

Competitive Bidding, Fees and Auditor Changes: Additional Evidence

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Abstract

The major research questions addressed in this study were: Do auditor changes result in lower audit fees? Are audit fees of auditor changers correlated with nonaudit fees? Do clients which obtain competitive audit engagement bids have lower audit fees? A sample of 106 firms, including both auditor changers and nonchangers, was used to test several hypotheses regarding audit fees, nonaudit fees, and competitive bidding. Our major conclusions were: (1) firms can effectively achieve lower audit fees by changing auditors, (2) firms which changed auditors achieved significantly lower total costs for nonaudit services than nonchangers, (3) there are very high correlations between audit fees and nonaudit fees (both scaled by total asset size), (4) firms which had competitive bids submitted for an audit engagement, versus those that did not, achieved significantly larger decreases in audit fees, and (5) choosing the lowest of the bids may not result in lower fees, on average, than firms that chose other than the lowest bid.

Introduction

Recent Congressional inquiries into the nature of the public accounting profession by the Dingell Committee (1985) have raised a number of concerns. This study focuses on one of them -- audit independence. Specifically, the study examines three possible manifestations of lack of auditor independence -- low-balling, extent of nonaudit services, and competitive bidding -- when there are auditor changes.

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With respect to the first question, the Cohen Commission (1977, p. 121) has said:

We believe that accepting an audit engagement with the expectation of offsetting early losses or lower revenues with fees to be charged in future audits creates the same condition and represents the same threat to independence (as an unpaid audit fee).

The Cohen Commission (1977, p. 95) also addressed the second research question when they examined potential lack of independence when auditors provide nonaudit services. The basic issue is whether auditors

can be objective with respect to accounting systems which their firms helped design and implement. The Securities and Exchange Commission and Congress have also been concerned with this issue.

The third research question, dealing with competitive bids, has also raised concerns for auditor independence. Critics of the bidding process argue that auditors may lose their objectivity when they bid too low. In fact, the state of Texas recently changed its public accountancy laws to make a presumption of loss of independence if an audit is performed for less than direct cost.

The remainder of the paper contains four sections. Section II provides background by summarizing prior studies which have addressed the research questions raised in this study. It is followed by a description of the research methodology, including the hypotheses tested. Section IV presents and discusses the results obtained, and the last section is a brief summary.

Background

Low-balling

The desire to obtain lower audit fees is often given as a primary reason for auditor changes (Eichenseher and Schields, 1983, p. 23). In fact, for many years there has

been the allegation that CPA firms attempt to gain new clients by bidding below their costs for new audit engagements (i.e., 'low-balling') (Wallace, 1984, pp. 58-59). In subsequent audits of the newly-acquired client, it is alleged, the CPA firm charges fees more consistent with the audit's real economic cost (DeAngelo, 1983, pp. 113-127). On the other hand, it is clear that first-year (i.e., the CPA firm is auditing a client for the first time) audits are more expensive to perform than continuing audits because of the significant increase required in auditing procedures (Wallace, 1984, p. 59).

The research dealing with the question of changes in audit fees following a change in auditors has resulted in somewhat conflicting results. Simon and Francis (1988, p. 267), in a study of 214 auditor changes in the period 1979-1984, found evidence of audit fee discounts in the year after the change, as well as in the next two years. The actual extent of price cutting, however, was no doubt understated because, as Simon and Francis noted, first year audit start-up costs were excluded from the analysis. Francis and Simon (1987, p. 155) had reached a similar conclusion that 'initial audit engagements are significantly lower in price...' (note, however, their small sample size of 12). Finally, Schatzberg (1990, p. 359) found evidence, through a laboratory investigation, that supports low-balling behavior.

However, other studies have presented evidence which contradicts the results of the studies just reported. Rubin (1988, pp. 234-235) studied the association between audit fees in 189 cities (i.e., municipal audits) and numerous independent variables. The variable most relevant to his study was auditor tenure, which was not found to be significantly associated with audit fees. Wallace (1984, p. 61) also found no significant difference in standardized audit fees for entities that changed auditors versus those that did not, while Francis (1984, p. 147) concluded that initial engagements resulted in higher audit fees. Given the lack of consensus in these prior studies, this study was motivated by a desire to gather evidence to help clarify these issues.

Nonaudit Services

Several prominent studies which have examined the relation between audit fees and nonaudit fees have come to the conclusion that there is a significant correlation. Simunic (1984, p. 681) found that audit fees of clients who also purchase other nonaudit services are 'significantly higher than audit fees of clients who do not do so.' Simon (1985, p. 71) replicated Simunic's results with respect to nonaudit services. Palmrose (1986, p. 410) regressed nonaudit services fees and other variables on audit fees and concluded that there is a 'positive relation between fees for audit services and fees for ... nonaudit services...'

