The Relationship Between Audit Fees and Earnings Quality of Financial Institutions

Steven Muzatko
University of Wisconsin-Green Bay

Mussie Teclezion
University of Wisconsin-Green Bay

Literature on auditing has proposed that audit fees are a proxy for audit quality. Auditors who charge higher fees might provide a higher quality audit, either related to a fee premium for specialization or as compensation for providing a higher level of effort. A contrary view might be taken; auditors who charge higher fees might be economically reliant on those fees and allow clients more latitude in reporting earnings. Overall, our findings show that bank firms that pay relatively higher audit fees have lower earnings quality in terms of discretionary accruals.

INTRODUCTION

We investigate whether auditors that charge bank holding companies (BHCs) relatively higher audit fees provide higher (or lower) quality audits, as measured by the client firm's earnings quality. Auditors play an important role in the capital markets by providing opinions as to the fair presentation of financial reports. The auditor's attestation service provides assurance that financial statements conform to Generally Accepted Accounting Principles (GAAP), thus adding credibility and value to the financial information.

The regulatory and legislative attention given to audit quality and audit fees has recently increased. For example, the Security and Exchange Commission's (SEC's) Chief Accountant has stated concerns about declining audit fees leading to lower quality audits (Beswick 2013). Additionally, both the American Institute of CPA's (AICPA) and the Public Company Accounting Oversight Board (PCAOB) have recently launched initiatives in an effort to raise audit quality. In May 2014, in response to concerns over audit quality, the AICPA launched an initiative to enhance audit quality. The goal of the initiative is to improve audit performance. In June 2015, the PCAOB issued a concept release seeking public comment on audit quality indicators in an effort to improve the transparency of auditing services.

Understanding the relationship between earnings quality and audit fees is of contemporary importance. A recent study found that many Chief Financial Officers (CFO's) believe that many companies, approximately 20%, manage earnings even when reporting within the bounds of GAAP (Dichev 2016). For those companies that manage earnings, the CFO's interviewed in the study estimated that the misstatements are approximately 10% of reported net income. In regard to audit fees, they are a significant cost for most companies. For BHCs examined in this study, audit fees averaged $574,759 (median $335,500**)**.

Auditors are motivated to perform high quality audits by both professional standards and the adverse economic consequences of performing substandard audits. The auditing profession and regulators have imposed several mechanisms to ensure auditors achieve an appropriate level of care in providing audits. For example, all audits must be conducted to meet the requirements established by Generally Accepted Auditing Standards (GAAS). There are professional licensing requirements that include experience and a Uniform CPA examination. Both the PCAOB and the AICPA have established a system of peer reviews for audit firms' systems of quality control. Auditors found to perform substandard audits might suffer economically through a loss of reputation. Finally, auditors are subject to legal liability for negligence in performing the audit and issuing their report, and they are subject to pay damages after performing a substandard audit.

Given the professional standards, economic consequences, and legal implications, it might be expected that there is little difference in the conduct or outcome of financial statement audits. However, auditing research has provided evidence that company audits are a heterogeneous product differentiated in quality, fees, and litigation. Some of these differences have been shown to be systematically related to auditor characteristics. For example, evidence suggests that larger audit firms are associated with audits of higher quality, lower fraud, and fewer SEC enforcement actions. Other studies have found a similar relationship if an auditor is an industry specialist, oftentimes measured by the market share of a particular industry that is audited by a particular audit firm.

More recently, the auditing literature has proposed that audit fees are a proxy for audit quality. Auditors who charge relatively higher fees might be compensated for greater effort, thus leading to a higher quality audit. However, audit firms who are paid relatively higher fees might become economically reliant on the client and be willing to allow the client greater latitude in financial reporting. We examine the relationship between audit fees and earnings quality in the BHC industry. We contribute to auditing and finance literature by providing empirical evidence of the inverse relationship of audit fees with earnings quality.

LITERATURE REVIEW

Managers have incentives to manage reported earnings and numerous studies have provided evidence that companies manage earnings (e.g., DeFond and Park 1997; Jones 1991; and Healy 1985). Earnings management can lead to adverse consequences such as a perception of poor earnings quality leading to lack of trust, stock price declines, and higher cost of capital (Dichev et al. 2016). In the banking industry, bank managers have the ability to manage earnings through loan portfolio quality (Beaver and Engel 1996; Beatty et al. 2002).

