INTERNAL CONTROL REPORTING AND AUDIT FEES OF NON-ACCELERATED FILERS

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Abstract

Recent actions by regulators and legislators reflect the belief that compliance with Section 404 of SOX is quite costly for non-accelerated filers. In this paper, we examine (a) the associations between the presence and remediation of internal control problems and audit fees for non-accelerated filers, and (b) how such associations differ for non-accelerated filers from those for accelerated filers. Using data from fiscal years 2008 and 2009, we find that the audit fee premium for non-accelerated filers disclosing a material weakness in internal controls (a) is significantly lower than the corresponding premium paid by accelerated filers, and (b) declines significantly over time only for the non-accelerated filers. We also examine subsequent remediation of internal control problems and find that in the case of accelerated filers remediating clients pay lower fees compared to clients continuing to report internal control problems; however, such differences are not observed in the case of non-accelerated filers. Overall, our findings suggest that the market for audit services differs significantly for non-accelerated filers than from the audit market for accelerated filers.

INTERNAL CONTROL REPORTING AND AUDIT FEES OF NON-ACCELERATED FILERS: A NOTE

In this paper we examine the associations between the presence and remediation of internal control problems and audit fees for non-accelerated filers, and how such associations differ for non-accelerated filers from those for accelerated filers.[1] Motivation for this study comes from the numerous actions of legislators and regulators in treating non-accelerated filers differently from accelerated filers with respect to internal control reporting. We focus on 2008 and 2009 because these were the first two years of implementation of 404(a) on non-accelerated filers.

Section 404(a) of the Sarbanes-Oxley Act (SOX 2002) requires management to provide an assessment about the effectiveness of the internal control system over financial reporting, while Section 404(b) requires auditor attestation of internal controls. Section 404 became applicable for accelerated filers for fiscal years starting on or after November 15, 2004. The SEC granted multiple extensions for non-accelerated filers to comply with Section 404.[2] Before the final postponement for non-accelerated filers to comply with Section 404(b) ended, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (2010) was enacted in July 2010. Section 989G(a) of the Dodd-Frank Act

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1 Accelerated filers are SEC registrants with a public float of at least $75 million, measured as of the end of the last day of the second quarter of a fiscal year

2 Initially, when the SEC (2003) issued rules to implement Section 404 of SOX, non-accelerated filers would have been subject to Sections 404(a) and 404(b) for fiscal years ending on or after April 15, 2005. In February 2004, the deadline for non-accelerated filers was extended to fiscal years ending on or after July 15, 2005. The deadline was further postponed in March 2005, September 2005, December 2006 and October 2009.

provides permanent exemption from the requirements of Section 404(b) for non-accelerated filers. In addition, Section 989G(b) of the Dodd-Frank Act also requires the SEC to conduct a study to determine how the burden of complying with Section 404(b) can be reduced for registrants with market capitalization up to $250 million.

A primary reason for the numerous postponements, and the eventual exemption, related to compliance with Section 404(b) for non-accelerated filers is the cost associated with such compliance. In particular, registrants and others have complained about the impact of Section 404(b) on fees paid to auditors (e.g., SEC 2005, 2006). Prior research indicates that fees paid to auditors constitute a significant part of total SOX costs (Krishnan, Rama, and Zhang 2008).

While some prior studies have examined the impact of internal control problems on audit fees for accelerated filers (e.g., Raghunandan and Rama 2006; Hoitash, Hoitash, and Bedard 2008; Munsif, Raghunandan, Rama, and Singhvi 2011), empirical evidence about the association between internal control problems disclosed by non-accelerated filers (pursuant to Section 404(a) of SOX) and audit fees for non-accelerated filers is sparse. Since the auditor's involvement in internal control assessment is significantly lower in the case of non-accelerated filers than for accelerated filers, and since the extent of competition is much greater in the small client segment of the audit market (GAO 2003; Kohlbeck, Mayhew, Murphy, and Wilkins 2008), it is likely that such association between internal control quality and audit fees will differ for accelerated and non-accelerated filers.

We use data for fiscal years 2008 and 2009 for this study. We find that the fee premium for non-accelerated filers disclosing a material weakness in internal controls is significantly lower than the corresponding premium paid by accelerated filers for fiscal years 2008 and 2009.

We also add to the emerging stream of research that examines the consequences of remediating internal control problems (Johnstone, Li, and Rupley 2010; Li, Sun, and Ettredge

2010; Feng, Li, and McVay 2010; Munsif et al. 2011). We find that there is a significant reduction in fees following remediation (when compared to firms that did not remediate) for accelerated filers, but not for non-accelerated filers.

Anecdotal evidence indicates that the market for audit services has become more competitive in recent years, once the initial effects of Section 404 related work abated. Further, with the passage of time, the fee premium associated with internal control problems can be expected to decline (since, among other reasons, the manpower constraints associated with any extra work for clients with internal control problems can be expected to decline as we move further away from the initial years of implementing Section 404). Hence, we examine if the fee premium associated with internal control problems decline over time. We find that for non-accelerated filers, there is a decline in the fee premium associated with internal control problems from 2008 to 2009; however, for accelerated filers there is no such decline. The decline is such that the fee premium for non-accelerated filers disclosing a material weakness is not statistically significant in 2009.

Overall, our results suggest that the market for audit services for non-accelerated filers differs significantly from the market for accelerated filers. Our results are also consistent with suggestions that auditors rely to a lesser extent on internal controls in audits of smaller companies, and that internal control problems have a smaller effect on audit fees for non-accelerated filers than for accelerated filers. Our findings about the decline in the magnitude of the audit fee premium associated with material weaknesses in internal control are consistent with suggestions that the market for audit services has become more competitive in recent years than in the initial years of applying Section 404. Finally, our results related to remediation suggest interesting avenues for future research.

The next section discusses the related research and develops the research questions. After a description of the method, data and the results are presented; the paper ends with a summary and conclusions.

