



A Study of Related Party Transactions, Operational Risks and Audit Fees from the Perspective of the Nature of Ownership

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Abstract. The related party transaction model may exacerbate the operational risk of listed companies in terms of bargaining power, conversion of related investment costs, etc., which in turn may affect audit fees. Studies have focused on the impact of related party transactions on audit behaviour, with little literature focusing on the mechanisms at play. This paper empirically analyzes the impact of related party transactions on audit fees based on the operational risk theory perspective by selecting relevant data of manufacturing companies listed in Shanghai and Shenzhen A-shares from 2012-2021. The results show that related party transactions significantly exacerbate the concentration of business risk in firms, which in turn raises audit fees, i.e. business risk plays a mediating role in the impact of related party transactions on audit fees. Further study, after distinguishing the nature of ownership, the empirical results show that the positive relationship between related party transactions and audit fees is more significant in non-state owned enterprises, providing empirical evidence to support reasonable audit pricing by auditors.

Keywords: Related party transactions; audit fees; operational risk; nature of ownership

1 Introduction

The audit fee is the auditor's fee for audit services to the business and is the result of the auditor's choice after taking into account factors such as audit cost, audit quality and audit risk. Its empirical research began with the audit cost model proposed by Simunic in 1980 and was extended by (HoustonC, 1999) after further decomposition of audit risk, forming a more mature area of research to date. Most domestic scholars have studied audit fees from the perspectives of surplus management practices (Wu Lina, 2003), audit changes (Shuang Li and Xi Wu, 2004), M&A goodwill (Chunmei Zheng and Xiao Li, 2018) and firm size and brand (Qifeng Zhang et al., 2017).

In the context of the current emerging plus transition economy, China's market economy system is not yet perfect, and economic and social development is heavily influenced by Confucian culture, favours and relationships can also be considered as a

business resource to be used in market transactions. In order to reduce the high transaction costs arising from incomplete external markets, firms are more willing to choose to establish business models based on a network of familiar, trusting relationships, i.e. related party transactions (Hongxing Fang and Yong Zhang, 2016). Related party transactions are those where an enterprise's sales activities are dependent on a small number of related enterprises, and the extent to which an enterprise relies on related party transactions is determined by the related transactions to the main related enterprises and the proportion of sales. For listed companies in China, related party transactions may not only affect the various stages of an enterprise from the supply of raw materials, production of goods to sales, but may also affect the enterprise's investment and financing policies, investment in product research and development, the extent of surplus management, etc., becoming factors that affect the enterprise's business risks to varying degrees. For listed companies, enterprises with a higher degree of related party transactions rely on a few downstream enterprises for their operations. At this time, downstream enterprises have stronger bargaining power, which may force enterprises to improve product quality and lower product prices in the production process, thus affecting the performance of enterprises and bringing about an increase in enterprise business risks (Jun Chen et al., 2015).

Most of the existing literature has only examined the direct impact of audit fees, while little literature has examined the impact of related party transactions on audit fees based on an operational risk perspective. Related-party transactions have now become a norm in the trading patterns of companies in the supply chain in our related-party social networks. Related party transactions can either be a winning strategy for companies competing in the product market or a falling stone for companies increasing their risk of insolvency. This paper attempts to incorporate related party transactions, corporate business risk and audit fees into the model for research, focusing on the following issues: (1) how the mechanism of corporate business risk influence on the relationship between related party transactions and audit fees manifests itself and whether it exacerbates or mitigates this effect; and (2) whether the effect of related party transactions on audit fees persists after the nature of ownership is distinguished.

The possible contributions of this paper are: (1) examining the effect of operational risks faced by listed manufacturing companies on audit fees from a risk perspective, expanding the study of the economic consequences of corporate operational risks and the factors influencing audit fees; (2) Incorporating related party transactions, corporate business risk and audit fees as a whole into the research framework, the mediating role of corporate business risk on the relationship between related party transactions and audit fees was examined; (3) After distinguishing the nature of ownership, the mechanism of the role of related party transactions on audit fees is further examined from the perspective of the nature of the enterprise, which provides a reference for the auditor and the regulator's decision making and supervision.

