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Audit pricing in China and Pakistan: a comparative review of audit practices

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Abstract: The purpose of this study is to investigate the firm-level factors effect on the audit pricing in China and Pakistan. For this purpose, we used the panel data of 160 firms of each country of study for the period from 2005 to 2011. First, we run the combined model for two countries and observed that complexity of business transaction is the only variable contributing positively and significantly in audit pricing of both countries. Then, for comparative review, we segregated the data of each country and run separate model. The results of separate models show that, in the case of Pakistan auditors mainly consider complexity of business transactions and client risk while pricing their engagement as an auditor. However, in the case of China the auditors only consider the Big 4 audit firm effect as a reputational tool while pricing their audit activity. The auditors in China totally ignore the client risk and complexity of business transactions which may be problematic for their auditing firm in future. The study concludes that audit pricing in Pakistan is more rational in comparison to China.

Keywords: audit pricing, corporate governance, client risk, big 4 audit firms, audit quality

JEL codes: M41, M42

1. Introduction

External audit has a main affect on the reliability and availability of financial information. The SECP (Securities and Exchange Commission of Pakistan) in Pakistan and the CSRC (China Securities and Regulatory Commission) in China

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require each company to submit the audited financial statements at the end of the financial year. No one can deny the importance of financial statements because they are the fundamental source of financial information of any corporation; may be used by the stakeholders and analysts to test the financial health of corporations. Audited financial statements provide trust and faith to financial analysts and investors about the validity of financial statements (Simunic, 1980).

External audit requires an independent opinion by auditors, about the validity of representation made by management, on its financial statements. For this independent audit opinion the auditor evaluates accounting procedure, methods and different estimations used by the management in financial reports. In addition, audit also involves transaction testing, observing and interviewing the clients, evaluating the internal control measures and checking the movement of physical inventory within the corporation.

Because of the compulsory annual audit requirement of SECP and CSRC and the amount and nature of audit work required to be performed by auditors, audit fee is a substantial expenditure in total expenditure of firm. Moreover, independent audit improves the credibility of financial information and ease the access of audited corporations to the capital markets. However, whether independent audit will play its role or not, depends on the quality of audit services being provided. In order to observe the quality of audit services, audit fee is the basic research variable.

As audit price incorporate the risk attach with audit engagement, so, on the one side it is sensitive to strategic decision of any corporation while on the other side it helps auditor in understanding and evaluating their liability. The purpose of audit engagement is to perform the services and issue an independent opinion on the validity of financial statements. The process of giving an opinion about the reliability of financial statements involves a high degree of risk. The auditor is answerable to regulators and stakeholders for his audit performance. The inherent risk in audit is that material misstatement may exist in the financial accounting and auditor fails to detect it and thus may issue an unqualified report.

However, if auditor conducts the audit in accordance with International Financial Reporting Standards (IFRS) he will not be liable for any misstatement in financial statements. But if he does not follow the IFRS and fails to detect any fraudulent misrepresentation and users of these financial statements face damages due to it, then the auditor must be held responsible for those damages. For example, Arthur Anderson (the audit firm of Enron) was failed to follow the International Standards on Auditing (ISA) and was held responsible for the damages which further lead to the dissolution of Enron. Because the audit fee cannot be adjusted after disclosure of material misstatement in financial statements, the auditor can minimize its loss by incorporating this inherent loss in his audit fee.

Both regulator and academia in western countries gave a considerable attention to audit fee and conducted an extensive research on it in past. Simunic(1980) developed a model to find whether 8 big audit firms charged higher audit fee as compare to the other firms. Many researchers, in western countries, conducted the research on the factors which affect audit fee. They obtained new insights but their conclusions are not justifiable for countries like China and Pakistan. Because, both of the economies are not market driven economies and regulatory measures on governance of audit firm especially in China is under review to improve the quality of audit and protection of auditing firms.

Our study considers the firm level characteristics like complexity of business transaction to increase the protection of auditing firms in China and Pakistan. However, the previous studies of Ferguson *et al.* (2006) address the issue of audit pricing in China but failed to incorporate the complexity of business transactions, our study fills this gape by considering the complexity of business transaction as a major determinant of audit pricing at micro level in China. Our results also show in a comparative manner that audit firms in China are failed to incorporate it in their audit pricing policy as compare to the audit firms of Pakistan.