The independent, external auditors add to the credibility of the financial statements by verifying their compliance with GAAP; therefore, audits can restrict the ability of managers to manage earnings. The demand for auditing is grounded in agency theory and asserts that an independent audit is a means to reduce costs due to the conflict of interest between investors and managers (Jensen and Meckling 1976; Fama and Jensen 1983; Watts and Zimmerman 1983). It has been demonstrated that external audits are a cost-effective monitoring device to reduce agency costs (Simunic 1980; Johnson and Lys 1990).

DeAngelo (1981b) defines audit quality as the probability of an auditor discovering a misstatement and reporting the misstatement. Professional standards establish a minimum level of care by requiring an auditor to conduct an audit that will provide reasonable assurance of detecting material misstatements (PCAOB Auditing Standard No. 12, AICPA Statement on Auditing Standard No. 122). However, the standards give auditors a great amount of latitude in determining the auditing procedures to use in order to accomplish that objective. The auditor's effort in meeting the professional standards is not observable and, therefore, it is difficult to ascertain the quality of the audit services provided by the auditor. A number of academic studies have tried to identify the determinants of audit quality and its relationship to other factors. Francis (2011) and Knechel et al. (2013) provide extensive reviews of the academic literature related to audit quality.

An audit firm's market acceptance relies on the reputation of their services and auditor's suffer losses in the way of reputational capital if their reputation is harmed by being associated with an audit failure (DeAngelo 1981b). DeAngelo (1981b) asserts that larger firms have the most to lose in the way of reputational capital and will therefore provide higher quality audits. Based on this research, many subsequent studies have used auditor size as a proxy for audit quality and empirical studies have provided evidence supporting the assertion that audit quality is differentiated based on the size of the audit firm (Teoh and Wong 1993; Simunic and Stein 1995). Relatedly, auditor brand name has also been used as proxy for audit quality (Becker et al. 1998; Reynolds and Francis 2000).

A separate line of research has examined how the fees charged to the client by an auditor are related to the quality of the audit delivered. An auditor is paid by the company for which an audit is performed. Simunic (1980) proposed a model where auditors set their fee based on both the cost of performing the audit and expected litigation losses. Dye (1995) demonstrates by an analytical model that the auditor incurs both direct costs (the cost of performing the audit) and indirect cost (the potential liability of the auditor). Bedard and Johnstone (2004) show that auditors respond to greater risk by adjusting audit procedures, increasing planned audit effort, and increasing billing rates. A number of other studies provide evidence that audit firms charge higher fees to clients where the auditor faces increased litigation risk; riskier companies have larger audit costs (Bell et al. 2001; Charles et al. 2010). These studies suggest that higher fees are related to greater audit effort. It should be expected that greater audit effort would constrain the ability of the client firm to manage earnings.

On the contrary, auditors who are paid abnormally high fees might be willing to allow the client more discretion in reporting earnings. DeAngelo (1981a) demonstrates that auditors are more likely to acquiesce to client demands if the client is economically important to the audit firm. In these cases, the auditor stands to lose future quasi-rents in the way of fees if a client terminates the audit services. Frankel et al. (2002) provide some evidence that when auditors are associated with a higher percentage of non-audit fees billed to their clients, those clients tend to report larger amounts of discretionary accruals, as measured in absolute value. This finding would be consistent with DeAngelo's (1981a) model.

Other empirical research has examined the relationship between audit fees and earnings quality. Hoitash et al. (2007) find a positive relationship between abnormal audit fees and accruals quality. Choi et al. (2010) find that abnormal audit fees are negatively associated with discretionary accruals, but their results hold only when the auditors are paid a premium. Where audit fees are discounted, they find no relationship between the audit fees and discretionary accruals. Asthana and Boone (2012) find similar results, however they were able to demonstrate that discretionary accruals were also positively related to discounted audit fees. These studies examined the absolute value of discretionary accruals, not differentiating between income increasing and income decreasing accruals. (Hoitash et al. 2007 do examine a second proxy for audit quality, accrual estimation error metric, in their study.) All three studies exclude financial industries.

Although most studies find a positive relationship between audit fees and earnings quality, a study by Mitra et al. (2009) found contradictory evidence; their evidence suggests an inverse association between audit fees and discretionary accruals. In their test, they found the results held for the absolute value of all discretionary accruals, as well as both income increasing and income decreasing accruals tested separately. This study also eliminated financial industries from the sample.

