

The Effect of Audit Firm Size & Abnormal Audit Fees on Independent Auditor's Opinion: Conceptual Framework (Bangladesh Perspective)

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Abstract

The purpose of the study is to present a new framework in the relationship among audit firm size, abnormal audit fees & independent auditor's opinion by introducing positive and negative abnormal fees as a mediator variable. In this study merely uphold a systematic representation of relationship among Audit Firm Size, Abnormal Audit Fees & Auditor's Independence. This study constructs a measure of auditor profitability as a proxy for audit quality and the paper is based on the idea that audit quality is influence by abnormal audit fees and audit firm size. So two model is developed here to find out the relation. Pearson's co efficient of correlation will be shown to uphold the relation among them. Multiple regression will be used to check the developed hypothesis. The main contribution of this studies is i) To know about the auditor's fee structure for ensuring auditor quality, ii) Ensure the auditors independence and firm size Relationships, iii) Potential investment decision making, iv) Familiarizing with auditing criterion

Keywords: audit quality, audit firm size, abnormal audit fee.

1. Introduction

The origin of audit may be traced to middle age. The word "audit" derived from the Latin word "audire" which means "to hear". In olden times, whenever the owner of a business

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suspected fraud, they appointed certain persons to check the accounts. Such persons sent for the accountants and “heard” whatever they had to say in connection with the account.

It was an Italian, Luca Paciolo who first published his treatise on Double entry system of book-keeping for the first time in 1494. He mentioned and described the duties and responsibilities of an auditor. According to Arens & Loebbecke (2000), Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. They also added that Auditing should be done by a competent, independent person.

According to one group of small firm and regulators have claimed that audit quality should not merely be judged on the size of big accounting firms (DeAngelo, 1981). However Deangelo (1981) opposed this argument of small firms and opinion that big audit firms have a lot of freedom and higher quality in audit work.

To reveal material problems in financial statement, big audit firms are pionner and have more intention (Francis and Yu, 2009). De \Angelo (1981) noted that big audit firms get more independence in case of audit revenue, so that the opinion is qualified. Large audit firms will in a position of potential treat to lose their clients. if they become ill framed have lower audit quality and present a lack of independence in their judgments. Hence these baring issues motivate for increase audit quality. Scholar’s showered the positive relationship between firm size and audit quality (Cheng et al, 2009).

2. Statement of the Problems

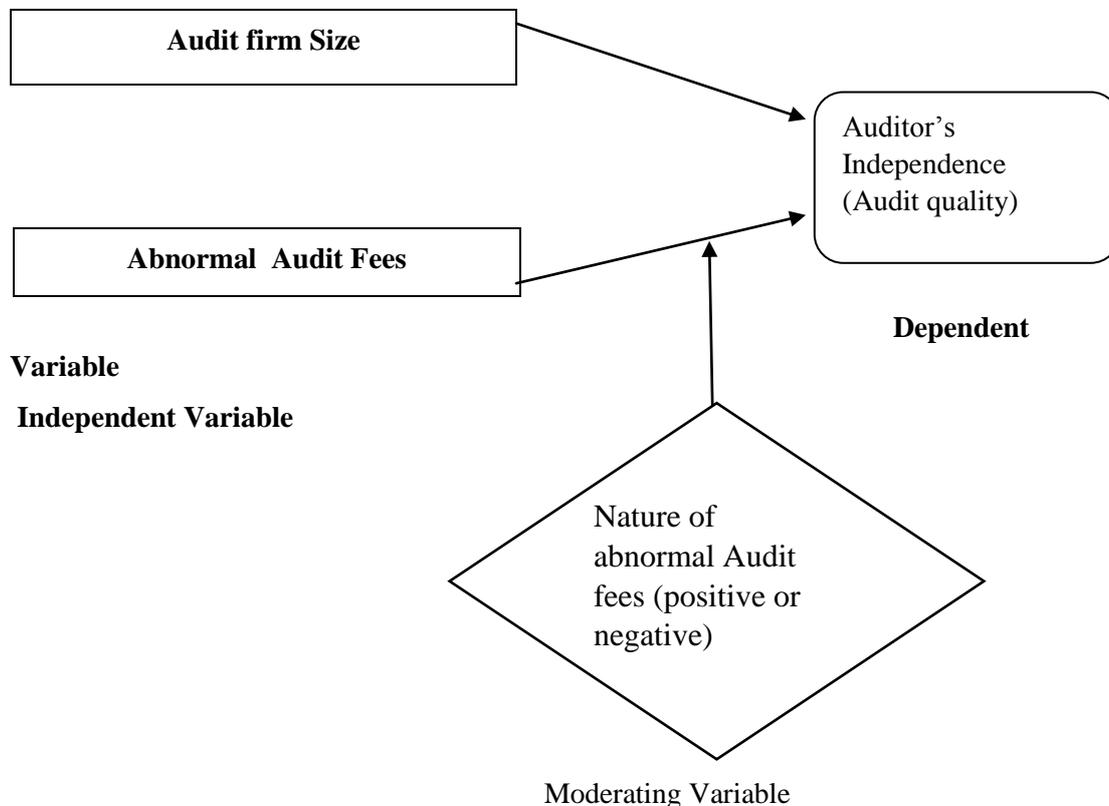
Much greater coercion have to be made by the auditors to insure the quality of the audit. The measurement of audit endeavor depends on the audit fees which can be normal & abnormal. An anecdotal engagement is found with the audit firm size and the auditor independence relevantly. The empirical smeared is to be grounded on that purpose. So the problem statement is

