

ANALYSIS OF EFFECTIVE FACTORS IN AUDIT FEES AND FRAUD OF FINANCIAL STATEMENTS

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ABSTRACT

This study has been conducted to assess the similarities and differences between effective factors in audit fees of financial statements from the perspective of independent auditors in auditing institutions (managers and senior managers), as well as board members, managers and finance assistants of employers. The studied factors include client-related variables, auditor-related variables and audit work-related variables. This study is based on the survey from independent auditors in auditing institutes and executive managers of companies in Tehran Stock exchange. According to the obtained results, there is not a significant difference between perspectives of independent auditors and financial managers in specific scopes of client, auditor and audit work.

Keywords: *Independent Auditing of Financial Statements, Audit Fees, Client-Related Variables, Auditor-Related Variables and Audit Work-Related Variables*

INTRODUCTION

Audit Committee includes non-executive and independent members of Board. Audit Committee is responsible to supervise the financial reporting process, evaluation of relevant processes to internal risk and control, assessment of audit process (internal and external) and assurance of following rules and regulations by companies.

Determining of audit fees has been a problem so that conflicts of pricing methods of audit services have led to lack of a reliable base to determine audit fees. Hence, some professional judgments of auditors would lead to inconsistent suggestions (Nikbakh & Tanani, 2010). Hence, this study has assessed the ideas of audit activists in order to determine effective factors in financial audit fees in Iran. Determination of these factors can increase coherence of market and reduce confusion of audit work.

It would be important to study effective factors in audit fees in accordance with their effects on audit quality. Audit fee can effect on appropriate planning and implementation of high quality financial auditing.

The low quality of auditing would reduce trust of users of financial statements so that this issue not only prevent from auditing goals but also reduces validity of audit process within large scales and prevents from optimal allocation of capital in stock market. Therefore, capital cost and finance supply will be increased (Rajabi, 2004).

This paper includes problem statement in part 2, part 3 is related to theoretical literature of study and part 4 includes research background. Part 5 includes hypotheses of study and part 6 introduces variables. The model of study has been presented in part 7 and data collection method is explained in part 8. Statistical population is described in part 9 and part 10 presents results of descriptive statistics. Part 11 of this study includes analysis of variables. Conclusion and suggestions are proposed in part 12 and finally, part 13 includes limitations of study.

Problem Statement

Familiarity with effective factors in audit fees is important for auditors, clients and those persons who follow policies and legal rules of auditing (Nikbakht & Tanani, 2010).

Auditors will be able to price their services when they know the mentioned factors (Gist, 1992). The importance of this issue can be seen in Iran after formation of Society of Official Auditors during current years because the monopoly of audit work has broken and a great competition has been shaped after formation of this Society (Rajabi & Mohammad Khoshooee, 2008). In this conditions, an auditor can be

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successful if is able to determine audit fee in accordance with features of audited unit in order to audit that unit with minimum cost without reducing quality of work (Nikbakht & Tanani, 2010).

In fact, auditors will be able to obtain reliable criteria with a special coherence and order in field of audit fees. In this way, the disadvantages of audit work will be reduced. These disadvantages are due to the market view towards auditing (Moosavi & Darooghe Hazrati, 2011).

Auditing institute ted to provide audit services with more quality and low cost in accordance with growth of competition in this work. Auditing institutes are willing to optimize their audit fees through best suggestions in order to have more qualified and distinguishable services so that they would be able to maximize their incomes within competitive conditions. For this purpose, it would be beneficial to be aware of effective factors in audit fees (Choi *et al.*, 2008).

Determining the effective factors in audit costs would help client to percept the benefits of this service and know that why it is required to spend expenses for audit works. It is obvious that awareness of this issue can facilitate the audit work because of participation of client so that audit work is more qualified (Gist, 1992).

The current business world has changed and globalization not only has occurred in business but also it can be seen in different works. It means that the demand for professional works has increased; therefore, costs of professional works are more considered so that it is not possible to rely on traditional systems and methods. Audit work has changed a lot because of increasing competition between auditing institutes during current years. Increasing professional competition and economic pressures are additional factors have made clients sensitive towards audit services and fees (Hassas Yegane & Alavi Tabari, 2004).

