

NON-AUDIT SERVICE FEES, AUDITOR CHARACTERISTICS AND EARNINGS RESTATEMENTS

SORIN-SANDU VÎNĂTORU, GEORGE CALOTĂ *

ABSTRACT: *The objective of the study is to provide empirical evidence of the impact of non-audit services (NAS) as well as other auditor characteristics on auditor independence by testing the relationship of NAS fees to the occurrence of financial statement restatements. The authors tested whether firms that restate their financial statements have higher levels of total service fees or higher levels of NAS fees than non-restatement firms. The testing also includes an examination of the relationship between the audit firm size and the audit firm industry specialization to financial statement restatements. The study found only limited evidence to support the concept that firms with higher NAS fees are more likely to restate earnings. The study did find stronger evidence that the level of total fees paid to the audit firm is significant in the predictability of a restatement. Results demonstrate the necessity of regulations concerning NAS and conflict of interest.*

KEY WORDS: *auditor's fee; auditors; earnings; financial reporting*

1. INTRODUCTION

During the 1980s, the environment within many accounting firms focused on revenue generation and firm growth as the primary criteria for auditors to become partners an “up or out” or “whatever it takes” culture developed (Almer et al., 2000). The sale of non-audit services (NAS) became a major strategy for achieving firm growth. This strategy included linking a partner’s performance to the amount of NAS sold. In 1975, NAS represented 11 percent of the Big 8’s (now Big 4) total revenues. By 1998, NAS had grown to comprise 45 percent of the Big 5’s total revenues (GAO, 2003 a, b). The strategy was successful but with this new prosperity came criticism and concern about the conflict of interest perceived by regulators and the public. Amid increasing scrutiny and after independence violations were investigated by the SEC, the Big 5 firms began to spin-off their consulting arms in an attempt to appease the SEC

* *Assist.Prof., Ph.D., University of Craiova, Romania, vinatorus@yahoo.com
Ph.D. Student, Internal Auditor - Central Unit for Public Internal Audit Harmonization,
Ministry of Finance, Romania, gcalota2003@yahoo.com*

(Gilbert et al., 2001). By 2000, the consulting divisions of the firms had been sold or divested, resulting in NAS shrinking to approximately 30 percent of firm revenue.

The following year, the Enron and Arthur Andersen scandal would be exposed. Other corporate accounting scandals followed resulting in increased scrutiny of the accounting profession, particularly the incentive for auditors to continue the practice of joint provision of services. The Enron debacle brought this debate to the forefront when it was disclosed that Arthur Andersen received \$25 million in audit fees and \$27 million in NAS (Beattie and Fearnley, 2002). In the Enron example, not just non-audit fees but fees in general, exceeding \$50 million, raised questions about the economic dependence of the audit firm to its client and the conflict of interest fees created. Arthur Andersen's US Net Revenue was \$3.6 billion for their fiscal year ended August 31, 2000. This meant Enron alone would constitute 1 percent of the firm's annual revenue. The number of firm partners for the same time period totaled 1,313 which would mean the average partner revenue stream to the firm would be \$2.7 million indicating that the partners on the engagement for Enron would have placed a high value on retaining the client and its associated revenue stream.

At the same time, concerns over the quality of the financial information provided to the public and regulators were on the rise. In October 2002, the United States General Accounting Office (GAO, 2002) reported that although the number of companies restating financial statements constitutes a small percentage of publicly listed companies, the number of restatements related to accounting irregularities had increased by a staggering 145 percent from January 1997 to June 2002.

In combination, the perceived conflict of interest resulting from the joint provision of services and the increase in accounting irregularities, led to the passage of legislation that restricted such fees. This historic legislation has led to a growing academic interest in the question as to whether the payment of NAS fees impacts auditor independence.

This study adds to the small but growing literature that examines the relationship of joint provision of NAS fees to earnings management using restatement data (Agrawal and Chadha, 2005; Raghunandan et al., 2003; Kinney et al., 2004). These studies have generally found little or no effect of NAS fees on auditor independence and leaves researchers to question how important is the marketing pressure for NAS in comparison to actual NAS fees or whether the accounting profession is in a no win battle with public perception. This statement raises questions as to whether the actual providing of NAS can lead to impairment of independence or whether the need to market and sell these services leads to impairment.

This study directly compares auditor characteristics and auditor fees as explanatory factors in restatement risk. The study did find evidence that the level of total fees paid to the audit firm is significant in the predictability of a restatement. In addition, the study also found a negative correlation to audit firm industry specialization and a strong positive correlation to Big 5 audit firms. Overall, this study finds that auditor characteristics have much stronger explanatory power than auditor fees when it comes to predicting restatements.

