Audit Fee Structure, Financial Crisis and Corporate Governance*

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ABSTRACT: This study examines the effect of corporate governance on audit fees and audit hours during the financial crisis and pre-crisis periods. While the literature on the effect of corporate governance on audit fees is replete, the results are still mixed. By exploiting the crisis setting which represents exogenous shock unrelated to governance choices or auditing, we find that firms with strong corporate governance pay significantly higher audit fees and purchase additional audit hours. We also find that the sensitivity of audit fees and hours to the strength of corporate governance is higher during the crisis period relative to the pre-crisis period. Furthermore, the structure of audit fees and hours differs between the crisis and pre-crisis periods for firms with poor corporate governance. Collectively, the above results provide useful insights into the effect of governance on determination of audit fees.

Keywords: Audit fee; Audit hour; Audit fee structure; Corporate governance; Crisis.

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I. Introduction

This study examines the relation between corporate governance and audit fees and audit hours during the financial crisis and pre-crisis periods. While the literature on the effect of corporate governance on audit fees is replete, the results are still mixed. On the one hand, several studies document a positive relation between corporate governance and audit fees because firms with stronger boards purchase higher quality auditing services, which lead to higher fees (Carcello, Hermanson, Neal, and Riley 2002; Abbott, Parker, Peter, and Raghunandan 2003, Park, Shin, and Suh 2013). On the other hand, a line of literature suggests that better governance reduces control risk which in turn reduces audit fees (Tsui, Jaggi, and Gul 2001; Fan and Wong 2005). Furthermore, subsequent studies provide evidence of joint determination of audit fees and corporate governance (Bedard and Johnstone 2004: Griffin, Lont, and Sun 2008). Crisis represents an exogenous shock (Watts and Zuo 2011) that is not directly related to governance choices or auditing. Exploiting the shock to nonfinancial firms during crisis allows us to disentangle the effect of governance on audit fee structure.

In this study, we examine the relation between corporate governance and audit fees (hours) separately for crisis and pre-crisis periods to pin down the differential effect of governance on fees (hours) depending on the economic situation. We intend to provide answers to the three interrelated questions: (1) Do firms with superior corporate governance pay significantly higher audit fees and purchase additional audit hours?; (2) does the relation between the strength of corporate governance and audit fees (hours) differ between crisis and pre-crisis periods?; and (3) does the strength of corporate governance have a differential effect on the determinants of audit fees (hours) between crisis and pre-crisis periods?

First, we examine whether good governance firms are likely to pay higher

1) Watts and Zuo (2011) explain that the financial crisis is an exogenous shock that is not related to most individual firms. However, we acknowledge that it may be related to country-level economic situation, which may affect firm performance.