- Has audit firm size any effect on Auditor Independence?
- How has the abnormal Audit Fees affected the auditor’s independence?

3. Theoretical framework

- In our study, Audit firm Size & Abnormal Audit Fees are independent variables. Positive or negative Abnormal Audit Fees is moderating variable. Auditor’s Independence (Audit Quality) is taken as dependent variable. Year & Industry will be control variable.
- The main intention of this study to find out the relationship among audit firm size & abnormal audit fees and auditors independence from Bangladesh.

- The relationship between independent variable and dependent variable either positive or negative.
- A Schematic diagram will be presented below



4. Hypotheses development

After studying the literature review and problem statement we may uphold the following will be the Alternative Hypotheses for our study

H1: There is a significant effect of Audit Firm Size on Auditor's independence.

H2: There is a significant effect of Abnormal Audit Fees on Auditors Independence.

5. Objectives of the study

To find a solution about the audit firm size, abnormal audit fee's effect on auditors independence in Bangladesh for the period of 2013-2014. More specifically

1. Whether the audit firm's size have any effect on auditor independence.
2. Whether abnormal audit fee affect the auditor independence.

6. Literature Review

The relationship among Audit Firm Size, Abnormal Audit Fees and Auditor Independence is a convention which is extremely controversial by the researchers. Whether a patchy relationship between the audit firm size and auditor independence has influential is to determine as a few studies have been composed on this. On the same way, the auditor independence is pursuivant or not on the abnormal audit fees.

Several distinct schools thought regarding Audit Fees and Audit Quality. According to one school, Hoitash, R., Markelevich, A., and Barragato C. A. (2007) found that a prominent negative relationship between Audit Fees paid to auditors and Auditor Independence where they take only non financial companies. In consistence with, Holland & Lane (2008) said that high total fees rebuff the auditor's independence.

Two views are found on determining Audit Fees; one is considered Abnormal & another is Normal Audit Fees. Eshleman and Guo (2013) found that audit quality relates positively with abnormal audit fees. Conversely, Xie et al (2010) claims that there are no significant association between abnormal audit fees and audit quality.

The different views have been established on abnormal audit fees by the Literature, where one dispute that auditors independence may be affirmatively affected by positive abnormal audit fees. Another school proposes that abnormal fees might have adversely impact on auditor's independence. Likewise, Blankley et al (2012) found that affirmative abnormal audit fees are positively associated with audit quality, where they take financial re-statement as their quality measurement. However, Gupta et al (2009), examined that negative abnormal audit fees are negatively connected with audit quality where discretionary accruals is used as proxy of auditors independent. Nevertheless, Choi et al (2010) asserted that negatively audit quality relates with positive abnormal audit fees, where they check this research in US market.