2 Theoretical basis and research hypothesis

According to the transaction cost theory, due to the incomplete nature of contracts and the imperfect legal system, enterprises have to bear high transaction costs to enter into contracts with related enterprises, and are therefore motivated to reduce transaction costs by forming a network of related party transactions. Chinese firms are more likely to choose related party transactions, both in terms of concentrated shareholding structures and political and business relationships, which are highly likely to facilitate related party transactions upstream and downstream of the firm (Zengquan Li, 2017). The higher the level of related party transactions, the higher the proportion of sales with the main related enterprises, which shows that the enterprise is more dependent on the enterprises forming a stable relationship. As the level of related party transactions gradually increases, the position of the enterprise and the main related enterprises will change, and when the bargaining power of the related enterprises exceeds that of the enterprise, the enterprise will be forced to produce higher quality products according to the requirements of the related enterprises, or to reduce the selling price of the products, or to postpone the collection of payments. In addition, a few related firms may terminate their relationship transactions with the firm at any time and may also enter into new related party transactions with the firm's product competitors, impacting the firm's product operations and financial position (Maksimovic and Titman, 1991), increasing the firm's cash flow risk and putting the firm in financial distress (Wang, 2012). As a result, the accumulation of related party transactions is more likely to be a risk to the business and the auditor's identification of the risk of related party transactions with related companies increases the auditor's workload and therefore the audit fee. In addition, companies choose to engage high quality firm auditors to audit their annual results in order to signal to their affiliates that they are doing well, which also has an impact on audit fees. Based on the above analysis, the following hypotheses 1 and 2 are formulated.

H1: Related party transactions have a significant increase in audit fees.

H2: Operational risk plays a mediating role in the impact of related party transactions on audit fees.

Under China's current market economy system, the difference in the nature of ownership of enterprises has led to different characteristics in the choice of related party transactions between state-owned enterprises and non-state-owned enterprises. It has advantages in financing that non-state enterprises cannot match, and state-owned enterprises undertake government procurement and have more stable bargaining power in the face of affiliated enterprises, with less potential risk from the loss of affiliated enterprises. Accordingly, the extent of its related party transactions with related enterprises does not affect the strengthening effect of business risks on audit fees. For non-state enterprises, faced with a highly competitive market environment, they show a stronger reliance on relationship resources, a weaker market position and bargaining power in their relationships with associated enterprises, and are vulnerable to significant risks from the loss of major associated enterprises. Companies that lose affiliated companies are exposed to higher business risks. Therefore, for non-state owned enterprises, due to their lower level of resource

endowment and lack of competitiveness in the market, higher levels of related party transactions will expose them to increased business risks such as reduced bargaining power and loss of related companies, which will require higher risk compensation for audit fees. Based on this, this paper proposes hypothesis 3.

H3: Relative to SOEs, related party transactions increase the business risk of non-SOEs more significantly, and thus have a more pronounced effect on the elevated audit fees of non-SOEs.

3 Study Design

3.1 Sample Selection and Data Sources

This paper selects a sample of A-share manufacturing companies listed in Shanghai and Shenzhen from 2012 to 2021, and divides the sample by industry according to the new "Index of Industry Classification of Listed Companies" issued by the China Securities Regulatory Commission. On this basis, the data were screened as follows: (1) exclude the sample of ST and *ST companies (2) exclude samples with missing relevant variables (3) To eliminate the effect of extreme values, the continuous variables are Winsorized to shrink the tails on 0% to 1% and 99% to 100%. A final sample of 12,382 valid data was obtained. Financial data and related party business characteristics data are obtained from the CSMAR database.

