

**MANAGERS' AND AUDITORS' INCENTIVES, MATERIALITY JUDGMENTS, AND  
THE RESOLUTION OF FINANCIAL STATEMENT MISSTATEMENTS**

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# MANAGERS' AND AUDITORS' INCENTIVES, MATERIALITY JUDGMENTS, AND THE RESOLUTION OF FINANCIAL STATEMENT MISSTATEMENTS

## ABSTRACT:

This paper investigates the roles of managers' and auditors' incentives in materiality judgments concerning the resolution of detected financial statement misstatements. Using data on such misstatements that occurred during 2003 to 2006, we find a negative association between audit fees (level of audit fees, abnormal audit fees, and the rank of audit fees within the audit firm) and the likelihood of managers having waived *quantitatively* material misstatements (i.e., those exceeding the common size threshold of one percent of net sales) or *qualitatively* material misstatements (i.e., those that, when waived, enable managers to meet or beat rather than miss analysts' consensus forecasts). Our analyses also show that managers are more likely to waive *qualitatively* material misstatements as analyst following increases. However, managers are less likely to waive *qualitatively* material misstatements as audit fees increase, which is consistent with auditors expending effort to protect their reputations and reduce their risk exposure by being unwilling to acquiesce to managers' demands in such settings.

**Keywords:** Audit Fees, Book-or-Waive Decisions, Error Correction, Materiality, Staff Accounting Bulletin No. 108, Stock Analysts.

**Data Availability:** Data used in the study are available from public sources.

# **MANAGERS' AND AUDITORS' INCENTIVES, MATERIALITY JUDGMENTS, AND THE RESOLUTION OF FINANCIAL STATEMENT MISSTATEMENTS**

## **I. INTRODUCTION**

Auditors detect and inform client managers of financial statement misstatements, and the two parties must then reach agreement about whether managers will or will not correct the misstatements prior to the issuance of the audited financial statements. Managers may elect to waive the correction of misstatements and auditors may concur if they both conclude that the misstatements do not render the financial statements *materially* incorrect. Yet, the Securities and Exchange Commission (SEC) and others have asked the rhetorical question: if the misstatement is, indeed, immaterial, why not simply correct it (SEC 1999)? Levitt (1998) articulates the opinion that materiality abuse and other financial gimmicks occur in part due to managers' and auditors' incentives. Understanding the roles of managers' incentives (e.g., analyst pressure and executive compensation) and auditors' incentives (e.g., economic, regulatory, litigation, and ethical) in misstatement materiality judgments is important because it helps to explain the reasons for decisions underlying observed audit and financial reporting outcomes that can affect users. However, information concerning managers' use of materiality judgments to achieve financial reporting outcomes and auditors' concurrence with these judgments has not previously been publicly observable (Kinney and Libby 2002; Nelson et al. 2002).

The purpose of this paper is to investigate the roles of managers' incentives and auditors' incentives in materiality judgments during the resolution of detected financial statement misstatements. Bringing together theory from the literatures on auditor independence, materiality, and earnings management, we present and test a conceptual model of the manager-auditor resolution process for detected misstatements. Our investigation of this process is made possible by recent regulation concerning the resolution of misstatements, which is contained in

Staff Accounting Bulletin No. 108 (SAB 108). The implementation of SAB 108 provides disclosure data on misstatements that were previously judged immaterial and remained uncorrected in the financial statements, but that have now been judged to be material (SEC 2006). We use these disclosures to measure the quantitative materiality of misstatements (i.e., those exceeding the common size threshold of one percent of net sales) and the qualitative materiality of misstatements (i.e., those that, when waived, enable managers to meet or beat rather than miss analysts' consensus forecasts). We then analyze the association of these variables with both managers' incentives associated with security analyst following and auditors' competing economic and reputational incentives. We use 869 misstatements in our quantitative materiality analyses and 372 misstatements in our qualitative materiality analyses. According to SAB 108 disclosures, these misstatements were detected, were waived by managers with auditors' concurrence, and therefore were present in reported financial statements during the period January 1, 2003 to September 30, 2006.

The SEC issued SAB 108 in September 2006, and it became effective for annual financial statements covering the first fiscal year end after November 15, 2006. Historically, the quantitative materiality of detected misstatements was evaluated using either a balance sheet (the “iron curtain”) *or* an income statement (the “rollover”) approach.<sup>1</sup> SAB 108 requires that managers and their auditors now use a “dual approach” to assess the materiality of detected misstatements (SEC 2006). This approach requires applying *both* the rollover and iron curtain methods to financial statement misstatements. As companies initially adopted SAB 108, those

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<sup>1</sup> The rollover method focuses on the materiality of current year misstatements and the reversing effect of prior year misstatements on the income statement, which may allow misstatements to accumulate on the balance sheet. The iron curtain method focuses on ensuring that the year-end balance sheet is correct. Historically, the use of either method for quantifying misstatements was acceptable according to generally accepted auditing and accounting standards, and audit firms' client portfolios varied in their used of the two methods (Keune and Johnstone 2009). See Nelson et al. (2005) for examples of the application of these methods.

companies with misstatements now judged material under the dual approach could correct the misstatements by recording a one-time cumulative transition adjustment to retained earnings, by adjusting current year earnings, or by restating financial statements (SEC 2006). The disclosures about these corrections provide our data on previously detected and waived misstatements.

This paper makes two fundamental contributions to existing literature. First, we extend the literature on auditor independence in relation to professional services fees. Prior studies examine the relation between such fees and various proxies for audit and financial reporting quality (e.g., Reynolds and Francis 2001; Frankel et al. 2002; Ashbaugh et al. 2003; Geiger and Rama 2003; Kinney et al. 2004; Larcker and Richardson 2004). This line of research reports mixed results and uses a variety of measures, including accounting accruals, auditors' going-concern reports, and restatements (Francis 2006). Our use of SAB 108 disclosure data extends this literature by providing evidence on the association between professional services fees and the materiality of detected misstatements in a context where managers knowingly issued, and auditors concurred with the issuance of, financial statements containing these misstatements.

There are competing predictions concerning the underlying relation between professional services fees and measures of *poor* audit and financial reporting quality. One theory suggests a positive association whereby economic dependence exists between auditors and their clients, which causes auditors to accept managers' demands in order to earn future fees (e.g., DeAngelo 1981b; Beck et al. 1988; Magee and Tseng 1990; Frankel et al. 2002). A competing theory regarding the relation between fees and *poor* audit and financial reporting quality suggests a negative association whereby auditors work to protect their reputations by rejecting managers' demands when the downside risk to accepting those demands is high (Reynolds and Francis

2001; Larcker and Richardson 2004). Using data from SAB 108 disclosures, we provide new evidence concerning the validity of these competing predictions.

Second, we extend the materiality literature and the earnings management literature by examining the quantitative and qualitative characteristics of misstatements in relation to managers' incentives (security analyst following) and auditors' incentives (economic and reputational). Thus, we use publicly available data to complement prior archival (Wright and Wright 1997), survey (Nelson et al. 2002, 2003), and experimental research (Libby and Kinney 2000; Braun 2001; Nelson et al. 2005; DeZoort et al. 2006; Ng 2007; Ng and Tan 2007) on materiality judgments and book-or-waive decisions in which earnings management is a concern.<sup>2</sup> We construct a unique new variable using SAB 108 disclosure and analysts' forecast data that enables us to identify companies that meet or beat analysts' consensus forecasts by waiving the correction of misstatements (i.e., misstatements that, if booked, would have resulted in missing analysts' consensus forecasts). This variable enables us to provide explicit evidence on managers' incentives associated with security analyst following. In conducting this analysis, we extend the materiality literature by providing evidence on the joint role of managers' and auditors' incentives in materiality judgments (Kinney and Libby 2002) and the use of materiality justifications to achieve desirable financial reporting outcomes.

Turning to results, our analyses reveal a negative association between the likelihood of a manager waiving either a quantitatively or a qualitatively material misstatement and the level of audit fees, abnormal audit fees, or the rank of audit fees within the audit firm. These results are consistent with the theory that auditors expend effort to protect their reputations in this era when audit fees are publicly available and therefore highly visible to financial statement users.

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<sup>2</sup> The process of determining whether to correct or not correct a misstatement is the "the book-or-waive" decision. "Booking" the misstatement implies correcting it, and "waiving" the misstatement implies not correcting it.

The results also reveal a positive association between analyst following and the likelihood of a manager waiving a qualitatively material misstatement. Further, the results show a negative interaction between analyst following and audit fees (level of audit fees, abnormal levels of audit fees, and the firm rank of audit fees), which illustrates that the joint role of analyst following and auditors' fees is important in determining managers' decisions to waive qualitatively material misstatements that will result in missing rather than meeting or beating consensus earnings forecasts. Taken together, the pattern of results implies that analyst following creates incentives for managers to waive qualitatively material misstatements and that auditors seek to protect their reputations by being less likely to allow the waiving of qualitatively material misstatements as audit fees increase.

The paper proceeds as follows. In Section II, we articulate the manager-auditor resolution process for detected misstatements and detail the academic theory underlying our hypotheses. We describe our method and research design in Section III and our results in Section IV. Section V contains a discussion of conclusions.

## **II. BACKGROUND AND HYPOTHESES**

### **The Manager-Auditor Resolution Process for Detected Misstatements**

DeAngelo (1981a, 1981b) articulates audit quality as a joint construct that involves both detecting misstatements in a client's accounting system and reporting those misstatements. The conceptual model that we outline in Figure 1 describes the manager-auditor resolution process that occurs when a misstatement is detected (Phase One), auditors and managers weigh their respective incentives related to the misstatement's resolution (Phase Two), they consider professional standards regarding the misstatement's materiality (Phase Three), and they jointly decide whether to book or to waive the misstatement (Phase Four). Prior research on manager-

auditor negotiation illustrates that this process is an important aspect of auditors' ability to curtail managers' earnings management attempts during the book-or-waive decision (Nelson et al. 2002; Trotman et al. 2005; Sanchez et al. 2007).

