Audit Fees and Firm Performance: The Case of Thailand

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Abstract

The previous studies have evidenced that firm performance is statistically related to audit fees. The higher demand of audit fees can be varied according to the complexity of firm's economic conditions. The audit fee can help to understand the firm performance. This study employs data from an emerging market to evidence the association between firm performance and audit fees. By using different measures in the investigation, empirical results show that relative to firms with lower audit fees, firms with higher audit fees are more likely to have weak financial performance. This study provides additional empirical evidence to the study that employs emerging market data.

Keywords: Audit Fee; Firm Performance; Thailand; Audit Pricing

Introduction

Audit pricing is an important research area in accounting. Researchers have sought for the effect of audit pricing on other components or vice versa, i.e. corporate governance, cost of debt and equity or firm performance. Based on prior studies that are mainly conducted in US firms, this study investigates the association between audit pricing and firm performance Thai listed firms to determine whether or not the association can be founded in non-US firms. Generally speaking, audit pricing should be driven by risks that auditors would like to take (Krishnan and Krishnan 1997). In other words, higher risks, higher audit fees. By this notion, this study views that the link between audit pricing and firm performance should be observed because the risk is varied according to firm performances. Relative to poor performance firms, good performance firms, i.e. profit-generating firms, are more likely to have lower risks. It is due to the fact that the high performance firm tends to be under the market watchdog. The market generally helps the auditor to evaluating firms' quality (i.e. Sutton, 1993; Reed et al.,2000; Lai, 2009; and Venkataraman et al., 2010). On the other hand, the loss-generating firm is more likely to have higher risks because the poor performance attracts not only the market but also many financial statements' users, i.e. creditors concerning to loans (DeFond and Jiambalvo, 2010), competitors concerning to merger and acquisition, or the revenue department concerning to income tax collections (Tendeloo and Vanstraelen, 2008). However, ones could argue that high risks can be found in a high performance but low quality firm, i.e. its earnings are manipulated. If this is the case, this study views that 1) the auditor should be able to determine earnings management by auditing processes and 2) in the long run, earnings management should be captured by the market. Therefore, such firm is finally determined as a poor performance firm. Based on prior studies, we hypothesize that the association between firm performance and audit pricing is negative. The firm performance is measured by Q ratio and earnings and audit pricing is measured by audit fees. Based on our sample firm-years and results, we conclude that firm performance is negatively related to audit pricing.

It is consistent to the prior study. We organize this research study as follows. Next section is prior literature and hypothesis development. We explain research design in section 3. Section 4 and 5 are results and conclusions, respectively.

Prior literature and hypothesis development

Many research studies examine the relationship between audit quality and financial reporting quality. For example, Becker (1998) and Bruce et al. (2008) finds that audit quality, i.e. audit firms, is related to earnings quality. Chen et al. (2005) find the consistent result in Taiwan firms. In addition, the relationship between an audit firm and a company is associated with the quality of financial reports (Van et al., 2002). They find that a lower quality of financial reports is observed in the company with a short relationship between the audit firm and company. Prior studies suggest that audit fees and litigation risk are indicative of audit quality. For example, Tendeloo and Vanstraelen (2008) examine the relationship between auditors and European firms. They find that auditors pay more attentions to earnings manipulations in the regime that firms' financial statements are required to align with tax authorities. Hoitash et al. (2007) find that audit quality measured by audit independence is negatively associated with audit fees. The finding suggests that audit quality is influenced by effort and risk-adjusted fees. However, Larcker and Richardson (2004) suggest that firm reputation affects auditor behavior, allowing large firms with weak governance to engage in high accrual numbers with lower audit fees. Consistent with Larcker and Richardson (2004), Lawrence et al. (2011) suggest that client characteristics are related to audit quality performed by either Big Four or non-Big Four audit firms. On the other hand, Choi et al. (2010) find that unlike negative abnormal audit fees, positive abnormal audit fees impair audit quality. Venkataraman et al. (2010) reveal that audit fees are higher in a higher-litigation environment, but Hope and Langli (2010) find that audit quality, i.e. independence, is not depended on audit fees even though it is under low litigation risk environment. Those prior studies suggest that audit quality, audit fee and audit environment are important aspects for the research area in auditing. Additionally, many research studies suggest that audit fee is more likely to be priced by business risk (Lyon and Maher, 2005), litigation risk (Seetharaman et al., 2002), financial reporting risk (Charles et al., 2010), or client integrity (Beaulieu, 2001). However, Bell et al. (2001) suggest that business risk increases audit hours but not audit fees. From those prior studies, the investigation between audit fees and firm performance is rare. The link between audit fees and firm performance are driven by business risk. The higher business risk results in the lower firm performance. As suggested by Lawrence et al. (2009), they conclude that enterprise risk management is significantly positively associated with firm performance. By these reasons, this study suggests that a lower risk firm leading to the lower audit fee has the higher firm performance. Therefore, the relationship between audit fee and firm performance should be negative. We hypothesize as follows.

