

Dissecting the price of assurance: A case study about audit fee determination in a Dutch Big 4 audit firm

Master's Thesis

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Abstract

The topic of audit fee determination and what factors influence the height of audit fees have been widely discussed in quantitative research. However, the results of the previous studies show that the different factors are not always consistent. On top of this, the measures used in quantitative research are often proxies of the real constructs used in practice. Therefore, this study examines how audit fees are determined in practice and what considerations the auditor actually takes into account. This is done by using the case study method at a Big 4 audit firm in the Netherlands. The results of this study indicate that there are three main phases in which audit fees are being determined and these are: the construction of the technical budget, negotiations with the client about the commercial budget and finally the additional work phase during the audit process. Each of these phases has its own considerations that come along with it. The results of this study provide input for further discussions into audit fee determination by looking at considerations that auditors make in practice.

Key words: audit fee determination, technical budget, commercial budget, additional work.

Table of Contents

1.	Introduction	4
2.	Literature review	7
2.1	Introduction	7
2.2	The size of the auditee	7
2.3	The complexity of the auditee	8
2.4	The risk of the auditee	9
2.5	The internal controls of the auditee	11
2.6	Other factors affecting audit fees	12
2.7	The framework	13
3.	Methodology	15
3.1	Research method	15
3.2	Methods for data collection	15
3.3	The case	18
4.	Results	19
4.1	Introduction	19
4.2	Key technical considerations	20
4.2.1	Auditee size	21
4.2.2	Auditee complexity	21
4.2.3	Auditee risk	23
4.2.4	Auditee internal controls	25
4.2.5	Rules and regulation	27
4.2.6	Client characteristics as technical consideration	28
4.3	Key commercial considerations	29
4.3.1	Partner characteristics	30
4.3.2	Client characteristics as commercial consideration	30
4.3.3	Other factors that could influence the commercial budget	32
4.4	Additional work	33
5.	Discussion	36
6.	Conclusion	40
	References	43
	Appendices	46

1. Introduction

In the Netherlands, a firm must hire an external auditor when it meets certain criteria stated by Dutch law in title 9 of book 2 Burgerlijk Wetboek. If this is the case and the organization is a so-called ‘middle-size firm’ or a small-size firm that voluntarily wants to hire an external auditor, you have to let the external auditor examine your financial statements. The costs for these services are called audit fees and although these audit fees seem to be subjectively stated, there is a whole process, with different factors that the auditor has to keep in mind, underlying the determination of audit fees (Hay et al., 2006).

The seminal paper of Simunic (1980), was one of the first studies, which tried to explain how audit fees are determined. His study sees audit fees as a joint determination of the quantity (the q-component) and the price (the p-component) and he argues that, although audit fees are determined by these two components, both individual components are not observable in the market, because only the audit fee as $p \cdot q$ can be observed. This distinction between the p- and q-component of audit fees will be used throughout this study, when disentangling the audit process and finding out how the auditor thinks that these components change in certain situations. The q-component will often reflect the audit effort that is used when auditing a client. The p-component will either reflect the risk premium or the presence of more experienced auditors at an auditee leading to a higher average hourly rate. Next to the pricing model, Simunic (1980) also argued that certain factors are influencing audit fees. The most important factors, he argued, are size, complexity and problems with certain financial statement components of the client being audited.

After this first, exploratory, study many other studies followed that built upon his work and started to delve deeper into the various factors affecting audit fees. For example, Jubb et al. (1996) examined how risk influences the pricing of audit services and discovered that risk should be dissected into two components, namely ‘business risk’ and ‘audit risk’, which will be discussed in the literature study. Next to risk, the variables complexity (Firth, 1985; Simon and Francis, 1987; Taylor and Baker, 1981), industry (Ettredge & Greenberg, 1990; Low et al., 1990; Maher et al., 1992 and Palmrose, 1986;), size of the auditee/auditor (Francis & Simon, 1987) and corporate governance (Carcello et al., 2002; Tsui et al., 2001) have been widely investigated and could potentially change the height of audit fees. However, most of these studies use quantitative methods to find evidence and draw conclusions on the determinants of audit fees. The quantitative methods, however, suffer from some limitations, like a lack of internal data and variables based on questionable proxies (Hay et al., 2006). These shortcomings

in using the quantitative methods could be the reason that some factors, determining audit fees, keep giving inconsistent results across the various studies.

By using a qualitative research method, this study will try to circumvent these limitations of doing quantitative research and give a more in-depth analysis of how audit fees are determined as well as how different situations throughout the audit process change this determination in practice. The contribution of this study to the research area of audit fee determination thus will be twofold. First, this study will try to determine how various auditors make sense of certain situations in the audit process and how the considerations of the auditors, in turn, change the q- and/or p-component for the external auditor auditing a client. This is something that is virtually impossible to measure quantitatively. Second, this study will try to fill the gap that is left by quantitative research, due to lack of internal data and the use of proxies, which could have led to the mixed results and omitted variables (Hay et al., 2006).

According to Carson et al. (2004), the most widely used audit fee model in quantitative research is the model that measures audit fees as a function of client size, client complexity, client risk and auditor quality. Since this thesis wants to contribute to the existing scientific literature in the broadest way possible, extra attention was paid to these factors and it was tried to examine if and how auditors take these factors into consideration throughout the audit process when determining audit fees. A note should be made that with the Sarbanes-Oxley Act in the United States and frameworks like COSO it became clear that the internal controls of a company are becoming increasingly more important for the auditor to check and audit. So, throughout this study there was also examined what kind of considerations auditors make regarding audit fees when internal controls work (im)properly. With the reasoning above in mind, the following main research question for this study can be formulated:

RQ: *How do auditors determine audit fees throughout the audit process?*

In order to find answers to the main research question, this study used the case study method. The case that was examined, is a Big 4 audit firm that is located in the Netherlands. In order to find corroborating evidence about the determinants of audit fees, data triangulation has been used. The methods for data collection consisted of: interviews with various employees and partners at the Big 4 firm, inspection of relevant documents for determining audit fees and field research. During the field research, evidence was collected by listening to conversations about audit fees between the different members of an audit engagement team and what they consider to be important for this determination.

From the data analysis it appeared that a clear line between the technical budget and the commercial budget within audit fee determination has to be made. The technical budget is often prepared by the (senior) manager and forwarded to the partner-in-charge for further discussions. The auditors at the Big 4 audit firm see the following factors as influential on the technical budget: the size, complexity, riskiness, internal controls and general characteristics of the client as well as the current rules and regulations they have to apply to. When the technical budget has been agreed upon internally, the commercial budget will have to be made. This happens in negotiations with the client. The auditors at the Big 4 audit firm considered the following aspects to be of influence in determining the commercial budget: the characteristics of the partner, some general characteristics of the client and some other aspects like timing of the audit. These aspects were not researched before, which makes it a theoretical contribution to the existing literature. When the commercial budget has been agreed upon and nothing changes within the client's environment this will also be the final audit fee that the client has to pay. However, when things deviate from the ideal situation or things change in the client's environment, the auditor often has to do additional work, which could change the final audit fee that the client has to pay.

The remainder of this study is divided in five sections. In the second section, there will be an overview of the relevant theoretical and empirical literature about the factors determining audit fees mentioned in the introduction and there will be discussed how these factors could change the auditor's determination of audit fees. In section 3, the research method and case will be discussed, followed by a discussion of the data collection methods used within this case study. Section 4 will describe the results in detail, supported by the data gathered throughout this case study. In section 5, a discussion of the results will be done followed by the conclusion of this case study in section 6, where also its limitations will be discussed together with some suggestions for future research.

2. Literature review

2.1 Introduction

Most of the literature on the determination of audit fees have been done quantitatively. Some of the most important factors found in those studies will be discussed below and will be elaborated. Also, it will be discussed how the auditor might make sense of these factors throughout the audit process when determining the audit fee of a client.

2.2 The size of the auditee

According to the meta-analysis by Hay et al. (2006), the size of the client that is being audited, is the most frequently found variable that determines audit fees. Of the 87 studies that were investigated in their analysis, 85 studies found a significant positive relationship between this variable and audit fees. This is in line with the study of Simunic (1980), where the size of the auditee was introduced as a control variable. He argued that size should be measured by looking at the size of assets at year's end of a firm, because auditors rely on using a sample for their assessments to which also the year's end assets belong. Given this fact, the auditor could determine that the audit fee should be higher, because the auditor needs to take a bigger sample which leads to more work for the auditor. This means that, in this situation, the q-component for the auditor increases. However, the relationship between audit fees and client size is unlikely to be linear, because the external auditor should be able to achieve some economies of scale when it comes to delivering the audit services when the client size increases (Simon and Francis, 1986). However, they do not mention why the p-component should be kept constant, because it might very well be that external auditors consider the size of a company as an equivalent to more exposure from the different stakeholders. Various studies, for example, found that larger firms tend to have a higher analyst following (Brennan & Hughes, 1990; Christensen et al, 2004; O'Brien and Bhushan, 1990) and have relatively higher percentages of institutional ownership (O'Brien and Bhushan, 1990). These parties demand much information from the firm, including high quality financial statements. When something then goes wrong during the audit process, a lawsuit will be more often started by stakeholders of the relatively bigger audit client, compared to a smaller audit client where there is less exposure. To compensate for this fact, the external auditor might also ask for a higher fee, which leads to an increasing p-component next to the already increasing q-component.