Determining the minimum rate of audit fee and rate breaking of some auditing institutes are the main conflicts of audit work. It would be possible to make appropriate policies for the issues of audit work through recognizing effective factors in audit fees (Rajabi & Mohammad Khoshooee, 2008).

It seems that the final point is related to creation of a model such as Simunic Model (1980) in order to determine the audit fee in Iran. In this model, fee is related to the audit cost, working hours multiplied by the price rate of services and risk premium that is considered due to the possible legal cases and future losses of client (Nikbakht & Tanani, 2010).

Auditing is a systematic process to neutrally collect and evaluate evidences about management claims in relation with the economic activities and events, to determine the applicability of these claims and statements with predefined criteria and report the results to stakeholders. The most important and valuable service of audit work is independent opinion about financial statements and reported results to stakeholders. The purpose of auditing the financial statements is to make auditor able to present idea about important aspects of financial statements if they are prepared based on accounting standards. In fact, auditors would increase validity of financial reports of audited companies and help users in decision-making process through accurate investigations. It should be mentioned that fraud has been always along with audit work. In fact, the goal of auditor is to discover validity or fraud of financial statements.

Theoretical Literature

Auditing has had a long history. It was considered when it was required to control different financial operation especially government funds. The need of auditing was more considered after Renaissance and International Business Development. Therefore, the principles of double entry accounting were born in Italy in the 15th century. Industrial revolution created large companies, large capitals were formed after combination of small companies and capitals, and finally stock exchange market was created (Audit Organization, 2009).

Stock Exchange Organization has created a new dimension in accounting such as providing financial information for shareholders and other individuals in order to help them manage and evaluate the performance and efficiency of managers (Audit Organization, 2009). The accounting reports could not be prepared by employees through a complete and perfect state because their employment relationship made them to follow opinions of managers of economic units when preparing financial statements while financial statements should meet the needs of different users. Hence, the solution was to choose an independent and professional auditor by General assembly's of Shareholders. Aggregation of trained

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accountants with sufficient expertise who conducted these operations in associations in which, it was necessary to follow professional behavior, created the auditing profession. The first example of was England Chartered Accountants, which was a model in other countries (Audit organization, 2009). The financial statements of companies of Stock Exchange are used in this study to investigate the fraud of financial statements.

Research Background

Foreign Studies

Chakrabarti *et al.*, (2015) have considered some factors in their studies including customer retention, reputation maintenance, fee analysis and fraud of financial statements. In response to cost reduction, auditors should make balance between incentive to customer retention and reputation, and should make balance relationship between audit fee and possibility of fraud. They assessed the incident of pricing an audit work with high possibility of fraud. The obtained results indicated that there is a negative relationship between fraud possibility and audit fees, auditor and firm size.

Lobo and Zhao (2013) have assessed the relationship between audit attempt and deviations of financial reporting. According to the obtained results, there is a negative relationship between audit fee and representation after control to adjust the danger of auditor. Therefore, the negative relationship between audit fee and fraud possibility can be predicted within incident of customer retention.

Srinivasan and Skinner (2012) have studied the quality of auditing and credibility of auditor (evidences from Japan). The obtained results indicated that when audit work of a large company is failed, a quarter of customer would be reduced due to the reputation failure.

Mironiuc *et al.*, (2012) have studied the influence of audit fee analysis and non-audit costs to fraud risk. Logistic regression has been applied in this study to evaluate fraud risk in field of customers' activities. The obtained results of this study claimed that a low level of auditing and high level of non-auditing costs caused the increase in fraud risk of companies listed in New York Stock Exchange during 2001-2002.

An auditor is responsible to audit accounts in order to make sure that there is not a deviation, error or fraud in financial statements. However, Dyck, Neez, Morse and Zingales (2010) found that auditors consider an amount for less than 10% fraud of account and these amounts are related to employees, financial analysts, adjustor, media and sellers.