### **Insert Figure 1 Here**

#### ***Managers' Incentives***

After a misstatement has been detected, the conceptual model articulates the roles of both managers' incentives and auditors' incentives in this context. In terms of managers' incentives, some prior literature characterizes analysts as external monitors who reduce managers' incentives and ability to manage earnings (e.g., Jensen and Meckling 1976; Healy and Palepu 2001), but it is generally accepted that analyst coverage, as well as executive compensation contracts, create significant pressure on managers to manage earnings (Levitt 1998; Matsunaga and Park 2001; Brown and Caylor 2005; Burns and Kedia 2006). For example, Graham et al. (2005) report that CFOs anticipate severe negative market reactions to missing analysts' consensus expectations and work to meet or beat earnings benchmarks in order to achieve credibility in the capital markets, maintain or increase stock prices, enhance managers' external reputations, and convey future growth prospects for the company. Similarly, Dhaliwal et al. (2004) find that managers actively manage their earnings in order to meet analysts' forecasts. In addition, Cheng and Warfield (2005) find a positive association between the number of analysts and earnings reports that meet or just beat analysts' forecasts. Bartov et al. (2002) provide a motivation for this relation by showing that companies that meet or beat analysts' earnings expectations have a higher quarterly return than companies with similar forecast errors that do not meet analysts' expectations. Importantly, their results show that the premium to meeting or beating persists even when it is achieved through earnings management.



### ***Auditors' Incentives***

Managers' incentives affect auditors by creating pressure for auditors to acquiesce to managers' financial reporting demands (Johnstone et al. 2001; Kinney and Libby 2002). One theory suggests that the presence of an economic bond between auditors and clients creates auditors' dependence on clients and motivates auditors to accept managers' financial reporting demands in order to earn future fees (e.g., DeAngelo 1981a; DeAngelo 1981b; Beck et al. 1988; Magee and Tseng 1990). Some empirical evidence supports this theory (e.g., Frankel et al. 2002; Ashbaugh et al. 2003; Hoitash et al. 2007; Hatfield et al. 2008; Lim and Tan 2008). In our setting, the economic dependence theory suggests that auditors are more likely to allow managers to waive material misstatements as their economic dependence increases, which implies a positive relation between measures of audit fees (i.e., the level of fees, abnormally high audit fees, and the relative importance of the fees to the entire audit firm) and waived material misstatements. As audit fees increase, auditors experience a greater risk of future income in the negotiation context (DeAngelo 1981a; DeAngelo 1981b), providing managers with the ability to exert pressure on auditors to concur with the managers' demands to waive material misstatements (Wright and Wright 1997; Nelson et al. 2002).

While there is some support for the economic dependence theory, the results are not unanimous. In fact, the experimental work of Braun (2001) shows that auditors' decisions to allow managers to waive a material misstatement are not influenced by the relative size of audit fees (in relation to the audit firm local office's total fees) and that auditors are less likely to allow managers to waive a material misstatement when the company or misstatement poses greater litigation risk to the audit firm. Thus, an important competing possibility to the theory of

economic dependence arises from auditors' reputational incentives associated with adhering to professional regulations, avoiding litigation, and maintaining professional ethical standards.

The theory of reputation protection suggests that auditors value their reputations, identify the risks posed by their clients, respond to these risks by exerting incremental audit effort (Bedard and Johnstone 2004), and work to protect their reputations and reduce litigation risk (e.g., Stice 1991; Lys and Watts 1994; Johnstone and Bedard 2001). Some prior research provides evidence consistent with the reputation protection theory (e.g., Reynolds and Francis 2001; Larcker and Richardson 2004; Mitra et al. 2009). In our setting, the reputation protection theory predicts a negative relation between audit fees and the materiality of waived misstatements: auditors are less likely to allow managers to waive material misstatements as the downside risk of reputation loss increases with audit fees. Reputation loss associated with relatively high audit fees is especially relevant in the contemporary era in which we study because audit fees are publicly available and therefore highly visible to financial statement users. Consistent with this idea, but in the context of discretionary accruals, Larcker and Richardson (2004) show a negative relation between the level of audit fees and the size of accruals, which the authors attribute to “auditor behavior being constrained by reputation effects” (p. 625). In essence, the larger the audit fees, the greater the risk that the auditor experiences with regard to the visibility of his/her reputation, leading to a reduced willingness on the part of the auditor to waive material misstatements. Also consistent with the theory of reputation protection, prior research shows that auditors require clients with lower financial reporting quality to pay higher audit fees to compensate for the time required to adequately perform necessary audit work (Kinney et al. 2004). In our setting, this implies that auditors charging higher (lower) fees

perform more (less) necessary audit work and are thus less (more) likely to allow managers to waive material misstatements.

### ***Quantitative and Qualitative Materiality***

The combination of managers' and auditors' incentives may then affect whether or not the misstatement is determined to be either quantitatively or qualitatively material based on the standards outlined in Staff Accounting Bulletin No. 99 (SAB 99). Managers may elect to waive the correction of a misstatement if both managers and auditors judge that the misstatement is immaterial, and this judgment is linked to concerns about auditors' independence and audit fees (Levitt 1998; Johnstone et al. 2001). The overarching standard of determining materiality is evaluating whether correcting or not correcting a misstatement will affect the judgments and decisions of a "reasonable person" using the financial statements (FASB 1980). To apply this standard, the SEC (1999) issued SAB 99 and urged auditors and managers to consider both the quantitative and qualitative characteristics of misstatements in judging whether they are material.

Quantitative characteristics involve thresholds used to assess the size of misstatements in relation to the overall financial statements. These thresholds are often based on some component of the income statement (Holstrum and Messier 1982; Messier et al. 2005), and thresholds of five percent of net income and one percent of revenues are typical (Brody et al. 2003). Qualitative characteristics of misstatements are considerations that may affect the decisions of financial statement users regardless of their quantitative materiality. SAB 99 identifies various considerations that would cause a quantitatively small misstatement to be qualitatively material, including factors such as "whether the misstatement masks a change in earnings or other trends, whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise, whether the misstatement changes a loss into income or vice versa, and whether the

misstatement has the effect of increasing management's compensation". The list in SAB 99 is not intended to be all inclusive, but instead emphasizes the need to examine misstatement characteristics beyond quantitative factors.

## **Hypotheses**

### ***The Quantitative Materiality of Detected Misstatements***

As noted in our discussion of the manager-auditor resolution process for detected misstatements, prior research suggests competing possibilities regarding whether auditors will allow managers to waive quantitatively material misstatements. Consistent with the theory of economic dependence (DeAngelo 1981a, 1981b; Magee and Tseng 1990), some research finds that auditors are more likely to allow managers of larger companies to waive misstatements (Wright and Wright 1997; Nelson et al. 2003), which these researchers attribute to the association between company size and audit fees (although they do not explicitly measure audit fees). Consistent with the theory of reputation protection, some experimental research finds that auditors are unwilling to allow managers to waive detected misstatements, even when future audit fees are at risk (Hatfield et al. 2008) or when audit fees are important to the auditor's local office (Braun 2001). In a related context, Frankel et al. (2002) and Larcker and Richardson (2004) report a negative association between the relative importance of a given client's audit fees to the audit firm and the level of earnings management present in a company's financial statements. Based on these disparate results concerning the effects of auditors' incentives, we make the following non-directional prediction regarding the association between audit fees and the likelihood of quantitatively material (versus immaterial) waived misstatements:

**H1: There is an association between the likelihood of quantitatively material waived misstatements and audit fees.**

### ***The Qualitative Materiality of Detected Misstatements***

Qualitative materiality thresholds provide opportunities for examining both managers' and auditors' incentives in relation to waived detected misstatements. A prominent earnings management benchmark is meeting or beating analysts' consensus forecasts (Ashbaugh et al. 2003; Lim and Tan 2008), and archival auditing research reveals that auditors judge a pattern of just meeting consensus forecasts as the most common indicator of their clients' earnings management risk (Bedard and Johnstone 2004). SAB 99 recognizes that a misstatement that hides a failure to meet security analysts' consensus expectations can be qualitatively material. Indeed, analysts' consensus forecasts are arguably one of the most important benchmarks to managers (Nelson et al. 2002; Dechow et al. 2003; Graham et al. 2005).

