

## The market for audit services in Kosovo

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### **Abstract:**

*The main objective of this study is to examine the factors that influence the level of external audit fees paid by firms to their auditors. In practice, audit fees are determined based on agreement, negotiation and consensus between client and auditor. Many studies have been conducted on the market of audit services, but many countries, including Kosovo, have not been studied. In this paper, we have tested the effect of audit client size, client complexity, client risk and the size of the audit firm on the amount of audit fees for a sample of audit engagements performed in Kosovo major cities. Required data were collected from interviews with audit partners from various audit firms and individual auditors with purpose to assess the client's attributes and other factors that have influence on the audit fees.*

*Consistent with previous studies, the result of our data analysis showed that the amount of external audit fees is significantly influenced by the client's size of business (measured either by total assets or turnover) and complexity of business (measured by number of the companies in the same group). Also, clients' risk is found to have a significant impact on the level of audit fees. On the other hand, is not found any impact of client's industry type on audit fees. Our findings also suggest that audit fees are not significantly influenced by audit season and client profitability.*

**Key words:** audit fees, audit risk, client attributes, external auditing

## 1. INTRODUCTION

The purpose of this study is to examine the factors influencing the level of external audit fees paid by firms to their auditors in Kosovo. Pricing of audit services has been an interesting subject for many of the researchers and various studies have already been done in this field. Many studies were conducted to explore the factors that determine the audit fee charged by an auditing firm. The knowledge of these factors is helpful both for client and the auditor.

The external audit services and audit fees paid by companies to their auditors are obviously of interest to both companies and auditors: Companies are statutorily required to have their financial statements audited and want the fees they pay to be reasonable, auditors provide such services and want to ensure that the fees they charge are sufficient to enable a satisfactory service to be provided (Gist, 1992).

Audit fee is determined on the basis of characteristics specific to auditing firm and client. Characteristics of client include: size of its business, complexity of its business and risk of liquidation or risk in doing the audit of business. Hay (2010), in his study concluded that auditors charge fee on the basis of three attributes: client specific (client's business size, client's risk and client complexity), auditor specific (big or non-big firm) and engagement (busy season).

The much more audit fees would result in more effort and increase in audit quality. But in this sense, the auditors would be financially dependent to their customers and due to fear of losing the work, they may not be able to manage the auditing work sufficiently, although this decision may result in unpleasant financial consequences for them (Simunic, 1984).

The study of market of audit services in different countries is beneficial as it helps in understanding the similarities and differences in those countries. The practical advantage of this study is that it will help in gaining knowledge of economics of audit services in Kosovo and will help in

development and harmonization of international auditing and accounting standards. One of the goals of this paper is to contribute in international auditing literature by testing the factors influencing the audit fees in Kosovo.

## 2. LITERATURE REVIEW

Previous literature on the factors which influence the level of audit fees has investigated the relationship between audit fees and various corporate attributes. The most common corporate attributes in previous research include corporate size, profitability, risk and complexity. The first empirical evidence on the market of audit services was presented by Simunic (1980), which opened the way for future researchers to conduct audit fee studies in different countries. Simunic (1980) concluded that the price charged by auditors is function of: a) resources utilized by auditor in auditing and b) the opportunity cost of conducting an audit. Therefore, auditors charge fee on the basis of client specific and auditor specific attributes. Causholli et al. (2011), in their study regarding overview of empirical research related to audit fee find out that client's size of business is the most significant determinant of audit fee among all other determinants. The reason for positive and significant relationship of audit fee with size of client's business is that labor usage and effort of auditor gets high as the size of company's business gets high. Causholli et al. (2011), say that common proxy for measuring clients' size of business is natural log of assets or sales. The larger company will have more transactions, therefore, requires the auditor to perform more detailed audit processes and procedures, and thus the auditors have to be more attentive and diligent to audit and review their clients business, which results in higher audit fees (Taylor & Simon, 1999; Meshari, 2008). Fleischer (2012) provides evidence of German market regarding the relation between client's size and audit fee by using a different proxy than actually used for client's size of business. His study uses

number of employees for client's size of business and results of study show that client's size of business has highest explanatory power and shows a significant positive relationship with audit fee. Harshani (2008) concluded that the external audit firm is expected to perform more audit work as the client size increases to ensure the performance of an adequate amount of compliance and substantive testing. This increase in audit effort is naturally expected to be associated with the increase in the amount of audit fees.