3.2 Model Design and Design of Key Variables

In this paper, model(1) is constructed to test the impact of related party transactions on audit fees.

$$\text{LnFee} = \beta_0 + \beta_1 \text{Customer} + \beta_2 \text{OCF} + \beta_3 \text{QUICKER} + \beta_4 \text{IDP} + \beta_5 \text{Size} + \beta_6 \text{Lev} + \beta_7 \text{IND} + \beta_8 \text{YEAR} \quad (1)$$

Measurement of Business Risk

In this paper, the variance of Tobins' Q and ROE over the sample period are used to measure the business risk of firms respectively, following the method of Lin, Li (2009) and Zhenglin, Chen (2016).

Measurement of Audit Fees

This paper follows Buxi, Li and Pingxin, Wang (2006) in measuring audit fees as "(audit fees disclosed in the company's annual financial report / total assets) * 100".

Measurement of Related Party Transactions

Drawing on Xiongyuan, Wang (2014) and Jun, Chen et al. (2015), this paper selects (1) the amount of related transactions as a proportion of the firm's accounts receivable (CT) as a measure variable of related party transactions, which can be used as a

pass-through signal of related party transactions; and (2) the Herfindahl Index (CCHHI) to measure the extent of related party transactions of the firm.

Control Variables

Control variables include CF, QUICKER, IDP, Size, Lev, IND, YEAR. The relevant variable definitions are shown in Table 1.

Table 1. Variable definitions

Nature of variables	Variable name	Variable symbols	Calculation formula
Explained variables	Audit Fees	AuditFee	Audit fees/total assets*100%
	Explanatory variables	Related party transactions (Relation)	CT
		CCHHI	Herfindahl Index
		CusUnstable	Stability of top five customers for three consecutive years
Control variables	Business risks (Risk)	stROE	Variance of ROE
	Operating cash flow	CF	Net cash flow from operating activities/total liabilities
	Quick ratio	QUICKER	(Current assets - inventories)/current liabilities
	Percentage of independent directors	IDP	Number of independent directors/total number of board members
	Company size	Size	ln(Total assets)
	Gearing ratio	Lev	Total liabilities at end of period / Total assets at end of period
	Industries	IND	Industry control variables
	Year	YEAR	Annual control variables

4 Analysis of Empirical Results

4.1 Descriptive Statistics

Table 2 shows the results of descriptive statistics, the average annual audit fee (AuditFee) for companies listed in the A-share manufacturing sector over the period 2012-2021 is 0.0351 with a standard deviation of 0.0371, indicating a relatively small fluctuation in audit fees. The mean value of related party transactions (CT) between firms and related enterprises is 19.7122 with a standard deviation of 2.3166, indicating that Wei, a listed manufacturing company, relies on related party transactions and has a minimum value of 13.6177 and a maximum value of 24.7243, indicating that the extent to which firms rely on related party transactions spans a

wide range across firms. The maximum values of the variance of Tobins' Q (stTobins' Q) and the variance of ROE (stROE), a measure of business risk, were 4.5963 and 1.2423 respectively, while the minimum values were 0.0774 and 0.0062 respectively, indicating that the level of business risk varied considerably across firms. All other control variables were largely in line with expectations.

Table 2. Descriptive statistics

Variable name	Sample size	Average value	Standard deviation	Minimum value	Maximum value
AuditFee	12382	0.035	0.037	0.001	0.001
CT	12382	19.7122	2.316	13.617	24.724
CCHHI	8786	0.041	0.069	0.001	0.411
CusUnstable	1366	0.654	0.166	0.222	1
stTobins'Q	12382	1.234	0.985	0.086	0.087
stROE	12382	0.086	0.311	0.003	2.198
CF	12382	0.044	0.077	-0.157	0.312
QUICKER	12382	2.221	2.911	0.179	19.123
IDP	12382	0.456	0.069	0.142	0.555
Size	12382	20.413	1.258	18.561	24.159
Lev	12382	0.385	0.303	0.045	0.897