Domestic Studies

Rajabi and Mohammadi Khoshooee (2008) have studied the relationship between costs of representatives and pricing the independent audit works of listed companies in Tehran Stock Exchange during 2005. This study has been conducted through statistical method of regression. The obtained results proved that there was a significant relationship between variables of average total of assets and operating incomes, share percentage of main shareholder, end of the fiscal year, type of auditor and audit fee while there was an insignificant relationship between audit fees and relevant factors to representative costs such as ratio of receivable accounts and inventory to total assets, the ratio of total debt to total assets, the ratio of earnings before deducting interest and taxes to total assets.

Tanani and Nikbakht (2010) have investigated the effective factors in audit fees of listed companies in Tehran Stock Exchange during 2003-2007. Correlation analysis through specification of panel data has been applied in this study as statistical method. According to the obtained results of this study, there was a significant relationship between audit fees and variables of operation volume (firm size), complexity of operations and type of audit firm while there was not any statistical relationship between dependent variable of audit fee and variables of audit risk, education and experience of provider of financial statements.

Moosavi and Darooghe Hazrati (2011) have studied the role of free cash flow of companies in audit fees. The purpose of this study has been to assess whether there was a significant relationship between free cash flow and audit fee. The method of this study was multiple regression and Pearson correlation coefficient and the obtained results indicated that companies with high free cash flows among 300 companies had more audit fees during 2003-2008. There was also a significant relationship between debt, dividend and audit fees.

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Khodadadi and Hajizade (2011) conducted a study under the title of “representative theory and independent audit fee: testing hypothesis of free cash flows” to assess the effect of representative costs originated from hypothesis of free cash flows on audit fees. This study was conducted for period of 2006-2009 through regression pattern of panel data and the obtained results proved that there was a positive significant relationship between representative costs originated from free cash flows of company and audit fees.

The observed evidences indicated that there was a positive significant relationship between debt level and audit fee in companies with high free cash flows while there was a negative significant relationship between opportunities of future growth and audit fee.

Zandi *et al.*, (2012) have studies audited financial statements and their role in discovering and prevention from fraud and financial corruption. Auditing would validate the information of financial statements. Auditing is an accountability process and accountability is essential for social welfare. Hence, the important role of auditing would be clarified.

Some events such as collapse of Enron Company and its consequences for the great audit organization of Arthur Andersen, financial corruption of Parmalat Company and current financial corruption in Iran in which, auditors are involved would indicate the new role of official auditors and accountants compared to their traditional role so that the social responsibility of official accountants in relation with social welfare is emphasized in societies. Therefore, auditor should consider all deviations and frauds of financial statements through a professional attitude.

Ibrahim *et al.*, (2013) have assessed the effective factors in discovering fraud of financial statements through presenting a conceptual model. In this study, a comprehensive analysis has been done in relation with the effective factors in fraud of financial statements within three internal, external and movement groups and some suggestions have been provided for each scope. Presence of these factors has an important effect on planning of audit operations and makes the auditors to have analyses that are more extensive.

The present study has been analytical-descriptive in terms of nature and methodology. This study is survey and an applied study in terms of research purposes used by auditors and accountants. Library studies have been applied to data collection in this study.

Hypotheses of Study

Main hypothesis of study: there is a significant relationship between audit fees and emergence of fraud in financial statements of companies.

According to the main hypothesis, some secondary hypotheses can be considered as follows:

Hypothesis 1: there is a direct relationship between internal control weaknesses and emergence of fraud in financial statements of companies.

Hypothesis 2: there is a direct relationship auditor-related variables and emergence of fraud in financial statements of companies.

Hypothesis 3: there is a significant relationship between emergence of fraud in financial statements and managers resignation.

Study Variables

Dependent Variable

Natural log of total audit fees for fiscal year (LAF):

This independent variable is considered in model of study and similar to relevant studies natural log of audit fee paid by company for audit works during studied years has been used through assessment of effective factors in audit fee. Relevant information to audit fee has been adopted from attached notes of financial statements and public and administrative costs of companies.

Experimental Variables

Free cash flow:

In this study, free cash flows are calculated and de-scaled using operating profit before depreciation minus tax expense, interest expense and paid dividends to common shareholders that are divided by the book value of total assets.

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Growth opportunities:

The ratio of market value of assets to book value of them has been considered as the index of growth opportunities in this study.

