Chapter 13
The Impact of Conservatism Accounting on Audit Fees:
Evidence From Portugal and Spain

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ABSTRACT

For a sample of listed Portuguese and Spanish firms from 2010 to 2018, this study draws on audit pricing, substitution, signaling, and complementary theories to evaluate the impact of conservatism accounting on audit fees. Using fixed effects technique, the author finds a positive relationship between conservatism accounting and audit fees. The results suggest that firms with more conservative accounting (with strong internal corporate governance) could be more likely to demand high-quality audit to strengthen investor confidence in financial information and, thus pay higher audit fees. Therefore, this study supports signaling and complementary theories. The results also suggest that Big 4, growth, firm size, and leverage are positively related with audit fees. To Spain, audit risk and ROA are also positively related with audit fees.

INTRODUCTION

Management is responsible for providing stakeholders with information regarding various entity activities, which can be achieved through financial reporting (Baker & Al-Thuneibat, 2011). Nevertheless, the inherent flexibility in many accounting standards facilitates managers to take advantage of it and misrepresent information. Thus, a key element of the financial reporting process is to guarantee an independent

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verification of the financial statements prepared by the firm's management (Chan, Ezzamel, & Gwilliam, 1993). Auditing aims to ensure the credibility of the financial statements. Audit quality is the joint probability that the external auditor detects an irregularity in financial statements, and then reveals it to the external users (DeAngelo, 1981).

Audit pricing theory suggests that in a competitive audit market, audit fee is a function of audit effort and the auditor's client-specific business risk (Simunic, 1980; Simunic & Stein, 1996). Audit effort is driven by audit risk. According to International Auditing and Assurance Standards Board, audit risk is defined as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. The client's business risk is also expected to influence audit effort. Thus, for a client presenting a higher risk level, the auditor asks for higher fees to cover higher audit effort (costs) (Simunic & Stein, 1996).

Auditors risk losing reputation capital when audit market participants perceive that they have allowed misreporting (Skinner & Srinivasan, 2012; Weber, Willenborg, & Zhang, 2008). Prior research finds evidence that restatements harm auditors' reputation by triggering auditor dismissals (Hennes, Leone, & Miller, 2014). Litigation exposes auditors to direct financial penalties, while lost reputation impairs the ability to retain and attract clients (DeFond, Lim, & Zang, 2016). In the case of wrong opinions or a failure to discover breaches, auditors suffer significant damages to their brand reputation and high litigation costs if sued (Becker, DeFond, Jiambalso, & Subramanyam, 1998; DeAngelo 1981; Francis & Krishnan 1999; Khurana & Raman, 2004). Therefore, a client's business risk is expected to be associated with audit fees.

Audit quality is reflected by financial reporting quality, and accounting conservatism is one of the key factors that determine financial reporting quality (Lim, 2011; Watts, 2003a, b). Therefore, auditors may also consider the level of conservatism in financial reporting to avoid legal liability and promote shareholder interest, which reduces audit risk and, thereby, decreases audit fees.

Accounting conservatism enhances financial statement usefulness by reducing residual losses arising from asymmetric information between managers and other parties to the firm (Ahmed & Duellman, 2007). This is achieved by restricting managers' opportunistic payments to themselves and other parties, minimising agency problems associated with managerial investment decisions, improving the efficiency of debt and other contracting, better facilitating the monitoring of contracts and reducing litigation and political costs (Ball & Shivakumar, 2005; Watts, 2003a). Conservative reporting reduces the potential for overstatements by mitigating aggressive managerial estimates (Basu, 1997; Holthausen & Watts, 2001; Khan & Watts, 2009; Watts, 2003a). Accounting conservatism also reduces managements' tendency to misreport (LaFond & Watts, 2008; Watts, 2003a); thereby reducing the chances that auditors will fail to prevent misreporting, which adversely affect

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