Prior archival studies use the propensity to meet or beat analysts' consensus forecasts as a measure of poor audit and financial reporting quality. However, some firms legitimately achieve their forecast targets, and prior studies are unable to differentiate between achieving targets through operations and achieving targets through earnings management. Using SAB 108 disclosures, we are able to identify misstatements that enabled companies to meet or beat analysts' consensus forecasts; if those same misstatements had been corrected, the companies would not have been able to meet or beat analysts' forecasts. Analyzing these misstatements allows us to identify financial reporting decisions that are inconsistent with GAAP, but for which a materiality judgment justified the decision to waive the correction of the misstatement.<sup>3</sup>

In terms of managers' incentives in this context, we have noted previously that analyst coverage creates pressure on managers to manage earnings (Levitt 1998; Matsunaga and Park 2001; Bartov et al. 2002; Dhaliwal et al. 2004; Brown and Caylor 2005). This occurs because

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<sup>3</sup> Experimental studies identify waiving a misstatement to allow a client to meet or beat analysts' consensus forecasts as non-GAAP behavior (e.g., Ng and Tan 2007).

managers anticipate negative market reactions to missing analysts' consensus expectations and work to meet or beat earnings benchmarks (Graham et al. 2005). Further, prior research demonstrates a positive association between the number of analysts and earnings reports that meet or just beat analysts' forecasts (Cheng and Warfield 2005). This line of literature suggests the following regarding the relation between the level of analyst following and the likelihood that managers will waive qualitatively material (versus immaterial) misstatements:

**H2: There is a positive association between the likelihood of qualitatively material waived misstatements that enabled companies to meet or beat analysts' consensus earnings forecasts and the level of security analyst following.**

In addition to managers' incentives to waive detected misstatements, experimental and survey studies suggest that auditors are sometimes willing to allow managers to waive misstatements that enable companies to meet or beat analysts' consensus forecasts. For example, Libby and Kinney (2000) show that auditors judge the correction of an earnings overstatement as less likely if it would cause a missed forecast, even for objectively measured misstatements. Ng (2007) reports that auditors are less likely to require correction of a quantitatively immaterial misstatement when doing so would cause the company to miss analysts' consensus forecasts compared to when it would disrupt the prior-year earnings trend. Ng and Tan (2007) extend Ng (2007) by providing evidence that auditors are less likely to require correction of a quantitatively immaterial audit difference that affects the company's ability to meet analysts' consensus forecasts when the manager expresses concern about the adverse consequences of such an action. However, studies examining auditors' incentives and the meeting or beating benchmark find no association between audit fees and companies meeting or beating forecasts (Ashbaugh et al. 2003; Lim and Tan 2008). Based on the disparate results concerning the efficacy of the theories of auditor economic dependence versus auditor reputation protection, we make the following

non-directional prediction regarding the association between audit fees and the waiving of qualitatively material (versus immaterial) misstatements:

**H3: There is an association between the likelihood of qualitatively material waived misstatements that enabled companies to meet or beat analysts' consensus earnings forecasts and audit fees.**

We study a setting in which managers decide whether or not to book detected misstatements *and* auditors decide whether or not to concur with managers' decisions. Thus, the joint role of both managers' incentives to manage earnings and auditors' incentives to deny or accept those attempts is important (Antle and Nalebuff 1991; Levitt 1998; Kinney and Libby 2002; Nelson et al. 2002). The research investigating the use of materiality judgments to meet or beat analysts' forecasts focuses on examining the role of analysts' forecasts and associated managers' incentives, but has not explicitly considered the role of auditors' incentives.

To understand the importance of auditors' incentives and how those incentives may interact with managers' incentives, consider the following example. First, assume that analyst pressure does indeed create incentives for managers to waive qualitatively material misstatements and that there is a positive association between security analyst following and the likelihood that managers will waive qualitatively material misstatements. If auditors make judgments consistent with the theory of reputation protection, then higher audit fees may reduce the positive association between analyst following and the likelihood that managers will waive qualitatively material misstatements. In contrast, if auditors make judgments consistent with the theory of economic dependence, higher audit fees may increase the positive association between analyst following and the likelihood that managers will waive qualitatively material misstatements. Given these competing possibilities and the lack of prior empirical research in this area, we explore whether there is an interaction between managers' and auditors' incentives in the waiving of qualitatively material (versus immaterial) misstatements:

**H4: The positive association between the likelihood of qualitatively material waived misstatements that enabled companies to meet or beat analysts' consensus earnings forecasts and the level of security analyst following is contingent on audit fees.**

### **III. METHOD AND RESEARCH DESIGN**

#### **Sample Description**

Our data collection period covers 10-Qs filed from November 15, 2006 to February 28, 2007 and 10-Ks filed from November 15, 2006 to February 15, 2008, and our analyses examine waived misstatements that existed in the financial statements during the period January 1, 2003 to September 30, 2006.<sup>4</sup> To identify the misstatements in our sample, we read the SAB 108 disclosures and identified companies that corrected misstatements via SAB 108, thus providing the requisite data for our models. The calculation of our dependent and control variables requires that companies disclose misstatement-type descriptions (e.g., derivatives, business combinations, or revenue) and data that allows us to determine the individual misstatement amounts present in the financial statements during specific years in our sample period.<sup>5</sup> The Appendix provides examples of SAB 108 disclosures and the misstatement-level data that we extract from these disclosures (e.g., misstatement descriptions and annual misstatement amounts). Using these data, each misstatement in our sample represents an individual misstatement that existed in a company's financial statements in a particular year during our sample period. We conduct our tests at the individual misstatement level to avoid netting or aggregating individual misstatements and to control for the accounting complexity of individual misstatements.<sup>6</sup>

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<sup>4</sup> Although some SAB 108 companies did disclose misstatements that existed prior to this period, we restrict our sample to examine the period after the Sarbanes-Oxley Act of 2002 (SOX), as implementing the many sections of SOX could have changed managers' and auditors' book-or-waive decisions.

<sup>5</sup> Consequently, our analyses do not include misstatements where the company disclosed the correction of a cumulative amount and did not provide sufficient disclosure to allow us to ascertain the misstatement amounts present in the financial statements during the periods in our sample.

<sup>6</sup> Later in the paper we report sensitivity tests in which we conduct our tests at the company level rather than at the individual misstatement level.



Table 1 Panel A reports our sample selection, while Panels B and C display sample concentrations by industry and year. Our sample initially consists of 1,290 SAB 108 misstatements with disclosures containing the information necessary for our analyses. We then eliminate 295 misstatements that were detected and corrected by companies in the same year as the implementation of SAB 108. These misstatements were not subject to the differential application of either the balance sheet or income statement approaches in past periods; they were only subject to the dual approach required by SAB 108. As such, these misstatements fundamentally differ from the other SAB 108 misstatements and so we eliminate them from our sample. Next, we eliminate 32 misstatements related to non-US and holding firms, 7 misstatements without requisite Compustat data, and 87 misstatements without requisite Audit Analytics data to arrive at our Model 1 sample of 869 misstatements. Our second model examines misstatements that, when waived, enabled companies to meet or beat analysts' median consensus forecasts. For this model, we remove 214 misstatements without requisite IBES data and 283 misstatements for companies that do not meet or beat analysts' median consensus forecasts to arrive at a final sample of 372 misstatements.

### **Insert Table 1 Here**

#### **Model 1 – Quantitative Materiality of Detected Misstatements**

Model 1 tests H1 by estimating the coefficients in a logit regression model that predicts the probability of a quantitatively material (versus immaterial) waived misstatement in the financial statements:

$$\begin{aligned} \text{QUANTITATIVE REV} = & \alpha + \beta_1 FEE + \beta_2 MIS\_TYPE + \beta_3 TENURE + \beta_4 BIG\_N + \beta_5 INVREC \\ & + \beta_6 AGE + \beta_7 MW + \beta_8 LITRISK + \beta_9 LOSS + \beta_{10} SEG + \beta_{11} SALESGROWTH + \beta_{12} ASSETS \\ & + \beta_{13} Industry_i + \beta_{14} Year_i + \varepsilon. \end{aligned} \quad (1)$$

Quantitative materiality may be measured using a variety of thresholds (Brody et al. 2003), but is most commonly measured with income statement components (Messier et al. 2005).

Many companies, except those reporting net losses or breakeven results, use some derivative of net income (e.g., net income before taxes, from continuing operations, etc.) for calculating quantitative materiality. To avoid the effects of companies with net losses and challenges in defining the appropriate net income measure for companies with breakeven results, we utilize a common threshold of one percent of net sales (Brody et al. 2003) as our dependent variable measuring quantitative materiality, *QUANTITATIVE REV.*<sup>7</sup> Table 2 provides variable definitions.

### **Insert Table 2 Here**

#### ***Independent Variables***

Our analyses include three complementary measures of audit fees. First, we measure *LNAUDIT* as the natural logarithm of audit fees, which represents audit fee magnitude. As noted by Wright and Wright (1997), “the larger the audit fees, the greater is the risk to future income and the higher is the incentive to waive adjustments consistent with client pressures” (Wright and Wright 1997, 20). The empirical question that we address, of course, is whether auditors will acquiesce to this pressure or will protect their reputations in a setting where third parties can observe audit fees.

Second, we measure *ABNORMALAUDIT* using the residual from an estimation model predicting *LNAUDIT*, which represents the abnormal or unexpected audit fee for the client.<sup>8</sup> Consistent with the arguments in Larcker and Richardson (2004), we anticipate that auditors’ behavior may vary depending on whether they are paid more or less than a relevant economic

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<sup>7</sup> Later in the paper we report sensitivity tests in which we use alternative quantitative materiality thresholds.

<sup>8</sup> To predict *LNAUDIT*, we estimate the following model from Larcker and Richardson (2004), which is based on Simunic (1984) and Craswell et al. (1995), using a sample of 12,236 firm years from Compustat and Audit Analytics:  $LNAUDIT = \alpha + \beta_1 ASSETS + \beta_2 SEG + \beta_3 INVREC + \beta_4 DEBT + \beta_5 INCOME + \beta_6 LOSS + \beta_7 GC + \beta_8 MW + \beta_9 Industry_i$  where *DEBT* = (debt in current and long-term liabilities, Compustat “dlc” and “dltt”)/total assets (Compustat “at”), *INCOME* = operating income after depreciation (Compustat “oiadp”)/total assets (Compustat “at”), *GC* = 1 if going concern opinion in Audit Analytics, 0 otherwise, and all other variables are as defined in Table 2. The model predicts *LNAUDIT* with an Adjusted R-Square = 0.711, which is comparable to the Adjusted R-Square = 0.749 for total fees reported by Larcker and Richardson (2004).

benchmark for the audit. For example, if the abnormal fee is less than or equal to zero, auditors presumably have little to lose by insisting that the client correct the misstatement because their audit fees are not commensurate with the risk and effort associated with the audit engagement. If the abnormal fee is greater than zero, then we anticipate that this is the setting in which auditors will feel the greatest pressure to maintain the relationship with the client. However, auditors' judgments in this setting may not be biased in favor of managers' preferences. Instead, auditors may have competing incentives to charge and use abnormally high audit fees to perform additional work to protect their reputations and ensure compliance with regulatory and professional ethics requirements, particularly in the post-SOX period that we examine.

