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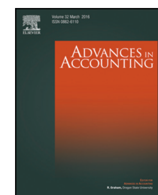

The influence of earnings management conducted through the use of accretive stock repurchases on audit fees

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A B S T R A C T

This study investigates whether auditor perceptions of risk are affected by accretive stock repurchases, which prior research has suggested is a form of earnings management. We argue that auditors are likely to view earnings management conducted through the use of accretive stock repurchases as a signal of increased risk, leading to higher audit fees. Consistent with our hypothesis, we find evidence of a positive and significant association between the use of accretive stock repurchases as an earnings management technique and audit fees. The results suggest that audit fees are 6.0% higher when accretive stock repurchases are used to manage earnings, which corresponds to an audit fee that is approximately $107,000 higher for the average firm-year observation in our sample.

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1. Introduction

This study examines whether earnings management conducted through the use of accretive stock repurchases is associated with higher audit fees.[1] While prior research most commonly focuses on earnings management that is carried out by increasing earnings (the numerator of earnings per share [EPS]), earnings management can also be executed by using share repurchases to decrease the number of shares outstanding (the denominator of EPS), which can increase EPS. Supporting this idea, prior research provides evidence that managers use share repurchases to manage earnings (e.g., Almeida, Fos, & Kronlund, 2016; Bens, Nagar, Skinner, & Wong, 2003; Cheng, Harford, & Zhang, 2015; Hribar, Jenkins, & Johnson, 2006; Myers, Myers, & Skinner, 2007). We argue that auditors are likely to view earnings management by use of accretive stock repurchases as a signal of increased risk, leading to higher audit fees.

Our study is related to prior literature that examines the auditor's response to earnings management. Prior research investigates whether earnings management affects auditor perceptions of risk, as reflected in audit fees (e.g., Abbott, Parker, & Peters, 2006; Greiner, Kohlbeck, & Smith, 2013; Gul, Chen, & Tsui, 2003; Krishnan, Sun, Wang, & Yang, 2013; Schelleman & Knechel, 2010). This stream of literature provides evidence of a positive association between earnings management and audit fees. While prior studies in this area focus on earnings management that is executed by increasing earnings, a distinguishing feature of our study is that we investigate earnings management that is accomplished by decreasing the number of shares outstanding by the use of share repurchases.

Regardless of its form, earnings management is an unscrupulous practice because it is used to "either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (Healy & Wahlen, 1999). When using accretive stock repurchases as an earnings management technique, managers are likely to be successful in deceiving at least some investors about the firm's financial performance. Consistent with this idea, Hribar et al. (2006) provide evidence that using accretive stock repurchases to meet or beat analysts' EPS targets helps reduce the negative stock price reaction that is associated with failing to reach analysts' forecasts of EPS.

Further, recent research suggests that managers use share repurchases to opportunistically manipulate EPS and provides evidence that this manipulation negatively affects the firm. For example, Cheng et al. (2015) find that share repurchases are more likely to occur when a CEO's bonus is linked to EPS, and this effect is stronger when the firm would have missed the bonus-inducing EPS target without a share repurchase. The authors also show that firms linking CEO bonuses to EPS fail to achieve positive long-run abnormal returns. In addition, Almeida et al. (2016) provide evidence that firms engage in accretive

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[1] Accretive stock repurchases are share repurchases that increase earnings per share.

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stock repurchases to meet or beat analysts' forecasts of EPS. The authors furthermore find that these share repurchases are associated with decreased employment and investment.[2]

Although auditors are unable to challenge earnings management conducted through the use of share repurchases because it involves the firm engaging in real business transactions, auditors are likely to take notice of management's willingness and desire to manipulate financial results. While accretive stock repurchases, in and of themselves, should not affect audit risk[3] as long as the share repurchases are properly reflected in the financial reports, when an auditor observes management using share repurchases as an earnings management technique in order to artificially achieve certain financial results, it may provide a signal of low management integrity. Hence, even when the EPS-increasing effect of accretive stock repurchases is reflected appropriately in the financial reports, using share repurchases to manage earnings may influence an auditor's assessment of audit risk by affecting the auditor's perception of management integrity.

Auditing standards as well as the Committee of Sponsoring Organizations (COSO) recognize that management integrity affects audit risk. For example, Auditing Standard No. 12 addresses the impact of management integrity on the control environment, which is an important factor that affects audit risk (PCAOB, 2010b). Auditing Standard No. 12 states "Obtaining an understanding of the control environment includes assessing whether sound integrity and ethical values, particularly of top management, are developed and understood" (PCAOB, 2010b). In addition, with respect to assessing audit risk in making client-acceptance decisions, COSO notes: "screening of potential risks, particularly the impact of management's integrity and ethical values, may lead to better considerations of overall audit risk" (COSO, 1999). Accordingly, upon an auditor observing earnings management conducted through the use of accretive stock repurchases, the auditor is likely to perceive audit risk as being higher if the auditor views earnings management as a signal that management integrity may be low.

Based on prior literature that investigates the relation between audit risk and audit fees (e.g., Gul et al., 2003; Hogan & Wilkins, 2008; Krishnan et al., 2013; Schelleman & Knechel, 2010; Simunic, 1980), we expect auditors to respond to greater audit risk by charging higher audit fees. Therefore, we hypothesize a positive association between earnings management conducted through the use of accretive stock repurchases and audit fees.