4.2 Analysis of Regression Results

Related Party Transactions and Audit Fees

In order to test the hypothesis proposed in the previous section, this paper uses a mixed cross-sectional least squares (OLS) approach to verify the impact of related party transactions on audit fees, and the results are shown in Table 3. Columns (1) and (3) show that when no industry and year control variables are added, the coefficients of CT and CCHHI on related party transactions and AuditFee are 0.00553 and 0.0214, respectively, which are significantly positively correlated at the 5% and 1% levels, respectively. Columns (2) and (4) show that the coefficients on CT and CCHHI remain significantly positive at the 1% level after controlling for year and industry, respectively, and that the goodness of fit of the model has improved. The regression results columns (5) and (6) mainly present the impact of CusUnstable, the degree of stability of related party transactions, on audit fees. The coefficients of CusUnstable are 0.0352 and 0.0384 respectively, which are significantly positive at the 5% and 1% levels respectively, indicating that the more unstable a firm's relationship with its related companies, the higher the audit fees. The above results indicate that related party transactions have a significant elevating effect on audit fees. Specifically, related party transactions are perceived by the auditor as a business risk to the firm, and related party transactions increase audit risk, and therefore the auditor will adopt a strategy to increase audit fees. Therefore, hypothesis 1 is verified.

Table 3. Related party transactions and audit fees

	(1)	(2)	(3)	(4)	(5)	(6)
	CT		CCHHI		CusUnstable	
	AuditFee	AuditFee	AuditFee	AuditFee	AuditFee	AuditFee
CT	0.005*** (2.454)	0.008*** (2.856)				
CCHHI			0.024*** (2.753)	0.024*** (3.211)		
CusUnstable					0.029** (2.245)	0.041*** (3.155)
CF	-0.011*** (-2.111)	-0.010*** (-2.255)	0.008*** (-1.391)	0.008*** (-1.639)	-0.179*** (-5.632)	-0.201*** (-5.557)
QUICKER	0.001** (2.489)	0.001** (2.745)	0.001*** (2.614)	0.003* (2.014)	0.0059*** (4.522)	0.0054*** (4.123)
IDP	0.031*** (6.999)	0.029** (6.159)	0.025*** (5.987)	0.021*** (5.147)	0.091*** (2.314)	0.055 (1.326)
Size	-0.017*** (-36.487)	-0.02 (-36.28)	-0.017*** (-30.452)	-0.017*** (-32.478)	-0.021*** (-5.287)	-0.027*** (-4.123)
Lev	0.012*** (4.987)	0.011** (4.254)	0.015*** (4.222)	0.014*** (4.321)	0.025*** (1.587)	0.039*** (2.654)
Constant	0.426*** (49.566)	0.411*** (41.26)	0.4987** (39.15)	0.451*** (31.254)	0.997*** (21.256)	0.901*** (15.245)
IND&Year	Uncontroll ed	Controlled	Uncontroll ed	Controlled	Uncontroll ed	Controlled
N	12382	12382	8786	8786	1366	1366
Adjust-R ²	0.356	0.352	0.315	0.340	0.471	0.490

Related Party Transactions, Operational Risk and Audit Fees

From the previous analysis, it is clear that the auditor's pricing decisions will inevitably take into account the risk factors of the audited company. The core affiliates formed by related party transactions occupy favourable bargaining positions or force companies to make concessions in terms of product quality and payment terms, bringing about an increase in operational risk, and thus the effect of related party transactions on audit fees will also be affected by operational risk. In order to explore whether operational risk plays a mediating effect in the process of related party transactions affecting audit fees, the following mediating effect test model was designed:

$$\text{AuditFee} = \beta_0 + \beta_1 \text{Customer} + \beta_2 \text{CF} + \beta_3 \text{QUICKER} + \beta_4 \text{IDP} + \beta_5 \text{Size} + \beta_6 \text{Lev} + \beta_7 \text{IND} + \beta_8 \text{YEAR} \tag{2}$$

$$\text{Risk} = \beta_0 + \beta_1 \text{Customer} + \beta_2 \text{CF} + \beta_3 \text{QUICKER} + \beta_4 \text{IDP} + \beta_5 \text{Size} + \beta_6 \text{Lev} + \beta_7 \text{IND} + \beta_8 \text{YEAR} \tag{3}$$

$$\text{AuditFee} = \beta_0 + \beta_1 \text{Risk} + \beta_2 \text{Customer} + \beta_3 \text{CF} + \beta_4 \text{QUICKER} + \beta_5 \text{IDP} + \beta_6 \text{Size} + \beta_7 \text{Lev} + \beta_8 \text{IND} + \beta_9 \text{YEAR} \tag{4}$$

