

The relationship between audit quality and audit fees

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Due to recent high-profile corporate failures in South Africa, questions are being asked about the relationship between auditor independence, the amount of fees and audit quality. There is a perception in various circles that lower audit fees equate to lower audit quality, writes Thandokuhle Myoli, Saica project director: assurance.



In this article, we aim to educate readers about some of the key determinants of the level of an external audit fee. These include the size and complexity of the entity being audited, the level of audit quality and the independence of the prospective auditor

Those charged with governance, including audit committees, need to be aware of the risks relating to fee pressure. This article highlights some of the areas that those responsible for the appointment or reappointment of auditors should consider when making their decision and points out what some of the threats to auditor independence are.

The relationship between assessed risks of material misstatement, the auditor's work effort and the audit fee

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, through understanding the entity and its environment, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement (RoMM) (ISA315 par.3). RoMM may be affected by a number of engagement-specific factors such as the nature of the industry that the client operates in, including regulatory requirements, investment and financing activities, the complexity of the audited entity's transactions, profitability, the going concern status of the company and ownership structure.

The higher the RoMM for an audit engagement, the more work effort that can be expected in order to reduce the risk to an acceptable level. Therefore, there should be a correlation between the RoMM, the work effort and the audit fees for an audit engagement.

The auditor's knowledge of the entity and its industry may also have an impact on the level of the audit fee. Initial engagements may be expected to have higher audit fees as the auditor may spend more time obtaining an understanding of the entity and its environment. As the years progress, the time spent on obtaining an understanding of the entity may reduce due to the auditor's history with the entity. In this regard, those charged with governance, including audit committees, should be wary of auditors charging extremely low fees on initial appointments as this could create threats to the auditor's independence. This could result in a situation where the fee is so low that it might be difficult for the auditor to perform the audit in accordance with applicable technical and professional standards.

A more complex audit where there are a relatively high number of identified RoMM that have been assessed as significant

requires auditors with higher skills and more experience, and more time to be allocated to the audit, which should logically result in higher fees. These experienced audit team members are engaged at higher rates due to their level of experience and competence.

Another example is where RoMM relate to complex, specialised areas where the auditor may need to engage with experts in obtaining sufficient appropriate audit evidence. This may also have the effect of increasing the audit fee even further due to the specialised nature of the services provided by the experts, the time they spend on the engagement and the rates they charge to the auditors, required in order to achieve high audit quality.

The relationship between audit quality and fees

[The Framework for Audit Quality](#), issued by the International Auditing and Assurance Standards Board (IAASB), has noted that there is a relationship between the quality of an audit and the quality and quantity of resources used in its performance (which should be reflected in the audit fee). A quality audit is likely to have been achieved by an engagement team that:

- Exhibited appropriate values, ethics and attitudes;
- Was sufficiently knowledgeable, skilled, and experienced and had sufficient time allocated to perform the audit work;
- Applied a rigorous audit process and quality control procedures that complied with law, regulation and applicable standards;
- Provided useful and timely reports; and
- Interacted appropriately with relevant stakeholders.

The above indicates that the mindset of those responsible for the appointment of auditors should be on maximising quality rather than minimising costs. This could ensure that sufficient, appropriate resources are allocated to the audit, which, in turn, may improve audit quality. For the auditor, there is a direct link between the costs involved in gathering sufficient appropriate audit evidence and the fees charged by the auditor.

The relationship between auditor independence and fees

Fees may have an impact not only on audit quality, but they may also have an impact on the independence of the auditor. The objectivity of the auditor may also be impaired where the auditor is forced to reduce the extent of audit procedures to be performed due to a lower audit fee.

The IRBA Code is based on the International Ethics Standards Boards for Accountant's (IESBA) *Code of Ethics for Professional Accountants (Including International Independence Standards)* (the IESBA Code). The IESBA has identified fees as an area that requires their attention and have recently published [proposed revisions to the fee-related provisions of the IESBA Code](#), which will result in amendments being made to the IESBA Code, and therefore to the IRBA Code. The proposed amendments are aimed at strengthening the provisions addressing fees. Both extant codes focus on three main areas: the relative size of fees, overdue fees and contingent fees.

