Order Number 9308164

Audit fee effects on auditor independence

Bailey, James Alma, Ph.D.

The University of Nebraska - Lincoln, 1992

U·M·I
300 N. Zeeb Rd.
Ann Arbor, MI 48106

AUDIT FEE EFFECTS ON AUDITOR INDEPENDENCE

by

James Alma Bailey

A DISSERTATION

Presented to the Faculty of

The Graduate College at the University of Nebraska

In Partial Fulfillment of Requirements

For the Degree of Doctor of Philosophy

Major: Interdepartmental Area of Business

Under the Supervision of Professor Kung H. Chen

Lincoln, Nebraska

August, 1992

DISSERTATION TITLE

Audit Fee Effects on Auditor Independence

BY

James Alma Bailey

SUPERVISORY COMMITTEE:

APPROVED	DATE
Kung H. Chen (Signature)	8/20/92
Kung H. Chen (Typed Name)	
Thomas D. Hubbard (Signature)	8/20/92
Thomas D. Hubbard (Typed Name)	
James W. Gentry (Signature)	8/20/92
James W. Gentry (Typed Name)	
John W. Creswell (Signature)	August 20, 1992
John W. Creswell (Typed Name)	
Signature	
Typed Name	
Signature	
Typed Name	

GRADUATE COLLEGE
UNIVERSITY OF NEBRASKA

AUDIT FEE EFFECTS ON AUDITOR INDEPENDENCE

James Alma Bailey, Ph.D.

University of Nebraska, 1992

Adviser: Kung H. Chen

Auditor independence provides investors confidence in audited financial statements. Any threat to audit independence may undermine this confidence. Because unpaid audit fees may threaten independence, this study examines the effect of audit fees on audit independence.

One hundred forty-three individuals attending continuing education classes for Certified Public Accountants served as subjects for this study. Subjects responded to three scenarios in which they must decide whether to disclose a threatening situation concerning their client's ability to continue in existence. A disclosure may jeopardize eventual collection of unpaid audit fees. Prospect theory, framing, escalating commitment, motivated reasoning, and social indebtedness theory literatures form theoretical bases for predictions of auditors' choices.

In the first scenario, subjects were asked whether or not they would require disclosure of certain information in the notes to the financial statements. Although more subjects given a loss frame than a gain frame risked not requiring disclosure, as was hypothesized, the results were not statistically significant. Several studies

provide evidence consistent with these non-significant results, suggesting escalating commitment is sensitive to the subjects' frames of reference, risk attitudes, experience, and other factors.

In the second scenario, subjects indicated whether or not they would continue the engagement with the client. In the loss condition, audit fee non-collectors escalated as hypothesized; however, audit fee collectors de-escalated. Neither result was significant in the hypothesized direction; however, a significant interaction occurred between groups. This result is consistent with several studies which observe that inexperienced individuals escalate more than experienced individuals.

In the third scenario, subjects were asked to assess the reliability of several sources of evidence. Significant escalation did not occur as hypothesized in the loss condition.

Choices made by gain condition subjects in the second scenario were compared to a lottery choice. Subjects tended to escalate more with the client relationship than with the lottery choice; however, results were not statistically significant.

ACKNOWLEDGMENTS

Many individuals contributed to the completion of this dissertation. While the following list is incomplete, it represents several individuals to whom I owe a special debt of gratitude.

I appreciate the concern and help Kung Chen has given me throughout my Ph.D. program, and especially for the time he has spent reviewing and commenting on this dissertation. I also thank Thomas Hubbard, James Gentry, and John Creswell for the help they gave me as members of my dissertation committee. Thomas Hubbard allowed me to collect data at his seminars, and he gave me helpful comments related to the professional literature. James Gentry introduced me to several thought provoking ideas, and his comments expanded my perspective. John Creswell gave me suggestions on how to improve the clarity and presentation of the major ideas of this study.

I value the patience and support of my wife, Roberta, and of my children, Bill, Becca, Robbie, Katie, Richard, and Timothy. I also thank my parents and my brothers and sisters for their support.

Finally, I thank Irv, John, Martha, Konrad, Jim, Ibrahim, Janice, Sue, Carol, and many other doctoral students and faculty for the support they have given me throughout my doctoral program.

TABLE OF CONTENTS

LIST OF FIGURES

Figure

LIST OF TABLES

Table

CHAPTER 1 - INTRODUCTION AND OVERVIEW OF THE STUDY

1.1 MOTIVATION

Auditor independence is the cornerstone of the public accounting profession (Mednick 1990). It provides the investing public greater confidence in audited financial reports. Without auditor independence, financial statements lose much of their credibility in the eyes of creditors and investors.

