

The Effect of Auditors' Incentives on the Disclosure Prominence of Identified Misstatements

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Abstract: This paper investigates how auditor incentives affect the disclosure of misstatements from previously audited financial statements. We identify a sample of misstatement disclosures that vary in prominence between non-reliance restatements, revision restatements, and out-of-period adjustments. Requiring that the auditor during the misstated period be the same as at the misstatement disclosure date, we find that greater auditor engagement risk (i.e., the risk of litigation and reputational damage) and greater client importance to an audit office are associated with less prominent disclosure of prior period misstatements. We find consistent results when the magnitude of the misstatement is held constant across disclosure types. Further tests show that this association does not exist when misstatements are clearly material but does occur when the materiality of the misstatement is close to auditors' quantitative materiality thresholds. Our results are supported by several analyses used to rule out alternative explanations. These findings suggest that while the potential for litigation and reputation risk encourage auditors to provide higher quality during the *current* period, those same incentives align with the desire to appease the client when auditors are faced with acknowledging failed audits from prior periods. These results provide important insights regarding auditors' response to incentives.

Keywords: Litigation, reputation, restatements, audit quality, incentives, engagement risk

1. Introduction

Auditors have a responsibility to provide reasonable—but not absolute—assurance that financial statements are free of material misstatement. Accordingly, auditors necessarily bear some risk that the opinion they provide could subsequently prove inaccurate, potentially exposing them to financial penalties, future litigation, and the loss of reputation. Exposure to litigation and reputation risk are the main components of what is referred to as engagement risk (Messier, Glover, and Prawitt 2014). Prior research shows that higher engagement risk generally incentivizes auditors to improve audit quality (Geiger and Raghunandan 2001; Lee and Mande 2003; Venkataraman, Weber, and Willenborg 2008). Importantly, this incentive to avoid subsequent litigation and reputational damages tends to overcome the opposing incentive to cater to important clients' preferences for more aggressive accounting choices (Craswell, Stokes, and Laughton 2002; Reynolds and Francis 2000; Chung and Kallapur 2003). However, when auditors are faced with evaluating and disclosing misstatements related to their *previously issued audit opinions*, auditors may prefer the disclosure method that minimizes their immediate litigation and reputational damage, thus bringing their incentives into alignment with client preferences. Thus, we examine whether auditor incentives to 1) avoid litigation and reputational damage and 2) acquiesce to important clients are associated with *less* prominent disclosure of misstatements from their clients' previously audited financial statements.

Although the decision to correct previously issued financial statements ultimately lies with management, auditors play an important role in this decision for at least two reasons. First, current and prior year errors are often identified during the audit (e.g., Bedard and Graham 2011).¹ Second, when the auditor becomes aware that the financial statements on which s/he

¹ We note that management's own incentives to avoid litigation and subsequent employment termination are aligned with those of the auditor, in that increased risk of subsequent negative outcomes also incentivizes management to prefer less prominent disclosure (Desai, Hogan, and Wilkins 2006). We control for management's exposure to

opined are materially misstated, auditing standards require the auditor to discuss the matter with the client and take action to prevent future reliance on the audit report, which includes advising the client to make appropriate disclosure if the misstatement is material.² However, materiality thresholds are based on professional judgment and differ across client- and audit firm-specific situations (Eilifsen and Messier 2014). Research finds that audit materiality plays a key role in determining whether prior period accounting errors result in restatements or adjustments (Acito, Burks, and Johnson 2009).³

This subjectivity in materiality judgments enables manager and auditor incentives to influence how misstatements are disclosed. All else equal, managers likely prefer less prominent disclosure of prior period errors (Files, Swanson, and Tse 2009). On the other hand, auditors exercising due professional care would be *less* likely to encourage or support client decisions to disclose misstatements less prominently, unless clearly immaterial. However, the presence of strong auditor incentives to avoid litigation, reputational damage, and the loss of an important client could lead auditors to align their disclosure preferences with those of management, particularly when the disclosure of the misstatement retracts reliance on the previously issued audit opinion.⁴ Consistent with this notion, Lynn Turner, former Chief Accountant at the Securities and Exchange Commission stated that “...once an [audit] firm has issued a report on

dissemination of negative news through analyst following. In untabulated analysis, our results also hold after controlling for executives’ stock-based compensation incentives (Core and Guay 1999). Additionally, we find that our results regarding auditor incentives continue to hold even when management incentives to avoid prominent disclosures are lower. Finally, while we recognize that we cannot completely disentangle auditors’ and management’s incentives, subsequent tests involving auditors unconnected to the misstated period provide further support that our results relate to auditor incentives rather than management incentives.

² See PCAOB AS 2905.

³ While Acito et al. (2009) examine the impact of materiality on error disclosures, our examination focuses on whether auditor incentives influence the way that companies correct and disclose prior period errors while controlling for, or matching on, the materiality of the error.

⁴ Our arguments suggest that more prominently disclosed misstatements are associated with an increased frequency of litigation against the auditor and subsequent client losses. We provide evidence supporting this premise in Section 4.2.

the financial statements of a company, there is an inherent conflict in later concluding that the financial statements were wrong” (PCAOB 2011). Thus, we predict that as auditors’ ex-ante incentives to avoid prominent misstatement disclosure increases, the disclosure prominence of misstatements related to previously audited financial statements decreases.

We examine our prediction by testing the association between auditors’ incentives to avoid litigation and reputation damage, auditors’ incentives to appease important clients, and the subsequent disclosure prominence of misstatements from previously audited financial statements. We examine three channels through which misstatements are revealed to the public. The most prominent form of misstatement disclosure comes through filing an 8-K with the Securities and Exchange Commission (SEC) and filing restated financial statements. This 8-K requirement is triggered when it is determined that the previously issued financial statements and related audit report should no longer be relied upon by the investing public (i.e., non-reliance restatements). In this instance, amended financial statements are filed with the SEC along with a revised audit opinion. The next most prominent form is a ‘revision restatement’, in which prior period numbers are restated within the current period’s comparative financial statements instead of issuing a standalone amendment to a prior filing.⁵ These misstatements are considered immaterial to each individual financial reporting period but are cumulatively material in the current set of comparative financial statements. Thus, the auditor does not need to issue a revised audit opinion regarding prior financial reporting periods.

Finally, the least-prominent form of disclosure is relatively new to the academic accounting literature: an out-of-period adjustment, in which misstatements from prior periods are charged to current period accounts, resulting in no restatement or revision of prior period

⁵ Some prior literature refers to these revision restatements as “little r” restatements (e.g., Tan and Young 2015).

financial statement account balances. These are misstatements that are considered immaterial to each individual financial reporting period *and* cumulatively immaterial to the current reporting period. Because the prior individual financial reporting periods were not materially misstated, there is no need for the auditor to issue a revised audit opinion. While out-of-period adjustments are inherently smaller in magnitude than either form of restatement, Choudhary, Merkley, and Schipper (2017) find that out-of-period adjustments are predictive of future material and immaterial errors and thus still constitute meaningful adjustments.

To perform our tests, we identify a sample of 2,868 restatement and out-of-period adjustment disclosures from 2004 through 2014. We require that the auditor during the misstated period be the same as the auditor during the disclosure period, thus ensuring that auditors in our sample have the theorized incentives to seek less prominent disclosure methods regarding errors missed during prior period audits. Consistent with our hypotheses, we find less prominent disclosures of prior period errors, on average, when auditors face higher engagement risk or when the client in question is more important to the audit office. Further, we obtain these results controlling for various characteristics of the misstatement including its magnitude, income effect, duration, and timeliness of the disclosure, and management's exposure to the quick dissemination of negative news. We also find that these results hold after matching observations across the three disclosure types based on the magnitude of the misstatement's net income impact. Thus, our results are not due to fundamental differences in error magnitude between the disclosure types.

In additional analysis, we find that the effects are present among misstatements whose magnitudes are most uncertain in terms of materiality (i.e., near auditors' overall quantitative materiality thresholds). However, we do not find evidence of an association between disclosure

prominence and auditor incentives when the magnitude of the misstatement is clearly material. Thus, when the quantitative materiality of the misstatement is less obvious, but still nontrivial, auditor incentives to avoid litigation and reputation damage and appease important clients are associated with less-prominent disclosure channels.

We perform several analyses to alleviate concerns about alternative explanations. First, we re-perform our analyses on a sample of misstatement disclosures where the audit firm changed after the misstated period (i.e., the auditor at the time of the disclosure differs from the auditor during the misstated period). Because auditors uninvolved with the misstated period should not be concerned about the potential for damaged reputation or increased litigation risk when considering the disclosure of errors missed by the previous auditor, we do not expect an association between auditor incentives to avoid prominent misstatement disclosure and the disclosure prominence of misstatements in this subsample. Consistent with our expectations, we do not find a significant association between auditor incentives and disclosure prominence in this subsample. Taken together with our main results, these results are important because they provide evidence that our documented results pertain to how the *auditor's* incentives affect the subsequent disclosure prominence of identified misstatements, not management's.

Another potential explanation for our results is that increased engagement risk leads auditors to increase effort in the current year, thereby decreasing the likelihood of a large error going undetected and reducing the severity of any subsequent adjustments. To address this possibility, we limit our sample to company-year observations with lower than expected audit fees in the latest misstated year. To the extent that abnormal (or unexpected) fees capture audit effort (Blankley, Hurtt, and MacGregor 2012), the observations in this subsample demonstrate abnormally lower levels of auditor effort and thus reduces the possibility that the association

between engagement risk and subsequent disclosure prominence is due to greater auditor effort in the misstated year. Within this subsample, we continue to find results related to engagement risk, suggesting that our main results are not an artifact of higher audit effort during misstatement years that would reduce the size of any errors detected in subsequent years.