H_1: The audit fee is negatively associated with firm performance.

Research design

Data

The initial sample firms are chosen from all non-financial firms listed on the Stock Exchange of Thailand (SET) during 2007 – 2011. Audit fees are obtained from the Form-56-1 required by the Securities and Exchange Commission of Thailand. Other financial data and share prices are obtained from SET Market Analysis and Reporting Tool (SETSMART) provided by SET. Base on the analysis in this study, there are 1,399 out of 2,672 firm-year observations across 24 business sectors according to SET. However, one of the business sectors includes the companies under rehabilitation, that those firms are suspended from share trading activities until they can recover their financial performances. The total market capitalization of the sample firm is 63.04 per cent of the total market capitalization of all sectors. Table 1 presents the distribution of sample firms across business sectors and market capitalization.

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Table 1 A Number of Observations

Panel A Firm-year observations across business sectors

Sector	Firm-Year Observations					Total
	2007	2008	2009	2010	2011	
1. Agribusiness	10	12	11	11	10	54
2. Automotive	15	16	18	15	12	76
3. Commerce	11	13	13	13	12	62
4. Construction Material	13	14	13	13	12	65
5. Electronic Components	8	8	10	10	9	45
6. Energy and Utilities	12	17	17	19	16	81
7. Fashion	14	16	19	19	17	85
8. Food and Beverage	18	21	22	20	20	101
9. Health Care Services	9	11	10	11	10	51
10. Home and Office Products	4	4	4	5	4	21
11. Industrial Material and Machinery	6	6	5	5	6	28
12. Information and Communication Technology	16	20	22	22	20	100
13. Media and Publishing	12	14	17	17	16	76
14. Mining	1	1	1	1	1	5
15. Packaging	8	7	7	8	7	37
16. Paper and Printing Materials	1	2	2	2	2	9
17. Personal Products and Pharmaceuticals	3	3	4	4	4	18
18. Petrochemicals and Chemicals	10	10	9	9	9	47
19. Professional Services	2	3	3	3	3	14
20. Property Development	31	40	42	43	42	198
21. Steel	15	22	22	21	22	102
22. Tourism and Leisure	9	9	9	8	7	42
23. Transportation and Logistics	11	12	12	14	10	59
24. Companies Under Rehabilitation	1	3	5	8	6	23
Total Sample firms	240	284	297	301	277	1,399
Total Listed Firms	546	520	531	536	539	2,672

Panel B Market capitalizations

Year	TOTAL MARKET (Millions)	SAMPLE (Millions)	%
2007	6,635,000	3,980,000	59.98
2008	3,568,000	2,280,000	63.90
2009	5,873,000	3,820,000	65.04
2010	8,335,000	5,500,000	65.99
2011	8,408,000	5,110,000	60.78
Total	32,819,000	20,690,000	63.04

Firm performance and audit pricing

We determine the association of firm performance and audit pricing by regressing firm performance on audit fees and control variables.Following the prior literature, firm performance is determined by Q ratio (Q) and earnings per share (EPS). Audit pricing includes audit fees (AUDFEE), audit firm (AUDIT) and special and other fees (OTHFEE). The control variables consist of debt (DE), growth (GRW) and size (SIZE). We include debt as a control variable because it is more likely that a high-debt firm tends to improve their performance aggressively to respond their creditor monitoring. We measure a growth of firm in terms of the market perspective by using a market to book ratio. We use firm's total assets to measure the firm size. We employ OLS business sector fixed effects with robust standard error to estimate the coefficients. The testable regressions are as follows.

$$Q_{it} = \beta_0 + \beta_1 AUDFEE_{it} + \beta_2 AUDIT_{it} + \beta_3 OTHFEEit + \beta_4 DE_{it} + \beta_5 SIZE_{it} + \varepsilon_{it} \quad (1)$$

$$EPS_{it} = \alpha_0 + \alpha_1 AUDFEE_{it} + \alpha_2 AUDIT_{it} + \alpha_3 OTHFEE_{it} + \alpha_4 GRW_{it} + \alpha 5DE_{it} + \alpha\ 6SIZE_{it} + \varepsilon_{it} \quad (2)$$