BACKGROUND AND RESEARCH QUESTIONS

The Sarbanes-Oxley Act (SOX 2002) was enacted in the aftermath of the spectacular failures of Enron and WorldCom. Section 404 of SOX has two parts. Section 404(a) directs the SEC to issue rules requiring a report on internal control by management that includes an assessment of the effectiveness of internal controls over financial reporting; Section 404(b) directs the SEC to issue rules requiring that the external auditors attest such a management report.

Direct auditor involvement with respect to internal control reporting is applicable only when a client becomes subject to the requirements of Section 404(b). Nevertheless, auditing standards have long held the auditors to be responsible (though to a lesser extent) for other disclosures made in audited financial statements; as such, auditors having an indirect responsibility for statements made by management in Section 404(a) reports.

In addition, Section 302 of SOX requires quarterly statements by management about disclosure controls. The SEC and others (e.g., Hermanson and Ye 2009) have noted that while there is significant overlap between Sections 302 and 404, there also are some important differences. Both anecdotal and empirical evidence (Hermanson and Ye 2009) indicates that many accelerated filer registrants that disclosed internal control weaknesses pursuant to Section 404 had still issued clean Section 302 reports in the immediately preceding quarterly statements.

In summary, there are significant differences between internal control weakness disclosures made pursuant to Sections 302 and 404 of SOX, and also between Sections 404(a) and 404(b) of SOX. Such differences suggest that findings from prior studies examining auditor internal control evaluation disclosures made pursuant to Sections 404(b) or 302 of SOX need not necessarily hold when considering management disclosures made pursuant to Section 404(a) of SOX.

Related Research

Given the concerns over the cost of Section 404, and the fact that auditors' fees constitute a substantial part of such costs, prior studies have examined the association between internal control weakness disclosures and audit fees. The basic premise underlying such studies is that the presence of a material weakness in internal controls will lead to the auditor assessing higher control risk. The standard audit risk model predicts that when the assessed control risk is higher, for a given level of audit risk, the auditor must aim to have a lower level of detection risk; this in turn suggests that the auditor must do more work, which in turn leads to higher audit fees.[3]

Raghunandan and Rama (2006) examined 660 manufacturing firms with a December 31, 2004 fiscal year end that had filed their 10-Ks by May 15, 2005, and found that audit fees are 43 percent higher for clients with a material weakness disclosure compared to clients without such disclosure. Hoitash et al. (2008) used a sample of 2,501 accelerated filers with available data for fiscal years from November 2004 through October 2005 (i.e., the first fiscal year of SOX 404) and found that the fee premium varies by problem severity (measured either as material weaknesses versus significant deficiencies, or by general versus account specific). Krishnan et al. (2008) analyzed voluntary disclosures by 266 firms about total costs to comply with Section 404, and found that such costs are higher in the presence of material weaknesses in internal control. Munsif et al. (2011) examined audit fees for accelerated filers from 2004 to 2007, and found that firms remediating internal control weaknesses have lower audit fees when compared to firms continuing to report material weaknesses in internal control. However, the remediating firms pay, in the year of remediation as well as one and two years subsequent to remediation, significantly

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3 In addition, the auditor may wish to price protect, by increasing the fees. Without data about the quality and quantity of audit hours, it is not possible to separate out these two components of higher audit fees.

higher audit fees compared to firms that have clean Section 404 reports in each of the first four years.

All of the above studies examined accelerated filers. This is perhaps because non-accelerated filers were required to disclose information about internal controls pursuant to Section 404 (a) of SOX only for fiscal years beginning on or after December 15, 2007.

In this study we extend prior research by focusing on the association between internal control disclosures by non-accelerated filers made pursuant to Section 404(a) of SOX and audit fees; in addition, we add to prior research on accelerated filers by using more recent data.[4] The auditor's involvement in internal control assessment is significantly lower for non-accelerated filers than for accelerated filers. Anecdotal evidence, from discussions with audit partners, suggests that auditors rely on internal controls to a lesser extent in the case of non-accelerated filers; this is also consistent with evidence from prior research indicating that smaller firms are less likely to have strong internal controls (e.g., Ge and McVay 2005; Doyle, Ge, and McVay 2007a). Further, prior studies have shown that the market for small audit clients is much more competitive than the market for large audit clients (e.g., Simunic 1980; Francis and Simon 1987). Recent empirical evidence confirms that the small client segment of the market for audit services continues to be more competitive than the large client segment (Huang, Liu, Raghunandan, and Rama 2007; Kohlbeck et al. 2008). Hence, we expect that the audit fee premium associated with material weaknesses in internal control would be much lower for non-accelerated filers than for accelerated filers. This notion leads to our first research question:

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4 Bedard et al. (2008) used data from 2003 and 2004 and found that non-accelerated firms disclosing material weaknesses, in Section 302 disclosures, pay higher audit fees than firms that did not disclose such weaknesses. They also find that firms remediating internal control problems disclosed in fiscal 2003 continue to pay higher fees in 2004.

RQ_1: Is the audit fee premium associated with material weaknesses in internal control lower for non-accelerated filers than for accelerated filers?

While many papers have examined issues related to internal control weakness disclosures, research related to the remediation of such weaknesses is sparse. Johnstone et al. (2010), using 3,602 firm-year observations with no material weaknesses disclosure and 733 firm-year observations with material weaknesses disclosure for fiscal years 2004 through 2007, found that remediation of internal control problems is associated with improvements in characteristics of audit committees, boards, and top management. Li et al. (2010) showed that remediation is more likely to occur following the hiring of a new CFO with better qualifications. Feng et al. (2010) found that management forecasts become more accurate after firms remediate material weaknesses. Bedard, Hoitash, Hoitash, and Westermann (2010) found that remediation of material weaknesses in areas such as information technology, segregation of duties, tax, revenue, inventory and receivables, is associated with immediate improvement in earnings quality.