DeAgelo (1981) tasted the quality of auditor's independence and size of audit firm. One study reveals that Sweeny and Roberts (1997) deemed that auditor's independence and audit firm size relationship is insignificant and ambiguous. Caramanis and Spathis (2006) also supported the opinion of Sweeny and Roberts. Finally we do not find any complete story regarding the size of audit firm and auditor's independences.

7. Methodology

In study, All the CA firms who are practicing in Bangladesh will be our Population. Total number of CA firms both A and B category is 113. Krejcie and Morgan (1970) table use for selecting sample size. According to them our total sample size will be 92 audit firms. In real study, random selection is used to select the CA firms from both categories to do the research.

Before going to ensure reliability and validity of measurement first will check T-values for items analysis. Reliability consists of stability and consistency. For stability, Parallel Form reliability and for consistency will use Cronbach's coefficient Alpha (Cronbach's Alpha; Cronbach, 1946). Validity consists of construct, criterion and content validity. For content validity, communication with an Expert in this field will be ensured. Pearson Correlation will present for construct validity. Two model will construct in that case that are, one for audit firm size and audit quality and another is for audit quality and abnormal audit fees.

8. Measurement of abnormal audit fees

The first model is based on abnormal audit fees and audit quality. So to analysis the hypothesis we first need to measure the abnormal audit fees and audit quality. We take the following formula to estimate the abnormal audit fees. **Abnormal audit fees** = (actual audit fee paid by the client to its auditor - the predicted (normal) audit fee). We use the following equation to calculate the normal audit fees. We take this model from **Choi et al, 2006**.

$$\text{NAFEE} = \alpha_0 + \alpha_1 \text{LTA} + \alpha_2 \text{BS} + \alpha_3 \text{GS} + \alpha_4 \text{INRE} + \alpha_5 \text{RNE} + \alpha_6 \text{DETA} + \alpha_7 \text{FIT} + \alpha_8 \text{EXGL} + \alpha_9 \text{LOSSDY} + \alpha_{10} \text{LEV} + \alpha_{11} \text{ROA} + \alpha_{12} \text{CR} + \alpha_{13} \text{BIG4} + \alpha_{14} \text{BTM} + \text{Industry Year Dummies error} \dots \dots \dots (1)$$

Where

NAFEE = natural log of total fees paid to auditors for the audit of their financial statement audits.

LTA = natural log of total assets

BS = natural log of one plus number of business segments;

GS = natural log of one plus number of geographic segments;

INRE = inventory and receivables divided by total assets;

RNE = square root of the number of employees;

DETA = 1 if the sum of debt or equity issued during the past 3 years are more than 5% of the total assets, 0 otherwise;

FIT = 1 if the firm pays any foreign income tax, 0 otherwise;

EXGL = 1 if the firm reports any extraordinary gains or losses, 0 otherwise;

LOSSDY = 1 if the firm reported a loss during the year, 0 otherwise;

LEV = (leverage) total liabilities of firm divided by total assets of that firm;

ROA = return on assets

CR = current assets of a firm divided by current liabilities of that firm;

BIG4 = 1 if the auditor is one of Big 4, 0 otherwise;

BTM = book-to-market ratio.

9. Measurements of discretionary accruals:

Audit quality as a nature which is unobservable. Giving importance the prior research, we try to define audit quality as equal to the Client’s earnings quality (Higgs and Skantz 2006; Lim and Tan 2008; Davis et al. 2009; Francis and Yu 2009; Reichelt and Wang 2010; Choi et al. 2010). With the prior research we find commonly used proxies for earnings quality that is absolute discretionary accruals and propensity to meet or beat earnings expectations. Here we estimated the discretionary accruals as proxy for audit quality.

The level of discretionary accruals has generally been used as an alternative for managers’ practice of discretion from GAAP. To the extent of discretionary element of accruals is taken by managers to opportunistically uphold earnings and at the same time auditors agree the manipulation to remain uncorrected, this adversely reverberate on the audit and as well as the earnings quality (Schipper 1989; Jones 1991; Levitt 2000; DeFond and Park 2001). By using Discretionary accruals which is used for increasing or decreasing earnings on the basis of the incentives of managers. Because of no specific managerial incentives, so no directional predictions used for accruals. We therefore here use absolute value of discretionary accruals (|DACC|) as the independent variable in our study. Discretionary accruals (DACC) are measured by using the cross-sectional modified adaptation of the Jones model (Jones 1991; Dechow et al. 1995), deflated by total assets, and uphold by year and for each industry. Thus the TACC is the following model

$$TACC = (IBEI - CFOA)/Lag (AT)..... (2)$$

Where,

IBEI is the income before extraordinary items

CFOA is net cash flow from operating activities, and

AT is total assets.