Our study extends this line of research by examining BHCs. Financial institutions are often excluded from studies of earnings management. BHCs are highly regulated and the ability to manage earnings might be reduced through regulatory oversight. (Adams and Mehran 2003; Bryan and Klein 2005). BHCs operate in an industry where the Federal Deposit Insurance Company (FDIC) might subject them, based on their size, to independent, external audits even if they are not subject to the SEC requirements. Therefore, our sample includes companies oftentimes not included in academic research. Finally, we examine the relationship between audit fees on both income increasing and income decreasing discretionary accruals separately, as well as the absolute value of the discretionary accruals.

HYPOTHESES

The research question addressed in this study is whether audit fees are related to earnings quality. If higher audit fees are associated with greater auditor effort or a fee premium for auditor specialization, it could be expected that the quality of the audit would be higher. Contrarily, relatively larger audit fees might lead the auditor to become economically dependent on the client, thereby eroding independence. In such cases, the auditor might be willing to acquiesce to the client's desire to misrepresent or manage earnings through discretionary accruals.

Although the findings of extant research is mixed, the evidence provided by the studies most closely related to ours suggests that audit fees are positively related to earnings management as measured by discretionary accruals. Therefore, we propose the following hypothesis:

H1: There is a positive relationship between absolute value of discretionary accruals and audit fees.

Under certain circumstances, firms might have an incentive to overstate earnings. If the auditor acquiesces to the desires of the client, these firms would have positive discretionary accruals. Given that relatively higher audit fees might give auditors an economic reason to allow the client to manage earnings, we expect a direct relationship between positive discretionary accruals and audit fees. A similar argument can be made for firms wishing to underreport earnings. Thus, we propose the following two hypotheses:

H2: For firms with positive discretionary accruals, there is positive relationship between discretionary accruals and audit fees.

H3: For firms with negative discretionary accruals, there is positive relationship between discretionary accruals and audit fees.

METHODOLOGY

Bank managers have discretion in estimating loan loss provisions, and the discretion to realize gains or losses from securities available for trading. Thus, loan loss provisions and security gains and losses are components of earnings that are subject to manipulation (Beaver and Engel, 1996; Beatty et al. 2002). Following Beatty et al. (2002), we estimate loan loss provisions using Model (1) and realized security gains and losses using Model (2). The error term from Model (1) serves as an estimate of the discretionary component of loan loss provisions while the error term in Model (2) captures of discretionary component of realized security gains and losses.

$$\begin{aligned} \mathrm{LLP}_{it} = {} & \alpha_{tr} + \beta_1 \mathrm{LNASSETS}_{it} + \beta_2 \Delta\mathrm{NPL}_{it} + \beta_3 \mathrm{LLR}_{it} + \beta_4 \mathrm{LOANR}_{it} + \beta_5 \mathrm{LOANC}_{it} \\ & + \beta_6 \mathrm{LOAND}_{it} + \beta_7 \mathrm{LOANA}_{it} + \beta_8 \mathrm{LOANI}_{it} + \beta_9 \mathrm{LOANF}_{it} + \mathrm{e}_{it} \end{aligned} \quad (1)$$

Subscripts i and t, respectively, represent a BHC's identifier and the year indicator spanning from 2006 through 2014; r captures the U.S. Department of Commerce defined region index; LLP is loan loss provisions as a percentage of average loans; LNASSETS is the natural log of total assets and serves as a proxy for BHC's size, while ΔNPL is change in nonperforming loans (includes loans past due 90 days or more and still accruing interest and loans in nonaccrual status) as a percentage of average assets. LLR is loan loss reserve as a percentage of total loans at the beginning of the year; LOANR is real estate loans as a percentage of total loans; LOANC is commercial and industrial loans as a percentage of total loans; LOAND is loans to depository institutions as a percentage of total loans; LOANA is agriculture loans as a percentage of total loans; LOANI is consumer loans as a percentage of total loans; and LOANF is loans to

foreign governments as a percentage of total loans. Finally, e represents the stochastic error term. Model (1) is estimated using pooled OLS regression controlling for year and region fixed effects. Influential observations are deleted using Cook's (1977) criteria.