Our study makes several important contributions. First, if auditors are economic agents and gatekeepers to the public interest, then it is important to understand the incentives that guide their actions (Antle 1982). We find evidence that auditors behave in accordance with their incentives to avoid prominently disclosing misstatements. However, it is important to note that auditor incentives do *not* affect the disclosure prominence of clearly material misstatements. Second, we contribute to the stream of research examining whether auditors cater to important clients. Although experimental research suggests this is a concern (Hackenbrack and Nelson 1996; Kadous, Kennedy, and Peecher 2003), prior archival research generally does not find on-average evidence of auditors catering to important clients (Craswell et al. 2002; Reynolds and Francis 2000; Chung and Kallapur 2003). We contribute to this research by identifying a setting in which auditors appear to concede to preferences of important clients – supporting or encouraging less prominent disclosure of misstatements of previously audited work. Finally, it has been noted that empirical evidence regarding the effects of reputation on audit quality is limited (DeFond and Zhang 2014). Our results show that reputational concerns are relevant to auditor decision-making.

2. Background and Hypothesis

In this section, we first discuss the influence of auditor engagement risk and economic bonding on audit quality in the *current* year. We then discuss the various methods used to disclose misstatements related to *prior* periods. Finally, we develop our hypothesis examining

whether auditor incentives to avoid litigation and reputation damage and to appease important clients influence the disclosure prominence of misstatements from previously audited financial statements.

2.1 Engagement Risk and Contemporaneous Audit Quality

Because auditors do not provide absolute assurance that the company's financial statements are fairly stated, auditors incur some level of risk they will issue an unqualified opinion in the presence of an undetected material misstatement. When this occurs, auditors are then exposed to litigation and reputation damage, collectively referred to as engagement risk (Messier et al. 2014). These risk factors influence client acceptance/continuance decisions, but once a client is accepted, auditors respond to higher engagement risk by lowering the acceptable level of audit risk (i.e., increasing audit effort) (Bedard and Johnstone 2004; Johnstone and Bedard 2003, 2004). For example, Hackenbrack and Nelson (1996) find experimental evidence that auditors respond to high engagement risk by requiring more conservative application of accounting standards.

Consistent with this notion, most theoretical research investigating one component of engagement risk—litigation risk—suggests that higher (lower) litigation risk is associated with higher (lower) contemporaneous audit quality (Chan and Pae 1998; Liu and Wang 2006; Schwartz 1997; Zhang and Thoman 1999). Further, a wide range of empirical studies show that auditors charge higher audit fees for firms with higher litigation risk, suggesting greater auditor effort (Choi, Kim, Liu, and Simunic 2008; Choi, Kim, Liu, and Simunic 2009; Magnan 2008; Seetharaman, Gul, and Lynn 2002; Simunic 1980; Simunic and Stein 1996).⁶ Similarly, a number of studies find that auditors respond to higher (lower) litigation risk by becoming more

⁶ Auditors plan additional *audit hours* in the presence of increased litigation risk, which implies greater auditor effort and not just a litigation risk premium (see Simunic and Stein 1996).

(less) conservative in financial reporting (Geiger and Raghunandan 2001; Lee and Mande 2003; Venkataraman et al. 2008). Taken together, research supports the notion that auditors increase contemporaneous audit effort, thereby lowering the level of audit risk they are willing to accept, in the presence of higher litigation risk.

DeAngelo (1981) argues that the other component of engagement risk—the risk of reputational damage—should have a similar effect on acceptable audit risk.⁷ Empirically, Keune and Johnstone (2012) use audit fees to proxy for the risk of auditor reputation loss, arguing that large, high profile clients pay higher audit fees, thus exposing the audit firm to greater potential reputation loss should the audit of those clients fail. The authors find that as the risk of reputation loss increases, auditors are less likely to waive current-period misstatements (i.e., are more likely to request management to correct the misstatement). Thus, the potential exposure to adverse publicity and loss of reputation leads auditors to lower acceptable audit risk (i.e., achieve higher audit quality) when considering identified errors related to the *current* year.

2.2 Client Importance and Contemporaneous Audit Quality

A large stream of research examines the proposition that auditors report more favorably for larger clients or acquiesce to these clients' accounting preferences due to economic bonding. Although Kadous et al. (2003) find experimental evidence consistent with this idea, archival evidence either fails to find conclusive evidence that economic bonding leads to more favorable going-concern reporting or increased managerial discretion in accruals (Craswell et al. 2002; Chung and Kallapur 2003) or finds more *conservative* reporting (Reynolds and Francis 2000; Li

⁷ Concern about negative outcomes following reputation damage are well-founded. Weber, Willenborg, and Zhang (2008) examine a high-profile accounting scandal in Germany and find that clients of the audit firm involved in the scandal suffered negative abnormal stock returns and the audit firm itself lost a number of clients, presumably due to the scandal's detrimental effect on the firm's reputation. Similarly, Skinner and Srinivasan (2012) show that one audit firm lost approximately 25 percent of its client base following an accounting fraud in Japan.

2009). Reynolds and Francis (2000) suggest that greater litigation risk and exposure to reputation loss are “sufficient to motivate auditors to be independent, despite the presence of economic dependence” (Reynolds and Francis 2000, 377). Findings in Chen, Sun, and Wu (2010) shed additional insight. They find evidence in China that individual auditors were less likely to issue modified audit opinions to important clients when the institutional environment for investor protection was weaker, suggesting these auditors likely compromised their objectivity for these clients. However, when investor protection was strengthened through litigation and regulatory reform in 2001, the propensity to issue modified audit opinions to important clients increased. Although this finding is pronounced at the individual auditor level, it aligns with U.S. based evidence that exposure to litigation and reputation loss (i.e., engagement risk) can offset (or overcome) auditor incentives to report more favorably for important clients.

2.3 Methods of Disclosing Identified Misstatements

The way identified misstatements are disclosed varies in practice in part because of a lack of “bright line” rules on what constitutes a material misstatement. When an identified misstatement is deemed material and the previously issued financial statements and audit report should no longer be relied upon, SEC rules require companies to file an 8-K with Item 4.02 within four business days of the non-reliance judgment and an amended filing with restated financial statements and an amended audit opinion.

However, some companies choose to restate prior period financial statements in a ‘revision restatement’ rather than issuing a press release and related 8-K filing. A revision restatement refers to instances in which prior periods are materially correct on a standalone basis, but an accumulation of errors has become material in the current year. Thus, this cumulative error is corrected through prior year accounts and displayed in the current periodic filing without

issuing a separate amended filing or revised audit opinion for the misstated financial statements. Finally, other companies simply correct prior period errors by making and disclosing out-of-period adjustments to the current year's financial statements. In this case, prior period statements and figures are neither restated nor revised. Instead, the misstatement is charged to current-year accounts. Even though out-of-period adjustments are likely to be smaller in magnitude than some restatements, recent research finds them relevant to investors and related to future financial reporting quality (Choudhary et al. 2017). Additionally, the fact that these errors eventually required correction and disclosure of *any* kind signals their importance in the eyes of the issuer and its auditor.

2.4 Hypothesis Development

Prior research findings suggest that auditor's response to engagement risk leads to higher quality audits, thereby overcoming incentives arising from economic dependence on important clients (Reynolds and Francis 2000; Chung and Kallapur 2003). However, our study examines how these incentives influence decisions of how to disclose previously unreported misstatements related to the auditor's *prior* audit opinion. This examination is important because unlike previous research settings where auditor incentives related to engagement risk and economic bonding are in opposition, in our setting these incentives align with each other and with management preferences to avoid prominent disclosure of prior period errors. Although materiality should be the primary consideration for how to disclose identified misstatements, discretion in materiality judgments enables manager and auditor incentives to influence these disclosure decisions. For instance, managers are likely motivated to disclose misstatements less prominently to avoid a negative stock market reaction (Palmrose, Richardson, and Scholz 2004; Files et al. 2009) and reduce the likelihood of management turnover (Desai et al. 2006).

Although the financial statements are the responsibility of management, Bedard and Graham (2011) find that most internal control deficiencies are identified by audit testing, and the same fact pattern likely extends to the identification of misstatements. Because auditing standards require the auditor to discuss the prior period misstatement with the client and take action to prevent future reliance on the audit report if the misstatement is deemed material, auditor incentives likely influence auditors' materiality assessment.

Prior research in organizational behavior and human performance investigates whether individuals will revise past decisions or behavior when faced with negative consequences (Staw 1976). This research finds that individuals generally increase their commitment to prior decisions when contradictory information is subsequently identified. This escalation of commitment results in individuals biasing their future actions to support their initial decision—in this case, that the original financial statements were fairly stated.⁸ Increased engagement risk and its associated costs should escalate auditors' commitment to previously audited work.

Regarding the reputation component of engagement risk more specifically, auditors develop their reputation over time by consistently producing high quality audits. However, the disclosure of a misstatement generally indicates the error was undetected in a previous audit. Kanodia, Bushman, and Dickhaut (1989) argue that changing prior decisions informs the public that the decision maker's judgments are fallible, thereby damaging the individual's reputation. Prior audit literature supports this notion in that auditors are more likely dismissed and lose market share following restatement announcements (Hennes, Leone, and Miller 2014; Swanquist

⁸ Although the argument could be made that these adjustments are clearly immaterial, Choudhary et al. (2017) find that out-of-period adjustments are predictive of future material and immaterial errors. This finding could suggest that auditors may be more willing to agree to an immaterial adjustment related to prior periods (i.e., less than the auditor's materiality threshold) that is perhaps smaller than the true prior period error to avoid more prominent disclosure, which ultimately leads to needed adjustments in the future.

and Whited 2015). When the client is faced with the decision to announce a misstatement of previously audited financial statements, auditors may prefer the disclosure method that minimizes reputational damage. Given that investor attention is limited (Hirshleifer and Teoh 2003) and that prominence or placement of disclosure can influence the weight placed on extracted information (Hirst and Hopkins 1998; Maines and McDaniel 2000), more prominent disclosures of misstatements are likely to be more damaging to an auditor's reputation. As such—and holding the magnitude of the misstatement constant—we expect that auditors will prefer less prominent disclosure of identified misstatements when ex-ante potential reputational costs are high.