As noted earlier, Munsif et al. (2011) found, in a sample of accelerated filers, that firms that remediated internal control weaknesses continue to pay higher audit fees compared to firms that always had clean opinions, both in the year of remediation and in the following two years. However, given the differences between accelerated and non-accelerated filers discussed earlier, it is not clear that the results of Munsif et al. (2011) will necessarily apply also to non-accelerated firms. Bedard, Hoitash, and Hoitash (2008) examine audit fees paid by non-accelerated filers in 2003 and 2004, and found that even after remediating weaknesses disclosed pursuant to Section 302 of SOX, non-accelerated filers continued to pay higher audit fees than those firms that had clean internal control report in both years (2003 and 2004). As shown by Hermanson and Ye (2009), there are significant differences between disclosures made pursuant to Sections 302 and 404. In addition, since the auditor still has significant work in the year of

the client's remediation (for example, to ensure that the remediation has in fact satisfactorily resolved the problem), the audit fees may not go down fully (to the level of firms without problems). This argument will not be valid in the subsequent year, so we look at audit fees paid by non-accelerated filers disclosing internal control problems (in fiscal year 2007) both in the year of remediation (fiscal year 2008) and in the following year (fiscal year 2009). In this paper, we look at internal control problems disclosed pursuant to Section 404(a) of SOX; further, we look at the fees both in the year of remediation and in the year following remediation. The second research question is:

RQ_2: Do non-accelerated filers continue to pay a premium in the year of remediation of internal control problems, and how does this differ from the accelerated filers?

When Section 404 was initially implemented, many SEC registrants and business organizations complained vehemently about the high cost associated with Section 404 audits (e.g., ABA 2005; AEA 2005; FEI 2005; Microsoft 2005). The SEC convened two round-tables, in 2005 and 2006, about implementation issues related to Section 404. Following such dialogue, the PCAOB issued additional guidance and then replaced the much-criticized AS No.2 with the new AS No. 5 (PCAOB 2007); AS No.5 emphasizes a risk-based or "top-down" approach to risks and the testing of controls and is viewed as the answer to criticism of over-auditing by the auditors in the initial years of implementing Section 404.[5]

Auditors have noted that Section 404 audits would become more efficient over time (e.g., Ernst & Young 2005; PricewaterhouseCoopers 2005). The benefits from such

5 SEC Chairman Cox (U.S. House of Representatives 2007) noted during congressional testimony that "we expect the unduly high costs of implementing section 404 of the Act under the previous auditing standard will come down."

streamlined audits would be particularly relevant for clients with internal control problems. In the initial years, clients with material weaknesses in internal control would have been particularly problematic for auditors who already had to contend with manpower shortages and the need to train staff in Section 404 related procedures even while simultaneously conducting Section 404 audits. When auditors are under severe time and resource pressure for all clients it is natural that a client who requires more time and resources would be charged a higher premium. Such a fee premium can be expected to decline in subsequent years, when the resource pressures faced by auditors are lower.

Consistent with the above argument, auditors and others have noted that by 2007 the nature of the audit market began to change. Media stories have noted that the trend of increasing audit fees after SOX has stopped, and perhaps reversed, recently (Whitehouse 2008, 2010).

The above discussion suggests that the audit fee premium associated with a material weakness in internal controls would decline over time. This leads to the third research question:

RQ_3: Does the audit fee premium associated with material weaknesses in internal control decline over time?

Method

Model. We use the following model to examine the association between audit fees and material weaknesses in internal control:

$$LAFEE = b_0 + b_1*LNTA + b_2*RECINV + b_3*SQSEG + b_4*FORGN + b_5*LIQ + b_6*ROA + b_7*DA + b_8*BIG4 + b_9*GC + b_{10}*INITIAL + b_{11}*MW + b_{12\text{-}21}*(10\ Industry\ Variables) + error$$

The variables are defined as follows:

LAFEE= natural log of audit fees;

LNTA = natural log of client's total assets;
RECINV = proportion of total assets in accounts receivable and inventory;
SQSEG = square root of the number of segments;
FORGN = 1 if the firm has foreign operations, else 0;
LIQ = ratio of current assets divided by current liabilities;
ROA = return on assets (operating income divided by total assets);
DA = debt to assets (total debt divided by total assets);
BIG4 = 1 if Big 4 auditor, else 0;
GC = 1 if audit opinion modified for going concern, else 0;
INITIAL = 1 if first year audit engagement, else 0;
MW = 1 if material weakness in internal control disclosed, else 0.

All of the control variables are derived from prior studies and the variables are measured as of the relevant fiscal year ends. We use *LNTA* as proxy for size; *RECINV, SQSEG,* and *FORGN* are measures of client complexity; *LIQ, GC, ROA* and *DA* are proxies for financial condition and performance; *BIG4* and *INITIAL* are auditor related variables. We winsorize *ROA* and *DA* at absolute values of 10 and other continuous variables at the 1st and the 99th percentiles.

Data. We obtain audit fee information and information regarding the material internal control weakness for fiscal years 2008 and 2009 from the *Audit Analytics* database. For ease of exposition, we refer to firms with a fiscal year end between December 2008 and February 2009 as fiscal year 2008, similarly for fiscal year 2009 includes firms with fiscal year ends up to February 28, 2010.[6]

6 *Audit Analytics* classifies fiscal years between November 15, 2004 and November 14, 2005 as year one of SOX 404 reporting; so year four of SOX 404 reporting includes fiscal years between November 15, 2007 and November 14, 2008.

Financial information is obtained from the *Compustat* annual database.

As seen in Panel A of Table 1, we start with 9,828 observations in fiscal year 2008 and delete observations as follows: (a) foreign firms, (n=1,659); (b) observations in the financial sector (SIC 60-67), (n=2,121); (c) duplicate observations, (n=133); (d) fiscal years other than those between December 15th and after February 28th of the following year, (n=1613);[7](e) not in Compustat, (n = 1,068); (f) missing financial data, (n=30); and (g) missing audit fee data (n = 98). This yields a sample of 3,234 observations. We follow the same process for fiscal 2009; our sample for fiscal 2009 is 2,933. Since we want to look at the impact of audit fees over a two-year period, we delete observations that were not common in both years. Hence, our final sample size is 2,839.

