# Audit quality and audit fee in European context

**Abstract** *Audit fee is the direct link between the client and the audit company, this is why the fee can directly impact auditor's independence. Usually, discretionary accruals are considered an indirect measure for financial reporting quality and audit quality as reporting component. Using a sample of 8407 European non-financial observations in the period 2017-2023, we estimated the impact of reporting quality over the audit fee. The audit fee is set as dependent variable, and the audit quality, proxied by discretionary accruals calculated using Jones model (Jones, 1991) is variable of interest. We have included in the model audit related and firm related control variables. Reporting quality has a significant impact in predicting audit fee, but the main drivers of fee variation are client related controls (ROA, levier, size measured by market capitalization). Industry expert, and reporting lag are influencing also the audit fee variation.*

Key words: *audit fee, audit quality, reporting quality, discretionary accruals*

## Introduction

The body of literature on audit fees followed two main directions: evaluating the competitiveness of audit market in the context of small number of service providers (especially for the listed auditees) and examining the independence of audit process, usually using proxies as low-balling and non-audit services (Hay et al., 2006). Research in the field of audit quality has evolved from asking simple questions about audit quality to exploring detailed questions about quality differences across various audit firms, audit offices, and even audit partners (Molociniuc et al., 2022; Pascaru & Hațegan, 2024).

Audit quality is a complex process influenced by multiple factors: the inputs of the audit process (such as testing procedures, technologies used, and the individuals involved in the audit), the auditing process itself (which includes the collection and interpretation of audit evidence by the audit partner, as well as deficiencies identified in inspections conducted by bodies like the PCAOB, FRC, or AFM), audit firms (through their internal quality control systems), and the outputs of the audit (the audit report and the audited financial statements) (Francis, 2023). In the

past, the studies which have examined the demand- side of the audit process were using almost exclusively input factors as proxies for audit quality, as the audit fee (DeFond & Zhang, 2014).

Literature employs a significant number of indicators to measure audit quality, without reaching a consensus on the most effective indicators of audit quality. Audit quality depends on the intentions and competencies present both within the client companies and the audit service providers (DeFond & Zhang, 2014).

The most visible outputs of the audit process are the audit report and the audited financial statements. Since for large entities the presentation of factual data in cash flows is insufficient, reporting is conducted based on accrual accounting, which includes, in addition to factual data, certain forecasts and complex estimates (Francis, 2023). Dechow & Schrand (2010) note that the reported profit is a function of the company's financial performance over a specific period.

Auditor independence is arguably the most critical characteristic of auditing. Given that the primary link between the audit client and the auditor is the audit fee, the study will investigate the factors that influence audit fees as a dependent variable. From the multitude of indicators that can be used to determine audit quality, this paper will focus on discretionary accruals and their impact over the audit fee.

The audit attributes were mainly studied in United States, United Kingdome and Asiatic countries. Even if size influence over the audit fee is clear, other attributes are still facing mixed results in the research field (Hay et al., 2006).

This research aims to explore audit quality in an European non-financial setting, focusing on the discretionary accruals as a key indicator for audit fee variation. Earnings management through discretionary accrual was considered as a quality proxy for audit quality, but also for reporting quality.

In our study, we have used a combined approach of mainly input factors and discretionary accruals as an output factor to analyze audit quality. We contribute to the body of literature by using a different control measure for size in constructing a model which includes manly variables with mixed results in prior research, while focusing on discretionary accruals as measure of audit quality. Also, our sample consists of non-financial European companies from 30 European countries, and in the literature, there are only a few studies which investigated audit quality in a

similar setting. The data was processed using Microsoft Excel, while descriptive statistics, correlation matrices, and regressions were performed using Stata software.

This paper starts with the review of existing literature on the matter of audit fee and audit quality, followed by the methodology used in the study, and ends with the results obtained.

**Literature review**

The declared scope of audit process is to enhance the trust of the stakeholders that the financial reports of an entity are reflecting faithfully the reality of its economic activities (Chang et al., 2022; DeFond & Zhang, 2014). Audit fee can be considered an audit input quality proxy, while discretionary accruals are considered more of an output indirect quality indicator (DeFond & Zhang, 2014).