By considering audit fee as a basic criterion of audit quality services, the regulatory bodies in China and Pakistan has recently started setting the criterion for charging the audit fee. Regulatory bodies incorporate all the relevant factors in setting the audit fee. In order to access which factors affect audit fee in Pakistan and China, it is essential to know about three pillars i.e. regulatory bodies, auditor and auditee. Because of the late reforms in audit industry and slow process of privatization in both economies, audit industry remained unattractive and no proper study is available on determination of audit pricing. Taylor and Simon (1999) have already conducted the research on audit market of Pakistan and explored the country level characteristics in order to detect the determinant of audit fee. But after the research period of their study, the audit market of Pakistan has subject to new different rules, which are very important in determining the audit fee. Thus, the results and conclusion of Taylor and Simon (1999) are not justified in new audit environment of Pakistan. Moreover, that study was based on macro factors but our study is centered on firm level characteristics contributing towards the audit fee of an auditor. Our study seems to be a contribution in the existing literature available on audit pricing in Pakistan, because it uses the recent data of firms, which incorporates all regulatory measure introduced by ICAP (Institute of Chartered Accountancy of Pakistan), SECP in Pakistan, and CSRC in China.

2. Literature review

Meshari and Al-Harshani (2008) focus on the determinants of audit fee in Kuwait. Their findings strongly confirm that the audit fee in Kuwait is positively related with audit client size (total assets) and profitability of audit client. This study also suggests inverse relation between audit fees and firm liquidity ratio, uses as a measurement of client risk. Nevertheless, they could not find any significant relation of audit fees with the number of audit locations visited the client's debt to equity ratio, and the audit firm size due to the different attributes of audit market as compared to large and more developed countries.

Choi *et al.* (2011) examine the role of a firm's earnings quality in determining audit fees. Empirically, they develop seven parameters to capture the firm's earnings quality i.e. accrual quality, earnings persistence, predictability, smoothness, value relevance, timeliness and conservatism. They use them as proxies for overall accounting quality. The study sample consists of 2376 publically listed firms in USA. The study shows that auditors charge higher audit fee to firms with less desirable attributes of earnings, as compare to client-firms with more favorable earnings quality. The analysis also explains that the auditors give more weight to the earnings quality induced by the economic fundamentals (innate sources) than by management choices (discretionary sources) in evaluating risk, which in turn is reflected in audit fee. In addition, the study documents weak evidence on the association of audit fees and earnings attributes for client of Big 4 audit firms, as compared to clients of non-Big 4 audit firms.

Pop and Iosivan (2008) report the determinants of the external audit fees in Romania. The study uses the data of 60 firms from 2004 to 2006. The results suggest the significant relation of audit fees with client size, client complexity and size of audit firm.

Cantoni *et al.* (2011) investigate the determinants of audit fees in charity sector of U.K. For this purpose, the study uses the data of 119 largest charitable institutions of U.K. This study concludes that the charity's size, risk and non-audit service are the major factors that determine the audit fee. Contrary to Beattie *et al.* (2001), they do not find any significant relationship between audit fees and organizational complexity. In addition, the study also confirms that amount of audit fees is positively associated with non-audit services fees, the presence of an audit fee premium between big 4 and non-big 4 auditors and the experience of auditor.

Fields *et al.* (2004) observe audit pricing of 277 banks in U.S. This study modifies the audit pricing model for manufacturing firms by introducing measures of risk and complexity that are more appropriate for banks. The study incorporates variables that deal directly with the regulatory structure; include ratios related to

deposits, commercial loans, mortgage loans and charge-offs for nonperforming loans, which are special to the banking industry. The purpose is to develop an audit pricing model that can explain audit fees and investigate the consistency of government regulations with the variables used by accounting firms to price audits. Fields *et al.* (2004)conclude that banks with more transactions accounts, fewer securities as a percentage of total assets, lower levels of efficiency, and higher degrees of credit risk, charge higher audit fee.

Taylor and Simon (1999) collect the fee observations of 20 countries in a single sample. They assert that benefit of collecting fee observations from differing countries provides an opportunity to include variables such as litigation and regulation, which vary across countries but not within a given country. However, this research is centered on "macro" determinants of audit fees. The results indicate that litigation pressures, institutional traditions of increased disclosure, and increased regulation put upward pressures on audit fees.

3. Methodology

3.1. Data and data sources

Our analysis is based on consolidated data from 2005 to 2011 of 160 companies of both countries listed on KSE (Karachi Stock Exchange) in the case of Pakistan, and on Shanghai Stock Exchange in the case of China. For our research need and homogeneity purpose, we ignored the firms from financial sector and only focused on manufacturing sector for this study. In the case of Pakistan, information on all variables is obtained from annual reports of each company. For China the data on audit fee is obtained from Chinese CSMAR data base and the data on other firm specific financial variables is obtained from Chinese RESSET financial data base. However, for compatibility purpose, all variables are converted in US dollar to remove the currency differences between two countries.