2.3 The complexity of the auditee

Another factor that is frequently found to be determining audit fees is the complexity of the auditee. When, for example, the extent of decentralization and diversification become greater, more decisions need to be made. In addition to this, decisions that have to be made will be more diverse. These notions lead to an increase in decision centers, which have to be monitored in order to check if they are making the decisions that are in the best interest of the company (Simunic, 1980).

The implementation of the Foreign Corrupt Practices Act (FCPA) of 1977 in the United States is a further confirmation that there are relatively more problems when people want to obtain information of large and decentralized companies. The FCPA requires that listed firms in the United States need to meet the accounting provisions, which state that their books should be transparent and should have a system of adequate internal controls for accounting in place. The increased decentralization and diversification of companies could lead to a higher loss exposure for the external auditor (Simunic, 1980). Although Simunic (1980) does not argue how this loss exposure could be overcome, it would be logical to reason that a higher p-component could be asked by the external auditor in order to compensate for the potential loss exposure they might face. In his analysis, Simunic (1980) measures auditee complexity by using the number of consolidated subsidiaries in the financial statements of the client as proxy for decentralization and the number of SIC industries in which the audit client operates as proxy for diversification. He finds that both proxies have a positive and significant relationship with the audit fees that a client pays, which leads to the conclusion that, in fact, the p-component increases when auditee complexity increases, leading to higher audit fees.

On the other hand, it could be argued that, as an auditee becomes more complex, more time must be spent in order to arrange, coordinate and execute the audit plan. This would lead to an increase in the q-component for the external auditor, eventually leading to a higher audit fee as well (Gerrard et al., 1994). Take, for example, the number of estimations that is needed to be made for certain journal entries. Journal entries, which need many estimations, like participations, could lead to a higher complexity for the external auditor, because estimations are more subjective than journal entries without estimations and these estimations could also lead to some discussions between the client and the external auditor (Knechel & Salterio, 2017). When the auditor needs many hours to discuss the estimations of certain journal entries, he also should consider that there are more hours put into the client than previously planned, leading to an increased q-component.

Gerrard et al. (1994) also partially agree with Simunic (1980), by arguing that if an auditee is more complex, the number of difficulties that arise would also increase, together with the level of those difficulties when performing an audit of the financial statements. With a higher level of difficulty, it is more likely that the manager of an audit firm decides that more experienced auditors need to look at the problems in the financial statements and these experienced auditors are likely to receive, on average, a higher hourly wage than the relatively less experienced auditors, leading to an increase in the p-component of audit fees. Look, for example, again at the situation of journal entries which are based on estimations made by management. More often than not, estimations will be discussed with management by the more experienced auditors who have a higher hourly wage. This means that next to an increase of demanded working hours, there also occurs a need for more experienced auditors when dealing with estimations. Overall, the relationship between auditee complexity and audit fees is expected and found to be positive throughout the quantitative studies (Gerrard et al., 1994; Hackenbrack & Knechel, 1997 and Palmrose, 1986). Thus, as the various arguments mentioned above reveal, there are several considerations an auditor should take into account throughout the audit process when auditing a complex client to be able to deliver an adequate audit.

2.4 The risk of the auditee

Studies have researched the relationship between risk and the height of audit fees an auditee has to pay in some way or the other. In the study of Gist (1992), on audit fee determinants for 95 publicly owned US firms, for example, he finds that the variables ‘return on investment’ and ‘long-term debt to total assets’, which were proxies for financial distress of the auditee, were significant in relationship to the height of the audit fees. This means that an auditor would charge a higher audit fee when the firm is in financial distress, because the risk of loss sharing is higher when this is the case. Although most of the studies find a positive relationship between risk and the height of audit fees, the concept of risk has varied from study to study (Jubb et al., 1996). In the study of Maher et al. (1992) only the concept of ‘audit risk’ has been discussed and in the study of Palmrose (1986) only the concept of ‘business risk’ has been discussed, while according to Jubb et al. (1996) both concepts should be used when constructing a model that determines audit fees.

It thus seems that the factor of risk in its relation to audit fees should be disentangled further into the concepts of ‘audit risk’ and ‘business risk’. Audit risk is the risk that an external auditor issues an opinion on the financial statements, which later turns out to be incorrect in spite of the auditor’s efforts to conduct a well-designed and effective audit. Although it seems,

at first, that the auditor cannot do much about this risk and thus the q- and p-component of audit fees do not seem to change.

Knechel & Salterio (2017) argue that audit risk can be further dissected into ‘the risk of material misstatements’ and ‘detection risk’. Risk of material misstatements is the risk that the financial statements of the auditee are misstated in some way prior to audit. They argue that the auditor cannot influence this risk directly in the current period, because it often has to do with the accounting- and internal control system of the auditee. However, detection risk, which is the risk that an auditor fails to detect a mistake in the financial statements of the auditee, is something that the auditor can reduce to virtually zero. It never will be zero, because an auditor will use samples when conducting an audit and this means that not every single transaction can be reviewed for misstatements. They might, however, reduce this risk through putting in more audit effort, which seems to imply that the q-component of audit fees increases with this kind of risk. This means that the auditor should consider how low he wants to put the detection risk of a client, because a lower detection risk means more work for the auditor and thus most likely a higher audit fee, but a high detection risk means less work for the auditor, but more chance of missing a material misstatement.

Knechel & Salterio (2017) go even further in disentangling the concept of risk by stating another category, which they name ‘engagement risk’. They describe engagement risk in the following way:

‘Engagement risk refers to the risk the audit firm is exposed to due to loss or injury from litigation, adverse publicity, or other events arising in connection with the audited financial statements’ (Knechel & Salterio, 2017 p. 68).

However, the authors do not reason how the auditor should consider this risk and its relationship with audit fees. The most likely option for the auditor would be to increase the p-component of the audit fees to compensate for the possible litigation risk. A prime example that requires the auditor to possibly change the reputational risk and litigation risk is the use of fair values. Various studies argue that the increased discretion used to estimate fair values by management increases agency costs. In turn, the auditor should re-evaluate both their reputational risk and their litigation risk, because management can use these estimations for their own benefit and not that of the stakeholders (Ramanna and Watts, 2010; Watts, 2006).

In sum, it can be concluded that the concept of risk has many dimensions, which are dissected in many different visions of risk and could all be possible considerations for the

auditor to take into account when auditing a client. It also seems that the various concepts of risk each determine a part of the audit fees in its own way. Where reducing detection risk, for example, could increase the q-component of audit fees, and engagement risk might increase the p-component of audit fees by adding a risk premium to the audit fees.

2.5 The internal controls of the auditee

While the auditor should give assurance that the financial statements are presented fairly, the auditee could also have internal controls which help them to produce fairly presented financial statements. This means that the audit process of the external auditor is also affected by the internal controls of the auditee in one way or the other (Knechel, 2001). In the course of the early 2000's there became increasingly more attention to the internal controls of a company. This happened because of a series of corporate scandals which came to light. Scandals like WorldCom, Enron and Ahold were eye-openers for policymakers and they decided that there should be more focus around the internal controls of a company. One of the most important steps in this redirected focus on the internal controls of a company was the introduction of the Sarbanes-Oxley act in 2002.

One of the key internal controls of a company is the audit committee. The job of the audit committee is to monitor financial reporting and disclosure. However, there could be two lines of reasoning about how the presence of an audit committee affects the height of audit fees that have to be paid by the company. On the one hand, you have the audit committee that might request that a certain level of audit quality has to be met. This could mean that the external auditor has to work at least a certain number of hours when the audit committee requests them to meet the required level of audit quality (Jack, 1993). These hours could further increase, because the engagement partner of the audit should discuss results, attend meetings and prepare reports for the audit committee (Goodwin-Stewart & Kent, 2006). As can be concluded from the reasoning above, the number of hours could increase for the external auditor when there is an audit committee present, because they could demand more audit effort leading to an increase in the q-component of the audit fees. Since most of this increased work is for the audit partner, it could also be argued that this leads to an increase in the p-component, because more hours have to be planned for the partner which has the highest hourly wage in an audit firm. This reasoning is further confirmed by the paper of Goodwin and Munro (2004), who find that auditors perceive the presence of an audit committee as increasing manager and partner time on that client which leads to a higher audit fee. When this is the case, it could be argued that the audit committee and the external auditor are complementary. The company with an audit

committee present thus also wants a strong corporate governance culture and would be prepared to pay a higher audit fee (Singh & Newby, 2010)

However, it could also be argued that the presence of an audit committee increases the level of internal control of a company which leads to less control risk for the auditor and results in less substantive testing being done by the external auditor (Collier and Gregory, 1996; Felix et al. 2001). This means that there is an opposite effect to the reasoning made above and the q-component of the audit fees will decrease, because less substantive testing means less work for the external auditor. If this is the case, it means that the internal monitoring function and the external monitoring function could be seen as partly substitutive of each other (Singh & Newby, 2010).

Next to the presence of an audit committee, companies could also perform an internal audit on the financial statements themselves. However, for the same reasons as the presence of an audit committee, the usage of an internal audit can both be seen as a substitute or a complement to the use of an external auditor. The study of Felix et al. (2001), argued that there is a negative relationship between the usage of an internal audit and the height of external audit fees, because the usage of an internal audit, again, strengthens the internal controls which could lead to a lower assessment of audit risk by the external auditor and thus less work that needs to be done when performing the audit. On the other side, you have studies, like the one of Carey et al., (2000), who find a positive relationship between the usage of an internal audit and the height of external audit fees a company has to pay. It is argued that the internal audit, nowadays, has been used in a much broader sense where it also looks at things like risk management and corporate governance (Leung et al., 2004). When companies use such an internal audit they will most likely have a stronger commitment to good corporate governance and are more likely prepared to pay a higher audit fee in order to get a high quality audit (Goodwin-Stewart and Kent, 2006).