None of these studies, however, gathered evidence with respect to this hypothesized relationship when there is a change of auditors. This study was designed to provide this additional evidence, using the methodology described in the next section.

Competitive Bidding

Prior research is very limited in addressing our third research question regarding the effect of competitive bidding on audit fees. The study that has come closest to this question was by Ettredge and Greenberg (1989), who tested the relationship between percentage fee cuts and the number of bidders for an audit engagement. They found a significant relationship -- the greater the number of bidders, the greater the decrease in audit fees. Their sample, however, consisted only of auditor changers. This study tests whether firms which seek competitive bids from auditors achieve lower audit fees, and also explores the effect of choosing the lowest bid.

Methodology

Hypotheses

The study was designed to test three hypotheses related to auditor independence.

H1: The change in audit fees of firms which have changed auditors will be the same as for firms which have not changed.

The alternative hypothesis is that auditor changers will have lower fees. One empirical result of low-balling is that audit fees will be lower in the year subsequent to an auditor change, or will increase by a smaller amount than would be the case if low-balling were absent.

H2: The change in nonaudit fees will be the same for firms changing auditors as for those that do not.

The alternative hypothesis is that auditor changers will have lower nonaudit fees. It was shown earlier that studies have found an association between audit fees and nonaudit fees. That association will be further tested in this study. It has not been shown, however, whether firms which change auditors also have greater decreases in nonaudit fees.

H3: The change in audit fees for firms soliciting competitive bids will be the same as for those that do not.

The alternative hypothesis is that those seeking bids will achieve lower audit fees. It has been argued that competitive bidding among CPA firms tends to drive prices down and provides a vehicle for low-balling.

Data Collection

In order to test the three hypotheses, data was collected for audit fees, nonaudit fees, auditor change, reasons for the change, and competitive bidding. This data was gathered by sending a survey to the chief financial officers of the 272 firms identified on the January 1988 Disclosure II database as having changed auditors from 1986 to 1987, and an additional 235 firms, selected from the database, that did not change auditors. These latter firms were matched by size and industry with 235 of the auditor change firms. The Disclosure II database also contains financial and other data on all firms registered with the Securities and Exchange Commission. Additional data collected from Disclosure II included net income, total assets, and audit report type. The survey instrument is shown in the Appendix.

Panel A of Table 1 contains descriptive data on the survey mailing, second requests, and responses. Of the 507 questionnaires mailed, 76 responses were received from the first mailing and 30 from the second mailing. The overall usable response rate was 20.9 percent. Twenty-seven additional responses were received, but could not be used in the tests because of missing audit fee data for one or both of the years.

Panel B of Table 1 shows descriptive data for mean total assets and mean net income for the sample firms. The firms are categorized by whether they changed auditors or not. Based on this data, both changers and nonchangers experienced similar increases in total assets over the two years, but changers showed a 26 percent decrease in net income compared to a 23 percent increase for nonchangers over the two years. The difference was significant at $p=.061$ ($t=1.561$).

Table 1

Questionnaire Response Rates and Descriptive Statistics

A. Responses					
		<u>Total Sample</u>	<u>Changed Auditors</u>	<u>Non- Changers</u>	
Questionnaires Mailed		507 ===	272 ===	235 ===	
Nonresponses		374	212	162	
Unuseable responses		27	15	12	
Usable replies to first requests		76	35	41	
Usable replies to second requests		30 ---	10 ---	20 ---	
		507 ===	272 ===	235 ===	
Response Rate		26.2%	22.1%	31.1%	
B. Descriptive Statistics (\$000 omitted)					
		Mean <u>Total Assets</u>		Mean <u>Net Income</u>	
		<u>1986</u>	<u>1987</u>	<u>1986</u>	<u>1987</u>
Changers	45	\$254,997.1	\$291,983.0	\$10,644.9	\$ 7,900.8
Nonchangers	61	\$322,760.8	\$376,775.1	\$15,306.2	\$18,874.7
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Total Firms	106	\$293,993.2 =====	\$340,778.4 =====	\$13,327.4 =====	\$14,216.0 =====

This result may indicate that the change firms were in financial distress, and that may have been a factor in their decision to change auditors.