Next, the error term from Model (1) is transformed into a proportion of average assets as follows:

$$\mathrm{DLLP_{it}} = \mathrm{e_{it}} * \left(\frac{\mathrm{AVERAGE\ LOANS_{it}}}{\mathrm{AVERAGE\ ASSETS_{it}}}\right).$$

We further estimate the second component of the earnings management model as shown in Model (2).

$$\mathrm{RSGL_{it}} = \alpha_{it} + \beta_1 \mathrm{LNASSETS_{it}} + \beta_2 \mathrm{URSGL_{it}} + \mathrm{e_{it}} \quad (2)$$

$\mathrm{RSGL_{it}}$ is realized security gains and losses (includes realized gains and losses from available-for sale securities and held-to-maturity securities) as a percentage of assets at the beginning of the year; $\mathrm{URSGL_{it}}$ is unrealized security gains and losses (includes only unrealized gains and losses from available-for-sale securities) as a percentage of assets at the beginning of the year. Subscripts i and t are as previously defined. The model is estimated using pooled OLS regression, controlling for year fixed effects. Influential observations are again deleted using Cook's (1977) criteria.

We measure earnings management variables as absolute value of total discretionary accruals ($|\mathrm{D\_AC\_REG_{it}}|$) where $\mathrm{D\_AC\_REG_{it}} = \mathrm{DRSGL_{it}} - \mathrm{DLLP_{it}}$. The construction of $\mathrm{DLLP_{it}}$ is shown above, and $\mathrm{DRSGL_{it}}$ is the regression error term ($\mathrm{e_{it}}$) from Model (2). A negative value of $\mathrm{DLLP_{it}}$ is added to $\mathrm{DRSGL_{it}}$ because $\mathrm{DLLP_{it}}$ is negatively related to earnings, whereas $\mathrm{DRSGL_{it}}$ is positively related to earnings. Thus a high level of $|\mathrm{D\_AC\_REG_{it}}|$ indicates high prevalence of earnings management.

To test our first hypotheses, we analyze the absolute value of discretionary accruals on natural log of audit fee and other control variables. The audit fee variable for BHCs that file FR FY-9C reports is available starting from 2008. The variable is reported in thousands of dollars. We use the natural log of the audit fee as the explanatory variable in our model. Model (3) is estimated using pooled OLS regression controlling for year fixed effects. Influential observations are deleted using Cook's (1977) criteria.

$$|\mathrm{D\_AC\_REG_{it}}| = \alpha_t + \beta_1 \mathrm{LNASSETS_{it}} + \beta_2 \mathrm{LNAuditFee_{it}} + \beta_3 \mathrm{Market\_Share_{it}} + \beta_4 \mathrm{Growth_{it}} + \beta_5 \mathrm{EBTP_{it}} + \beta_6 \mathrm{PASTLLP_{it}} + \beta_7 \mathrm{Equity\_To\_TA_{it}} + \beta_8 \mathrm{Loans\_To\_TA_{it}} + e_{it} \quad (3)$$

$|\mathrm{D\_AC\_REG}|$ is the absolute value of discretionary accruals; LNASSETS is the natural log of total assets; $\mathrm{LNAuditFee_{it}}$ is the natural log of the audit fee variable; Market_Share is the market share of the auditing firm for that year, computed as a percentage of total assets of BHCs audited by the firm to total assets of all BHCs that filed a FR FY-9C report for that year; Growth is the annual growth rate of BHC's total assets; EBTP is net income before taxes and loan loss provisions divided by total assets at the beginning of the year; Equity_To_TA is the ratio of the book value of total equity to total assets of a bank; Loans_To_TA is the ratio of total loans to total assets of a bank.

SAMPLE AND DESCRIPTIVE STATISTICS

We start with all U.S. BHCs that filed a FR Y-9C report with the Federal Reserve System from 2006 to 2014. We collect annual data from Call Reports available at the website of the Federal Reserve Bank of Chicago. The name of the auditing firm and audit fee variables are available in FR Y-9C reports starting from 2005 and 2008, respectively. Our dataset starts from 2006 because we lose two years of data to form lags for some of our variables. We compute the audit firm's market share for each year using the entire sample of BHCs for that year. Thus, our sample includes all BHCs for which data is available.

RESULTS

Panel A of Table 1 shows the descriptive statistics for variables used in Models (1) and (2). The sample size is more than 6544 firm years of BHCs. We also plot the average audit fee paid (in thousands of dollars) by BHCs from 2008 to 2014. The average audit fee fluctuated over the sample period as shown in Figure 1.

