Public Disclosure of Audit Fees and Bargaining Power between the Client and Auditor: Evidence from China

Xijia Su a, Xi Wu b,

a China Europe International Business School, China
b School of Accountancy, Central University of Finance and Economics, China

Abstract

Before the public disclosure of audit fees was mandated, it was unlikely for an audit client to have accurate information about how much other companies were charged by their auditors. Public fee disclosure decreases the cost of auditees' access to audit fee information for the auditor's portfolio of clients and is thus likely to increase the relative bargaining power of auditees over auditors when they negotiate audit fees. Using both proprietary and public audit fee data before and after public fee disclosure was mandated in China, we provide evidence consistent with the preceding conjecture. We find that public fee disclosure reinforces the magnitude of audit fee decreases for overcharged clients and weakens auditors' ability to raise audit fees for undercharged clients. These findings suggest the existence of unintended consequences of public fee disclosure regulation, the original rationale of which was a concern about audit pricing practices that could undermine auditor independence.

Keywords: Public fee disclosure, Bargaining power, Audit fee adjustments, China

1. Introduction

This study examines how the public disclosure of audit fees affects the bargaining power between the client and auditor. Numerous studies have examined the economics of audit pricing since Simunic (1980) (see Hay, Knechel, and Wong (2006) for a review). Some prior studies use surveyed proprietary audit fee data to conduct empirical analysis in an audit market without a public fee disclosure requirement, and others use publicly available audit fee data in a public disclosure regime. However, little has been done to compare the economics of audit pricing between the non-public and public disclosure regimes, possibly due to the lack of both proprietary and public audit fee data in a single audit market. 1

In comparing non-public and public fee disclosure regimes, one important research question to consider is how public fee disclosure affects the bargaining power between the client and auditor. The question is important because it speaks directly to Healy and Palepu's (2001) call for a better understanding of the effect of disclosure regulation on capital market development. The literature

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† Corresponding author.

E-mail address: xi.wu@cufe.edu.cn (X. Wu).

1 Due to this limitation, prior studies use an indirect approach to infer possible differences in audit pricing between the public fee disclosure and non-disclosure regimes. For example, Craswell and Francis (1999) examine initial engagement pricing in Australia (i.e., a public fee disclosure regime) during a time when comparable U.S. studies report fee discounts for initial engagements.

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documents that fee issues dominate negotiations between client management and auditors (Beattie, Brandt and Fearnley, 2000). As fee disclosure regulation reveals the contractual (particularly fee) relationship between clients and auditors (DeAngelo, 1981a), it is likely to affect such a relationship, as the extent of audit pricing information asymmetry is lower. For example, Francis and Wang (2005) find that audit fee precision increased and fee dispersion decreased following the initial regulation of public fee disclosure in the U.S. audit market, transcending its original rationale.2

As an auditee usually has a limited understanding of auditors’ effort level (and thus limited audit fee information) in a private fee disclosure regime, public fee disclosure considerably expands the set of audit pricing information faced by clients, who now have significantly more information about how much comparable companies are charged in the market. Therefore, an auditee is more capable of identifying herself as being overcharged or undercharged. Given that a prior-period overcharged client asks to pay lower audit fees in the next period (i.e., a negative association between the lagged audit fee residual and current-period audit fee change), we predict that such a negative association is stronger in the public fee disclosure regime than in the non-public regime.

However, an auditor often has access to a large portfolio of clients to make audit pricing decisions, even in the pre-disclosure regime. Although public fee disclosure expands the auditor’s fee information set to some extent, competition between auditors becomes more transparent, as clients can see many low-fee alternatives. Therefore, we predict that auditors’ ability to raise audit fees for undercharged clients is compromised in the public fee disclosure regime relative to the non-public regime.

We test and find evidence consistent with the preceding predictions using both proprietary and public audit fee data in China. China’s public fee disclosure regulation was released in December 2001,3 making audit fee data for Chinese listed companies available for 2001 and after. Moreover, before the public fee disclosure requirement, the China Securities Regulatory Commission (CSRC), the counterpart of the U.S. Securities Exchange Commission (SEC), conducted a survey among CSRC-licensed audit firms about audit fees charged to their listed clients during 1997–1999.4 Therefore, we are able to use the audit fee data both before and after public disclosure to test our predictions.

This study contributes to the literature in two ways. First, our evidence suggests that public fee disclosure increases the bargaining power of clients relative to auditors when negotiating audit fees. As the original rationale of public fee disclosure regulation in China was to deter questionable audit pricing practices that were likely to compromise auditor independence, our findings indicate an apparently unintended consequence of disclosure regulation in an emerging capital market. Given that gaining bargaining power in fee negotiation is important to both auditors and their clients in all markets, this unintended consequence may have implications for regulators and other stakeholders in jurisdictions beyond China. Second, although Francis and Wang (2005) find that audit fees are adjusted downward (upward) for overcharged (undercharged) clients in a public fee disclosure regime, Mayhew (2005) argues that such findings can be explained by a mean-reversion process and are thus not necessarily attributable to the effect of public fee disclosure. Using both non-public and public fee data, our evidence is more capable of discerning the effect of public fee disclosure regulation from a mean-reversion process of audit pricing.

We proceed with this study as follows. Section 2 develops research hypotheses. Section 3 introduces our research design. Section 4 presents empirical results. Section 5 concludes the study.

2. Hypotheses development

2.1. Information environment before the public disclosure of audit fees

Auditing can be characterized as an experience good of which consumers can determine the price but not the quality before purchase (Craswell and Francis, 1999), as audit quality is costly and difficult to assess ex ante (DeAngelo, 1981b). Moreover, Causholli and Knechel (2012) characterize auditing as a credence good by arguing that the benefit of information asymmetry between the auditee and auditor accrues to the auditor “because, ultimately, only the auditor can say how much effort is actually required to satisfy professional standards given the attributes of the auditee.” The difficulty in observing and assessing both audit quality and effort is likely to give the auditor incentives to under-audit, over-audit, or overcharge (Causholli and Knechel, 2012).

To complicate this, an auditee usually has limited access to auditors in a regime where audit fees are not publicly available and thus access to audit pricing information is limited. Once a contract for an audit service is settled, an auditee is bonded with an audit firm within the effective contract period. Moreover, incumbent auditors possess cost advantages over potential competitors in future audits of a given client, which implies the absence of perfect substitute auditors in future periods (DeAngelo, 1981b).

One approach to gaining access to alternative auditors in the non-public disclosure regime is through invited or uninvited solicitations (Chaney, Jeter and Shaw, 1997; Jeter and Shaw, 1995). However, the flow of information between clients and alternative auditors is still limited and the transaction cost can be high. In regimes where uninvited solicitation is banned, the exchange of information between non-incumbent auditors and prospective clients occurs only when clients are dissatisfied with their auditors (Jeter and Shaw, 1995). Even in regimes where uninvited solicitation is allowed, solicitation and searching costs still arise. For example, the client is usually faced with a limited scope when identifying an acceptable new auditor due to geographical distance and

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2 The original disclosure requirement in the U.S. market was made on the grounds of enhancing auditor independence, with a particular emphasis on disclosing non-audit fees as a percentage of total fees (Francis and Wang, 2005).

3 The requirement is titled Q&As on the Regulation of Disclosure by Issuers of Public Securities No. 6: Paying Service Fees to Public Accounting Firms and Related Disclosure.

4 The pre-disclosure audit fee data were provided to us with an understanding that they would be used for academic research only.
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