Managers may use the flexibility provided by accrual accounting to opportunistically alter financial performance. There are also situations where managers use accrual accounting to reduce information asymmetry between themselves and investors (Jones, 1991; Healy & Palepu, 1993). Opportunistically used discretionary accruals can increase audit fees because the likelihood of these accruals materializing in the future is lower, thereby increasing audit risk. Gul et al. (2003) demonstrated that although there is a positive correlation between audit fees and discretionary accruals, this effect is diminished when managers hold equity in the company. The permissiveness of the auditor regarding earnings manipulation was seen as an way to measure audit quality (Martinez & Moraes, 2017).

Discretionary accruals don't always have a negative impact. If a company's results fall below a critical value considered acceptable, to avoid exceeding a psychological threshold, managers might use discretionary accounting to adjust figures back to the psychological value (Lebert et al., 2021). Using such an approach might be beneficial if the adjustments are minor, preventing a situation where decisions would be distorted due to the psychological threshold (Bizer & Schindler, 2005; Lebert et al., 2021).

According to DeFond & Zhang (2014), introducing a measure of financial reporting quality is an effective way to gain insights into audit quality, as auditing is a subsystem of financial

reporting. External auditing serves as a good mechanism for monitoring the interaction between shareholders' interests and those of managers. However, for this mechanism to function optimally, external audit services must be of high quality (Idris et al., 2018). Accruals are a common problem for auditors as they are related to high risk accounts as inventories and receivables (Gul et al., 2003).

The models developed in 1995 for detecting discretionary accruals vary in complexity, using either total estimates or separating discretionary estimates from the remaining estimates. The Jones model defines accruals in accounting through increases in sales and fixed assets. Dechow et al. (2010) argue that the Jones model is susceptible to both Type I and Type II errors. The modified model, which is detailed below, seeks to reduce Type II errors but is associated with a higher incidence of Type I errors. The model developed by Kothari et al. (2005), which has been used in subsequent studies (Idris et al., 2018), includes the ratio of net income to total assets (ROA). However, according to Dechow et al. (2010), this model may significantly diminish the statistical power of the test and is thus recommended only when the correlation with financial performance is considered critical.

The research in this area evolved to analyze the impact of more complex topics over the earnings management. Dou et al. (2024) explored the impact of Chinese zodiac beliefs on audit quality, finding that older partners and larger audit firms with higher reputational risks are more affected. Their study analyzed discretionary accruals and financial restatements, incorporating various control variables related to auditors and companies in China. Christensen et al. (2016) determined that auditor characteristics are the most significant perceived factor in audit quality, with financial restatements indicating potential issues with audit quality, based on surveys of auditors and non-professional investors. Hasan et al. (2020) investigated earnings management as a proxy for financial reporting and assessed how audit committees' moderate earnings management through audit quality, focusing on Malaysian companies from 2013-2018, with company size and financial leverage as control variables. Hay et al. (2006) highlighted that audit fees reflect market competitiveness and influence auditor quality and independence, noting the impact of the relatively small number of international audit firms.

Cohen and Zarowin (2010) analyzed how the financial results of publicly traded companies are manipulated during periods of issuing new shares on capital markets. The authors employed

the Jones and Roychowdhury models in their analysis. They observed a subsequent decline in financial performance, which is attributed to the reversal of accounting accruals as well as the operational consequences of manipulating results during the stock issuance periods on the capital market.

According to Simunic (1980), the audit process is a subsystem of the audited company's financial reporting system, representing an economic good from which the audit client derives certain benefits. There is no consensus on the exact benefits received by audit clients, but DeAngelo (1981) identified auditor independence as the primary benefit, considered even more crucial than the auditor's technical expertise. Thus, although the client contracts and pays for audit services, there is an expectation that auditors maintain their independence (Hay et al., 2006).

Kacer et al. (2018) examined audit fees for Big Four audits in the UK, finding that company size was the main determinant. They assessed complexity and audit risk using various financial metrics. Their study used fixed effects and least squares methods for estimation. Several researchers, including Ganesan et al. (2019), view audit fees as indicative of audit quality, with high fees potentially signaling either a more extensive audit effort or concerns about auditor independence (Eshleman & Guo, 2013).