The complexity of business is another significant determinant of audit fee. Complexity of business is measured by presence and number of subsidiaries or branches, area of activity, complexity of operations and the complexity of assets reported in the balance sheet. A significant proportion of previous studies observed positive relationship between corporate complexity and audit fees. Simunic (1980), concluded that auditee companies with complexity are charged higher level of audit fees. Verbruggen et al.( 2011), found positive relationship between corporate complexity and audit fees. The main reasons to explain such a relationship is that greater numbers of subordinate financial statements require more audit time and greater expertise to ensure the accuracy of the consolidated financial statements (Sandra & Patrick, 1996). Moreover, auditing complex clients exposes external auditors to more professional liability claims than non-complex companies (Clatworthy & Peel, 2006).

It is natural to expect a positive relationship between audit fees and client complexity, because a more complex audit client means a more diverse organizational structure, and harder to review transactions. This increase in audit effort is naturally expected to be associated with an increase in the amount of audit fees.

Audit risk is another factor with significant influence on audit fees. Audit risk is the risk that audit firm will be held liable to third parties for failure of business or misstatements in financial statements. Simunic (1980) concluded that an audit

fee is a function of both the cost of performing the audit and the expected cost of the audit risk. Charles et al. (2010), point out that usually auditors assess the risk of client before conducting its audit. They say that when auditors feel that risk of client is high then they increase the amount of evidences and in doing so the effort and cost of audit increases which is compensated by high fee. Calderon et al. (2012), say that the auditors can never disclose all misstatements in financial statements as the time for conducting audit is limited and auditors rely on sampling techniques. The auditors therefore invariably charge extra fee in order to mitigate the risk arising from limited time available to them for conducting audit and such extra fee or premiums compensate the auditors for the potential loss associated in conducting an audit.

The impact of audit firm size on audit fees was examined by several audit fee studies, with purpose to find out whether audit fees paid to “Big” audit companies are significantly higher than fees paid to “non-Big” companies. Another reason for studying the audit firm size comes from the assumption that the firm’s size indicates the audit quality. Chia et al. (2007), show the evidence that the big firms conduct a high quality audit than the others and that’s why these firms charge high fee. The audit quality depends from the independence of auditor and an independent auditor is better able to perform his duties than the dependent auditor. The study of Sun et al. (2011), indicates that the audit quality differentiation of big firms is due to deep pocket hypothesis i.e. in case of high litigation firm Big firms are more likely to be sued and therefore perform a high quality audit. In the UK (Chan et al., 1993) found that audit fees charged by “Big” audit firms to be higher than fees charged by “non-Big” audit firms.

### **3. METHODOLOGY**

The main objective of this article is to establish empirical evidence about factors which influence the level of audit fees in

Kosovo. Required data were collected from interviews with audit partners from various audit firms and individual auditors, with purpose to assess the relation between audit fees and client's attributes. The entire population of this study consists from 56 auditors which are employed in Kosovo audit firms or are working as individual auditor.

**The hypotheses** of this study are based on the findings of previous studies in this area as well as our experience in this field. These hypotheses are as follows:

**H1 = Audit fee is positively associated with size of the auditee**

**H2 = Auditee fee is positively associated with the degree of auditee's complexity**

**H3 = Audit fee is positively associated with the clients' risk**

**H4 = Audit fee is positively associated with audit firm size**

**H5 = Audit fee is positively associated with busy season**

**H6 = Audit fee is positively associated with client's industri tipe**

**H7 = Audit fee is positively associated with client's profitability**

Based on these hypotheses is designed the research questionnaire, which was sent to the auditors in October 2014. The questionnaires were sent to 56 auditors, and 32 questionnaires were received and were judged useful for the study.

#### **4. ANALYSIS, DATA EXPLANATIONS**

To test the hypotheses we have processed and analyzed the results of the data collected.