A prominently disclosed misstatement can also increase the likelihood of costly legal action. The stock price drop that often accompanies the disclosure of a misstatement can lead investors to seek legal recourse in the form of class action lawsuits, including against the audit firm (e.g., Hogan, Lambert, and Schmidt 2014; Palmrose and Scholz 2004; Rice, Weber, and Wu 2015). As such, a prominently disclosed correction of a misstatement is expected to increase the likelihood of costly legal action, even if settled out of court.

These arguments suggest that when auditor's ex-ante litigation and reputational risk are high, auditors are likely to encourage or to support clients' decisions to disclose identified misstatements less prominently. Additionally, auditor and management incentives align in this instance to avoid prominent disclosure of prior period misstatements, thus enabling auditors to cater more to important clients. As such, our hypothesis is as follows:

Hypothesis: Auditor incentives to avoid litigation and reputational damage and appease important clients are negatively associated with the disclosure prominence of identified misstatements.

3. Research Design and Measurement

3.1 Research Design

We use the Audit Analytics Advanced Restatement database to identify misstatements that are subsequently disclosed through 1) Item 4.02 non-reliance restatements, 2) other restatements occurring through a periodic filing (i.e., revision restatements), or 3) out-of-period adjustments. We then limit our sample to disclosures in which the auditor during the misstated period(s) is the same at the date of the misstatement disclosure.⁹ This requirement is key, because an auditor unaffiliated with the misstated financial statements would not have the same incentive to avoid admitting that prior-period financial statements were misstated.

3.2 Auditor Engagement Risk

We measure the construct of auditor engagement risk by using previously established proxies for its main components: auditor litigation risk and the risk of reputation loss. We first measure an auditor's risk of litigation using three proxies. We first follow Shu (2000) by estimating a logistic model of the likelihood of auditor-related litigation. This measure of auditor-specific litigation captures litigation risk at the level of the client, thereby capturing the litigation risk faced by the auditors that could potentially influence the misstatement disclosure decision. The litigation risk score computation is as follows, consistent with Table 3 of Shu (2000):

$$\begin{aligned} LitRisk_Shu = & -10.049 + 0.276*Size + 1.153*INV + 2.075*REC + 1.251*ROA - \\ & 0.088*Current + 1.501*Leverage + 0.301*SalesGrowth - 0.371>Returns - \\ & 2.309*RETVOL + 0.235*Beta + 1.464*Turnover + 1.060*Delist + 0.928*TECH + \\ & 0.463*QUALOPIN \end{aligned} \quad (1)$$

We define the variable definitions in the Appendix. To test the effect of auditors'

⁹ Misstated periods for restatements are obtained from Audit Analytics using the restatement begin/end dates. Misstated periods for out-of-period adjustments were obtained by manually searching and reading the context and details of the adjustment in the SEC filing that includes the disclosure.

consideration of litigation risk in deciding how to disclose identified misstatements, we must measure the auditor's litigation risk before the misstatement disclosure. Therefore, we measure *LitRisk_Shu* at the most recent fiscal year-end before the misstatement disclosure.¹⁰ Finally, we rank the *LitRisk_Shu* score into deciles consistent with prior research (e.g., Iliev, Miller, and Roth 2014), in which a higher score represents a higher likelihood of litigation against the auditor.

Our second measure of litigation risk follows model 2 of Table 7 in Kim and Skinner (2012) estimated as follows:

$$LitRisk_KS = -7.718 + 0.180*FPS + 0.463*Size_{t-1} + 0.553*SalesGrowth_{t-1} - 0.498*Returns - 0.359*Returns\ Skewness + 14.437*RETVOL + 0.0004*Turnover \quad (2)$$

We define the variable definitions in the Appendix. Similar to the Shu (2000) measure, we measure *LitRisk_KS* at the most recent fiscal year-end before the misstatement disclosure and we rank the *LitRisk_KS* score into deciles. Our third measure of litigation risk (*InstOwn%*) is the percentage of company stock held by institutional investors. Cassell, Drake, and Dyer (2018) document a positive association between audit fees and institutional ownership suggesting that auditors are sensitive to litigation risk related to their clients having a greater number/proportion of sophisticated investors who rely on the audited financial reports.

We also measure auditor reputation risk using three accepted proxies. First, following Keune and Johnstone (2012), we use a client's audit fees in the year prior to the misstatement disclosure as a proxy for auditor reputation risk (*Fees*). Second, following the theoretical

¹⁰ For example, if a company announces during its 2014 fiscal year that prior periods were misstated, we measure components of engagement risk at the 2013 fiscal year-end. This approach captures auditors' concerns about litigation and reputation risk before the disclosure decision is made. It is important to note that we cannot measure components of engagement risk in the same year as the misstatement is disclosed because doing so would artificially increase *LitRisk_Shu* (which is partially measured by stock returns, which are directly affected by error disclosures) and *Fees* (which increase during error disclosure years).

argument of DeAngelo (1981), we use an indicator for whether the auditor is one of the Big 4 (*BigN*). Finally, Francis and Michas (2013) find evidence that some audit offices have consistent audit quality problems, but larger offices perform higher quality audits to respond to the risk of losing reputational capital, consistent with higher audit quality among larger Big 4 auditor offices (Francis and Yu 2009). Following this argument, we also measure reputation risk using *OfficeSize* measured in the year preceding the misstatement disclosure.

We acknowledge that auditor litigation risk and reputational concerns are related and very challenging to separate empirically (DeFond and Zhang 2014). For example, increased visibility resulting from litigation can lead to reputational damage. Additionally, as the risk of public exposure increases based on the size and familiarity of the client, the potential for lawsuits can increase. Thus, it is not surprising that correlations between our proxies for litigation and reputation risk (presented in Table 3) are large and significant (e.g., ranging from 0.225 to 0.745). Due to these high correlations and the inability to separate the constructs of litigation and reputation risk empirically in our setting, we use the principal components method of factor analysis to reduce these six variables to a single construct of auditor engagement risk.

This procedure results in only one factor with an eigenvalue greater than one, further supporting the notion that the six variables proxy for a single construct (see Hair, Anderson, Tatham, and Black 1995).¹¹ We label this factor *AudEngageRisk*. The final communality estimates, which capture the correlation between the common factor and the six individual variables, are 0.552 for *LitRisk_Shu*, 0.639 for *LitRisk_KS*, 0.251 for *InstOwn%*, 0.673 for *Fees*,

¹¹ We retain one factor with a score greater than one (3.217); the remaining factors are all below one. Our one retained factor explains 53.62 percent of variation.

and 0.548 for *BigN*, and 0.553 for *OfficeSize*.¹² We use this factor (*AudEngageRisk*) in our main analyses, but also report the results using each of the individual variables. Because this factor is composed of proxies for litigation and reputation risk previously used in the literature, we do not hold *AudEngageRisk* out as a “new” measure; rather, using this combined factor is necessary due to the empirical difficulty of separating litigation and reputation risk.

3.3 Client Importance

Reynolds and Francis (2000) argue that the local practice office is the primary level for decision-making related to client engagement, client retention, administering audits, and issuing opinions. Following prior research, we measure client importance by scaling client total fees by total fees for public clients of the respective audit office (Reynolds and Francis 2000; Chung and Kallapur 2003).

3.4 Sample Selection

Our sample includes company-year observations between 2004 and 2014. We begin the sample period in 2004 because of the addition of Item 4.02 as an 8-K triggering event to identify non-reliance restatements. We use the Audit Analytics Advanced Restatement database to collect out-of-period adjustments.¹³ Our sample consists of companies in non-regulated industries (i.e., we exclude companies with SIC codes 4400-4999 and 6000-6999) to limit the effect of regulatory influence on the method of misstatement disclosure. Because auditor incentives to prefer less prominent disclosure should only be manifest when the auditor provided the opinion on the misstated financial statements, we limit our sample to misstatement disclosures in which the auditor during the misstated period(s) is the same at the misstatement disclosure date. Table

¹² We note that two elements of *AudEngageRisk* are ranked (*LitRisk_Shu* and *LitRisk_KS*), while the others are not. Factor analysis results are similar when we also decile rank *InstOwn%*, *Fees*, and *OfficeSize* before performing the factor analysis.

¹³ As of May 2016, Audit Analytics Advanced Restatement database contains out-of-period adjustments from filings starting in 1998. We only include errors related to out-of-period adjustments from 2004 onward in our sample.

1, Panel A, describes how we arrived at our main sample of 2,868 company-year observations, each of which is a unique misstatement disclosure.