The model to estimate discretionary accruals is:

$$TDACC = \Theta1 + \Theta2 [1/Lag (AT)] + \Theta3 [\{\Delta CR+DAR\}/Lag (AT)] +\Theta4 [TPPE/Lag (AT)] + \Theta5 ROA + error..... (3)$$

Where Lag (AT) is total assets of past year; CR is change in revenue; DAR is the decrease in accounts receivables; TPPE is property plant and equipment (gross total); and ROA is return on assets, calculated as IBEI deflated by AT. Equation (3) is estimated by year for each industry (two digit SIC code). Then TACC minus the values obtained from regression equation (3) is the Discretionary accruals.

Model 1

Here the model 1 is based on abnormal audit fees and audit quality. DA or discretionary accruals is a proxy for audit quality measurement. TACC minus the predicted value from the above regression is our measure of discretionary accruals. Our test of DA is based on the following model:

$$|DA| = \alpha_0 + \alpha_1 \text{ANAF} + \alpha_2 \text{LTA} + \alpha_3 \text{BIG4} + \alpha_4 \text{BTM} + \alpha_5 \text{SALEC} + \alpha_6 \text{LOSSDY} + \alpha_7 \text{LEVE} + \alpha_8 \text{DETA} + \alpha_9 \text{AOFE} + \alpha_{10} \text{CFODTA} + \alpha_{11} \text{PTADTA} + \text{industry and year dummies} + \text{error term} \dots \dots \dots (4)$$

DA = discretionary accruals, which is based on Ball and Shiva Kumar's (2005) method;

ANAF = abnormal audit fees;

LTA = log value of total assets;

BIG4 = 1 if the auditor is a Big 4 or predecessor auditor, 0 otherwise;

BTM = book-to-market ratio

SALEC = sales change from the prior year to current year scaled by lagged total assets;

LOSSDY = 1 if the firm reported a loss during the year, 0 otherwise;

LEV = (leverage) total liabilities of firm divided by total assets of that firm;

DETA = 1 if the sum of debt or equity issued during the past 3 years are more than 5% of the total assets, 0 otherwise;

AOFE = 1 if auditor is in the first year of audit engagement, 0 otherwise;

CFODTA = cash flow from operation scaled by lagged total assets;

PTADTA = prior-year total accruals scaled by lagged total assets.

Model 2

The model 2 is basically based on the audit firm size and audit quality. Here we use the same estimation for audit quality as model 1. For audit firm size we developed a new proposed model. An audit firm can be measured in terms of number of audit done or number of partner in the audit firm. According to previous research no one use this model as a firm size. The model is

$$AFS = \alpha_0 + \alpha_1 NAD + \alpha_2 NP + \text{error.}$$

Where NAD means number of audit done in a particular year and NP means number of partner in the firm. All variables are described in the table one. Which is uphold the below

10. Methods of data collection analysis

First we administer a questionnaire to the sample size of 92 audit firms. Thereafter will go to the audit firm and give them the questionnaire and collect the data within our budgeted time. At first we will try to find out the Descriptive Statistics such as mean, median and mode. Then two Model will be construct to test the hypothesis, where one model is for audit firm size and auditor's independence, another model is for abnormal audit fees and auditor's independence. R-square value will be also seen for model fitness. Multiple regression will be also employed for measuring the relationship between independence and dependence variable.

11. Conclusion

Because of few studies on Audit Firm Size, Abnormal Audit Fees & Auditor's Independence. The study has a new suggestion for improving the relationship among Audit Firm Size, Abnormal Audit Fees & Auditor's Independence. The paper applied positive and negative abnormal audit fees as a mediator variable because of its effect on audit quality. The result of this study are expected to contribute the knowledge of audit firms partners about the effect of audit firm size and positive and negative abnormal audit fees. In near future data will be collected and further work under this study will be done.

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