As seen in Panel B of Table 1, the number of non-accelerated (accelerated) filers in our sample is 2,003 and 836 (1,973 and 866) in fiscal years 2008 and 2009, respectively. Panel C of Table 1 shows the number of material weakness by filer type and also by type of internal control weaknesses (systemic or account-specific). In the case of accelerated filers, there is a decline in the number of systemic and account-specific internal control weaknesses from fiscal 2008 to 2009. On the other hand, there is an increase in number of systemic as well as account-specific weaknesses from fiscal 2008 to 2009.

When multiple years of data are present, a panel data approach with control for clustering on the repeated measure (firm) can be used. However, we do not use a panel data approach for the following reasons. First, as noted in our Research Question 2, we expect the coefficients on the material weakness indicators to vary across years. Second, given our discussion preceding Research

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7 We restrict the sample to fiscal years starting December 15th because the non-accelerated filers were not required to provide management's report on internal control over financial reporting until December 15th 2007.

Question 1, it is likely that the pattern of changes in the coefficients for the material weakness indicators will differ for accelerated and non-accelerated filers. Third, related to our Research Question 3, we examine one-year lag, in our models for fiscal year 2009 one of the variables that we examine is *MW2008* – that is, if there was a material weakness in fiscal year 2008. By construction this measure will be coded as missing when we examine the 2009 regression (since there would only be a one year lag measure for this year). Hence, when we do the panel regression, all observations except those from fiscal 2009 are dropped (due to missing values). The above reasons preclude us from using a panel data approach.

Results

Table 2 provides descriptive data about the sample for fiscal years 2008 and 2009, for accelerated and non-accelerated filers partitioned by internal control opinion type. In each of the years, firms with material weaknesses (both accelerated and non-accelerated filers) are smaller in size when compared with firms with clean internal control opinions. The data also shows that firms with internal control weakness disclosures are (a) less likely to be profitable (b) more likely to have a going-concern modified audit opinion, and (c) less likely to have a Big-4 auditor. For the non-accelerated filers, these firms are also less liquid and have fewer foreign operations.

Regression Results

Table 3 shows the results of the regressions for each year. We do not pool the accelerated and non-accelerated filers because it is possible that the value of the coefficients for the control variables, in addition to the coefficients of *MW*, could vary across the two groups. For example, prior studies have shown that the magnitude of the Big-4 premium varies in the small and large client segments of the audit market (Francis and Simon 1987; Huang et al. 2007) and accelerated filers are typically larger than non-accelerated filers.

In each year the regressions for both accelerated and non-accelerated filers are significant and the adjusted R-squares range between 70 and 74 percent. All of the control variables for accelerated filers have the expected signs and are significant at conventional levels with the exception of *ROA*, which is not significant in fiscal year 2009. For non-accelerated filers, *GC* is not significant in both years 2008 and 2009; *LIQ* is not significant in fiscal year 2008 and *SQSEG* is not significant in fiscal 2009. A comparison of the coefficients indicates that the magnitude of the coefficients of *LNTA*, *RECINV, DA*, and *GC* are significantly ($p <$ .01) higher for accelerated filers than for non-accelerated filers in both years. In contrast, the coefficient of *BIG4* is significantly ($p <$ .01) higher for non-accelerated filers than for accelerated filers in both years, indicating that the Big-4 premium is proportionately higher in the small client segment of the audit market.

The two regressions for fiscal year 2008 show that the coefficient of *MW* is 0.25 for accelerated filers and 0.13 for the non-accelerated filers; thus, accelerated (non-accelerated) filer firms with material weakness in their internal control have a fee premium of 29 (14) percent.[8] Research question one examines if the audit fee premium associated with material weaknesses in internal control is lower for non-accelerated filers than for accelerated filers. When we compare the regression coefficients for accelerated and non-accelerated filers, we find that in each year the coefficient of *MW* is significantly smaller for the non-accelerated filers than for the accelerated filers ($p < .05$ for 2008, $p < .01$ for 2009). The results suggest that there are significant differences in the consequences associated with internal control weakness disclosures made pursuant to Sections 404(a) and 404(b) of SOX.

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8 Since our dependent variable is log transformed, the effect of the dependent variable increasing by 0.25 is given by $e^{0.25} = 1.29$, or the fee increases by 29 percent compared to the situation when there is no material weakness in internal controls.

Remediation of Material Weaknesses

Next, we consider the effects of remediating previously disclosed internal control weaknesses. This is because we want to examine what happens in the year of remediation; that is, for non-accelerated filers that disclosed an internal control weakness for fiscal year 2008 but remediated the problem such that they had a clean internal control opinion for fiscal year 2009, we want to examine the audit fees for fiscal year 2009. In fiscal year 2008, there were 243 firms with material weakness disclosures – 160 by non-accelerated filers and 83 by accelerated filers. Of these, 113 firms had remediated the weakness in 2009.

Table 4 presents the results from regressions with *REMEDIATE* as the variable of interest. We run regressions for both 160 non-accelerated filers and 83 accelerated filers that disclosed a material weakness for fiscal year 2008. From these two groups, 49 of the non-accelerated filers and 64 of the accelerated filers had a clean Section 404 opinion for fiscal year 2009, indicating that the internal control weakness had been remediated. The coefficient of *REMEDIATE* is negative and significant for accelerated filers; the magnitude of the coefficient indicates that when compared with those firms that continued to report material weaknesses in 2009, accelerated firms that remediated the problem had audit fees that were 23 percent lower. In contrast, the *REMEDIATE* variable is not significant for non-accelerated filers.

In summary, we find that accelerated firms that remediate previously disclosed problems pay significantly lower fees in 2009 than firms that did not remediate such problems; this finding is consistent with the results reported by Munsif et al. (2011) for the years 2005 through 2007. However, we find that the results do not hold for non-accelerated filers; the non-accelerated filers that remediate previously disclosed problems do not pay significantly lower fees in the year of remediation than firms continuing to report internal control problems.