Third, we measure *FIRMAUDIT* as the fractional rank of the client's audit fees within the opinion issuing firm, which represents the importance of the client to the entire firm and its partners.<sup>9</sup> Client importance may motivate auditors to allow managers to waive misstatements, but Frankel et al. (2002) find that this audit fee variable is negatively associated with various earnings management measures (earnings surprises and the magnitude of absolute, income-increasing, and income-decreasing discretionary accruals), which they interpret as indicating that the client's financial importance and visibility to the audit firm provides the audit firm with incentives to invest in its reputational capital. Consistent with prior research, we posit that investments in reputational capital and risk management likely occur through increased audit effort (Bedard and Johnstone 2004; Kinney et al. 2004). In total, these three audit fee measures capture potentially divergent incentives: the pressure to acquiesce to managers' demands on one hand, and the pressure to maintain a valuable professional reputation on the other hand.

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<sup>9</sup> The fractional rank variable ranges from 0.01 to 1 where 0.01 (1) is the smallest (largest) client within the sub-population.

Examining the directional association of these measures with the quantitative materiality of waived misstatements provides the basis for testing H1.

Our models also include a variety of control variables. We control for the nature of the waived misstatement, *MIS\_TYPE*, which is an indicator variable equal to one if the misstatement involves complex accounting judgments such as pensions, leases, business combinations, or deferred taxes, and equal to zero otherwise. We anticipate that complex waived misstatements are more likely to be material, consistent with prior descriptive research on such misstatements (Keune and Johnstone 2009). We measure *TENURE* as an indicator variable equal to one if the company-auditor relationship is three or more years, and equal to zero if the relationship is less than three years. Dopuch et al. (2001) suggest that longer tenure auditors display reduced independence, but other research shows that companies with short (long) auditor relationships have higher (lower) audit and financial reporting quality (Geiger and Raghunandan 2002; Johnson et al. 2002; Myers et al. 2003; Carcello and Nagy 2004), so we make no directional prediction for *TENURE*.<sup>10</sup> Next, we control for audit firm size using the variable *BIG\_N*. Although large audit firms may be associated with higher audit quality (DeAngelo 1981a, 1981b) and audit fees (Ashbaugh et al. 2003), no prior research exists that would cause us to expect that any one audit firm would be more or less likely to allow the waiving of a material misstatement, so we make no directional prediction for this variable.<sup>11</sup>

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<sup>10</sup> Our dichotomous measurement is consistent with Johnson et al. (2002) and Carcello and Nagy (2004). We are unable to use a continuous (Geiger and Raghunandan 2002) or decile (Myers et al. 2003) measurement as detail are not available within Compustat for all audit firms in our sample and Audit Analytics coverage began in 1999. Thus, Audit Analytics data would only provide truncated measures of auditor tenure.

<sup>11</sup> Keune and Johnstone (2009) find the presence of SAB 108 adjustments varies between audit firms. To examine the sensitivity of our results to our choice of *BIG\_N*, we re-perform (results not tabled) our analyses in Table 6 and Table 7 using indicator variables for Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers in place of *BIG\_N*. We find inferentially similar statistical results on our variables of interest ( $p \leq 0.10$ ) except for the main effect of *ABNORMALAUDIT* in Table 7 ( $p = 0.845$ ).

We also control for the characteristics of our sample companies, including the relative size of inventories and receivables (*INVREC*) and firm age (*AGE*). We make no directional prediction as to the relation between *INVREC* and *AGE* and waived misstatement materiality as these factors can be conflicting sources of misstatement materiality. We expect companies in a post-SOX environment disclosing internal control material weaknesses (*MW*) may be more likely to have larger financial misstatements because of their weak controls than companies without *MWs*, which would yield a positive relation between *MW* (where one equals the disclosure of a 302 or 404 material weakness in the annual report and zero otherwise) and waived misstatement materiality. However, auditors may be particularly stringent in their dealings with companies reporting *MWs*, given their relative riskiness, which would yield a negative relation between *MW* and waived misstatement materiality; as such we make no directional prediction for this variable. We also control for litigation risk (Francis et al. 1994, *LITRISK*), recent losses (*LOSS*), company complexity (*SEG*), and growth (*SALESGROWTH*). We expect that each of these variables will be positively associated with waived misstatement materiality because of the risk and complexity that they represent. We control for the size of the company (*ASSETS*), but make no directional prediction for this variable.<sup>12, 13</sup>

## **Model 2 – Qualitative Materiality of Detected Misstatements**

In Model 2, we test H2, H3, and H4 using a sample of waived misstatements for companies that meet or beat analysts' median annual consensus forecasts. We estimate the

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<sup>12</sup> Our industry dummies are consistent with Frankel et al. (2002) and Ashbaugh et al. (2003) except we add SIC 60-69 to their categories due to the prominence of financial services companies in our sample.

<sup>13</sup> In addition to these control variables, we also re-perform the analyses in Table 6 and Table 7 (results not tabled) using common variables associated with audit fees (*DEBT*, *INCOME*, and *GC*) that we use in estimating *ABNORMALAUDIT*. The control variables are not significant ( $p > 0.10$ ) in the analyses, and we find inferentially the same results for our variables of interest except for *ABNORMALAUDIT* ( $p > 0.10$ ) in the Table 7 analyses containing *DEBT* and *INCOME*.

coefficients in a logit regression model that predicts the probability of a qualitatively material waived misstatement in the financial statements:

$$\begin{aligned} MEETBEAT = & \alpha + \beta_1 FEE\_C + \beta_2 LNNUMEST\_C + \beta_3 FEE\_C * LNNUMEST\_C + \beta_4 MIS\_TYPE \\ & + \beta_5 TENURE + \beta_6 BIG\_N + \beta_7 INVREC + \beta_8 AGE + \beta_9 MW + \beta_{10} LITRISK + \beta_{11} LOSS + \beta_{12} SEG \\ & + \beta_{13} SALESGROWTH + \beta_{14} ASSETS + \beta_{15} Industry_i + \beta_{16} Year_i + \varepsilon. \end{aligned} \quad (2)$$

Our benchmark test of qualitative materiality differs from benchmark tests in studies that proxy for audit and financial reporting quality as the probability of meeting or beating analysts' consensus forecasts (Frankel et al. 2002; Ashbaugh et al. 2003; Lim and Tan 2008).<sup>14</sup> Instead, our sample is comprised only of misstatements that existed during the misstatement year and relate to companies that meet or beat analysts' median consensus forecasts, and we predict the probability of *using misstatements to achieve* meeting or beating analysts' consensus forecasts. We do this by comparing the per share effect of each individual misstatement to the relevant analyst consensus forecast for that period. Thus, *MEETBEAT* equals one if a company reported basic EPS that meet or beat the last analysts' median consensus forecast before the earnings report, but would have missed the forecast if the company corrected the misstatement, and equals zero otherwise.

### ***Independent Variables***

We proxy for the level of security analyst following using the log of the number of analysts' forecasts used to determine the consensus forecast, centered at its mean, *LNNUMEST\_C*. Examining the directional association of *LNNUMEST\_C* with the qualitative materiality of waived misstatements provides the basis for testing H2. Examining the directional association of the various *FEE\_C* measures (*FEE* measures centered at their means, including *LNAUDIT\_C*, *ABNORMALAUDIT\_C*, and *FIRMAUDIT\_C*) with the qualitative materiality of

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<sup>14</sup> Other benchmarks mentioned in SAB 99 include reporting net income versus net loss and reporting an earnings increase versus earnings decrease from prior year. We are unable to conduct tests using these benchmarks due to the low frequency of SAB 108 misstatements used to achieve these benchmarks ( $n \leq 20$  for each benchmark).

waived misstatements provides the basis for testing H3, and examining the directional association of *LNNUMEST\_C* interacted with the various *FEE\_C* measures provides the basis for testing H4. All other variables and expectations are as previously defined for Model 1.

## IV. RESULTS

### Descriptive Statistics

Table 3 provides insights on the relative size of quantitatively and qualitatively material misstatements. Table 3 Panel A illustrates the quantitative materiality of the misstatements in Model 1 where *QUANTITATIVEREV* = 1 (i.e., exceeding one percent of net sales). The results show that while 45 percent of these misstatements are between 1.00 and 1.49 percent of net sales, the majority of misstatements exceed that amount, with 8.3 percent of quantitatively material misstatements exceeding 5.00 percent of net sales. Table 3 Panel B illustrates the qualitative materiality of the misstatements in Model 2 where *MEETBEAT* = 1 (i.e., qualitatively material). The results show that 22 percent of qualitatively material misstatements relate to companies that just meet the analysts' consensus forecast by waiving the detected misstatement, 31.9 percent relate to companies that beat analysts' consensus forecast by one cent by waiving the detected misstatement, while the remaining companies beat analysts' consensus forecasts by two or more cents due to the waived misstatement. These results suggest that the relative size of material misstatements varies within the sample and is quite large in many cases.<sup>15</sup>

### Insert Table 3 Here

Table 4 provides descriptive statistics and univariate comparisons on variables in the hypothesis-testing models. Table 4 Panel A focuses on the misstatements for Model 1 and compares quantitatively material (i.e., exceeds one percent of net sales) and immaterial

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<sup>15</sup> Our measures of quantitative and qualitative materiality in Model 1 (*QUANTITATIVEREV*) and Model 2 (*MEETBEAT*), respectively, are marginally positively correlated ( $\rho = 0.09$ ,  $p = 0.08$ ), suggesting that material misstatements in our sample can be quantitatively, qualitatively, or both quantitatively and qualitatively material.

misstatements. Comparing the two groups, companies waiving quantitatively material misstatements have lower audit fees ( $t = -6.439$ ,  $p < 0.001$ ), abnormal audit fees ( $t = -2.417$ ,  $p = 0.016$ ), and percentile firm rank of audit fees ( $t = -4.671$ ,  $p < 0.001$ ), are more likely to have misstatements involving complex accounting judgments ( $X^2 = 6.233$ ,  $p = 0.013$ ), are less likely to be audited by a Big 4 auditor ( $X^2 = -6.970$ ,  $p = 0.008$ ), have lower relative inventories and receivables ( $t = -3.699$ ,  $p < 0.001$ ), are younger companies ( $t = -2.643$ ,  $p = 0.009$ ), and are less likely to have a material weakness in internal control ( $X^2 = 4.144$ ,  $p = 0.042$ ). Companies waiving quantitatively material misstatements are also more likely to be in a litigious industry ( $X^2 = 4.457$ ,  $p = 0.035$ ), have fewer business segments ( $t = -2.700$ ,  $p = 0.007$ ), and are smaller in terms of assets ( $t = -4.309$ ,  $p < 0.001$ ) than companies waiving immaterial misstatements.

