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Client pressure and auditor independence: Evidence from the "Great Recession" of 2007–2009 ☆

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ABSTRACT

This study investigates whether auditors' independence was compromised by client audit fee pressures during the recession of December 2007 through June 2009. We hypothesize that clients able to extract fee concessions from auditors during the recession, when audit risk increased, might also have been able to obtain more favorable audit opinions. We find that auditors are less likely to issue first-time going concern (GC) opinions to clients that exert fee pressure in 2008, but do not find this result in other years, including several years before and following the central recession year of 2008 (i.e. 2005–2007, 2009–2011). Our results suggest that the stringent economic environment of the recession may have weakened auditor independence for clients capable of exerting audit fee pressure, but this effect was restricted to 2008, the heart of the recession. We also find compensating payments (in the form of expected total fee increases or high current-year NAS fees) from fee pressure clients strengthen the negative association between fee pressure and auditors' GC opinions.

1. Introduction

Possible impairment of auditor independence has been a longstanding concern of regulators, legislators and market participants (SEC, 2000; Sarbanes-Oxley 2002 (SOX); PCAOB, 2010). This study investigates whether auditors acted with less independence for clients that were able to impose pressure on audit fees during the severe economic downturn of 2007–2009. Auditor independence sometimes requires auditors to take positions that client managers will dislike (DeAngelo, 1981; Watts and Zimmerman, 1986). The modification of an audit report for going concern (GC) reasons is a decision likely to displease client managers. Thus, following prior studies that have investigated possible auditor economic dependence on the client (as discussed in Carson et al., 2013; DeFond and Zhang, 2014), our proxy for auditor independence is auditors' willingness to issue first-time GC modified opinions to financially distressed clients. The economic downturn examined in this study is the "Great Recession",[1] which began in the U.S. in December of 2007 and officially ended in June of 2009 (NBER, 2010).

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[1] In February, 2010 the Associated Press added the term "Great Recession" to its stylebook as a reference for the recession of 2007–2009 (Schlisserman, 2010). We refer to this event as "the Recession".

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The effects of the Recession, however, lingered for more than an additional year and imposed severe financial pressures on many companies.[2]

We view the Recession as an important setting in which to revisit the issue of auditor independence for the following reasons. First, a GC modified opinion imposes significant economic costs on a client firm, such as negative stock returns and increased risk of client business failure (Mutchler, 1984; Menon and Schwartz, 1987; Geiger et al., 1998; Kausar et al., 2009). Thus clients sometimes pressure auditors not to issue first-time GC opinions and dismiss auditors who do issue such opinions (Carcello and Neal, 2000, 2003). The economic costs to clients associated with receiving GC opinions are likely to have increased significantly during the Recession when availability of financing was limited even for companies not stigmatized by GC opinions. Clients therefore might have been more averse than usual to the prospect of receiving GC opinions during the Recession, whereas the numbers of companies deserving such opinions probably increased.[3]

Prior studies examining auditors' willingness to issue GC opinions generally do not find that auditors compromise their independence for important clients (DeFond et al., 2002; Li, 2009; DeFond and Zhang, 2014), although those studies are conducted during periods with less severe economic conditions.[4] The extent to which auditors maintain their independence in a very stringent economic environment, characterized by increased client financial distress and reduced audit revenues, is unknown.[5] It is plausible that auditors were more reluctant than usual to risk losing clients during the Recession, which was a period of downward pressure on audit fees and of increased financial challenges for auditors (Ettredge et al., 2014). Therefore, the Recession provides a unique setting in which managers of many firms were likely to have had stronger incentives to avoid receiving GC opinions, and auditors were also under greater pressure not to lose clients due to already reduced audit revenues. Whether auditors are able to maintain their independence with respect to desirable clients in this situation is unknown.

The independence of auditors in relation to their GC decisions has also attracted the attention of regulators. The PCAOB is concerned that downward pressure on audit fees might cause some auditors to take cost cutting actions that could compromise audit quality (PCAOB, 2010, 26). The PCAOB noted that as the economic crisis (Recession) developed, the risk in certain audit areas increased, including the ability of clients to continue as going concerns (PCAOB, 2010, 4). The PCAOB specifically cautioned auditors to focus on this area of audit risk (PCAOB, 2008, 15).

We investigate whether financially stressed clients able to exert audit fee pressure on their auditors during the Recession also were able to exert pressure on auditors' GC decisions. We focus on audit fee pressure because, as mentioned above, the PCAOB is concerned that downward fee pressure during the Recession could adversely affect audit processes including the GC decision. We argue that a client firm able to exert fee pressure on its auditor during the Recession has demonstrated bargaining power, because a constrained or reduced audit fee in a period of increased audit risk represents a significant concession by the auditor. Clients able to exert pressure on auditors' fees during the Recession therefore might have had greater bargaining power with respect to GC decisions as well. This outcome is by no means certain *ex ante*, however, because potentially distressed clients paying reduced fees could be clients that auditors are more willing to risk losing. Given regulators' concerns whether auditors maintained their audit quality in a uniquely stringent economic environment, and their emphasis on the auditors' GC decisions during the Recession, we argue that the issue we raise deserves empirical study.

If clients successfully exerting fee pressure have made credible promises of compensating payments to the auditors in the future, or if those clients are buying other lucrative services such as non–audit services (NAS) from their auditors, the economic bonding between fee pressure clients and their auditors should be stronger. As a result, we expect the negative relationship between audit fee pressure and auditor GC opinions, if any, will be stronger for clients with larger expected total fee (the sum of audit and non–audit fees) growth (proxied by actual next-year total fee growth), or larger same-year purchases of NAS (proxied by current year NAS fees).[6]

Using a sample of 8581 financially distressed firm-years from 2005 to 2011, we examine whether client pressure impacted auditor propensity to issue a first-time GC opinion during the Recession (late 2007 through the first half of 2009), with attention primarily focused on the deep Recession year of 2008. We also examine periods that are clearly before (2005–2006) and after the Recession (2010–2011) to study if the results observed during the Recession also exist in more normal periods. We measure client pressure using the fee pressure metric in EFL (2014). We calculate client fee pressure for each year in our sample. We then estimate a going concern logistic model for each sample year and find that fee pressure

[2] The Recession was longer than any other since World War II. It also had more severe negative effects on gross domestic product, private sector jobs, and retail sales than preceding recessions (Ettredge et al., 2014).

[3] The number of U.S. commercial bankruptcies for the first eleven months of 2008 was 35 per cent greater than the number filed in the entire year of 2007 (Pugh, 2008). Not only did client risk of bankruptcy increase during the Recession; Trombetta and Imperatore (2014) find that managers increase earnings manipulation activities during severe financial crises including the Recession.

[4] A recent exception to this general result is a study by Chen et al. (2016). Using Chinese data on engagement signing partners, they find that clients are able to "opinion shop" successfully.

[5] Univariate data presented in Carson et al. (2013, TABLE 1, 356) show that among a large sample of U.S. firms, the per cent receiving GC opinions increased modestly in 2007–2009. However, those authors do not control for individual clients' financial conditions or abilities to exert pressure on auditors.

[6] We employ NAS fee levels rather than using actual NAS fee growth to proxy for expected fee growth because evidence we present subsequently indicates that growth in NAS fees was much more difficult to predict during the recession compared to growth in audit fees.