TABLE 1
DESCRIPTIVE STATISTICS AND OLS REGRESSIONS FOR MODELS

Panel A presents the descriptive statistics for the variables used in Models (1) and (2). Panel B presents pooled OLS regression models of Loan Loss Provisions and Realized Security Gains and Losses from 2008-2014. In Panel B, we present OLS regression results with years, and regions dummies for Model (1) and OLS regression results with year dummies for Model (2). Variable names are defined in the Methodology section. Influential observations are deleted using Cook's (1977) criteria. Standard errors for the estimates are clustered at firms' level. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Panel A: Descriptive Statistics

	Obs	Mean	Std. Dev.	Min	Median	Max
LNASSETS	6544	14.20817	1.30172	11.27161	13.81526	21.66825
LLP	6544	0.00816	0.01030	-0.02039	0.00460	0.12971
ΔNPL	6544	0.00061	0.02235	-0.19284	-0.00059	0.23592
LLR	6544	0.01803	0.00790	0.00000	0.01645	0.18141
LOANR	6544	0.74964	0.16175	0.00000	0.78062	1.00456
LOANC	6544	0.14730	0.10117	0.00000	0.12838	0.88710
LOAND	6544	0.00066	0.00499	0.00000	0.00000	0.17897
LOANA	6544	0.02261	0.05402	0.00000	0.00133	0.67108
LOANI	6544	0.04873	0.08358	0.00000	0.02349	0.99269
LOANF	6544	0.00005	0.00072	0.00000	0.00000	0.02579
RSGL	6656	0.00010	0.00338	-0.08481	0.00012	0.02834
URSGL	6656	0.00076	0.00454	-0.05516	0.00070	0.03815

Panel B: Pooled OLS regressions

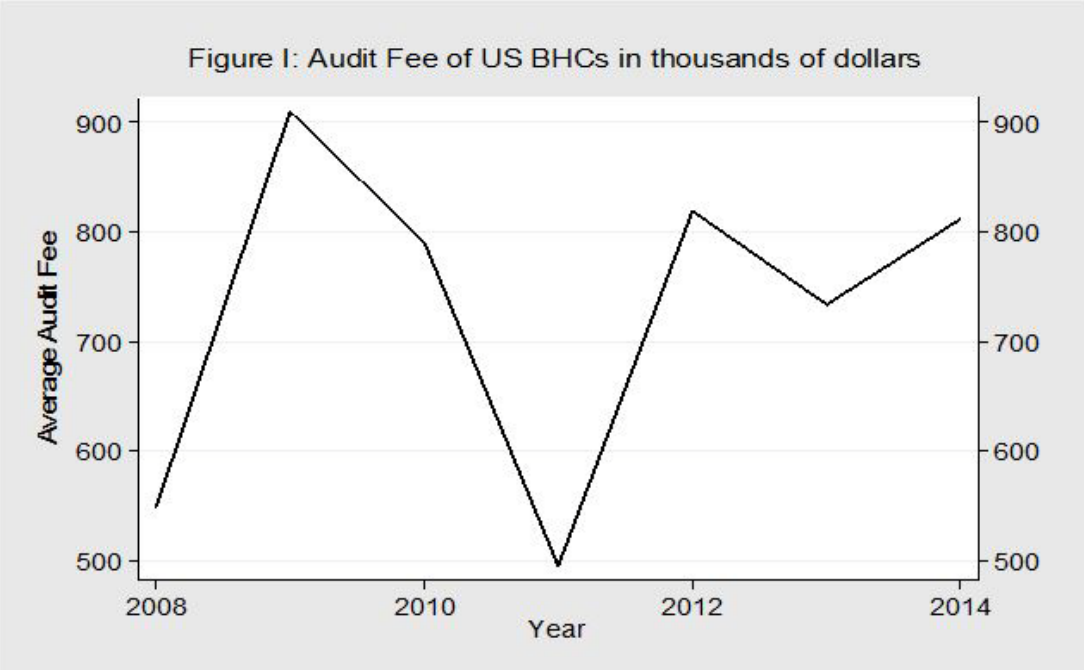
$$LLP_{it} = \alpha_{tr} + \beta_1 LNASSETS_{it} + \beta_2 \Delta NPL_{it} + \beta_3 LLR_{it} + \beta_4 LOANR_{it} + \beta_5 LOANC_{it} + \beta_6 LOAND_{it} + \beta_7 LOANA_{it} + \beta_8 LOANI_{it} + \beta_9 LOANF_{it} + e_{it} \quad \text{(Model 1)}$$

$$RSGL_{it} = \alpha_{it} + \beta_1 LNASSETS_{it} + \beta_2 URSGL_{it} + e_{it} \quad \text{(Model 2)}$$