where Q_{it} is the natural logarithm of the ratio of the total market value to asset for firm i at year t; EPS_{it} is earnings per share divided by closing share prices for firm i at year t; $AUDFEE_{it}$ is the natural logarithm of audit fees for firm i at year t; $AUDIT_{it}$ is a dummy variable equal to 1 if the auditor is in big 4 firms and 0 otherwise for firm i at year t; $OTHFEE_{it}$ is a dummy variable equal to 1 if firms hire an auditor to perform special or other audits and 0 otherwise for firm i at year t; GRW_{it} is the market to book value for firm i at year t; DE_{it} is debt to equity ratio for firm i at year t and $SIZE_{it}$ is the natural logarithm of total asset for firm i at year t. The primary interest of this analysis is the coefficient of AUDFEE and it is expected to be negative. Its negative sign indicates the lower audit pricing when the firm performance is higher. The sign of the other coefficients is not determined.

Results

Descriptive statistics

Table 2 presents descriptive statistics for each variable. We include the companies under rehabilitation to generalize the analysis. The sample firms have a high variation of debt to equity ratio. However, there are 4 (48) from 1,399 sample firm-year observations having 100 (5) times of debt to equity. Spearman and Pearson correlations are presented in Table 3. The result shows that the correlation between firm performance measured by both Q and EPS and audit fees measured by AUDFEE is negative but not statistically significant. The audit fee and firm size are significantly correlated.

Table 2 Descriptive Statistics

Variable	Mean	SD	MAX	Median	MIN	N
Q	6.258	0.884	9.120	6.299	1.967	1399
EPS	0.0117	0.415	1.542	0.079	-7.433	1363
AUDFEE	14.372	0.863	17.765	14.221	12.346	1399
AUDIT	0.536	0.499	1	1	0	1399
OTHFEE	0.327	0.470	1	0	0	1399
GRW	1.725	8.036	291.26	1.02	0.12	1363
DE	7.282	198.129	7395.12	0.820	0	1399
SIZE	15.260	1.449	21.061	14.986	11.539	1399

Q is the natural logarithm of the ratio of the total market value to asset; EPS is earnings per share divided by closing share prices; AUDFEE is the natural logarithm of audit fees; AUDIT is a dummy variable equal to 1 if the auditor is in big-4 firms and 0 otherwise; OTHFEE is a dummy variable equal to 1 if firms hire an auditor to perform special or other audits and 0 otherwise; GRW is the market to book value; DE is debt to equity ratio and SIZE is the natural logarithm of total asset; SD is standard deviation and N is a number of observations.

Table 3 Correlations: Spearman and Pearson are presented on the above and below diagonals, respectively. p values are in italics.

VARAILABLES	Q	EPS	AUDFEE	AUDIT	OTHFEE	DE	SIZE	GRW
Q		0.073 *0.007*	-0.014 *0.599*	0.107 *0.000*	0.052 *0.055*	-0.378 *0.000*	-0.012 *0.649*	0.815 *0.000*
EPS	0.277 *0.000*		-0.042 *0.117*	0.066 *0.015*	0.043 *0.116*	-0.188 *0.000*	0.061 *0.024*	-0.013 *0.636*
AUDFEE	- *0.688*	- *0.674*		0.387 *0.000*	0.164 *0.000*	0.294 *0.000*	0.679 *0.000*	0.137 *0.000*
AUDIT	0.100 *0.000*	0.110 *0.000*	0.367 *0.000*		0.066 *0.015*	0.039 *0.153*	0.342 *0.000*	0.120 *0.000*
OTHFEE	0.053 *0.050*	0.072 *0.008*	0.182 *0.000*	0.066 *0.015*		-0.020 *0.455*	0.191 *0.000*	0.062 *0.023*
DE	- *0.010*	- *0.000*	-0.001 *0.967*	-0.033 *0.221*	-0.020 *0.452*		0.292 *0.000*	0.137 *0.000*
SIZE	- *0.984*	0.064 *0.018*	0.705 *0.000*	0.308 *0.000*	0.189 *0.000*	0.015 *0.572*		0.138 *0.000*
GRW	0.130 *0.000*	- *0.918*	0.015 *0.576*	-0.024 *0.371*	-0.010 *0.708*	0.026 *0.337*	*-0.017* *0.530*	

Q is the natural logarithm of the ratio of the total market value to asset; EPS is earnings per share divided by closing share prices; AUDFEE is the natural logarithm of audit fees; AUDIT is a dummy variable equal to 1 if the auditor is in big-4 firms and 0 otherwise; OTHFEE is a dummy variable equal to 1 if firms hire an auditor to perform special or other audits and 0 otherwise; GRW is the market to book value; DE is debt to equity ratio and SIZE is the natural logarithm of total asset.