**H1 = Audit fee is positively associated with size of the auditee**

To test this hypothesis, we have analyzed the responses in our questionnaire regarding the relations between audit fee and size of auditee. Results are presented in the following table:

**Table 1 “Is audit fee positively associated with size of the auditee?”**

|           | Frequency | Percent | Valid Percent | Cumulative Percent |
|-----------|-----------|---------|---------------|--------------------|
| Valid yes | 25        | 78,1    | 78,1          | 78,1               |
| no        | 6         | 18,8    | 18,8          | 96,9               |
| n/a       | 1         | 3,1     | 3,1           | 100,0              |
| Total     | 32        | 100,0   | 100,0         |                    |

Details regarding the perception of the auditing professionals on the impact of the size of auditee on audit fee show that 78.1 % of respondents answered that audit fees are positively associated with size of the auditee. Only 18.8 % of respondents declared that audit fees are not positively associated with size of auditee.

As we said above, we can conclude that the hypothesis H1 is confirmed related with that the audit fee is positively associated with size of the auditee, because 78.1% of respondents claimed the reasonability of hypothesis.

**Data analysis related to the impact of auditee’s complexity on audit fee**

**H2 = Audit fee is positively associated with the degree of auditee's complexity**

To test this hypothesis, we have analyzed the responses in our questionnaire regarding the impact of auditee’s complexity on audit fee. Results are presented in the following table:

**Table 2 “Is audit fee positively associated with the degree of auditee's complexity?”**

|              | Frequency | Percent | Valid Percent | Cumulative Percent |
|--------------|-----------|---------|---------------|--------------------|
| Valid    yes | 20        | 62,5    | 62,5          | 62,5               |
| no           | 11        | 34,4    | 34,4          | 96,9               |
| n/a          | 1         | 3,1     | 3,1           | 100,0              |
| Total        | 32        | 100,0   | 100,0         |                    |

The perception of the auditing professionals on the impact of complexity of auditee on audit fee show that 62.5 % of respondents answered that audit fees are positively associated with complexity of the auditee. Only 34.4 % of respondents declared that audit fees are not positively associated with complexity of auditee.

Our results indicate that there is a significant positive relationship between complexity of the auditee and audit fee. Therefore, second hypothesis of study is supported and it can be concluded that complexity of auditee has significant impact on audit fee. The positive relationship is as a result of the fact that complex business is difficult to audit and requires more audit time.

### **Data analysis related to the impact of clients’ risk on audit fee**

#### **H3 = Audit fee is impacted by clients’ risk**

To test this hypothesis, we have analyzed the responses in our questionnaire regarding the impact of clients’ risk on audit fee. Results are presented in the following table:



**Table 3 “Is audit fee impacted by clients’ risk?”**

|       |       | Frequency | Percent | Valid Percent | Cumulative Percent |
|-------|-------|-----------|---------|---------------|--------------------|
| Valid | yes   | 27        | 84,4    | 84,4          | 84,4               |
|       | no    | 4         | 12,5    | 12,5          | 96,9               |
|       | n/a   | 1         | 3,1     | 3,1           | 100,0              |
|       | Total | 32        | 100,0   | 100,0         |                    |

The responses of the auditing professionals on the impact of clients’ risk on audit fee show that 84.4 % of respondents answered that audit fees are positively associated with risk of the client. Only 12.5 % of respondents declared that audit fees are not positively associated with clients’ risk.

Based on the results from the table above, we can conclude that the hypothesis H3 is confirmed related with that the audit fees are positively associated with clients’ risk and in this case 84.4% of the interviewees claimed the justification of hypothesis.