	Model(1)		**Model(2)**
VARIABLES	LLP	VARIABLES	LLP
LNASSETS	0.000575***	LNASSETS	-0.0000422**
ΔNPL	0.0904***	URSGL	0.0713***
LLR	0.681***		
LOANR	0.00186		
LOANC	-0.000818		
LOAND	0.000156		
LOANA	-0.00586**		
LOANI	0.00114		
LOANF	0.0253		
Constant	-0.0101***		0.000106***
Year controls	YES		YES
Region Controls	YES		NO
Bank Years	6,544		6,461
Adjusted R-Squared	0.602		0.104
F	186.8***		47.88***

Models (1) and (2) are used to generate the discretionary accruals variable. The results of the two regressions are in Panel B of Table 1. The first model is a pooled OLS regression with year and region dummies, while the second one is a pooled OLS model with year dummies. From the error terms of the two models, we construct a measure of discretionary accruals (D_AC_REG). Absolute value of discretionary accruals |D_AC_REG| is used as a measure of earnings management behavior. Firms with high level of |D_AC_REG| have the tendency to manage earnings.

FIGURE 1
AUDIT FEE OF US BHCS IN THOUSANDS OF DOLLARS



We start our preliminary analysis by comparing the average annual absolute value of discretionary accruals of the two groups in our sample, BHCs that paid above-median audit fee for a particular year and BHCs that paid below the median. The average annual absolute value of discretionary accruals for each group is shown in Figure 2.

Figure 2 shows that the earning management practices tend to go up during recessionary periods, and fade during economic recovery and expansionary periods. The same applies to both groups of BHCs. In addition, BHCs with above median audit fee have higher absolute value of discretionary accruals. This is consistent with our first hypothesis (H1) and shown consistently throughout the sample period except in 2009, when both groups had an equivalent level of average discretionary accruals.

FIGURE 2
ABSOLUTE VALUE OF DISCRETIONARY ACCRUALS FOR U.S. BHCS

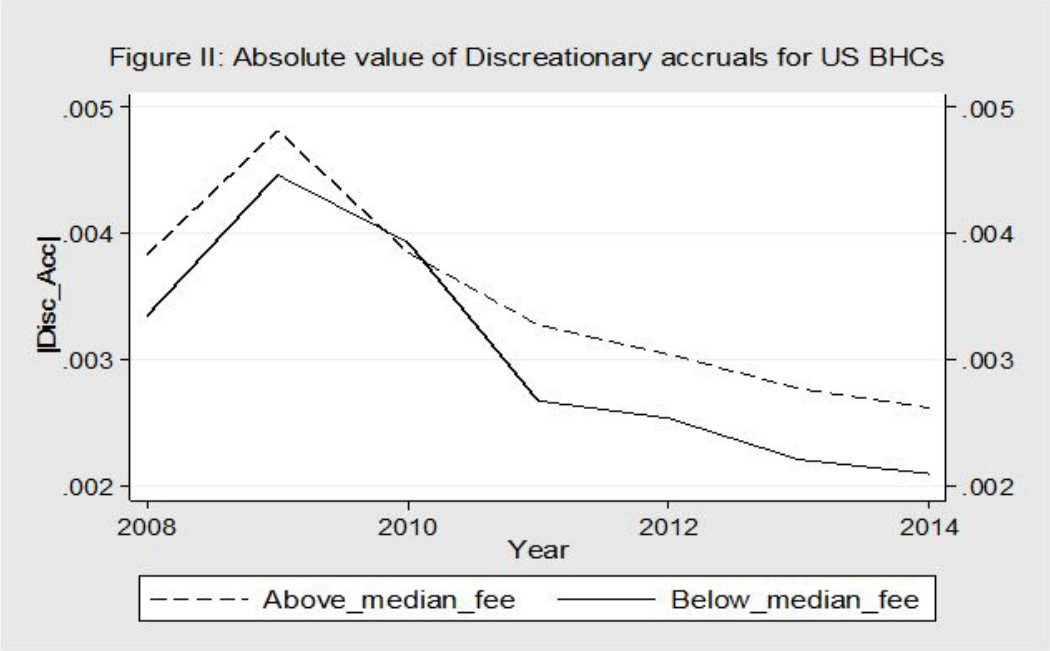


TABLE 2
TWO-SAMPLE T-TEST OF DISCRETIONARY ACCRUALS

Two-sample t-test of discretionary accruals: absolute (|D_AC_REG|), positive (D_AC_REG >0), and negative (D_AC_REG <0) discretionary accruals.

