

Do Misstatement Correction Disclosures Reflect Impaired Auditor Independence?

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ABSTRACT

Management has strong incentives to avoid correcting accounting misstatements through restatements, but auditor incentives are less clear. Using misstatement corrections disclosed in annual financial statements from 2006 to 2017, I investigate whether disclosures of misstatement corrections potentially reflect impaired auditor independence. I find that economically important clients and clients of non-specialist auditors are more likely to disclose misstatements as revisions or adjustments rather than as restatements. I also find that the magnitudes of disclosed revisions and adjustments are more likely to exceed traditional materiality thresholds for economically important clients and clients of non-specialist auditors. These relationships are strongest when audit offices experience negative client growth, when audit markets have high competition, when the auditor in the year of correction was also the auditor in the year of misstatement, and when the corrections have negative effects on financial statements. Overall, my study suggests that misstatement correction disclosures may reflect impaired auditor independence. As such, investors and regulators should exercise substantial skepticism as they identify and evaluate disclosures of misstatement corrections.

Keywords: Auditor independence, accounting misstatement correction, materiality assessment, client importance, auditor industry specialization

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I. INTRODUCTION

Accounting misstatements distort the information conveyed to financial statement users and may result in substantial financial losses (Palmrose, Richardson, and Scholz 2004; Files, Swanson, and Tse 2009; Badertscher, Hribar, and Jenkins 2011; Amiram, Bozanic, Cox, and Dupont 2018). As such, when misstatements are identified, it is crucial that misstatement correction disclosures be appropriate. Each misstatement must be assessed to determine whether the prior and/or current period financial statements are *materially* misstated (SAB 108). According to FASB ASC 250, material misstatements that undermine reliance on previously issued financial statements must be corrected and disclosed retrospectively through formal restatements. These “Big R” restatements (hereafter referred to as restatements) require an 8-K Item 4.02 “Non-Reliance on Previously Issued Financial Statements” filing within four business days of discovery to provide timely notice of the pending restatement (SEC 2004). In contrast, corrections of immaterial misstatements from prior periods can be disclosed through less conspicuous revisions (“little r” restatements, hereafter referred to as revisions) or adjustments to current period financial statements (out-of-period adjustments, hereafter referred to as adjustments). Although authoritative materiality guidance (e.g. SAB 99, SAB 108) and public accounting firm guidelines (e.g., PwC 2013; Ernst & Young 2015) both influence misstatement correction disclosures, the subjective judgments of financial statement preparers and auditors also play an important role. My purpose in this paper is to investigate whether misstatement correction disclosures may reflect potentially impaired auditor independence.

My study is motivated by two observations. First, companies have strong incentives to manage financial performance and avoid restatements. A recent Wall Street Journal (WSJ) article,

“Shh! Companies Are Fixing Accounting Errors Quietly,” discusses the phenomenon that companies are hiding severe accounting misstatements through inconspicuous corrections (i.e. revisions and adjustments).¹ Prior literature provides reasons for this phenomenon. For example, restatements signal poor financial reporting quality (e.g., Burks 2011; Scholz 2014; Thompson 2017) and are associated with increases in cost of equity (Chen, Cheng, and Lo 2014). Compared to revisions or adjustments, restatements are followed by more significant decreases in stock price (Files et al. 2009; Badertscher et al. 2011; Scholz 2014) and attract more negative public attention (Choudhary, Merkley, and Schipper 2019a). As a result, to avoid restatement disclosures and achieve desirable financial reporting outcomes, clients are likely to argue that even large accounting misstatements are “immaterial,” such that they can be disclosed through revisions or adjustments (Acito, Burks, and Johnson 2009; Keune and Johnstone 2012; Thompson 2017; Acito, Burks, and Johnson 2019; Choudhary et al. 2019a).

My second reason for studying the disclosure of misstatement corrections relates to the frequency and magnitude of misstatements that are classified as immaterial. Among misstatements disclosed in annual financial reports since 2006, roughly 75% involve corrections of immaterial misstatements that are disclosed through adjustments or revisions while only 25% are corrections of material misstatements that are disclosed through non-reliance restatements. I also observe that approximately 15% of misstatements disclosed in revisions or adjustments contain misstatements that exceed the 5% of pre-tax income “rule of thumb” materiality threshold (SAB 99). Given these data, the fact that financial statements are the joint product of managers and auditors (Keune and

¹ As one example, Papa John’s International Inc. discovered an error and corrected it through a revision in 2019 (WSJ 2019a). The Securities and Exchange Commission (SEC) commented on the correction decision and demanded an explanation of why the error was deemed immaterial. The company responded that even though revenue, expenses, and total assets were impacted by more than 5%, the impacts were all below the 10% measure the company uses to assess error materiality. Circumstances such as these suggest that managers may use materiality thresholds that are much larger than what is envisioned by SAB 99.

Johnstone 2012), and ongoing regulatory concerns related to auditor independence (PCAOB 2016a), it is important to investigate auditor behavior with respect to the reporting of misstatements.

While managers have strong incentives to disclose potentially material misstatements through revisions and adjustments, auditor incentives are less clear. On one hand, auditors need to remain independent from the client in order to deliver objective, high-quality audits. Relaxing a materiality threshold is suggestive of compromised independence, which may expose auditors to increased regulatory, litigation, and reputation risk. Since 2006, the PCAOB has reported more than 300 audit deficiencies related to material misstatement corrections. The PCAOB also has issued disciplinary actions which not only imposed monetary penalties on audit firms or individual auditors but also barred Certified Public Accountants (CPAs) from practice due to inappropriate accounting for misstatements (PCAOB 2008; PCAOB 2009a; PCAOB 2009b; PCAOB 2016c; PCAOB 2017a).² Because auditors strongly desire “clean” PCAOB inspection reports (Johnson, Keune, and Winchel 2019; Westermann, Cohen, and Trompeter 2019) and further recognize that there are reputation effects associated with permitting aggressive client behavior (Larcker and Richardson 2004), auditors may pressure clients to report more conservatively.

On the other hand, conservative reporting may have consequences for auditors because annual report restatements signal poor audit quality, damage an office’s reputation, and increase the likelihood of auditor dismissal (Mande and Son 2013; Hennes, Leone and Miller 2014; Irani,

² As one example, the PCAOB censured Goldman Kurland and Mohidin, LLP and one of the firm’s partners. revoking the firm’s registration, barring the partner from being an associated person of a registered public accounting firm, and imposing monetary fines on both the firm and the partner (PCAOB 2016c). Among other misconduct, during the audit of China United Insurance Service, Inc. (hereafter CUIS) for fiscal year 2012, the auditors failed to adequately accumulate and/or evaluate uncorrected misstatements. During the CUIS Audit, Mohidin reviewed the firm’s work papers identifying two misstatements and discussed the work papers and revenue testing with the engagement team. Each of these uncorrected misstatements exceeded the firm’s planning materiality. The net effect on the CUIS financial statements was an overstatement of reported pre-tax loss of 16 percent and an understatement of reported gross profit of 8 percent. However, Mohidin did not treat these uncorrected misstatements as material misstatements (PCAOB 2016c).

Tate, and Xu 2015; Swanquist and Whited 2015). For these reasons, and because auditors are economically dependent on their clients (e.g., DeAngelo 1981b; Beck, Frecka, and Solomon 1988; Johnstone, Sutton, and Warfield 2001), auditors may be inclined to acquiesce in certain circumstances and allow clients to disclose material misstatements as immaterial. I investigate whether factors that may affect auditor independence – i.e., client importance, audit office industry expertise, audit office growth, and audit market competition – are associated with accounting misstatement disclosure decisions.

My initial sample includes 5,087 accounting misstatements disclosed in annual financial statements (i.e. 10-K) between fiscal year 2006³ and 2017. This sample consists of 1,462 restatements, 2,439 revisions, and 1,364 adjustments.⁴ First, I investigate the association between misstatement disclosure decisions and client importance, where client importance is defined as the ratio of client total fees to office total fees. Focusing on accounting errors that are larger than 5% of pre-tax net income (1,169 observations), my results indicate that important clients are more likely to disclose potentially material accounting misstatements through revisions or adjustments rather than restatements. The estimated likelihood of issuing revisions or adjustments increases from 33.6% for the least important clients to 59.4% for the most important clients. Among the subsample of revisions or adjustments (3,625 observations), I also find that the most important clients, compared to the least important clients, are about 9% more likely to have misstatements that exceed traditional materiality thresholds. In total, my findings suggest that auditors are more likely to permit important clients to report error corrections opportunistically.

³ I begin my sample period in fiscal year 2006 because SAB 108 was effective for fiscal years ending after November 2006. SAB 108 provides the most recent guidance for how material and immaterial misstatements should be corrected.

⁴ There are 178 firm year observations that have both little r restatements (revisions) and out-of-period adjustments (adjustments).

I also investigate whether auditor industry specialization within a Metropolitan Statistical Area (MSA) affects misstatement disclosure decisions. I find that when an auditor is not an industry specialist, (1) clients are 11% more likely to report potentially material misstatements through revisions or adjustments compared to restatements, and (2) the magnitudes of disclosed revisions and adjustments are about 4% more likely to exceed traditional materiality thresholds. These findings suggest that non-specialist auditors' misstatement correction disclosures may reflect impaired independence through an increased sensitivity to the possibility of losing important clients to other auditors.

Next, I investigate whether audit office growth is related to misstatement correction disclosures. I find that when an audit office has a net loss of one or more clients in the previous year, important clients are more likely to report misstatements opportunistically. This association does not exist in offices that are gaining clients or maintaining the same number of clients. I also conduct cross-sectional tests related to audit market competition. In these tests, I find that important clients are more likely to report potentially opportunistic misstatement corrections primarily when audit market competition is high. My auditor specialization results are not concentrated in observations with negative client growth or high audit market competition. Overall, my findings suggest that auditors are more likely to allow less conspicuous (i.e. potentially opportunistic) misstatement correction disclosures when they are more concerned about client retention and office-level growth.

In additional tests, I find that potentially opportunistic misstatement corrections are more likely to be disclosed through revisions or adjustments when the restatement auditor is the same as the misstatement auditor, but not when the auditors are different. I also find that the associations documented in my main analyses are concentrated (do not exist) in misstatement correction

disclosures that have negative (positive) impacts on previously issued financial statements. These results provide additional evidence consistent with auditors bowing to client preferences in an effort to maintain a positive relationship with their clients.

My study makes several contributions to the literature. First, I provide evidence that is consistent with misstatement correction disclosure decisions being influenced by client importance, auditor industry specialization, audit office growth, and audit market competition. As such, my study provides new insights on the relationship between auditor independence and misstatement correction disclosures. Second, my findings highlight a need for financial statement users to pay careful attention to the differences in financial statements across years and exercise substantial skepticism when they are evaluating the materiality of disclosed misstatements. Third, given the subjective nature of materiality assessments and the general lack of rule-based guidance, my results point to important considerations for regulators as they evaluate recent proposals to ease auditor independence requirements (SEC 2019; IESBA 2020). Finally, my findings should prove beneficial to the PCAOB as it assesses the potential impact of FASB materiality proposals on audit regulation (PCAOB 2015 and 2016b, FASB 2015), evaluates the effectiveness of the new Rule 3526, *Communication with Audit Committees Concerning Independence* (PCAOB 2019), and continues to emphasize the appropriate application of professional skepticism in public company audits (PCAOB 2017b).