Based on the review of the proposed amendments by the IESBA on fees, the following have been identified as some of the potential areas where threats to auditor independence as a result of fees may arise:

- Level of audit fees: Unduly low or unduly high fees can impact the level of the self-interest threat and might create an intimidation threat to independence.
- Proportion of fees for services other than audit to audit fee: There is a reasonable perception that a high ratio of fees for services other than audit to audit fees creates threats to independence (particularly, threats to independence in appearance).
- Fee dependency: When the total fees generated from an audit client by a firm represent a large proportion of the total fees of that firm, the dependence on that client and concern about losing the client create a self-interest or intimidation threat.

What should the audit committee consider?

Section 94(7) (a) of the Companies Act, (No. 71 of 2008) explicitly outlines the duties of the audit committee when it comes to the appointment of registered auditors. These include:

- Nominating the appointment of an auditor and ensuring that the nominated auditor is independent of the company;
- Determining the fees to be paid to the auditor and the terms of engagement;
- Determining the nature and extent of any non-audit services that the auditor may provide to the company and pre-approving the proposed agreements related to such services with the auditor; and
- Ensuring that the appointment of the auditor complies with all relevant legislation relating to the appointment of auditors.

Section 94(8) also provides a comprehensive list that audit committees should consider when assessing whether a registered auditor is independent of a company. These include:

- Ascertaining that the auditor does not receive any direct or indirect remuneration or benefit from the company except as auditor or as permitted in terms of legislation;
- Consider compliance with other criteria relating to independence or conflict of interest prescribed by the IRBA; and
- Consider whether the auditor's independence has been prejudiced as a result of previous appointments; whether as auditor or any other consultancy, advisory or other work undertaken by the auditor.

The IRBA has issued a [Feedback Report](#) on audit quality indicators (AQIs). AQIs are qualitative or quantitative measures of audit quality that allow stakeholders to assess these indicators year-on-year internally, across engagements and across firms. AQIs are a tool that can be used by those charged with governance, including audit committees, when overseeing and assessing the quality of auditors to be appointed or reappointed. AQIs include aspects such as results of regulatory and other inspections, the independence of the auditors as well as the reputation of the firm. The competence and experience of the engagement team members, and the extent of investment that the audit firm has made in technology and in improving its audit methodology are other factors that those charged with governance, including audit committees, can consider when appointing or reappointing the auditors.

Audit firm transparency reports, provided by some audit firms, also give audit clients an indication of the auditors' commitment to audit quality. These reports usually contain information about the firm's policies and procedures on aspects such as:

- Firm structure;
- Human capital;
- Engagement related information; and
- Quality management.

After the robust interrogation of the factors identified above, a suitable audit fee should be determined. The fee should be determined based on a clear process and criteria that emphasise audit quality. This will ensure that audit quality remains the focus of the discussion rather than the fee itself.

Conclusion

Audit firms that retain or win audit appointments by using unrealistically low fees act to the detriment of the audit profession as audit quality is likely undermined. Sustained audit quality is what should give firms the edge in the audit market, not charging low audit fees in order to gain or retain clients.

Where audited entities put pressure on auditors by placing a restriction on the audit fee, this creates a threat to one of the fundamental principles of the IRBA Code that auditors have to abide by professional competence and due care.

While there is a clear understanding that audit firms are profit-oriented entities, commercial interests should not triumph over ethical requirements. Ethics continues to be the cornerstone that holds the auditing profession together. In order for the profession to keep its esteemed reputation in society and for the public to retain its trust, it is critical that its members uphold the highest level of ethics. Unrealistically low audit fees that blur the lines of professional competence and due care, without a clear relationship to audit quality is one of the surest and shortest paths that will lead to the destruction of a noble and trusted profession whose primary mandate is the protection of the public's interest.

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