From the arguments made above it is clear that there is still some controversy, whether the internal controls of a company actually lead to less or more audit fees that a company has to pay to the external auditor.

2.6 Other factors affecting audit fees

While the factors discussed above seem to be the most important ones for external auditors in the literature to date, it should be recognized that external auditors might perceive several other factors as possible reasons for a change in the audit fee. Some of these other possible reasons found in the literature will be discussed in the paragraphs below.

One of the factors that also seems to affect the height of audit fees is the type of industry that a company is operating in. The type of industry in which the company operates could matter for audit fee determination by the auditor. Certain industries have more rules and regulations compared to other industries. The banking industry, for example, has many rules and regulations for a wide array of financial products each with their own level of complexity (Castro et al., 2015). This added layer of complexity not only could increase the p-component of audit fees, since more experienced auditors will most likely be put on these kind of companies, but also the level of risk could increase, leading to a higher risk premium. On the other hand, you have the retail industry, which has relatively easy transactions leading to lower audit fees on average, because of the lower complexity involved.

One other factor that also could lead to a change in the determination of audit fees is audit tenure (Hay et al., 2006). In their study, Hay et al. (2006) find that there is a positive relationship between audit fees and audit tenure. This means that if the external auditor is new at the client, the audit fees should be relatively low compared to a client who has the same auditor for several years. One reason for this result could be that auditors use a low-ball tactic, where they decide to lower the height of audit fees in an extreme way in order to reel in the client. This reduction in audit fees could then be compensated by other non-audit services for which the client has to pay huge sums of money or by gradually increasing the audit fee for the client as years pass. However, it could also be the case that, as time progresses, the external auditor gets a better understanding of the client and the environment in which it operates, which could lead to a more effective and efficient audit process. This could result in a reduction in audit fees over the years, because the auditor can work more efficient leading to a decrease in the q-component of audit fees.

2.7 The framework

As can be seen from all the different arguments made above, there seem to be many factors which an external auditor needs to take into account when determining the level of audit fees. During the remainder of this study, there will be paid extra attention to these factors, since quantitative studies have found a significant relationship between these factors and audit fees. However, there could also be some other factors affecting audit fees like the type of industry in which the auditee operates. In practice, there might even be some factors that auditors take into

account when determining audit fees that have not even be examined in previous, quantitative, research. These arguments lead to the following framework:

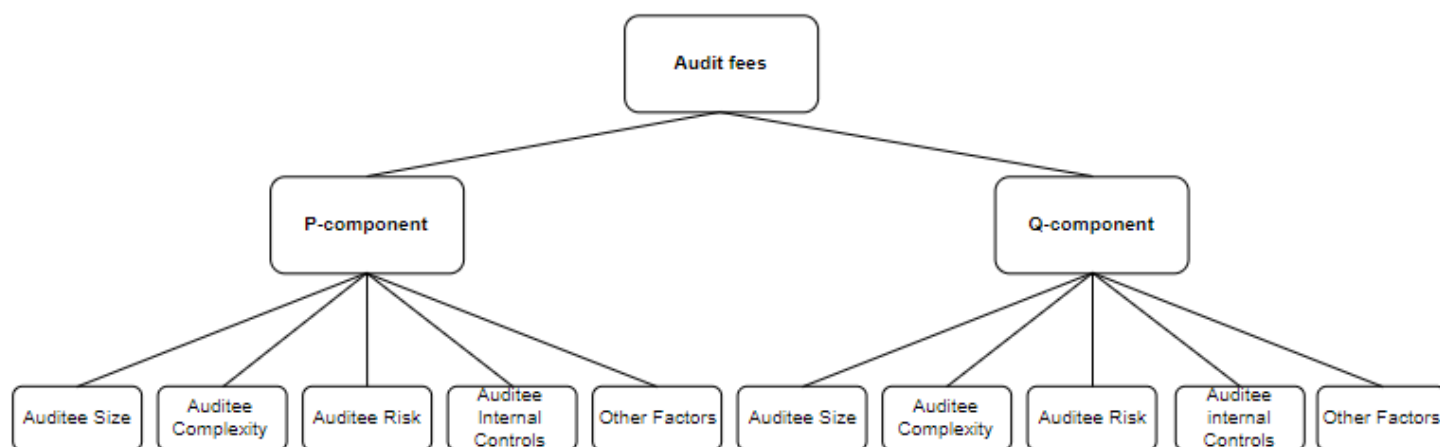


Figure 1: *Used framework on how auditors consider the level of audit fees*

3. Methodology

3.1 Research method

The research method that was used for this study is the case study method. The choice for the case study method is because this method should deliver rich data about the auditors' determination of audit fees and is an appropriate method to do qualitative research (Bleijenbergh, 2015; Yin, 2014). The data can specifically be used to interpret how the considerations of the auditor about the p- and q-component change when certain factors at the client that is being audited change. Additionally, this type of research method can be used to discover some factors, which are hard to quantify, but also are considered by the auditor when determining the level of audit fees paid by the client. One possible consideration of the auditor, for example, is how estimations by management could potentially influence the complexity and risk factors for the auditor in determining the level of audit fees. Because it is possible through this method to examine the different considerations an auditor has to take into account when determining audit fees in practice, this is also a reason that makes the qualitative method appropriate for this research,.

3.2 Methods for data collection

Within this case study, data was collected through the use of data triangulation. The three methods of data collection which were used are: interviews, document analysis and field observations, as is in line with Doorewaard et al. (2015). With these three methods it was possible to collect data to answer the main research question. The three methods mentioned above will be discussed in the following paragraphs. However, it should be noted that this process of gathering data was an iterative process, where there were switches between the different methods of data collection and theory. The gathered data was used as basis for further interviews, document analysis and field observations (Yin, 2014).

The main source of data for this case study were interviews which were conducted with the different employees and partners of the Big 4 audit firm. Seven semi-structured interviews were conducted which lasted somewhere between twenty-five and forty minutes. Mainly partners were interviewed, because they have the final responsibility of negotiating the audit fee with the client. However, also (senior)managers were interviewed, because they are the ones that put the planning for an audit together and are relatively the closest to the client when looking at who is determining the audit fees. For these reasons, the composition of interviewees was as follows: four partners, one senior manager and two managers, which have worked approximately sixteen year, on average, at the Big 4 audit firm. This way, a broad view was

developed of how auditors made sense of audit fees when considering the p- and q-component of these fees. The interviews were recorded and transcribed immediately afterwards. The transcribed interviews were coded, analyzed and cross-analyzed to find patterns that could help me reach conclusions on the main research question of this case study.

Function	Years in function	Years at firm
Partner	18	29
Partner	12	25
Partner	5	18
Partner	6	16
Senior Manager	1,5	10,5
Manager	1	7
Manager	0,5	7

Table 1: *Characteristics of the people that were interviewed for this case study*

The semi-structured interviews were conducted until more and more repetitive answers from the interviewees appeared in the data analysis. In this case, seven interviews were conducted to find saturation in the given answers to the interview questions. Doing it this way, it was made sure that not too little data was collected when doing the interviews.

The second method of data collection was the analysis of documents that have been granted access to. Because of the connections at this firm, I was able to get some documents that otherwise would not have been accessible for other researchers. These documents contain information about pricing and margins, which need to be taken into account when working with the client as well as client engagement letters. Furthermore, also documents were analyzed, which contain information about all the different kind of characteristics of the auditee that have to be looked at when accepting the auditee as a client. The information gathered from the analysis of these documents adds to the information already received from the conducted interviews and thus in answering the main research question. Just as with the data gathered from the interviews, the documents were also coded first and analyzed afterwards to answer the main research question.

Finally, also field observations were used as method of data collection. During the first half of 2018, I have been at several clients with various audit teams. This opportunity allowed me to also do some field observations. The field observations consisted of listening to the different audit team members discussing the topic of audit fees as well as some informal

conversations at the client or at the office of this Big 4 audit firm. The role in which I placed myself can be seen through the perspective of Bleijenbergh (2015), who identifies certain criteria to be met, when doing observations. The first one is accessibility and this was not a problem for me since I was allowed, through my connections with this firm, to get access to the situation where I am at a client with an audit team of this Big audit 4 firm. The second criterion is to not disturb the social situation too much and try to blend in. This criterion also was not a problem, because through my connections I managed to credibly gain access to these situations and was able listen to the various conversations. When the topic of audit fees came up in a conversation or discussion I tried to listen and make notes without interrupting the conversation in order to keep it as natural as possible and get unbiased opinions. However, if I thought that, during a certain week when I was at a client with an audit team, the subject of audit fees has not been touched upon enough, I would adopt a so-called open research-role. This means that I would clearly state my intentions for bringing up the topic of audit fees and I would ask the team members how they make sense of the current situation at the client and how they think it could affect the level of audit fees. This way, the other team members would know why I am so interested in this topic and I legitimized myself as a researcher (Bleijenbergh, 2015). When this was the case, I also made notes and analyzed them later.

In the analysis of the data, gathered from the three types of data collection methods, a code structure was used in order to systematically analyze the data gathered and give them appropriate codes. This way of doing analysis also adds to the creditworthiness of this thesis, since the usage of such a coding system makes data analysis systematic and easy to follow. The code structured that has been used throughout the data analysis can be found in table 2 down below.

