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Articles

Do auditors care about real earnings management in their audit fee decisions?

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Abstra

This stu ential
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Notes

1. For example, the other client characteristics include client satisfaction, bargaining power, governance mechanisms, and internal control quality. Auditor characteristics include auditor size, non-audit services, auditor change, direction of auditor change, auditor industry specialization. Finally, audit environments include Sarbanes-Oxley Act (SOX) passage, the legal regime of the country where the client is located, cross-listing, the education requirement for new accountants, and audit market competition (Palmrose 1986a, 1986b; Francis and Simon 1987; Simon and Francis 1988; Craswell, Francis, … stone and Bedard … nisenant, Sankara… ar 2004; Hay, Kne… Choi et al. 2009; Hu… y and Knechel …

2. Fr… 03), and Srinid… paper, namely, … ent.

3. Howe… dit fees and their me… bbott, Parker, a…

4. The measured REM from statistical models could be due to measurement errors rather than due to firms' actual earnings management through real operation adjustments.

5. Krishnan et al. (2013) report the pecking order of auditor response to risky clients: Auditors first charge higher audit fees as risk increases for clients with an acceptable level of risk. However, if the risk exceed the auditors' tolerance level, auditors resign from their clients. Thus, it is natural to examine the audit fee change first to look at auditors' responses before moving to their resignation decisions.

6. We use total accruals as the dependent variable of this model to measure the intensity of AEM instead of current accruals used in Dechow and Dichev (2002) because the competing variable (i.e. REM proxies) includes research and development expenditure (R&D), which is an investment in intangible assets, as one component. Including depreciation and amortization expenses, the latter of which is directly related to intangible assets and R&D expenditures, in measuring AEM variables allows more a reasonable comparison between AEM and REM. However, the main implications are unaltered when using current accruals to measure AEM proxies.

7. We first calculate the standardized ranks of each individual REM measures based on their raw values. Then we take the average of the standardized ranks of three REM proxies and use this average as the 'raw' value of the composite measure of REM (i.e.

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P_AbREM, respectively, and 741.5 is median AFEE in thousands.

13. Because the sample proportion for auditor change from a Big 5 (non-Big 5) to a non-Big 5 (Big 5) is very small, a change in a Big 5 indicator is mostly coded as zero, which could result in a spurious coefficient.

14. The variable INST_OWN has a value of one if institutional investors own any share in the firm, and zero otherwise. We alternatively measure institutional ownership using a continuous variable (i.e. the percentage of common shares owned by institutional investors to the outstanding shares). The results using this alternative measure are qualitatively similar. When the continuous INST_OWN is interacted with DAC and P_AbREM, the coefficients on DAC*INST_OWN and P_AbREM*INST_OWN are both positive and significant at the 1% level (DAC*INST_OWN = 1.011, t = 3.246; P_AbREM*INST_OWN = 0.403, t = 5.585). We retrieve institutional ownership data from Thomson-Reuters database.

15. Interestingly, we find that the coefficients on INST_OWN are always negative (and significant in column (2)), suggesting that auditors charge lower audit fees for firms with institutional investors. A potential reason for the negative coefficient is the reduced audit risk for such firms due to strong governance mechanisms (e.g. Griffin, Lont, and Sun 2008).

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