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Auditor compensation, disclosure quality, and market liquidity: Evidence from the stock market

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Abstract

Previous studies on the effects of auditor compensation on disclosure quality have focused on accounting measures, such as earnings management, discretionary accruals, and restatements. In contrast, we investigate the impact of fees paid for audit and non-audit services on a market-based measure of disclosure quality and stock market liquidity. Based on a large sample of NYSE-traded S&P 1500 stocks, we find only weak evidence to support the argument that auditor compensation lowers firm disclosure quality and market liquidity. This finding is robust to alternative measures of bid-ask spreads and asymmetric information costs of trading. In addition, we find some evidence to suggest that the adverse effects of auditor compensation on market liquidity are concentrated in firms with weak corporate governance mechanisms. Our results

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underscore the need to revisit the rationale and scope of restrictions on non-audit services imposed recently by the Sarbanes-Oxley Act.
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1. Introduction

Are the fees for audit and non-audit services paid by a firm (i.e., auditor compensation) associated with lower quality accounting information and/or impaired disclosure by the firm, leading to heightened information asymmetry and decreased market liquidity? This would seem to be the supposition behind the Sarbanes-Oxley Act of 2002. The recent collapse of Enron and the irregularities found in its accounting statements have brought to sharp focus the relationship between the client and its auditor. On September 10, 2003, Enron's former treasurer, Ben Glisan, Jr., entered a guilty plea to charges that he conspired to "manipulate artificially Enron's financial statements".[3] More recently, Andrew Fastow, Enron's former Chief Financial Officer, admitted that he and others at Enron "fraudulently manipulated Enron's publicly reported financial results. Our purpose was to mislead investors and others about the true financial position" of Enron.[4] The effects on Enron's auditor, Arthur Anderson, were devastating, forcing the venerable accounting firm to near bankruptcy. One recurring theme in the popular business press is that the auditor–audited firm relationship between Arthur Anderson and Enron was compromised by a conflict of interest and that this conflict of interest was at the heart of Enron's ability to manipulate its financial accounting statements and the investing public. This theme was echoed in the provisions of Sarbanes-Oxley Act of 2002. One source of the presupposed conflict of interest is the non-audit (e.g., consulting) services that Anderson, the auditor, provided Enron, the client. For example, in 2000, The Investor Responsibility Research Center (IRRC) reported that Enron paid $25,000,000 to Anderson for consulting services and $27,000,000 for audit-related services. Clearly, the fees paid for non-audit services are significant and comparable to the fees paid for auditing services and thus potentially give rise to a conflict of interest. Further, the total fees paid by Enron to Anderson illustrate the significant economic importance of Enron as a client of Anderson. In fact, the IRRC report indicates that for

[3] New York Times, September 11, 2003, p. C1.
[4] Wall Street Journal, January 15, 2004, p. A3.

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