Used colours	Axial code	Frequent open codes
	Auditee Size	Sample size; Specialists; Economies of scale
	Auditee Risk	Fraud risk; Corruption risk; Riskprofile
	Auditee Complexity	Specialists; Experienced auditors; Journal entries
	Auditee Internal Controls	Quality of internal controls; Information delivery
	Audit Tenure	Transition costs; Indexing
	Client Type	Competition; Journal entries
	Auditor Characteristics	Negotiation style; Responsibility of partner
	Other Particularities	Additional work; Group audit; Ideal situations
	Rules and Regulations	External guidelines; pressure of rules; pricing policy

Table 2: *Code structure*

3.3 The case

The case that was used for this study is a Big 4 audit firm that is located in the Netherlands. Just like all the other audit firms, this audit firm generates revenues through letting clients pay for the services delivered by them. The result is that the Big 4 audit firm, in this case, will receive an audit fee. Since only a Big 4 audit firm in the Netherlands has been examined, the results of this case study can only be interpreted in context of the Dutch law and society. Other countries might have different institutions and regulations, which could change the considerations made by the different auditors at this Big 4 audit firm.

It was chosen to examine this specific case, because I have connections at this firm, which granted me access to data and observations that would otherwise be most likely restricted for other researchers. Furthermore, it allowed me to interview some of the employees and partners at the firm that gave me the information necessary to answer the main research question of this study.

During this case study, it was tried to discover what kind of considerations on the level of audit fees the auditor has in mind throughout the audit process when auditing a client. These considerations can be considerations that might decrease or increase the p- or q-component of audit fees paid by the client. The theoretical constructs developed in quantitative research thus will be used to delve deeper into the case of how audit fees are exactly determined and what factors the auditors deem important when considering audit fees (Yin, 2014). However, next to the theoretical constructs developed in quantitative research, there were also some considerations that auditors made, which were not examined by previous research. These considerations, along with all the other considerations, which auditors at this Big 4 audit firm seem to make, will be discussed in more detail in chapter 4.

4. Results

4.1 Introduction

In this chapter, the collected data gathered throughout this case study at a Big 4 audit firm, will be analyzed. This analysis will be aided by various quotes from the interviews and useful fragments from the documents or observations from this Big 4 audit firm.

During the interviews it became apparent that a clear line needs to be drawn between the technical budget, which was used as a basis for determining audit fees and the commercial budget that was agreed upon between the Big 4 audit firm and the client. The technical budget was often determined by the manager or senior manager at the Big 4 audit firm and it is in this technical budget that the various factors discussed in chapter 2 find their way in the considerations of the auditor.

When the technical budget was determined it was often the partner-in-charge that had the end responsibility to take this technical budget in consideration and finally come up with the commercial budget together with the client. However, there are also some considerations that were made when determining the commercial budget. These considerations are: characteristics of the partner, reputational gain considerations and timing of the audit. It are these considerations that are hard to quantify, but could significantly change the height of audit fees a client has to pay. This difference between the two kind of budgets is also explained in the following quote:

Partner: “The team makes the technical budget, thus what resources do I need to get the job done in a responsible way? These are the hours that we need and then you can put the respective hourly rates on these hours and you get to your amount in euro’s. However, out of commercial reasons you could say: I really want this client in my portfolio or some other reasons that could make you take some euros off.” (Partner, interview 3)

After the commercial budget was agreed upon between the Big 4 audit firm and the client, you had to add up or subtract any additional work that had to be done during the audit process to end up with the final audit fee the client had to pay to the Big 4 audit firm. Figure 2 displays where all the factors, mentioned above, are considered in the audit fee determination process.

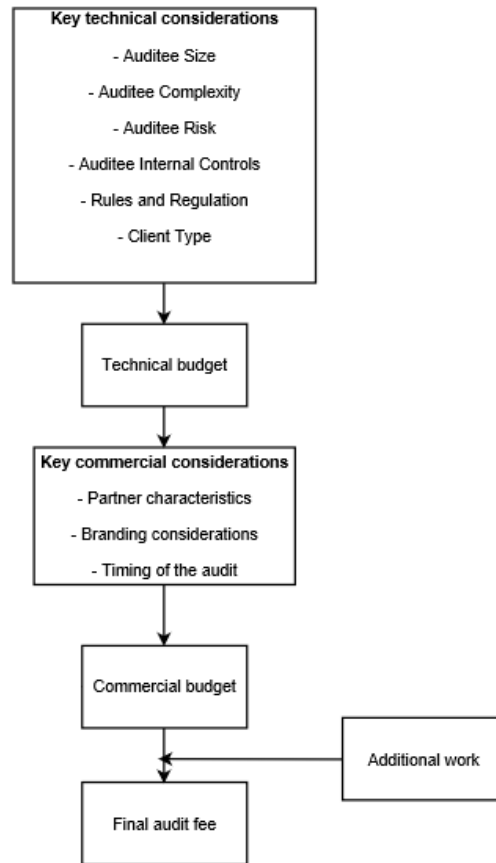


Figure 2: Summary of analysis

In section 4.2 the relationship between the key technical considerations and the technical budget will be described and elaborated, followed by the key commercial considerations in section 4.3. Finally, in section 4.4 some of the reasons for additional work and how these reasons could impact the final audit fee will be described.

4.2 Key technical considerations

As mentioned above, the key technical considerations are used to make a technical budget, which often is made by the (senior) manager and will be send to the partner-in-charge for feedback and discussion about the assumed considerations. When they have agreed internally, this budget will be used as basis for the negotiations on the commercial budget, which will be discussed in paragraph 4.3. Most of the key technical considerations are also discussed in the literature, but will be elaborated further in this analysis by looking at how these factors are considered in practice at the Big 4 audit firm along with some other factors that became apparent through analyzing the different sources of data for this case study.

4.2.1 Auditee size

One of the first considerations that auditors seem to take into account is the size of the client they are auditing. During the interviews it felt that this was one of the most self-evident considerations that the auditors took into account, because all respondents answered that they saw the size of the auditee as a factor that makes the fee higher. This was explained by one of the respondents:

Partner: "I think, when a client is bigger, you will have to work with more files. There is also a higher chance that specialists need to get involved and you need to have more experienced auditors in your team composition." (Partner, interview 2)

This indicates that as the client becomes bigger, the amount of files rises and this leads to an increase in the q-component for the auditor. Additionally, this also was mentioned during one of the conversations that was overheard, where they talked about that some of the managers at this Big 4 audit firm only have one very big client they had to work for and this indicates that as a client becomes bigger, the amount of work that has to be done also increases. The quote also indicates that, as a client becomes bigger, more experienced auditors need to be put on that client. In general, the more experienced auditors will also have a higher hourly rate, leading to an increase in the average p-component at a client as well. However, it should be mentioned that the respondents did not see a linear relationship between size and audit fees, but argued that there is some form of economies of scale when auditing a bigger client as the following respondent also mentioned:

Manager: "How bigger the client gets, how lower the percentual fee, which is logical, because if you have a smaller client, you still need to do the basic activities to set up your files." (Manager, interview 4)

This indicates that the respondents see some form of economies of scale when auditing a relatively bigger client. All of this combined seems to point to the fact that auditors consider size to be a factor that increases the audit fee that a client has to pay, but not in a linear fashion.

4.2.2 Auditee complexity

One other key technical consideration that auditors take into account when determining audit fees is the complexity of a client. During the case study there was plenty of evidence found in

the methods of data collection. In a document about client acceptance it was mentioned that partners need to consider the complexity of the client before accepting or continuing the engagement. This kind of complexity often comes from certain journal entries that a client has in his financial statements. This point was also elaborated on by one of the respondents:

Partner: “Imagine you have a building project and that the total building costs are one hundred in total and you have a total of forty invoices (...) but what if the project is only thirty percent ready or fifty-five percent? Then, the client has to make estimations of that process, but how did the client come to that estimation? We have to compare that estimation with the estimation of the year before and if there is a large gap between the two estimations, we need to discuss this with the client and examine the possible reasons. These are things won’t be done by a first year accountant.” (Partner, interview 5)

This elaborates on the point made earlier that the complexity of the client is certainly something that is being considered by the auditor when determining the technical budget. However, next to the added work, this quote also shows that more experienced auditors need to look at these kind of complex journal entries due to their difficulty, increasing the average p-component of the technical budget. As became clear from the interviews, it also is dependent on the type of client that is being audited as is mentioned by one of the respondents:

Manager: “There are many factors that determine the revenues of a hospital. What type of contracts are there? What are the standards? You also need to make a prognosis about what you think will be the total revenue [etc..] too complex to explain in only half an hour.” (Manager, interview 4)

It thus seems that different clients could have different certain complex journal entries that increase the complexity of the client and thus increasing the technical budget needed to audit this client.

Next to the typology of the client, it is also important to note that some of the respondents argued that whether a company is a listed company or not also is of influence in determining the technical budget for the audit fees. This can be seen in the following quote:

Partner: “It is just more complex to determine the right fee for a listed company, than for a small healthcare company. I can almost intuitively determine a fee for that kind of companies,

but you need an entire study for to determine the right fee for a listed company. Like which countries? Which size? What are the current problems? Which standards? Et cetera.” (Partner, interview 2)

It appears from this quote that a listed company is relatively more complex than just some middle-sized firm. With this added complexity, it will be likely that the q-component for the auditor increases within the technical budget of the final audit fee.

