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Management Entrenchment, Agency Problem and Audit Fees

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Abstract

This study examines the association between audit fees and management entrenchment, which is proxied by Bebchuk et al. (2005) entrenchment index. The results show that audit fees are significantly positively correlated with Bebchuk et al. (2005) entrenchment index controlling for other factors. Further results show that the positive relation between audit fees and the entrenchment index exists only in firm with low growth opportunity and high free cash flow (i.e. firms with severe Jensen agency problem). These results indicate that firms' agency problems moderate the association between audit fees and management entrenchment.

Keywords: Audit fee, Management entrenchment, Agency problem

JEL Classification: M42, G34

1. Introduction

A number of firms adopt corporate governance provisions to fight against takeover. Although these governance provisions provide possible attempts to fend off being targets of merger and acquisitions, it is of great interest to know whether these governance provisions have any negative effects perceived by either capital markets or external auditors.

Corporate governance provisions have attracted attention from both academics and practitioners. Prior studies on governance provisions focus on the effect of these provisions on market valuation (e.g. Compers et al. (2003), Bebchuk et al. (2005)). This study complements prior studies by investigating whether entrenchment governance provisions result in high level of risk and demand more audit effort by external auditors.

It is reasonable to assume that auditors assess entrenchment provisions in auditing planning. The assumption is valid because auditors are sensitive to firm corporate governance and management control in both preplanning and planning judgment (Cohen and Hanno, 2000). If entrenchment provisions are perceived as higher risk, auditors would charge more audit fees due to more audit effort exercised for high risk clients (other things being equal). If entrenchment provisions are perceived as lower risk, auditors would charge less audit fees since auditors would exercise less audit effort on low risk clients (other things being equal).

Using audit fee data from U.S. firms, we examine whether auditors charge higher or lower audit fees for firms with higher entrenchment index scores controlling for other factors. We further investigate whether the association between audit fees and management entrenchment is contingent on firms' agency problems.

The contribution of this study is two-fold. First, this study contributes to the corporate governance provisions research by providing empirical evidence that entrenchment provisions results in higher audit fees, suggesting entrenchment provisions lead to higher audit risk. This provides one possible explanation why management entrenchment index has a negative effect on firm value. To this end, this study complements Becheck et al. (2005) by providing evidence that entrenchment provisions result in high internal risk, and consequently reduce firm value. Second, this study contributes to the auditing literature by providing empirical evidence that auditors charge higher audit fees for firms with more entrenchment governance provisions. This complements the experimental study of Cohen (2000) by documenting empirical evidence that auditors are sensitive to the corporate governance ontrol of their clients.

The next section develops testable hypotheses. Section three presents methodology used in the empirical tests. Section four describes the sample and section five provides empirical results and reports sensitivity tests. The final section concludes.

2. Hypotheses Development

2.1 Entrenchment Index

Compers et al. (2003) constructed a board index based on 24 corporate governance provisions and show that the index is negatively associated with firm value. Bebchuk et al. (2005)

construct an entrenchment index using six of 24 corporate governance provisions, and provide empirical evidence that the negative relation between governance index and firm value documented by Gompers et al. (2003) is driven by the entrenchment provisions (based on six provisions) rather than the other 18 provisions. Among these six provisions, four "constitutional" provisions (staggered board, limits to shareholder bylaw amendments, supermajority requirements for mergers, supermajority requirements for charter amendments) prevent a majority of shareholders from having their way and two "takeover readiness" provisions (poison pills and golden parachutes) defend against a hostile takeover. The entrenchment index ranges from zero to six given equal weight on each of the six provisions. Higher entrenchment index score represents more power for management and places strong restriction on shareholder's ability to exercise their will.

2.2 Competing Views on Governance Provisions

There are two opposite views regarding these governance provisions. One view is that these governance provisions weaken discipline mechanism to remove management and thus entrench management. Manne (1965) argues that the entrenchment governance provisions are harmful to shareholders by weakening the disciplinary threat of removal and consequently increase empire building, shirking and stealing. Thus, entrenched management is more likely to be associated with opportunistic and inefficient behavior, which could reduce firm value.

The counterargument is that firms adopt entrenchment governance provisions to attract and retain good managers (i.e. these entrenchment provisions are adopted to insulate managers) because managers who are insulated by these entrenching provisions are more likely to invest optimally in long-term projects (Stein 1988; Bebchuk and Stole 1993) and avoid inefficient actions that otherwise be undertaken to reduce the likelihood of a takeover bid (Arlen and Tally 2003). Thus, corporate governance provisions are used to serve the long-term interests of shareholders by insulating management from focusing on short term. Companies adopt entrenchment provisions to attract good managers to behavior in the way which benefits the long-run interests of shareholders.