II. BACKGROUND

Accounting Misstatement Disclosure Decision Process

Figure 1 depicts a conceptual model that describes the manager-auditor-audit committee accounting misstatement resolution process based on Keune and Johnstone (2012). The process begins when a misstatement is discovered by management, the external auditor, an internal

accountant, the internal control system, or regulators (Phase One). Managers, auditors, and audit committee members then evaluate the misstatement. The evaluation judgment in Phase Two is influenced by different incentives, professional characteristics, and regulatory guidance (SAB 108). After discussions and negotiations, the auditor, management, and audit committee reach an agreement on how managers will disclose the misstatement correction (Phase Three). Although immaterial misstatements may sometimes remain uncorrected in practice, both regulators and public accounting firms indicate that when financial statement misstatements are discovered they should be corrected – regardless of materiality (e.g., SEC 1999; PwC 2013; Ernst & Young 2015).⁵ The decision regarding accounting misstatement corrections in Phase Three of Figure 1 could result in a restatement (Big R restatement), revision (little r restatement), or adjustment (out-of-period adjustment).⁶

=====FIGURE 1 HERE=====

Regulatory Requirements on Accounting Misstatement Disclosure

In March 2004, the SEC issued “*Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date.*” In this rule, the SEC requires Item 4.02 to be filed when a company’s previously issued financial statements covering one or more years should no longer be relied upon because of a misstatement. After discovering that companies were inconsistently using either the “iron curtain” or the “rollover” method when accounting for misstatements, in September 2006 the SEC issued Staff Accounting Bulletin No. 108 – *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current*

⁵ I acknowledge that accounting standards do not apply to immaterial items (ASC 105), meaning that accounting misstatements deemed by management to be immaterial to prior periods may be left uncorrected.

⁶ Although I would be most interested in investigating how misstatement materiality specifically is evaluated in Phase 2, unfortunately that process is unobservable. Therefore, I use the misstatement correction disclosure outcomes in Phase 3 to try to understand the factors impacting Phase 2.

Year Financial Statements to clarify how to properly disclose accounting misstatement corrections. To eliminate inconsistencies in the treatment of historical accounting misstatements, the SAB 108 provision requires companies to use *both* the “iron curtain” and the “rollover” method to evaluate the cumulative impact of a misstatement. The rollover method is used to evaluate whether previously issued financial statements are materially misstated and the iron curtain test quantifies misstatements that exist at the end of the current period, irrespective of their year(s) of origination (SAB 108). After evaluating a misstatement using both methods, the company then provides the appropriate remediation in one of three ways: restatement, revision, or adjustment.

Restatements (“Big R”) are disclosed when the previously issued financial statements are materially misstated. In this circumstance, companies must file an 8-K Item 4.02 *Non-Reliance on Previously Issued Financial Statements* with the SEC within four business days.⁷ Subsequent correction typically is accomplished through amendments to prior filings (e.g., 10-K/A or 10-Q/A). In accordance with ASC 250, the restated financial statements should disclose the nature of the misstatements and the quantitative effects of disclosure on each affected financial statement line item (including per share amounts). Auditors also should include an explanatory paragraph in the audit report, indicating that the previously issued financial statements have been restated to correct a material misstatement (PCAOB AS 3101).

Revisions (“little r”) or adjustments (“out-of-period adjustments”) are issued when the previously issued financial statements are not deemed to be materially misstated. Revisions are appropriate when accumulated misstatements across previously issued financial statements are large enough that making a single, comprehensive correction would materially affect the current year’s financials. Revisions do not require formal restatements or 8-K filings. Instead, prior period

⁷ These “non-reliance filings” usually include the disclosure of incorrect financial statements as well as a brief description of the misstatements and discussions with the external auditor (ASC 250).

numbers are simply corrected (will be marked as “revised” or “restated”) and disclosed in supporting footnotes when the company files its next annual report. If the impact of prior immaterial misstatements on the current period financial statements is also immaterial, however, companies only need to disclose corrections in current period financial statements through adjustments (out-of-period adjustments). In this circumstance, companies should disclose the nature and extent of the adjustment, but no revisions to prior period numbers or the auditor’s report are required. Most firms only correct the misstatement and do not provide detailed information in the footnote. Overall, revisions and adjustments are much less conspicuous than restatements. In many cases, unless financial statement users make targeted comparisons of financial statements across years using different 10-Ks, they will not be aware of misstatement corrections at all.

Management Incentives and Misstatement Correction Disclosures

Guidelines related to misstatement correction disclosures exist (e.g., SAB 108; ASC 250; PwC 2013; Ernst & Young 2015). However, the authoritative guidance does not provide “bright-line” rules for assessing materiality (Keune and Johnstone 2012; Tan and Young 2015; Thompson 2017). Given that the decision to restate, revise, or adjust hinges on the assessment of the materiality of the misstatement, companies may manipulate the qualitative and/or quantitative factors used to evaluate materiality under SAB 108 in order to avoid a restatement (WSJ 2019a). Restatements call attention to the existence and severity of accounting misstatements and draw negative publicity to the company and its auditor (Hirbar and Jenkins 2004; Desai, Hogan, and Wilkins 2006; Files et al. 2009; Dechow, Ge, Larson, and Sloan 2011; Badertscher et al. 2011; Scholz 2014; Swanquist and Whited 2015; Thompson 2017). However, revisions or adjustments, which avoid non-reliance filings and financial statement amendments, should be less likely to

trigger attention from investors and regulators (Files et al. 2009; Scholz 2014; Thompson 2017; Choudhary et al. 2019a).

Prior literature has shown that companies have incentives to avoid restatements because they signal poor financial reporting quality. Scholz (2014) documents an average 1.5% decrease in stock price across restatements and revisions, but restatements have an average 2.3% decrease compared to only 0.6% decrease for revisions. Files et al. (2009) also document considerable differences in three-day stock returns related to restatements with high (-8.3%) versus low (-1.5%) prominence. In addition, restatements lead to a significant increase in cost of equity (Peterson 2012; Chen et al. 2014), information risk (Karvet and Shevlin 2010), and the number of lawsuits against the company, officers, directors, and auditors (Burks 2010; Badertscher et al. 2011). Further, managers and directors at restatement firms experience significantly higher turnover (Srinivasan 2005; Desai et al. 2006; Hennes, Leone, and Miller 2008; Badertscher et al. 2011; Peterson 2012), and restatements (but not revisions or adjustments) often trigger contractual obligations, such as repayment or forfeiture of executive compensation under clawback provisions (Thompson 2017).

To avoid a restatement and the associated Form 8-K non-reliance filing, managers are likely to argue that *any* accounting misstatements are “immaterial” so that they can be disclosed less conspicuously. Acito, Burks, and Johnson (2009) test materiality considerations on operating lease misstatement corrections from 2004 to 2006 under SAB 99. They find that materiality determinations can be adjusted to achieve desirable financial reporting outcomes. Using data on detected misstatements that occurred between 2003 and 2006, Keune and Johnstone (2012) find that when a firm is unable to meet or beat analyst forecasts because of a misstatement, management generally is more likely to waive the material misstatement. In another materiality study, Acito, Burks, and Johnson (2019) review SEC comment letter correspondence and find that managers

view misstatements as immaterial even when they exceed the traditional benchmarks by a large degree. They also find that when companies receive comment letters, managers often are forthcoming about the impact of large misstatements but rationalize treating them as immaterial by claiming that the traditional benchmarks were abnormally low during the violation period. My study investigates whether accounting misstatement disclosure decisions are influenced by factors *other than management incentives* under SAB 108.

III. HYPOTHESES DEVELOPMENT

The focus of this paper is to investigate whether misstatement correction disclosures reflect potentially impaired auditor independence. Although managers have strong incentives to classify material misstatements as immaterial, auditor incentives related to the disclosure of misstatement corrections are unclear. Auditors attenuate audit risk – i.e., the risk that a clean opinion will be expressed on financial statements that are materially misstated – by evaluating the risk of material misstatement and adjusting audit procedures accordingly (Bedard and Johnstone 2004; Hogan and Wilkins 2008; DeFond and Zhang 2014). Relaxing a materiality threshold may expose auditors to increased regulation, litigation, and reputation risk. Braun (2001) shows that auditors are less likely to allow managers to waive a material misstatement if the waiver is expected to increase auditor litigation risk. Previous research also indicates that auditors are concerned about reputation effects and will reject managers' demands when the associated risk is high (Reynolds and Francis 2000; Larcker and Richardson 2004). Keune and Johnstone (2012) find that auditors' incentives to protect their reputation weakens the effect of managerial incentives associated with the pressure created by analyst following, and that auditors are less likely to allow managers to waive quantitatively material misstatements as audit fees increase.

From a regulatory perspective, the PCAOB has reported more than 300 audit deficiencies related to material misstatement corrections since 2006 (PCAOB 2008; PCAOB 2009a; PCAOB

2009b; PCAOB 2016c; PCAOB 2017a). A negative PCAOB inspection reflects poorly on the reputation of audit firms, resulting in client loss and firm-level fines for individual audit partners (Houston and Stefaniak 2013; Lamoreaux 2016; Johnson et al. 2019). As a result, auditors strongly desire “clean” PCAOB inspection reports (Johnson et al. 2019; Westermann et al. 2019). The PCAOB may also sanction individual CPAs and accounting firms for particularly egregious behavior (PCAOB 2016c). Taken together, previous research and regulatory activity suggest that auditors may pressure clients to report more conservatively in order to minimize potential penalties, litigation, and reputation damage.

Although auditors certainly are sensitive to the above concerns, they also are profit-seeking. The theory of economic bonding suggests that auditors are dependent on clients and cater to management’s financial reporting demands in order to retain clients and earn future fees (e.g., DeAngelo 1981a, 1981b; Beck et al. 1988; Johnstone et al. 2001; Blay and Geiger 2013; DeFond and Zhang 2014; Tepalagul and Lin 2015). In my setting, if an auditor is economically dependent on a client, the auditor’s judgment with respect to the materiality of a misstatement may be biased. For example, prior literature has shown that auditors are less likely to correct an immaterial misstatement when the correction would cause the client to miss an earnings forecast (Libby and Kinney 2000; Ng 2007; Ng and Tan 2007). In addition, there are various negative consequences associated with an annual report restatement, such as signaling poor audit quality, damaging an office’s reputation, and increasing auditor dismissal risk (Mande and Son 2013; Hennes et al. 2014; Irani et al. 2015; Swanquist and Whited 2015). These findings, taken together, suggest that clients may be able to influence auditors’ judgment related to misstatement correction disclosures. In other words, auditors may be inclined to permit more favorable treatment of potentially material misstatements when they are more sensitive to the loss of fee revenue.

The arguments presented above offer competing predictions regarding auditor incentives in the misstatement disclosure setting. All else equal, litigation, reputation, and regulatory concerns should lead to more conservative reporting of misstatements. However, economic bonding arguments generate the opposite prediction. Effects related to economic dependence appear to be increasing in client importance, as large clients (i.e., those that pay higher fees) are less likely to be given qualified audit opinions (Krishnan and Krishnan 1996) or going concern opinions (Blay and Geiger 2013); are more likely to engage in earnings management (Sharma, Sharma, and Anathanarayanan 2011); and are more likely to have their audit adjustments waived (Wright and Wright 1997). I expect that when a client is important to the office, economic bonding incentives should dominate litigation, reputation, and regulatory concerns. As such, my first hypothesis is stated as follows (in the alternative form):

H1: Clients that are more important to an audit office are more likely to have potentially opportunistic misstatement correction disclosures.

My second hypothesis relates to auditor industry specialization. Cairney and Young (2006) and Bills, Jeter, and Stein (2014) argue that auditors achieve intended levels of audit quality in homogenous industries more efficiently because industry homogeneity facilitates expert knowledge transfer across audit clients at the local office level. As such, audit offices with industry expertise are able to provide higher quality audits. Further, these offices are incentivized to maintain high levels of audit quality because they have more reputational capital at stake (Francis, et al. 2005; Reichelt and Wang 2010; Bills, et al. 2014; DeFond and Zhang 2014). In the misstatement disclosure setting, specialist auditors should be more likely to understand the impact of a discovered misstatement and less likely to relax a materiality threshold for a client because of their heightened reputational risks. In contrast, auditors without industry experience may be less confident in their judgment of the importance of accounting misstatements and may also be more

sensitive to the possibility of losing clients to competing auditors. Based on this reasoning, clients should be more likely to use potentially opportunistic misstatement disclosures when their auditors are not industry specialists.⁸ My second hypothesis is stated as follows (in the alternative form):

H2: Clients with non-specialist auditors are more likely to have potentially opportunistic misstatement correction disclosures.