4.2.3 Auditee risk

The risk of the client was something that was considered in various different dimensions by the auditors of this Big 4 audit firm. One of these dimensions is fraud risk, but also corruption risk, reputational risk and detection risk were mentioned during the interviews. The Big 4 audit firm even has a audit methodology which states that there should be a risk assessment done during the audit process. It was common in this audit firm to work with different risk profiles as is expressed by the following quotes:

Partner: “There are four categories: low, medium, high and close monitoring. These are the four categories that could come out of your client acceptance procedure and logically: the higher the risk is, the higher the fee should be (...) With close monitoring clients you will need to have extra partner and manager involvement and also more specialist involvement. This needs to be reflected in the technical budget.” (Partner, interview 5)

Partner: “You need to look from your risk profile and if there are risks, you need to spend time on that. With a higher risk profile it is not necessarily the case that you need a higher price, but just that you need to spend more time on evaluating these risks.” (Partner, interview 3)

It seems that as the risk profile increases, so does the technical budget for the audit fee, because of more (senior) manager and partner involvement. This does not necessarily happen, because of a higher price, but because of more hours the auditor thinks he needs to spend on that specific client. This is also something that is interesting, because auditors do not seem to take a risk premium into account when constructing the technical budget as one of the respondents pointed out:

Partner: “You keep talking about fees. I would like to say that it is an hourly-increasing effect that is happening. The average hourly rate that corresponds to that leads to higher costs for the client, but actually we are only talking about hours in most recent years. (...) The start is always: how many hours do I need on every level?” (Partner, interview 6)

This statement made clear how the auditors determine the composition of audit fees with the various considerations they take into account when constructing the technical budget. Every of these technical considerations was looked at as: if the auditor considers this to be the situation at the client, how many hours does he need for every function level at that client and as you get a higher function, your hourly rate will also increase. This means that a partner is more expensive per hour than a staff member is.

As has been said above, the risk profiles can be constructed by looking at the different risks of a client. The first one that is being considered is fraud risk. When a client has inherently more risk, because of, for example, fraud-sensitive products that are being stored in a warehouse, the technical budget will rise. This happens, because more work has to be done by the auditor to make sure that this kind of fraud hasn't occurred during the last year.

Another risk that auditors seem to take into consideration is the corruption risk that some countries are exposed to. Especially in countries that are in Africa or the Middle-East there is a chance that bribery occurs. If the auditor thinks that a specific client has an enhanced risk of bribery it will do more work in order to cover this specific risk, as is also stated by one of the respondents:

Manager: “When you, for example, are dealing with African countries, then there is a risk of bribery. This will lead to a higher risk profile and more activities that you have to perform. (Manager, interview 4)

Just as with complexity, it seems that auditors also consider more risk when a company is a listed firm. The reason could be that a listed company has relatively more stakeholders compared to a non-listed firm. On top of this, the stakeholders also often have a relatively bigger stake in the listed company and this could lead to more media scrutiny when something goes wrong. This increased risk could lead to the auditor to do more work in order to cover for this risk. One of the respondents has also explained this during one of the interviews:

[Interviewer asked if there were different considerations when auditing a listed firm] Partner: “The risk profile is just inherently higher at a listed company. When something has happened at that firm, it will be in the newspapers tomorrow and so are we.” (Partner, interview 5)

In summary, it seems that there are various dimensions of risk that auditors take into consideration when determining the technical budget of audit fees. The risks that were mentioned the most during the interviews are: fraud risk, corruption risk and reputational risk. These considerations seem to increase the q-component of audit fees, since almost all respondents thought that more work should be needed to cover for these risks when they occur. However, as became clear from an informal conversation with one of the senior staff members, the p-component could also increase, because they often put more experienced auditors on these kind of clients, which increases the average hourly rate.

4.2.4 Auditee internal controls

In recent literature about audit fee determination, the internal controls of an auditee seem to become increasingly more important. This trend in the literature seems to also take place at the Big 4 audit firm with the internal controls of a client being mentioned in the pricing strategy documents of the Big 4 audit firm. In this document, it is mentioned that partners need to let the clients confirm that they need to improve their information delivery and firm processes in the engagement letters, because this could help in (future) discussions about audit fees and additional work. This is just one example of the importance of the quality of internal controls at a client for this Big 4 audit firm. When it comes to the internal controls of a client, there also needs to be made a distinction between substantive-based control and system-based control. When the internal controls of a company work fluently and in the right way, it means that the auditor can rely on these internal controls and thus perform a system-based control. However, when the internal controls of the client are not reliable, the auditors have to perform more substantive testing. From the different interviews it appeared that a system-based control generally takes less hours to complete. This is also expressed by one of the respondents:

Senior manager: “In general, if we can rely on the internal controls of a company, then the audit fee would be lower (...) When we really can rely on the internal controls, then it gives us some insurance that the internal controls worked appropriately during the entire year. This leads to less data that we have to examine. When you have to do a substantive control, the sample sizes will be much bigger, which leads to a higher fee.” (Senior manager, interview 1)

The quality of the internal controls of a client does not seem to depend on the size of the client. It could be that a very small client does not have appropriate internal controls and the auditor needs relatively more time to check everything, but it could also be a very big client with no appropriate internal controls and this takes even more time as one respondent explains:

Manager: "I think that the size of a client is an important factor, but so is the quality of a client (...) It partly depends on the size of the client, but it also does not have to be that way, because you also have very big clients where the quality of the internal controls is just bad.(...) You can also calculate it in that you need more hours at a client where the internal controls do not work appropriately. Well, that leads to more hours of work." (Manager, interview 7)

One other party that could potentially influence the technical budget of the audit fees is the audit committee of a client. Not only could the audit committee be the sparring partner of the auditor when it comes to negotiating the audit fee, but it could also demand some additional control activities from the auditor which lie outside the normal scope of controlling the financial statements of the client. These additional controls activities lead to more work for the auditor which means an increase in the q-component. Depending on what kind of additional work is asked, the average hourly rate could also increase when the additional work needs partner or specialist involvement. This is also expressed by one of the respondents:

Partner: The audit committee is the one with whom you talk about the audit fee and there could be a negotiation element (...) The audit committee could also say: in your regular scope of the audit this would be enough, but we would like you to also check this country or that country. With other words, they ask for additional work, which does not necessarily have to be checked and this changes the fee. (Partner, interview 6)

From this it can be concluded that both the quality of the internal controls of the client and the audit committee could change the considerations of the auditor when determining the technical budget of the audit fees. When the internal controls do not work appropriately, it will lead to the auditor performing a substantive control which leads to a higher q-component in the audit fee determination. Also, when the audit committee asks the auditor to perform additional activities this would also increase the q-component and thus the technical budget of the audit fee. However, since the auditor will always do at least the minimal amount of work that is required by law, the presence of an audit committee at a client will often only increase the amount of work and not decrease it.

4.2.5 Rules and regulation

This factor often cannot be controlled by the client nor by the Big 4 auditor, but could have a substantial effect on the technical budget of the audit fees. This was also expressed in a document about pricing strategy of this Big 4 audit firm, where it was stated that some changes in the Civil Code (Burgerlijk Wetboek) or control requirements might not have been included in the budget calculations. This suggests that some of the changes in the rules and regulation could have an effect on the audit fee. However, it is not explained in what way these added rules could impact the audit fee, but intuitively it could be argued that, more often than not, the addition of new rules would lead to more work for the auditor. This line of reasoning is also confirmed by some of the respondents in the following way:

Partner: “(...) Or there are other valuation principles which simply cost more time and these thus have a structural nature which includes also next year. In that case, you can’t argue that you, again, only use one thousand hours, but say: we need eleven hundred hours this year, because part of this, additional, work is structural.” (Partner, interview 3)

Partner: “We see now that there has changed so much in the rules and regulations for both clients as auditors, that we need more hours and you could increase the budget then annually with X-thousand, but that is nothing compared to the extra hours we need to put in.” (Partner, interview 5)

As is already explained in the risk part of this chapter, it seems that, because of this risk, a listed company is also the subject of a higher amount of quality checks. These quality checks increase the q-component for the Big 4 auditor, but there also often is a need for specialist involvement, which also increases the average hourly rate, since specialists, on average, have a higher hourly rate than most auditors. These consequences of being a listed company are also explained by one of the respondents:

Partner: “It also simply costs much more time, because a listed company has a higher risk and therefore is subject to more quality checks. On top of this, there are also often more specialists involved. There are governance specialists and accounting specialists involved (...) The audit of a listed company is simply more demanding than the audit of the average client.” (Partner, interview 5)

So, it can be argued from the evidence mentioned above that the addition of new rules and

regulations is demanding more work from the auditor which also leads to an increase in the q-component for the auditor and thus an increase in the technical budget of the audit fee.

4.2.6 Client characteristics as technical consideration

As has been briefly touched upon in some of the previous key technical considerations, the characteristics of a client could also substantially change the technical budget within audit fees. For example, whether a firm is listed or not made a huge difference in both the complexity as well as risks that the auditor takes into account when auditing a listed company.

