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Analysis of the Impact of Abnormal Audit Fees on Audit Quality

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Abstract: In recent years, there have been frequent cases of financial fraud and audit failures among listed companies in China. Audit quality issues continue to attract public attention. Audit quality is the lifeline of audit business and the fundamental factor for auditing to fully exert its functions, and its importance is self-evident. There are numerous factors that affect audit quality, and audit fees are one of the important factors that affect audit quality. The changes in the external macro environment and the speculative behavior of the audited entity will both lead to an increase in audit fees. Abnormally high audit fees often indicate that companies are engaging in high priced buying of audit opinions. The situation of oversupply in the audit market, coupled with the unequal status between accounting firms and clients, has led to a phenomenon of low price competition. Both positive and negative abnormal audit fees can lead to a decrease in the quality of auditors' practice. Therefore, this article will start from the definition of abnormal audit fees and audit quality, and further analyze the impact of abnormal audit fees on audit quality. At the same time, this article proposes countermeasures to address the phenomenon of abnormal audit fees damaging audit quality, in order to assist in improving audit quality.

1. Introduction

The emergence of accounting firms originated from the separation of management rights and ownership. As a third-party institution independent of the audited entity and stakeholders, accounting firms issue audit reports that convey signals to the market about the operational status of the audited entity. The audit report has greatly improved the transparency of the financial information of the audited entity and alleviated the problem of information asymmetry. In general, the objectivity and authenticity of audit reports issued by certified public accountants' firms can be trusted. However, in recent years, a series of audit failures have emerged both domestically and internationally, with accounting firms participating in financial fraud in listed companies. The false audit reports provided by the accounting firm is not only suspected of violating regulations, but also of violating the law. More and more well-known companies have violated the regulations, involving an increasing amount of money, which greatly reduces people's trust in audit results and raises doubts about audit quality.

Research in the field of audit practice and theory has found that audit fees are closely related to audit quality. The research results of some scholars indicate that there is negative correlation between abnormal audit fees and audit quality [1] [2]. Abnormal audit fees will significantly affect audit quality, and the greater the degree of abnormality, the lower the audit quality; Excessive audit fees significantly reduce audit quality, so audit regulatory authorities should focus on the audit quality of companies with excessive audit fees [3]. Some scholars use the absolute value of manipulative accruals as a substitute variable for audit quality, studying the effects of excessively high and excessively low audit fees on audit quality, and ultimately believe that both will reduce audit quality [4]. Abnormal audit fees can reduce audit quality [5][6]. Both positive and negative abnormal audit fees will lead to a decrease in audit quality; The former is because the independence of certified public accountants is damaged, and the latter is because auditors reduce costs by reducing audit procedure [7].

Given the increasing number of audit failures, this article starts from the definition of abnormal audit fees and audit quality, and analyzes the impact of abnormal audit fees on audit quality. Finally, the article proposes countermeasures for the phenomenon of abnormal audit fees damaging audit quality. Research has found that tax avoidance and rent-seeking behavior have led to the generation of positive abnormal audit fees, while the fiercely competitive audit market and the dominant position of audited entities have led to the generation of negative abnormal audit fees. Both positive and negative abnormal audit fees will reduce audit quality. I hope that the research in this article can improve audit quality, maintain the normal order of the audit market, and promote the healthy development of the industry.

2. Concept Definition and Theoretical Basis

2.1. Definition of Key Concepts

2.1.1. Definition of abnormal audit fees

The actual audit fees can be divided into two parts: one is the normal audit fees, which reflect the costs that auditors must spend during the audit process and the potential litigation risks they may face in the future. Due to differences in the size of the audited entity and the complexity of the audit business, the audit fees charged by accounting firms may also vary. The higher the complexity of the audited entity's business, the higher the cost that auditors need to invest in conducting audits. So, the normal audit fees will also be higher. The second is the abnormal audit fee, which refers to the difference between the actual audit fee and the normal audit fee, that is, the degree of deviation from the actual audit fee compared to the normal audit fee.