Audit fees have been frequently studied in relation to audit quality, which is crucial for ensuring that financial statements comply with reporting standards. The audit fee is a key link between auditors and clients, but it should not compromise auditor independence.

Hsieh et al. (2020) used machine learning to explore how auditors' fee-setting is influenced by the perceived trustworthiness of CFOs' and executives' facial features. Krishnan & Tanyi (2024) investigated how unusual audit fees affect audit quality, finding that abnormal fees impact quality only when there is a shortage of human capital in the audit firm.

In Europe, since 2006, the publication of the audit partner's name in financial statements has been mandated by the Council Directive 2006/43/EC. This measure could lead to higher audit fees and increased risk of the audit partner becoming involved in political processes (Carcello & Santore, 2015; King et al., 2012). In response, the PCAOB introduced an indirect method of auditor identification. Bédard et al. (2024) assessed whether the method of auditor identification (direct

vs. indirect) impacts audit quality using eight quality indicators. Their results showed no significant difference in audit quality based on the method of auditor identification.

Recent studies researched the auditor expertise in industry (usually proxied by auditor's market share in audit services market, calculated as auditors' fees in one industry divided by total audit fees obtained in the same industry. The understanding of clints activities comes with the needed expertise which enhance auditor's capability of fulfilling his responsibilities (Chang et al., 2022). The literature identifies an positive effect of auditor expertise over the audit fee (Chang et al., 2022; Frino et al., 2023; Mottinger, 2024).

In a study which has investigated the interaction between audit fee and earnings management, Martinez & Moraes, (2017) found that smaller than expected audit fees tends to predict higher values for discretionary accruals. Gandía & Huguet, (2021) states that in case of mandatory audits, higher fees predict less discretionary accruals.

Considering the above evidence we suggest the following hypothesis:

*H0 – Audit quality doesn't have an impact over the audit fee.*

*H1 – Audit quality has an impact over the audit fee.*

**Methodology**

We have used a sample of non-financial listed companies, downloaded from Audit Analytics. Financial data was extracted from the Orbis database. Mentioned databases are used in research community (Cameran & Campa, 2025; Chang et al., 2022). We have included in our sample only companies which had information available for the entire period analyzed. Our reference period was 2016 – 2023. The seps in constructing our sample are presented in Table 1. Starting with 2016, the format of the audit report was changed by adding key audit matters. Also, as prior used in the literature (De Franco et al., 2024) we have used year 2016 as a starting point for our period because it is the first year for which we have information available for most of the entities, for all of our variables. We have eliminated financial and utilities industries (De Franco et al., 2024), companies outside Europe, and companies with missing information. We have obtained an initial sample of 9608 observations, which were used to calculate discretionary accruals. Our final sample consisted of 8407 observations, for period 2017 – 2023. Even if large assets is a characteristic of financial and utilities industries, they are usually easier to audit than other

activities which are implying higher inventories, receivables or knowledge based assets (Hay et al., 2006). Including financial and utilities industries in our sample can affect the effect size for our regression, as size indicators are usually the main drivers for the audit fee.

**Table 1 – Sample**

| | |
|---|---|
| Total instances with full records in period 2016-2023 | 27760 |
| FInancial | 8152 |
| Utilities | 2352 |
| Outside europe | 544 |
| No information in ORBIS | 2992 |
| Other missing information | 4112 |
| Initial sample for discretionary accruals calculation | 9608 |
| Final sample | 8407 |

Source: own processing

To test our hypothesis, we have constructed the following regression model, using variables stated in audit fee and audit quality review studies (DeFond & Zhang, 2014; Hay et al., 2006):

$$LNaufee_{i,t} = \beta_0 + \beta_1 DA_{i,t} + \beta_2 lnreplg_{i,t} + \beta_3 DExpert_{i,t} + \beta_4 Dnbusy_{i,t} + \beta_5 ROA_{i,t} + \beta_6 lev_{i,t} + \beta_7 mc_{i,t}$$

The audit fee (LNaufee) is set as dependent variable, and the audit quality, proxied by discretionary accruals calculated using Jones model (Jones, 1991) is variable of interest. We have included in the model audit related and firm related control variables. To control audit related influences, we have included in the model the difference between the year end an audit report date (lnreplg), if the auditor is an expert in the industry (DExpert), and the working load of the audit teams, measured using the financial year end date (Dnbusy). For client related control, we have used the market capitalization as size indicator (mc), and for profitability ROA and financial levier (lev). We have used transformed data using the natural logarithm instead of raw data for some variables to improve the linear relationship those variables have with the audit fee.