In the analysis, it was also found that clients in different sectors could have different journal entries and these journal entries could vary in their complexity. However, there seem to be some other additional factors that could vary for every client. Arguably the most important one is the competition for a client. All other factors aside, the sector in which the client operates has a certain number of audit firms that could audit that specific company. Just as with almost every resource, there is the law of supply and demand. When there is a high supply of auditors, the audit fee would most likely drop, but when the supply of auditors is low, the audit fee would most likely rise. This is also confirmed by one of the respondents:

Partner: “It has happened to me that six parties [audit firms] get invited, but only three will actually compete and I even saw one time, that everyone said ‘no’ to a client. Well, this means that there is scarcity and when there is scarcity the price will increase. Especially when you look at the healthcare sector, where there are only six eligible parties and compare that to the middle-market profit sector where there are many more participants.” (Partner, interview 2)

Just as risk and complexity could influence the technical budget of audit fees, the rules and regulations in a certain sector could also influence this budget. When a certain sector has been hit by additional rules and regulations, it should mean that the q-component increases for the auditor, as has been previously discussed. However, what not has been discussed is that certain sectors are more likely to get additional rules and guidelines than other sectors. One of the prime examples is, of course, the banking sector which seems to change very quickly all the time with new financial instruments that could rise up at any moment. With these new financial instruments, often new guidelines are needed, leading to more work for the auditor. As with the banking sector, it seems that the housing sector also is prone to some new rules and regulation as one respondent explained:

Partner: “What you see is that the housing sector has had a parliamentary inquiry with lots of new rules and regulations. There has come an entirely new housing law (...) and this is something that is typical for this sector. This also has a big impact on our delivery of services, because new information has been demanded and sometimes added to the financial statements. In some cases, because the external supervisor wants the external auditor to examine this additional information.” (Partner, interview 3)

It thus can be concluded that the typology of the client and in which sector it operates is also being considered by the auditors at the Big 4 audit firm when they are constructing the technical budget. Most of the considerations will lead to a higher q-component for the technical budget of the audit fees.

4.3 Key commercial considerations

After the technical budget is finished, including all the key technical considerations that the auditors at the Big 4 audit firm seem to make, it will be handed off to the partner-in-charge. The partner-in-charge will discuss this technical budget with various team members, like the senior staff, managers and senior manager of the Big 4 audit firm working at this client. When they reach consensus, (s)he will use this technical budget as a basis for further negotiations with the client. This line of reasoning is also confirmed by one of the respondents:

Partner: “Yes, ultimately, I have the end responsibility, but I also will look at how the team proposes the technical budget for the audit fee and they take it to me for approval. I will respond to this technical budget and discuss it with the team and, finally, I will take it to the client for further negotiations.” (Partner, interview 3)

It is at these negotiations that some of the key commercial considerations come in to play. It are also these key commercial considerations that appeared to be very hard to quantify for previous research and thus often were neglected. However, these key commercial considerations could also be a big factor in deciding the final audit fee a client has to pay. The most important commercial considerations will be analyzed below and it will be discussed how these considerations by the auditor could possibly impact the commercial budget of the audit fee.

4.3.1 Partner characteristics

During the literature study of this thesis, it was not considered that the characteristics of a partner could also be of influence during the audit fee determination process. This factor only became clear when, during one of the observations, a senior staff mentioned to me that the partner-in-charge at that specific client is a good negotiator and does not shy away from discussions with the management of audit committee when it comes to audit fee determination. Once the interviews commenced, one of the partners at the Big 4 audit firm confirmed that the characteristics of a partner could play a role in the audit fee determination as is mentioned in the following quote:

Partner: "I think it depends every time on your personal style, your experience, your negotiation skills and how you, eventually, have the best strategy in order to get the height of fee you want to get." (Partner, interview 2)

So, next to the negotiating skills it also depends on your personal style and your experience according to some of the respondents at the Big 4 audit firm. This personal style of negotiating is further elaborated by another respondent in the following way:

Partner: "One partner only cares about the business-side, but another partner could be more compliant with the client and say: I get that this is a lot of money for the client, so I am happy with a lower fee. So, I might think that fifty percent margins should be achieved, while others might think that a thirty-five percent margin is enough." (Partner, interview 5)

So, it seems that, although the managers and senior managers make a technical budget, the characteristics of a partner and how he or she negotiates could still has an impact on the commercial budget and thus on the final audit fee.

4.3.2 Client characteristics as commercial consideration

The type and characteristics of a client keep coming back in this case study, because it seems that some characteristics of the client could influence also the commercial budget of the audit fee and therefore, also the final audit fee.

The first characteristic is a combination of the portfolio of a partner or Big 4 audit firm and the sector in which the client operates. It namely makes a difference whether a certain client is the first client operating in this sector for the partner or Big 4 audit firm or not. The

respondents seem to consider that if you want to get established in a certain sector, you need to go lower with your quotation to increase the chance that the client chooses you as their auditor. This is also explained by one of the respondents:

Partner: “A couple of years ago, we weren’t established in sector X, for example. We necessarily wanted to get established in this sector. Well, if you then win the first one, that is a huge victory, because afterwards you can say that you are established or, at least, that you have some clients in that sector. When you have zero clients in that sector, that is, of course, not a good track record and that is something that will be considered in the pricing.” (Partner, interview 6)

So, it seems that whether you are established in a sector or not is something that could affect the commercial budget of the audit fees. However, it could also work the other way around. When an audit firm is established in a sector, but for some reason this accounting firm seems to lose market share, it will also try to keep the remaining clients in this sector as is expressed by one of the respondents:

Manager: “In recent years, I saw some of the other offices lose a couple of their big clients and what they did next is that they submit a low-cost quotation in order to get back some of the lost market share, because clients really like it when you have a high size of market share and sector-specific knowledge.” (Manager, interview 4)

Clients seem to react positively when a certain auditor has sector-specific knowledge in which that client operates. In order to get this sector-specific knowledge the audit firm, of course, first needs to get established in that sector. The establishment of a sector seems to be done in practice through submitting a relatively low quotation in order to get the client attracted to the audit firm. This means that it will lower the commercial budget and most likely also the final audit fee.

The second consideration that the auditors of this Big 4 audit firm take into account is the reputational gains for the Big 4 audit firm when a certain client has been brought in. During the different interviews they named those clients ‘flagship accounts’, which often are big listed corporations who operate globally. It seems that these kind of clients get a discount on the fee in order to lure them to the Big 4 audit firm. The discount will also be there, because of the huge competition that is happening between most of the Big 4 audit firms when they want that

specific client. The following quotes illustrate how auditors at this Big 4 audit firm consider these kinds of aspects of a client:

Partner: “You always want to bring in the leading companies and not always for the highest price, because you need these flagship clients for your branding. That’s why we were very pleased when we brought in (Says company). Well, this company does not pay the highest price for their audit, but that is simply because we find it important to have this company as a client.” (Partner, interview 5)

Partner: “Well, look, a big listed company. Those are, of course, the clients that you want to have as an audit firm. You need a couple of those companies and it could be that you make a choice to lower your quotation a bit.” (Partner, interview 2)

Both the considerations about getting established as well as the consideration about reputational gains seem to lower the commercial budget of the audit fee at this Big 4 audit firm. This happens in order to get another edge over other competitors for this client, but it, in turn, lowers the final audit fee paid by the client.

4.3.3 Other factors that could influence the commercial budget

The first two factors mentioned above are relatively predictable, but there are also some factors and even situations that occur that still change the commercial budget, but cannot be linked to one of the factors mentioned above.

The first of these factors is the timing of an audit. This means that if a client wants to be audited during the months January or February it will most likely have to pay more, since it is during this time of the year that the auditors are already very busy with the audits of some of their listed companies. The timing thus can be linked to the scarcity of resources that auditors have to cope with during those times, because all their employees are already working for a client, but if another client necessarily wants to be audited during this time, the auditor has to move various clients in their planning. According to some of the respondents, they also consider this to be a factor that could change the commercial budget:

Partner: “We don’t say outright: if you allow us to audit you at that time or that time, that there will be a higher or lower fee, but we take it into consideration during discussions with the client. When our planning is already full and they necessarily want to be audited at that moment and

we have to move some of our already existing clients or even offer them, then I think that this should also be reflected in the price.” (Partner, interview 5)

Finally, there are also some situations that happen during negotiations that are almost impossible to predict and therefore are impossible to quantify during research nor to take into account when doing qualitative research. These situations happen, because the client also wants to influence the commercial budget and get the audit done as cheap as possible. Some of the respondents explained this kind of situations and how they dealt with it:

Partner: “If the client says: I want to pay less. Then I could say: fine I’ll take off X- amount of euros off the fee, but I am going to bill you twice [normally four times] and you have to pay within fourteen days. So, I don’t have to wait until all the work is finished.” (Partner, interview 5)

Partner: “The example that I just gave about the five hundred hours of work and you have done two hundred hours additional work that can be invoiced to the client, then the client has to pay that amount. But if it is the kind of client that always wants to lower the costs, then you can simply say: you had to pay two hundred and fifty hours, but I’ll give you fifty hours discount and in this way both of us are happy.” (Partner, interview 3)

The two situations described in the quotes above are very unpredictable in nature and could change with a different partner negotiating at that time. Another partner, for example, might have said that he will take off fifty hours off from the two hundred hours additional work and the client only had to pay the extra one hundred and fifty hours, which change the final audit fee. So, how this situations plays out really depends on the client and the partner negotiating at the moment which makes them so unpredictable.