This study adds to the existing research on restatements and auditor independence in three important ways. It is one of a growing number of studies to use

restatements as a proxy for earnings management rather than discretionary accruals or other methods. The database has been pre-scrubbed to include restatements limited to those arising from accounting irregularities. The previous studies employed various internet search techniques to create a population database. Third, this study includes the examination of additional sources of conflict of interest. Specifically, this study takes a closer look at the impact of auditor specialization and audit firm size and their relation to restatement risk.

1.1. Restatements and NAS fees

As previously stated, this study differs from many studies on earnings management and non-auditor fees in that it uses financial restatements as a proxy for earnings management. Other recent studies on NAS and earnings management have used alternative proxies such as analysis of discretionary or abnormal accruals (Frankel et al., 2002; Antle et al., 2002; Ashbaugh et al., 2003). However, the findings from these studies have been inconclusive. The use of discretionary accruals as a proxy for earnings management has proven to be a difficult methodology to use effectively and may be the reason for mixed study findings (Young, 1999). Beneish (2001) states the following with regard to using discretionary accruals as a proxy for earnings management:

The difficulties faced by aggregate accrual models suggest that studies of specific accruals, perhaps even case studies, are needed. One way in which one could assess the external validity of aggregate accrual models and learn about the exercise of discretion in specific industries is to study earnings restatements, the analysis of instances where firms restate earnings, e.g. where actual earnings management is more likely. Thus, restatements were used in this study as an alternative proxy for earnings management.

Following Beneish's recommendation for future research (2001), the use of restatements as a proxy for earnings management has been established in recent academic literature including Richardson et al. (2002), Raghunandan et al. (2003), Agrawal and Chadha (2005) and Kinney et al. (2004). Financial statement restatements are viewed as audit failures resulting from "the increasing reliance of audit firms on fees from non-audit services" (Raghunandan et al., 2003). Restatements provide a means for a direct test of the association between NAS and audit quality (Raghunandan et al., 2003).

Raghunandan et al. (2003) tested for an association between NAS and financial restatements based on the following research question: "Are firms that pay higher fees for NAS more likely to restate their financial statements?" The sample covered 110 firms drawn from SEC filings from 2000 to 2001 and compared the fees paid by the restatement sample to fee data from 3,481 firms filing proxies with the SEC from February 5, 2001 to August 31, 2002 (Raghunandan et al., 2003). The findings indicated that firms with restatements are not more likely to have unexpectedly high NAS, fee ratios or total fees. This study more than doubles the Raghunandan sample size to 250.

The Agrawal and Chadha (2005) study examined the effect of NAS fees on restatement probability using a sample of 318 firms of which 159 were US public companies that had restated earnings. The control firms were matched by industry and

size to the restatement firms. Fee measures included the proportion of NAS fees to total fees and a dummy variable for NAS fees greater than \$1 million. No strong association between NAS and restatements were found.

Kinney et al. (2004) examined the relationship between NAS fees and financial restatements using a data set prior to the heightened concern over NAS fees and financial reporting, covering 1995-2000. The sample included 617 restating SEC registrants matched with a non-restating firm that has the same SIC code, the same audit firm and similar size in total revenue. The study did not find a statistically significant association between fees for financial information system services or internal audit services, some association with unspecified NAS fees, and a negative association with tax services.

Overall, research on the impact of auditor size and NAS fees has usually shown negative or inconclusive results. One reason for this may be related to the pair matching methodologies used in some of these studies including Agrawal and Chadha (2005) and Kinney et al. (2004). While Raghunandan et al. (2003) compares the mean characteristics of restatement firms versus the mean characteristics of all non-restatement firms, the regressions in their paper were done with matched paired sampling. While matched paired sampling is common in auditing research methodologies, this approach has been criticized. For example, Carson and Hoyt (2003) point out that "Correlation between the matching variable (such as size) and the independent variable may produce coefficients that are biased and inconsistent." Of the three previous mentioned studies, only one of them (Agrawal and Chadha, 2005) also used auditor characteristics as explanatory variables. In fact, Kinney et al. (2004) employed matched pair by auditor so any conflict of interest effects from having a large auditor that offers non-auditor services could not be examined. The next section will review the literature on auditor characteristics and earnings management.

1.2. Restatements and auditor characteristics

This study examines the auditor characteristics of size and industry specialization which may be criteria reviewed by management in selecting an audit firm; thereby playing a role in the economic bond between auditor and client. One of the few studies to look at restatement risk and auditor size found no significant relationship (Agrawal and Chadha, 2005). While the research on NAS fees and restatements has found little or no evidence of conflict of interest, the largest auditor firms are the ones associated with offering the broadest range of NAS. While previous researchers have suggested that the largest auditor firms are chosen due to their high reputations of quality and independence and are thus less prone to conflict of interest (Ruddock et al., 2002; Francis et al., 1999), other research has produced contradictory results on auditor size and earnings management (Kim et al., 2003). This study enhances existing research by testing the auditor size variable in relation to financial statement restatements, finding a strong correlation between Big 5 firms and restatements.