Table 1, Panel B, presents the sample breakout, by year, for the various disclosure methods. We find that within our sample, 1,082 misstatements (37.7 percent) are revealed through a non-reliance restatement, 1,124 (39.2 percent) are revealed through a restatement other than a non-reliance restatement (i.e., revision restatements), and 662 (23.1 percent) are revealed through an out-of-period adjustment. We find a decreasing trend in non-reliance restatements from 2004 through 2014, consistent with Scholz (2008). Other restatements experience an upward trend after 2009. We find an increasing trend in out-of-period adjustments through 2008, remaining stable in the years following.¹⁴

3.5 Model Specification

To test our hypothesis, we use the following ordered logistic regression model with year and industry fixed effects:

$$\begin{aligned}
 \text{RestateCategory}_{t+1} = & \alpha_0 + \alpha_1 \text{AudEngageRisk}_{it} + \alpha_2 \text{ClientImportance}_{it} + \alpha_3 \text{Size}_{it} + \alpha_4 \text{MTB}_{it} \\
 & + \alpha_5 \text{Leverage}_{it} + \alpha_6 \text{Loss}_{it} + \alpha_7 \text{ICMW}_{it} + \alpha_8 \text{NTFiler}_{it} + \alpha_9 \text{Foreign}_{it} + \alpha_{10} \text{M\&A}_{it} + \\
 & \alpha_{11} \text{Restructure}_{it} + \alpha_{12} \text{Segments}_{it} + \alpha_{13} \text{ShareTurnover}_{it} + \alpha_{14} \text{NegIncomeImpact} + \\
 & \alpha_{15} \text{PosIncomeImpact} + \alpha_{16} \text{YearsMisstated} + \alpha_{17} \text{DaysToDisclose} + \\
 & \alpha_{18} \text{NumAnalysts}_{it} + \alpha_{19} \text{NR_Restate_Pr2}_{it-2, t-1} + \alpha_{20} \text{Revision_Restate_Pr2}_{it-2, t-1} + \\
 & \alpha_{21} \text{OOPA_Pr2}_{it-2, t-1} + \alpha_j \text{IndustryFE} + \alpha_k \text{YearFE}
 \end{aligned} \tag{3}$$

where:

RestateCategory = an ordered variable based on the prominence of misstatement disclosure; non-reliance restatements = 2, other restatements = 1, and out-of-period adjustments = 0;

¹⁴ Table 1 shows that non-reliance restatements decrease in frequency over our sample period and that out-of-period adjustments increase in frequency through 2008. Therefore, it is possible that the hypothesized relationship between engagement risk and less-prominent disclosures could merely capture these time trends. To alleviate this concern, we include year-fixed effects in all regressions. Results are also robust to only including observations post-2008 in which these trends are less pronounced.

AudEngageRisk = the common factor for *LitRisk_Shu*, *LitRisk_KS*, *InstOwn%*, *Fees*, *BigN*, and *OfficeSize* derived from the principal components method of factor analysis;

ClientImportance = total client fees divided by total fees of publicly listed clients of the respective auditor office; and

all other variables are defined in the Appendix. To test our hypothesis, the coefficients of interest are α_1 , the coefficient on *AudEngageRisk*, and α_2 , the coefficient on *ClientImportance*. We expect both coefficients to be negative, indicating less prominent disclosures.

We control for company characteristics and events/transactions that could potentially influence the severity and magnitude of the misstatement, thereby influencing the method of disclosure. All control variables are measured as of the most recent fiscal year-end before the misstatement disclosure.¹⁵ Specifically, we control for company size (*Size*), expected growth (*MTB*), leverage (*Leverage*), financial distress (*Loss*), the strength of the financial reporting environment (*ICMW*), delays in financial reporting (*NTFiler*), operating complexity (*Foreign* and *Segments*), involvement in merger and acquisition activity (*M&A*), and involvement in restructuring activities (*Restructure*). Additionally, because investors react more negatively to more prominently disclosed restatements (Files et al. 2009), greater investor attention could influence how a misstatement is disclosed. As such, we include share turnover (*ShareTurnover*) as a measure of investor attention.

Because materiality should be one of the most important determinants for how to disclose misstatements, we control for the magnitude of the misstatement as it relates to error adjustments that decrease net income (*NegIncomeImpact*) and, separately, adjustments that increase net income (*PosIncomeImpact*). We separate these variables because the perception of the

¹⁵ Measuring control variables in the year of the misstatement disclosure is problematic given that restatements can be announced at various times throughout the year, thus making it difficult to ensure that control variables precede the announcement date.

severity/magnitude of the error may not be symmetric. To further control for the severity of the misstatement, we control for the number of years that were misstated (*YearsMisstated*) and the time elapsed between the misstatement period and the disclosure date (*DaysToDisclose*) (Schmidt and Wilkins 2013).

To better isolate the auditor's incentives, we explicitly control for management's reputation risk as measured by analyst attention (*NumAnalysts*). To control for clients' past preference for error disclosure method, we control for whether companies have issued non-reliance restatements, other restatements, or out-of-period adjustments in the prior two years (*NR_Restate_Pr2*, *Revision_Restate_Pr2*, *OOPA_Pr2*). Finally, we include industry and year fixed effects to control for variation in disclosure methods for misstatements across industries and over time, and we cluster standard errors by company.¹⁶ All continuous variables are winsorized at 1 and 99 percent.

4. Results

4.1 Descriptive Statistics and Correlations

Table 2 presents descriptive statistics for our sample. 80.4 percent of companies in our sample are audited by a Big N firm (*BigN*). Average (unlogged) audit fees in the fiscal year before the disclosure are \$2.5 million (*Fees*). In the fiscal year preceding the misstatement disclosure, 36.2 percent report a loss (*Loss*), 17.7 percent file the annual report after the initial deadline (*NTFiler*), and 23.6 percent report a material weakness in internal control. This rate of material weakness disclosure prior to misstatement disclosure highlights the subjectivity in

¹⁶ We use aggregated industry indicators following Ashbaugh, LaFond, and Mayhew (2003) to avoid the incidental parameters problem of including a large number of fixed effects in a binary dependent variable model (see Greene 2004). In untabulated analyses, we re-estimate our models as linear probability models (rather than logistic regression models) and include industry indicators based on 2-digit SIC codes. All inferences remain robust to this alternative model specification.

materiality decisions and is consistent with evidence in Rice and Weber (2012) that companies do not always report material weaknesses in a timely manner. In terms of misstatement magnitude, the average cumulative net income impact for misstatements that decrease income is 1.1 percent of total assets (*NegIncomeImpact*), while the average cumulative net income impact for misstatements that increase income is 0.166 percent of total assets (*PosIncomeImpact*). On average 2.3 years are misstated (*YearsMisstated*) and the misstatement disclosure occurs on average 236.7 days after the latest misstated period (*DaysToDisclose*).¹⁷

Table 3 presents the Spearman and Pearson correlations among the misstatement disclosure categories, the individual proxies for auditor litigation and reputation risk, and the combined factor. Consistent with our hypothesis, we find a positive and significant correlation between engagement risk (*AudEngageRisk*) and revealing a misstatement through an out-of-period adjustment (*OOPA*, $p < 0.001$) but a negative relationship with non-reliance restatements (*NR_Restate*, $p < 0.001$). These results provide initial evidence supporting our hypothesis.

Table 4 presents descriptive statistics for select variables between the three different disclosure methods. As expected, we find that misstatement magnitudes are generally larger when disclosure is through more prominent channels. For example, mean *IncomeImpact* (the signed cumulative net income impact) and *ABS_IncomeImpact* (the absolute value of the cumulative net income impact) are significantly larger for misstatements disclosed through a non-reliance restatement than through a revision restatement or an out-of-period adjustment ($p < 0.01$) and for revision restatements compared to out-of-period adjustments.¹⁸ Non-reliance

¹⁷ Descriptive statistics are consistent with a sample of misstated financial statements (i.e., non-timely filings, higher incidence of material weaknesses, etc.) because we measure control variables in the year before the misstatement disclosure and because most disclosures happen within a year of the end of the misstated period (*DaysToDisclose*).

¹⁸ We present descriptive statistics of cumulative income impact instead of signed income impact (*NegIncomeImpact*, *PosIncomeImpact*) because the frequency of 0 counts in signed versions make descriptive information less useful.

restatement disclosures are also more likely to reduce net income (*IncomeImpact*) and cover more years (*YearsMisstated*) than other forms of restatement and out-of-period adjustments ($p < 0.01$ in all cases). However, relative to revision restatements and out-of-period adjustments, non-reliance restatements are timelier, in that the time between the last misstated period and the restatement announcement is shorter (*DaysToDisclose*, $p < 0.01$ in all cases). This is likely attributable to SEC rules requiring timely disclosure of this important corporate event.¹⁹ Regarding the misstated accounts, we find some differences in the reporting of *Revenue*, *Inventory/COGS*, *Liabilities/Reserves*, and *Other* restatements across the three categories. Out-of-period adjustments are less likely to be reported for *Expenses*, *Debt/Equity*, and *Liability/Reserves* misstatements, but more likely to be reported for *Tax* and *Other* error corrections.

4.2 Validation of Disclosure Prominence Categories

Prior research suggests that restatement announcements influence clients' auditor retention decisions (Hennes et al. 2014), which can negatively impact auditors' market share (Swanquist and Whited 2015). Therefore, our hypothesis presumes that auditors face a greater risk of litigation and reputation damage when the disclosure of misstatements from previously audited financial statements is more prominent. To empirically support this presumption, we investigate whether misstatement disclosure prominence impacts the number of lawsuits brought against an auditor and the number of public clients audited in the year after a misstatement disclosure.

We perform our tests at the audit firm-year level by aggregating client information by

¹⁹ According to SEC rules, once a prior period misstatement is determined material and reportable under 8-K filing rules, companies are required to file the related 8-K within four business days (see e.g., <https://www.sec.gov/rules/final/33-8400.htm>).

audit firm-year during our sample period. We capture the prominence of the misstatement disclosure with variables representing the number of non-reliance restatements (*Sum_NR_Restate*), revision restatements (*Sum_Revision_Restate*), and out-of-period adjustments (*Sum_OOPA*) disclosed by clients of an audit firm during the current year. These variables are defined in the Appendix. Our models also include audit firm and year fixed effects to control for changes in the dependent variable due to time and time-invariant characteristics of the audit firm and its client portfolio.

First, we examine whether disclosure prominence affects the number of lawsuits brought against an audit firm. In Column (1) of Table 5, we regress the sum of open litigation cases brought against an audit firm (*Sum_Auditor_Litigation*) per the Audit Analytics Legal Case and Legal Parties database on the number of misstatements disclosed during the year based on disclosure prominence. We find that the number of public audit client non-reliance restatements (*Sum_NR_Restate*) announced in year t is significantly associated with the number of lawsuits brought against the audit firm in that year. We also find that the audit firms are named in *fewer* lawsuits as the number of misstatements revealed through out-of-period adjustments (*Sum_OOPA*) increases.