A detailed presentation of variables used can be seen in Table 2. To deal with possible outlines in our sample we have winsorized our sample at 1 and 99 percentile similar as in previous studies (Friedrich & Quick, 2024; Hossain et al., 2023; Mottinger, 2024).

**Table 2 - Variables used**

| Predicted sign | Variable & type | Description |
|---|---|---|
| N/a | LNaufee – dependent | Natural logarithm of audit fees. |
| + | DA – interest | Discretionary accruals calculated using Jones Model. |
| + | DAJM – interest | Discretionary accruals calculated using modified Jones model |
| + | DAK – interest | Discretionary accruals calculated using Kothari performance adjusted model |
| + | lnreglg – control | Natural logarithm of the number of days between the financial year end and audit report signature date. |
| + | DExpert – control | Dummy variable equal with 1 in case the auditor is an expert in the industry, calculated using audit fee market share at Europe level, and 0 otherwise. |
| - | Dnbusy – control | Dummy variable equal with 1 in case the financial year end is not 31st of December, and 0 otherwise. |
| ? | ROA – control | Net profit divided by total assets |
| ? | lev – control | Total assets divided by equity |
| + | mc – control | Natural logarithm of client's market capitalization |

Source: own processing

Discretionary accruals are usually used as a proxy for reporting quality (Antle et al., 2006; Frino et al., 2023; Gul et al., 2003; Haak et al., 2018; Lai et al., 2017; Salem et al., 2023).

Audit report lag and the busy season indicator are considered to have an effect over the audit fee, but the result are inconsistent in the literature (Hay et al., 2006).

We have chosen ROA as a measure of profitability. The relationship between ROA and audit fee can be more intense when the company has a small profit or loss than when it has registered loss for previous years, which may cause nonlinearity (Hay et al., 2006). The ROA and lev as controls are offering mixed results as determinants of audit fee. Some studies found that ROA and lev are not significantly correlated with audit fee (Martinez & Moraes, 2017).

Usually, total assets are used as a control variable for size (Gul et al., 2003; Hay et al., 2006; Lin & Hwang, 2010; Martinez & Moraes, 2017; Mottinger, 2024) and market to book ratio

of equity is used also in models for complexity (Martinez & Moraes, 2017; Salem et al., 2023). We decided to use natural logarithm of market capitalization to follow the recommendation of avoiding correlation bias between first and second step repression for discretionary accruals and to limit the number of controls (Chen et al., 2018).

When we analyzed our sample, we observed that all the expert auditors are part of the Big Four, so we decided to only include DExpert variable and limit the number of control variables this way.

We have used discreationary accruals measured using modified Jones model (Dechow et al,. 1995) and performance adjusted model (Kothari et al., 2005) as different measures for financial reporting quality to test the robustness of our results. Both measures are widely used in literature. Breusch-Pagan test highlighted heteroscedasticity in our data, so we have used a generalized least squares regression (GLS) for panel data, implying heteroscedasticity.

**Results and discussion**

The descriptive statistics for our model can be found in Table 3.