|D_AC_REG|			D_AC_REG >0			D_AC_REG <0		
Variable	Obs	Mean	Std. Err.	Obs	Mean	Std. Err.	Obs	Mean	Std. Err.
Above Median	1809	.0034064	.0000756	940	.0030427	.0000803	869	-.0037998	.000130
Below Median	1759	.0029157	.0000684	937	.0027368	.0000719	822	-.0031198	.0001208
Difference		.0004907	.0000512		.00289	.000054		-.0006801	.000178
t = 4.8057; Ha: diff >0 Pr(T > t) = 0.0000				**t = 2.8368; Ha: diff > 0 Pr(T > t) = 0.0023**			**t = -3.8214 ; Ha: diff < 0 Pr(T< t) = 0.0001**		

Next we conduct univariate two-sample t-test between BHCs' bank years that have audit fee above the annual median and those that have below the annual median. Results are reported in Table 2. BHC firm years that have above the median annual audit fee have significantly higher level of |D_AC_REG| compared to those with audit fees below the median. We also test the difference between the discretionary accruals of the two groups for firm years with positive discretionary accruals (D_AC_REG >0) and for firm years with negative discretionary accruals, (D_AC_REG <0). For firm years with positive discretionary accruals, we find that bank firm years with above median annual audit fee have significantly higher discretionary accruals. The result provides preliminary support for our second hypothesis (H2) and is consistent with the notion that BHCs that pay higher audit fees tend to have higher discretionary accruals. On the other hand, the t-test for firm years with negative discretionary accruals is negative and significant. That is, bank years with audit fee higher than the median tend to have larger negative

discretionary accruals than BHC years with below median audit fee. This also provides preliminary support for our third hypothesis (H3) and underscores the fact that, for BHCs that have negative discretionary accruals, those BHCs that pay higher audit fee have the tendency to under-report earnings to a greater extent than BHCs that pay lower audit fees.

Although univariate tests in Table 2 support our hypotheses, other variables that affect earnings management behavior of BHCs are not controlled for in the univariate t-tests. We conduct further tests of earnings management behavior as a function of the natural log of audit fee paid by BHCs and other independent variables. The results of Model (3) are reported in Panel B of Table 3. The descriptive

TABLE 3
DESCRIPTIVE STATISTICS AND OLS REGRESSIONS CONTROLLING FOR YEAR EFFECTS

Panel A presents the descriptive statistics for the variables used in Model (3). Panel B presents pooled OLS regression model of discretionary accruals using data from 2008 to 2014. The regressions control for year fixed effects and influential observations are deleted using Cook's (1977) criteria. Model (3A) has |D_AC_REG|, an absolute value of discretionary accruals, as a dependent variable; Model (3B) has D_AC_REG as a dependent variable for firm years with D_AC_REG greater than zero; Model (3C) has D_AC_REG as a dependent variable for firm years with D_AC_REG less than zero. In panel B, we present OLS regression results. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Panel A: Descriptive Statistics

	Obs	Mean	Std. Dev.	Min	Median	Max
|D_AC_REG |	3234	0.00268	0.00216	0.00000	0.00214	0.01149
D_AC_REG_P	1752	0.00269	0.00203	0.00000	0.00223	0.01065
D_AC_REG_N	1482	-0.00268	0.00230	-0.01149	-0.00205	0.00000
LNASSETS	3234	13.85207	0.75329	11.52840	13.69133	19.70699
LNAuditFee	3234	5.87213	0.83173	1.79176	5.81562	11.78833
Market_Share	3234	0.04020	0.09750	0.00001	0.00168	0.40869
Growth	3234	0.05221	0.11236	-0.49207	0.03565	1.14957
EBTP	3234	0.01236	0.00784	-0.03491	0.01277	0.07811
Equity_To_TA	3234	0.09522	0.02958	-0.09976	0.09431	0.28209
Loans_To_TA	3234	0.66538	0.11817	0.06889	0.67476	0.95137