Why do the results for remediation differ for accelerated and non-accelerated filers? One possible reason, based on anecdotal

evidence from discussions with auditors, is that the extent of auditor involvement in internal control evaluation is greater for accelerated filers than for non-accelerated filers. In addition, accelerated filers have been subject to SOX Section 404(b) since 2004. The higher level of auditor involvement coupled with longer experience with Section 404 work possibly accounts for the remediation related fee decline being observed for accelerated filers but not for non-accelerated filers.

While the explanation above is speculative, the inferences from our findings suggest the need for caution in interpreting empirical research findings based on analyses of accelerated firms. The remediation related results reinforce the suggestion, made in the prior sub-section that research findings using samples of only accelerated filers need not necessarily apply to non-accelerated filer firms.

Does the Material Weakness Related Audit Fee Premium Decline over Time?

Research question three examines if the audit fee associated with material weaknesses in internal control declines over time. As seen in Table 3, the coefficients for *MW* for the non-accelerated filers decrease steadily from 2008 to 2009, reducing from 0.13 in 2008 to 0.06 in 2009; in fact, the coefficient of *MW* is only marginally significant in the regression for fiscal year 2009. When we compare the regression coefficients across years, we find that the decline from fiscal year 2008 to 2009 is not significant.

For accelerated filers, however, the value of the *MW* coefficient in 2009 is not significantly different from the *MW* coefficient in 2008. Thus, here again we find that the pattern of results differ for accelerated and non-accelerated firms.

Additional Analyses

Systemic and Account Specific Weaknesses. We then partition the material weakness based on the severity of the problem, as systemic internal control weaknesses (*SMW*) and account specific

internal control weaknesses (*AMW*).[9] Panel B of Table 3 presents the results when we use two dummy variables for the two types of internal control weaknesses. Prior researchers (e.g., Hoitash et al. 2008; Munsif et al. 2011) note that systemic problems are more difficult to audit around; hence the effect on audit fees should be higher for systemic internal control problems than for account-specific problems.

In the case of accelerated filers, in both the years the coefficient of the systemic weakness variable is significantly higher ($p < .01$) than the coefficient of the account-specific weakness variable. However, in the case of non-accelerated filers, for both fiscal years 2008 and 2009, the coefficient for account-specific weakness variable is higher than systemic weakness variable; in fact the coefficient for *SMW* is not significant in fiscal 2009.

Firms with Clean Section 404 Opinions in 2008 and 2009. We examine the effects of remediation also by comparing firms that remediated previously disclosed problems against firms without problems. The first regression in Table 5 presents the results from regressions where the sample includes 113 (64 accelerated and 49 non-accelerated) firms that disclosed a material weakness for fiscal year 2008 but remediated in year 2009. The results show that the

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9 If a firm reported both systemic and account specific internal control problems, then we coded that company as having a systemic problem. A firm coded as having only account-specific problems by definition has no systemic problem. Following Munsif et al. (2011), we classify an internal control weakness as systemic if, per Audit Analytics, the problem was in any one or more of the following categories: senior management competency, tone, reliability issues; accounting personnel resources, competency/training; segregations of duties/ design of controls (personnel); information technology, software, security & access issue; ethical or compliance issues with personnel; ineffective, non-existent or understaffed audit committee; insufficient or non-existent internal audit function; ineffective regulatory compliance issues.

coefficients for *MW2008* are 0.16 and 0.14 for the accelerated and non-accelerated filers, respectively for fiscal year 2009. Both coefficients are significant, indicating that when compared to firms that had clean opinions in 2008 to firms that had internal control problems in 2008 but remediated in 2009 continue to pay a fee premium in 2009. However, it is noteworthy that even in this sub-group, the fee premium is higher for accelerated filers than non-accelerated filers.

Sensitivity Analyses. Dodd-Frank Wall Street Reform and Consumer Protection Act (2010), has asked the SEC to call for further research on the impact of Section 404(b) on firms that are categorized as small-accelerated filers.[10] For sensitivity analysis we further divide our accelerated filers sample into – non-large accelerated filers and small accelerated filers.[11]

We first delete all accelerated filers that were categorized as large-accelerated filers according to the Audit Analytics database. The final sample size for non-large accelerated filers is 965 (946) firms in fiscal 2008 (2009). The results in Table 6 indicate that, even after deleting large accelerated filers, the impact on audit fees due to the presence of material weaknesses is higher for non-large accelerated filers as compared to non-accelerated filers in both years 2008 and 2009.

Similarly, we delete all observations from the above sample for accelerated filers with market capitalization greater than $250 million. This leads to a sample of 403 and 387 small-accelerated filers in years 2008 and 2009, respectively.

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[10] According to Dodd-Frank Act any company with a market capitalization between $75 million and $250 million at the end of the relevant fiscal year is categorized as a small-accelerated filer.

[11] According to SOX, large-accelerated filers are those with a public float of more than $700 million measured as of the last day of the second quarter. Other accelerated filers are those with public float between $75 million and $700 million measure as of the last day of the second quarter. We classify firms as non- large-accelerated as provided by the Audit Analytics database.

Table 7 presents the results for small-accelerated filers; the results show that the impact of disclosing material weaknesses in internal control on audit fees is much higher for small-accelerated filers as compared to non-accelerated filers in both years 2008 and 2009. The coefficient of *MW* for small-accelerated filers in 2008 is 0.46 ($p < .01$) and in 2009 is 0.37 ($p < .01$). In both the above analyses we use the same observations for non-accelerated filers used in the main analysis.

Overall, the results in our sensitivity analyses are consistent with those in our main analysis. The impact on audit fees due to the presence of material weaknesses in internal control is higher for accelerated filers (non-large accelerated and small-accelerated) as compared to non-accelerated filers.

SUMMARY AND CONCLUSIONS

Section 404 of SOX became applicable for accelerated filers starting November 15, 2004. Non-accelerated filers were granted numerous extensions from complying with Section 404, and were only required to comply with Section 404(a)—but not 404(b)—starting December 15, 2007. Most recently, the Dodd-Frank Act grants permanent exemption from Section 404(b) for non-accelerated filers. These actions by regulators and legislators reflect the belief that compliance with Section 404 is quite costly for non-accelerated filers. Both empirical evidence and statements by auditors suggest that fees paid to auditors constitute an important part of total Section 404 related costs (Ernst & Young 2005; Krishnan et al. 2008). Some recent studies have examined the association between internal control problems disclosed pursuant to Section 404 and audit fees (Raghunandan and Rama 2006; Hoitash et al. 2008; Munsif et al. 2011) but such studies have examined only accelerated filers. Our study adds to this stream of research by examining the association between internal control problems, as well as their remediation, and audit fees for non-accelerated filers.