3.2. Model of the study

As discussed before, in many developed and developing countries, many studies exist that explain the structure of audit fees. For this purpose, a large number of variables have been used in previous studies. We focus on those variables, which have a vital role in strategic decision of corporations of both countries and have a sound theoretical and empirical relationship with audit fee as well. In both countries it is very important to know how its corporate structure and results of operations effect audit fee. The model seeks to develop a link of audit fee with corporate size, profitability, complexity of operations, risk, liquidity position and presence of audit committee.

It is mostly said that auditors spend more time and efforts to check and verify the quality of financial statements of their large sized clients, which are involved in a variety of business operations and also operate a large number of business assets. Previous studies have also explained corporate size as an important determinant of audit fees (Joshi & Al-Bastaki, 2000; Langendijik, 1997; Pong & Whittington, 1994; Simon *et al.*, 1986; Taylor & Baker, 1981).In this study, we expect a positive relation between audit fees and client size because auditors conduct a detailed auditing procedure by applying substance testing and adequate amount of compliance to their large clients. We use natural logarithm of total assets as the indicator of size.

Different measures have been adopted in previous studies to measure the complexity of business operations. Some previous studies, such as Taylor and Baker (1981), Langendijik (1997), Joshi and Al-Bastaki (2000), Collier and Gregory (1996) have used variables namely foreign operations and number of subsidies/branches to measure complexity of a firm. Other studies like Chan *et al.*(1993), Peel and Clatworthy (2001), Naser *et al.*(2007) employed the measures inventory/total assets and accounts receivables/total assets to determine the complexity. In this study we use balance sheet composition ratios to estimate the complexity, due to ease in availability of data. Inventory and accounts receivables are two main assets which are very time and effort consuming. It is because complex nature of receivables and a wide range of inventory attached with variable cost. So, auditors spend a lot of time and efforts on them and demand higher audit fees.

Profitability of any business refers to efficient utilization of its assets and human resources. Simunic (1980), Joshi and Al-Bastaki (2000) and Wallace (1984) conclude in their studies that audit fees and profitability have a significant relationship. However, other studies, such as Francis and Simon (1987) and Chan *et al.* (1993) could not find any significant link. Successful corporations optimally utilize their assets in order to gain high returns. Usually, higher profitable firms purchase expensive audit service because profitability requires careful scrutiny of testing for revenues and expenses recognition which are very time demanding in nature. So, we expect positive relation between audit fee and profitability. Here, return on assets (ROA) is used to indicate firm's profitability.

Client risk is also an important factor that can highly influences audit fees. Previous studies show no adequate measure of client risk. Due to fall of Enron, WorldCom and an immense increase in lawsuits against auditors on issuing unqualified opinion on misstated financial statements, this factor is playing a vital role in determining audit fees. Therefore, auditors charge higher audit fees against high audit risk. In this study, debt ratio is used as an indicator of client risk.

Liquidity ratio basically measures the ability of a firm to meet its current obligations. Liquidity ratio is measured by the current assets of a company divided by its current obligations. Liquidity ratio is very useful for those stakeholders who are interested in the life of the business, such as creditors, shareholders etc. Different points of views are available about the relationship between audit fees and liquidity ratio. Some suggest that companies with better liquidity ratio prefer to spend more resources on audit fees. Companies with good liquidity position are interested in rigorous testing of their current assets as they have a significant effect in day-to-day business. However, others say that better liquidity ratio refers the low level of audit risk and also require less effort and time by external auditors. So, audit fees and liquidity ratio is inversely related. But in this study we assume a positive significant relation between audit fees and liquidity ratio.

It is very difficult to explain the exact relation between audit committees and audit fee because audit committees react in two ways. Firstly (demand side) the presence of audit committees does not compromise on low quality of external audit and pay higher amount of audit fee to improve the audit quality by increasing the hours and efforts of audit (Collier & Gregory, 1996). Secondly (supply side) involvement of audit committees in fortifying internal control reduces the level of audit risk which pushes the auditors to reduce the amount of audit fees (Collier & Gregory, 1996).