In Columns (2) and (3) of Table 5, we regress the net change in public audit clients audited by an auditor from the current to subsequent year (*NetChangeClients*) and the percentage change in public audit clients (*%ChangeClients*) on our disclosure prominence measures. We find that as the number of non-reliance restatement disclosures increases, there is a future loss of market share, suggesting that more prominently disclosed misstatements can negatively impact an auditor's reputation. Taken together, results in Table 5 provide direct evidence that misstatement disclosure prominence impacts litigation against the auditor and changes in

auditors' market share, consistent with our argument that auditors should be aware of the link between disclosure prominence and engagement risk, and thus act according to their incentives.

4.3 Hypothesis Test

Table 6 presents the results of our hypothesis test. We test our hypothesis with an ordered logistic regression in which the dependent variable *RestateCategory* is equal to 2 for non-reliance restatements, 1 for revision restatements, and 0 for out-of-period adjustments. Thus, higher values of *RestateCategory* capture more prominent misstatement disclosures. Regarding our variables of interest, and consistent with our hypothesis, we find that both higher levels of auditor engagement risk (*AudEngageRisk*) and greater economic bonding to the client (*ClientImportance*) are *negatively* associated with more prominent disclosure channels ($p < 0.01$ and $p < 0.10$, respectively). Table 6 also reports the results of regression estimates when *AudEngageRisk* is replaced with its individual components. Specifically, results suggest that elements of litigation risk (*LitRisk_KS*, $p < 0.05$) and reputation risk (*BigN*, *OfficeSize*, $p < 0.01$) are associated with disclosure prominence. Thus, our results regarding *AudEngageRisk* is not merely an artifact of the factor analysis process and we conclude that results from Table 6 support our hypothesis.

Results of control variables in Table 6 suggest that companies with disclosed material weaknesses (*ICMW*) and that file after the initial filing deadline (*NTFiler*) are more likely to disclose misstatements through more prominent channels. Companies with more foreign sales (*Foreign*) are less likely to disclose misstatements prominently. Further, companies are more likely to disclose the misstatement prominently when the magnitude of the cumulative impact to

net income is larger in either direction (*NegIncomeImpact* and *PosIncomeImpact*).²⁰ More prominent disclosure is used when the misstatement covers more years (*YearsMisstated*) but occurs more quickly (*DaysToDisclose*).

In Table 7, we further examine the impact of engagement risk on preferred disclosure channels by creating an alternative sample in which we match misstatements corrected through out-of-period adjustments with non-reliance and revision restatements based on the signed, cumulative impact of the misstatement on income.²¹ Specifically, we match *OOPA*, *NR Restate*, and *Revision Restate* observations in our sample within the same industry and year and closest signed, cumulative net income impact of the misstatement (i.e., *IncomeImpact*, with a maximum difference of +/- 0.03).²² Out of 662 potential matches, this results in 202 successful matches for a sample of 606 observations.

Panel A of Table 7 provides differences in mean and median signed, cumulative net income impact (*IncomeImpact*) between these three groups. We do not find significant differences in mean or median values. Panel B of Table 7 presents the results of estimating Equation (3) with *RestateCategory* as the dependent variable. Although our three groups are well balanced on the cumulative income impact of the misstatement, we continue to control for the magnitude of the impact (i.e., *NegIncomeImpact* and *PosIncomeImpact*) in our model as there is still variation between matched sets. We continue to find evidence that among a group of companies with similar sized misstatements to income, auditor engagement risk

²⁰ Because *NegIncomeImpact* is signed, the negative coefficient in Table 6 indicates less prominent disclosure methods as the negative income impact approaches zero.

²¹ Results from this matched-magnitude test are consistent when we limit the sample to restatements related to one annual report, thus removing any noise from considering multiple periods.

²² In untabulated analysis we instead match on *Size* and find consistent results. We match on the signed income impact (*IncomeImpact*) because matching on the absolute value could match income-increasing misstatements with income-decreasing misstatements, which are fundamentally different types of management errors. By matching on the signed income impact, we are more likely to match misstatements of similar magnitude and management intent.

(*AudEngageRisk*, $p < 0.001$) and client importance (*ClientImportance*, $p < 0.10$) are negatively associated with prominent disclosure of the misstatement. Further, results persist when *AudEngageRisk* is separated into its components (*LitRisk_KS*, *BigN*, *OfficeSize*, *ClientImportance*, $p < 0.10$). These results provide corroborating evidence that auditor incentives influence the prominence of disclosure of misstatements even when the income impact of the misstatement is similar.

5. Additional Analyses

In this section, we 1) perform additional analyses to further examine the role of misstatement magnitude in our results, 2) provide support for our inferences regarding auditor incentives, and 3) perform other sensitivity analyses.

5.1 Magnitude of Misstatement and Disclosure Method

We recognize that although materiality decisions require professional judgment, materiality should be the primary consideration for how to disclose misstatements (Acito et al. 2009). As such, auditors' incentive to avoid prominent disclosure of misstatements should play a smaller role in the face of increasing misstatement magnitude. To test this assumption, we limit the sample to observations where the materiality of the signed error is less certain (i.e., *IncomeImpact* is between 0.25 and 1.0 percent of total assets) and where the cumulative signed net income impact is clearly material (i.e., *IncomeImpact* is greater than 1.0 percent of total assets).²³

Table 8 reports multivariate tests to this effect. Specifically, in the first column we find that the auditor incentive effects captured by *AudEngageRisk* remain negative and significant.

We also find that the coefficient on *ClientImportance* is negative, but insignificant at

²³ The more uncertain materiality range is based on the ranges auditors typically use when establishing overall materiality (Eilifsen and Messier 2014).

conventional levels ($p = 0.128$). In the second column, we examine our results when the misstatement is clearly material. In this setting, we find that both *AudEngageRisk* and *ClientImportance* are insignificant at conventional levels.²⁴ Thus, our main results from Tables 6 and 7 do not suggest that auditors ignore materiality and intentionally conceal large misstatements through out-of-period adjustments. Instead, the results reflect an average incentive for auditors to, *when possible*, use the least-prominent disclosure method as engagement risk increases. Thus, one key takeaway from our study is that auditors' incentives play a role in error disclosure prominence when materiality is uncertain.

5.2 Auditor during Misstated Period(s) Differs from Auditor at Disclosure Date

To provide further evidence that empirical results from Tables 6 through 8 are influenced by auditor and not management incentives, we examine whether our results differ in a sample of misstatement disclosures in which the auditor during the misstated period(s) is different than the auditor at the disclosure date. In these cases, because the disclosing auditor's prior work is not called into question and the risk of reputational damage and litigation risk is not a central issue, we would not expect auditor engagement risk to affect disclosure prominence. To perform this analysis, we incorporate all misstatement disclosures where the auditor at the disclosure date is different from the misstated periods.

Using this sample of observations, we re-estimate Equation (3) with *RestateCategory* as the dependent variable and *AudEngageRisk* and *ClientImportance* as the variables of interest.²⁵

The results of this test are presented in Table 9. In this test, we find insignificant coefficients on

²⁴ To test the difference between the coefficients on *AudEngageRisk* in the two different subsample estimations, we calculate a Z-statistic following Clogg, Petkova, and Haritou (1995) as $(\beta_{pre} - \beta_{post}) / \sqrt{(SE\beta_{pre}^2 + SE\beta_{post}^2)}$ and find a significant difference (Z-statistic = 1.302, p -value = 0.093).

²⁵ In this test, we are unable to control for *NR_Restate_Pr2*, *Revision_Restate_Pr2*, or *OOPA_Pr2* because of insufficient variation in the control variables in the reduced different-auditor sample.

both *AudEngageRisk* and *ClientImportance* ($p = 0.330$ and 0.224 , respectively). In fact, when *AudEngageRisk* is broken into its individual components, we find some evidence that misstatement disclosure becomes *more* prominent when the new auditor is from a large office or auditing an important client (*OfficeSize*, *ClientImportance*, $p < 0.10$). These results suggest that new auditors are not averse to prominently disclosing clients' misstatements related to the prior auditor's work. Together, these results suggest that engagement risk and client importance have a fundamentally different effect on misstatement disclosure prominence when the auditor at the disclosure date differs from the auditor during the misstated period. This test provides support that our main inferences are influenced by auditor incentives and not those of management.

5.4 Additional Sensitivity Analyses

An alternative explanation for our observed results is that because engagement risk is not likely to change drastically over time, the inferences we attribute to the post-audit consideration of engagement risk are instead due to *current* period consideration of engagement risk. Prior literature shows that higher current period engagement risk leads auditors to lower acceptable audit risk and perform more work, thereby decreasing the likelihood of a material error not being detected—and thus reducing the subsequent need for a prominent disclosure. However, if our main results were simply due to greater auditor effort in the current year, the identified association between engagement risk and subsequent misstatement disclosure prominence would not exist in lower effort audits. To examine this, we estimate abnormal audit fees within the broader population of available company-years between 2004 and 2014.²⁶ After merging this

²⁶ To estimate abnormal audit fees, we use the residual from a regression of the natural log of audit fees on company characteristics (i.e., size, leverage, performance, expected growth, filer status, internal control strength, debt/equity issuances, restructuring activities, merger and acquisition activities, financial distress, auditor size, industry and year fixed effects). The residual captures the variance in logged audit fees not attributable to these client, auditor, industry, and year effects and should represent higher or lower than expected audit fees after controlling for these characteristics.

variable into our sample dataset, we limit our sample to company-year observations where the abnormal (or unexpected) audit fees in the latest misstated year are *not* positive (i.e., lower-than-expected fees/effort), resulting in a sample of 1,329 observations. With this sample (untabulated), we continue to find a negative and significant coefficient on *AudEngageRisk* ($p < 0.05$) and a negative coefficient on *ClientImportance* that is insignificant at conventional levels ($p = 0.188$). To the extent abnormal fees capture audit effort, these results suggest that auditors act according to their post-audit incentives and that our results are not an artifact of higher effort in the current period.