Given that auditor involvement with reporting on internal controls is lower for non-accelerated filers (because there is no

auditor attestation requirement for such firms), we expect that the fee premium associated with internal control material weakness disclosures will be lower for non-accelerated filers than for accelerated filers. Our empirical analyses, based on data from fiscal years 2007 and 2009, confirm this expectation. This finding is also consistent with suggestions that auditors rely to a lesser extent on internal controls for audits of smaller companies, and hence internal control quality will have a smaller effect on audit fees for non-accelerated filers than for accelerated filers. Further, we find that firms that accelerated filers that remediated previously disclosed internal control problems pay lower fees when compared to firms that did not remediate such problems; however, this difference is not observed for non-accelerated filers. Finally, we find that for non-accelerated filers there is a steady decline in the magnitude of the audit fee premium associated with material weaknesses in internal control; in fact, the fee premium is not statistically significant in the audit fee regression for 2009. The fee premium associated with internal control problems, while showing a decline from 2007 to 2008, continues to remain statistically—and economically— significant in 2009 for accelerated filers.

Taken together, our results indicate that there are significant differences between accelerated and non-accelerated filers reporting internal control problems. Hence, internal control reporting related results based on samples of accelerated filers may not be directly transferable to non-accelerated filers. In addition, the findings are consistent with suggestions that the market for audit services has changed recently and is more competitive than in the immediate aftermath of the enactment of SOX and the initial years of applying Section 404.

The results suggest some interesting avenues for future research. In light of the fact that the Dodd-Frank Act permanently exempts non-accelerated filers from Section 404(b) of SOX, do auditors' judgments differ for accelerated and non-accelerated filers in other audit contexts? Also, given that remediation has a different effect on audit fees for accelerated and non-accelerated filers, how does remediation of material internal control

weaknesses affect other audit judgments for accelerated and non-accelerated filers?

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Table 1
Sample Selection

Panel A – Sample by Year

	2008	**2009**
Total Observations from Audit Analytics (AA)	**9828**	**9180**
Less Foreign Firms	(1659)	(1575)
Less Financial Firms (SIC 60-67)	(2121)	(1993)
Less Duplicates	(133)	(66)
Less Fiscal year other than between 12/15 and 2/28	(1613)	(1468)
Total Observations from Compustat	**3234**	**3032**
Less Firm without financial information	(30)	(15)
Less Financial without audit fee data	(98)	(84)
Total Sample from Compustat and AA	**3106**	**2933**
Less observations not common in both years	(267)	(94)
Final Sample for analysis	**2839**	**2839**

Panel B – Sample by Filer Status

	2008	**2009**
Accelerated filers	2003	1973
Non-accelerated filers	836	866
Total Sample of analysis	**2839**	**2839**

*The Filer status is based as follows: we define firms to be accelerated if they filed both management and auditors report for internal control and define non-accelerated filers if a firm only had managements report. Some firms might have changed their status, either from accelerated to non-accelerated or vise-versa. The status in our analysis is based on a firm's status (as defined above) in the year of analysis. Hence, if a firm had both management and auditors in fiscal 2008 we classify it as accelerated filer status, but if that same firm has only management report in fiscal 2009 we classify that firm as non-accelerated filer status.

Panel C – Firms with Internal Control Weakness Disclosures

	2008	**2009**
Systemic Internal Control Weakness		
Accelerated filers	53	32
Non-accelerated filers	131	139
Total Systemic Internal Control Weaknesses	184	171
Account Specific Internal Control Weaknesses		
Accelerated filers	35	26
Non-accelerated filers	24	30
Total Account-Specific Internal Control Weaknesses	59	56
Total Observations with Internal Control Problems	**243**	**227**

Table 2
Sample Statistics: Mean (Median) Values of Variables

Variable	Fiscal Year 2008 (n= 2839)				Fiscal Year 2009 (n=2839)			
	Accelerated (n= 2003)		Non Accelerated (n = 836)		Accelerated (n= 1973)		Non Accelerated (n = 866)	
	ICW (n= 88)	Non-ICW (n=1915)	ICW (n= 155)	Non-ICW (n=681)	ICW (n= 58)	Non-ICW (n=1915)	ICW (n= 169)	Non-ICW (n=697)
LAFEE	13.80** (13.81)	14.06 (14.01)	11.49*** (11.50)	12.13 (12.12)	13.48*** (13.43)	14.01 (13.95)	11.45*** (11.35)	12.13 (12.12)
LNTA	19.59*** (19.78)	20.60 (20.50)	15.33*** (15.65)	17.38 (17.24)	19.99*** (19.42)	20.68 (20.56)	15.46*** (15.51)	17.26 (17.23)
RECINV	0.24 (0.21)	0.21 (0.18)	0.25 (0.14)	0.24 (0.17)	0.19 (0.12)	0.20 (0.17)	0.22 (0.13)	0.25 (0.19)
SQSEG	1.32 (1.00)	1.37 (1.00)	1.15 (1.00)	1.18 (1.00)	1.32 (1.00)	1.39 (1.00)	1.10*** (1.00)	1.17 (1.00)
FORGN	0.50 (0.50)	0.51 (1.00)	0.10*** (0.00)	0.17 (0.00)	0.45 (0.00)	0.52 (1.00)	0.09*** (0.00)	0.21 (0.00)
LIQ	2.57 (1.89)	2.43 (1.82)	1.30*** (0.64)	2.45 (1.60)	2.79 (2.50)	2.53 (1.94)	1.37*** (0.64)	2.63 (1.69)
ROA	-0.20** (-0.05)	-0.08 (-0.03)	-2.47*** (-0.57)	-0.76 (-0.11)	-0.20*** (-0.02)	-0.04 (-0.02)	-1.98*** (-0.43)	-0.68 (-0.08)
DA	0.56 (0.57)	0.57 (0.55)	2.70*** (0.80)	1.07 (0.56)	0.57 (0.55)	0.55 (0.52)	2.78*** (0.92)	1.05 (0.54)
BIG4	0.66*** (1.00)	0.84 (1.00)	0.07*** (0.00)	0.34 (0.00)	0.69*** (1.00)	0.83 (1.00)	0.05*** (0.00)	0.30 (0.00)
GC	0.10** (0.00)	0.03 (0.00)	0.61*** (1.00)	0.25 (0.00)	0.14** (0.00)	0.02 (0.00)	0.63*** (1.00)	0.23 (0.00)
INITIAL	0.16*** (0.00)	0.04 (0.00)	0.26*** (0.00)	0.15 (0.00)	0.16** (0.00)	0.04 (0.00)	0.29*** (0.00)	0.15 (0.00)