My third hypothesis relates to auditor office growth. When the local audit office is losing clients, the economic bonds with retained clients are strengthened because the office will rely more on the revenue of these clients going forward. The greater the office's concern about losing clients, the greater should be its tendency to permit potentially opportunistic misstatement disclosures. If the office is not losing clients, however, it should be less worried about the risk of dismissal and less susceptible to independence concerns. Based on these arguments, in H3 I examine whether audit office growth differentially impacts the relationships proposed in H1 and H2. If an office experiences a net loss in clients during the prior year, it is reasonable to suppose that auditors will be incrementally more likely to acquiesce to the misstatement reporting preferences of important clients. Audit office growth may also influence the relationship between auditor industry specialization and misstatement disclosure decisions. For example, because non-specialist auditors do not have reputations that are as strong as those of specialist auditors (Francis et al. 2005), they are likely to be more concerned about losing clients to competing auditors. Therefore, non-specialist auditors may be more inclined to allow potentially opportunistic misstatement disclosures when the office is experiencing client loss. My third hypothesis cross-sectionally tests H1 and H2 based on negative or non-negative office growth. I state H3a and H3b in the alternative form:

⁸ Note that if non-specialists deliver lower quality audits, any misstatements that are discovered may be more likely to be material (requiring Big R restatements). This relationship biases against finding support for H2.

H3a: The association between client importance and misstatement correction disclosures is more pronounced when an audit office experiences negative growth.

H3b: The association between non-specialist auditors and misstatement correction disclosures is more pronounced when an audit office experiences negative growth.

My fourth hypothesis relates to audit market competition. Previous research shows that audit market competition affects audit pricing. For example, high audit market competition contributes to low-balling in initial engagements (Elizur and Falk 1996; Chan 1999; Causholli and Knechel 2012) and lower audit fees in general (Chaney, Jeter, and Shaw 2003; Numan and Willekens 2012). More relevant to my study, previous research also shows that audit market competition affects audit quality. Specifically, Newton, Wang, and Wilkins (2013) find that firms in MSAs with high auditor competition file more restatements, which suggests that auditors have a tendency to under-audit when audit market competition is high (Causholli and Knechel 2012). Market competition also affects auditor turnover. For example, Hennes et al. (2014) find that after a restatement, clients are more likely to dismiss their auditors unless the firm has higher switching costs and fewer replacement auditor choices. Further, Newton, Persellin, Wang, and Wilkins (2016) find that internal control opinion shopping is more likely in competitive audit markets. Taken together, these findings suggest that auditors are more likely to worry about being dismissed when audit market competition is high.

Based on the above development, in H4 I examine whether audit market competition differentially impacts the relationships I investigate in H1 and H2. With respect to H1, audit market competition may influence the relationship between the auditor's economic bond with the client and the reporting of misstatements. Specifically, auditors may be more inclined to allow revisions or adjustments when the client is important and could easily find a comparable auditor (i.e., when the client is located in a highly competitive audit market). If audit market competition is low,

however, auditors are less likely to be worried about losing an important client. In such situations, regulatory, litigation, and reputation concerns may make auditors more likely to push for conservative accounting misstatement disclosures. Regarding H2, audit market competition may affect the association between auditor industry specialization and misstatement disclosures. In audit markets with more potential substitutes, non-specialist auditors should be more concerned than specialist auditors about losing market share to other auditors. Therefore, non-specialists should be relatively more likely to focus on maintaining their client portfolios – i.e., should be more likely to relax misstatement correction disclosure criteria – when competition between auditors is high. However, if audit market competition is low, non-specialists and specialists may be similarly confident in the safety of their client portfolios. Thus, in low competition markets, the behavior of specialist auditors may not be different from that of non-specialist auditors. My fourth hypothesis cross-sectionally tests H1 and H2 based on the level of audit market competition. I state H4a and H4b in the alternative form as follows:

H4a: The association between client importance and misstatement correction disclosures is more pronounced when the audit market is more competitive.

H4b: The association between non-specialist auditors and misstatement correction disclosures is more pronounced when the audit market is more competitive.

IV. RESEARCH DESIGN AND SAMPLE

Research Design

Auditors typically use quantitative thresholds as “rules of thumb” to assist in evaluating whether a misstatement would be considered material to users of financial statements (SAB 99). The materiality threshold that is used most commonly in practice is 5% of pre-tax income (Eilifsen and Messier 2015; SAB 99; Choudhary et al. 2019a). In my tests, I use two proxies to measure potentially opportunistic misstatement correction disclosures. The first is *RorA*, which equals one

if the client discloses a revision or adjustment on a previously issued 10-K that is greater than 5% of pre-tax income and zero if the client discloses a restatement.⁹ If auditors acquiesce to client preferences, I expect to observe more potentially material misstatement corrections disclosed as immaterial instead of material (i.e., more likely to observe $RorA = 1$). I use the following model to test H1 to H4:

$$\begin{aligned}
 Pr(RorA = 1) = & \beta_0 + \alpha_1 CLIENT_IMPORTANCE_{it} + \alpha_2 NON_SPECIALIST_{it} + \beta_1 SIZE_{it} + \beta_2 \\
 & ROA_{it} + \beta_3 BTM_{it} + \beta_4 CHGLEV_{it} + \beta_5 ALTMAN_{it} + \beta_6 GEOSEG_{it} + \beta_7 BUSSEG_{it} + \\
 & \beta_8 NEWFIN_{it} + \beta_9 TOTALACCRUAL_{it} + \beta_{10} GROWTH_{it} + \beta_{11} ICMW_{it} + \beta_{12} \\
 & LAG_RESTATE_{it} + \beta_{13} AC_EXPERT + \beta_{14} BIG4_i + \beta_{15} TENURE_{it} + YEAR\ FE + \\
 & INDUSTRY\ FE + \varepsilon_{it}
 \end{aligned} \tag{1}$$

I estimate Model (1) using a binary probit regression. The model is estimated from 2006 to 2017 for companies disclosing accounting misstatement corrections of any type that are greater than 5% of pre-tax income. Following prior literature, Model (1) includes control variables expected to be correlated with the existence of accounting misstatements (Kenue and Johnstone 2012; Tan and Young 2015; Thompson 2017). The model includes controls for company characteristics that are associated with client risk and complexity (*SIZE*, *ALTMAN*, *GEOSEG*, *BUSSEG*, *NEWFIN*, *TOTALACCRUAL*, *ICMW*, and *LAG_RESTATE*) as well as potential earnings management behavior (*ROA*, *BTM*, *CHGLEV*, and *GROWTH*). I control for audit committee accounting expertise (*AC_EXPERT*) because audit committees are actively engaged in the misstatement disclosure process (Kenue and Johnstone 2012). In addition, I control for auditor

⁹ I acknowledge that when the company has low income, using 5% of pre-tax income as the benchmark may lead to inaccurate materiality assessments. Therefore, in robustness tests, I use 1% of total assets as an alternative materiality threshold. My results in these tests are consistent with those that are reported in the main analyses.

characteristics (*BIG4* and *TENURE*), as these may affect audit quality. Finally, I include industry and year fixed effects and cluster standard errors by firm. All variables are defined in Appendix A.

As an alternative test, I restrict my sample to firm-year observations with misstatements disclosed as immaterial (i.e., adjustments or revisions). I then use a dependent variable (*ABNORMAL*) that is equal to one (zero) if the client discloses a revision or adjustment on a previously issued 10-K that is greater than (less than) 5% of pre-tax income. Again, I use binary probit regressions to analyze H1 through H4.

$$\begin{aligned}
 ABNORMAL = & \beta_0 + \alpha_1 CLIENT_IMPORTANCE_{it} + \alpha_2 NON_SPECIALIST_{it} + \beta_1 SIZE_{it} + \beta_2 \\
 & ROA_{it} + \beta_3 BTM_{it} + \beta_4 CHGLEV_{it} + \beta_5 ALTMAN_{it} + \beta_6 GEOSEG_{it} + \beta_7 BUSSEG_{it} + \\
 & \beta_8 NEWFIN_{it} + \beta_9 TOTALACCRUAL_{it} + \beta_{10} GROWTH_{it} + \beta_{11} ICMW_{it} + \beta_{12} \\
 & LAG_RESTATE_{it} + \beta_{13} AC_EXPERT + \beta_{14} BIG4_i + \beta_{15} TENURE_{it} + YEAR\ FE + \\
 & INDUSTRY\ FE + \varepsilon_{it}
 \end{aligned} \tag{2}$$

Tests of Hypothesis 1

The variable of interest for H1 is *CLIENT_IMPORTANCE*, which measures how important a client is to the local office in terms of office revenue. Following prior literature (Li 2009; Sharma et al. 2011), *CLIENT_IMPORTANCE* is defined as decile-ranked client total fees divided by office total fees.¹⁰ A significant, positive value for α_1 in Model (1) or (2) would suggest, consistent with the theory of economic bonding, that auditors are more likely to acquiesce to the preferences of important clients. On the other hand, if α_1 is significantly negative, the inference would be that auditors require more conservative reporting of accounting misstatements for important clients due to greater litigation, reputation, and regulation concerns.

¹⁰ I use a decile-ranked client importance measure because client importance is not likely to be a linear function of client total fees divided by office total fees. My findings are consistent when using a continuous, quintile, or quartile-ranked measure of client importance.

Tests of Hypothesis 2

The variable of interest for H2 is *NON_SPECIALIST*, which equals one when clients do not have an industry specialist auditor and zero when clients have an industry specialist auditor. My variable of interest defines clients of non-specialist (rather than specialist) auditors so that my coefficient predictions for both H1 and H2 are the same. Consistent with prior literature (Francis et al. 2005; Reichelt and Wang 2010), auditor industry expertise is based on the auditor's annual market share of audit fees within a two-digit SIC category for an MSA. *NON_SPECIALIST* equals zero if a client's auditor has the largest industry market share within the local MSA and has a market share that is at least ten percentage points greater than the second largest industry leader in the MSA (Mayhew and Wilkins 2003; Reichelt and Wang 2010), and one otherwise. A positive value for α_2 would suggest that clients of non-specialist auditors are more likely to have potentially opportunistic misstatement corrections, relative to clients of industry specialist auditors (H2). In contrast, a negative value for α_2 could indicate that non-specialist auditors deliver lower quality audits during the periods in which misstatements occur, such that any necessary corrections are more likely to be material (requiring restatements rather than revisions or adjustments).

Tests of Hypothesis 3

For tests of H3a and H3b, I estimate Model (1) separately for client firm-year observations where the local audit office has reduced or not reduced (i.e., held constant or increased) its total number of clients in the previous year.¹¹ I define a local office as having positive (negative) growth if the number of clients in year t-1 is the same or more (less) than the number of clients in year t-

¹¹ I use cross-sectional tests rather than interactions because Chow tests indicate that the control variable coefficients are significantly different ($p < 0.001$) when the audit office is experiencing positive versus negative growth. In robustness tests, I use an alternative measure based on audit office growth, which is defined as whether the total office-level audit fees decrease compared to the previous year. My results are consistent using this measure.