Where AuditFee indicates audit fees; Risk is an indicator of mediating effects, indicating the business risk of the firm, and is expressed using the variance between the firm's Tobins'Q and ROE, stTobins'Q and stROE. Customer indicates related party transactions between a company and a related company, including the related transaction CT, the Herfindahl index CCHHI and the customer stability CusUnstable. Other variables defined as in model (1).

The specific validation steps are as follows:(1) Regressing the related party transaction variable on audit fees and if the coefficient on the related party transaction variable is significant, it indicates that audit fees are influenced by related party transactions. (2) Regressing the related party transaction variable on the business risk variable separately, if the coefficient on the related party transaction variable is significant, it indicates that related party transactions affect business risk. (3) Putting related party transactions, operational risk and audit fees into the model at the same time for regression testing, if the coefficient of related party transactions is insignificant or decreases in significance, it proves that operational risk plays a mediating effect in the process of related party transactions affecting audit risk. Tables 4, 5 and 6 show the results of the empirical tests. Table 4 shows that all related party transactions have a positive and significant impact on audit fees, with related party transactions significantly increasing the level of audit fees for firms. Table 5 shows that the impact of related party transactions on business risk is significantly positive, indicating that related party transactions have the effect of increasing business risk. Table 6 shows that although the coefficients on related party transactions remain significant, they are all less significant, indicating that related party transactions do increase business risk and hence audit fees, and that business risk is partly mediating the effect of related party transactions on audit fees. Therefore, hypothesis 2 of this paper is tested.

Table 4. Connected transactions, operational risk and audit fees

Variables	(1)	(2)	(3)	(4)	(5)
	AuditFee	stTobins'Q	AuditFee	stROE	AuditFee
CT	0.008*** (2.865)	0.278*** (7.125)	0.0033* (1.569)	0.069*** (3.158)	0.022*** (6.258)
stTobins'Q			0.009*** (9.687)		
stROE					0.014*** (3.454)
Other control variables	Controlled	Controlled	Controlled	Controlled	Controlled
Constant	0.412*** (44.588)	8.957*** (32.154)	0.341*** (59.241)	1.158*** (5.288)	0.789*** (40.569)
IND&Year	Controlled	Controlled	Controlled	Controlled	Controlled
N	12382	12382	12382	12382	12382
Adjust-R ²	0.352	0.312	0.401	0.212	0.451

Table 5. Herfindahl Index, operational risk and audit fees

Variables	(1)	(2)	(3)	(4)	(5)
	AuditFee	stTobins'Q		stROE	
		stTobins'Q	AuditFee	stROE	AuditFee
CCHHI	0.024*** (3.121)	0.702*** (4.815)	0.018** (2.159)	0.184*** (3.956)	0.026*** (3.087)
stTobins'Q			0.009*** (8.477)		
stROE					0.028*** (3.151)
Other control variables	Controlled	Controlled	Controlled	Controlled	Controlled
Constant	0.489*** (35.111)	9.456*** (31.258)	0.348*** (47.151)	0.951*** (8.157)	0.544*** (45.287)
IND&Year	Controlled	Controlled	Controlled	Controlled	Controlled
N	8786	8786	8786	8786	8786
Adjust-R ²	0.340	0.333	0.358	0.244	0.354