We recognize that the misstatements in our sample vary in terms of the length of time corrected, which may impact the cumulative net income impact of the misstatement. In sensitivity analysis, we limit the sample to corrections related to one annual report, thereby removing any noise from considering multiple periods. This results in a limited sample of 1,295 observations. We find consistent results with our main tests using this more limited sample ($p < 0.01$ on *AudEngageRisk*, untabulated), but *ClientImportance* is insignificant ($p = 0.627$).

6. Conclusion

Due to the inherent nature of a risk-based audit, auditors are exposed to engagement risk, which is the risk that costs will be incurred for providing an inaccurate opinion on a company's financial statements. The risk of losses due to litigation or diminished reputation can incentivize auditors to perform high quality audits to minimize this exposure. Research finds that these incentives help achieve higher contemporaneous audit quality, effectively overcoming auditors' competing incentives to acquiesce to the demands of economically important clients. However, it is unclear how these competing incentives of reducing engagement risk and appeasing the client combine to affect disclosure decisions when auditors are faced with admitting missed errors from

a *previous* year's audit. In this instance, auditors and management incentives to prefer less prominent disclosure of prior period misstatements are aligned. We identify a sample of 2,868 misstatement disclosures from 2004 through 2014 and investigate the effect of engagement risk and client importance on the disclosure channel through which misstatements are corrected and communicated to the public.

We find that both higher auditor engagement risk and client importance are associated with a lower likelihood of disclosing misstatements through prominent channels. While in all cases the company admits to a misstatement, less prominent disclosures do not retract reliance on the previously issued audit opinion, thus potentially sparing the auditor (and client) reputational damage and negative publicity. Importantly, we find that this association is manifest when materiality is uncertain (i.e., around an auditor's overall quantitative materiality threshold) but not when the misstatement is clearly material.

Our results contribute to the literature in several ways. First, while extant literature shows how engagement risk serves to increase contemporaneous audit quality, our results demonstrate how this risk affects auditors and clients when considering previously issued financial statements. Second, we provide evidence of the effect that reputational concerns can have on the audit, a topic currently receiving little attention in the literature (DeFond and Zhang 2014). Third, we provide archival evidence of a setting in which auditors are more likely to favor important clients, providing support to past experimental research (Kadous et al. 2003). Fourth, we document that incentives to use less prominent disclosure methods are somewhat offset by the materiality of the misstatement, suggesting that clients and their auditors do not disclose clearly material misstatements through less prominent methods. Rather, results indicate that clients and their auditors operate within general materiality guidelines and act in accordance with

their incentives by seeking to minimize the prominence of misstatement disclosures when the materiality is less certain. These results shed light on the effect of incentives on auditor judgment.

Our results are subject to the limitation that the final decision to disclose misstatements, and how to do so, is the responsibility of management. Although our analyses control for management's exposure to dissemination of negative news and we perform additional analyses to strengthen inferences that auditor incentives are driving our observed results, we recognize that we cannot fully disentangle management and auditor incentives. However, the collective evidence suggests that *auditor* incentives, and not just those of management, play a role in the prominence of misstatement disclosures.

Appendix Variable Definitions

Variable	Definition
<i>%ChangeClients</i>	The percentage change in the number of public clients audited by an audit firm from the current to the subsequent year
<i>ABS_IncomeImpact</i>	The absolute value of the cumulative net income impact of the misstatement, scaled by total assets and multiplied by 100 for expositional convenience
<i>AudEngageRisk</i>	The common factor for <i>LitRisk_Shu</i> , <i>LitRisk_KS</i> , <i>InstOwn%</i> , <i>Fees</i> , <i>BigN</i> , and <i>OfficeSize</i> derived from the principal components method of factor analysis
<i>Beta</i>	The slope coefficient of a regression of daily stock returns on equal-weighted market returns
<i>BigN</i>	An indicator variable set equal to 1 if the auditor is from the Big 4, and 0 otherwise
<i>ClientImportance</i>	Total client fees divided by total fees of publicly listed clients of the respective auditor office
<i>Current</i>	The current ratio (current assets divided by current liabilities)
<i>DaysToDisclose</i>	The number of days between the misstatement period and the disclosure date
<i>Delist</i>	One if the company delists in the year following the two year window following the year under question, and zero otherwise
<i>Fees</i>	Logged total audit fees during the year
<i>Foreign</i>	An indicator variable equal to 1 if the company reports income from foreign operations in year t, and 0 otherwise
<i>ICMW</i>	An indicator variable set equal to 1 if a material weakness in internal controls over financial reporting is disclosed in the year, and 0 otherwise
<i>IncomeImpact</i>	The signed value of the cumulative net income impact of the misstatement, scaled by total assets and multiplied by 100 for expositional convenience
<i>IndustryFE</i>	Industry fixed effects using SIC codes to define industries as follows (Ashbaugh et al. 2003): agriculture (0100-0999), mining and construction (1000-1999, excluding 1300-1399), food (2000-2111), textiles and printing/publishing (2200-2799), chemicals (2800-2824; 2840-2899), pharmaceuticals (2830-2836), extractive (1300-1399; 2900-2999), durable manufacturers (3000-3999, excluding 3570-3579 and 3670-3679), transportation (4000-4899), retail (5000-5999), services (7000-8999, excluding 7370-7379), computers (3570-3579; 3670-3679; 7370-7379), and utilities (4900-4999)
<i>InstOwn%</i>	The percentage of company stock held by institutions
<i>INV</i>	Inventory scaled by prior year total assets

<i>Leverage</i>	Long-term debt plus the current portion of long-term debt divided by total assets
<i>LitRisk_KS</i>	The sample decile ranking of the probability of litigation following model 2 of Table 7 of Kim and Skinner (2012)
<i>LitRisk_Shu</i>	The sample decile ranking of the probability of litigation following Shu (2000)
<i>Loss</i>	An indicator variable set equal to 1 if net income is less than zero, and 0 otherwise
<i>M&A</i>	An indicator variable set equal to 1 if there was a merger or acquisition in the year, and 0 otherwise
<i>MTB</i>	The market-to-book ratio, calculated as the market value of equity divided by the book value of equity
<i>NegIncomeImpact</i>	the signed value of the cumulative net income impact of the misstatement, scaled by total assets and multiplied by 100 for expositional convenience, when net income is reduced, and 0 when the misstatement does not reduce net income
<i>NetChangeClients</i>	The net change in the public audit clients audited by an auditor from the current to the subsequent year
<i>NR_Restate</i>	An indicator variable equal to 1 if the misstatement was subsequently revealed through a non-reliance restatement, and zero otherwise
<i>NR_Restate_Pr2</i>	An indicator variable equal to 1 if a non-reliance restatement was disclosed in the previous two years, and zero otherwise
<i>NTFiler</i>	An indicator variable set equal to 1 if the company files an ‘NT 10-K’, and 0 otherwise
<i>NumAnalysts</i>	The number of analysts making earnings estimates during the year
<i>OfficeSize</i>	Size of the audit office that performs the audit, measured as the natural log of total fees received from publicly listed clients of the office
<i>OOPA</i>	An indicator variable equal to 1 if the misstatement was subsequently revealed through an out-of-period adjustment, and zero otherwise
<i>OOPA_Pr2</i>	An indicator variable equal to 1 if an out-of-period adjustment was disclosed in the previous two years, and zero otherwise
<i>PosIncomeImpact</i>	the signed value of the cumulative net income impact of the misstatement, scaled by total assets and multiplied by 100 for expositional convenience, when net income is increased, and 0 when the misstatement does not increase net income
<i>QUALOPIN</i>	An indicator variable set equal to 1 if the company received a qualified audit opinion, and 0 otherwise
<i>REC</i>	Accounts receivable scaled by prior year total assets

<i>RestateCategory</i>	An ordered variable based on the prominence of disclosure of misstatements; misstatements disclosed through non-reliance restatements = 2, misstatements disclosed through other restatements = 1, and misstatements disclosed as out-of-period adjustments = 0
<i>Restructure</i>	An indicator variable equal to 1 if the company reports restructuring charges in year t, and 0 otherwise
<i>Returns</i>	Market-adjusted 12 month stock returns
<i>Returns Skewness</i>	Skewness of the company's 12 month stock return
<i>RETVOL</i>	Equals the standard deviation of the company's 12 month stock return
<i>Revision_Restate</i>	An indicator variable equal to 1 if the misstatement was subsequently revealed through a revision restatement, and zero otherwise
<i>Revision_Restate_Pr2</i>	An indicator variable equal to 1 if a revision restatement was disclosed in the previous two years, and zero otherwise
<i>ROA</i>	Return on assets measured as net income divided by total assets
<i>SalesGrowth</i>	Sales growth over the previous year
<i>Segments</i>	The natural log of the number of a company's business segments
<i>ShareTurnover</i>	Share turnover during the year
<i>Size</i>	The natural log of total assets
<i>Sum_Auditor_Litigation</i>	The number of law suits against an audit firm that are open during the fiscal year
<i>Sum_OOPA</i>	The number of public audit clients for an audit firm that report OOPAs during the fiscal year
<i>Sum_NR_Restate</i>	The number of public audit clients for an audit firm that report non-reliance restatements during the fiscal year
<i>Sum_Revision_Restate</i>	The number of public audit clients for an audit firm that report revision restatements during the fiscal year
<i>TECH</i>	One if the company is in a technology industry (i.e., SIC codes 2830s, 3570s, 7370s, 8730s, and between 3825 and 3839), and zero otherwise
<i>Turnover</i>	Trading volume accumulated over the 12 month period scaled by beginning of the year shares outstanding
<i>YearFE</i>	Indicator variables for each year in the sample period
<i>YearsMisstated</i>	The number of misstated years