Again referring to the economic bond of the client firm to the independent auditor, the concept that the firm paying for the audit has the ability to "hire and fire" the auditor, leads to other questions regarding the selection of audit firms. While there

are many considerations in selecting a public accounting firm to conduct an independent audit, one of the main criteria is that the auditor specializes in the client's industry. This is significant because it means that the audit firm is experienced in any unique accounting practices or issues within the industry. The firm, based on knowledge gained in the industry, should be better qualified than other firms, to design an audit program that would incorporate industry specific items. If a firm chooses an audit firm that does not have expertise in their industry, a question is raised as to why. Therefore, this study examined the relationship of auditor specialization and restatements and found a negative correlation.

2. HYPOTHESES

Regulators, financial statement users, and researchers are all concerned that higher total fees compromise auditor independence (Ashbaugh et al., 2003). Economic theory of auditor independence suggests that when client fees are a larger component of total firm fee revenue, there is an incentive for the auditor to compromise independence for important clients as measured by fee contribution (Chung and Kallapur, 2003). This economic bond between clients and their auditors is the main threat to auditor independence (Ashbaugh et al., 2003). Therefore, the first set of hypotheses tested was structured to disprove that independent auditors, in cases involving restatements, have compromised independence based on higher fee levels. The related hypotheses are:

H1(a). There is a positive relationship between higher total service fees paid to auditors and restatements.

H1(b). There is a positive relationship between the ratio of higher total service fees to total auditor revenue and restatements.

Second, the joint provision of NAS to audit clients has been considered an impairment of auditor independence by legislators and the public (Raghunandan et al., 2003). These fees is being particularly dangerous in terms of a conflict of interest. If NAS are, in fact, a source of conflict of interest and give the client additional bargaining power over the auditor, there should be a positive relationship between NAS and restatement risk. The related hypotheses are:

H2(a). There is a positive relationship between the ratio of non-audit service fees to total fees paid to auditors and restatements.

H2(b). There is a positive relationship between the ratio of non-audit service fees to total auditor's revenue and restatements.

H2(c). There is a positive relationship between NAS fees paid to auditors and restatements.

Empirical evidence on auditor size and earnings management has been inconsistent and contradictory. The Public Accounting Report's (PAR) Top 100 for 2001 and 2002 data indicate that the Big 5/Big 4 firms provided \$8.7 billion and \$5.9 billion in NAS in 2001 and 2002, respectively, compared to non-Big 5/Big 4 firms of \$850 and 800 million, respectively. According to the logic of H2(a),(b),(c), NAS leads to conflict of interest problems. However, the level of NAS fees received might not necessarily be the best indicator of conflict of interest. Simply offering NAS along with the concurrent pressure to market such services to audit clients might be as big if not a

greater predictor of conflict of interest. Since, the Big 5 audit firms generally offer the majority of NAS we expect them to face greater pressure to market NAS; hence, the following hypothesis is proposed:

H3(a). Big 5 audit firms are associated with firms registered with the SEC that restate their financial statements.

Finally, again referring to the economic bond of the client firm to the independent auditor, the concept that the firm paying for the audit has the ability to “hire and fire” the auditor leads to other questions regarding the selection of audit firms. One important criteria in selecting an audit firm that has received attention in the auditing literature as a possible explanatory factor for disclosure or fraud, is auditor industry specialization (AIS) (Carcello and Nagy, 2004, Dunn and Mayhew, 2004). This choice of whether a firm selects an audit firm with industry specialization is significant. For example, Carcello and Nagy (2004) find that firms who choose an auditor without specialization in their industry are more likely to engage in fraud. Krishnan (2003), found that auditors with client industry expertise mitigate accruals-based earnings management. To test the relationship between AIS and restatement risk, the following hypothesis is proposed:

H3(b). There is a positive relationship between the choice of an auditor outside the firm’s specialization and restatements.

3. THE VARIABLES

For the dependent variable we simply used a dummy variable, which carries a value of 1 if the firm is a restatement firm and a value of 0 for a non-restatement firm. This is similar the approach used in Kinney et al. (2004).

We used annual revenues as the primary control variable for size which is similar to Kinney et al. (2004). As tests for sensitivity of the results, we also used total assets and total number of employees as alternative measures of size. The profitability of the firms was measured as a return on assets in two ways. The primary way we measured profitability was by using net cash flow from operations divided by total assets. This is often considered a more reliable measure of the financial health of the firm than the traditional measure of net income to total assets. Net income can be influenced by many factors that do not relate to operations or that are subject to manipulation. However, as a test of sensitivity, we used the ratio of net income to total assets as a secondary measure of profitability.