***, **, *** Significantly different at 0.10, 0.05, and 0.01 level from non-ICW firms, respectively**

Note: The sample includes all such firms (excluding those in SIC codes 60-67) that have fiscal years between November 15 of the relevant fiscal year and February 28 of the following fiscal year. Variables are defined as follows: *LAFEE*= natural log of audit fees; *LNTA*= natural log of client's total assets; *RECINV*= proportion of total assets in accounts receivable and inventory; *SQSEG*= square root of the number of segments; *FORGN*= 1 if the firm has foreign operations, else 0;*LIQ*= ratio of current assets divided by current liabilities; *ROA*= return on assets (operating income divided by total assets); *DA* = debt to asset (total debt divided by total assets); *BIG4*= 1 if Big 4 auditor, else 0; *GC* = 1 if audit opinion modified for going concern, else 0; *INITIAL*= 1 if first year audit engagement year, else 0.

Table 3
Regression Results: Effects of Material Weakness in Internal Controls on Audit Fees

Panel A: Single Dummy Variable for Internal Control Disclosure

Model: $LAFEE = b_0 + b_1*LNTA + b_2*RECINV + b_3*SQSEG + b_4*FORGN + b_5*LIQ + b_6*ROA + b_7*DA + b_8*BIG4 + b_9*GC + b_{10}*INITIAL + b11*MW + b_{12\text{-}21}*(10\ Industry\ Variables) + error$

Variable	Fiscal Year 2008 (n= 2839)		Fiscal Year 2009 (n= 2839)	
	Accelerated (n=2003)	Non-Accelerated (n=836)	Accelerated (n=1973)	Non-Accelerated (n=866)
Intercept	10.08 (<.01)	10.11 (<.01)	10.00 (<.01)	10.57 (<.01)
LNTA	0.45 (<.01)	0.39 (<.01)	0.45 (<.01)	0.36 (<.01)
RECINV	0.57 (<.01)	0.22 (.03)	0.74 (<.01)	0.29 (<.01)
SQSEG	0.14 (<.01)	0.17 (.01)	0.15 (<.01)	0.06 (.19)
FORGN	0.37 (<.01)	0.31 (<.01)	0.32 (<.01)	0.31 (<.01)
LIQ	-0.01 (.41)	-0.01 (.34)	-0.01 (.36)	-0.03 (<.01)
ROA	-0.11 (<.01)	-0.05 (<.01)	-0.03 (.21)	-0.07 (<.01)
DA	0.21 (<.01)	0.06 (<.01)	0.18 (<.01)	0.03 (.02)
BIG4	0.29 (<.01)	0.49 (<.01)	0.25 (<.01)	0.49 (<.01)
GC	0.17 (.02)	0.06 (.21)	0.21 (<.01)	0.01 (.49)
INITIAL	-0.46 (<.01)	-0.47 (<.01)	-0.71 (<.01)	-0.52 (<.01)
MW	0.25 (<.01)	0.13 (.03)	0.26 (<.01)	0.06 (.10)
	F = 287.01 p < .001 Adj. R^2 = 0.74	F = 96.76 p < .001 Adj. R^2 = 0.70	F = 280.88 p < .001 Adj. R^2 = 0.74	F = 101.70 p < .001 Adj. R^2 = 0.70

Note: *MW* = 1 if material weakness in internal control disclosed, else 0. Other variables are defined as in Table 2. Industry dummy variables have been suppressed in the tables for brevity. P-values are in parentheses.

Panel B: Material Weaknesses Partitioned by Type (Systemic or Account Specific)

Model: $LAFEE = b_0 + b_1*LNTA + b_2*RECINV + b_3*SQSEG + b_4*FORGN + b_5*LIQ + b_6*ROA + b_7*DA + b_8*BIG4 + b_9*GC + b_{10}*INITIAL + b_{11}*SMW + b_{12}*AMW + b_{13\text{-}22}*(10\ Industry\ Variables) + error$

Variable	Fiscal Year 2008 (n= 2839)		Fiscal Year 2009 (n= 2839)	
	Accelerated (n=2003)	**Non-Accelerated (n=836)**	**Accelerated (n=1973)**	**Non-Accelerated (n=866)**
Other variables omitted for brevity				
SMW	0.34 (<.01)	0.10 (.10)	0.47 (<.01)	0.01 (.41)
AMW	0.11 (.13)	0.34 (.01)	0.02 (.43)	0.23 (.03)
	F = 273.84 p < .001 Adj. R^2 = 0.74	F = 92.47 p < .001 Adj. R^2 = 0.70	F = 269.04 p < .001 Adj. R^2 = 0.74	F = 97.20 p < .001 Adj. R^2 = 0.70

Note: *SMW*= 1 if there is a systemic material weakness in internal control, else 0; *AMW*= 1 if there is only account-specific material weakness in internal control, else 0. Other variables are defined as in Table 2. Industry dummy variables have been suppressed in the tables for brevity. P-values are in parentheses.