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Table 1
Sample Selection

Panel A: Sample Selection

	N
Restatement and out-of-period announcements from Audit Analytics Advanced Restatement Database covering misstatement disclosures between 2004 and 2014	13,642
Less: Restatement and out-of-period announcements in regulated industries in non-regulated industries (where regulated industries capture SIC codes 4400-4999 and 6000- 6999)	(2,948)
Less: Restatement and out-of-period announcements with missing data for model variables	(7,674)
Less: Restatement and out-of-period announcements where the auditor at the announcement date is different from the auditor during the misstated period(s)	(152)
	2,868
Where auditor is the same during misstatement period and public disclosure	
Non-reliance restatement announcements	1,082
Other restatements	1,124
Out-of-period adjustments	662
	2,868

Panel B: Misstatement Disclosures by Year

Misstatement Disclosure:	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total
Non-reliance restatement	276	268	143	87	55	59	51	36	52	29	26	1,082
Other restatement	93	103	69	61	77	74	80	112	153	165	137	1,124
Out-of-period adjustment	9	15	30	62	71	91	75	83	72	73	81	662
Total	378	386	242	210	203	224	206	231	277	267	244	2,868

Table 2
Descriptive Statistics

Variable	N	Mean	STD	25th Percentile	Median	75th Percentile
<i>AudEngageRisk</i>	2,868	0.029	0.907	-0.486	0.185	0.691
<i>BigN</i>	2,868	0.804	0.397	1.000	1.000	1.000
<i>ClientImportance</i>	2,868	0.123	0.208	0.015	0.041	0.123
<i>DaysToDisclose</i>	2,868	236.760	202.643	121.000	162.000	365.000
<i>Fees</i>	2,868	14.016	1.180	13.303	14.044	14.754
<i>Foreign</i>	2,868	0.364	0.481	0.000	0.000	1.000
<i>ICMW</i>	2,868	0.236	0.425	0.000	0.000	0.000
<i>Inst%</i>	2,868	0.421	0.354	0.029	0.389	0.749
<i>Leverage</i>	2,868	0.207	0.210	0.009	0.157	0.326
<i>LitRisk_Shu</i>	2,868	5.368	2.806	3.000	6.000	8.000
<i>LitRisk_KS</i>	2,868	4.189	2.743	2.000	4.000	6.000
<i>Loss</i>	2,868	0.362	0.481	0.000	0.000	1.000
<i>M&A</i>	2,868	0.200	0.400	0.000	0.000	0.000
<i>MTB</i>	2,868	3.014	4.878	1.220	1.960	3.488
<i>NegIncomeImpact</i>	2,868	-1.128	3.635	-0.546	0.000	0.000
<i>NR_Restate</i>	2,868	0.377	0.485	0.000	0.000	1.000
<i>NR_Restate_Pr2</i>	2,868	0.174	0.379	0.000	0.000	0.000
<i>NTFiler</i>	2,868	0.177	0.382	0.000	0.000	0.000
<i>NumAnalysts</i>	2,868	5.929	6.707	1.000	3.833	8.545
<i>OfficeSize</i>	2,868	17.262	1.737	16.176	17.607	18.604
<i>OOPA</i>	2,868	0.231	0.421	0.000	0.000	0.000
<i>OOPA_Pr2</i>	2,868	0.097	0.296	0.000	0.000	0.000
<i>PosIncomeImpact</i>	2,868	0.166	0.655	0.000	0.000	0.000
<i>Restructure</i>	2,868	0.369	0.482	0.000	0.000	1.000
<i>Revision_Restate</i>	2,868	0.392	0.488	0.000	0.000	1.000
<i>Revision_Restate_Pr2</i>	2,868	0.129	0.335	0.000	0.000	0.000
<i>Segments</i>	2,868	0.159	0.603	0.000	0.000	0.000
<i>ShareTurnover</i>	2,868	2.266	2.067	0.813	1.720	2.999
<i>Size</i>	2,868	6.283	1.830	5.025	6.255	7.553
<i>YearsMisstated</i>	2,868	2.328	1.805	1.000	2.000	3.000

Notes: Descriptive statistics for variables included in our multivariate hypothesis test in Equation (3). All variables are defined in the Appendix.

Table 3
Univariate Correlations

Variable	<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(5)</i>	<i>(6)</i>	<i>(7)</i>	<i>(8)</i>	<i>(9)</i>	<i>(10)</i>	<i>(11)</i>
<i>(1) NR_Restate</i>		-0.625	-0.426	-0.076	-0.143	-0.078	-0.192	-0.214	-0.139	-0.179	-0.020
<i>(2) Revision_Restate</i>	-0.625		-0.440	-0.014	0.047	-0.010	0.047	0.065	-0.009	0.018	0.053
<i>(3) OOPA</i>	-0.426	-0.440		0.103	0.111	0.101	0.166	0.170	0.171	0.185	-0.038
<i>(4) LitRisk_Shu</i>	-0.071	-0.016	0.101		0.497	0.302	0.472	0.315	0.284	0.579	-0.026
<i>(5) LitRisk_KS</i>	-0.146	0.052	0.108	0.496		0.273	0.491	0.330	0.291	0.718	0.005
<i>(6) InstOwn%</i>	-0.065	-0.012	0.089	0.253	0.225		0.331	0.259	0.288	0.543	-0.129
<i>(7) Fees</i>	-0.192	0.049	0.164	0.450	0.491	0.286		0.535	0.553	0.760	0.052
<i>(8) BigN</i>	-0.214	0.065	0.170	0.289	0.332	0.214	0.518		0.678	0.658	-0.257
<i>(9) OfficeSize</i>	-0.132	-0.015	0.169	0.230	0.268	0.228	0.485	0.616		0.655	-0.607
<i>(10) AudEngageRisk</i>	-0.162	0.006	0.179	0.573	0.745	0.507	0.731	0.575	0.574		-0.173
<i>(11) ClientImportance</i>	0.014	0.051	-0.075	0.049	0.056	-0.069	0.151	-0.380	-0.741	-0.120	

Notes: The table summarizes correlations for key variables used in our analyses. Pearson (Spearman) correlations are above (below) the diagonal. Correlations that are significant at p -value < 0.05 are bolded. See the Appendix for variable definitions.

Table 4
Select Descriptive Statistics by Disclosure Method

Variable	(1) <i>NR_Restate</i> (N=1,082)		(2) <i>Revision_Restate</i> (N=1,124)		(3) <i>OOPA</i> (N=662)	
	Mean	Median	Mean	Median	Mean	Median
<i>IncomeImpact</i>	-0.020	-0.004	-0.003	0.000	-0.001	0.000
<i>ABS_IncomeImpact</i>	0.025	0.008	0.006	0.000	0.003	0.001
<i>YearsMisstated</i>	2.864	2.000	2.075	2.000	1.882	1.000
<i>DaysToDisclose</i>	160.567	135.000	263.153	218.000	316.480	365.000
Restated Accounts:						
<i>Revenue</i>	0.166	0.000	0.107	0.000	0.086	0.000
<i>Inventory/COGS</i>	0.110	0.000	0.083	0.000	0.076	0.000
<i>Expenses</i>	0.193	0.000	0.094	0.000	0.017	0.000
<i>Debt/Equity</i>	0.140	0.000	0.114	0.000	0.020	0.000
<i>Liability/Reserves</i>	0.107	0.000	0.084	0.000	0.060	0.000
<i>Tax</i>	0.166	0.000	0.198	0.000	0.288	0.000
<i>Other</i>	0.348	0.000	0.462	0.000	0.484	0.000
Variable	(1) vs (2)		(1) vs (3)		(2) vs (3)	
	Diff in Mean	Diff in Median	Diff in Mean	Diff in Median	Diff in Mean	Diff in Median
<i>IncomeImpact</i>	-0.017***	-0.004***	-0.019***	-0.004***	-0.003***	0.000*
<i>ABS_IncomeImpact</i>	0.020***	0.008***	0.023***	0.006***	0.003***	-0.001
<i>YearsMisstated</i>	0.789***	0.000***	0.982***	1.000***	0.193***	1.000***
<i>DaysToDisclose</i>	-102.586***	-83.000***	-155.913***	-230.000***	-53.327***	-147.000
<i>Revenue</i>	0.060***	0.000***	0.080***	0.000***	0.021	0.000
<i>Inventory/COGS</i>	0.027**	0.000**	0.034**	0.000**	0.007	0.000
<i>Expenses</i>	0.099***	0.000***	0.177***	0.000***	0.078***	0.000***
<i>Debt/Equity</i>	0.027*	0.000*	0.121***	0.000***	0.094***	0.000***
<i>Liability/Reserves</i>	0.024*	0.000*	0.047***	0.000***	0.023*	0.000*
<i>Tax</i>	-0.032*	0.000*	-0.122***	0.000***	-0.090***	0.000***
<i>Other</i>	-0.113***	0.000***	-0.135***	0.000***	-0.022*	0.000*

Notes: This table presents the differences in mean and median values of variables capturing the severity and magnitude of misstated-years (*IncomeImpact*, *ABS_IncomeImpact*, *YearsMisstated*, and *DaysToDisclose*) and affected accounts between disclosure method (non-reliance restatement, revision restatement, and out-of-period adjustment). Differences in sample means for severity and magnitude are based on t-tests, and the tests for differences in sample medians are based on Wilcoxon-Mann-Whitney tests. P-values are two-tailed. *, **, and *** denote statistical significance at 0.10, 0.05, and 0.01 levels, respectively.