At present, scholars usually use two methods to measure audit fees. The first method is the residual method, which is the most commonly used measurement method. In theory, the calculation results of the residual method are closest to the true value of abnormal audit fees. The specific approach of the residual method is to construct an audit model and combine different influencing factors to estimate the normal fees for a certain audit project. The abnormal audit fee is equal to the actual fee incurred minus the normal fee calculated by the above model, which is the residual of the model. When the residual is greater than 0, the actual fee is higher and there is a positive abnormal audit fee. Similarly, when the residual is less than 0, there is a negative abnormal audit fee. Some scholars have adopted the residual method in their research [8]. The second method is the proportional method, which treats the audit fees of the previous period as normal fees and studies the difference between the audit fees of the current period and the previous period given an acceptable proportion of audit fee changes. Some scholars also use the proportional method [9].

Due to the fact that the proportional method assumes that the audit fees for the base period are normal audit fees, it ignores the possibility of anomalies in the base period audit fees and has certain limitations. So this article uses the residual method to determine abnormal audit fees, dividing them into two directions: positive and negative. Positive abnormal audit fees refer to excessively high audit fees, while negative abnormal audit fees refer to excessively low audit fees.

2.1.2. Definition of audit quality

Audit quality is the level of audit work, and its specific manifestation is the effectiveness of the audit. In 2003, The National Audit Office of the United States defines audit quality as: "Auditors conduct audits in accordance with generally accepted accounting standards, ensuring that the audited financial reports and related disclosures are expressed in accordance with generally accepted accounting principles in the industry; there are no significant misstatements caused by errors or fraud.” The level of audit quality not only directly affects the achievement of audit objectives, but also indirectly or directly affects the development and stability of the social economy. From the above definition, it can be seen that audit quality depends on the professional ability of certified public accountants and their ability to make correct judgments independently of clients, and truthfully reflect the problems identified. By comparing and analyzing various definitions of audit quality in the current academic community, this article believes that audit quality is the joint probability that auditors discover and report significant misstatements in the financial reports of the audited entity. The likelihood of discovering significant misstatements is determined by the auditor's professional ability and efforts, while the likelihood of reporting significant misstatements is determined by the auditor's independence.

2.2. Related Theoretical Foundations

2.2.1. Asymmetric information

Information asymmetry is the opposite of information symmetry. The so-called information symmetry refers to the fact that under market conditions, there is no difference in the information held by both trading parties. If one party has more information than the other, then there is an issue of information asymmetry, and both parties cannot achieve fair transactions. The problem of information asymmetry will lead to opportunism behavior, which can be divided into ex ante and ex post opportunism behavior in terms of time. Prior opportunism behavior is called "adverse selection", that is, due to the existence of information asymmetry, one party with information advantage among the two parties to the transaction uses its information advantage to induce the other party to sign a contract, thus benefiting itself and damaging the other party. The opportunism behavior after the event is called "moral hazard", that is, because of the existence of information asymmetry, the party with information advantage between the two parties violates the contract or does not fully perform the contract by using its information advantage, thus benefiting itself and damaging the other party.

2.2.2. Principal-agent theory

The principal-agent theory is based on the theory of information asymmetry as the basic premise and assumption, that is, the principal-agent relationship only arises when there is information asymmetry between the two parties in the transaction. In terms of the operation of a company, the owner is the principal and the operator is the agent. Both business owners and operators are rational "economic people", so they will seek to maximize their own interests. The purpose of business owners is to seek long-term development of the enterprise, with the goal of enhancing the interests of shareholders. However, business operators often pursue short-term benefits and maximizing personal wealth, often possessing more corporate information. The principal-agent theory is based on the theory of information asymmetry as the basic premise and assumption, that is, the principal-agent relationship only arises when there is information asymmetry between the two parties in the transaction. In terms of the operation of a company, the owner is the principal and the operator is the agent. Both business owners and operators are rational "economic people", so they will seek to maximize their own interests. The purpose of business owners is to seek long-term development of the enterprise, with the goal of enhancing the interests of shareholders. However, business operators often pursue short-term benefits and maximize personal wealth, often possessing more corporate information. The different pursuit of interests between owners and operators has led to a series of problems. At this point, the emergence of the accounting firm is undoubtedly a timely help. As a third-party service agency independent of the company and expected users, the firm is known as the "economic police". As an independent third party, certified public accountants can undertake audit services more objectively and fairly, minimizing the problem of information asymmetry between operators and owners.