**Table 3 – Descriptive statistics**

| | count | mean | sd | min | max |
|---|---|---|---|---|---|
| LNaufee | 8407 | 12.6765 | 1.689827 | 8.869961 | 16.79901 |
| da2 | 8407 | -.0000209 | .0753733 | -.2752565 | .2469079 |
| dajm2 | 8407 | -.0000494 | .07518 | -.2743401 | .2462893 |
| dak2 | 8407 | .0003164 | .0703992 | -.2233145 | .2426402 |
| mc | 8407 | 19.73647 | 2.274506 | 15.04208 | 25.16833 |
| lev | 8407 | .5345791 | .2000758 | .0904037 | 1.120322 |
| ROA | 8407 | .0318261 | .101132 | -.4703052 | .2647782 |
| lnreplg | 8407 | 4.381736 | .3410715 | 3.091042 | 5.159055 |
| Expert | 8407 | .2394433 | .4267691 | 0 | 1 |
| Dummybusy | 8407 | .1364339 | .3432692 | 0 | 1 |
| *N* | 8407 | | | | |

Source: own processing

The mean value for AuFee is 12.6 and a standard deviation of 1.69. Similar results were obtained by Chang et al., (2022), with a mean of 13.3 and a standard deviation of 1.33. The nature

of our sample (companies within 30 different European countries) explains a higher value for the standard deviation.

The mean values for discretionary accruals measurement are close to 0 for all three measures and a standard deviation of 0.075, but this can be because we are not using the absolute value of accruals and winsorisation eliminated outliners effects. Martinez & Moraes, (2017) used discretionary accruals in their study. Even if the mean was higher (0.149), the median value is close to 0. This can be explained by a higher standard deviation (0.3569) and the winsorization of our results. Our results for discretionary accruals are really similar to results obtained on a sample with Spanish entities (Gandía & Huguet, 2021)

The dummy variables have a mean of 0.23 for Expert and 0.13 for non-busy period year end. For ROA and lev we have similar result as Martinez & Moraes, (2017) for the mean and standard deviation. In Table 4 the correlation matrix is presented to test multicollinearity. We can see that all the variables used in the model are significantly correlated to the audit fee, which is implying they are properly selected for predicting dependent variable variation. The client-related variables present a higher correlation with the audit fee than the audit-related selected variables. The highest correlation with the audit fee of an audit-related control is the audit conducted by an expert in the industry. According to Wooldridge (2015), multicollinearity is present when the correlation coefficient exceeds 0.7. The size control is exceeding the coefficient limit, but similar studies considered it acceptable (Sundgren, & Svanström, 2011). Also, VIF was calculated and as the maximum level obtained was 1.5 and a mean of 1.22. It can be considered that multicollinearity is not a serios concern.

**Table 4 – Correlation matrix**

| Variables | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) |
|---|---|---|---|---|---|---|---|---|---|---|
| (1) LNaufee | 1.000 | | | | | | | | | |
| (2) da | -0.054*** | 1.000 | | | | | | | | |
| (3) dajm | -0.054*** | 1.000*** | 1.000 | | | | | | | |
| (4) dak | -0.063*** | 0.943*** | 0.943*** | 1.000 | | | | | | |
| (5) mc | 0.829*** | 0.005 | 0.005 | -0.065*** | 1.000 | | | | | |
| (6) lev | 0.275*** | -0.152*** | -0.154*** | -0.082*** | 0.075*** | 1.000 | | | | |
| (7) ROA | 0.065*** | 0.368*** | 0.367*** | 0.070*** | 0.264*** | -0.220*** | 1.000 | | | |
| (8) lnreplg | -0.470*** | 0.006 | 0.006 | 0.057*** | -0.530*** | -0.041*** | -0.167*** | 1.000 | | |
| (9) Expert | 0.159*** | -0.007 | -0.007 | -0.015 | 0.157*** | -0.015 | 0.036*** | -0.144*** | 1.000 | |
| (10) Dummybusy | -0.046*** | 0.012 | 0.012 | 0.015 | -0.064*** | -0.045*** | -0.008 | 0.031*** | -0.014 | 1.000 |

**** p<0.01, ** p<0.05, * p<0.1*

Source: own processing

GLS regression results are presented in Table 5. Our model predicts audit fee variation well enough with pseudo $R^2$ of 0.7478, with a $p$ value below 0.001. The empirical findings provide sufficient evidence to reject the null hypothesis, suggesting that the effect of audit quality and firm related characteristics on audit fee is not equal to zero. All the variables' influences are significant. As a general observation, client's related attributes have a higher predictive value than audit related attributes.