We test our hypothesis using a sample of 19,136 firm-year observations from the period 2005–2013. To identify accretive stock repurchases that were likely used to manage earnings, we utilize an indicator variable that identifies accretive stock repurchases that allowed a firm to meet or beat the consensus analyst forecast of EPS by no more than five cents when the firm would have otherwise missed the EPS target by no more than five cents. Using an audit fee model that controls for many determinants of audit fees established by prior research, we find a positive and significant association between accretive stock repurchases that allowed a firm to meet or beat analysts' forecasts of EPS and audit fees. The results suggest that audit fees are 6.0% higher when accretive stock repurchases are used to manage earnings. This represents an audit fee that is approximately $107,000 higher for the average firm-year observation in our sample.

This study contributes to the stream of research that examines the use of accretive stock repurchases as an earnings management technique. While prior research suggests that managers use share repurchases to manage earnings (e.g., Almeida et al., 2016; Bens et al., 2003; Cheng et al., 2015; Hribar et al., 2006; Myers et al., 2007), we are not aware of any study that has examined whether auditors view this practice as increasing audit risk. We fill this void in the literature by providing evidence that using accretive stock repurchases to manage earnings is associated with higher audit fees. This study also contributes to the line of literature that investigates the influence of earnings management on auditor risk assessments. While prior studies in this area examine earnings management that is carried out by increasing earnings (e.g., Abbott et al., 2006; Greiner et al., 2013; Gul et al., 2003; Krishnan et al., 2013; Schelleman & Knechel, 2010), we are the first to investigate whether earnings management that is achieved by decreasing the number of shares outstanding through the use of share repurchases affects auditor risk assessments. Our study also adds to this line of literature by examining the influence of earnings management on audit fees using an earnings management proxy that does not rely on fitted models, as is the case with discretionary accruals and commonly used measures of real earnings management. Thus, our study helps move this line of research forward by providing triangulation concerning this research question.[4]

The rest of this paper is structured as follows. Section 2 discusses background literature and formally states our hypothesis, Section 3 describes our methodology, Section 4 presents the results of the study, and Section 5 provides concluding remarks.

2. Background literature and hypothesis

Open-market share repurchase programs are required to be approved by a firm's board of directors and are typically completed within three years of when the program is initiated (Burnett, Cripe, Martin, & McAllister, 2012; Hribar et al., 2006; Stephens & Weisbach, 1998). Once the board of directors authorizes a certain quantity of shares to be repurchased, managers have the ability to determine both the timing of share repurchases as well as the quantity of shares to be repurchased (Burnett et al., 2012; Cook, Krigman, & Leach, 2003; Hribar et al., 2006).[5] Since share repurchases decrease both the numerator and denominator of EPS, share repurchases can either increase or decrease EPS. Share repurchases decrease the numerator of EPS because the firm incurs an opportunity cost attributable to not being able to earn a return on the cash that it expended for the repurchases, while share repurchases decrease the denominator of EPS by decreasing the number of shares outstanding (Burnett et al., 2012; Hribar et al., 2006).

Several studies investigate the use of accretive stock repurchases as an earnings management technique. Bens et al. (2003) suggest that firms increase EPS through the use of share repurchases in order to maintain EPS growth rates and in response to EPS dilution from employee stock options. Hribar et al. (2006) find that managers use accretive stock repurchases to boost EPS in order to meet or beat analysts' forecasts of EPS. The authors also suggest that using share repurchases to meet or beat analysts' EPS targets helps reduce the negative stock price reaction that is associated with failing to reach analysts' forecasts of EPS. Myers et al. (2007) investigate earnings management by firms

[2] The business press has also recognized that CEOs may use share repurchases to opportunistically manipulate EPS to the detriment of shareholders. *Reuters* notes that "Soaring CEO pay tied to short-term performance measures like EPS is prompting criticism that executives are using stock repurchases to enrich themselves at the expense of long-term corporate health, capital investment and employment" (Brettell, Gaffen, & Rohde, 2015). Also, *The Wall Street Journal* notes that "As corporations step up stock repurchases to return cash to shareholders, compensation targets tied to per-share earnings—a common factor in executive-pay calculations—are helping increase many executives' pay. The link worries some investors and compensation advisers because they fear the figure is too easily manipulated" (Thurm & Ng, 2013). *Reuters* cites the following example regarding a share repurchase by Humana: "It added around two cents to the company's annual earnings per share, allowing Humana to surpass its $7.50 EPS target by a single cent and unlocking higher pay for top managers under terms of the company's compensation agreement. Thanks to Humana hitting that target, Chief Executive Officer Bruce Broussard earned a $1.68 million bonus for 2014" (Brettell et al., 2015).

[3] Audit risk is the "risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated" (PCAOB, 2010a).

[4] Abdel-Khalik and Ajinkya (1979) note that "multiplicity of methods, or 'triangulation,' is a desirable feature of research… The extent to which triangulation produces similar results can be used as a measure of confidence in the findings and validity of the underlying theory."

[5] Managers are not required to repurchase the entire quantity of shares that were authorized by the board of directors to be repurchased (Stephens & Weisbach, 1998).

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