4.4 Additional work

Now the technical budget is internally agreed upon and the commercial budget is agreed upon by the client, the final audit fee can be constructed. In a situation where everything remains constant, the commercial budget will not differ from the final audit fee the client has to pay. However, most of the time, things do not remain constant and things tend to change as one of the respondents put it:

Senior manager: "The audit fee has been agreed upon at the beginning of the year and has been agreed on in writing. However, it could be the case that there are developments at the client that need attention from us as accountant. If, for example, our client takes-over another company, then this company also needs to be audited. This will be invoiced as additional work."
(Senior manager, interview 1)

Something that also can lead to additional work is a deviation from the so-called 'ideal situation' that some of the auditors at the Big 4 audit firm talked about. It could be, for example, that some client says that they have appropriately working internal controls, but when the auditor gets there, it does not seem to be the case. However, they made the technical- and commercial budget based upon the premise that the internal controls of the client work appropriately. This is also explained by one of the respondents:

Partner: "When you look at the internal controls of a client and you discover that they don't work appropriately then this means for our financial statement audit (...) that we have to do additional work." (Partner, interview 3)

The statement of this respondent is also backed up by a document about the pricing strategy of the Big 4 audit firm in that it states that partners need to make clear agreements with the client about the appropriateness of the internal controls and the quality of the information delivery, since this helps in (future) discussions about additional work. However, after an informal conversation with one of the partners, he said that additional work does not always have to lead to a higher audit fee, because it could also be the case that the auditor expects to find no appropriate internal controls, but when they are being tested, they seem to work appropriate. In this case, there can be a system-based control which leads to a lower q-component for the auditor and thus a lower final audit fee.

Another factor that could lead to more additional work is the complexity of the journal entries and how they could affect the team composition. How this team composition should be considered was further elaborated in some of the observations that were made, while being at a client. At this particular client, there were various discussions going on about the estimations of some of the participations the client had. A senior staff and partner were in discussion about how to continue, since the client seemed to have made some mistakes in the estimations of this participations. They concluded that the partner-in-charge had to discuss the estimations with

the management of the client and this costs extra time. After another informal conversation with the partner-in-charge it became clear that the client had to redo some of the estimations which led to more work for the auditor and thus increasing the q-component and the amount of additional work.

A final factor that could lead to additional work is when fraud actually occurs at a client, when the accountant is auditing the financial statements of that client. When there is a case of fraud at the client, the auditor has to put in more hours to investigate how bad the fraud actually is and which persons actually are connected to the fraud. The involvement of specialists is also often needed to look at the specific fraud case. All these things lead to more work for the auditor and will be calculated in the audit fee as also is expressed by one of the respondents:

Partner: "When fraud happens you need to follow guideline 240, which says that you need to do certain extra activities and then you discuss this with your client about how you are going to charge this through the audit fee." (Partner, interview 3)

This extra work and the involvement of specialists will often lead to more work and a higher average hourly rate than when the fraud would not have occurred. This increase of the fee will be discussed with the client as additional work.

So, from the analysis it can be concluded that there are three broad points of consideration that the auditors at the Big 4 audit firm use when determining the final audit fee, which are the technical budget, the commercial budget and the additional work discussion. Each of these three budgets has its own factors, further determining the height of the final audit fee that a client has to pay. How these three points of consideration for the auditors differ or are in line with previous literature will be discussed in chapter 5 of this study.

5. Discussion

Based on previous literature, a framework was made that showed all the factors that researchers identified as important factors that could determine an audit fee. As expected, this framework coincides with the considerations that were made during the construction of the technical budget and the possible discussions about additional work with the client. The similarities with the model could be explained, because these factors are relatively easier to quantify than factors like partner characteristics and how these could influence the commercial budget of the final audit fee. With most of the previous studies being predominantly quantitative it was expected that these two sides would coincide.

The first factor identified in the framework and widely discussed in previous literature is the size of the auditee and how this affects the height of audit fees. As Simon and Francis (1988) mentioned in their paper, the size of a client has an effect on the audit fee a client has to pay, because of more work and thus a higher q-component. Gerrard et al. (1994) add to this argument that, although the audit fees rise when the client becomes bigger, it does not have to be in a linear fashion, as also became clear from the analysis. Both extant research and the analysis seem to agree that it is the q-component that rises, because of the added size of a client. It should be mentioned that it became clear in the analysis that the auditors at the Big 4 audit firm often will start from the number of hours that need to be put in as to what the average hourly rate would be when constructing the technical budget.

The literature and the analysis seem to show the same results on how the complexity of a client changes an audit fee. The study of Palmrose (1986) found higher audit fees when the complexity increases. This happens through more work that needs to be done and thus an increasing q-component. However, there appears to be a gap between how previous quantitative studies tried to measure the complexity of the client and how auditors at the Big 4 audit firm seem to take the complexity of a client into consideration. Where previous studies predominantly looked at measures like diversity of products or diversity of salesforce, the auditors at the Big 4 audit firm seem to find the complexity of certain journal entries and whether a company is listed or not as possible factors to take into consideration during the construction of the technical budget. So, this is something that could be used in further research about the relationship between audit complexity and audit fees.

Just as in previous literature, the analysis finds various dimensions of risk that the auditors take into consideration. However, whereas literature uses more abstract terms to describe risk, like detection risk and audit risk as described by Knechel & Salterio (2017) and business risk

as described by Palmrose (1986), the auditors in this case study use more specific terms when they consider risk. These more specific terms include terms like fraud risk or corruption risk and point to more specific situations than detection risk or audit risk. It seems from the analysis that the terms used in previous literature are also being considered, but only indirectly. Take, for example fraud risk. When the risk of fraud is high, the auditor wants to do more work in order to prevent this risk to go undetected. When a risk goes undetected it means that there is detection risk. The term detection risk was not mentioned often, but they still do more work in order to not let fraud go undetected.

What was quite interesting to see during the analysis of both the data as well as the analysis of the literature is that the internal controls of a client are becoming an important factor to consider when determining audit fees. Where the paper of Simunic (1980) did not mention anything about how internal controls of a client could affect the audit fee, the papers of Goodwin-Stewart & Kent (2006) and Singh & Newby (2010) did their whole study about this one factor. The reasoning of Felix et al. (2001), where they argue that the presence of an audit committee and internal audit could decrease the amount of work done for the auditor seems to not hold in practice, because the analysis indicates that when there is an audit committee present, they might ask for more work to be done at the client and the auditor will always do the minimum amount of work which is required by law. So, it seems that an audit committee can only increase the amount of work and not decrease it. The same goes for the internal audit of a company. As the analysis indicates, it seems that, only in very rare cases, the auditors of this Big 4 audit firm will rely on the internal audit of a company due to increased rules and regulations made by the AFM (Autoriteit Financiële Markten). However, when the internal controls of a client are of an appropriate quality and the auditor can rely on these internal controls, it will lead to a lower q-component for the auditor and thus a lower technical budget.

Something that was barely touched upon in the literature and seems to strongly depend on the type of client being audited, are the rules and regulations and how they could influence the audit fee within the technical budget. One of the few papers discussing these topics is the paper of Castro et al. (2015), who argue that different industries in which the client operates could have an effect on the audit fee, because of more stringent rules and regulations. This line of reasoning can also be found in the analysis, since some of the respondents indicated that certain sectors are bound to have more rules attached to them than others.

Now the technical determinants have been discussed, the commercial determinants will be examined. First of all, it should be noted that the considerations that the auditors of this Big 4 audit firm seem to take into consideration were not found in previous literature, because of

the difficulty to quantify some of these aspects. This part of the budget stands apart from the various factors discussed in the paragraphs about the technical budget and the including q- and p-component that come with the technical budget. Since no previous literature has touched upon considerations like characteristics of the partner-in-charge or reputations of a certain client, this also is a theoretical contribution to the existing literature.

It became clear through the answers that some of the respondents gave that the characteristics of the partner-in-charge could also influence the price of the final audit fee by influencing the commercial budget. When a partner is all about the commercial side of things and less about the long-term relationship with the client, it could lead to a relatively higher audit fee, because he or she wants to maintain a high margin of profits at the cost of the client. However, a partner who cares relatively more about the long-term relationship with the client could say that less of a fee is also fine, leading to a lower profit margin. It could also be that the partner really wants to have a specific client in his portfolio. In order to have the highest chance to actually acquire the client, he or she might lower the price to be more attractive compared to other competing audit firms.

Closely linked with the 'attractiveness' of certain clients are the reputational gains an audit firm could get when reeling in a certain client with reputation. From the analysis it became clear that especially the listed firms give the audit firm a reputational gain that leads to considerations with the auditors of this Big 4 audit firm to consider lowering the price in order to have a competitive offer.

The commercial budget also has somewhat of a negotiation-aspect associated with it, because the client and partner-in-charge discuss different points in order to come to a certain commercial budget. Some of these aspects are already discussed above, but there could also be some small, unpredictable, aspects that are also being taken into consideration. One example that became clear from the analysis is the timing of the audit, which means the period in which the client actually is going to be audited. The auditor could say at the negotiations that if a client wants to be audited during busy-season, which is during the first quarter and parts of the second quarter of the year, it will come at a higher price. However, when the client accepts to be audited at a later date, it could decrease the commercial budget. This is just one example that might come into play during negotiations between the auditor and the client, but could also affect the final audit fee.

When the commercial budget and the corresponding requirements have been agreed upon by the client, the actual process of auditing the client can commence. However, during this audit process various situations could arise that lead to a change in the amount of work that is needed

to complete the entire audit. During the analysis this became apparent through the observations and documents as well as the interviews with the auditors of this Big 4 audit firm. This extra work was often referred to as 'additional work'. The amount of additional work needed, changes per client and per year and is being billed separately

The reasons for additional work are plenty and could stem from a variety of situations that occur during the audit process, so only the most frequent and impactful reasons will be discussed. The first reason that almost every respondent gave for additional work is the information delivery by the client. When the information delivered by the client is too late or not complete, the auditor cannot work efficiently and this will lead to more working hours and thus a higher q-component.