Effective audit committee reduces the fear of auditor's dismissal and raises the bargaining power of auditor to increase audit fee, thus it shows a positive relationship between audit fees and audit committees (Abbott *et al.*, 2003).Therefore, we assume the demand side of audit committee here and expect the positive relation between audit fee and the implementation of audit committees. As discussed before, the audit committee demands higher quality of audit services. Some studies also presented the evidence that the services of big 4 auditors are much better than non-big 4 (Bedard& Johnstone,1998; Francis & Krishnan, 1999). To achieve this target, the audit committee prefers to conduct audit from big 4 audit firms. Prior studies of Choi *et al.*(2008), Craswell *et al.* (1995) and Simunic and Stein (1996) also conclude that big 4 auditors charge higher price of audit fee for better quality of audit. Since big 4 auditors are very conscious about the reputation of their services quality in the market, they adjust their procedures of audit according to the changes in firms operations and demand higher audit fees. Insofar, this study expects positive relationship between audit fee and big 4 audit firm.

As a summary, the following model is developed to observe the determinants of audit fee in Pakistan and China**:**

$$\ln \text{Fee}_{i,t} = \alpha + \beta_1 \text{SZ}_{i,t} + \beta_2 \text{PRO}_{i,t} + \beta_3 \text{RIS}_{i,t} + \beta_4 \text{LIQ}_{i,t} + \beta_5 \text{COMP}_{i,t} + \beta_6 \text{Big 4}_{i,t} + \beta_7 \text{AUC}_{i,t}$$

with

$\ln Fee_{i,t}$ = Natural log of audit fee.

$SZ_{i,t}$ = Firm size: measured as natural log of total assets; positive sign expected.

$PRO_{i,t}$ = Profitability of firm: captured by Return on Assets (ROA); positive sign expected.

$RIS_{i,t}$ = Client risk: captured by debt ratio of firm; positive sign expected.

$LIQ_{i,t}$ = Liquidity: captured by current ratio; positive sign expected.

$COMP_{i,t}$ = Business Complexity: measured by the sum of ratio of inventory to total assets and ratio of account receivables to total assets; positive sign expected.

$Big4_{i,t}$ = big four audit firm: dummy of 1, otherwise 0; positive sign expected.

$AUC_{i,t}$ = Presence of an audit committee; dummy of 1, otherwise 0; positive sign expected.

In this study first we run the combine model for both countries to find the determinants of audit fee and then we segregated the firms and run separate model to see the determinants of audit fee at country level. The next segment of study deals with the results of study.

4. Results

The results of descriptive statistics and correlation matrix are shown in table 1 and table 2 respectively.

Table 1. Descriptive statistics

Variables	Mean	Median	Maximum	Minimum	Std. Dev.
AUC	0.850	0.999	1.000	0.000	0.358
BIG4	0.493	0.000	1.000	0.000	0.501
RIS	0.982	1.000	5.980	-4.586	0.962
LIQ	14.998	0.995	916.203	0.0527	104.212
PRO	2.35	0.125926	7.05	-3.786	4.07
SZ	22.212	20.094	25.263	11.699	23.019
COMP	196.638	1.629	9388.738	-1.014	727.632

The summary statistics given in table 1 shows that audit committee and big 4 variables have maximum value 1. It is because they are dummy variables. The mean and median values of risk and size variables are very closer which show normal distribution of these variables.

Table 2. Correlation coefficient among the sample variables

	AUC	Fee	BIG4	RIS	LIQ	PRO	SZ	COMP
AUC	1.000							
Fee	0.04135	1.0000						
BIG4	-0.0456	0.0290	1.0000					
RIS	-0.0168	-0.0881	0.0025	1.0000				
LIQ	-0.0148	-0.0191	-0.0124	-0.0132	1.0000			
PRO	-0.0138	-0.0124	0.0586	0.0033	-0.0077	1.0000		
SZ	-0.0039	-0.0662	0.0182	-0.0279	-0.0589	-0.0256	1.0000	
COMP	-0.0736	0.0125	0.0287	0.0159	0.0070	-0.0146	-0.0120	1.0000

The study has used correlation matrix to observe the multicollinearity among the independent variables in combined model. The results of table 2 show that there is no significant correlation among the independent variables. The correlation matrix shows that there is no multicollinearity among independent variables. We also used correlation matrix for each country and did not find multicollinearity. However, for brevity purposes, study just provides the correlation matrix of combined model.

The model estimation technique used in this study is fixed and random effects. However, which of the model is to be selected among the fix and random effect depends upon Hausman test. The results of Hausman test shown in table 3 are insignificant. Their insignificance indicates that there is random effect in cross section in combined and separate model for each country. Thus for the further analysis of combined model we will select random effect model.