These two different views lead to two opposite effects of corporate governance provisions. Thus, it is an empirical issue whether the corporate governance provisions entrench management (a negative effect) or insulate management and allow them to pursue long-term projects (a positive effect). To address this issue, this study uses the audit fee model empirically examines whether audit fees are positively or negatively correlated with Bebchuk et al. (2005) entrenchment index.

2.3 Audit Fees and Entrenchment Provisions

As shown by Cohen (2000), external auditors are sensitive to firms' corporate governance and management control in their auditing planning. If entrenchment provisions entrench management and induce non-value maximizing behavior, external auditors will perceive firms with higher level of entrenchment provision as firms with higher risk and thus exercise more audit effort, which leads to higher audit fees. If entrenchment provisions are adopted to attract good managers and induce mangers to pursue long-term projects, external auditors

will consider firms with higher level of entrenchment provisions as firms with lower risk and thereby exercise less audit effort, which results in lower audit fees. These two competing arguments predict different associations between audit fees and entrenchment provisions. As a result, this study examines the following two competing hypotheses:

Hypothesis 1a: Ceteris paribus, audit fees are positively associated with entrenchment provisions.

Hypothesis 1b: Ceteris paribus, audit fees are negatively associated with entrenchment provisions.

2.4 Agency Problems

A stream of empirical research (e.g. Harvey et al. 2004; Gul and Tsui 1998) which suggests that firm's agency problem as an important moderator. In firms with severe agency problems, management entrenchment is more likely to result in opportunistic and inefficient behavior.

Jensen (1986) argues that firms with low growth and high level of free cash flows are more likely to involve in "value destroying activities" and have severe agency problems. The non-value maximizing behavior includes excessive consumption of perquisites, masking of non-optimal expenditures, misappropriation of assets, and salary enhancement (Amihu and Lev 1981; Jensen 1986; Christie and Zimmerman 1994; Rediker and Seth 1995). Both Christie and Zimmerman (1994) and Gul and Tsui (1998) suggest that managers of firms with low growth opportunities and high free cash flows are more likely to mask non-optimal activities by accounting manipulation (Gul & Tsui 1998, 221) and thus such firms have audit implications in terms of higher inherent audit risks (Gul and Tsui 2001). Consequently, external auditors perceive these firms with high audit risk and exercise more audit effort, which leads to higher audit fees. Thus, we further investigate whether agency problems within firms moderate the association between audit fees and management entrenchment. Two competing hypotheses are composed in this regard:

Hypothesis 2a: Ceteris paribus, agency problems (i.e. low growth and high level of free cash flows) moderate the association between audit fees and entrenchment provisions.

Hypothesis 2b: Ceteris paribus, agency problems (i.e. low growth and high level of free cash flows) do not moderate the association between audit fees and entrenchment provisions.

3. Methodology

The OLS audit fee regression model is widely used in prior studies (e.g. Simunic 1980, Francis and Simon 1987, Chan et al. 1983, Gul and Tsui (2001), Ferguson et al. (2003), Francis et al. (2005)). The model uses a set of variables to control for general cross-sectional differences in factors that affect audit fees. Prior studies show that the model has good explanatory power (adjusted R^2 is 0.70 or higher) and are robust across different samples, time periods, countries and sensitivity analyses for model misspecification.

Based on prior studies (e.g. Ferguson et al. (2003), Francis et al. (2005), Gul and Tsui (2001)), the following audit fee model is used to examine the association between audit fees and

management entrenchment:

$$LAF = \alpha_0 + \beta_1 SIZE + \beta_2 LSEG + \beta_3 CURRENT + \beta_4 QUICK + \beta_5 DE + \beta_6 ROI + \beta_7 FOREIGN + \beta_8 Qopinion + \beta_9 YE + \beta_{10} LOSS + \beta_{11} adjFCF + \beta_{12} E\_index + Fixed\ effects + \varepsilon$$

LAF = natural log of total audit fees;

SIZE = natural log of total assets in millions of dollars;

LSEG = natural log of the number of unique business segments;

CURRENT = ratio of current assets to total assets;

QUICK = ratio of current assets less inventory to current liability;

DE = ratio of long-term debt divided by total assets;

ROI = ratio of earnings before interest and tax to total assets;

FOREIGN = proportion of total sales from foreign operations;

Qopinion = indicator variable, 1=qualified audit report;

YE = indicator variable, 1=31/12 fiscal year end;

LOSS = indicator variable, 1= loss in current fiscal year;

adjFCF = Jensen free cash flow; defined as cash flow (revenues less cash expenses including tax and interest payments) less dividends, divided by total assets (Gul & Tsui 2001; Chirinko & Schaller 2004);

E_index = Entrechment index (Bebchuk et al. 2005);

Fixed effects = industry dummy variables for two-digit SIC industry classification and year dummy variables;

ε = error term.

