Spring 2021

Business Risk and Attest Service Fees: Understanding the Effect of Low Fed Interest Rates on Bank Audit Fees

Lucas Erik Jones

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Undergraduate Honors Thesis Proposal

Business Risk and Attest Service Fees:

Understanding the Effect of Low Fed Interest Rates on Bank Audit Fees

by

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December 2020
Introduction

The objective of this study is to examine the relationship between the federal funds rate and the audit fees paid by financial institutions. A lower federal funds rate is likely to inject countervailing pressures into audit fee negotiations; (1) downward pressure stemming from reduced profit margins, and (2) upward pressure from increased audit risk. With respect to (1), the extant literature suggests reduced economic performance creates downward fee pressure (Beck and Mauldin 2014), and a lower federal funds rate decreases the profitability of financial institutions. Specifically, when the federal funds rate is lower, a bank’s net interest margin is reduced, and there is less demand for loans (Borio, Gambacorta, and Hofmann, 2017). With respect to (2), the audit risk model states that higher levels of risk require additional audit effort. Assuming the auditor shares these costs with the client, the client will pay higher fees. Prior literature finds reduced profitability is one condition that increases audit risk and results in higher fees (Walker and Casterella 2000). Further, prior research suggests that banks are willing to invest in riskier assets when interest rates are low (Altunbas 2010). These countervailing pressures make the relation between the federal funds rate and audit fees an empirical question.

The federal funds rate is the rate at which banks can invest their money in U.S Treasuries or other institutions overnight, in order to meet reserve requirements and generate short-term returns. Cutting and hiking the fed rate is a tool used by the U.S. Federal Reserve (the Fed) to conduct monetary policy. ¹ The rate is generally cut during times of economic stress, which promotes more lending and borrowing. As the cost of capital is reduced and the economy begins to strengthen, consumers spend more money on goods and services. However, excessive rate cuts can

¹ Although changing the short-term rate can be considered both a “tool” for monetary policy and a “form” of monetary policy, I refer to it as a tool.
overstimulate the economy and lead to inflation. To keep economic growth at sustainable levels, the Fed can raise rates. This reduces inflation, and increases the value of the U.S. dollar.

The fees auditors charge clients are primarily a function of the amount of work performed by the auditor, and the amount of work performed increases with the auditor’s assessment of risk (Turpen 1995). While audit fees are primarily a function of risk, Beck and Mauldin (2014) suggest that during periods of economic stress, this relation weakens. Audit fees are one of the most commonly negotiated audit items, and clients can bargain for lower fees. During a period of economic stress, a client is especially motivated to negotiate lower audit fees as a cost-cutting measure. Auditors are likely to accept negotiations under certain circumstances to maintain relationships, retain clients, and earn future economic rents (Beck and Mauldin 2014).

To the best of my knowledge, this is the first study to examine the relationship between the federal funds rate and audit fees. Consequently, this study makes several contributions to extant literature. First, it contributes to a growing stream of literature focused on interest rates and bank profitability (Altunbas, 2010; Bikker and Vervliet, 2018; Borio et al., 2017). My results suggest interest rates and profitability effect a party other than the bank, the bank’s auditor. Second, I contribute to a stream of literature that examines the effects of economic performance on audit fee negotiations. While prior studies find macro-level economic stress reduces audit fees, I find a less pervasive form of economic stress does not. Finally, this study introduces a new variable that has a significant impact on audit fees, contributing to the existing fee literature (DeFond and Zhang, 2014).
Background and Hypothesis

The Federal Funds Rate

The Fed is defined as a monopolistic entity seeking to affect nonfinancial economic activity such as employment and inflation (Friedman 2000). The Fed is responsible for supervising the nation’s largest banks, providing financial services to the U.S. Government, and implementing monetary policy. The Federal Reserve Act mandates that the Fed conduct monetary policy “so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates” (Washington: Board of Governors 2016, p. 1). Decisions about monetary policy are made by the Fed’s Open Market Committee (FOMC), which is a committee comprised of the Fed Board of Governors, the President of the Federal Reserve Bank of New York, and 4 (out of 11) of the remaining reserve presidents (Reserve 2021). The FOMC meets 8 times per year and discusses both financial and non-financial economic conditions including employment, inflation, GDP, and interest rates.