#### **Insert Table 4 Here**

Table 4 Panel B classifies misstatements in terms of whether they are qualitatively material (i.e., whether the company meet or beat the analysts' forecast by not correcting the misstatement) versus qualitatively immaterial (i.e., if the company meet or beat the analysts' forecast regardless of whether or not it corrected the misstatement). Comparing the two groups, companies waiving qualitatively material misstatements have lower audit fees ( $t = -2.359$ ,  $p = 0.019$ ) and lower abnormal audit fees ( $t = -2.526$ ,  $p = 0.012$ ). They are more likely to have misstatements involving complex accounting judgments ( $X^2 = 6.107$ ,  $p = 0.013$ ), have higher relative inventories and receivables ( $t = 2.795$ ,  $p = 0.005$ ), are marginally less likely to report a recent loss ( $X^2 = 3.735$ ,  $p = 0.053$ ), and have lower sales growth ( $t = -3.174$ ,  $p = 0.002$ ) than companies waiving qualitatively immaterial misstatements.

Table 5 Panels A and B provide correlations for the Model 1 and Model 2 samples, respectively. The correlations among the independent variables are relatively low. The only



exceptions, consistent across Panels A and B, are the correlations between company size (*ASSETS*) and two audit fee measures (*LNAUDIT* and *FIRMAUDIT*) and the measure of security analyst following (*LNNUMEST*), which are consistently above 0.50. However, collinearity does not appear to be a problem in any of the hypothesis-testing models, with VIF's from linear regressions all consistently well-below the 10.00 cutoff suggested by Belsley et al. (1980).<sup>16</sup>

### **Insert Table 5 Here**

#### **Model 1: Tests of H1**

H1 predicts an association between the likelihood of quantitatively material (versus immaterial) waived misstatements and audit fees. The results of tests of this hypothesis appear in Table 6.<sup>17</sup> The results show a negative association between the likelihood of a company waiving a quantitatively material misstatement and audit fees (*LNAUDIT*,  $p = 0.021$ ), abnormal audit fees (*ABNORMALAUDIT*,  $p = 0.078$ ), and the firm rank of audit fees (*FIRMAUDIT*,  $p = 0.040$ ). Analyzing economic effects, a one standard deviation increase in *FEE* from its mean results in a 1.8 percent to 3.4 percent *decrease* in the probability of a company waiving a quantitatively material versus immaterial misstatement. Thus, these results are consistent with the theory that auditors act to protect their reputations by being less (more) likely to allow a material misstatement to remain uncorrected in the financial statements when their audit fees are higher (lower). The results are not consistent with the theory of economic dependence.<sup>18</sup>

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<sup>16</sup> As a sensitivity test, we re-estimate Models 1 and 2 (results not tabled) after removing *ASSETS* and find inferentially the same hypothesized results. Thus, our results do not appear to be due to collinearity.

<sup>17</sup> We estimate models in Table 6 and Table 7 and all sensitivity tests using robust standard errors clustered by company. We also winsorize all continuous variables at the 1<sup>st</sup> and 99<sup>th</sup> percentiles.

<sup>18</sup> Historically, auditors and managers used one of two methods to quantify and evaluate misstatements. In our sample, companies representing 55.8 (53.0) percent of misstatements in Table 6 (Table 7) used the rollover method, and 1.0 (0.3) percent of misstatements in Table 6 (Table 7) used the iron curtain method prior to SAB 108. The remaining companies did not disclose a historical materiality approach. To examine the sensitivity of our results to historical materiality approach, we re-perform the analyses in Table 6 and Table 7 and include an indicator variable for “rollover” method and an indicator variable for “iron curtain” method. These variables are not significant ( $p > 0.10$ ) in our models and do not change the inferences we draw regarding our hypothesis tests.

### Insert Table 6 Here

Considering control variables that present consistent results across the various fee variable models, the results show that companies waiving quantitatively material misstatements are less likely to be audited by a Big 4 firm, have lower relative levels of accounts receivables and inventories, and are less likely to have a material weakness in internal control compared to companies waiving quantitatively immaterial misstatements.

### Model 2: Tests of H2, H3, and H4

H2 predicts a positive association between the likelihood of qualitatively material (versus immaterial) waived misstatements and the level of security analyst following. H3 predicts an association between the likelihood of qualitatively material (versus immaterial) waived misstatements and audit fees. H4 predicts an interaction between security analyst following and audit fees. Table 7 presents evidence on these hypotheses.<sup>19</sup>

### Insert Table 7 Here

The results show a positive association between analyst following and the likelihood of a company waiving a qualitatively material misstatement in models using the level of audit fees (*LNAUDIT*,  $p = 0.010$ ), abnormal audit fees (*ABNORMALAUDIT*,  $p = 0.013$ ), and the firm rank of audit fees (*FIRMAUDIT*,  $p = 0.004$ ).<sup>20</sup> The results also show a negative association between

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<sup>19</sup> *LNNUMEST* and *FEE* are mean centered in the model to aid interpretation in testing H2 and H3. These mean centered variables are then used to calculate *FEE\_C \* LNNUMEST\_C*.

<sup>20</sup> In addition to the role of analyst pressure, managers face pressure based on their compensation contracts and performance goals therein (e.g., Burns and Kedia 2006; Efendi et al. 2007). However, Collins et al. (2008) show that firms penalize executives via lower bonuses for both the detection of low quality financial reporting and the subsequent restatement of financial statements. Thus, while compensation contracts provide incentives for aggressive financial reporting, there are also competing incentives for accurate financial reporting and the maintenance of a high quality management reputation (Desai et al. 2006). To examine the effects of compensation contracts on managers' incentives, we re-perform the Model 2 analyses in Table 7 and include compensation contract variables (i.e., cash bonus to salary ratio, number of shares owned by CEO deflated by total shares outstanding, number of stock options paid to CEO deflated by total shares outstanding, and percentage of stock-based CEO compensation). Consistent with the competing incentives provided by these contracts, these variables are not significantly related to the likelihood of qualitatively material misstatements in any of the analyses ( $p > 0.10$ ).

the likelihood of waiving a qualitatively material misstatement and audit fees in models using the level of audit fees (*LNAUDIT*,  $p = 0.032$ ), abnormal audit fees (*ABNORMALAUDIT*,  $p = 0.028$ ), and firm rank of audit fees (*FIRMAUDIT*,  $p = 0.018$ ).

However, these results should be interpreted in light of the negative interactions between analyst following and the level of audit fees (*LNAUDIT*,  $p = 0.001$ ), abnormal audit fees (*ABNORMALAUDIT*,  $p = 0.042$ ), and firm rank of audit fees (*FIRMAUDIT*,  $p = 0.000$ ). Figure 2 illustrates this interaction at three levels of audit fee magnitude (*LNAUDIT*) across the sample range of security analyst following (*LNNUMEST*). For example, when *LNAUDIT* is low (i.e., the 20<sup>th</sup> percentile) and *LNNUMEST* is high (i.e., the 80<sup>th</sup> percentile) there is a high probability (approximately 80 percent) that a detected misstatement will be waived to achieve the analysts' consensus forecasts. Thus, the joint role of analyst following and audit fees is important in determining managers' decisions to waive qualitatively material misstatements that, if corrected, will result in missing rather than meeting or beating their consensus earnings forecasts. The pattern of results implies that analyst pressure creates incentives for managers to waive qualitatively material misstatements and that auditors seek to protect their reputations by being even less likely to allow the waiving of material misstatements as audit fees become higher.

### **Insert Figure 2 Here**

To further understand the interaction term, we examine the interaction effects (i.e., marginal effects of the interaction term, which is the impact a one unit change in the interaction term has on the probability of *MEETBEAT*=1) in Model 2 (Ai and Norton 2003; Norton et al. 2004). A one unit change in *FEE*\**LNNUMEST* in the *LNAUDIT*, *ABNORMALAUDIT*, and *FIRMAUDIT* models represents a 8.7% ( $z = -1.76$ ,  $p = 0.08$ ), 9.6% ( $z = -1.76$ ,  $p = 0.08$ ), and 64.4% ( $z = -1.82$ ,  $p = 0.07$ ), respectively, decrease in the probability that managers waive

misstatements that, if corrected, would change reported meeting or beating analysts' consensus forecasts to missing these forecasts. In addition, Figure 3 Panel A and Panel B graphically illustrate the interaction effect in the *LNAUDIT* model. Figure 3 Panel A reveals that the interaction effects for 92% of the observations in the *LNAUDIT* model are negative, while Figure 3 Panel B graphically reveals that 58% of the z-statistics for the observations' interaction effects are significantly negative ( $p < 0.10$ ). Together, these interpretations of the interaction effects are consistent with the importance of the joint role of managers' and auditors' incentives on the waiving of qualitatively material versus immaterial misstatements.