2.2.3. Signalling theory

The signal theory was first proposed by economist Michael Spence. According to this theory, in the capital market, due to the direct participation of operators in the operation and management of enterprises, they have a clear understanding of the operating conditions and financial results of the enterprise. At the same time, operators may also have some "hidden actions" that cannot be directly observed by investors. Even if investors have relevant professional knowledge, they cannot distinguish the authenticity of a company's financial information. Therefore, operators have an information advantage over investors, that is, there is information asymmetry between operators and investors. If the operator is unable to reduce and correct information asymmetry, it will inevitably lead to the consequences of "inferior companies expelling high-quality companies", and financial information that has been independently audited and verified can reduce this information asymmetry. For investors, audit reports issued by independent auditors play a signalling role.

3. Reasons for Abnormal Audit Fees

3.1. Reasons for Positive Abnormal Audit Fees

Positive abnormal audit fees may be due to the audited entity "buying" registered accountants in order to obtain a better audit opinion. The speculative behavior of the audited entity has motivated it to purchase favorable audit opinions, leading to an increase in audit fees for accounting firms.

3.1.1. Avoiding taxes

Reasonable tax avoidance can reduce the expenses of the audited entity, and tax avoidance behavior can also be vividly understood as the internal financing behavior of the audited entity. The saved funds can enhance the sustainable operation ability of the audited entity. However, in order to prevent tax evasion from being discovered by the regulatory authorities, the audited entity will deliberately reduce the information disclosed or hide some transaction behaviors, while the management may also have fraud, rent-seeking and other opportunism behaviors in order to seek their own interests. Research has shown that when the degree of tax evasion by the audited entity is low, management will choose more appropriate tax preferential policies to save tax expenses and alleviate the financial pressure on the audited entity; If the degree of tax evasion by the audited entity is high, the risk of fraud by the audited entity will increase, so the management is more willing to purchase audit opinions at a higher price [10].

3.1.2. Rent-seeking behavior

Due to the fact that the rent-seeking behavior of the audited entity can provide it with more policy or tax incentives, as well as more investment and financing opportunities and other economic privileges granted by the government, the rent-seeking audited entity can obtain rich profits. If the financial information of the audited entity is truthfully disclosed, its rent-seeking behavior is easily discovered. In order to avoid external public opinion and supervision pressure, as well as administrative penalties and litigation risks imposed by regulatory authorities, the management of the audited entity seeking rent may reduce the transparency of financial information. Therefore, the audited entity has the motivation to purchase audit opinions through high audit fees. Enterprises with rent-seeking behavior often continuously hire current certified public accountants and increase audit fees to achieve the purpose of purchasing audit opinions [11]. So, when the current certified public accountant receives less pressure from regulatory authorities than from clients, they are more likely to be lured by clients and bought off.

In summary, the speculative behavior of the audited entity itself can lead to an increase in audit fees. At the same time, audited entities are more inclined to adopt the method of purchasing audit opinions to gain the trust of the market and investors.

3.2. Reasons for Negative Abnormal Audit Fees

3.2.1. The fiercely competitive audit market

At present, China's audit market is mainly based on industry supervision, supplemented by government supervision. The Chinese Association of Certified Public Accountants has greater power, and the promulgation of the new Securities Law has changed the approval system to a registration system, relaxing the restrictions on the securities qualifications of accounting firms. As a result, some small and medium-sized firms have entered the auditing industry, intensifying competition in the auditing market [12]. In a fiercely competitive market, accounting firms often lower audit fees in order to attract customers, which means it is easy to engage in the behavior of "soliciting customers at a low price" [13]. This behavior can be explained by the "prisoner's dilemma" in economics. If both firms agree to maintain normal prices, their profits will be 5. If Firm A chooses to lower the price, Firm A's profit will increase to 6, and Firm B's profit will decrease to 0. The reverse is also true. So, in the absence of a guarantee that the other party will fulfill the agreement, in order to avoid risks and gain customers, both firms will seek to maximize their own interests and reduce audit fees, thus forming a Nash equilibrium. However, both firms' profits will decrease. The game process is shown in Table 1.

Table 1: Price Game

Firm A \ Firm B	Normal price	Lower price
Normal price	(5,5)	(0,6)
Lower price	(6,0)	(3,3)

3.2.2. The audited entity is in a strong position

In China, the competition in the audit market is fierce, and customers generally have strong bargaining power [14]. At present, the current market situation in China is that it is difficult for enterprises to obtain listing qualifications, while the establishment of accounting firms is relatively easy. Therefore, in the market, the number of audit resources in accounting firms far exceeds the demand for audit resources by listed companies, which forms the buyer's market for current audit services. The audited entity has more say in the price negotiation of audit services. In addition, many companies, after successfully listing, audit their annual reports mainly to meet the relevant requirements of national regulatory authorities. So major shareholders and management have low requirements for the quality of audit reports. Therefore, when choosing accounting firms, they may be more inclined towards firms with lower quotations. This has led to many accounting firms adopting a low price strategy in order to occupy the market, resulting in negative abnormal audit fees.