2. The reason for using the change in the number of clients in the prior year is to allow enough time for client portfolio shifts to impact misstatement disclosure decisions.¹²

Tests of Hypothesis 4

For H4a and H4b, I estimate Model (1) separately for client firm-year observations in audit markets with high versus low competition.¹³ Following prior literature (GAO 2003, 2008; Boone, Khurana, and Raman 2012; Newton et al. 2013), the audit market competition measure I employ is derived from the Herfindahl-Hirschman index (HHI). This measure captures variation in the number of audit firms present in a local market and the distribution of audit clients among those firms. The HHI at the MSA level is calculated as the sum of squares of total fees in each audit office divided by MSA total fees. To construct HHI, I obtain data regarding auditor location and audit fees from Audit Analytics, and I collect MSA information from the U.S. Census Bureau. Because the HHI measures auditor concentration, lower values of the index are indicative of higher auditor competition. Therefore, if the MSA HHI is lower than the median for a sample year, I classify the MSA as having high audit competition. If the MSA level HHI is above or equal to the median, I classify the MSA as having low audit market competition. To test H4a and H4b, I re-estimate equation (1) separately for firm-year observations within high versus low competition audit markets.

Sample

Table 1 summarizes my sample selection procedure. The sample includes only firm-year observations that have misstatement correction disclosures (i.e., restatements, revisions, and

¹² My inferences remain the same when I use the change in the number of clients in the current year as my office growth measure. In additional analyses, I use the change in office total fees as an alternative proxy for office growth and my results are consistent.

¹³ Similar to my tests of H3, I use cross-sectional tests rather than interactions because a Chow test indicates that the control variable coefficients are significantly different ($p < 0.05$) in high vs. low competition markets.

adjustments). I collect restatement and revision observations from the Audit Analytics Restatements database. Among those observations, restatements requiring 8-K Item 4.02 filings are classified as (Big R) restatements, and restatements that do not require 8-K filings are classified as revisions (little r restatements). I collect out-of-period adjustment observations from the Audit Analytics Adjustments database. My sample period begins in fiscal year 2006 because SAB 108 was effective for fiscal year ends following November 2006. My sample period ends in 2017. I obtain all financial, audit opinion, internal control opinion, and audit committee expertise data from the intersection of Audit Analytics, Compustat, and the BoardEx Education and Employment database.

Panel A of Table 1 shows that there are 7,954 firm-year observations with misstatement correction disclosures during my sample period. I remove 1,417 firm-year observations involving firms that operate in the financial industry (SIC 6000 through 6999) and 347 observations for firms that have less than \$1 million in total assets.¹⁴ I omit 1,103 firm-year observations that do not have the data needed to construct the control variables used in Models (1) and (2). After eliminating these observations, my sample includes 5,087 accounting misstatement disclosure observations in annual reports between 2006 and 2017, including 1,462 restatements, 2,439 revisions, and 1,364 adjustments.¹⁵ In Panel B of Table 1, I present the sample composition for Models (1) and (2). Model (1) is estimated for the 1,169 accounting misstatement corrections that have magnitude greater than 5% of pre-tax income. Among these 1,169 observations, there are 529 revisions or adjustments ($RorA=1$) and 640 restatements ($RorA=0$). Model (2) is estimated for the 3,625 firm-

¹⁴ I remove firms with less than \$1 million in total assets to prevent my control variables from having extreme values when scaling by assets (Cassell, Dreher, and Myers 2013). My results are consistent when I include these observations.

¹⁵ There are 178 firm-year observations that have both little r restatements (revisions) and out-of-period adjustments (adjustments). My sample contains SAB 108 restatements; however, my inferences remain the same if I exclude these observations.

year observations with misstatements disclosed as immaterial (i.e., $RorA=1$). Among these observations, 3,096 (529) have a misstatement correction that is less than or equal to (larger than) 5% of pre-tax income. Observations with corrections that are below (above) the 5% threshold are defined as $ABNORMAL=0$ ($ABNORMAL=1$).¹⁶

=====TABLE 1 HERE=====

Table 2 contains descriptive statistics for the variables used in my tests. In the sample for Model (1), I only include the 1,169 observations (Panel A) with misstatement correction disclosures that exceed 5% of pre-tax net income. Approximately 54.8% of the Model (1) sample observations contain restatements, while 45.2% have revisions and/or adjustments.¹⁷ Among the 1,169 Model (1) observations, 845 (324) of the corrections have a negative (positive) impact on the financial statements. Table 2 Panel B presents descriptive statistics for the variables included in Model (2). The sample for Model (2) is limited to the 3,625 observations with revisions or adjustments (i.e., no restatements). Approximately 67.3% of observations contain revisions and 37.6% have adjustments.¹⁸ The average value for $ABNORMAL$ is 0.146, which indicates that 14.6% (529) of the sample observations are potentially material misstatements that are disclosed as immaterial through revisions or adjustments. Financial variables are calculated using the Compustat data measured at the date of the last 10-K that includes the misstatement disclosure announcement, and all continuous variables are winsorized at the 1 percent and 99 percent levels.

=====TABLE 2 HERE=====

¹⁶ The 822 restatements with magnitude that is less than or equal to 5% of pre-tax income are not included in my study due to the potential unobservable qualitative materiality measures used when evaluating the materiality of these misstatements. My study focuses on quantitative materiality measures, therefore

¹⁷ Among the 1,169 observations in Panel A, there are 22 firm-year observations with both revisions and adjustments.

¹⁸ The percentages do not sum to 100% for the 3,625 observations in Panel B because there are 178 firm-year observations with both revisions and adjustments.

Table 3 Panels A and B present the correlation matrices for dependent and independent variables for Model (1) and (2), with Pearson (Spearman) correlation coefficients below (above) the diagonal. In Panel A, *RorA* is strongly positively correlated with both *CLIENT_IMPORTANCE* and *NON_SPECIALIST*. *RorA* is negatively correlated with *NEG_OFFICE_GROWTH*, *CHGLEV*, *ICMW*, and *LAG_RESTATE*, and positively correlated with *SIZE*, *ROA*, *BIG4*, and *TENURE*. In Panel B, *ABNORMAL* is strongly positively correlated with both *CLIENT_IMPORTANCE* and *NON_SPECIALIST*. *ABNORMAL* is negatively correlated with *SIZE*, *ROA*, *BTM*, and *TENURE*, and positively correlated with *COMPETITION* and *ICMW*. Although the correlations of several variables are above 0.35, the variance inflation factors (VIF) observed in analyses are all under the suggested multicollinearity threshold of 10 except for *SIZE*. In untabulated analyses, I find that the inferences remain the same if I remove *SIZE* from the models.

=====TABLE 3 HERE=====

V. RESULTS

Table 4 presents the primary results associated with H1 and H2. In column 1, I investigate the likelihood of reporting revisions or adjustments versus restatements for misstatements that exceed the 5% materiality threshold. With respect to control variables, I find that *RorA* is positively associated with client size, distress, and having a Big 4 auditor, and negatively associated with return on assets, change in leverage, number of business segments, and having internal control material weaknesses. In my test of H1, I find a significant positive coefficient on *CLIENT_IMPORTANCE* (p-value=0.003), which indicates that important clients are more likely to disclose revisions or adjustments rather than formal restatements when the misstatements are potentially material. This finding suggests that auditors may allow more aggressive misstatement correction reporting when they have stronger economic bonds with clients. The effect is also

economically significant, as a one decile-rank increase in *CLIENT_IMPORTANCE* increases a client's propensity to disclose a misstatement correction through adjustments or revisions by 2.9% (nominally), holding all control variables at their mean. The estimated likelihood of issuing revisions or adjustments increases from 33.6% to 59.4% as *CLIENT_IMPORTANCE* increases from the lowest to the highest decile. For H2, I find a significant positive coefficient on *NON_SPECIALIST* (p-value<0.001). This result indicates that when auditors are not industry specialists, clients' propensity to disclose misstatement corrections through revisions or adjustments increases when the misstatements are potentially material. The result is aligned with the argument that non-specialist auditors are relatively more worried about losing clients, and hence are more likely to allow potentially opportunistic misstatement reporting. The average marginal effect associated with a non-specialist auditor is a 10.7% (nominal) increase in the likelihood of having a revision or adjustment relative to a formal restatement when the misstatement is potentially material.

Column 2 of Table 4 limits the sample to revisions and adjustments and presents the results associated with the likelihood of reporting misstatements that exceed traditional materiality thresholds. I find that *CLIENT_IMPORTANCE* is positively associated with *ABNORMAL* (p-value=0.038), which indicates that important clients with revisions or adjustments are more likely to have misstatements that exceed 5% of pre-tax income.¹⁹ A one decile-rank increase in *CLIENT_IMPORTANCE* increases the likelihood that these companies report potentially material misstatements by 1% (nominally), holding all control variables at their mean. The estimated likelihood that companies with revisions or adjustments have potentially material misstatements increases from 11.1% to 20.0% as *CLIENT_IMPORTANCE* increases from the lowest to the

¹⁹ In untabulated analyses, I also investigate whether there are differential auditor incentives between allowing clients to disclose revisions versus adjustments, but I do not find any significant differences.

highest decile. Consistent with my results regarding *RorA* (column 1), this finding suggests that auditors may be more likely to compromise their independence and allow more aggressive misstatement disclosure reporting when they have stronger economic bonds with clients. I also find a significant positive coefficient on *NON_SPECIALIST* (p-value=0.005), indicating that when auditors are not industry specialists, clients with revisions or adjustments are more likely to have misstatements that exceed traditional materiality thresholds. For companies with revisions or adjustments, the average marginal effect associated with a non-specialist auditor is a 3.7% (nominal) increase in the likelihood of disclosing a potentially material misstatement. Again, consistent with my previous findings, this result is aligned with the argument that auditors without industry specialization are more likely to acquiesce to client reporting preferences.

=====TABLE 4 HERE=====

Table 5 presents the results associated with tests of H3a and H3b. Table 5 columns 1 and 3 (2 and 4) investigate the association between accounting misstatement correction disclosure and *CLIENT_IMPORTANCE* and *NON_SPECIALIST* when audit offices have negative (non-negative) growth. In column 1, *CLIENT_IMPORTANCE* is positively associated with *RorA* (p-value=0.002) when an audit office loses clients in the previous year (negative growth). No such relationship exists when the audit office does not lose clients (column 2). The coefficient estimates on *CLIENT_IMPORTANCE* in columns 1 and 2 are significantly different (p-value<0.10). Overall, these results suggest, consistent with H3a, that when offices are suffering from a loss of clients, auditors are more likely to allow important clients to disclose potentially material misstatement corrections through revisions or adjustments rather than restatements. The coefficient estimates on *NON_SPECIALIST* are positively associated with *RorA* when the audit office is experiencing negative growth (p-value=0.003) and also when experiencing non-negative growth (p-

value=0.026). In addition, the coefficient estimates on *NON_SPECIALIST* between column 1 and 2 are not significantly different (p-value>0.10). In contrast to the prediction of H3b, this result suggests that non-specialist auditors are more likely to compromise their independence (H2) regardless of audit office growth.

Columns 3 and 4 present the results associated with tests of audit office growth and the likelihood of reporting potentially material misstatements for companies that disclose revisions or adjustments. *CLIENT_IMPORTANCE* is positively associated with *ABNORMAL* when audit offices experience client loss in t-1 (p-value=0.011, column 3), but not when offices maintain or increase their client base in t-1 (p-value=0.178, column 4). The coefficient estimates on *CLIENT_IMPORTANCE* in columns 3 and 4 are significantly different (p-value=0.10). Consistent with H3a, this finding suggests that important clients are more likely to disclose accounting misstatements more opportunistically when clients and auditors have stronger economic bonds, particularly when the office experiences negative growth. Finally, I find that *NON_SPECIALIST* is significantly associated with *ABNORMAL* both when the office loses clients (p=0.024) and when the office does not lose clients (p-value=0.024). Overall, the findings presented in Table 4 provide strong support for H3a but do not provide support for H3b.