Results And Discussion

Low-Balling

Table 2 shows a comparison of changes in audit fees for firms that changed auditors and those that did not. The 45 firms that changed auditors had an average decrease in audit fees of \$9.91 per thousand dollars of total assets, while the 61 firms that did not change auditors had only a \$.84 decrease. A t-test of the difference in means was significant at a probability of .054. We conclude from this that firms can effectively achieve lower audit fees by changing auditors. We can therefore reject the hypothesis that the fees are the same for changers and nonchangers. These results buttress the results of the prior studies (e.g. Francis and Simon (1987); Simon and Francis (1988); Ettredge and Greenberg (1989)) that have found lower audit fees following auditor changes.

Even though there is a significant difference in the change in audit fees between changers and nonchangers, it is interesting to note that even after the change, changers still reported audit fees about two times as much as audit fees for nonchangers per \$1,000 of total assets. It may be that the nonchanger firms were recent change firms themselves, and are still operating on lower early bid fees.

While this evidence of price cutting on initial audit engagements certainly cannot be interpreted as proof

that auditing firms engage in low-balling, it may encourage a continued concern on the part of the SEC and Congress. The reason for the greater decrease in audit fees of changers may simply reflect the effects of competition among CPA firms and the inefficiency of the prior audit firm. As Palmrose (1989, p. 498) concludes, based on her results in studying fixed fee vs. cost-reimbursement contracts on audit engagements, we cannot assume 'that reducing audit fees necessarily compromises audit performance.'

Nonaudit Services

Table 3 presents a test of the hypothesis that the change in total cost for nonaudit services will be the same for firms changing auditors as for those that do not. Not all the firms in our sample had nonaudit fees in addition to audit fees, so the sample sizes are smaller than in our test of H1. The 29 firms changing auditors had an average decrease in nonaudit fees of \$17.54 per thousand dollars of total assets, compared to an average decrease of \$1.17 for the 44 nonchangers. This difference is significant at a probability of .01, and leads us to reject H2.

We conclude that the sample firms which changed auditors achieved significantly lower total costs for nonaudit services than nonchangers. One explanation for this finding is that firms attempting cost savings by changing auditors also strive to reduce nonaudit services simultaneously. This is consistent with Haskins and Williams' (1988, p. 16) conclusion that auditor changes are related to financial distress of the client. Firms that are financially distressed would be more likely to seek an auditor change to reduce costs, as well as eliminate discretionary costs such as nonaudit services.

Table 2

Change in Audit Fees for Auditor Changers vs. Nonchangers

	n	Mean Audit Fees*		Mean Change in Audit Fees	Value of t	Prob.
		1986	1987			
Changers	45	18.753	8.842	-9.91		
Nonchangers	61	4.658	3.822	-.84	1.626	.054
Total	106					

*Per \$1,000 of total assets.

Table 3

**Change in Total Cost for Nonaudit Services for
Auditor Changers vs. Nonchangers**

	<u>n</u>	Mean Total Cost for Nonaudit Services*		Mean Change in Total Cost for Nonaudit Services	Value of t	Prob.
		<u>1986</u>	<u>1987</u>			
Changers	29	29.495	11.950	-17.54		
Nonchangers	44	11.700	10.528	- 1.17	2.381	.01
Total	73					

*Per \$1,000 of total assets

Another explanation for the reported change in nonaudit service fees is that firms which changed auditors may want to observe the new audit firm for some period before they are confident in acquiring nonaudit services from that audit firm. Also, firms may change auditors as a way to control nonaudit service fees. It can be noted from Table 3 that before the change (1986), changers reported nonaudit service fees per \$1,000 of total assets about two and one-half times higher than for nonchangers. Yet, after the change (1987), nonaudit service fees were nearly the same for audit changers and nonchangers.

As in several prior studies (e.g. Simon (1985); Simunic (1984); Palmrose (1986)), we found very high correlations between audit fees and nonaudit fees (both scaled by total asset size). In 1987, the Pearson correlation was .81 (significant at less than .0001), and in 1986 it was .99. The correlations were equally high for audit changers and nonchangers. Prior studies have not examined this latter relationship.

Competitive Bidding

Panel A of Table 4 presents the average audit fees for firms which had competitive bids submitted for an audit engagement, versus those that did not. Of the 38 firms using competitive bidding, 33 were audit changers and five firms did not change auditors. The 38 firms using competitive bids achieved a decrease of \$11.86 for every \$1,000 of total assets, compared to a decrease of only \$.68 for firms not using bids. The difference is significant at a probability of less than .03. We therefore reject the hypothesis of no difference in average audit fees. These results can be compared to those of Ettredge and Greenberg (1989, p. 20), who found that firms soliciting a greater number of bids achieved larger audit fee cuts.