A crucial job of the FOMC is setting the target federal funds rate. The target rate, as opposed to the effective rate, is the Fed’s desired interest rate level, defined as a range. The Fed implements monetary policy with the goal of ensuring the effective rate falls within the target range. The effective federal funds rate (EFFR) is “the interest rate at which depository institutions lend reserve balances to other depository institutions overnight” (Federal Reserve, 2021, p. 1). It is important to understand that the EFFR is a short-term rate, therefore it only directly affects reserves lent from bank to bank overnight. However, since the 2008 financial crisis, the Fed has made an effort to buy and sell more long-term treasury assets in order to put pressure on long-term rates (Reserve 2021).
The Federal Reserve Banks are in charge of implementing monetary policy and have a number of tools, or instruments, they use to ensure effective rates stay within the target range (Reserve 2021). The most common instrument utilized by the Fed to raise or lower short-term rates is Open Market Operations (OMO). The U.S. Federal Reserve (2021) describes Open Market Operations as “the purchase and sale of securities in the open market by a central bank”. It is important to distinguish Open Market Operations from Quantitative Easing (QE), as they both involve buying and selling treasury assets, but on different ends of the yield curve. OMO involves only short-term assets, while Quantitative Easing targets longer maturity assets that will have a more direct effect on the corresponding rates. During expansionary monetary policy, the trading desk at a central bank purchases Treasury securities from financial institutions that hold reserves at the Fed (Koenig 2004). Money is placed into their reserve accounts, increasing the amount of capital banks can lend to their customers (corporations and individuals). With larger reserve pools, banks are able to lend money at a lower interest rate.

Interest Rates and Bank Profitability

Many studies in extant literature have examined the relationship between sovereign monetary policy and bank profitability, but only few have focused on interest rates specifically (Borio et al., 2017). Borio et al. (2017) discusses various determinants of bank profitability, and how interest rates can be expected to affect them. One profitability determinant is net interest income. This is the income generated from banks’ lending money to individuals and organizations and charging interest in return. As Borio et al. (2017) points out, there are two mechanisms that define the relationship between the effective federal funds rate and net interest income: the retail deposits endowment effect and the quantity effect.
The retail deposits endowment effect refers to the relation between the effective federal funds rate and the net interest earned on deposits. Typically, the interest paid from banks to customers for bank deposits is marked down from market rates. The difference between these two rates is known as the net interest margin (NIM). During periods of high interest rates, this margin expands, and banks turn a higher profit. Conversely, bank deposit rates cannot dip below zero; therefore, as market rates drop, the markdown to market for bank deposits must be compressed (Borio et al. 2017). This reduces NIM and banks lose out on profit. The quantity effect refers to the relation between the effective federal funds rate and loan demand. There is an erosion of profitability as interest rates increase due to the elasticity of loan demand (Borio et al. 2017). In simple terms, the demand for bank loans is more responsive to changes in interest rates than deposits, therefore higher rates could decrease net interest margin to a degree. However, the magnitude of the quantity effect is not sufficient to overcome the retail deposits endowment effect.

Wheelock (2016) explains another perspective on the relationship between interest rates and NIM. Banks typically tend to “lend long and borrow short” (Wheelock, 2016, p.1), meaning the maturities for outstanding loans in a bank’s portfolio are longer than the maturities of deposits funding the bank’s activities (their cost of funding). This would mean that as interest rates fall, funding costs would fall much faster, therefore increasing net interest margin in the short term (Wheelock 2016). This, however, would begin to level out over time as longer-maturity loans are issued at the lower rate. This may suggest that as long as interest rates remain low for a long period of time, the retail endowment effect will ensue and NIM will be squeezed.
Audit Risk and Fee Pressure

While a lower effective federal funds rate can affect all types of businesses, the rate has a particularly strong relationship with bank profitability. Specifically, as when the EFFR is lower, banks earn lower profits. Prior audit fee literature suggests poor firm performance results in downward fee pressure. When firms are less profitable managers take actions to cut costs and these actions include negotiating lower fees. Ettredge et al. (2014) provide evidence of downward fee pressure during the most recent economic recession. Similarly, Christensen et al. (2014) find that during the same recession, the correlation between risk and fees became materially weaker. This suggests the lower levels of bank profitability associated reductions in the effective federal funds rate will inject downward pressure into audit fee negotiations.