**Table 5. GLS Regression results**

| | (1) LNaufee | (2) LNaufee | (3) LNaufee |
|---|---|---|---|
| da2 | 0.411*** | | |
| | (0.0764) | | |
| mc | 0.608*** | 0.608*** | 0.607*** |
| | (0.00249) | (0.00249) | (0.00249) |
| lev | 1.600*** | 1.600*** | 1.598*** |
| | (0.0255) | (0.0255) | (0.0255) |
| ROA | -2.019*** | -2.023*** | -1.934*** |
| | (0.0703) | (0.0703) | (0.0667) |
| lnreplg | -0.221*** | -0.221*** | -0.222*** |
| | (0.0156) | (0.0156) | (0.0156) |
| DExpert | 0.116*** | 0.116*** | 0.116*** |
| | (0.0102) | (0.0102) | (0.0102) |
| Dnbusy | 0.0750*** | 0.0749*** | 0.0747*** |
| | (0.0121) | (0.0122) | (0.0122) |
| dajm2_w | | 0.422*** | |
| | | (0.0766) | |
| dak2_w | | | 0.434*** |
| | | | (0.0768) |
| _cons | 0.841*** | 0.840*** | 0.845*** |
| | (0.101) | (0.101) | (0.101) |
| *N* | 8407 | 8407 | 8407 |
| *Pseudo* $R^2$ | 0.7478 | 0.7478 | 0.7478 |

Standard errors in parentheses
* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$
Source: own processing

Our value of interest has a significant and positive impact over the audit fee, which means that the existence of discretionary accruals increases the audit fee. An increasing effect over the audit fee can be observed in the case of an industry expert, but the financial year end of the client has no significant impact. Our results are similar with prior studies (Antle et al., 2006; Gandía & Huguet, 2021).

In previous studies, was demonstrated that size alone accounts for a significant part of fee variation (Hay et al., 2006). The control used by us for size and complexity is significant at p 0.01, with a coefficient of 0.608 which is similar with the size effect obtained in studies which used the total assets as an indicator of auditee size (Frino et al., 2023; Gul et al., 2003).

A different year end than usual has a small positive significant effect over the audit fee. This result is similar with Frino et al., (2023). Gul et al. (2003) found negative results for year end 31st December. As the variable is defined in the opposite way, we can assume a positive effect for companies with different year-end. The auditor being a specialist in the industry has an positive impact over the audit fee, with an coefficient of 0.116, similar with previous studies (Frino et al., 2023)

ROA impact is significant and negative, similar with Campa, (2013); Johnson et al. (2018); Gul et al. (2003). Lev effect is significant and positive similar with Salem et al. (2023); Campa, (2013).

**Conclusion**

Financial reporting is based on accrual accounting, which includes both simple and complex transactions as well as estimates of future cash inflows and outflows. The informational value of accrual accounting is higher than merely recording cash inflows and outflows because it is based on the principle of going concern. Many accounting transactions do not involve immediate cash movement. In other words, if there are no indications that the entity is likely to go out of business in the near future, transactions involving cash movements are likely to be completed, providing a more accurate picture of the financial position.

Auditing is a complex process that ensures the accuracy of financial statements in accordance with the applicable regulatory framework. Financial auditing is a component of the reporting process, where its added value comes from the independent verification of information published by the company's management.

One of the most visible threats to auditor independence is the economic relationship between the auditor and the audited company. Although the value added to the reporting process by the auditor is derived from their independence, the revenues and continuity of auditing firms depend on the fees they receive. In other words, audit fees must be set at a level that does not

compromise the auditor's independence. The study examines how audit fees are influenced by various factors.

According to our results, reporting quality has a significant impact in predicting audit fee, but the main drivers of fee variation are client related controls (ROA, levier, size measured by market capitalization). Industry expert, and reporting lag are influencing also the audit fee variation. Our results indicate that if the financial year end is different than 31st of December, there is a small increase in the audit fee.

Potential omitted variables are a potential limitation of our study, as all empirical models suffer from this problem to some extent. Also, we have used public information, thus leading to missing information for some companies, which need to be excluded from the sample.

We contribute to the body of literature by analyzing audit quality factors on a large sample of European countries. Future research directions in audit quality in an European setting could analyze the difference between geographical regions.

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