



ELSEVIER

Contents lists available at ScienceDirect

J. Account. Public Policy

journal homepage: www.elsevier.com/locate/jaccpubpol



Does lowballing impair audit quality? Evidence from client accruals surrounding analyst forecasts



Jonathan D. Stanley^a, Duane M. Brandon^{a,*}, Jeffrey J. McMillan^b

^a Auburn University, United States

^b Clemson University, United States

A B S T R A C T

The pricing of initial audit engagements has long been of interest to regulators because of audit quality concerns speculated to arise with lowball pricing tactics. However, there has been very little empirical investigation specifically aimed at understanding the link between audit fees and audit quality on new engagements. We examine a sample of initial engagements spanning 2000–2009 and find evidence suggesting that the magnitude of initial engagement discounting is positively associated with audit clients' ability to meet analyst forecasts using discretionary accruals. Additional analysis reveals that this effect is more pronounced before the passage of SOX. Further examination of the post-SOX period shows the effect is present in the latter half of our sample (2006–2009) but not in the years immediately following the passage of SOX (2002–2005). Additional supplemental tests suggest that the primary results are driven more by time and/or budget pressures than impaired independence. Overall, we interpret these results as consistent with longstanding concerns surrounding auditor lowballing and discuss the regulatory and practical implications for the audit profession with respect to the pricing and monitoring of new audit engagements.

© 2015 Elsevier Inc. All rights reserved.

* Corresponding author.

1. Introduction

Historically, regulators have expressed concerns that issues unique to the pricing and performance of initial audit engagements are likely to impair audit quality and, therefore, the assurance auditors provide on these engagements. Much of this attention focuses on the existence and potential effects of “lowballing,” whereby auditors offer their services at discounted prices to attract new clients. Regulators have long argued that such practices can impair audit quality in at least two ways. First, the auditor may be more likely to acquiesce to client pressures during an initial engagement in order to retain the client and subsequently recoup upfront losses. In fact, the Cohen Commission likens the initial losses on a lowballed engagement to a receivable that provides the auditor a financial interest in the client (AICPA, 1978, 121). Second, regulators express concern over potential excessive time and budget pressures faced by an auditor when severe price competition exists. These pressures, in turn, are believed to heighten the incentive to “underaudit” in an attempt to control costs (NCFFR, 1987).

Prior research on lowballing has tended to focus on the existence and magnitude of initial fee discounting (e.g., Simon and Francis, 1988; Ghosh and Pawlewicz, 2009; Casterella et al., *Forthcoming*). Despite considerable evidence that audit fee discounting occurs on new engagements, little research has been specifically aimed at understanding the potential impact of this pricing strategy on audit quality (Watkins et al., 2004; Gramling et al., 2010). Prior archival research that attempts to shed light on this issue offers inconclusive evidence at best (e.g., Gul et al., 2007; Stanley and DeZoort, 2007; Gul et al., 2009; Sankaraguruswamy et al., 2012).

We extend this line of research by investigating the impact of initial engagement pricing on audit clients' ability to use discretionary accruals to manage earnings around analyst forecasts. This form of earnings management is of particular interest to regulators and served as a catalyst for many of the regulatory initiatives of the early 2000s (Levitt, 1998; Davis et al., 2009). Furthermore, this definition of earnings management can provide for a more powerful empirical test of audit quality than a definition focused more broadly on the unconditional magnitude of discretionary accruals (Davis et al., 2009). Other than Stanley and DeZoort (2007) and Sankaraguruswamy et al. (2012), related prior studies follow the broader approach and find no evidence that initial fee discounts are associated with lower audit quality.¹ However, our approach differs in that we focus on whether the magnitude of fee discounts is associated with auditors allowing, or failing to constrain, the management of discretionary accruals to meet or beat analysts' forecasts. By utilizing this more restrictive definition of audit quality, we are able to focus our analysis on firms with a specific incentive to utilize discretionary accruals to manage earnings.

Our study is conducted using a sample of 402 first-year public company audit engagements spanning 2000–2009. We find, consistent with concerns of regulators and similar to other recent evidence on the magnitude of fee discounts, a mean discount of approximately 23 percent on initial engagements (e.g., Simon and Francis, 1988; Sankaraguruswamy et al., 2012; Casterella et al., *Forthcoming*). Also consistent with the concerns of regulators, when we partition the sample on whether the client managed accruals around the consensus forecast, our univariate results reveal that firms categorized as having managed earnings received an average fee discount of approximately 29 percent compared to 19 percent for a control sample of non-earnings management initial engagement firms. While controlling for factors shown previously to impact firms' likelihood of meeting or beating analyst forecasts with discretionary accruals, our regression analysis provides additional evidence of a significant relation between the magnitude of initial fee discounts and earnings management. Supplemental testing reveals that this relationship is less pronounced following the passage of SOX. In further examining the post-SOX period, we find evidence of a significant relationship in the latter half of our sample (2006–2009) but not in the years immediately after the passage of SOX (2002–2005).

Finally, we perform additional supplemental tests designed to offer preliminary evidence on whether the primary results are driven by (1) impaired independence and/or (2) excessive time and

¹ Both Stanley and DeZoort (2007) and Sankaraguruswamy et al. (2012) examine subsequent restatements of clients' audited financial statements. Davis et al. (2009) explain that this type of audit failure provides an unambiguous measure of quality; however, this type of extreme event may limit generalizability as well as the ability to establish a relationship between audit quality concerns and clients' financial reporting quality. The authors speculate that these methodological problems may underlie regulators' interest in more subtle impairments to audit quality (e.g., SEC, 2001).

Download English Version:

<https://daneshyari.com/en/article/1005754>

Download Persian Version:

<https://daneshyari.com/article/1005754>

[Daneshyari.com](https://daneshyari.com)