In order to protect this public perception of independence, the public accounting profession and government regulators have adopted rules which prescribe auditor behavior, including a stipulation that auditors avoid having a financial interest in their clients. The rules and regulations, however, ignore one of the greatest potential financial conflicts; namely, that the auditor is paid by the client for the audit. While recognizing that prior year fees owed by the client may affect auditor independence (AICPA 1992, SEC 1989), the rules and regulations are silent on current fees owed by the client.

If past due bills are considered loans (and therefore imply a financial interest in the company), the collection of <u>current</u> fees might also have this effect. Unless audit fees are paid in advance, auditors risk losing fees if their audit decisions conflict with the wishes of their clients. Unpaid current audit fees, therefore, may

provide audit clients an opportunity to exert pressure on auditors to revise their opinions.

Prospect theory and the escalating commitment literature suggest that the possible loss of fees may lead auditors to take more risks than they would have otherwise taken had the fees been paid in advance. Social indebtedness theory also suggests that auditors who are paid fees are likely to take more risks. These potentially undesirable behaviors, if they occur, are impairments of auditors' independence.

A clear understanding of how audit fees affect audit independence will help the auditing profession in its efforts to achieve audit independence. Any effort which improves audit independence, or the perception of audit independence is important to the profession.

1.2 RESEARCH QUESTION

This study tests the effects of audit fees on auditing decisions. It explores new ground by using prospect theory, framing, escalating commitment, social indebtedness and motivated reasoning literatures to analyze the relationship between audit fees and independence.

1.3 ESCALATING COMMITMENT AND AUDIT FEES

Escalating commitment occurs when individuals take risks to avoid certain losses. Whyte (1986) suggests that prospect theory (Kahneman and Tversky 1979) can be used to explain escalating commitment. Whyte argues that prospect theory suggests three stages in committing new resources to a course of action. First, the decision maker has a certain reference point. Second, the decision maker pursues an action. Third, the decision maker receives feedback concerning the consequences of the action. At the point feedback is received, the decision maker frames the consequences as being either positive or negative.

Whyte employed Tversky and Kahneman's (1981) race track example to argue that in framing a continuing loss situation an individual may use one of two different reference points with the incurrance of losses as the dividing line. Expected utility theory suggests that an individual who takes a post-loss reference point will likely be risk averse and not take the gamble.[1] With the pre-loss reference point, on the other hand, Whyte argues that an individual will probably attempt to return to the reference point that existed at the beginning of the day by taking the gamble. Therefore, an individual with the pre-loss reference point is likely to escalate by taking

---

[1] Whyte does not directly address the post-loss reference point.

the gamble, even though the gamble is the riskier course of action of the two.

Whyte notes that an individual's frame for a wagering choice is similar to choice situations in which previous decisions (failures or successes) may affect the current decision frame. The "sunk costs" of previous decisions, therefore, may affect the framing of current decisions.

When auditors face a sunk cost/loss situation, the escalating commitment explanation predicts that the auditors will attempt to return to the reference point before loss and take more risk than they otherwise would take. This theory led to the development of two hypotheses. Hypothesis one predicted that auditors in a fee loss situation will take more risk than auditors in a fee gain situation by decreasing their requirement for a going concern disclosure. Hypothesis two predicted that auditors would be more likely to continue an audit engagement when they face a fee loss situation than when they faced a fee gain situation.

1.3.1 TEST OF HYPOTHESIS ONE

Participants at continuing education seminars for certified public accountants served as subjects in this study. The subjects were given a research instrument that contained three scenarios and a lottery choice. The scenarios included three different client going concern

situations. For each situation, the client did not want to disclose the going concern situation in the notes to the financial statements. The hypothesis one scenario asked the subjects to choose whether they would or would not require disclosure of the financial statement information.

Hypothesis one predicted that auditors in a loss situation will take more risk by decreasing their requirement for a going concern disclosure. The independent variable used to test the hypothesis was manipulated by randomly assigning subjects to the audit fee gain or loss condition. The dependent variable was the subject's choice to require or not require disclosure. Logit was used to test the null hypothesis.

The logit test results were not significant; therefore, the test does not provide adequate support for hypothesis one, although the results were in the hypothesized direction. The small significance criterion, sample size, and effect size contributed to low statistical power.

Evidence from several non-auditing studies may explain the small effect size. The subjects may have framed the decision from an after loss reference, resulting in risk averse behavior. Several studies observe risk averse behavior in a loss situation (Garland, Sandefur, and Rogers 1990; Phillips, Battatio, and Kogut

1991). The low loss amount may have been considered an insurance payment to avoid a possible higher litigation loss (Kahneman and Tversky 1979). The potentially high litigation costs may have been sufficiently salient to the subjects that they ignored the probabilities associated with the lawsuit and concentrated on the lawsuit itself (Diamond 1988). Subjects also may have perceived high risk associated with risky choice which would result in low escalation (Barton, Duchon, and Dunegan 1989; Schaubroeck and Davis 1992). Ethical accountability may also have influenced the subjects' choices (Ponemon 1992; Tetlock 1985). Chapter 4 presents evidence and discusses these possible alternative explanations in detail.

