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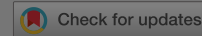
Articles

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

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Abstract

This study examines the effect of litigation risk on audit fee management related to accruals. This position is more auditors tests.

Keywords

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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. AbREM)

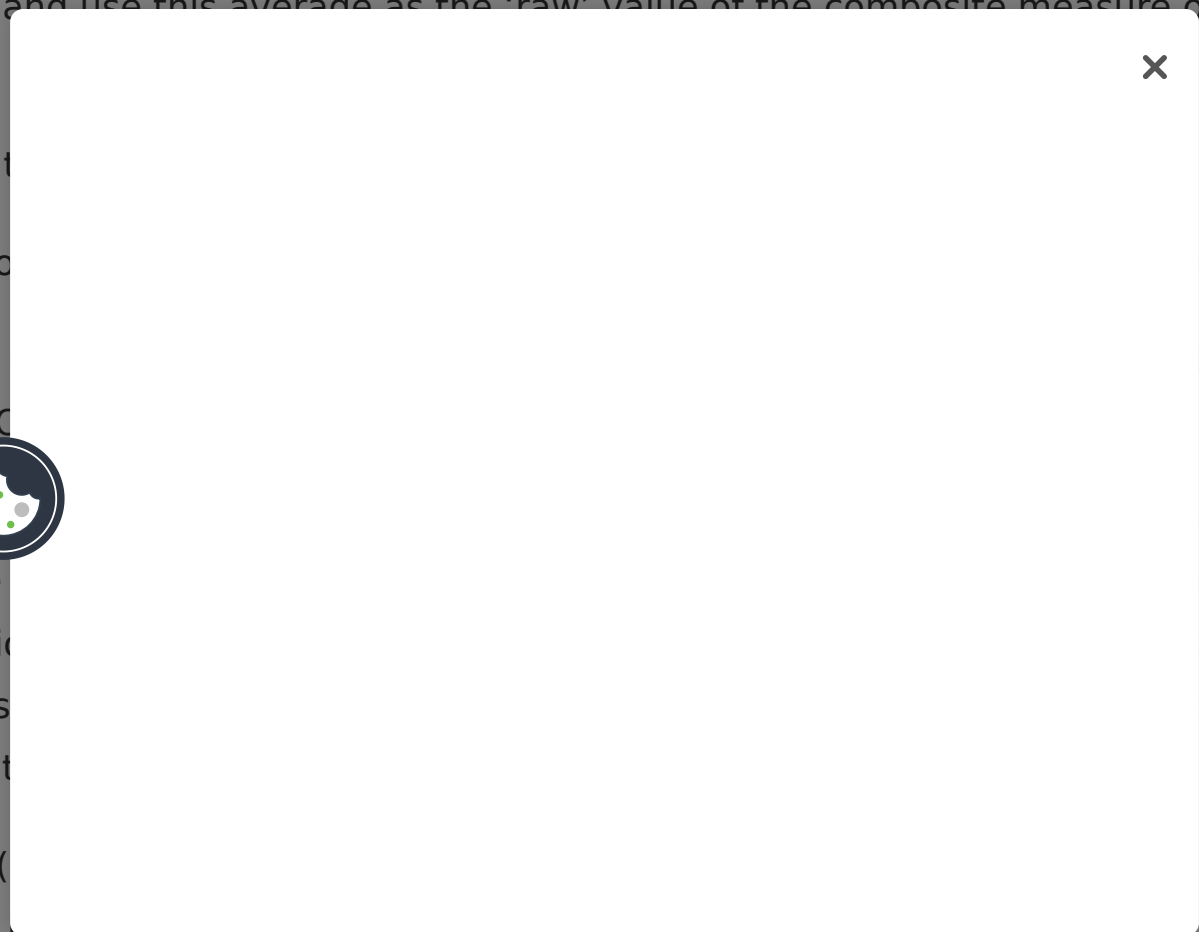
8. Note t

9. We co is study.

10. The values of DAC, P_AbCFC

11. T antly positive multivariate regression discretionary accruals at the 1% level in t

12. exp(.61 is median Ln(LE), C102 and C125 are the coefficients on, and the standard deviation of,



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](#)).

16. All firms with more financial

17. |DAC| are used instead of P_AbREM and P_AbREM| are used instead of |AbDiscE|, the direction of earnings management. Because earnings management is used to inflate



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