### **Insert Figure 3 Here**

Considering control variables that present consistent results across the various fee variable models, the results show that companies waiving qualitatively material misstatements are more likely to have misstatements involving complex accounting judgments, have higher relative levels of inventories and receivables, and have lower levels of sales growth compared to companies waiving qualitatively immaterial misstatements.

### **Robustness Checks**

#### ***Alternative Quantitative Materiality Benchmarks***

To examine the sensitivity of our Model 1 results to dependent variable measurement, we eliminate from our sample those companies with current year losses and breakeven results to arrive at a sample of 496 misstatements. We then re-estimate Model 1 (results not tabled) with a dependent variable that equals one when the misstatement is greater than five percent of net income, greater than one percent of total assets, or greater than one percent of total sales, and that equals zero otherwise. We find inferentially the same results in the *LNAUDIT* (coef. = -0.625,  $p = 0.018$ ), *ABNORMALAUDIT* (coef. = -0.578,  $p = 0.033$ ), and *FIRMAUDIT* (coef. = -2.349,  $p =$

0.056) variables as in our primary tests. Thus, our results for H1 are robust to alternative quantitative materiality benchmarks.<sup>21</sup>

### *Company-Level Sample and Analyses*

Our primary tests use misstatement-level data. We examine the sensitivity of our results to this choice by re-estimating Model 1 and Model 2 using dependent variables that are measured using the company-level netted or aggregated sum of misstatements. We also remove the variable *MIS\_TYPE* because it is not relevant in company-level analyses. The results for Model 1 (not tabled) are weaker than in our primary tests: *LNAUDIT* (coef. = -0.360,  $p = 0.261$ ), *ABNORMALAUDIT* (coef. = -0.282,  $p = 0.348$ ), and *FIRMAUDIT* (coef. = -2.510,  $p = 0.076$ ). Thus, there remains some marginal support for H1 when analyses are performed at the company level, but only in the case of *FIRMAUDIT*. The results for Model 2 (not tabled) are inferentially the same as in our primary tests: *LNNUMEST* and *FEE* in the *LNAUDIT* (coef. = 0.560,  $p = 0.083$ ; coef. = -0.853,  $p = 0.021$ ), *ABNORMALAUDIT* (coef. = 0.548,  $p = 0.111$ ; coef. = -0.780,  $p = 0.014$ ), and *FIRMAUDIT* (coef. = 0.605,  $p = 0.062$ ; coef. = -4.954,  $p = 0.012$ ) models. The results for the *LNNUMEST*\**FEE* interactions in the *LNAUDIT* (coef. = -0.579,  $p = 0.004$ ), *ABNORMALAUDIT* (coef. = -0.675,  $p = 0.028$ ), and *FIRMAUDIT* (coef. = -4.227,  $p = 0.004$ ) models are also inferentially the same as in our primary tests. Thus, these robustness checks provide further assurances regarding the conclusions we draw concerning H2, H3, and H4.

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<sup>21</sup> We also re-estimate our models using the variable, *OfficeAudit*, which is the client's percentile rank of audit fees within the audit firm's office. This variable represents the importance of the client to the local office and its partners (Reynolds and Francis 2001). The results show a positive relation between security analyst following and qualitatively material misstatements ( $p \leq 0.01$ ), but the main effect of *FEE* (measured as *OfficeAudit*) in Model 1 is insignificant, as is the main effect of *FEE* and the interaction of *FEE\_C* \* *LNNUMEST\_C* in Model 2. These insignificant results concerning *OfficeAudit* are similar to those in Braun (2001), which also reports that *OfficeAudit* is not associated with the materiality of waived misstatements.

## V. CONCLUSIONS

This paper uses data derived from SAB 108 disclosures on previously uncorrected financial statement misstatements to investigate the roles of managers' incentives (e.g., analyst pressure) and auditors' incentives (e.g., economic, regulatory, litigation, and ethical) in materiality judgments concerning the resolution of these misstatements. We acknowledge that there exist certain limitations to our analyses. First, we do not measure all of managers' or auditors' incentives, nor do we consider the potential moderating role of elements of corporate governance in affecting those incentives. Rather, we proxy for managers' and auditors' incentives using measures of analyst following and audit fees, and in sensitivity tests we show that manager compensation is unrelated to the qualitative materiality of waived misstatements. Future research may examine other incentives or the role of corporate governance in relation to previously waived misstatements. Second, the data include only those disclosures on misstatements that were initially judged immaterial and then subsequently judged material under SAB 108. There exists two other potential misstatement samples: (1) those misstatements that managers and auditors immediately deemed material and therefore corrected in the initial period of detection and (2) those misstatements that were waived in the initial period of detection and that were not subsequently disclosed or corrected under SAB 108 even though managers and auditors judged them to be material (although note that judgments leading to this latter sample would flagrantly violate managers' and auditors' regulatory and ethical principles). Those potential misstatement samples are of obvious theoretical interest, but the data that would enable analysis of such possible misstatements are not publicly available. Third, we acknowledge that the relative number of misstatements in our sample (869 for the quantitative materiality model - of which 109 exceed the one percent of net sales materiality threshold, and 372 for the

qualitative materiality model – of which 91 were material) are a relatively small number of individual misstatements in relation to the overall number of transactions occurring for publicly traded entities during our sample period.

Turning to conclusions about our overall results, we first find that there exists a negative association between the likelihood of managers waiving (and auditors concurring with the waiving of) either quantitatively material misstatements (i.e., those exceeding the common size threshold of one percent of net sales) or qualitatively material misstatements (i.e., those that, when waived, enable managers to meet or beat rather than miss analysts' consensus forecasts) and audit fees, abnormal audit fees, and the firm rank of audit fees. Thus, while prior research notes that auditors have incentives to allow managers to waive detected misstatements based on the theory of economic dependence, our results are more consistent with the theory of auditor reputation protection, showing that auditors make materiality judgments that are consistent with their incentives concerning regulation, litigation, and professional ethics. While unobservable, we posit that the mechanism by which this may occur is via audit effort. Audit fees that are higher overall, higher than "normal", and higher in terms of audit firm importance provide greater resources to the audit firm to obtain evidence necessary to talk managers away from relatively aggressive financial reporting preferences (Kinney et al. 2004). Thus, while higher audit fees may provide incentives for auditors to yield to client pressures, they also heighten the visibility of auditors' judgments in this era of publicly available audit fee data, and through increased effort auditors are able to find ways to encourage managers to yield to auditor demands for reputation protection when their exposure to that visibility is high. This interpretation is consistent with Bedard and Johnstone (2004), who find a positive association between earnings management risk (of which the most common indicator is a client with a history of exactly

meeting consensus earnings estimates) and audit effort and fees. We find these results across robust and varied measures of audit fees, and we report sensitivity tests that provide further assurances regarding these results.

Our second major conclusion is that there exists a positive association between the level of analyst following and the likelihood of managers waiving qualitatively material misstatements. This association implies that analyst pressure creates incentives for managers to use aggressive financial reporting, especially in situations in which a company is close to missing its consensus forecast. Third, the results show that the incentives for managers associated with analyst following are mitigated by auditors' concerns about their own reputations. Specifically, the results show that auditors are less likely to allow managers to waive qualitatively material misstatements as audit fees increase. Thus, while the results in Wright and Wright (1997) illustrate the importance of manager pressure on auditors, our results are consistent with the findings in Frankel et al. (2002), who find that audit fees are negatively associated with managers' earnings management, illustrating that the company's financial importance to the audit firm provides the auditors with strong incentives to invest in reputational capital, at least in the post-SOX time period of our sample period. Taken together, these results illustrate the complex interplay between analyst following, the associated pressure on managers, and the important role that auditors play in curbing aggressive financial reporting.



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## APPENDIX

### Examples of SAB 108 Disclosures

#### **Panel A: Excerpt from Navigant Consulting, Inc. December 31, 2006 10-K**

“The Company adopted SAB 108 during the fourth quarter of 2006 and accordingly, the Company recorded a \$5.8 million, net of tax, cumulative effect of accounting change to accumulated deficit as of January 1, 2006. The \$5.8 million cumulative effect of accounting change related to certain payments in connection with previously disclosed acquisitions and revenue recognition related to a long-term claims processing engagement. The cumulative effect of accounting change related to payments in connection with previously disclosed acquisitions aggregated \$4.4 million. The Company has determined that such payments previously determined to be purchase price were compensatory in nature. The net income impact of the additional compensation expense would have been \$0.2 million in 2002, \$1.3 million in 2003, \$1.5 million in 2004, and \$1.4 million in 2005. The cumulative effect of the accounting change related to the revenue recognition of a long-term claims processing engagement was \$1.4 million. If revenue had been recorded correctly, net income would have been reduced by \$0.8 million in 2004 and \$0.6 million in 2005. The error related to an inadvertent acceleration of revenue based on billing terms.”

#### **Illustration of misstatement level data extracted from disclosure:**

<b>Misstatement type</b>	<b>2002<sup>a</sup></b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Business combinations	-200,000	-1,300,000	-1,500,000	-1,400,000
Revenue recognition	-	-	-800,000	-600,000

<sup>a</sup> Our sample period is from January 1, 2003 to September 30, 2006.

#### **Panel B: Excerpt from Websense, Inc. December 31, 2006 10-K**

“The Company reviewed its revenue recognition policy in consideration of guidance provided in SOP 97-2 and concluded that its prior accounting policy (effective since 1997) to recognize revenue on a monthly straight-line basis, commencing with the month the subscription begins is not consistent with SOP 97-2. As a result, the Company has adjusted revenue as recognized on a daily straight-line basis, commencing on the day rather than the month the subscription begins...

