



The Impact of Financial Restatements on Audit Fees: Consideration of Restatement Severity

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Abstract: This study extends prior research on audit fees and financial restatements by examining whether audit fees are higher for firms with more severe types of restatements. We hypothesize that auditors charge higher audit fees following a firm's restatement to compensate for the risk of audit increased from the restatement as restatements are considered as financial reporting failures. We further hypothesize that more severe restatements lead to higher audit fees due to the increased audit risk from the severity of the restatements. We first separate restatements into three subgroups based on their perceived severity (from most to least severe): restatements that affect net income, restatements that do not affect net income, and technical restatements. We then test for the effect that each type of restatement has on audit fees relative to firms that have no restatements. We find evidence that audit fees are higher for more severe types of restatements: net income restatements have the highest audit fees out of the three subgroups; non-net income restatements have lower audit fees than net income restatements, but higher audit fees than technical restatements; and technical restatements have the lowest audit fees. Furthermore, we find evidence that restatements related to fraud result in higher audit fees than restatements in general. Overall, the evidence suggest that audit fees increase in response to restatements and that the extent audit fees increase depends on the severity of the restatements.

1. Introduction

The purpose of this paper is to examine the effect that different categories of financial restatements have on audit pricing in a subsequent period. A financial restatement is generally considered as a reporting failure since it