=====TABLE 5 HERE=====

Table 6 presents the results associated with tests of H4a and H4b. Table 6 columns 1 and 3 (2 and 4) provide test results on the association between reporting of accounting misstatements and *CLIENT_IMPORTANCE* and *NON_SPECIALIST* in audit markets with low (high) competition. Columns 1 and 2 show that *CLIENT_IMPORTANCE* is positively associated with *RorA* when audit market competition is low (p-value=0.086) and when market competition is high (p-value=0.030). Consistent with H4a, the coefficient estimate on *CLIENT_IMPORTANCE* in

column 2 is significantly larger than the coefficient estimate in column1 (p-value<0.10). These results suggest that when an auditor can be replaced more easily by alternative auditors in the local MSA, the auditor is more likely to compromise its independence for important clients. Columns 1 and 2 also show that *NON_SPECIALIST* is positively associated with *RorA* when audit market competition is high or low, and the coefficient estimates are not significantly different from each other. These findings suggest that non-specialist auditors are more likely to compromise their independence (H2) regardless of audit market competition.

Columns 3 and 4 of Table 6 present the results associated with tests of audit market competition and the likelihood of reporting potentially material misstatements for companies that disclose revisions or adjustments. Column 4 shows that the positive association between *CLIENT_IMPORTANCE* and *ABNORMAL* (p-value=0.002) exists in highly competitive audit markets but not in less competitive audit markets (p-value=0.210) (column 3). These results suggest, consistent with H4a, that important clients are more likely to disclose potentially material misstatements through revisions or adjustments when there is high audit market competition. Column 3 and 4 also shows that *NON_SPECIALIST* is significantly associated with *ABNORMAL* (p-value=0.016) when market competition is low, but not when audit market competition is high (p-value=0.417). Taken together, the results presented in Table 6 provide strong support for H4a but do not support H4b.

=====TABLE 6 HERE=====

VI. ADDITIONAL ANALYSES

Effect of Auditor Changes

An auditor that is correcting another auditor's work should have fewer reputational concerns (Singer and Zhang 2018). As such, client importance may be less associated with

misstatement disclosure decisions when the misstatement and restatement auditors are different. However, when auditors are correcting their own work, they may be more likely to understate the extent of discovered misstatements to avoid reputation concerns and potential client loss (Christensen et al. 2019). Table 7 presents cross-sectional tests of H1 and H2 based on whether the misstatement and restatement auditors were the same or different. I find that when the auditors are different (columns 1 and 3), there is no relationship between *CLIENT_IMPORTANCE* or *NON_SPECIALIST* and accounting misstatement disclosure decisions (*RorA* or *ABNORMAL*). However, when the auditors are the same (columns 2 and 4), *CLIENT_IMPORTANCE* is positively associated with *RorA* and *ABNORMAL*. Thus, auditors appear to be more permissive in misstatement disclosure decisions when they are correcting their own work. I also find that when the auditors are the same (columns 2 and 4), *NON_SPECIALIST* is positively associated with *RorA* and *ABNORMAL*. This finding suggests that auditors without industry expertise permit more aggressive reporting than auditors with industry expertise when they are correcting their own work.

=====TABLE 7 HERE=====

Positive and Negative Impact of Accounting Misstatement Corrections

During the misstatement disclosure process, managers are more likely to be sensitive about misstatement correction disclosures with a negative impact on the financial statements than those with a positive impact (e.g., Pittman and Zhao 2018). Further, my previous tests suggest that when clients are more important to auditors, auditors may be more likely to allow potentially opportunistic misstatement disclosures. Therefore, I estimate separate models for misstatement correction disclosures with a positive versus a negative impact on financial statements so that I can investigate whether these two types of misstatements differentially impact auditor incentives.

In Table 8, I present the results for testing H1 and H2 separately for misstatement corrections that have a negative versus a positive effect on the financial statements. Table 8 shows that the associations between *CLIENT_IMPORTANCE* and *NON_SPECIALIST* and the dependent variables documented in the full sample (Table 4) are concentrated in misstatement correction disclosures that have negative impacts. In columns 1 and 3, I find that *CLIENT_IMPORTANCE* is positively associated with *RorA* (p-value=0.011) and *ABNORMAL* (p-value=0.010), and that *NON_SPECIALIST* is positively associated with *RorA* (p-value=0.000) and *ABNORMAL* (p-value=0.009). No association exists when the misstatement disclosures have positive impacts (columns 2 and 4). These findings are consistent with companies being more likely to try to avoid restatements (and with auditors being more complicit) when the disclosures have a negative impact on the financial statements.

=====TABLE 8 HERE=====

VII. ROBUSTNESS TESTS

I perform several robustness tests (untabulated) to evaluate the sensitivity of my results to various research design choices. First, to examine the sensitivity of my choice of using 5% of pre-tax income as the materiality threshold, I re-analyze my tests using 1% of total assets as an alternative threshold. Using this alternative materiality benchmark, I find results consistent with those that are reported in my main analyses.

To test the sensitivity of my office growth measure, I use growth in total office fees as an alternative measure. Negative growth offices are defined as those collecting fewer total fees in fiscal year *t* than *t-1*, since audit fees typically are negotiated at the beginning of the engagement year. Non-negative growth offices are classified as those collecting the same or higher total fees in fiscal year *t* compared to year *t-1*. Using this alternative classification, I find results consistent

with those that are reported for H3. To further test the sensitivity of the growth measure, I restrict the definition of negative growth to include offices with material total fee loss. Negative growth offices are defined as those that lose more than 1% or 5% of total fees in fiscal year t relative to year $t-1$, and non-negative growth offices include all other observations. Using these more restrictive classifications, I still find results that are consistent with H3.

To examine the sensitivity of using reverse HHI as my audit market competition measure, I use alternative proxies for audit market competition. Although HHI is the most commonly employed measure for audit market competition in prior research, HHI is only based on one aspect of audit market structure: the audit fee. Because empirical HHI measures are not as consistently associated with audit fees as theory would suggest (DeFond and Zhang 2014; Ettredge, Sherwood, and Sun 2018), I use two alternative cut-offs for high and low audit market competition. Specifically, I define audit market competition as high 1) when there are at least two Big 4 audit firms within the MSA; and 2) if the number of audit offices within the MSA is bigger than the national median. For both of these alternative measures, my inferences remain the same as in my primary tests of H4.

VIII. CONCLUSION

Regulators and previous studies have documented that management has strong incentives to under-report material misstatements through revisions or adjustments. My study provides insights on how auditor incentives play a role in accounting misstatement disclosure decisions. I examine whether factors that may affect auditor independence – such as client importance, audit office industry expertise, audit office growth, and audit market competition – are associated with accounting misstatement disclosure decisions. Using accounting misstatements disclosed in annual financial statements from fiscal year 2006 to 2017, I find that economically important clients and

clients of non-specialist auditors are more likely to disclose potentially material misstatements through revisions or adjustments than through formal restatements. I also find that among revisions and adjustments, the error corrections are likely to be above the traditional materiality thresholds for economically important clients and clients of non-specialist auditors. My findings are strongest in audit offices with negative growth and in audit markets with high competition. I also find that my results are strongest when restatement auditors are the same as misstatement auditors and when accounting misstatement disclosures have a negative impact on the financial statements.

My study contributes to the literature by providing evidence that auditor incentives impact how accounting misstatements are disclosed. I find that auditors are more likely to cater to management's opportunistic misstatement reporting preferences when the economic bond with the client is stronger and when the auditor is not an industry specialist. I also find that these effects are strongest when the office is experiencing pressure from negative growth or competition and when the auditor is correcting its own work. Overall, I provide persuasive evidence that misstatement correction disclosures may be associated with impaired auditor independence. My findings suggest the need for additional attention from regulators and substantial caution on the part of investors who are attempting to evaluate the true materiality of accounting misstatements.

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Appendix A
Variable Definitions

Variable	Variable Definition
<i>ABNORMAL</i>	= 1 if the client discloses a revision or adjustment during fiscal year <i>t</i> on a previously issued 10-K when the misstatement amount is greater than 5% of pre-tax income, and zero if the client discloses a revision or adjustment when the misstatement amount is less than 5% of pre-tax income.
<i>AC_EXPERT</i>	= 1 if there is at least one accounting expert on the audit committee, and zero otherwise
<i>ADJUSTMENT</i>	= 1 if the company issues an out-of-period adjustment in fiscal year <i>t</i> , and zero otherwise
<i>ALTMAN</i>	= The probability of bankruptcy score at the end of the fiscal year <i>t</i> calculated using Altman's (1968) model
<i>BIG4</i>	= 1 if the auditor is a Big 4 auditor, and zero otherwise
<i>BTM</i>	= Book to market ratio at the end of the fiscal year <i>t</i>
<i>BUSSEG</i>	= The number of business segments at the end of the fiscal year <i>t</i>
<i>CHGLEV</i>	= The change in leverage from the fiscal year <i>t-1</i> to the fiscal year <i>t</i>
<i>CLIENT_IMPORTANCE</i>	= The decile ranking of client total fees divided by office total fees in year <i>t</i>
<i>COMPETITION</i>	= 1 if the MSA level Herfindahl-Hirschman index (HHI) is below the median for a sample year, and zero otherwise
<i>GEOSEG</i>	= The number of geographic segments at the end of the fiscal year <i>t</i>
<i>GROWTH</i>	= Growth in sales from the fiscal year <i>t-1</i> to the fiscal year <i>t</i>
<i>ICMW</i>	= 1 if the company has an adverse internal control opinion in fiscal year <i>t</i> , zero otherwise
<i>LAG_RESTATE</i>	= 1 if the company restated in fiscal year <i>t-1</i> , and zero otherwise.
<i>NEG_OFFICE_GROWTH</i>	= 1 if the number of clients in year <i>t-1</i> is less than the number of clients in year <i>t-2</i> , and zero otherwise
<i>NEWFIN</i>	= 1 if the company has a new issuance of equity or debt during the subsequent fiscal year <i>t+1</i> (i.e., if the absolute value of Compustat item DLTIS or SSTK is over 5 percent of the firm's market value of equity), and zero otherwise

<i>NON_SPECIALIST</i>	=	0 if clients have an auditor that has the biggest industry market share within the local MSA and is at least 10% points greater than the second largest industry leader in the MSA, and 1 otherwise
<i>RESTATEMENT</i>	=	1 if the company issues a restatement (Big R) in fiscal year t, and zero otherwise
<i>REVISION</i>	=	1 if the company issues a revision (little r) in fiscal year t, and zero otherwise
<i>ROA</i>	=	The ratio of operating income after depreciation over total assets at the beginning of the fiscal year
<i>RorA</i>	=	1 if the company discloses revisions or adjustments in fiscal year t, and zero if the company discloses restatements
<i>SIZE</i>	=	The natural log of total assets at the end of the fiscal year
<i>TENURE</i>	=	The number of years that an auditor has been retained by a firm as of the end of the fiscal year