Alternatively, a lower effective federal funds rate and reduced bank profitability may result in higher audit fees. Audit fees are primarily driven by auditor effort, and auditor effort is driven primarily by risk (DeFond and Zhang, 2014). The extant literature suggests during periods of low interest rates banks are likely to be riskier clients for two reasons. First, banks make riskier decisions when profits are lower (Bikker and Vervliet, 2018; Altunbas, 2010). Risk-taking for banks can happen through two channels: income diversification, and/or high yield investing. With income diversification, institutions will find new ways to make money outside of their core business model. With high yield investing, banks will find riskier, but more profitable assets to invest in rather than Treasuries or other bank reserves. In response to low interest rates banks expand in areas outside their core markets, extend their range of services, shift investment strategies and establish new lines of business (Bikker and Vervliet, 2018). Second, firms with lower levels of profitability have additional incentives to manage earnings and the auditing standards identify lower profitability as a factor the auditor must consider to be a condition
indicative of higher risk. Assuming either of these two factors causes the auditor to increase their risk assessment, lower levels of profitability will inject upward pressure into audit fee negotiations.

**Hypothesis**

While the extant literature suggests audit fees are discounted when a client experiences economic stress, these studies focus primarily on macro-level economic stress, and represent a subset of the extant literature (Beck and Mauldin, 2014; Christensen et al, 2014). Studies that examine the relation between less pervasive forms of economic stress and audit fees provide consistent evidence of an inverse relation between profitability and audit fees (e.g. Walker and Casterella, 2000; Hay, Knechel, and Wong, 2006; DeFond and Zhang, 2014). Because a lower effective federal funds rate is a condition that will only impact a subset of the auditor’s clients, I expect an inverse relation between the federal funds rate and audit fees. I state my hypothesis in its alternative form:

H1: Firm-years where the effective federal funds rate is low in more months will be associated with higher levels of audit fees.

**Methodology**

**Sample Selection**

The sample selection process starts with all firms for which fee data is available on the Audit Analytics database. I drop observations missing data on Compustat (106,041 observations) and outside the financial section (96,529 observations). I then drop observations missing the data
necessary for calculating the variables of interest (18,376 observations). This selection process yields a final sample of 3,332 observations.

| Table 1
Sample Selection |
<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Observations with audit fee data for 2000-2020 on Audit Analytics</td>
</tr>
<tr>
<td>Less:</td>
</tr>
<tr>
<td>Companies not available on Compustat</td>
</tr>
<tr>
<td>Companies not in the financial sector (SIC Codes 6000-6999)</td>
</tr>
<tr>
<td>Companies without the data necessary to calculate the control variables</td>
</tr>
<tr>
<td>Final Sample</td>
</tr>
</tbody>
</table>

Regression Model

Following Francis et al. (2005) and Fung et al. (2012), I estimate the following regression model to test my hypothesis:

\[
LAF = \beta_0 + \beta_1(LOW \ or \ MONTHS\_LOW) + \beta_2BIGN + \beta_3Spec + \beta_4Scale + \\
\beta_5CITYSIZE + \beta_6LTA + \beta_7SEG + \beta_8CATA + \beta_9QUICK + \beta_{10}DE + \beta_{11}ROI + \\
\beta_{12}FOREIGN + \beta_{13}OPINION + \beta_{14}YE + \beta_{15}LOSS + \beta_{16}Fixed\_effects + \epsilon,
\]

where:

- \(LOW\) = an indicator coded 1 if the effective federal funds rate was below 2% for at least nine of 12 months in the year, and 0 otherwise;
- \(MONTHS\_LOW\) = the number of months in a year the effective federal funds rate was below two percent;
- \(LAF\) = natural log of audit fees (in thousands of dollars);
- \(BIGN\) = indicator coded 1 if the auditor is in the big 4, and 0 otherwise;
- \(Spec\) = indicator variable coded 1 for auditors that are city industry leaders, and 0
otherwise;

\( Scale = \) percentile rank of the city-industry number of audit clients (NClients) for each

Big N audit firm (variable values range from 0.01 to 1);

\( CITYSIZE = \) natural log of aggregate audit fees for all firms audited by the company’s

auditor for each city;

\( LTA = \) natural log of total assets (in millions of dollars);

\( LSEG = \) natural log of the number of unique business segments;

\( CATA = \) ratio of current assets to total assets;

\( QUICK = \) ratio of current assets (excluding inventories) to current liabilities;

\( DE = \) ratio of long-term debt to total assets;

\( ROI = \) ratio of earnings before interest and tax to total assets;

\( FOREIGN = \) proportion of total sales from foreign operations;

\( OPINION = \) indicator variable coded 1 for modified audit report, and 0 otherwise;

\( YE = \) indicator variable coded 1 for non-December 31 year-end, and 0 otherwise;

\( LOSS = \) indicator variable coded 1 if loss in current fiscal year, and 0 otherwise;

\( FixedEffects = \) year indicator variables; and

\( \varepsilon = \) random-error term.

The variables of interest are \( LOW \) and \( MONTHSLOW \). \( LOW \) is an indicator variable coded 1 if the effective federal funds rate was below 2% for at least nine of 12 months in a year. I chose 2% because it approximates the average fed funds rate over the past 10 years. \( MONTHSLOW \) is a continuous measure, defined as the number of months within a year the
effective federal funds rate was below the 2% threshold. The dependent variable, \( LAF \) is the natural log of audit fees in thousands of dollars.

Following Fung et al. (2012), I use control variables that capture other audit fee determinants. I use variables that control for firm size (\( LTA \)), fiscal year-end (\( YE \)), audit opinion (\( OPINION \)), and other measures that capture complexity and risk. The complexity and risk variables include \( LSEG, FOREIGN, CATA, DE, LOSS, QUICK, \) and \( ROI \).

**Results**

**Descriptive Statistics**

Table 1 reports descriptive statistics for all variables. All continuous variables are winsorized at the 1 and 99 percent levels. The mean for \( MONTHS_{LOW} \) suggests the effective federal funds rate is below 2% for nine of twelve months in the average year. The binary variable \( LOW \) is coded 1 in 69 percent of firm-years. The value of the dependent variable, \( LAF \), is consistent with prior research (Fung et al., 2012). The mean (median) audit fee is $1,338,000 ($331,000). Descriptive statistics for all control variables are consistent with prior research (Fung et al., 2012).
Audit Fees

My hypothesis predicts the effective federal funds rate will be inversely associated with audit fees for firms in the banking industry. To test this hypothesis, I examine whether $LOW$ and $MONTHS\_LOW$ are positively associated with $LAF$. In Table 3, I use ordinary least square regression to examine the relation between these variables. Column (1) reports results from the