<b>Years Ended December 31,</b>	<b>Net after-tax effect of adjustment</b>	<b>Reported net income</b>	<b>Percent of reported net income</b>
2005	\$ 1,259	\$ 38,768	3.25%
2004	1,375	26,176	5.25%
2003	770	16,688	4.62%
2002	824	16,737	4.92%
<b>Total</b>	<b>\$ 4,228</b>	<b>\$ 98,369</b>	<b>4.30%</b>

#### **Illustration of misstatement level data extracted from disclosure:**

<b>Misstatement type</b>	<b>2002<sup>a</sup></b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Revenue recognition	-824,000	-770,000	-1,375,000	-1,259,000

<sup>a</sup> Our sample period is from January 1, 2003 to September 30, 2006.

**TABLE 1**  
**Misstatements Sample**

**Panel A: Number of Misstatements**

	<b>Misstatements<sup>a</sup></b>
Misstatements with identifying data	1,290
Less: Misstatements detected by companies in the same year the misstatements were corrected	295
Less: Non-U.S. and holding companies	32
Less: Compustat missing data	7
Less: Audit Analytics missing data	87
<b>Final Model 1 sample</b>	<b>869</b>
Less: IBES missing data	214
Less: Companies that do not meet or beat analyst median consensus forecast	283
<b>Final Model 2 sample</b>	<b>372</b>

**Notes:** <sup>a</sup> Sample period is from January 1, 2003 to September 30, 2006.

**Panel B: Sample Frequency by Industry**

<b>Industry Description</b>	<b>2 Digit SIC Codes</b>	<b>% of Misstatements</b>	
		<b>Model 1 (n=869)</b>	<b>Model 2 (n=372)</b>
Ag., Forestry, Mining	00 – 19	8.2%	7.8%
Manufacturing 1	20 – 29	13.7%	12.4%
Manufacturing 2	30 – 39	9.6%	12.9%
Trans., Comm., Utilities	40 – 49	10.4%	6.5%
Wholesale and Retail	50 – 59	6.4%	9.4%
Banks, Insurance, Real Estate	60 – 69	27.0%	22.6%
Hotels and Services	70 – 79	19.7%	25.0%
Health, Legal, Ed., Eng. Svcs	80 – 99	5.1%	3.5%
Total <sup>a</sup>		100.0%	100.0%

**Notes:** <sup>a</sup> Percentages do not sum to 100.0 due to rounding.

**Panel C: Sample Frequency by Year**

<b>Year</b>	<b>% of Misstatements</b>	
	<b>Model 1 (n=869)</b>	<b>Model 2 (n=372)</b>
2003	25.8%	24.2%
2004	30.5%	31.5%
2005	37.7%	37.4%
2006 <sup>a</sup>	6.0%	7.0%
Total <sup>b</sup>	100.0%	100.0%

**Notes:** <sup>a</sup> The 2006 period is from January 1, 2006 to September 30, 2006. <sup>b</sup> Percentages do not sum to 100.0 due to rounding.

**TABLE 2**  
**Variable Definitions**

Variable Name	Description
<b>Dependent Variables:</b>	
<i>QUANTITATIVEREV</i>	= 1 if abs(misstatement amount / net sales using Compustat “sale”) is $\geq 1\%$ ; 0 otherwise.
<i>MEETBEAT</i>	= 1 if company reported basic EPS that meet or beat last analysts’ median consensus forecast before earnings report, but would have missed the forecast if it corrected the misstatement; 0 otherwise.
<b>Independent Variables:</b>	
<i>FEE</i>	= <i>LNAUDIT</i> , <i>ABNORMALAUDIT</i> , and <i>FIRMAUDIT</i> , respectively.
<i>LNAUDIT</i>	= ln(Audit Fees) from Audit Analytics.
<i>ABNORMALAUDIT</i>	= Residual (i.e., <i>LNAUDIT</i> – predicted value) from audit fee estimation model where a negative (positive) value implies audit fees lower (higher) than predicted for auditor’s effort and risk.
<i>FIRMAUDIT</i>	= Fractional percentile rank of client’s audit fees within auditor’s firm in Audit Analytics where higher values imply larger fees.
<i>LNNUMEST</i>	= ln(number of analysts’ forecasts determining consensus) using IBES “numest”.
<b>Control Variables:</b>	
<i>MIS_TYPE</i>	= 1 if revenue, reserve, tax, derivative, business combination, lease, pension, or stock option misstatement; 0 otherwise.
<i>TENURE</i>	= 1 if auditor tenure in Audit Analytics is 3 or more years; 0 otherwise.
<i>BIG_N</i>	= 1 if KPMG, PricewaterhouseCoopers, Deloitte, or Ernst & Young is auditor in Audit Analytics; 0 otherwise.
<i>INVREC</i>	= Sum of total inventory (Compustat “inv”) and total receivables (Compustat “rect”) deflated by total assets (Compustat “at”).
<i>AGE</i>	= ln(data year – first year company listed in Compustat).
<i>MW</i>	= 1 if SOX Section 302 or 404 material weakness is reported in 10-K according to Audit Analytics; 0 otherwise.
<i>LITRISK</i>	= 1 if industry is 2833-2836, 8731-8734, 3570-3577, 7370-7374, 3600-3674, 5200-5961; 0 otherwise.
<i>LOSS</i>	= 1 if net loss in any of last three years (using Compustat “ib”); 0 otherwise.
<i>SEG</i>	= ln(number of business segments from Compustat segment file).
<i>SALES GROWTH</i>	= (current year net sales - prior year net sales) / prior year net sales (using Compustat “sale”).
<i>ASSETS</i>	= ln(total assets) using Compustat “at”.
<i>Industry</i>	= Industry dummy variables are SIC 01-14, SIC 15-19, SIC 20-21, SIC 22-23, SIC 24-27, SIC 28-32, SIC 33-34, SIC 35-39, SIC 40-48, SIC 49, SIC 50-52, SIC 53-59, SIC 60-69, and SIC 70-79.
<i>Year</i>	= Year dummy variables.



**TABLE 3**  
**Relative Size of Quantitatively and Qualitatively Material Waived Misstatements**

**Panel A: Model 1 Quantitatively Material Misstatements**

<b>Percent of net sales<sup>a</sup></b>	<b>Number</b>	<b>%</b>
1.00 to 1.49 percent	49	45.0%
1.50 to 1.99 percent	14	12.8%
2.00 to 2.99 percent	21	19.3%
3.00 to 3.99 percent	10	9.2%
4.00 to 4.99 percent	6	5.5%
5.00 or more percent	9	8.3%
<b>Total misstatements<sup>b</sup></b>	<b>109</b>	<b>100%</b>

**Notes:** <sup>a</sup> Quantitatively material misstatements refers to *QUANTITATIVE*=1. Levels represent abs(misstatement amount) as a percentage of net sales (Compustat “sale”). <sup>b</sup> Percentages do not sum to 100.0 due to rounding.

**Panel B: Model 2 Qualitatively Material Misstatements**

<b>Reported earnings per share</b>	<b>Number</b>	<b>%</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>Med</b>
Meet forecast	20	22.0%	0.05	0.07	0.02
Beat by one cent	29	31.9%	0.06	0.06	0.04
Beat by two cents	13	14.3%	0.08	0.07	0.06
Beat by three cents	10	11.0%	0.07	0.05	0.04
Beat by four to five cents	6	6.6%	0.08	0.04	0.07
Beat by six to ten cents	10	11.0%	0.12	0.05	0.11
Beat by eleven or more cents	3	3.3%	0.37	0.16	0.46
<b>Total misstatements<sup>b</sup></b>	<b>91</b>	<b>100.0%</b>	<b>0.08</b>	<b>0.09</b>	<b>0.05</b>

**Notes:** <sup>a</sup> Qualitatively material misstatements refers to *MEETBEAT*=1. Amounts represent abs(misstatement amount) divided by number of shares used to calculate earnings per share (Compustat “cshpri”). <sup>b</sup> Percentages do not sum to 100.0 due to rounding.

**TABLE 4**  
**Descriptive Statistics**

**Panel A: Comparison of Quantitatively Material to Immaterial Misstatements (Model 1)**

Variables <sup>b</sup>	Quantitatively Material Misstatements <sup>a</sup> (n=109)			Quantitatively Immaterial Misstatements <sup>a</sup> (n=760)			stat <sup>c</sup>	p- value <sup>c</sup>
	Mean	Std. Dev.	Med	Mean	Std. Dev.	Med		
<i>LNAUDIT</i>	13.02	1.10	13.07	13.76	1.28	13.74	-6.439	<0.001
<i>ABNORMALAUDIT</i>	-0.32	0.79	-0.20	-0.13	0.77	-0.17	-2.417	0.016
<i>FIRMAUDIT</i>	0.63	0.20	0.64	0.72	0.20	0.76	-4.671	<0.001
<i>MIS_TYPE</i>	0.63	0.48	1.00	0.50	0.50	0.50	6.233	0.013
<i>TENURE</i>	0.61	0.49	1.00	0.70	0.46	1.00	-2.955	0.086
<i>BIG_N</i>	0.76	0.43	1.00	0.86	0.34	1.00	-6.970	0.008
<i>INVREC</i>	0.22	0.24	0.12	0.32	0.25	0.27	-3.699	<0.001
<i>AGE</i>	2.42	0.50	2.56	2.55	0.43	2.64	-2.643	0.009
<i>MW</i>	0.07	0.26	0.00	0.15	0.36	0.00	4.144	0.042
<i>LITRISK</i>	0.29	0.46	0.00	0.20	0.40	0.00	4.457	0.035
<i>LOSS</i>	0.45	0.50	0.00	0.37	0.48	0.00	2.011	0.156
<i>SEG</i>	0.98	0.83	0.69	1.22	0.84	1.10	-2.700	0.007
<i>SALESGROWTH</i>	0.15	0.29	0.08	0.14	0.24	0.09	0.180	0.857
<i>ASSETS</i>	6.25	1.71	6.34	6.99	1.69	6.78	-4.309	<0.001

**Notes:** <sup>a</sup> Quantitatively material misstatements refers to *QUANTITATIVE*REV = 1. Quantitatively immaterial misstatements refers to *QUANTITATIVE*REV = 0. <sup>b</sup> Variable definitions are located in the Table 2. <sup>c</sup> Continuous variable statistics are t-stats from means tests. Indicator variable statistics are Chi-Squares with continuity corrections. All p-values are two-sided.