The above model is similar to Francis et al. (2005) except for two variables: adjFCF and E_index. AdjFCF (Jensen free cash flow) is measured in the same way as Gul and Tsui (1998), Gul and Tsui (2001) and Chirinkoand Schaller (2004). E_index is the variable of interest and is the entrenchment index defined by Bebchuk et al. (2005) entrenchment index.

The positive coefficient on E_index suggests that entrenchment provisions entrench management and induce inefficient or opportunistic behavior. The negative coefficient on E_index suggests that entrenchment provisions are adopted to attract good managers to pursue long-term projects. Furthermore, this study investigates whether the relation between audit fees and entrenchment provisions is contingent on firms' agency problem. We expect that the association between audit fees and entrenchment provisions is stronger for firms with agency problems (i.e. firms with low growth and high level of free cash flows).

Following Chirinko & Schaller (2004) and Gul & Tsui (2001), free cash flows are defined as cash flow less dividends, divided by total assets; cash flow is defined as revenues less cash

expenses including tax and interest payments. Following prior research (Chirinko & Schaller 2004; Harvey et al. 2004; Lang et al. 1991), Tobin's Q, which measures growth opportunities, is computed as market value of equity plus book value of assets minus book value of equity, and then divided by book value of assets. Base on Jensen (1986), this study defines firms with agency problems as the firms with low growth and high level of free cash flows. Firms with Tobin's Q below the full sample median of Tobin's Q are classified as firms with low growth opportunities; while firms with free cash flows above the full sample median free cash flows are classified as high level of free cash flows.

4. Sample

The initial sample consists of all firms with data available on Compustat between 2000 and 2004. The sample also meets the following screens: 1) audited by Big N accounting firms; 2) required financial statement data available on Compustat; 3) not in the financial services sector (SIC codes 6000 to 6999); 4) audit fees data available from Standard & Poor audit fee database; 5) entrenchment provision index available (entrenchment index data are provided by Professor Bebchuk, please refer to his website). Because Bebchuk et al. (2005) get corporate provisions data from IRRC (Investor Responsibility Research Center) and IRRC publications are available only for year 2000, 2002 and 2004, that firms' governance provisions are assumed to be in place during the period immediately following the publication of the volume until the publication of the subsequent IRRC volume, which follows Bebchuck et al. (2005) and Gompers et al. (2003). The final sample meeting the above requirements has 2,510 firm-year observations from 2000 to 2004.

Table 1. Descriptive Statistics

N=2510

Variable	Mean	Median	Std Dev	Q1	Q3	Minimum	Maximum
AUDITFEE	2071.240	931.450	3702.940	474.000	2132.200	2.684	80593.000
laf	6.947	6.837	1.115	6.161	7.665	0.987	11.297
assets	5613.550	1368.280	13002.970	562.101	4335.000	30.531	174278.000
SIZE	7.418	7.221	1.512	6.332	8.374	3.419	12.068
LSEG	0.895	1.099	0.686	0.000	1.386	0.000	2.303
CURRENT	0.461	0.443	0.201	0.317	0.606	0.028	0.969
QUICK	1.917	1.311	2.346	0.891	2.042	0.044	35.795
DE	0.213	0.203	0.182	0.064	0.309	0.000	1.555
ROI	0.070	0.079	0.132	0.032	0.127	-1.599	0.858
FOR	0.333	0.325	0.219	0.154	0.481	0.000	1.286
Qopinion	0.476	0.000	0.500	0.000	1.000	0.000	1.000
YE	0.653	1.000	0.476	0.000	1.000	0.000	1.000
loss	0.083	0.000	0.276	0.000	0.000	0.000	1.000
adjFCF	0.069	0.078	0.107	0.043	0.113	-1.039	0.453
E_Index	2.479	3.000	1.253	2.000	3.000	0.000	6.000

Variables are defined as the following:

AUDITFEE = total audit fees in thousand dollars

ASSETS	=	total assets in million of dollars
LAF	=	natural log of total audit fees in thousand dollars
SIZE	=	natural log of total assets in millions of dollars
LSEG	=	natural log of the number of unique business segments
CURRENT	=	ratio of current assets to total assets
QUICK	=	ratio of current assets less inventory to current liability
DE	=	ratio of long-term debt divided by total assets
ROI	=	ratio of earnings before interest and tax to total assets
FOR	=	proportion of total sales from foreign operations
Qopinion	=	indicator variable, 1=qualified audit report
YE	=	indicator variable, 1=31/12 fiscal year end
LOSS	=	indicator variable, 1= loss in current fiscal year;
adjFCF	=	Jensen free cash flow; defined as cash flow (revenues less cash expenses including tax and interest payments) less dividends, divided by total assets
E_index	=	Entrechment index (Bebchuk et al. 2005)

Table 1 provides descriptive statistics. As shown in Table 1, there is a big difference between the mean and median of audit fee and distribution of audit fees is skewed. In contrast, the difference is much smaller for natural log of audit fees and the distribution of natural log of audit fees is approximately normal. This provides support for natural log-transformation of audit fee and total assets.

5. Empirical Results

Table 2. Regressions of Audit Fees on Control Variables and Entrenchment Index

Variable	Estimate	White t value	White p value
Intercept	2.186	16.373	0
SIZE	0.586	48.661	0
LSEG	0.163	8.703	0
CURRENT	0.581	6.6	0
QUICK	-0.061	-6.324	0
DE	0.166	2.094	0.036
ROI	-0.372	-1.66	0.097
FOR	0.653	9.576	0
Qopinion	0.121	4.054	0
YE	0.157	5.336	0
loss	0.069	1.187	0.235
adjFCF	0.055	0.2	0.841
E_Index	0.021	2.556	0.011
y2000	-0.773	-12.914	0
y2001	-0.69	-11.56	0
y2002	-0.382	-6.403	0
y2003	-0.259	-4.279	0
N		2510	
R^2		0.7382	

Variables in the regression are defined as the following:

LAF = natural log of total audit fees in thousand dollars
SIZE = natural log of total assets in millions of dollars
LSEG = natural log of the number of unique business segments
CURRENT = ratio of current assets to total assets
QUICK = ratio of current assets less inventory to current liability
DE = ratio of long-term debt divided by total assets
ROI = ratio of earnings before interest and tax to total assets
FOR = proportion of total sales from foreign operations
Qopinion = indicator variable, 1=qualified audit report
YE = indicator variable, 1=31/12 fiscal year end
LOSS = indicator variable, 1= loss in current fiscal year;
adjFCF = Jensen free cash flow; defined as cash flow (revenues less cash expenses including tax and interest payments) less dividends, divided by total assets
E_index = Entrechment index (Bebchuk et al. 2005)

We control the following 34 two-digit SIC industries with more than ten firm year observations: 10, 13, 16, 20, 23, 24, 25, 26, 27, 28, 29, 30, 32, 33, 34, 35, 36, 37, 38, 39, 42, 45, 48, 49, 50, 51, 54, 56, 57, 58, 59, 72,

73 and 87.

For brevity, we do not report coefficients on two-digit SIC industry dummy variables.

White t value and white p value are t value and p value based on white (1980) corrected for heteroscedasticity.

Table 2 shows that the coefficient on E_index is 0.021 significant at 0.01 level (white-corrected p value), supporting hypothesis 1a. Based on the coefficient, an increase of corporate governance provision by one causes the increase of audit fees by around 1,020 dollars. This suggests that entrenchment provisions entrench management and result in high risk perceived by external auditors.

Additionally, the results on other control variables are similar with Francis et al. (2005 Table 4): positive and significant coefficient on SIZE, LSEG, CURRENT, DE, FOR and Qopinion; negative and significant coefficient on QUICK and ROI. The coefficient on YE is positive in this study, but negative in Francis et al. (2005) because Francis et al. (2005) define YE indicator equals one if non December 31 year end and this study defines YE indicator equals one if December 31 year end. Inconsistent with Francis et al. (2005 Table 4), we do not find significant results on indicator variable Loss.

After excluding firms with missing data to compute Tobin's Q, the sample size drops from 2,510 to 2,444. Among the 2,444 firm year observations, 394 observations are classified as observations with low growth and high level of free cash flows.