Table 2

<table>
<thead>
<tr>
<th>Variable</th>
<th>n</th>
<th>Mean</th>
<th>Median</th>
<th>Q1</th>
<th>Q3</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUDIT_FEES</td>
<td>3,332</td>
<td>1,338,880</td>
<td>331,000</td>
<td>76,980</td>
<td>1,288,615</td>
<td>2,839,411</td>
</tr>
<tr>
<td>LAF</td>
<td>3,332</td>
<td>12.66</td>
<td>12.71</td>
<td>11.25</td>
<td>14.07</td>
<td>1.84</td>
</tr>
<tr>
<td>LOW</td>
<td>3,332</td>
<td>0.69</td>
<td>1.00</td>
<td>0.00</td>
<td>1.00</td>
<td>0.46</td>
</tr>
<tr>
<td>MONTHS_LOW</td>
<td>3,332</td>
<td>8.54</td>
<td>12.00</td>
<td>1.00</td>
<td>12.00</td>
<td>5.05</td>
</tr>
<tr>
<td>BIGN</td>
<td>3,332</td>
<td>0.57</td>
<td>1.00</td>
<td>0.00</td>
<td>1.00</td>
<td>0.49</td>
</tr>
<tr>
<td>SPEC</td>
<td>3,332</td>
<td>0.59</td>
<td>1.00</td>
<td>0.00</td>
<td>1.00</td>
<td>0.49</td>
</tr>
<tr>
<td>SCALE</td>
<td>3,332</td>
<td>0.32</td>
<td>0.18</td>
<td>0.18</td>
<td>0.42</td>
<td>0.19</td>
</tr>
<tr>
<td>CITYSIZE</td>
<td>3,332</td>
<td>15.62</td>
<td>15.87</td>
<td>13.82</td>
<td>17.63</td>
<td>2.47</td>
</tr>
<tr>
<td>LTA</td>
<td>3,332</td>
<td>4.72</td>
<td>5.12</td>
<td>2.70</td>
<td>7.08</td>
<td>3.32</td>
</tr>
<tr>
<td>LSEG</td>
<td>3,332</td>
<td>0.55</td>
<td>0.00</td>
<td>0.00</td>
<td>1.10</td>
<td>0.66</td>
</tr>
<tr>
<td>CATA</td>
<td>3,332</td>
<td>0.51</td>
<td>0.50</td>
<td>0.24</td>
<td>0.77</td>
<td>0.31</td>
</tr>
<tr>
<td>QUICK</td>
<td>3,332</td>
<td>8.19</td>
<td>1.48</td>
<td>0.87</td>
<td>3.04</td>
<td>51.72</td>
</tr>
<tr>
<td>DE</td>
<td>3,332</td>
<td>0.20</td>
<td>0.06</td>
<td>0.00</td>
<td>0.25</td>
<td>0.51</td>
</tr>
<tr>
<td>ROI</td>
<td>3,332</td>
<td>-1.27</td>
<td>0.03</td>
<td>-0.08</td>
<td>0.10</td>
<td>15.08</td>
</tr>
<tr>
<td>FOREIGN</td>
<td>3,332</td>
<td>0.12</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.29</td>
</tr>
<tr>
<td>OPINION</td>
<td>3,332</td>
<td>0.16</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.37</td>
</tr>
<tr>
<td>LOSS</td>
<td>3,332</td>
<td>0.42</td>
<td>0.00</td>
<td>0.00</td>
<td>1.00</td>
<td>0.49</td>
</tr>
<tr>
<td>YE</td>
<td>3,332</td>
<td>0.78</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>0.41</td>
</tr>
</tbody>
</table>

Table 2 presents descriptive statistics for the sample comprising 3,332 firm-year observations. All variable definitions are provided in Appendix A.
estimation of Model (1) using the full sample and shows the coefficient on \(LOW\) is positive and significant \((p < 0.01)\). Column (2) reports results from the estimation of Model (1) using the full sample and shows the coefficient on \(MONTHS_{LOW}\) is positive and significant \((p < 0.01)\). The positive coefficients associated with both variables suggest in firm-years where the effective federal funds rate is lower are associated with higher fees. In sum, the evidence presented in Table 3 supports my hypothesis.
TABLE 3
Relation Between Low Interest Rates and Audit Fees