Table 4 Main Results:- regressing firm performance on audit fees and auditing firms. OLS with sector fixed effects and robust standard errors are employed for the regression estimation.

Panel A

$$Q_{it} = \beta_0 + \beta_1 AUDFEE_{it} + \beta_2 AUDIT_{it} + \beta_3 OTHFEEit + \beta_4 DE_{it} + \beta_5 SIZE_{it} + \varepsilon_{it}$$

Var.	**Coef.**	***t value***	***p value***
β_0	7.380	18.270	0.000
β_1	-0.091	-2.390	0.017
β_2	0.134	2.800	0.005
β_3	0.099	2.120	0.034
β_4	-0.000	-8.720	0.000

Var.	Coef.	*t value*	*p value*
β_5	0.005	0.220	0.823
Adj. R^2	0.18		
F-test	21.30		
N	1399		

Panel B

$$EPS_{it} = \alpha_0 + \alpha_1 AUDFEE_{it} + \alpha_2 AUDIT_{it} + \alpha_3 OTHFEE_{it} + \alpha_4 GRW_{it} + \alpha 5DE_{it} + \alpha\ 6SIZE_{it} + \varepsilon_{it}$$

Var.	Coef.	*t value*	*p value*
α_0	0.409	2.050	0.041
α_1	-0.076	-3.450	0.001
α_2	0.089	3.620	0.000
α_3	0.057	2.790	0.005
α_4	0.000	0.420	0.672
α_5	-0.000	-9.420	0.000
α_6	0.041	3.550	0.000
Adj. R^2	0.06		
F-test	17.62		
N	1363		

Q is the natural logarithm of the ratio of the total market value to asset; EPS is earnings per share divided by closing share prices; AUDFEE is the natural logarithm of audit fees; AUDIT is a dummy variable equal to 1 if the auditor is in big-4 firms and 0 otherwise; OTHFEE is a dummy variable equal to 1 if firms hire an auditor to perform special or other audits and 0 otherwise; GRW is the market to book value; DE is debt to equity ratio and SIZE is the natural logarithm of total asset; SD is standard deviation and N is a number of observations.

Result of firm performance and audit pricing

Table 4 presents the association between firm performance and audit pricing. In Panel A, the firm performance is measured by Q ratio. The coefficient of AUDFEE (β_1) is negative and significant, suggesting that the higher firm performance, the lower audit fee. The coefficient of AUDITOR (β_2) is positive and significant, suggesting that relative to non-big-4, big-

4 auditing firms are more likely to be hired by high performance firms. As measured by β_3 that is positive and significant, high performance firms tend to hire auditing firms to perform other services than financial audits. Table 4 Panel B presents the analysis when the firm performance is measured by earnings per share divided by share prices. Company growth (GRW) measured by the share price to book value is included as an additional control variable. The results shown in Panel A and B are consistent that the association between firm performance and audit fees is negative and significant, and high performances firms are more likely to hire big-4 auditing firms and use services other than financial audits.

Table 4 Main Results:- regressing firm performance on audit fees and auditing firms. OLS with sector fixed effects and robust standard errors are employed for the regression estimation.

Panel A

$$Q_{it} = \beta_0 + \beta_1 AUDFEE_{it} + \beta_2 AUDIT_{it} + \beta_3 OTHFEEit + \beta_4 DE_{it} + \beta_5 SIZE_{it} + \varepsilon_{it}$$

Var.	Coef.	*t value*	*p value*
β_0	7.380	18.270	0.000
β_1	-0.091	-2.390	0.017
β_2	0.134	2.800	0.005
β_3	0.099	2.120	0.034
β_4	-0.000	-8.720	0.000
β_5	0.005	0.220	0.823
Adj. R^2	0.18		
F-test	21.30		
N	1399		

Panel B

$$EPS_{it} = \alpha_0 + \alpha_1 AUDFEE_{it} + \alpha_2 AUDIT_{it} + \alpha_3 OTHFEE_{it} + \alpha_4 GRW_{it} + \alpha 5DE_{it} + \alpha\ 6SIZE_{it} + \varepsilon_{it}$$

Var.	Coef.	*t value*	*p value*
α_0	0.409	2.050	0.041
α_1	-0.076	-3.450	0.001
α_2	0.089	3.620	0.000
α_3	0.057	2.790	0.005

α_4	0.000	0.420	0.672
α_5	-0.000	-9.420	0.000
α_6	0.041	3.550	0.000
Adj. R^2	0.06		
F-test	17.62		
N	1363		

Q is the natural logarithm of the ratio of the total market value to asset; EPS is earnings per share divided by closing share prices; AUDFEE is the natural logarithm of audit fees; AUDIT is a dummy variable equal to 1 if the auditor is in big-4 firms and 0 otherwise; OTHFEE is a dummy variable equal to 1 if firms hire an auditor to perform special or other audits and 0 otherwise; GRW is the market to book value; DE is debt to equity ratio and SIZE is the natural logarithm of total asset; SD is standard deviation and N is a number of observations.

