Discussion of "Longer Term Audit Costs of IFRS and the Differential Impact of Implied Auditor Cost Structures"

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Summary of the paper

- Using a sample of NZX companies during 2002-2012 period, with 855 firm-years from 78 firms, the paper addresses three questions:
  - Are audit fees *persistently* higher post-IFRS? Yes
  - Do audit fees vary dependent on IFRS adoption year? Yes
  - Did audit marginal pricing vary heterogeneously post-IFRS across audit firms? Yes

- Timely, well-written, well-thought research design, competently executed

- Importance of IFRS research and the fit into the literature

- Incorporation of discussions on both empirical findings and practitioners' views on the issue

General Issues to Consider

- The longer term analysis
  - Trade off
    - Benefit of observing the longer horizon change in audit fees subsequent to of IFRS adoption
    - Confounding factors may kick in
  - International Auditing Standards in 2008, Auditor Regulation Act 2011
    - To what extent the persistent higher fees in the longer term are explained by the adoption of IAS 2008, instead of IFRS?
  - Over-time change in characteristics of clients, audit firm risk strategy, and/or audit market competition
    - Suggestion: the time-series changes in selected client characteristics (e.g. size, complexity, risk) should be reported and analysed (T1)
- The New Zealand Context
  - Trade off
    - Contextual relevance and unique market conditions
    - Generalizability and empirical power
  - 78 companies for 11 years; DEL (96 [8 firms]), EY (45 [4 firms]), KPMG (190 [17 firms]), PwC (354 [32 firms]), Non-Big4 (as a group 170 [17 firms])
    - Suggestion: assess the representativeness of the sample
    - Suggestion: inclusion of and comparison with similar (or different) relevant features

Issues to Consider

- On RQ1: The long(er) impact of IFRS on increase in audit fees
  - Components of audit fees
    - Audit production costs (effort): Clients' size, complexity and risk; Production efficiencies
    - Reputation premium (?)
    - Expected future losses (litigation risk): Change in litigation environment/ client risks
    - Competition: Relative change in scale; Auditor switch and low balling
  - Improve comparability of financial statements
  - Increase quality of financial reporting (Barth et al. 08; Chen et al. 10; Ahmed et al. 09, among others)
  - Potential effects of other economic consequences on fees (lower cost of capital, higher liquidity, more investment flows, greater analyst coverage)
  - Increase reporting complexity
  - Additional training of audit staff, re-design and restructuring of audit procedures or audit technology

  → Some cross-sectional analyses would be helpful

Issues to Consider

- On RQ2: Early Adopters have higher audit fees?
  - Tension: early adopters (1) bear more of the learning or transitional costs that are likely to be short-lived; (2) “invest in higher financial reporting quality” and “greater audit monitoring” i.e. demand for higher audit quality and are willing to pay more
  - An interesting tension, but argument (2) is essentially a self-selection argument
  - Is endogeneity issue controlled for successfully?
    - Shall it be Heckman selection model or 2SLS?
    - Exclusion restrictions? *LSUB* and *LSUBIFRS* affects both *EarlyADOPT* and *LAF*
    - How successful is stage 1 estimation (T4C Model 5)?
  - Inferences made with 24 Early Adopters (N = 263)
  - Suggestion: as an additional test, consider removing the early adopters

Issues to Consider

- On RQ3: Differences across audit firms?
  - Inferences on audit cost structures made based on audit fees in the absence of audit cost data (e.g. Banker et al. 2013)
  - The assumptions that differential pricing reflects the implied auditor cost structures
    - The tendency to pass the cost changes to clients remain constant
    - The client features remain constant
    - The level/ form of audit market competition remains constant
    - Pricing strategies for Big 4 similar
    - Price differentials across client industries
  - How powerful is the test sample?
    - Sample size issue: Representative?
    - Sample restricted to mature clients + clients with long tenure

Other Minor Issues to Consider

- LTA as a measure of audit effort
  - T3 coefficients
  - Audit report lag?
- Inclusion of finance and utilities firms
  - Trade off between sample size and structural influence in fees
- Model Specification
  - Consider subsidiaries / business segments, timing (Yrend)
- Some clarifications e.g. the use of calendar year to define IFRS, the availability of two set of GAAPs in RECONCILE etc.

Concluding Remarks

- A nice paper to read – comprehensive, well-thought and well-written, competently executed
- Potentially interesting and timely study:
  - We know little about the long term impacts of IFRS
  - We know little about how auditors react to IFRS (effort, fee)
  - We know little about the differences within Big N auditors in various contexts
- Rooms for further explorations
- Congratulations