4. The Impact of Abnormal Audit Fees on Audit Quality

4.1. The Impact of Positive Abnormal Audit Fees on Audit Quality

Some scholars in China have found a significant negative correlation between positive abnormal audit fees and audit quality.[15] During the financial crisis, higher audit fees will lead to a decrease in audit quality [16]. Listed companies have shifted from easily identifiable accrual earnings management to more covert real earnings management, and have adopted measures to improve audit opinions by increasing audit fees or threatening to terminate cooperation [17].

Both the audited entity and the accounting firm can be regarded as rational economic individuals. As a rational economic person, the audited entity may engage in financial fraud in pursuit of profits due to its own speculative behavior. It is also possible to bribe accounting firms to issue standard unqualified audit opinions in order to achieve economic profit targets. As a rational economic person, accounting firms disregard professional ethics and conceal the fact of fraud by the audited entity when tempted by interests. When the audited entity uses earnings management to whitewash financial statements, the audited entity tends to achieve the goal by purchasing audit opinions at a high price. The positive abnormal audit fees of accounting firms will affect the substantive and formal independence of auditors, and they are more willing to provide the audit opinions required by the audited entity, thereby affecting the audit quality. At the same time, accounting firms lack independence even more when the audited entity pays higher audit fees. When the audit report issued by a certified public accountant does not meet the actual needs of the audited entity, the audited entity will use termination of cooperation as a pretext to request modification of the report, resulting in a difficult situation for the certified public accountant and affecting the audit quality.

4.2. The Impact of Negative Abnormal Audit Fees on Audit Quality

There is a significant negative correlation between negative abnormal audit fees and audit quality [18]. The impact of low audit fees on audit quality is more significant [19]. There is a significant negative correlation between negative abnormal audit fees and audit quality. The impact of low audit fees on audit quality is more significant. Negative abnormal audit fees lead auditors to reduce costs by reducing audit procedure. Generally speaking, audit fees are often proportional to the workload invested by accounting firms in the audit business. However, there is a phenomenon of a buyer's market in the current market, which has led many accounting firms to adopt a low-priced competition strategy. However, the low audit fees have significantly reduced the profit margin of accounting firms. Therefore, accounting firms often choose to invest insufficient workload in audit services to reduce business costs, resulting in a decrease in audit quality.

Negative abnormal audit fees have led to a serious loss of audit talent in accounting firms. The determination of audit fees depends on the dynamic balance between the supply side factors of the accounting firm and the demand side factors of the audited entity. For accounting firms, the determination of audit fees includes the risk level of the audit project, the allocation of audit resources, the estimation of workload, the bargaining power of the accounting firm, and so on. For the audited entity, the determination of audit fees includes the willingness of the audited entity, signal transmission mechanisms, agency costs, and so on. Many firms are at a disadvantage in the bargaining process due to the intense competitive environment they are currently facing. The low-priced competition strategy makes it difficult for accounting firms to provide high returns to high-level auditors, resulting in a significant loss of talent in accounting firms, greatly affecting their professional quality and resulting in a decrease in audit quality.

Based on the impact of abnormal audit fees on audit opinions, relevant departments should not only increase the illegal costs of accounting firms through mandatory constraints such as laws and regulations, but also take into account the important role of soft constraints such as reputation. Based on reputation, administrative penalties can have a more deterrent effect on accounting firms compared to property penalties, so the governance of the audit market should consider multiple factors [20].

5. Countermeasures for Abnormal Audit Fees to Damage Audit Quality

In summary, both positive and negative abnormal audit fees have a significant adverse impact on audit quality. Therefore, in order to ensure audit quality, effective measures should be taken to control low price competition and high price purchase of audit opinions.