The firm industry dummy variables were defined by the first digit in the SIC number and were denoted as SIC. The categories ranged one through seven as follows:

- agriculture, mining, and construction;
- manufacturing;
- technology;
- transport, communications, and utilities;
- wholesale and retail;
- financial services; and
- services.

For each firm, the firm industry variable carried a value of 1 with the other six groupings carrying a 0 value.

4. CONCLUSION AND IMPLICATIONS

The results of this paper show that characteristics of the auditor rather than fees paid to auditors are more important predictors of earnings management as measured by restatements. The result that NAS fees do not have strong explanatory power is consistent with previous studies. We do find that total fees paid to auditors have some mild but significant explanatory power. The variable that appears to have

the strongest explanatory power is the BIG 5 auditor variable. The study findings, while not supportive of the need to limit NAS through regulation, does highlight the need for regulation and supports the spirit of Title II of the act which includes among other components, the establishment of the Public Company Accounting Oversight Board, audit partner rotation, conflict of interest policies and requiring auditors to report to the audit committee. In addition, the study results related to large audit firms highlights the concerns explored by the US GAO with regard to mandatory audit firm rotation and the impact of consolidation and competition on the public accounting industry. Finally, the study results raise additional questions for academic researchers to pursue - to add to the knowledge on audit quality, auditor independence, and earnings management.

Throughout history as large profile public companies announce financial statement restatements the question “where were the independent auditors?” arises. From the crash of 1929, to the savings and loans crises of the 1980s, to the large fraud cases of the turn of the millennium, the government and the public have turned to the accounting profession for answers. While the SEC has the primary regulatory responsibility over the accounting profession, the US Congress has the ability to legislate and thereby regulate the profession as well (Chenok, 2000).

During 1976-1977 a Senate Subcommittee of the Government Affairs Committee held hearings to investigate publicly owned company failures and wrongdoings that had not been reported by independent auditors (Chenok, 2000). The committee was concerned with the quality of audits and auditor independence. The resulting staff report made recommendations for reform that boiled down to taking away the ability of the accounting profession to self-regulate and transferring the responsibility to the federal government (Chenok, 2000). The AICPA formed a response and lobbied congress to stall the legislation. In spite of almost three decades of effort to preserve the right to self-regulate the accounting profession, the battle was lost when the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board.

Respondents to the GAO study on Accounting Firm Consolidation (2003), required as a part of the Sarbanes-Oxley Act, commented that new regulations deriving from the Sarbanes-Oxley Act and changing auditing standards have had an impact on audit quality and independence. Another GAO study on mandatory audit firm rotation (2004) concluded that mandatory rotation should not be regulated until the effectiveness of the act for enhancing auditor independence and audit quality could be monitored and evaluated.

Future academic research will need to examine the effectiveness of this increased oversight and regulation on reducing the number of audit failures and financial statement restatements. These studies should include pre and post Sarbanes-Oxley Act testing to determine if the increased regulation has had an impact on audit quality and the number of financial statement restatements. An examination of the effectiveness or correlation of the regulatory variables should be conducted as well as impact studies of moving from self-regulation to external oversight of the accounting industry. Additional root cause and systemic research should be conducted to determine what audit firm characteristics, including firm size, industry specialization, audit processes and quality controls, are factors impacting audit quality and audit failure.

The independent audit is a crucial component of the US capital market system, as evidenced by the market's reaction to stock prices of companies that announce an accounting restatement. It is imperative that regulators, audit committees, corporate management, the accounting profession and academic researchers continue to work collaboratively to mitigate the risk of audit failures.

REFERENCES:

- [1]. Agrawal, A.; Chadha, S. - *Corporate governance and accounting scandals*, Journal of Law & Economics, vol.48, no.2, 2005
- [2]. Ashbaugh, H.; LaFond, R.; Mayhew, B. - *Do non-audit services compromise auditor independence? Further evidence*, The Accounting Review, vol.78, no.3, 2003
- [3]. Beattie, V.; Fearnley, S. - *Auditor independence and non-audit services: a literature review*, ICAEW Research Report, August, 2003
- [4]. Beneish, M. - *Earnings management: a perspective*, Managerial Finance, vol.27, no.12, 2001
- [5]. Carcello, J.; Nagy, A. - *Client size, auditor specialization and fraudulent financial reporting*, Managerial Auditing Journal, vol.19, no.5, 2004
- [6]. Domnişoru, S.; Vinătoru, S. - *Audit and internal control*, Sitech Publishing House, Craiova, 2008