Control Variables

According to the obtained results of previous studies, several variables have been used in model of study to control effective variables in audit fee. These variables are as follows:

Firm size of client: the natural log of total assets of company

Quick ratio: total of current assets minus inventory and advance payments divided by current debts

Ratio of debt to assets: total debts to total assets of company

Loss of client's company: a dummy variable has been used to measure this variable so that the zero is considered if there is any loss of client's company during studied years, otherwise the considered number is equal to one.

Variables of quick ratio, ratio of debt to assets and loss of client's company have been applied in this study to control audit risk.

End of the fiscal year: a dummy variable has been used in this study to enter this variable into the model so that number one is considered if fiscal year is ended on 19 March, otherwise the considered number is equal to zero.

Stock sale: total received cash from the sale of shares and the issuance of long-term cash minus debt used for the repurchase of shares that causes the payment of dividends and debt reduction.

Study Models

Model of Audit Fees

The following regression model based on model of Feng, Goal and Krishna (2012) has been applied to assess the relationship between audit fees and possibility of fraud:

(1)

$$AUDITFEES_{i,t} = B_0 + B_1 BENFORD\ SCORE_{i,t} + B_2 SPECIALIST_{i,t} + B_3 ASSETS_{i,t} + B_4 CURRENT_{i,t} + B_5 QUICK_{i,t} + B_6 DEBT_{i,t} + B_7 ROI_{i,t} + B_8 GC_{i,t} + B_9 YE_{i,t} + B_{10} LOSS_{i,t} + B_{11} BIG4_{i,t} + B_{12} SWITCH_{i,t} + \sum B\ Year + \sum B\ Industry + \epsilon_{i,t}$$

The following logistic regression model based on the model of Brenj and Weber (2012) in order to assess the possibility of internal control weaknesses:

(2)

$$ICW_{i,t} = B_0 + B_1 BENFORD\ SCORE_{i,t} + B_2 LAG - RESTATE_{i,t} + B_3 ASSETS_{i,t} + B_4 LOSS_{i,t} + B_5 \Delta FINANCING_{i,t} + B_6 BIG\ 4_{i,t} + B_7 AUDIT\ FEES_{i,t} + B_8 NON\ AUDIT\ FEES_{i,t} + B_9 SWITCH_{i,t} + \sum B\ Year + \sum B\ Industry + \epsilon_{i,t}$$

The following regression model has been applied to assess the possibility of fired auditor toward resigned auditor:

(3)

$$RESIGN_{i,t} = B_0 + B_1 BENFORD\ SCORE_{i,t} + B_2 GROWTH_{i,t} + B_3 ABS - DACC_{i,t} + B_4 INVEV_{i,t} + B_5 GC_{i,t} + B_6 MODOP_{i,t} + B_7 AUDIT\ TENURE_{i,t} + B_8 ROA_{i,t} + B_9 LOSS_{i,t} + B_{10} LEV_{i,t} + B_{11} CASH_{i,t} + B_{12} DISAGREE_{i,t} + B_{13} REP\ EVENTS_{i,t} + B_{14} ASSETS_{i,t} + B_{15} MA_{i,t} + B_{16} EXPERT_{i,t} + B_{17} DOWN_{i,t} + \sum B\ Year + \sum B\ Industry + \epsilon_{i,t}$$

The model of possibility of financial fraud:

(4)

$$BENFORD_{i,t} = B_0 + B_1 BCOMM\ SIZE_{i,t} + B_2 PERC\ IND_{i,t} + B_3 TENURE_{i,t} + B_4 AUDIT\ FEES_{i,t} + B_5 SPECIALIST_{i,t} + B_6 ASSETS_{i,t} + B_7 CURRENT_{i,t} + B_8 QUICK_{i,t} + B_9 DEBT_{i,t} + B_{10} ROI_{i,t} + B_{11} GC_{i,t} + B_{12} YE_{i,t} + B_{13} LOSS_{i,t} + B_{14} BIG\ 4_{i,t} + B_{15} SWITCH_{i,t} + \sum B\ Year + \sum B\ Industry + \epsilon_{i,t}$$