<table>
<thead>
<tr>
<th>Variable</th>
<th>Est.</th>
<th>P-Val</th>
<th>Sig.</th>
<th>Est.</th>
<th>P-Val</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>LOW</td>
<td>0.563</td>
<td>0.00</td>
<td>***</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MONTHS_LOW</td>
<td></td>
<td></td>
<td></td>
<td>0.047</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>BIGN</td>
<td>-0.010</td>
<td>0.92</td>
<td></td>
<td>-0.010</td>
<td>0.92</td>
<td></td>
</tr>
<tr>
<td>SPEC</td>
<td>0.220</td>
<td>0.00</td>
<td>***</td>
<td>0.220</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>SCALE</td>
<td>-0.948</td>
<td>0.00</td>
<td>***</td>
<td>-0.948</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>CITYSIZE</td>
<td>0.218</td>
<td>0.00</td>
<td>***</td>
<td>0.218</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>LTA</td>
<td>0.393</td>
<td>0.00</td>
<td>***</td>
<td>0.393</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>LSEG</td>
<td>0.230</td>
<td>0.00</td>
<td>***</td>
<td>0.230</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>CATA</td>
<td>0.446</td>
<td>0.00</td>
<td>***</td>
<td>0.446</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>QUICK</td>
<td>-0.002</td>
<td>0.00</td>
<td>***</td>
<td>-0.002</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>DE</td>
<td>0.119</td>
<td>0.00</td>
<td>***</td>
<td>0.119</td>
<td>0.00</td>
<td>***</td>
</tr>
<tr>
<td>ROI</td>
<td>-0.005</td>
<td>0.01</td>
<td>***</td>
<td>-0.005</td>
<td>0.01</td>
<td>***</td>
</tr>
<tr>
<td>FOREIGN</td>
<td>0.031</td>
<td>0.73</td>
<td></td>
<td>0.031</td>
<td>0.73</td>
<td></td>
</tr>
<tr>
<td>OPINION</td>
<td>0.142</td>
<td>0.07</td>
<td>*</td>
<td>0.142</td>
<td>0.07</td>
<td>*</td>
</tr>
<tr>
<td>LOSS</td>
<td>0.115</td>
<td>0.01</td>
<td>**</td>
<td>0.115</td>
<td>0.01</td>
<td>**</td>
</tr>
<tr>
<td>YE</td>
<td>0.069</td>
<td>0.34</td>
<td></td>
<td>0.069</td>
<td>0.34</td>
<td></td>
</tr>
<tr>
<td>INTERCEPT</td>
<td>6.689</td>
<td>0.00</td>
<td>***</td>
<td>6.689</td>
<td>0.00</td>
<td>***</td>
</tr>
</tbody>
</table>

Year F.E.      | Yes |       | Yes |
Robust SE      | Yes |       | Yes |
Adj. R2         | 0.864 | 0.864 |      |
n               | 3,332 | 3,332 |      |

Table 3 presents the results from the estimation of Model (1). The dependent variable is LAF. *, **, and *** represent significance levels of 0.10, 0.05, and 0.01, respectively, using a 2-tailed test for all variables. All continuous variables are winsorized at the 1st and 99th percentiles. Year indicator variables are omitted for brevity. All variable definitions are provided in Appendix A.
Conclusion

The objective of my research was to examine the role of short-term interest rates in bank profitability and audit pricing for financial institutions. The literature suggested multiple possible scenarios, of which indicated both upward and downward fee pressure when rates are low. Audit fees may be higher for financial institutions when the EFFR is low due to a higher level of risk taken on by the auditor. This risk could be a function of riskier investing or income diversification for banks as their net interest income is squeezed. Conversely, audit fees may be lower for financial institutions when the EFFR is low due to downward fee pressure from fee negotiation. Lowered interest rates are typically a result of an economic recession or downturn, therefore low rates would indicate economic instability. In order to maintain client relationships (their business), audit firms commonly accept negotiation of fees, especially in a weaker economy. I expected audit fees to be materially higher (inverse relation) during periods of low interest rates. My basis for this expectation was that the risk for auditors heavily outweighed any fee negotiation. The results of the simple regression indicated this to be true, however there is potential that other factors could exist beyond what is outlined in my research.

Being the first to examine the relationship between the EFFR and audit fees, my research makes several contributions to the extant literature. First, it adds a new perspective to a stream of literature surrounding financial institutions and profitability; However, my focus is partial to short-term rates only. Second, my research contributes to a stream of literature surrounding audit fee negotiations. I specifically explore one sector of the economy, the financial sector, but still consider the broader idea of fee negotiation during times of economic stress. Finally, my research contributes a new factor to the literature, the EFFR, that, in conclusion, has a significant impact on audit fees.
References