Additional tests

We further investigate the association between firm performance and audit pricing. We employ the change model as presented in Table 5. The expected sign of coefficient of ΔAUDFEE is negative. The result in Panel A reveals that the change in firm performance measured by Q ratio is significantly negatively correlated with the change in audit fees. This suggests that the lower firm performance, the higher audit fee. The result remains unchanged when the firm performance is measured by earnings per share, as presented in Panel B. However, the explanatory power is lower when using the change model. Other than the change model, we perform several analyses to confirm the main results but those additional results are available upon request. First, we repeat the analysis in equation 2 by using return of assets (ROA) and return of equity (ROE) as firm performance measures. Second, we exclude DE from the analysis and estimate equation 1 and 2 with the sample firms that their debt to equity ratio is less than 10 times. Next, we exclude 23 firms under rehabilitations because those firms are not active in share trading activity. Those results remain qualitatively unchanged.

Table 5 Additional Results:- regressing changes in firm performance on changes in audit fees and auditing firms.

OLS with sector fixed effects and robust standard errors are employed for the regression estimation.

Panel A

$$\Delta Q_{it} = \theta_0 + \theta_1 \Delta AUDFEE_{it} + \theta_2 AUDIT_{it} + \theta_3 OTHFEE_{it} + \theta_4 DE_{it} + \theta_5 SIZE_{it} + \varepsilon_{it}$$

Var.	Coef.	*t value*	*p value*
θ_0	0.133	0.590	0.555
θ_1	-0.455	-4.910	0.000
θ_2	0.025	0.590	0.555
θ_3	0.002	0.060	0.951
θ_4	-0.000	-6.010	0.000
θ_5	-0.007	-0.480	0.634
Adj. R^2	0.03		
F-test	13.60	*(p = 0.000)*	
N	1080		

Panel B

$$\Delta EPS_{it} = \gamma_0 + \gamma_1 \Delta AUDFEE_{it} + \gamma_2 AUDIT_{it} + \gamma_3 OTHFEE_{it} + \gamma_4 GRW_{it} + \gamma 5DE_{it} + \gamma_6 SIZE_{it} + \varepsilon_{it}$$

Var.	Coef.	*t value*	*p value*
γ_0	0.186	0.940	0.348
γ_1	-0.132	-1.900	0.058
γ_2	0.074	1.680	0.094
γ_3	0.003	0.110	0.912
γ_4	0.002	2.230	0.026
γ_5	-0.000	-2.400	0.017
γ_6	-0.015	-1.160	0.245
Adj. R^2	-0.01		

F-test	3.84	*(p = 0.001)*
N	1044	

ΔQ is the change in the natural logarithm of the ratio of the total market value to total asset; ΔEPS is the change in earnings per share divided by closing share prices; ΔAUDFEE is the change in the natural logarithm of audit fees; AUDIT is a dummy variable equal to 1 if the auditor is in big 4 firms and 0 otherwise; OTHFEE is a dummy variable equal to 1 if firms hire an auditor to perform special or other audits and 0 otherwise; GRW is the market to book value; DE is debt to equity ratio and SIZE is the natural logarithm of total asset and N is a number of observations.

Conclusions and Discussion

The firm performance investigation has been widely explored in different aspects. One of those aspects is to investigation firm performance through the audit process. It has been evidenced by previous studies that the complexity of firm performance is critical factor for audit process leading to the requirement of higher audit fees. This study is to confirm if audit fees are reasonable indicators for firm economic conditions. Based on non-US data, the estimation's result with fixed effects and control variables provides empirical evidence on the relationship between firm performance and audit fees. Our hypothesis is not rejected that the negative relationship between firm performance and audit fees has been observed in Thai settings. This research has some limitations. First, this research employs only two firm performance variables for the estimation. A more varieties of firm performance estimations may be used and they probably provide different results. Some relevant variables may be left out in this study. And, the use of different estimation methods to account for the relationship between firm performance and audit fees may help to better understand such relationship. On account of the limitations, further research on this relationship is needed. For example, disaggregated items can be applied. The future research probably employs audit service fees, special audit fees, or consulting fees paid to the audit firm. In addition, the different estimation method may be used to provide more empirical results. However, this study provides initial grounds on the firm performance perspective of the indicated relationship in an emerging market.

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