Panel B: OLS regression with dummy for bank years

$$\text{Disc}_{\text{Accruals}} = \alpha_t + \beta_1 \text{LNASSETS}_{it} + \beta_2 \text{LNAuditFee}_{it} + \beta_3 \text{A\_Speciality}_{it} + \beta_4 \text{Growth}_{it} + \beta_5 \text{EBTP}_{it} + \beta_6 \text{PASTLLP}_{it} + \beta_7 Equity\_To\_TA_{it} + \beta_8 Loans\_To\_TA_{it} + e_{it} \quad \text{(Model 3)}$$

Independent Variables	**|D_AC_REG$_{it}$|** **Model (3A)**	**D_AC_REG > 0** **Model (3B)**	**D_AC_REG < 0** **Model (3C)**
LNASSETS	-0.000182**	-0.000327***	0.000126
LNAuditFee	**0.000334*** **	**0.000223*** **	**-0.000415** **
Market_Share	-0.00117***	-0.00002	0.00195**
Growth	-0.00112***	0.000883**	0.00342***
EBTP	-0.0339***	-0.0194***	0.0295***
Equity_To_TA	-0.00273*	0.00454**	0.0109***
Loans_To_TA	0.00170***	0.000862**	-0.00381***
Constnant	0.00311***	0.00503***	-0.00237
Year controls	YES	YES	YES
Observations	3,234	1,706	1,551
Adjusted R-squared	0.103	0.0789	0.199
F	22.75***	9.66***	20.04***

statistics of the variables used in Model (3) are reported in Panel A of Table 3. D_AC_REG_P is discretionary accruals when it is positive, while D_AC_REG_N is discretionary accruals when it is negative. Other variables are defined in the Methodology section. We run pooled OLS regression of discretionary accruals on LNAuditFee and other control variables. Influential observations are deleted using Cook's (1977) criteria. The results are reported in Panel B of Table 3. In the first version of Model (3), LNAuditFee has a positive and significant effect on absolute value of discretionary accruals. The result supports our hypothesis (H1) that discretionary accruals are higher for BHCs that pay audit fee above the annual median. This is indeed consistent with existing literature and shows auditor's inclination to be lenient towards reporting higher discretionary accruals when audit fee paid for their services is higher. The second version of Model (3) examines the effect of LNAuditFee on discretionary accruals for firm years with positive discretionary accruals. LNAuditFee is positive and significant, providing support for our second hypothesis (2). That is, discretionary accruals are higher for firms that pay higher audit fee when BHCs report positive discretionary accruals. This is when auditor judgment becomes even more important in providing quality audits. In a highly litigious business environment such as the United States, auditors have to be cautious of firms which may mislead investors by managing earnings upwards because it may be very costly to the auditor's reputational capital. However, we find audit fees to have positive relationship with discretionary accruals when discretionary accruals are positive. The third version of Model (3) examines the effect of LNAuditFee on earnings management behavior of BHCs with negative discretionary accruals. LNAuditFee in the model is negative and significant at less than 5%. For BHC years with negative discretionary accruals, BHCs that pay higher audit fees report larger negative discretionary accruals. This consistent with the notion that audit firms allow BHCs to underreport earnings to a greater extent when BHCs pay higher audit fees and supports our third hypothesis (H3).

Our findings are consistent with the earnings management literature; audit fees are positively and significantly related with the earnings management behavior of BHCs. The findings also highlight the priorities of auditors and BHCs. Audit fees seem to be more correlated with earnings management practices of BHCs when earnings is being managed upwards than downwards.

CONCLUSION

Our study empirically examines the relation between audit fees and earnings management, as measured by discretionary accruals, in the banking industry. Our results support the hypothesis that higher audit fees are associated with companies reporting higher discretionary accruals. We also examine whether there is a difference in the relationship conditional on whether the discretionary accruals are positive (income increasing) or negative (income-decreasing). We find the relationship between fees and accruals holds across both conditions. These results are consistent with auditors providing greater latitude in reported earnings for BHC clients that are charged relatively higher audit fees. Our findings are pertinent to the increasing focus of standard setters on audit quality.

This study is subject to several limitations. This study examines only one industry, BHCs. These companies operate in a highly regulated industry and the results of this study might not be generalizable to other industries. Second, earnings management is not observable, so a proxy measure, discretionary accruals, was used. Third, our study uses total audit fees as the independent variable. We did not attempt to decompose the audit fee into components related to the normal cost of performing an audit and excessive fees pertaining to the specific relationship with the client. Finally, our study does not capture how changes in audit fees affect discretionary accruals across time. Several of these limitations can be addressed empirically in future studies.

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