Figure 1

Evaluating and Correcting Accounting Misstatements

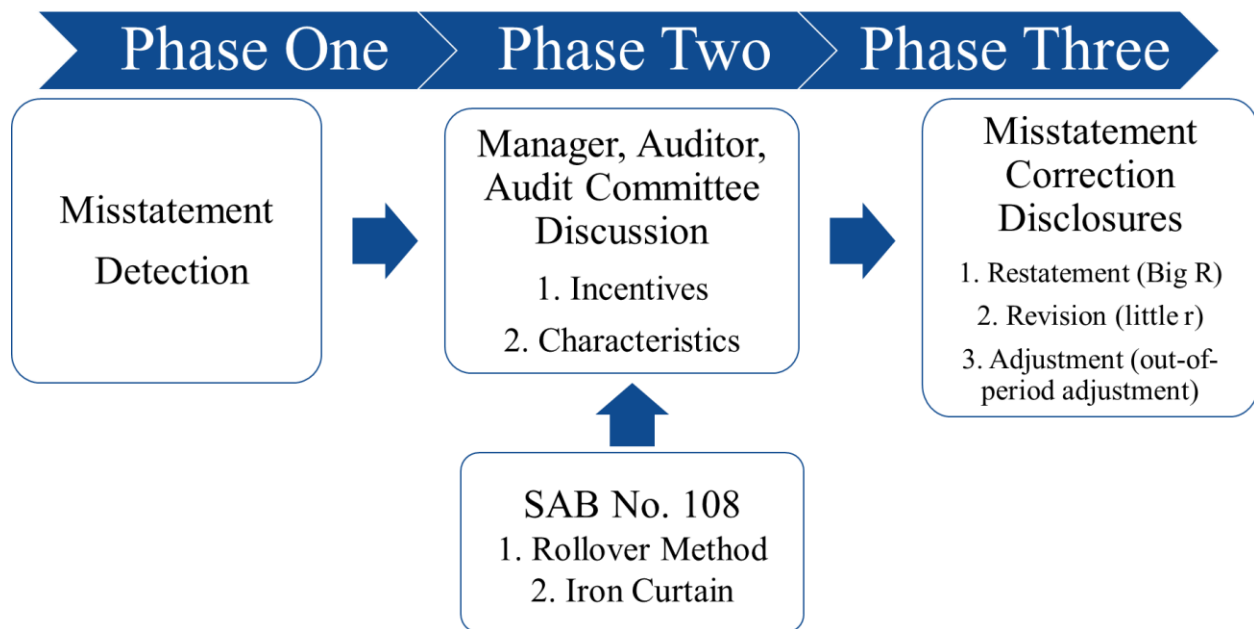


Table 1**Panel A: Misstatement Correction Disclosures Sample**

Companies in both Compustat and Audit Analytics with Big R restatements, little r restatements, or out-of-period adjustments from 2006 to 2017	7,954
Less: observations from financial industries	(1,417)
observations with assets less than \$1 million	(347)
observations missing data required for control variables	(1,103)
Final Sample	<u>5,087</u>

Panel B: Sample Composition for Model (1) and (2)

Observations	$\leq 5\%$ Pre-Tax Income	$> 5\%$ Pre-Tax Income	Total
<i>RorA</i> =1 (revisions or adjustments)	3,096	529	3,625
<i>RorA</i> =0 (restatements)	822	640	1,462
Total	3,918	1,169	5,087

Table 2
Descriptive Statistics

Panel A: Sample Statistics for Model 1

Variable	N	Mean	p25	p50	p75	Std. Dev.
<i>RESTATEMENT</i>	1,169	0.548	0	1	1	0.498
<i>REVISION</i>	1,169	0.277	0	0	1	0.448
<i>ADJUSTMENT</i>	1,169	0.193	0	0	0	0.395
<i>RorA</i>	1,169	0.452	0	0	1	0.498
<i>CLIENT_IMPORTANCE</i>	1,169	5.228	4	6	6	1.283
<i>NON_SPECIALIST</i>	1,169	0.285	0	0	1	0.452
<i>NEG_OFFICE_GROWTH</i>	1,169	0.198	0	0	0	0.398
<i>COMPETITION</i>	1,169	0.544	0	1	1	0.498
<i>SIZE</i>	1,169	5.688	4.384	6	6.969	1.864
<i>ROA</i>	1,169	-0.067	-0.050	0	0.075	0.443
<i>BTM</i>	1,169	0.543	0.227	0	0.835	2.703
<i>CHGLEV</i>	1,169	0.018	-0.042	0	0.067	0.667
<i>ALTMAN</i>	1,169	2.359	0.979	2	4.074	9.555
<i>BUSSEG</i>	1,169	1.038	0	1	1.792	0.978
<i>GEOSEG</i>	1,169	1.095	0	1	1.946	1.127
<i>NEWFIN</i>	1,169	0.400	0	0	1	0.490
<i>TOTALACCRUAL</i>	1,169	-0.004	-0.038	0	0.038	0.177
<i>GROWTH</i>	1,169	0.426	-0.058	0	0.232	2.931
<i>ICMW</i>	1,169	0.174	0	0	0	0.379
<i>LAG_RESTATE</i>	1,169	0.166	0	0	0	0.372
<i>AC_EXPERT</i>	1,169	0.656	0	1	1	0.475
<i>BIG4</i>	1,169	0.636	0	1	1	0.481
<i>TENURE</i>	1,169	1.921	1.386	2	2.485	0.757

See Appendix A for variable definitions.

Table 2
Descriptive Statistics (Cont.)

Panel B: Sample Statistics for Model 2

Variable	N	Mean	p25	p50	p75	Std. Dev.
<i>RESTATEMENT</i>	3,625	0	0	0	0	0
<i>REVISION</i>	3,625	0.673	0	1	1	0.469
<i>ADJUSTMENT</i>	3,625	0.376	0	0	1	0.485
<i>ABNORMAL</i>	3,625	0.146	0	0	0	0.353
<i>CLIENT_IMPORTANCE</i>	3,625	5.221	4	6	6	1.287
<i>NON_SPECIALIST</i>	3,625	0.274	0	0	1	0.446
<i>NEG_OFFICE_GROWTH</i>	3,625	0.171	0	0	0	0.377
<i>COMPETITION</i>	3,625	0.480	0	0	1	0.500
<i>SIZE</i>	3,625	6.367	4.983	6.513	8	2.234
<i>ROA</i>	3,625	-0.050	-0.027	0.051	0	0.451
<i>BTM</i>	3,625	0.367	0.209	0.447	1	3.241
<i>CHGLEV</i>	3,625	-0.137	-0.041	0.002	0	7.634
<i>ALTMAN</i>	3,625	2.180	1.024	2.394	4	9.081
<i>BUSSEG</i>	3,625	1.054	0	1.099	2	1.003
<i>GEOSEG</i>	3,625	1.148	0	1.386	2	1.125
<i>NEWFIN</i>	3,625	0.415	0	0	1	0.493
<i>TOTALACCRUAL</i>	3,625	0	-0.029	0.000	0	0.162
<i>GROWTH</i>	3,625	0.259	-0.051	0.049	0	1.735
<i>ICMW</i>	3,625	0.074	0	0	0	0.261
<i>LAG_RESTATE</i>	3,625	0.149	0	0	0	0.356
<i>AC_EXPERT</i>	3,625	0.639	0	1	1	0.480
<i>BIG4</i>	3,625	0.753	1	1	1	0.431
<i>TENURE</i>	3,625	2.148	1.609	2.197	3	0.789

See Appendix A for variable definitions.

Table 3
Correlation Coefficients

Panel A: Correlation Coefficients for Model 1

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) <i>RorA</i>		0.10**	0.11**	-0.07*	-0.03	0.19**	0.06*	-0.02	-0.09**	0.01
(2) <i>CLIENT_IMPORTANCE</i>	0.08**		-0.02	-0.33**	-0.22**	-0.12**	0.00	0.00	-0.01	-0.02
(3) <i>NON_SPECIALIST</i>	0.11**	-0.02		-0.02	0.37**	0.09**	0.01	0.03	-0.05	0.06*
(4) <i>NEG OFFICE GROWTH</i>	-0.07*	-0.33**	-0.02		0.12**	0.13**	0.03	-0.06*	0.04	-0.02
(5) <i>COMPETITION</i>	-0.03	-0.26**	0.37**	0.12**		0.07*	-0.02	0.02	0.02	0.00
(6) <i>SIZE</i>	0.20**	-0.11**	0.11**	0.13**	0.08**		0.40**	0.11**	-0.05	0.00
(7) <i>ROA</i>	-0.01	-0.06*	0.06*	0.05	0.06*	0.41**		-0.04	-0.27**	0.37**
(8) <i>BTM</i>	-0.02	0.02	0.03	0.01	0.00	0.02	0.06*		-0.06*	-0.01
(9) <i>CHGLEV</i>	-0.07*	0.02	-0.02	0.02	0.01	-0.09**	-0.01	-0.11**		-0.34**
(10) <i>ALTMAN</i>	0.04	0.00	0.05	-0.03	-0.01	0.10**	0.24**	0.06**	-0.40**	
(11) <i>BUSSEG</i>	-0.05	0.02	-0.08**	-0.01	-0.06*	0.11**	0.08**	0.01	-0.04	0.01
(12) <i>GEOSEG</i>	0.02	0.01	-0.02	0.05	-0.05	0.20**	0.15**	-0.04	-0.03	0.02
(13) <i>NEWFIN</i>	-0.01	0.02	-0.10**	-0.02	-0.04	0.04	-0.09**	0.03	0.05	-0.08**
(14) <i>TOTALACCRUAL</i>	0.01	0.00	0.04	0.00	0.04	0.13**	0.34**	0.04	-0.38**	0.33**
(15) <i>GROWTH</i>	-0.02	0.04	0.00	-0.03	0.01	-0.12**	-0.37**	-0.02	0.02	0.00
(16) <i>ICMW</i>	-0.17**	0.00	-0.02	0.01	0.05	0.14**	0.09**	0.03	0.01	0.00
(17) <i>LAG_RESTATE</i>	-0.09**	-0.01	-0.03	0.00	0.05	-0.03	0.02	0.01	0.00	-0.02
(18) <i>AC_EXPERT</i>	-0.03	-0.09**	-0.17**	0.07*	-0.11**	0.09**	0.06*	-0.02	-0.07**	0.01
(19) <i>BIG4</i>	0.17**	-0.31**	0.18**	0.11**	0.05	0.59**	0.22**	0.00	-0.05	0.06**
(20) <i>TENURE</i>	0.10**	-0.06	0.03	0.06*	-0.04	0.31**	0.11**	0.03	0.01	0.01

Lower-triangular cells report Pearson's correlation coefficients, upper-triangular cells are Spearman's rank correlation. **p<0.01, *p<0.05. See Appendix A for variable definitions.

Table 3
Correlation Coefficients

Panel A: Correlation Coefficients for Model 1 (cont.)