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The studied variables of mentioned models are as follows:

AUDITFEES_{i,t}: includes audit fees for auditors

BENFORD SCORE_{i,t}

SPECIALIST_{i,t}

ASSETS_{i,t}: Total assets entering into a system

CURRENT_{i,t}: Current ratio: current assets/total assets

QUICK_{i,t}: Quick ratio: current assets/current debt

DEBT_{i,t}: Debt ratio: long-term debts/total debts

ROI_{i,t}: Return on investment: the income before interest and tax deduction/total assets

GC_{i,t}: If this the company has this variable, the index will be equal to 1 and if not it will be equal to 0

YE_{i,t}: It is an index variable. If the financial statement is ended on March, the index will be 1 and if not 0

LOSS_{i,t}: A maximum level is considered for company income. If this amount is obtained the index will be equal to 1 and if not 0

BIG4_{i,t}: It is an index variable in which, the index is equal to 1 if company has one of features of four big companies and if not the index will be equal to 0

SWITCH_{i,t}: If the audit company has changed compared to previous year, the index will be equal to 1 and if not it is equal to 0

ΔFINANCING_{i,t}: Total cash obtained from stock sale

RESIGN_{i,t}: If the auditor resigns, the index will be equal to 1 and if not it is equal to 0

GROWTH_{i,t}: Asset growth: amount of assets of beginning of period minus the amount of assets of end of period/ amount of assets of beginning of the period

ABS – DACC_{i,t}: The absolute value is calculated from discretionary accruals (using Jones Model).

INVEV_{i,t}: Inventory plus all receivables/ total assets

MODOP_{i,t}: It is an index variable and is equal to 1 if company creates modifications otherwise, it is equal to 0

AUDIT TENURE_{i,t}: Tenure period of auditor that is equal to audited years by auditors that are 10 years maximum

ROA_{i,t}: Return on assets that is equal to gained revenues/total assets

LEV_{i,t}: Ratio of calculated debt: total debt/total assets

BCOMM SIZE_{i,t}: Number of managers in Audit Committee

PERC IND_{i,t}: Size of independent Audit Committee

TENURE_{i,t}: Tenure years that manager is working in Audit Board

Data Collection Method

Data has been collected from financial statements, discs of Stock exchange, Tadbir Padaz and Rah Avard Novin Software because of the survey method of this study that includes real data of companies. Excel and SPSS software have been applied to data process.

Statistical Population

The statistical population of this study includes all listed companies in Tehran Stock exchange. Companies listed in Tehran Stock exchange are selected as statistical population because of availability of more reliable information of these companies that are accepted in stock market after it is confirmed that they have required conditions and criteria. All auditing steps have been done with high quality supervision during the mentioned periods so that those companies are accepted that their stocks are priced or transacted and are more considered by investors and creditors who pay attention to performance of company.

Statistical population of this study includes 60 listed companies in Tehran Stock Exchange during 2008-2014.

Elimination sampling method has been used in this study to choose statistical sample. For this purpose, the following criteria have been considered for those listed companies in Tehran stock exchange.

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1. The considered companies should be accepted in Tehran Stock Exchange from the beginning of 2008.
 2. The considered companies should not be included in investment and intermediation companies.
 3. The fiscal year of considered companies should not be changed during study period.
- The statistical sample of study has been chosen in accordance with the mentioned conditions.

Results of Descriptive Statistics

The applied descriptive statistics in models of study is presented in table 1. The reported statistics include mean, med, standard deviation, minimum and maximum of data. According to comparison of mean and med, it is found that there is not any deviation between these variables and distribution of data is smooth. The variable of book value of assets among control variable, except the ratio of debt to asset and quick ratio, is non-smooth at the end of fiscal year mean deviation from med is significant. Non-normal observations have been eliminated when testing hypotheses.