5.1. Improving the Transparency of Audit Fees

Given the large number of abnormal audit fees in the current auditing industry, the first step to improve audit quality is to enhance the transparency of its audit fees. The relevant management departments of accounting firms should formulate relevant laws and regulations, requiring accounting firms to report their audit fees in a timely manner, in order to effectively supervise their audit fees. At the same time, create an open online platform to publish relevant fee information for reference and comparison by enterprises that require external auditing. In addition, relevant management departments should further require accounting firms to disclose the detailed content of their audit fees and conduct regular verification, in order to effectively regulate the unfair bargaining behavior between the audited entity and the accounting firm, and make their information more open and transparent.

5.2. Standardizing the Auditing Practice Environment

Given the increasingly fierce competition in the auditing industry, the relevant management departments of accounting firms should introduce corresponding policies to standardize the auditing practice environment and enhance the professional image of auditors. Firstly, relevant management departments can introduce relevant policies to clarify the basis and standards of audit fees, and severely crack down on accounting firms that use low-priced strategies as their main competitive means. This can to some extent purify the current market environment. Secondly, relevant management departments can strengthen the inspection of the independence of accounting firms in their audit work, conduct irregular inspections of their audit operations, and focus on checking their independence, so that accounting firms can strengthen their independence awareness, be less subject to the audited units, prevent the occurrence of purchasing audit opinions, and avoid financial statement users making wrong decisions.

5.3. Fully Leveraging the Power of External Supervision

Institutional investors and analysts can serve as important external supervision mechanisms. Institutional investors will determine investment targets through long-term research, and their research activities will continue throughout the entire investment period. In addition, institutional investors have the advantages of professional talent, sufficient funds, and rich investment experience, and can conduct research on the invested enterprises from time to time. So institutional investors can continuously play a supervisory role in listed companies, thereby inspiring management to pay attention to operational efficiency and risk warning. Therefore, external supervision can reduce the degree of information asymmetry and prevent speculative behavior by the audited entity.

5.4. Establishing a Reputation Mechanism, Increasing Penalties and Illegal Costs

It is recommended that government departments or regulatory agencies establish a credit list and rate it to enhance its credibility. Once a company or firm is found to have illegal or irregular behavior, it should be immediately criticized and its credit rating should be lowered, or even removed from the list, and ordered to make corrections. In this way, illegal and irregular enterprises and firms not only face more centralized and strict supervision, but also face questioning and supervision from external investors, making them under pressure to reduce the occurrence of opportunistic behavior. Increase the intensity of property punishment and joint liability, and adopt methods such as revoking business licenses and prohibiting entry into the market for violators, making the cost of punishment for violations far greater than the illegal gains.

5.5. Utilizing big data analysis

At present, the means by which enterprises purchase audit opinions have become more covert, so regulatory agencies should strengthen their monitoring of the purchase of audit opinions. Supervisory and regulatory agencies should make full use of existing technologies, such as big data, to conduct analysis, investigating and inquiring about sensitive behaviors such as abnormal audit fees, improvement of audit opinions, or frequent changes in registered accountants. At the same time, regulatory agencies should review situations where business and work abilities do not match, in order to enhance the risk awareness of certified public accountants and increase regulatory pressure.

6. Conclusion of the Study

In the process of China's economic development, financial fraud and audit failure cases of listed companies have emerged one after another, seriously damaging the healthy and orderly development of China's capital market. Audit quality has become a historical and long-term research topic, among which the relationship between abnormal audit fees and audit quality has become a focus of attention and discussion in various sectors of society, especially academia.

This article explores the relationship between abnormal audit fees and audit quality, and summarizes domestic and foreign literature. Based on information asymmetry theory, principal-agent theory, and signal transmission theory, the article analyzes the reasons for the occurrence of positive and negative abnormal audit fees, and further explores the impact of positive and negative abnormal audit fees on audit quality. After the above research process, this article concludes that the audited entity's own speculative behavior, including tax evasion and rent-seeking behavior, motivates it to purchase favorable audit opinions, leading to the generation of positive abnormal audit fees. In addition, the generation of negative abnormal audit fees is partly due to the fierce competition in the audit market, which leads accounting firms to lower audit fees in order to obtain customers. On the other hand, it is because the audited entity is in a disadvantaged position and customers generally have strong bargaining power. In order to ensure audit quality, the audited units and accounting firms can be constrained by improving the transparency of audit fees, standardizing the audit practice environment, fully leveraging the power of external supervision, establishing a reputation mechanism, increasing punishment and illegal costs, and other measures.

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