	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)
(1) <i>RorA</i>	-0.05	0.02	-0.01	0.00	-0.04	-0.17**	-0.09**	-0.03	0.17**	0.09**
(2) <i>CLIENT_IMPORTANCE</i>	0.02	0.01	0.01	-0.02	-0.04	-0.02	-0.01	-0.09**	-0.31**	-0.06
(3) <i>NON_SPECALIST</i>	-0.09**	-0.02	-0.10**	0.04	0.08**	-0.02	-0.03	-0.17**	0.18**	0.04
(4) <i>NEG_OFFICE_GROWTH</i>	-0.01	0.05	-0.02	0.01	0.03	0.01	0.00	0.07*	0.11**	0.06
(5) <i>COMPETITION</i>	-0.06*	-0.05	-0.04	0.00	0.05	0.05	0.05	-0.11**	0.05	-0.03
(6) <i>SIZE</i>	0.10**	0.19**	0.06	0.06	-0.06*	0.14**	-0.04	0.10**	0.60**	0.31**
(7) <i>ROA</i>	0.06*	0.12**	-0.03	0.24**	0.24**	0.03	0.01	0.03	0.20**	0.07*
(8) <i>BTM</i>	0.11**	0.08*	0.04	0.08**	-0.17**	0.06	0.00	0.01	0.00	0.05
(9) <i>CHGLEV</i>	-0.02	-0.01	0.07*	-0.24**	-0.10**	0.05	-0.01	-0.04	-0.06*	0.05
(10) <i>ALTMAN</i>	0.02	0.06	-0.20**	0.17**	0.19**	-0.04	-0.04	0.03	0.07*	0.01
(11) <i>BUSSEG</i>		0.67**	0.03	0.01	-0.11**	0.07*	0.01	0.12**	0.06*	0.18**
(12) <i>GEOSEG</i>	0.66**		0.00	0.04	-0.13**	0.04	0.03	0.12**	0.15**	0.21**
(13) <i>NEWFIN</i>	0.04	0.00		-0.01	0.03	0.01	0.03	0.03	-0.02	-0.01
(14) <i>TOTALACCRUAL</i>	0.03	0.05	-0.04		0.15**	-0.03	-0.02	-0.01	0.02	0.01
(15) <i>GROWTH</i>	-0.03	-0.08**	0.05	-0.18**		0.00	0.00	-0.09**	-0.04	-0.17**
(16) <i>ICMW</i>	0.07*	0.04	0.01	0.03	-0.03		0.09**	0.01	0.10**	0.00
(17) <i>LAG_RESTATE</i>	0.02	0.03	0.03	-0.02	-0.04	0.09**		-0.07	-0.02	-0.01
(18) <i>AC_EXPERT</i>	0.12**	0.12**	0.03	-0.01	-0.03	0.01	-0.07*		0.13**	0.12**
(19) <i>BIG4</i>	0.06*	0.16**	-0.02	0.05	-0.07*	0.10**	-0.02	0.13**		0.32**
(20) <i>TENURE</i>	0.19**	0.22**	0.00	0.01	-0.07*	-0.01	-0.01	0.11**	0.31**	

Lower-triangular cells report Pearson's correlation coefficients, upper-triangular cells are Spearman's rank correlation. **p<0.01, * p<0.05. See Appendix A for variable definitions.

Table 3
Correlation Coefficients

Panel B: Correlation Coefficients for Model 2

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) <i>ABNORMAL</i>		0.05**	0.06**	-0.01	0.04	-0.07**	-0.08**	0.02	-0.04	0.00
(2) <i>CLIENT_IMPORTANCE</i>	0.04*		0.01	-0.33**	-0.20**	-0.08**	0.00	-0.01	0.01	0.00
(3) <i>NON_SPECIALIST</i>	0.06**	0.01		-0.02	0.37**	-0.01	-0.02	-0.02	-0.01	0.06**
(4) <i>NEG_OFFICE_GROWTH</i>	-0.01	-0.33**	-0.02		0.09**	0.10**	0.01	0.02	0.03	-0.02
(5) <i>COMPETITION</i>	0.04*	-0.23**	0.37**	0.09**		0.01	-0.03	0.00	0.00	-0.02
(6) <i>SIZE</i>	-0.05**	-0.07**	0.01	0.10**	0.02		0.42**	0.13**	-0.03	0.06**
(7) <i>ROA</i>	-0.02	-0.06**	0.02	0.05**	0.02	0.45**		-0.08**	-0.21**	0.48**
(8) <i>BTM</i>	0.02	0.02	0.04*	0.00	0.03	0.05**	0.10**		-0.05**	-0.02
(9) <i>CHGLEV</i>	0.01	-0.01	0.01	0.01	0.02	0.04*	0.20**	0.00		-0.27**
(10) <i>ALTMAN</i>	0.03	-0.03	0.08**	-0.02	0.02	0.21**	0.33**	0.12**	0.01	
(11) <i>BUSSEG</i>	-0.03	0.00	-0.11**	0.03*	-0.11**	0.18**	0.10**	0.03	0.02	0.02
(12) <i>GEOSEG</i>	-0.01	-0.02	-0.01	0.06**	-0.03*	0.27**	0.16**	0.01	0.02	0.05**
(13) <i>NEWFIN</i>	-0.02	-0.02	-0.08**	-0.02	-0.01	0.11**	-0.07**	0.01	0.01	-0.09**
(14) <i>TOTALACCRUAL</i>	-0.01	-0.01	0.02	0.02	-0.01	0.05**	0.15**	0.05**	-0.20**	0.11**
(15) <i>GROWTH</i>	0.02	0.01	-0.01	-0.02	0.00	-0.13**	-0.27**	0.00	-0.03	0.02
(16) <i>ICMW</i>	0.05**	0.02	0.01	0.03	0.04*	0.04**	0.04*	0.02	0.01	0.01
(17) <i>LAG_RESTATE</i>	-0.02	0.01	-0.02	0.01	0.01	0.02	0.01	-0.02	0.00	-0.02
(18) <i>AC_EXPERT</i>	0.00	-0.12**	-0.11**	0.05**	-0.08**	0.24**	0.18**	0.04*	0.02	0.10**
(19) <i>BIG4</i>	-0.03	-0.28**	0.15**	0.11**	0.03	0.64**	0.32**	0.01	0.03	0.18**
(20) <i>TENURE</i>	-0.08**	-0.03	-0.04*	0.03	-0.10**	0.36**	0.17**	0.00	0.00	0.03

Lower-triangular cells report Pearson's correlation coefficients, upper-triangular cells are Spearman's rank correlation. **p<0.01, * p<0.05. See Appendix A for variable definitions.

Table 3
Correlation Coefficients

Panel B: Correlation Coefficients for Model 2 (cont.)

	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)
(1) <i>ABNORMAL</i>	-0.03	-0.01	-0.02	-0.02	0.01	0.05**	-0.02	0.00	-0.03	-0.08**
(2) <i>CLIENT_IMPORTANCE</i>	0.00	-0.03	-0.04	-0.02	-0.03	0.02	0.00	-0.12**	-0.29**	-0.04
(3) <i>NON_SPECIALIST</i>	-0.11**	-0.01	-0.08**	0.00	0.06**	0.01	-0.02	-0.11**	0.15**	-0.04
(4) <i>NEG_OFFICE_GROWTH</i>	0.03	0.07**	-0.02	0.02	-0.04	0.03	0.01	0.05**	0.11**	0.03
(5) <i>COMPETITION</i>	-0.11**	-0.04	-0.01	-0.02	0.03	0.04	0.01	-0.08**	0.03	-0.10**
(6) <i>SIZE</i>	0.17**	0.27**	0.13**	0.02	-0.06**	0.03	0.02	0.21**	0.61**	0.38**
(7) <i>ROA</i>	0.08**	0.14**	-0.03	0.20**	0.19**	-0.03	-0.01	0.15**	0.30**	0.20**
(8) <i>BTM</i>	0.10**	0.09**	0.01	0.05**	-0.14**	0.03	0.01	0.04	0.03	0.03
(9) <i>CHGLEV</i>	0.00	0.01	0.08**	-0.14**	-0.07**	0.05**	0.03	-0.03	-0.05**	0.02
(10) <i>ALTMAN</i>	0.05**	0.11**	-0.21**	0.12**	0.16**	-0.02	-0.06**	0.14**	0.17**	0.08**
(11) <i>BUSSEG</i>		0.63**	0.05**	0.02	-0.11**	0.00	0.03	0.12**	0.10**	0.27**
(12) <i>GEOSEG</i>	0.62**		-0.01	0.01	-0.11**	-0.01	0.04	0.15**	0.21**	0.28**
(13) <i>NEWFIN</i>	0.06**	0.00		0.01	0.03	-0.01	0.03	0.05**	0.02	0.00
(14) <i>TOTALACCRUAL</i>	0.02	0.01	0.01		0.18**	0.01	-0.02	0.02	0.01	0.00
(15) <i>GROWTH</i>	-0.06**	-0.09**	0.04*	-0.09**		0.00	-0.04	-0.05**	-0.04	-0.13**
(16) <i>ICMW</i>	0.00	-0.01	-0.01	0.02	-0.01		0.04	0.01	0.04**	-0.03
(17) <i>LAG_RESTATE</i>	0.03	0.04*	0.03*	0.00	-0.02	0.04*		0.02	0.00	0.01
(18) <i>AC_EXPERT</i>	0.12**	0.15**	0.05**	0.02	-0.07**	0.01	0.02		0.30**	0.17**
(19) <i>BIG4</i>	0.11**	0.21**	0.02	0.02	-0.11**	0.04**	0.00	0.30**		0.34**
(20) <i>TENURE</i>	0.26**	0.27**	0.00	0.01	-0.09**	-0.04*	0.01	0.17**	0.34**	

Lower-triangular cells report Pearson's correlation coefficients, upper-triangular cells are Spearman's rank correlation. **p<0.01, * p<0.05. See Appendix A for variable definitions.

Table 4
Client Importance, Auditor Industry Expertise and Misstatement Correction Disclosure

VARIABLES	(1) <i>RorA</i>	(2) <i>ABNORMAL</i>
<i>CLIENT_IMPORTANCE</i>	0.098*** (0.003)	0.044** (0.038)
<i>NON_SPECIALIST</i>	0.361*** (0.000)	0.166*** (0.005)
<i>SIZE</i>	0.068* (0.055)	-0.037* (0.070)
<i>ROA</i>	-0.312** (0.027)	-0.033 (0.661)
<i>BTM</i>	-0.018 (0.483)	0.008 (0.475)
<i>CHGLEV</i>	-0.145* (0.084)	0.003 (0.162)
<i>ALTMAN</i>	0.011** (0.032)	0.006* (0.057)
<i>GEOSEG</i>	0.117** (0.032)	0.043 (0.192)
<i>BUSSEG</i>	-0.129** (0.036)	-0.044 (0.232)
<i>NEWFIN</i>	0.001 (0.987)	0.022 (0.711)
<i>TOTALACCRUAL</i>	-0.201 (0.547)	-0.051 (0.767)
<i>GROWTH</i>	-0.015 (0.367)	0.005 (0.719)
<i>ICMW</i>	-0.869*** (0.000)	0.254*** (0.008)
<i>LAG_RESTATE</i>	-0.155 (0.181)	-0.111 (0.131)
<i>AC_EXPERT</i>	-0.037 (0.720)	0.066 (0.356)
<i>BIG4</i>	0.414*** (0.001)	0.099 (0.293)
<i>TENURE</i>	0.007 (0.912)	-0.139*** (0.000)
<i>Constant</i>	-2.042*** (0.001)	-0.499 (0.246)
Observations	1,169	3,625
Year&Industry FE	YES	YES
Cluster by firm	YES	YES
ROC	0.811	0.721
Pseudo R ²	0.241	0.0362

Robust p-value in parentheses. *, ** and *** indicate two-tailed significance at the 10%, 5%, and 1% levels, respectively, except for the variables of interest, which reflect one-tailed tests because I have directional hypotheses. See Appendix A for variable definitions. All continuous variables are winsorized at the 1st and 99th percentiles.