Table 3. Effects of Entrenchment Index on Audit Fees in Two Different Subsamples

	Panel A: Low growth and high free cash flow			Panel B: the other sample		
Variable	Estimate	White t value	White p value	Estimate	White t value	White p value
Intercept	2.458	7.07	0	2.191	14.831	0
SIZE	0.589	22.971	0	0.585	42.943	0
LSEG	0.158	3.77	0	0.168	7.666	0
CURRENT	0.701	2.947	0.003	0.612	6.242	0
QUICK	-0.183	-4.741	0	-0.065	-6.976	0
DE	0.209	0.631	0.528	0.138	1.636	0.102
ROI	-1.789	-2.659	0.008	-0.153	-0.654	0.513
FOR	0.488	3.04	0.003	0.653	8.584	0
Qopinion	0.181	3.129	0.002	0.117	3.511	0
YE	0.105	1.565	0.119	0.163	4.713	0
loss	0.337	1.709	0.088	0.05	0.863	0.388
adjFCF	1.067	1.149	0.251	-0.27	-0.923	0.356
E_Index	0.043	1.921	0.056	0.014	1.455	0.146
y2000	-0.699	-5.133	0	-0.801	-11.828	0
y2001	-0.557	-4.359	0	-0.728	-11.287	0
y2002	-0.291	-2.283	0.023	-0.414	-6.423	0
y2003	-0.205	-1.62	0.106	-0.28	-4.274	0
N		394			2050	
R^2		0.813			0.7336	

Variables in the regression are defined as the following:

LAF = natural log of total audit fees in thousand dollars

SIZE = natural log of total assets in millions of dollars

LSEG = natural log of the number of unique business segments

CURRENT = ratio of current assets to total assets

QUICK = ratio of current assets less inventory to current liability

DE = ratio of long-term debt divided by total assets

ROI = ratio of earnings before interest and tax to total assets

FOR = proportion of total sales from foreign operations

Qopinion = indicator variable, 1=qualified audit report

YE = indicator variable, 1=31/12 fiscal year end

LOSS = indicator variable, 1= loss in current fiscal year;

adjFCF = Jensen free cash flow; defined as cash flow (revenues less cash expenses including tax and interest payments) less dividends, divided by total assets

E_index = Entrechment index (Bebchuk et al. 2005)

We defined firms with low growth and high free cash flow as firms with below full sample median of Tobin's Q and above full sample median of free cash flow (adjFCF). The rest are in the *Others* sample.

We control the following 34 two-digit SIC industries with more than ten firm year observations: 10, 13, 16,

20, 23, 24, 25, 26, 27, 28, 29, 30, 32, 33, 34, 35, 36, 37, 38, 39, 42, 45, 48, 49, 50, 51, 54, 56, 57, 58, 59, 72, 73 and 87.

For brevity, we do not report coefficient on two-digit SIC industry dummy variables.

White t value and white p value are t value and p value based on white (1980) corrected for heteroscedasticity.

Table 3 panel A shows that the coefficient on E_index is 0.043 (p=0.044) significant at 0.05 level (white-correct p value=0.056) for the sample with Jensen agency problems (i.e. low growth and high free cash flow). Table 3 panel B reports that the coefficient on E_index is 0.014 insignificant (white corrected p=0.146) for other firms. The coefficient on E_index is three times larger in the agency problem firms (low growth and high free cash flow) than in other firms. Moreover, R^2 is higher for the test sample (R^2=0.813) than for the control sample (R^2=0.734).

Sensitivity Tests

We performance several robustness tests and robustness tests show the tenor of the results is unchanged. First, In order to rule out the results are not driven by outliers. We rerun the regression after winsorizing top 1% and bottom 1% of outliers. The results are qualitatively the same. Second, we calculate VIF (variance inflation factors) for independent variables and all VIFs are less than ten, which shows that multicollinearity is not a concern. Third, to ease concern on omitted correlated variables, we rerun the regression after controlling for non-audit fees using two stage least square equation models to control for simultaneous determination for audit fees and non-audit fees. The unreported results are qualitatively unchanged. Finally, we also run the regressions with and without controlling for growth (defined by Tobin's Q) and results are similar.

5. Conclusion

This study investigates the association between audit fees and management entrenchment (proxied by Bebchuk et al. 2005 entrenchment index). It further investigates whether the association between audit fees and management entrenchment is contingent on firms' agency problems. The results show that audit fees are positively associated with the entrenchment index (Bebchuk et al. 2005). Furthermore, results show that the positive relation between audit fees and the entrenchment index only exists for Jensen agency problem firms (firms with low growth and high free cash flow). These results provide empirical evidence that the association between audit fees and entrenchment provisions is contingent on firms' agency problems.

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