Table 6. Customer Stability, operational risk and audit fees

Variables	(1)	(2)	(3)	(4)	(5)
	AuditFee	stTobins'Q		stROE	
		stTobins'Q	AuditFee	stROE	AuditFee
CusUnstable	0.041*** (3.214)	0.315* (2.001)	0.032*** (2.987)	0.091*** (2.874)	0.037*** (3.089)
stTobins'Q			0.022*** (6.897)		
stROE					0.028 (1.745)
Other control variables	Controlled	Controlled	Controlled	Controlled	Controlled
Constant	0.980*** (14.569)	10.945*** (12.258)	0.735*** (13.566)	1.099*** (5.487)	0.958*** (15.014)
IND&Year	Controlled	Controlled	Controlled	Controlled	Controlled
N	1366	1366	1366	1366	1366
Adjust-R ²	0.490	0.311	0.551	0.248	0.506

Micro Perspective on the Impact of the Nature of Property Rights

In order to examine the difference in the effect on audit fees caused by the different preferences presented by state-owned and non-state-owned enterprises in the choice of related party transactions, this paper introduces a dummy variable for the nature of property rights based on model (1), divides the full sample into state-owned and non-state-owned enterprises, and performs group regression tests on this basis. In the full sample, the sample size of state-owned enterprises was 4049, accounting for 35.38% of the total sample; the sample size of non-state-owned enterprises was 7458,

accounting for 63.99% of the total sample. The regression results are shown in Table 7. The results in columns (2)(4)(6) are all regressions of related party transactions on audit fees in the sample of non-state owned enterprises, where the coefficients on CT, CCHHI and CusUnstable are all significantly positive at the 1% level. This result indicates that the effect of related party transactions on audit fees differs between state-owned and non-state-owned enterprises, with the risk effect of a firm's related party transactions being more pronounced in non-state-owned enterprises and having a more significant effect on the auditor's audit pricing decision. This may be due to the fact that SOEs naturally have good access to finance and sales channels, are more easily diversified in terms of risk and are in a stronger bargaining position in their relationships with related companies, whereas non-SOEs are more dependent on their own relationship resources and are therefore more exposed to the risk of related party transactions, and the auditor is unable to control the risk arising from related party transactions and therefore tends to adopt a premium strategy, requiring higher risk compensation for the audit fee.

Table 7. Property Rights Perspective on Related Party Transactions and Audit Fees

Variables	(1)		(2)		(3)		(4)		(5)		(6)	
	CT		CCHHI		CusUnstable							
	State-owned enterprises	Non-state enterprises	State-owned enterprises	Non-state enterprises	State-owned enterprises	Non-state enterprises	State-owned enterprises	Non-state enterprises	State-owned enterprises	Non-state enterprises	State-owned enterprises	Non-state enterprises
CT	0.001 (1.411)	0.008** (3.015)										
CCHHI			0.001 (0.109)	0.028*** (2.874)								
CusUnstable							0.015 (0.896)	0.044*** (3.056)				
Other control variables	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled
Constant	0.322*** (41.255)	0.547*** (35.111)	0.301*** (36.119)	0.611*** (28.556)	0.603*** (9.997)	1.331*** (13.258)						
IND&Year	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled	Controlled
N	4049	7458	2158	6258	552	711						
Adjust-R ²	0.511	0.347	0.521	0.369	0.454	0.611						

5 Research Conclusions and Recommendations

This paper analyses the mechanism of the impact of related party transactions on audit fees from an operational risk perspective, using a sample of manufacturing companies listed in Shanghai and Shenzhen A-shares from 2012-2021. The study found that: related party transactions exacerbate the concentration of business risk in a firm, which in turn has a positive impact on audit fees. Further research, after distinguishing the nature of ownership, shows that the positive relationship between

related party transactions and audit fees is more significant in non-state owned enterprises. The above findings reveal the positive impact of potential business risks arising from related party transactions on audit fees, providing empirical evidence for auditors to effectively consider corporate related party transactions when making audit fee decisions, as well as facilitating corporate information users to understand the behavioral decision factors of audit fees, and providing evidence to support managers of listed manufacturing companies to grasp the extent of related party transactions to control corporate business risks until they influence auditors' pricing decisions.

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