Panel B of Table 4 compares the 24 firms choosing the CPA firm with the lowest bid and the 14 that did not choose the lowest bid. The average audit fee decrease for auditees using the lowest competitive bid was \$17.71 per thousand dollars of total assets. This compares with an average decrease of only \$1.82 for auditees not choosing the lowest bid. The difference between the two is not statistically significant (probability = .157). The sample size for this test, though, may not provide sufficient data to test this question.

The significant result shown in Table 4A indicates that clients may be able to save on audit fees by obtaining competitive bids from CPA firms. This may be discouraging to many CPA firms, since cost has often been cited (e.g., the Public Accounting Report's annual surveys) as one of the primary factors clients consider in their decision to change auditors. But CPA firms may be encouraged by the evidence shown in Table 4B which indicated that there was no significant difference in the change in audit fees for firms selecting the lowest bid versus firms not selecting the lowest bid.

Reasons for Auditor Change

This study also gathered evidence regarding the reasons given by the respondents for changing auditors. Table 5 shows the results. The most frequently mentioned reason for changing auditors was service (23 of the 55 responses given). The various responses had to be interpreted by the authors, of course, but the types of responses classified as service included comments such as lack of knowledge, staff turnover, timeliness of service, lack of industry experience, extent of partner involvement, poor quality of work, and lack of responsiveness.

Table 4
Competitive Bidding

A. Change in Audit Fee of Firms Using Competitive Bids vs. Firms Not Using Competitive Bids						
	<u>n</u>	Mean Audit Fee*		Mean Change	Value of t	Prob.
		<u>1986</u>	<u>1987</u>	<u>in Audit Fees</u>		
Competitive Bid	38	20.685	8.826	-11.86		
No Bid	68	5.029	4.347	- .68	1.953	.027
Total	106					

B. Change in Audit Fee of Firms that Selected the Lowest Competitive Bids vs. Firms that Did Not						
	<u>n</u>	Mean Audit Fee*		Mean Change	Value of t	Prob.
		<u>1986</u>	<u>1987</u>	<u>in Audit Fees</u>		
Selected Lowest Competitive Bid	24	30.084	12.371	-17.71		
Did Not Select Lowest	14	4.574	2.750	- 1.82	1.019	.157
Total	38					

*Per \$1,000 of total assets

The second most frequent (mentioned 17 times) reason for changing auditors was cost. This is consistent with prior studies (e.g., Public Accounting Report) which have surveyed auditees on reasons for changing. Cost is typically the first or second most frequently mentioned reason. The third most frequent response was because of ownership changes. This category involved firms that were acquired and were forced to change to the acquiring firm's choice of auditors. Three firms indicated the auditor's lack of independence as the reason for the change. The conditions that created the lack of independence were addition of a new director to the board, hiring an employee of the audit firm, and inability to pay the prior year's audit fee.

Summary

A sample of 106 firms, including both auditor changers and nonchangers, was used to test several hypotheses regarding audit fees, nonaudit fees, and competitive bidding. Our major conclusions were: (1) firms can effectively achieve lower audit fees by changing auditors, (2) firms which changed auditors achieved

Table 5
Reasons for Changing Auditors

Reason	Count
Quality of Service	23
Cost	17
Ownership Changes	8
Miscellaneous	7
Total Responses	55

significantly lower total cost for nonaudit services than nonchangers, (3) there are very high correlations between audit fees and nonaudit fees (both scaled by total asset size) for both changers and nonchangers, (4) firms which had competitive bids submitted for an audit engagement, versus those that did not, achieved signifi-

cantly larger decreases in audit fees, and (5) choosing the lowest of the bids may not result in lower fees, on average, than firms that chose other than the lowest bid. A limitation of this study was that measurement of audit fees and nonaudit fees was self-reported by the sample firms.

Suggestions For Future Research

Given the significant results in the test of audit fees when competitive bids were obtained, and given the relatively few studies which have addressed this issue, we would suggest there are several interesting questions which could be worth while to pursue in future research efforts. For example, are clients as satisfied with the audit firms used as a result of competitive bids as they were with the prior audit firm? For clients who chose the lowest audit firm bidder, what magnitude of future years' audit fees did they incur, compared to clients who did not choose the low bidder or did not offer the audit engagement for bids? In addition to examining audit fees for "n" years after a competitive bid, it would be useful to gather data on the number of hours required for the audit (while trying to hold variables such as change in size of client and environmental factors constant), then compare it to the period(s) before the bid.

There are many unanswered questions with respect to auditor independence. Pursuing the answers to the types of questions suggested above should shed additional light on the subject and provide policy makers with the information they need to address the issue of how audit fees are determined and how they relate to independence. 20

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