1.3.2 TEST OF HYPOTHESIS TWO

Hypothesis two predicted that auditors would be more likely to continue an audit engagement when they face a fee loss situation than when they faced a fee gain situation. Subjects were assigned to the same conditions as in hypothesis one. Logit was used to test the subject's choice to continue or not continue the engagement.

The logit test results were not significant. A significant interaction occurred between the audit fee collector and audit fee non-collector groups. While the audit fee non-collector group escalated, the audit fee

collector group de-escalated. This behavior is consistent with evidence from several studies that indicate experience with a problem decreases escalation behavior (Garland, Sandefur, and Rogers 1990; McCain 1986; Phillips, Battatio, and Kogut 1991; Staw and Fox 1977). Another possible reason for lack of significant results is that the percentage of the sunk costs to the total budget is low. Several studies observe that higher escalation occurs when a larger percent of the budget has been spent (Garland 1990; Garland and Newport 1991).

1.4 INDEBTEDNESS THEORY AND AUDIT FEES

Greenberg (1980) developed a theory of indebtedness based on the assumption of reciprocity (Gouldner 1960). When people receive benefits from other people, they become psychologically indebted to the other people until the benefits are repaid.

One study showed subjects reducing the inequity through future interactions (Leventhal, Allen, and Kemelgor 1969). If auditors receive a payment for a job, they may feel obligated to reciprocate in some way to repay the social debt they have incurred by receiving the payment from the client. Indebtedness theory, therefore, suggests escalating commitment for payment of fees. One way to repay this obligation would be to continue

relations with the client even when it may not be in the auditors best interest to do so.

Social indebtedness theory, therefore, predicts auditors are more likely to choose a riskier alternative when they feel obligated to repay a social debt than when no social debt is present. According to social indebtedness theory, the choice auditors make in a client relationship where a social debt exists will be different from the choice the auditors make when choosing between lottery choices where no social debt exists.

Hypothesis three predicted that auditors would choose a riskier alternative more often when the gain situation involves a client relationship than when it involves a lottery choice. The independent variable was manipulated by comparing subjects' responses from the second scenario with their lottery choices. The dependent variable was the subject's choice to continue the engagement in the scenario or to receive the uncertain gain in the lottery versus choosing not to continue the engagement in the scenario or to receive the certain gain in the lottery choice. Logit was used to test the null hypothesis.

The logit test results were not significant; therefore, the test does not provide adequate support for hypothesis three, although the results were in the hypothesized direction. The non-significant results for hypothesis three may also indicate that the magnitude of

indebtedness of the subjects was not sufficiently high to produce results. Donor's motives, magnitude of rewards and costs for donors and recipients, and locus of causality may affect the subjects's magnitude of indebtedness.

1.5 MOTIVATED REASONING AND AUDIT FEES

People who are motivated to arrive at a particular conclusion rely on cognitive processes which are likely to lead them to their desired conclusion (Kunda 1990). Therefore, motivation may lead to biased cognitive processes. These biased cognitive processes affect the reasoning strategies which individuals use to access, construct, and evaluate beliefs. Thus, if individuals can use these reasoning strategies to construct reasonable justifications for their goals, they will use biased cognitive processes to arrive at their desired conclusions.

Pyszczynski and Greenberg (1987) stated that inferential processes are affected by individual motives and needs in such a way as to maintain an "illusion of objectivity." They point out that even though accuracy is important, other goals may be more influential in choosing the inferential rules used to assess a situation.

Based on the prospect theory and escalating commitment literatures, auditors in a loss situation are

more likely to be risk-seeking than auditors in a gain situation. If motivation plays a role in examining evidence, auditors in the risk-seeking/loss situation will place more weight on management produced information than on non-management produced information. Management produced information is ostensibly less objective and more likely to justify a risk-seeking decision to escalate the auditors' commitment. For auditors in the risk averse/gain situation, the opposite result is predicted because auditors who seek to avoid risk will rely more on non-management produced evidence, such as court documents and attorneys' letters. Presumably external documents are less biased and optimistic than management information.

For hypothesis 4, the participants assessed the reliability of the following four sources of information related to the going concern situation: management's letter, management's discussion, court documents and attorney's letter. Hypothesis 4a predicted that auditors in the fee loss situation would place higher reliability on management letter and discussions with management than would auditors in the fee gain situation. Hypothesis 4b predicted that auditors in the fee loss situation would place lower reliability on court documents and attorney's letter than would auditors in the fee gain situation. The independent variable was manipulated by randomly assigning subjects to the audit fee gain or loss situation. The