Table 4
Regression Results: Effects of Remediation

Model: $LAFEE = b_0 + b_1*LNTA + b_2*RECINV + b_3*SQSEG + b_4*FORGN + b_5*LIQ + b_6*ROA + b_7*DA + b_8*BIG4 + b_9*GC + b_{10}*INITIAL + b_{11}*REMEDIATE + b_{12\text{-}21}*(10\ Industry\ Variables) + error$

Variable	Fee Model for Fiscal Year 2009 for Firms with *MW* = 1 in 2008	
	Accelerated (n=83)	**Non-Accelerated (n= 160)**
Intercept	10.31 (<.01)	10.72 (<.01)
LNTA	0.52 (<.01)	0.33 (<.01)
RECINV	0.72 (.12)	0.29 (.13)
SQSEG	0.03 (.45)	0.29 (.10)
FORGN	0.40 (.05)	0.46 (.02)
LIQ	-0.03 (.28)	-0.08 (.02)
ROA	-0.32 (.20)	-0.08 (.01)
DA	-0.13 (.31)	0.01 (.22)
BIG4	0.21 (.20)	0.64 (.01)
GC	0.05 (.45)	-0.19 (.14)
INITIAL	-0.71 (<.01)	-0.29 (.02)
REMEDIATE	-0.23 (.16)	0.01 (.49)
	F = 6.27 p < .001 Adj. R^2 = 0.56	F = 13.38 p < .001 Adj. R^2 = 0.61

Note: *REMEDIATE* = 1 if a previously disclosed material weakness was remediated and there is a clean Section 404 opinion, 0 otherwise; other variables are defined as in Table 2. Industry dummy variables have been suppressed in the tables for brevity. P-values are in parentheses.

Table 5

Regression Results: Sub-samples of Firms with Clean Section 404 Opinions in 2009

Model: $LAFEE = b_0 + b_1*LNTA + b_2*RECINV + b_3*SQSEG + b_4*FORGN + b_5*LIQ + b_6*ROA + b_7*DA + b_8*BIG4 + b_9*GC + b_{10}*INITIAL + b_{11}*MW\_08 + b_{12\text{-}21}*(10\ Industry\ Variables) + error$

Variable	Fiscal Year 2009	
	Accelerated (n=1915)	**Non-Accelerated (n=697)**
Intercept	10.00 (<.01)	10.62 (<.01)
LNTA	0.45 (<.01)	0.37 (<.01)
RECINV	0.71 (<.01)	0.30 (.01)
SQSEG	0.15 (<.01)	0.01 (.46)
FORGN	0.32 (<.01)	0.29 (<.01)
LIQ	-0.01 (.39)	-0.02 (.01)
ROA	-0.02 (.25)	-0.06 (<.01)
DA	0.18 (<.01)	0.04 (.04)
BIG4	0.24 (<.01)	0.44 (<.01)
GC	0.23 (<.01)	0.01 (.44)
INITIAL	-0.75 (<.01)	-0.57 (<.01)
MW2008	0.16 (.03)	0.14 (.05)
	F = 279.22 p < .001 Adj. R^2 = 0.74	F = 82.39 p < .001 Adj. R^2 = 0.70

Note: *MW2008* = 1 if there is a material weakness in internal control in year 2008, else 0. Other variables are defined as in Table 2. Industry dummy variables have been suppressed in the tables for brevity. P-values are in parentheses.

Table 6
Regression Results: Effects of Material Weakness in Internal Controls on Audit Fees (Non-Large Accelerated Filers)

Model: $LAFEE = b_0 + b_1*LNTA + b_2*RECINV + b_3*SQSEG + b_4*FORGN + b_5*LIQ + b_6*ROA + b_7*DA + b_8*BIG4 + b_9*GC + b_{10}*INITIAL + b11*MW + b_{12\text{-}21}*(10\ Industry\ Variables) + error$

Variable	Fiscal Year 2008 (n= 1801)		Fiscal Year 2009 (n= 1812)	
	Non-Large Accelerated (n=965)	**Non-Accelerated (n=836)**	**Non-Large Accelerated (n=946)**	**Non-Accelerated (n=866)**
Intercept	10.70 (<.01)	10.11 (<.01)	10.52 (<.01)	10.57 (<.01)
Other variables omitted for brevity				
MW	0.29 (<.01)	0.13 (.03)	0.24 (<.01)	0.06 (.10)
	F = 54.63 p < .001 Adj. R^2 = 0.53	F = 96.76 p < .001 Adj. R^2 = 0.70	F = 53.66 p < .001 Adj. R^2 = 0.53	F = 101.70 p < .001 Adj. R^2 = 0.70

Note: Variables are defined as in Table 2. Industry dummy variables have been suppressed in the tables for brevity. P-values are in parentheses

Table 7
Regression Results: Effects of Material Weakness in Internal Controls on Audit Fees (Small-Accelerated Filers)

Model: $LAFEE = b_0 + b_1*LNTA + b_2*RECINV + b_3*SQSEG + b_4*FORGN + b_5*LIQ + b_6*ROA + b_7*DA + b_8*BIG4 + b_9*GC + b_{10}*INITIAL + b11*MW + b_{12\text{-}21}*(10\ Industry\ Variables) + error$

Variable	Fiscal Year 2008 (n= 1801)		Fiscal Year 2009 (n= 1812)	
	Small-Accelerated (n=403)	**Non-Accelerated (n=836)**	**Small-Accelerated (n=387)**	**Non-Accelerated (n=866)**
Intercept	10.43 (<.01)	10.11 (<.01)	10.17 (<.01)	10.57 (<.01)
Other variables omitted for brevity				
MW	0.46 (<.01)	0.13 (.03)	0.37 (<.01)	0.06 (.10)
	F = 23.00 p < .001 Adj. R^2 = 0.52	F = 96.76 p < .001 Adj. R^2 = 0.70	F = 23.08 p < .001 Adj. R^2 = 0.54	F = 101.70 p < .001 Adj. R^2 = 0.70

Note: Variables are defined as in Table 2. Industry dummy variables have been suppressed in the tables for brevity. P-values are in parentheses