Table 5
Audit Office Growth and Misstatement Correction Disclosures

Office Growth	Negative	Non-Neg	Negative	Non-Neg
VARIABLES	(1)	(2)	(3)	(4)
	<i>RorA</i>	<i>RorA</i>	<i>ABNORMAL</i>	<i>ABNORMAL</i>
<i>CLIENT_IMPORTANCE</i>	0.135*** (0.002)	-0.016 (0.433)	0.067** (0.011)	-0.052 (0.178)
<i>NON_SPECIALIST</i>	0.319*** (0.003)	0.570** (0.026)	0.141** (0.024)	0.298** (0.024)
<i>SIZE</i>	0.063 (0.116)	0.109 (0.308)	-0.037* (0.099)	-0.030 (0.587)
<i>ROA</i>	-0.269** (0.037)	-1.197** (0.022)	-0.028 (0.722)	-0.167 (0.626)
<i>BTM</i>	-0.024 (0.484)	-0.006 (0.862)	-0.000 (0.976)	0.022 (0.139)
<i>CHGLEV</i>	-0.114 (0.103)	-0.333 (0.364)	0.003 (0.258)	0.036 (0.335)
<i>ALTMAN</i>	0.013** (0.016)	0.008 (0.701)	0.008** (0.020)	-0.001 (0.918)
<i>GEOSEG</i>	0.122* (0.055)	0.095 (0.560)	0.037 (0.310)	0.154* (0.065)
<i>BUSSEG</i>	-0.167** (0.021)	0.225 (0.186)	-0.031 (0.450)	-0.166* (0.064)
<i>NEWFIN</i>	-0.005 (0.963)	-0.373 (0.190)	0.026 (0.692)	-0.068 (0.662)
<i>TOTALACCRUAL</i>	-0.552 (0.105)	2.265** (0.014)	-0.070 (0.699)	0.419 (0.517)
<i>GROWTH</i>	-0.017 (0.302)	0.148** (0.023)	0.001 (0.936)	0.025 (0.544)
<i>ICMW</i>	-1.036*** (0.000)	-0.448 (0.141)	0.226** (0.039)	0.381* (0.069)
<i>LAG_RESTATE</i>	-0.130 (0.315)	-0.757** (0.044)	-0.096 (0.233)	-0.231 (0.267)
<i>AC_EXPERT</i>	0.024 (0.841)	-0.479 (0.128)	0.047 (0.554)	0.047 (0.788)
<i>BIG4</i>	0.517*** (0.000)	0.477 (0.218)	0.164 (0.111)	-0.379 (0.129)
<i>TENURE</i>	-0.031 (0.653)	0.101 (0.563)	-0.164*** (0.000)	0.032 (0.746)
<i>Constant</i>	-1.899*** (0.000)	-2.263** (0.040)	-0.637 (0.156)	0.893 (0.355)
Observations	231	938	621	3,004
Year&Industry FE	YES	YES	YES	YES
Cluster by firm	YES	YES	YES	YES
ROC	0.818	0.887	0.701	0.720
Pseudo R ²	0.256	0.391	0.039	0.113

Robust p-value in parentheses. *, ** and *** indicate two-tailed significance at the 10%, 5%, and 1% levels, respectively, except for the variables of interest, which reflect one-tailed tests because I have directional hypotheses. See Appendix A for variable definitions. All continuous variables are winsorized at the 1st and 99th percentiles.

Table 6
Audit Market Competition and Misstatement Correction Disclosures

Market Competition	Low	High	Low	High
VARIABLES	(1)	(2)	(3)	(4)
	<i>RorA</i>	<i>RorA</i>	<i>ABNORMAL</i>	<i>ABNORMAL</i>
<i>CLIENT_IMPORTANCE</i>	0.089* (0.086)	0.156** (0.030)	0.026 (0.210)	0.121*** (0.002)
<i>NON_SPECIALIST</i>	0.374*** (0.002)	0.478* (0.037)	0.190** (0.016)	0.027 (0.417)
<i>SIZE</i>	0.038 (0.435)	0.091 (0.126)	-0.049 (0.105)	-0.062** (0.037)
<i>ROA</i>	-0.149 (0.587)	-0.264 (0.166)	0.209 (0.112)	-0.133 (0.220)
<i>BTM</i>	-0.019 (0.373)	-0.170*** (0.006)	-0.001 (0.940)	0.017* (0.098)
<i>CHGLEV</i>	-0.481** (0.017)	-0.321 (0.115)	-0.157** (0.047)	0.018 (0.601)
<i>ALTMAN</i>	0.011 (0.158)	0.010 (0.200)	0.000 (0.994)	0.009* (0.090)
<i>GEOSEG</i>	0.131* (0.092)	0.050 (0.556)	-0.026 (0.595)	0.128*** (0.009)
<i>BUSSEG</i>	-0.127 (0.176)	-0.044 (0.641)	0.038 (0.510)	-0.119** (0.017)
<i>NEWFIN</i>	-0.034 (0.796)	0.023 (0.883)	-0.100 (0.232)	0.121 (0.184)
<i>TOTALACCRUAL</i>	-0.221 (0.703)	-0.564 (0.320)	0.178 (0.543)	-0.132 (0.564)
<i>GROWTH</i>	-0.280*** (0.002)	0.060* (0.066)	-0.096*** (0.009)	0.015 (0.323)
<i>ICMW</i>	-0.750*** (0.000)	-1.231*** (0.000)	0.233* (0.071)	0.188 (0.230)
<i>LAG_RESTATE</i>	-0.014 (0.926)	-0.481** (0.028)	0.032 (0.752)	-0.276** (0.015)
<i>AC_EXPERT</i>	0.001 (0.996)	-0.186 (0.249)	0.058 (0.600)	0.073 (0.455)
<i>BIG4</i>	0.565*** (0.001)	0.332 (0.126)	0.157 (0.254)	0.131 (0.329)
<i>TENURE</i>	0.001 (0.992)	0.060 (0.539)	-0.119** (0.046)	-0.183*** (0.001)
<i>Constant</i>	-1.123** (0.044)	-2.640*** (0.000)	0.419 (0.622)	-1.224** (0.024)
Observations	610	500	1,740	1,885
Year&Industry FE	YES	YES	YES	YES
Cluster by firm	YES	YES	YES	YES
ROC	0.812	0.867	0.701	0.713
Pseudo R ²	0.241	0.362	0.055	0.0700

Robust p-value in parentheses. *, ** and *** indicate two-tailed significance at the 10%, 5%, and 1% levels, respectively, except for the variables of interest, which reflect one-tailed tests because I have directional hypotheses. See Appendix A for variable definitions. All continuous variables are winsorized at the 1st and 99th percentiles.

Table 7
Auditor Switches and Misstatement Correction Disclosures

Auditor	Different	Same	Different	Same
VARIABLES	(1)	(2)	(3)	(4)
	<i>RorA</i>	<i>RorA</i>	<i>ABNORMAL</i>	<i>ABNORMAL</i>
<i>CLIENT_IMPORTANCE</i>	0.201 (0.235)	0.116*** (0.002)	0.092 (0.372)	0.042* (0.096)
<i>NON_SPECIALIST</i>	0.587 (0.245)	0.377*** (0.001)	0.665 (0.146)	0.166** (0.013)
<i>SIZE</i>	0.246* (0.081)	0.068* (0.069)	-0.071 (0.404)	-0.033 (0.128)
<i>ROA</i>	-0.993** (0.011)	-0.344** (0.022)	-0.701** (0.034)	-0.026 (0.745)
<i>BTM</i>	0.285 (0.281)	-0.013 (0.577)	0.065 (0.347)	0.008 (0.508)
<i>CHGLEV</i>	1.597** (0.031)	-0.125 (0.125)	0.004 (0.985)	0.003 (0.124)
<i>ALTMAN</i>	0.060 (0.112)	0.010* (0.053)	0.026** (0.043)	0.005 (0.153)
<i>GEOSEG</i>	-0.062 (0.777)	0.157*** (0.009)	-0.138 (0.441)	0.052 (0.121)
<i>BUSSEG</i>	0.580** (0.041)	-0.163** (0.014)	0.553*** (0.003)	-0.060 (0.112)
<i>NEWFIN</i>	0.826** (0.025)	-0.038 (0.706)	-0.099 (0.708)	0.024 (0.694)
<i>TOTALACCRUAL</i>	-0.446 (0.696)	-0.166 (0.656)	0.193 (0.822)	-0.010 (0.958)
<i>GROWTH</i>	-0.282 (0.294)	-0.016 (0.312)	-0.005 (0.965)	0.005 (0.720)
<i>ICMW</i>	-0.811 (0.101)	-0.876*** (0.000)	0.034 (0.916)	0.270*** (0.007)
<i>LAG_RESTATE</i>	-0.831* (0.064)	-0.060 (0.632)	0.071 (0.791)	-0.111 (0.152)
<i>AC_EXPERT</i>	0.471 (0.297)	-0.043 (0.691)	0.119 (0.716)	0.051 (0.493)
<i>BIG4</i>	0.091 (0.826)	0.494*** (0.000)	-0.519 (0.110)	0.114 (0.263)
<i>TENURE</i>	0.450 (0.442)	-0.045 (0.534)	0.158 (0.769)	-0.141*** (0.001)
<i>Constant</i>	-5.208*** (0.001)	-2.043*** (0.001)	-1.708* (0.079)	-0.433 (0.296)
Observations	125	1,036	204	3,383
Year&Industry FE	YES	YES	YES	YES
Cluster by firm	YES	YES	YES	YES
ROC	0.908	0.815	0.764	0.700
Pseudo R ²	0.443	0.251	0.167	0.0317

Robust p-value in parentheses. *, ** and *** indicate two-tailed significance at the 10%, 5%, and 1% levels, respectively. See Appendix A for variable definitions. All continuous variables are winsorized at the 1st and 99th percentiles.

Impact of Misstatements	Negative	Positive	Negative	Positive
VARIABLES	(1)	(2)	(3)	(4)
	<i>RorA</i>	<i>RorA</i>	<i>ABNORMAL</i>	<i>ABNORMAL</i>
<i>CLIENT_IMPORTANCE</i>	0.114** (0.011)	-0.001 (0.995)	0.096*** (0.010)	0.010 (0.819)
<i>NON_SPECIALIST</i>	0.443*** (0.000)	-0.240 (0.264)	0.261*** (0.009)	-0.039 (0.732)
<i>SIZE</i>	0.043 (0.293)	0.194** (0.018)	-0.139*** (0.000)	0.056* (0.096)
<i>ROA</i>	0.075 (0.686)	-0.738*** (0.007)	0.134 (0.515)	-0.122 (0.193)
<i>BTM</i>	-0.094 (0.136)	0.003 (0.924)	0.023 (0.216)	0.009 (0.455)
<i>CHGLEV</i>	-0.390** (0.040)	-0.052 (0.713)	-0.527** (0.015)	0.016 (0.489)
<i>ALTMAN</i>	0.010 (0.108)	0.020** (0.042)	-0.009 (0.182)	0.003 (0.607)
<i>GEOSEG</i>	0.037 (0.582)	0.379*** (0.003)	-0.011 (0.828)	0.065 (0.288)
<i>BUSSEG</i>	-0.061 (0.433)	-0.322** (0.016)	-0.035 (0.545)	-0.070 (0.303)
<i>NEWFIN</i>	0.137 (0.243)	-0.240 (0.241)	0.153 (0.121)	-0.097 (0.341)
<i>TOTALACCRUAL</i>	-0.251 (0.608)	-0.499 (0.401)	-0.128 (0.747)	-0.203 (0.359)
<i>GROWTH</i>	-0.059 (0.191)	-0.044 (0.129)	-0.013 (0.832)	0.025* (0.068)
<i>ICMW</i>	-0.934*** (0.000)	-0.811*** (0.004)	0.152 (0.296)	0.185 (0.356)
<i>LAG_RESTATE</i>	-0.336** (0.023)	0.352 (0.163)	-0.035 (0.787)	-0.034 (0.803)
<i>AC_EXPERT</i>	0.003 (0.982)	-0.302 (0.174)	-0.015 (0.885)	0.099 (0.482)
<i>BIG4</i>	0.357** (0.016)	0.368 (0.193)	-0.163 (0.250)	0.380** (0.040)
<i>TENURE</i>	0.108 (0.150)	-0.254* (0.063)	-0.039 (0.559)	-0.228*** (0.001)
<i>Constant</i>	-1.968*** (0.000)	-1.622* (0.063)	1.354*** (0.002)	-0.213 (0.790)
Observations	845	324	1,105	1,190
Year&Industry FE	YES	YES	YES	YES
Cluster by firm	YES	YES	YES	YES
ROC	0.836	0.828	0.718	0.705
Pseudo R ²	0.285	0.265	0.107	0.0753

Robust p-value in parentheses. *, ** and *** indicate two-tailed significance at the 10%, 5%, and 1% levels, respectively. See Appendix A for variable definitions. All continuous variables are winsorized at the 1st and 99th percentiles.