A second reason is whether all the requirements agreed upon during the composition of the different budgets are met, because during the analysis it became clear that the client is not always able to meet the agreed upon certain requirements, which will often lead to more work for the auditor. The most apparent requirement that the clients at this Big 4 audit firm not always seemed to meet is the quality of the internal controls. When the quality of these controls are high and the auditor can rely on them to a certain extent, it will save the auditor a lot of work. However, it appeared that the client often thinks that their internal controls are of a high quality when in reality they are not high enough. This leads to the auditor to perform a substantive-control, which leads to more work and thus a higher q-component.

The third reason does not happen as frequently as the other two mentioned above, but when it happens, it will lead to significantly more work for the auditors and even specialist involvement. This reason is when there appears to be fraud at a certain client. When fraud occurs, the auditor has to take a variety of steps and also needs to have specialists involved in order to examine the fraud that occurred. All this combined leads to a higher q-component as well as a higher average hourly rate, because of specialist involvement.

So, it can be concluded from the analysis that there are three main phases in which audit fees are being determined and considerations are being taken into account by the auditors of this Big 4 audit firm. Each of the three main phases has its own aspects that could eventually change the final audit fee that the client has to pay.

6. Conclusion

Every firm that wants the financial statements to be checked or is required by law to get the financial statements checked by an external auditor will have to pay a certain amount of money, which is called an audit fee. What factors determine an audit fee has already been widely discussed and examined by previous quantitative research. However, this study uses a case study method at a Big 4 audit firm in order to discover whether the factors, discovered in quantitative research, are also considered by the auditors in practice. The results of this case study are drawn from various documents, observations and interviews with seven auditors that work at the Big 4 audit firm (four partners, one senior manager and two managers).

The analysis of the case study indicated that there are three main phases that eventually determine the final audit fee, which a client has to pay. Within these three phases, there were some key considerations identified that the auditors of the Big 4 audit firm take into account when determining an audit fee. Table 3 presents the three main phases, including the key determinants that are connected with each of the three phases. As can be seen from table 3, there are four clear considerations that can be linked to the technical budget of the audit fee and two categories that hold some considerations which differs per client like characteristics of the client and rules and regulations for a specific sector. Most of these considerations also have been widely discussed in quantitative research and it can be concluded that these are indeed factors that auditors take into account when determining audit fees in practice.

Main phases of audit fee determination & their key considerations	Auditee size	Auditee Risk	Auditee Complexity	Auditee Internal Controls	Rules and Regulations	Client characteristics	Partner characteristics
1. Technical budget	X	X	X	X	X	X	
2. Commercial budget						X	X
3. Additional work		X	X	X	X		

Table 3: *Main phases of audit fee determination and their key considerations*

During the second phase, the commercial budget, the considerations taken into account at the technical budget are being used as basis for negotiations with the client. Mainly the characteristics of the partner-in-charge and his negotiation skills and willingness to acquire/keep the client in his portfolio play a role in this phase. This all could lead to a commercial budget that is different than the technical budget. Also, the q- and p-component will play no role during this phase of audit fee determination. The considerations that are made during this phase were not examined before in previous research and this makes it a theoretical contribution to the existing literature.

After the technical budget has been agreed upon internally and the commercial budget has been agreed upon by the client, the audit process can begin. During the audit process, there could be situations which demand extra work of the auditor and this is the so-called additional work and is the third phase of the audit fee determination. The factors that could affect the amount of additional work an auditor has to do are the risk of a client, the complexity of a client, the quality of the internal controls of a client and whether there is an addition of new rules and regulations during the audit process that may increase the workload of the auditor.

This study has a practical contribution, because both auditors and auditees can find what kind of general factors are being taken into account in practice, when determining audit fees. This way, auditees could use this to their advantage, because they could possibly change some of the factors leading to a potential lower final audit fee. The auditors can also discover whether they make the same considerations in practice or that they should potentially take some other factors into consideration.

One limitation of this study is that only the auditors at one Big 4 audit firm and at one location are being examined during this case study. Especially auditors at some of the smaller auditing firms and in different regions/countries could make different considerations, but this is not taken into account during this study. A second limitation is that during the audit fee determination, the client also could influence the height of audit fees it has to pay, either through good negotiation skills during the commercial budget phase or during the additional work phase, where they either could potentially mess it up by having a bad information delivery or having lower quality internal controls than expected. Although these factors are identified in this study, it is not taken into account how certain characteristics of the client, in turn, influence the final audit fee it has to pay.

A suggestion for future research would be to further examine how negotiations about the commercial budget and how partner characteristics, among others, play a role and potentially influence the final audit fee that the client has to pay, since prior literature was mostly about the

technical budget and seems to somewhat neglect this aspect of the final audit fee. It would also be advisable to not only look at one accounting firm in one region, but also to look at different sizes of audit firms as well as different countries, since these factors might change the considerations that auditors make in practice.

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Appendices

Interview plan

The input from the employees and partners at this Big 4 audit firm are an important source of information when it comes to which considerations they make during the determination of audit fees. The interviews are planned as a semi-structured interview, because I wanted to leave room for freedom in answering, but don't give them too much room either, because this could lead the respondent to wander off to other, unrelated, topics.

Furthermore, the questions under the heading: '*audit process*' were based on the audit methodology of this Big 4 audit firm, which I was given access to. With these questions added to the interview, it will be made sure that the entire audit process, as how this Big 4 audit firm performs it, will be discussed. This, thus, includes any possible considerations they make about audit fees during this audit process.

During the interviews, the respondents will be watched by the interviewer on certain signs of body language that could possibly nuance or invigorate the answers. Some examples of this body language are: tone of voice and hand gestures.

In total, there were seven interviews held during this research, which lasted between twenty-five and forty minutes. Down below, the semi-structured interview scheme can be found, that was used during the various interviews.

Interview questions

Persoonlijke vragen

Wat is je naam?

Hoe lang werk je al bij (Big 4 audit firm)?

Wat is je functie binnen (Big 4 audit firm)?

Hoe lang bezet je deze functie al?

Hoe heeft deze functie effect op het vaststellen van audit fees?

Ben je gespecialiseerd in een sector? Zo ja, welke?

Algemene vragen

Wat is er zo bijzonder aan de sector waarbinnen je werkt in vergelijking met andere sectoren/industrieën?

Is het vaststellen van audit fees een standaard procedure of verschilt dit per klant?

Heeft de grootte van de klant invloed op de audit fees? Zo ja, op welke manier?

Welke personen zijn betrokken bij het vaststellen van audit fees?

Zijn er verschillen tussen het vaststellen van audit fees tussen een beursgenoteerd en een niet-beursgenoteerd bedrijf?

Zijn er verschillen tussen het vaststellen van audit fees bij een enkelvoudige audit en een group audit? Zo ja, kun je voorbeelden noemen waaruit dit blijkt?

Wat zijn de effecten van het langer hebben van dezelfde klant op de audit fee?

Wat zijn de effecten van de timing van de audit op de audit fees en heeft dit hier nog invloed op?

Kunnen de karakteristieken van een partner nog invloed hebben op de audit fee, die een klant moet betalen?

Kunnen bepaalde posten van een klant invloed hebben op audit fees? Zo ja, kun je voorbeelden noemen en vertellen waarom dit van invloed is?

In hoeverre kan het management van het bedrijf jouw overwegingen veranderen over het vaststellen van audit fees?

Kunnen eventuele vermoedens van fraude effect hebben op de audit fees? Zo ja, welke overwegingen maak jij dan als het komt tot het vaststellen van de audit fees?

Audit proces

Wat zijn de eerste stappen die jullie ondernemen om te zien of jullie een klant aannemen als nieuwe klant en kunnen deze al invloed hebben op de audit fees?

Wat wordt er precies besproken tijdens een eerste meeting met het management van een klant en zijn er hier mogelijk overwegingen die jullie krijgen/hebben bij het vaststellen van een audit fee?

Wat zijn de verschillende stappen die jullie maken tijdens het risk assessment van een klant?

Hoe ziet een controle op de ‘internal controls’ van een bedrijf eruit?

In hoeverre levert een goed functionerende audit committee van een klant tijdwinst/verlies op in het werk dat jij moet doen?

Op welke manier maken jullie gebruik van de internal audit van de klant en kan dit invloed hebben op de audit fees?

Zijn er nog overwegingen/situaties die audit fees kunnen veranderen gedurende de interim periode?

Zijn er nog overwegingen/situaties die audit fees kunnen veranderen gedurende de afronding van de audit?

Zijn er nog bepaalde overwegingen die jij maakt tijdens het bepalen van audit fees, die niet aan bod zijn gekomen tijdens dit interview? Zo ja, welke zijn dit?

Observation plan

During the first half of 2018, there were various observations made. These observations were mostly made at a client of this Big 4 audit firm or at the office where I was granted entrance to and see how they worked there. During the observations, I tried to blend in with the other accountants and tried not to disrupt any conversations/situations in order to keep it as natural as possible.

The goal of the observations is to see how the different accountants interact with each other and with the client during all kind of situations that could have an effect on audit fees. Another goal is to see what kind of considerations accountants make during the audit process, when determining audit fees. To reach these goals, there was paid special attention during the observations on:

- What kind of considerations do they make in certain situations?
- How do the different accountants interact in certain situations, when the topic is about audit fees?
- Is there a link between the considerations of the auditors and the framework stated at the end of chapter 2?
 - o If the answer is yes, how can these considerations be linked with the p-component and q-component of audit fees?

As mentioned above, there were multiple observations being done throughout this research in order to get additional data about the considerations of accountants in determining the audit fee, next to the data from the interviews and the document analysis. Notes were made immediately after certain situations happened and were also analyzed after the day was over.