Table 5
The Association between the Number of Misstatement Disclosures (by Prominence) and Subsequent Litigation against the Audit Firm and Changes in Public Audit Clients at the Audit-Firm Level

Variable	(1)			(2)			(3)		
	DV = <i>Sum_Auditor_Litigation</i>			DV = <i>NetChangeClients</i>			DV = <i>%ChangeClients</i>		
	Coefficient		t-stat	Coefficient		t-stat	Coefficient		t-stat
<i>Sum_NR_Restate</i>	0.043	***	3.350	-1.570	*	-1.350	-0.007	***	-2.560
<i>Sum_Revision_Restate</i>	0.009		0.320	1.030		0.750	0.003		0.800
<i>Sum_OOPA</i>	-0.042	**	-2.260	3.211	*	1.920	0.004		1.170
<i>Year FE</i>	Included			Included			Included		
<i>Audit Firm FE</i>	Included			Included			Included		
N	234			234			234		
Adjusted R ²	0.607			0.439			0.846		

Notes: This table presents the results of tests examining the association between the number of misstatement disclosures (by prominence) by public audit clients of an audit firm and the number of lawsuits brought against an audit firm, the change in the number public audit clients in the following year and percentage change in the number of public audit clients in the following year. P-values are two-tailed. *, **, and *** denote statistical significance at 0.10, 0.05, and 0.01 levels, respectively. Standard errors are clustered by company. All variables are defined in the Appendix.

Table 6
The Association between Misstatement Disclosure Prominence and Auditor Incentives

Ordered Logistic Regression					
DV = <i>RestateCategory</i>					
Variable	Coefficient		z-statistic	Coefficient	z-statistic
<i>AudEngageRisk</i> (-)	-0.273	***	-3.490		
<i>LitRisk_Shu</i> (-)				0.006	0.200
<i>LitRisk_KS</i> (-)				-0.039	**
<i>InstOwn%</i> (-)				0.083	0.640
<i>Fees</i> (-)				-0.044	-0.530
<i>BigN</i> (-)				-0.448	***
<i>OfficeSize</i> (-)				-0.100	***
<i>ClientImportance</i> (-)	-0.270	*	-1.400	-0.769	***
<i>Size</i>	-0.037		-0.870	0.017	0.290
<i>MTB</i>	-0.004		-0.430	-0.002	-0.200
<i>Leverage</i>	0.514	**	2.400	0.421	*
<i>Loss</i>	-0.110		-1.140	-0.071	-0.730
<i>ICMW</i>	1.560	***	12.880	1.577	***
<i>NTFiler</i>	0.899	***	6.160	0.876	***
<i>Foreign</i>	-0.263	***	-2.990	-0.224	**
<i>M&A</i>	0.026		0.250	0.024	0.230
<i>Restructure</i>	0.027		0.280	0.011	0.110
<i>Segments</i>	-0.062		-1.010	-0.062	-1.020
<i>ShareTurnover</i>	0.000		0.020	-0.011	-0.320
<i>NegIncomeImpact</i>	-0.202	***	-3.550	-0.199	***
<i>PosIncomeImpact</i>	0.385	***	4.770	0.383	***
<i>YearsMisstated</i>	0.115	***	3.830	0.113	***
<i>DaysToDisclose</i>	-0.003	***	-11.700	-0.003	***
<i>NumAnalysts</i>	0.008		1.040	0.006	0.770
<i>NR_Restate_Pr2</i>	0.028		0.260	0.033	0.310
<i>Revision_Restate_Pr2</i>	0.146		1.280	0.149	1.300
<i>OOPA_Pr2</i>	-1.147	***	-6.950	-1.128	***
<i>Industry FE</i>		Included			Included
<i>Year FE</i>		Included			Included
N		2,868			2,868
N <i>NR_Restate</i>		1,082			1,082
N <i>Revision_Restate</i>		1,124			1,124
N <i>OOPA</i>		662			662
Pseudo R ²		0.290			0.294

Notes: P-values are two-tailed. Predicted direction for our variable of interest is in parentheses. *, **, and *** denote statistical significance at 0.10, 0.05, and 0.01 levels, respectively. Standard errors are clustered by company. All variables are defined in the Appendix.

Table 7
Matched Sample on Adjustment Magnitude

Panel A: Differences in Mean and Median *IncomeImpact* between Matched Companies

Variable	(1) OOPA		(2) Revision Restate		(3) NR_Restate	
	(N = 202)		(N = 202)		(N = 202)	
	Mean	Median	Mean	Median	Mean	Median
<i>IncomeImpact</i>	-0.075	0.000	-0.086	0.000	-0.100	0.000

	(1) vs (2)		(1) vs (3)		(2) vs (3)	
	Mean	Median	Mean	Median	Mean	Median
Difference	0.010	0.000	0.025	0.000	0.015	0.000
<i>p-value</i>	0.792	0.930	0.543	0.712	0.715	0.567

Notes: This panel presents the differences in mean and median *IncomeImpact* between observations with an out-of-period adjustment, revision restatement, or non-reliance restatement matched in the same year and industry and magnitude of the adjustment (with a maximum difference of +/- 0.03). This procedure resulted in 202 successful matches (out of 662 potential matches).

Panel B: Multiple Regression Analysis Using Matched Sample

Ordered Logistic Regression					
DV = <i>RestateCategory</i>					
Variable	Coefficient	z-statistic	Coefficient	z-statistic	
<i>AudEngageRisk</i> (-)	-0.582 ***	-3.66			
<i>LitRisk_Shu</i> (-)			0.022		0.340
<i>LitRisk_KS</i> (-)			-0.090 ***		-2.130
<i>InstOwn%</i> (-)			-0.015		-0.050
<i>Fees</i> (-)			-0.085		-0.460
<i>BigN</i> (-)			-0.461 *		-1.300
<i>OfficeSize</i> (-)			-0.271 **		-2.250
<i>ClientImportance</i> (-)	-0.587 *	-1.47	-1.677 ***		-2.410
<i>Size</i>	-0.025	-0.31	0.085		0.680
<i>MTB</i>	-0.002	-0.07	0.003		0.130
<i>Leverage</i>	1.599 ***	3.33	1.382 ***		2.700
<i>Loss</i>	0.167	0.81	0.282		1.330
<i>ICMW</i>	1.888 ***	7.59	1.934 ***		7.430
<i>NTFiler</i>	0.818 ***	2.86	0.712 **		2.340
<i>Foreign</i>	-0.023	-0.13	-0.006		-0.030
<i>M&A</i>	0.229	0.99	0.217		0.920
<i>Restructure</i>	-0.074	-0.32	-0.103		-0.450
<i>Segments</i>	-0.244	-1.57	-0.242		-1.660
<i>ShareTurnover</i>	0.039	0.83	0.020		0.270
<i>NegIncomeImpact</i>	0.260	0.84	0.220		0.690
<i>PosIncomeImpact</i>	-0.702	-1.57	-0.729		-1.630
<i>YearsMisstated</i>	0.013	0.21	0.015		0.250
<i>DaysToDisclose</i>	-0.002 ***	-5.02	-0.002 ***		-5.070
<i>NumAnalysts</i>	-0.002	-0.1	-0.012		-0.600
<i>NR_Restate_Pr2</i>	0.075	0.3	0.128		0.500
<i>Revision_Restate_Pr2</i>	0.067	0.27	0.022		0.090
<i>OOPA_Pr2</i>	-1.999 ***	-4.12	-2.018 ***		-4.190
<i>Industry FE</i>	Included		Included		
<i>Year FE</i>	Included		Included		
N	606		606		
N <i>NR_Restate</i>	202		202		
N <i>Revision_Restate</i>	202		202		
N <i>OOPA</i>	202		202		
Pseudo R ²	0.206		0.217		

Notes: This panel presents the results of our matched sample (where *OOPA* observations are matched with a non-*OOPA* observations in the same year, industry, and closest adjustment magnitude). Predicted direction for our variable of interest is in parentheses. P-values are two-tailed. *, **, and *** denote statistical significance at 0.10, 0.05, and 0.01 levels, respectively. Standard errors are clustered by company. All variables are defined in the Appendix.

Table 8
Misstatement Magnitude

Variable	NI impact <0.25% and <1% of assets DV= <i>RestateCategory</i>		NI impact > 1% of assets DV= <i>RestateCategory</i>	
	Coefficient	z-statistics	Coefficient	z-statistics
<i>AudEngageRisk</i> (- / ?)	-0.551 ***	-3.290	-0.205	-0.990
<i>ClientImportance</i> (- / ?)	-0.466	-1.140	-0.338	-0.660
Controls	Included		Included	
Industry and Year FE	Included		Included	
N	661		638	
N <i>NR_Restate</i>	272		476	
N <i>Revision_Restate</i>	225		132	
N <i>OOPA</i>	164		30	
Pseudo R ²	0.336		0.287	

Notes: P-values are two-tailed unless a prediction is made. Predicted directions for our variable of interest are in parentheses. *, **, and *** denote statistical significance at 0.10, 0.05, and 0.01 levels, respectively. Standard errors are clustered by company. All variables are defined in the Appendix.

Table 9
Different Auditor during Misstatement Period(s) from Disclosure Date

Variable	DV = <i>RestateCategory</i>			
	Coefficient	z-statistic	Coefficient	z-statistic
<i>AudEngageRisk</i> (?)	-0.316	-0.970		
<i>LitRisk_Shu</i> (?)			-0.038	-0.260
<i>LitRisk_KS</i> (?)			-0.071	-0.650
<i>InstOwn%</i> (?)			-0.479	-0.470
<i>Fees</i> (?)			-0.466	-0.980
<i>BigN</i> (?)			-1.110	-1.340
<i>OfficeSize</i> (?)			0.450 *	1.760
<i>ClientImportance</i> (?)	1.285	1.220	3.046 **	1.980
<i>Controls</i>	Included		Included	
<i>Industry FE</i>	Included		Included	
<i>Year FE</i>	Included		Included	
N	152		152	
N <i>NR_Restate</i>	63		63	
N <i>Revision_Restate</i>	46		46	
N <i>OOPA</i>	43		43	
Pseudo R ²	0.338		0.353	

Notes: P-values are two-tailed unless a prediction is made. Predicted directions for our variable of interest are in parentheses. *, **, and *** denote statistical significance at 0.10, 0.05, and 0.01 levels, respectively. Standard errors are clustered by company. All variables are defined in the Appendix.