**Data analysis related to the impact of audit firm size on audit fee**

**H4 = Audit fee is positively associated with audit firm size**

To test this hypothesis, we have analyzed the responses in our questionnaire regarding the impact of audit firm size on audit fee. Results are presented in the Table 4:

**Table 4 “Is Audit fee positively associated with audit firm size?”**

|       |       | Frequency | Percent | Valid Percent | Cumulative Percent |
|-------|-------|-----------|---------|---------------|--------------------|
| Valid | yes   | 22        | 68,8    | 68,8          | 68,8               |
|       | no    | 8         | 25,0    | 25,0          | 93,8               |
|       | n/a   | 2         | 6,3     | 6,3           | 100,0              |
|       | Total | 32        | 100,0   | 100,0         |                    |

Data analysis of respondents related with impact of audit firm size on audit fee shows that 22 from 32 of them evaluate that audit fees are positively associated with audit firm size. Only 8 (25%) of respondents declared that audit fees are not positively associated with audit firm size.

Based on the results from the Table 4, we can conclude that the hypothesis H4 is confirmed, therefore the audit fees are positively associated with audit firm size, since 68.8 % of the interviewees claimed the justification of hypothesis.

### Data analysis related to the impact of busy season on audit fee

#### H5 = Audit fee is positively associated with busy season

To test this hypothesis, we have analyzed the responses in our questionnaire regarding the impact of busy season on audit fee. Results are presented in the Table 5:

Table 5 “Is audit fee positively associated with busy season?”

|       |       | Frequency | Percent | Valid Percent | Cumulative Percent |
|-------|-------|-----------|---------|---------------|--------------------|
| Valid | yes   | 13        | 40,6    | 40,6          | 40,6               |
|       | no    | 17        | 53,1    | 53,1          | 93,8               |
|       | n/a   | 2         | 6,3     | 6,3           | 100,0              |
|       | Total | 32        | 100,0   | 100,0         |                    |

Data analysis of respondents related with impact of busy season on audit fee shows that 40.6 % of them evaluate that audit fees are positively associated with busy season. On the other hand 53.1 % of respondents declared that audit fees are not positively associated with busy season.

Based on the results from the Table 5, we can conclude that the hypothesis H5 is rejected, therefore the audit fees are not positively associated with busy season.

Our results indicate that there is not a positive relationship between client’s industry type of the auditee and

auditor fee. The findings also revealed that audit fees are not significantly influenced by client's profitability. Consequently, hypothesis H6 and H7 are not supported.

## 5. CONCLUSIONS

Results of this study indicate that the size of auditee is a significant factor in determination of audit fee. It is reasonable because the larger the company size, requires the longer the audit process, and consequently the higher the audit cost. In other word, the number of hours needed to complete the audit work determines the amount of audit fee. Our results are in accordance with prior findings. Simunic (1980), concluded that the large client will have more transactions, therefore, requires the auditor to perform more detailed audit processes and procedures, and thus the auditors have to be more attentive and diligent to audit and review their clients business, which results in higher audit fees.

Our results indicate that there is a significant positive relationship between complexity of the auditee and audit fee. The positive relationship is as a result of the fact that complex business is difficult to audit and require extra effort and time. Also, more complex company, measured by the number of subsidiaries, requires more audit work to examine individual company financial statements and consolidated financial statements. These results are in line with previous research. Greater number of subordinate financial statements requires more audit time and greater expertise to ensure the accuracy of the consolidated financial statements (Sandra & Patrick, 1996). Our results suggests that clients risk is a significant determinant of audit fee, because the higher auditee risk, obviously, causes more efforts exerted by auditors to lower future litigation risks. These results are in accordance with previous studies in this field. Firth (1993) found that higher level of client risk will increase the auditor effort which result

in higher audit fees, therefore, the auditing firm will have to undertake detailed work to resolve or moderate the risk.

Findings of this study indicate that audit firm size is another significant factor on audit fee. This is reasonable because the reputation and status of audit firm can have a great effect on audit fees. Hay et al., (2006) argued that higher audit fees are expected when an auditor is recognized to be of superior quality to other firms. The findings of this study also suggest that audit fees are not significantly influenced by client profitability and client industry type.

Most of the determinants of audit fees that were found to be significant are in line with prior studies. Therefore, we can conclude that in Kosovo is used similar platform on calculation of audit fees as in other countries. We believe that this study will help in gaining knowledge of economics of audit services in Kosovo and will help in development and harmonization of international auditing standards. This paper will contribute in international auditing literature by testing the factors that influence the audit fees in Kosovo.

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