Table 1: Results of Descriptive Statistics

Dependent Variable	2/3283	2/288	0/332178	1/4	3/86
Control Variable					
Book Value of Assets at the End of Year	937/7881	207/586	2/947/588	11/124	35/884/110
Size	5/4183	5/3272	0/61/25	4/06	4/66
Ratio of Debt to Asset	0/623	0/6462	0/2304	0	1/91
Quick Ratio	2/6688	0/688	29/466	-7/31	552/66
Mean	0/9092	0/6775	0/875	0/125	0/1062

Variable Analysis

Table 2: Analysis of Models and Variables of Study

				F value	Sig level	R ²	Durbin-Watson value
Model 1				170/430	0/000	19/5%	1/589
Fixed coefficient	1/015	10/098	0/000				
Audit fees	0/241	13/556	0/000				
Model 2				4/624	0/0033	0/07%	1/5
Fixed coefficient	2/2245	61/586	0/000				
Internal control weakness	0/117	2/150	0/0024				
Model 4				3/803	0/053	0/5%	1/5
Fixed coefficient	2/221	-184964	0/000				
Financial fraud	0/000	-1/966	0/052				
Model 3				0/0057	0/0813	0/000	1/5
Fixed coefficient	2/228	56/223	0/000				
Fired auditor	-0/001	-0/228	0/813				

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Table 3: Hypotheses Testing

Main Hypothesis	There is a significant relationship between audit fees and emergence of fraud in financial statements of companies	Accepted
Hypothesis 1	There is a direct relationship between internal control weaknesses and emergence of fraud in financial statements of companies	Accepted
Hypothesis 2	There is a direct relationship between auditor-related variables and emergence of fraud in financial statements of companies	Accepted
Hypothesis 3	There is a significant relationship between emergence of fraud in financial statements and managers resignation	Rejected

Conclusion and Suggestions

According to the obtained results of this study, the following suggestions are presented:

1. According to hypothesis 1, the audit work-related variables are the most important and effective factors in audit fees; hence, it is recommended to audit organizations either consider the quality control or create quality control sector.

It would be essential for auditors to establish large institutes in order to obtain more income, employ experienced and expert workers, to spend costs and to increase quality of works. It would be also necessary to revise the concept of professional supervision and to use effective methods such as quality control in order to make audit institutions try to improve their qualities.

2. The obtained results of hypothesis 2 indicated that auditor-related variables are the main effective factors in audit fees. The beginner audit institutions might reduce audit fees through a rapid audit work but experience is an inevitable factor in a work full of judgments. Experience would be an important factor in relevant issues to the various knowledge and professional behaviors. It is recommended to prepare some conditions through ranking methods to make those experienced and reputable audit institutions responsible for tasks with high economic importance in which, an extensive range of society are involved.

Users of financial statements are forced to rely on auditors' report in their decisions; hence, they should consider auditors as reliable people who propose reasonable judgments when there is a conflict between personal and public interests. Therefore, the implementation of permitted Act in this field is recommended within audit works.

3. The subsidiary findings of study indicated that presence of related works to auditing such as operating audit is important factor with undesired effect on audit fees of financial audit due to independence of auditor. It would be essential to conduct more studies to recognize different aspects of independence. The large number of audit institution compared to the size of audit market has led to increase in supply side of this market; therefore, the mentioned factor can reduce independence of auditors.

It is recommended to organize the existed official accountants instead of increasing number of institutions so that institutions will be more capable and more independent. The Professional code of ethics of CPAs considers more than 25% income obtained from client during more than 2 years as a violation. It seems that this verdict is not enough for minimum independence; therefore, it should be revised.

4. According to the obtained results of main hypothesis of this study, the studied statistical population considers the mentioned common factors of listed companies in Tehran Stock Exchange as effective factors in audit fees and audit fees can effect on quality of audit work. Therefore, it would be necessary to consider these factors within choosing and training future auditors in order to have high quality of audit works. The Iranian Official Auditors as professional supervisors on work of auditors and other decision-maker officials in audit scope can use the obtained results of this study with more

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emphasize on studied effective factors and variables in audit fees in order to increase quality of audit work so that the qualitative level of audit will be increased in country.

Study Limitations

1. The inherent limitation of measurement tool of this study
2. Lack of possibility to assess the accuracy of respondents of questionnaire
3. Unwillingness of some respondents to respond and return questionnaires
4. Limitations of measurement scale and LIKERT scale.

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