 2006a) and fees are determined by similar factors to those in other Western countries (Hay et al., 2006a). Further, auditors in New

¹ Further evidence of this perception can be found in statements by other commentators. Wyatt (2004, p. 46): “... accounting firms were precluded from advertising their skills and achievements through the 1970s. Reputations were gained, in part, from a firm’s policy on how tough a stance to take on the interpretation of accounting standards ... In effect, being tough on accounting standards was at the forefront of what today would be characterized as the firm’s marketing strategy.” Zeff (2003a, 202): “The elimination of the Institute’s bans on competitive bidding, uninvited solicitation, and advertising, coupled with the apparent topping out of the audit market all fundamentally changed the character of CPAs’ relations with clients.” Zeff (2003b, 280) lists five defining events and decisions that have brought the profession to where it is today. Number one on the list is “The actions taken by the Federal Trade Commission and the Department of Justice to force the profession to repeal its bans against competitive bidding and direct, uninvited solicitation of clients.” Palepu and Healy (2003, pp. 19–20): “Two major changes in the 1970s created substantial pressure for audit firms to cut costs and seek alternative revenue sources. First, in the mid-1970s the Federal Trade Commission, concerned with a potential oligopoly by the large audit firms, required the profession to change its standards to allow audit firms to advertise and compete aggressively with each other for clients. Second, legal standards shifted ...”

² An exception to this pattern of behavior is reported by Anderson and Zéghal (1994) who examine Canadian data in the early 1980s but find no change in fee levels after relaxation of rules allowing increased competition.

³ In contrast, in the US, deregulation of advertising and solicitation occurred at the same time as a comprehensive overhaul of the Code of Professional Ethics in response to anti-trust investigations by the US government.

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