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Further evidence on the determinants of audit pricing in universities

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ABSTRACT

This study investigates the determinants of audit fees for UK universities, involving an analysis of 451 university-year observations over the period 2007–2010. The study contributes to a fledgling strand of research examining audit pricing in the public sector. In seeking to identify an appropriate model to explain audit fees we interview a number of university auditors and use their insights in conjunction with prior findings from both private and public sector studies of audit pricing. Our findings show that audit fees in UK universities are positively influenced by size, the number of subsidiary companies, the amount of endowments, the level of debtors, being located in England and the use of a London-based auditor. We also find that more research-intensive universities (using a range of measures) and universities with greater operating surpluses pay lower audit fees.

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1. Introduction

Ever since Simunic's (1980) seminal paper a significant literature has grown up seeking to explain the determinants of audit fees. The existing literature focuses predominantly on audit pricing in the context of private companies with a number of factors emerging as having a reasonably consistent impact on fees (Hay, Knechel, & Wong, 2006). First, a number of audit client characteristics have consistently been found to influence audit fees. These include size, complexity, risk, profitability, and leverage. Second, prior research has also reported a number of auditor characteristics to be significant in the audit pricing decision, such as; whether the auditor is one of the big-four audit firms, the length of the auditor's tenure, the auditor's market share, and, in the case of UK-based research, whether the auditor is based in London. Third, a number of audit engagement attributes such as audit timing, the length of time between the financial year-end and the signing of the audit report as well as the presence of an audit qualification typically emerge as important influences on the audit fee. Fourth, more recent research has focused on the impact of the joint provision of non-audit services on audit fees with reasonably consistent evidence that the value of non-audit services purchased exerts a positive impact on the audit fee.

The literature on the determinants of audit fees in the public and non-profit sectors is less developed with only a handful of UK-based studies having examined the issue. The studies that have taken place tend to be heavily influenced by findings from the private sector with researchers focusing their investigations on organisational characteristics such as audit client size, complexity and risk as well as auditor characteristics such as size and location. For example, in a study of audit fees in NHS trusts by Clatworthy, Mellett, and Peel (2002), auditee size, certain aspects of complexity and London-based audits are found to exert a significant and positive impact on audit fees while audit tenure and the extent of consultancy fees paid to the auditor have a significant and negative impact. In a subsequent study of NHS trusts, Basioudis and Ellwood (2005), while confirming the earlier findings in respect of size, complexity, audit location and consultancy fees, find that large auditors do charge a premium for their audits. Finally, in a study of the UK charity sector, Beattie, Goodacre, Pratt, and Stevenson (2001)

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again find that organisation size, complexity and auditor location are significant influences on the level of audit fee paid but also find that large auditors charge a premium as do industry specialist auditors.

The purpose of this paper is to investigate the determinants of audit fees in the UK university sector. Universities are a sub-sample within the overall public sector in the UK so, in that respect, this study seeks to add to our understanding of the determinants of audit fees in the public sector. Despite the large number of studies that have investigated the determinants of audit fees in the private sector, very few have examined the issue in the context of the public sector so this study adds significantly to the current paucity of knowledge in this area. More specifically, the study seeks to build on prior research by Mellett, Peel, and Karbhari (2007) who examined the determinants of audit fees in a sample of UK universities using data from 2001. In summary, Mellett et al. (2007) find that university size, complexity, auditor size, auditor location and the joint provision of non-audit services exert a significant positive influence on audit fees while older universities exert a negative impact. We believe our study adds to the work of Mellett et al. (2007) in two important respects. First, we study the determinants of audit fees over the four-year period 2007–2010, therefore providing a more contemporary analysis of the issue as well as being able to examine the continued relevance of the findings of Mellett et al. (2007) over a period of significant change in the UK higher education sector. Furthermore, since we investigate audit fees over a four-year period, our findings are likely to be more robust than those from a single year study. Second, while Mellett et al. (2007), and other studies of audit pricing in the public and non-profit sectors, base their analysis largely on the established model for private companies, we also interview university auditors in order to improve our understanding of the factors that auditors themselves perceive as being important in their pricing decisions. These interviews have allowed us to design and test a more bespoke model for understanding the determinants of audit fees in UK universities. Our findings show that audit fees in UK universities are positively influenced by size, the number of subsidiary companies, the level of endowments, the proportion of assets in the form of debtors, being located in England and the use of a London-based auditor. We find that older universities and universities with greater operating surpluses pay lower audit fees. An important contribution of our study relates to the findings around the impact of income sources on audit fees with greater emphasis on research income (using a range of measures) being associated with lower audit fees while greater reliance on teaching income is associated with higher audit fees.

The paper is structured as follows: The next section reviews prior literature on audit fees, including a discussion of the applicability of aspects of the private sector pricing model to public and non-profit institutions. Section 3 discusses the governance and audit framework of UK universities and uses the feedback from our interviews with university auditors to discuss a revised model of the determinants of audit fees in the UK university sector. Section 4 describes the sample, presents some summary statistics and also presents some sub-sample comparisons. Section 5 presents the results of our multivariate analysis. Section 6 contains our conclusions as well as some discussion of possible avenues for further research.

2. Audit pricing in the private and public/non-profit sector

2.1. Audit pricing in the private sector

Simunic's (1980) seminal theoretical and empirical study of the determinants of corporate audit fees has initiated a vast amount of research seeking both to expand and verify Simunic's (1980) original model as well as applying it to different environmental and national settings. The available literature finds that audit fees are predominantly influenced by certain audit client characteristics, such as; size, complexity, risk and the level of non-audit business simultaneously purchased from the auditor, as well as some auditor characteristics, notably size and location. In their comprehensive review of the audit pricing literature, Hay et al. (2006) note that "the most dominant determinant of audit fees across virtually all published studies is size" (Hay et al., 2006: 8). Even though there is some discussion as to whether the most appropriate measure of size is assets or turnover (Pong & Whittington, 1994), studies have consistently shown that either measure exerts a very significant and positive impact on audit fees (Ezzamel, Gwilliam, & Holland, 1996; McMeeking, Peasnell, & Pope, 2006; O'Sullivan, 2000, 2009; Pong & Whittington, 1994).

The second key determinant of audit fees is audit client complexity, based on the view that the more complex a company is the more difficult and time-consuming it is to audit. Complexity has been measured in a number of ways ranging from the number and location of subsidiaries (O'Sullivan, 2000) to the diversity of the audit client's activities (Chan, Ezzamel, & Gwilliam, 1993) with consistent results suggesting that complexity exerts a significant and positive impact on audit fees. Furthermore, prior studies have also recognised the potential complexity associated with the audit of inventories and receivables and include some measure of this in the analysis, with studies typically reporting a positive link between the proportion of a client's assets represented by inventories and/or receivables and audit fees (Hay et al., 2006).

The auditor's perception of client risk has traditionally played an important role in audit pricing studies with significant evidence of more risky audits being associated with higher audit fees (Cobbin, 2002; Hay et al., 2006). This finding is based on the anticipation that more risky audits are likely to expose auditors to liability claims and/or reputational loss with auditors seeking to counter this possibility either through increased audit effort or by incorporating some form of insurance element in the audit fee (Simunic & Stein, 1996). Consequently, studies typically include some measure of financial performance and/or financial leverage since better performance reduces the likelihood of the auditor subsequently incurring losses while higher leverage increases the likelihood of business failure and hence possible auditor pay-outs. However, as noted by Hay et al. (2006), there is no consistent evidence that client profitability (or lack of it) impacts audit fees, especially in a non-USA

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