Table 3.Hausman test results

Test Summary	Combined Model			Model For Pakistan			Model For China		
	Chi-Sq Stat	Chi-Sq. d.f	Prob	Chi-Sq Stat	Chi-Sq. d.f	Prob	Chi-Sq Stat	Chi-Sq. d.f	Prob
Cross section random	9.5052	8	0.302	0.384	4	0.984	8.5963	4	0.204

Table 4. Panel data analysis estimation results

Variables	Combined Model			Model For Pakistan			Model for China		
	Coefficient	t-value	p-value	Coefficient	t-value	p-value	Coefficient	t-value	p-value
AUC	-1.629	-0.102281	0.9186	1.6765	2.5677	0.005	-1.1128	-0.112381	0.97675
Big4	1.066	0.678956	0.4977	1.7705	3.9992	0.002	1.7890	3.049233	0.0041
Ris	-2.887	-0.81287	0.4170	1.6664	2.7773	0.003	-3.644	-0.7124567	0.3265
Liq	-9.014	-0.764116	0.4454	9.5461	0.5768	0.666	8.0472	-0.665461	0.3347
Pro	-7.0521	-0.114065	0.9093	8.0561	0.4675	0.345	6.0461	0.415065	0.8864
Sz	-0.0001	-0.227669	0.8201	-0.0022	-0.1211	0.897	-0.0023	-0.334225	0.7654
Comp	1.8757	4.069353	0.0001	1.9946	5.4566	0.0001	6.5431	0.241524	0.8768
R-Squared	0.058			0.067			0.087		
Adjusted R-Squared	0.03			0.04			0.07		
F-Statistic	2.274104			3.64721			5.8765		
Prob F-Statistic	0.022			0.029			0.043		
Durbin Watson	1.76			1.56			2.54		

Table 4 shows that in the combined model complexity of transaction is the only variable which has statistically significant impact on audit fee. However, among the other variables in the combined model of both countries the existence of audit committee, client risk, firm size, profitability and liquidity showed statistically insignificant but negative relationship with audit fee. Though both the economies are in transitory stage and moving towards free market economy, but even then surprising and inconsistent results were obtained on the variables of profitability, liquidity, client risk and size. Thus the result of the combined model shows that in both countries at firm level are many differences regarding risk aptitude and business practices, so, it is not legitimate to combine the firms of both countries as one. On the basis of this argument, we segregated the data of the firms of both countries and run the model separately.

The result of separate model for Pakistan shows that existence of an audit committee, a Big4 audit firm, client risk and complexity of transaction positively and significantly affect the audit pricing in Pakistan. It means along with Big4 audit firm effect the auditing firm in Pakistan consciously considering the client risk and complexity of transaction while deciding the fee of their engagement as an external auditor, which is a healthy sign for their strategic existence.
The results for China indicate that, from a client perspective, the client has to pay higher audit price if the auditing firm is one of the big4 audit firms. Further, the results indicate that there is a negative relationship between audit pricing and client risk, which means as the client risk increases the auditors charge less price of their audit engagement. So, these practices of audit pricing in China may prove to be a suicide auditing in future. Among the other results, complexity of business transaction is positively related with audit pricing. While the control variables, profitability and liquidity, showed a positive relationship with audit fee. However, firm size showed a negative relationship with audit fee which reflects that larger firms in China pay low audit price and get the advantage of their size in this regard.

5. Conclusion

From a client perspective, if one of the big4 audit firms is involved, the client pays more for audit engagement in Pakistan and China. Auditors in Pakistan strategically seem to be more protected against their opinion. In Pakistan, auditors consider fraudulent reporting, in terms of complexity of business transactions, and financial viability of client, in terms of risk, as a safeguard to avoid future litigation against him or her. On the other side, the auditing practices in China are not as streamlined as in Pakistan because the auditor does not incorporate client risk as a part of audit pricing, which reflects that he may be insecure against litigation on his opinion by the stakeholders in future.

Insofar, attention from Chinese securities and regulatory commission is required to address such type of issues and set the certain criterion for audit fee as the ICAP in Pakistan. The ICAP had taken this sensitive issue seriously and did not left audit pricing on market forces completely by developing full guided mechanism for fee structure of audit engagement. Due to this, audit pricing in Pakistan seems to incorporate useful measures to avoid future inconveniences. Thus it is strongly recommended to the CSRC to follow the development of the ICAP and introduce regulations to strengthen their audit market to eliminate the maximum likelihood of future inconveniences for their auditors.

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