**TABLE 4 – Continued**

**Panel B: Comparison of Qualitatively Material to Immaterial Misstatements (Model 2)**

Variables <sup>b</sup>	Qualitatively Material Misstatements <sup>a</sup> (n=91)			Qualitatively Immaterial Misstatements <sup>a</sup> (n=281)			stat <sup>c</sup>	p- value <sup>c</sup>
	Mean	Std. Dev.	Med	Mean	Std. Dev.	Med		
<i>LNNUMEST</i>	1.60	1.00	1.79	1.50	1.09	1.39	0.834	0.405
<i>LNAUDIT</i>	13.71	0.99	13.75	14.01	1.29	13.96	-2.359	0.019
<i>ABNORMALAUDIT</i>	-0.23	0.70	-0.21	-0.01	0.74	0.00	-2.526	0.012
<i>FIRMAUDIT</i>	0.71	0.17	0.72	0.74	0.19	0.77	-1.592	0.113
<i>MIS_TYPE</i>	0.62	0.49	1.00	0.46	0.50	0.00	6.107	0.013
<i>TENURE</i>	0.74	0.44	1.00	0.74	0.44	1.00	0.000	1.000
<i>BIG_N</i>	0.96	0.21	1.00	0.97	0.17	1.00	0.149	0.700
<i>INVREC</i>	0.34	0.22	0.28	0.26	0.23	0.19	2.795	0.005
<i>AGE</i>	2.53	0.31	2.64	2.51	0.33	2.64	0.421	0.674
<i>MW</i>	0.11	0.31	0.00	0.12	0.33	0.00	0.010	0.922
<i>LITRISK</i>	0.25	0.44	0.00	0.30	0.46	0.00	0.508	0.476
<i>LOSS</i>	0.22	0.42	0.00	0.33	0.47	0.00	3.735	0.053
<i>SEG</i>	1.17	0.74	1.10	1.28	0.81	1.10	-1.211	0.228
<i>SALESGROWTH</i>	0.12	0.17	0.09	0.19	0.26	0.11	-3.174	0.002
<i>ASSETS</i>	7.16	1.54	7.53	7.21	1.79	7.28	-0.245	0.807

**Notes:** <sup>a</sup> Qualitatively material (immaterial) SAB 108 misstatements are *MEETBEAT* = 1 (0). <sup>b</sup> Variable definitions are located in Table 2. <sup>c</sup> Continuous variable statistics are t-stats from means tests. Indicator variable statistics are Chi-Squares with continuity corrections. All p-values are two-sided.

**TABLE 5**  
**Pearson and Spearman Correlation Analyses**

**Panel A: Model 1 Misstatements**

	<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>12</i>	<i>13</i>	<i>14</i>	<i>15</i>
<i>1.QUANTITATIVE</i> <i>REV</i>		-0.19 **	-0.08 *	-0.16 **	0.09 **	-0.06	-0.09 **	-0.12 **	-0.10 **	-0.07 *	0.08 *	0.05	-0.09 **	0.01	-0.14 **
<i>2.LNAUDIT</i>	-0.20 **		0.73 **	0.85 **	-0.01	0.26 **	0.33 **	-0.28 **	0.34 **	0.15 **	0.04	0.08 *	0.40 **	-0.07 *	0.63 **
<i>3.ABNORMALAUDIT</i>	-0.07 *	0.70 **		0.60 **	-0.01	0.20 **	0.18 **	-0.22 **	0.18 **	0.03	0.05	0.19 **	0.25 **	-0.03	0.05
<i>4.FIRMAUDIT</i>	-0.16 **	0.87 **	0.57 **		0.02	0.08 *	-0.02	-0.20 **	0.26 **	0.14 **	0.04	0.14 **	0.31 **	-0.09 *	0.54 **
<i>5.MIS_TYPE</i>	0.09 **	0.00	-0.01	0.04		-0.10 **	-0.08 *	0.00	0.00	-0.08 *	-0.06	0.03	-0.01	-0.01	0.02
<i>6.TENURE</i>	-0.06	0.23 **	0.19 **	0.07 *	-0.10 **		0.31 **	-0.15 **	0.21 **	0.04	-0.04	-0.09 **	0.19 **	0.05	0.20 **
<i>7.BIG_N</i>	-0.09 **	0.31 **	0.16 **	-0.05	-0.08 **	0.31 **		-0.33 **	0.22 **	-0.01	0.01	-0.07 *	0.21 **	-0.04	0.28 **
<i>8.INVREC</i>	-0.14 **	-0.27 **	-0.16 **	-0.18 **	-0.01	-0.14 **	-0.32 **		-0.22 **	-0.13 **	-0.22 **	-0.15 **	-0.34 **	-0.03	-0.03
<i>9.AGE</i>	-0.10 **	0.33 **	0.20 **	0.22 **	-0.02	0.21 **	0.18 **	-0.13 **		-0.02	-0.14 **	-0.09 **	0.24 **	-0.19 **	0.32 **
<i>10.MW</i>	-0.07 *	0.16 **	0.03	0.13 **	-0.08 *	0.04	-0.01	-0.11 **	0.02		0.05	0.03	0.16 **	0.09 **	-0.13 **
<i>11.LITRISK</i>	0.08 *	0.05	0.05	0.03	-0.06	-0.04	0.01	-0.16 **	-0.15 **	0.05		0.17 **	0.01	0.01	-0.16 **
<i>12.LOSS</i>	0.05	0.09 **	0.20 **	0.15 **	0.03	-0.09 **	-0.07 *	-0.16 **	-0.19 **	0.03	0.17 **		0.11 **	-0.10 **	-0.31 **
<i>13.SEG</i>	-0.09 **	0.41 **	0.26 **	0.35 **	-0.01	0.20 **	0.21 **	-0.29 **	0.25 **	0.15 **	-0.01	0.10 **		0.07 *	0.12 **
<i>14.SALES</i> <i>GROWTH</i>	-0.01	-0.05	-0.01	-0.11 **	-0.01	0.07 *	0.03	-0.01	-0.10 **	0.10 **	0.03	-0.16 **	0.11 **		-0.05
<i>15.ASSETS</i>	-0.13 **	0.60 **	0.04	0.55 **	0.03	0.18 **	0.27 **	-0.06	0.33 **	-0.15 **	-0.18 **	-0.28 **	0.09 **	-0.05	

**Notes:** Variable definitions are located in Table 2. Pearson correlation statistics are in the upper right portion of the table. Spearman correlation statistics are in the lower left portion of the table. \* and \*\* indicate significance at  $p < 0.05$  and  $p < 0.01$  (two-tailed), respectively. N=869.

**TABLE 5 – Continued**  
**Panel B: Model 2 Misstatements**

	<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>12</i>	<i>13</i>	<i>14</i>	<i>15</i>	<i>16</i>
<i>1.MEETBEAT</i>		0.04	-0.11 *	-0.13 *	-0.08	0.13 **	0.00	-0.04	0.14 **	0.02	-0.01	-0.04	-0.11 *	-0.06	-0.13 *	-0.01
<i>2.LNNUMEST</i>	0.05		0.57 **	0.13 *	0.56 **	0.05	0.02	0.19 **	-0.12 *	0.11 *	0.06	0.19 **	-0.09	-0.05	0.00	0.64 **
<i>3.LNAUDIT</i>	-0.10	0.56 **		0.68 **	0.90 **	0.05	0.19 **	0.10	0.02	0.26 **	0.11 *	-0.05	0.01	0.31 **	-0.04	0.70 **
<i>4.ABNORMALAUDIT</i>	-0.13 *	0.13 *	0.66 **		0.54 **	0.03	0.12 *	0.09	0.10	0.06	-0.13 **	-0.01	0.05	0.17 **	0.03	0.09
<i>5.FIRMAUDIT</i>	-0.10	0.58 **	0.93 **	0.53 **		0.07	0.07	-0.10	-0.02	0.24 **	0.06	-0.05	0.04	0.25 **	-0.10	0.69 **
<i>6.MIS_TYPE</i>	0.13 **	0.06	0.05	0.03	0.08		-0.08	-0.15 **	0.02	0.02	0.02	-0.09	0.02	0.08	0.03	0.03
<i>7.TENURE</i>	0.00	0.03	0.17 **	0.12 *	0.09	-0.08		0.13 *	0.03	0.02	0.05	-0.04	-0.08	0.23 **	0.00	0.16 **
<i>8.BIG_N</i>	-0.04	0.19 **	0.09	0.08	-0.11 *	-0.15 **	0.13 *		-0.13 **	0.05	0.02	0.02	-0.08	-0.10	0.09	0.10
<i>9.INVREC</i>	0.17 **	-0.11 *	0.01	0.15 **	-0.01	0.03	0.04	-0.13 *		-0.09	-0.11 *	-0.28 **	-0.24 **	-0.10	-0.02	0.13 **
<i>10.AGE</i>	-0.02	0.15 **	0.38 **	0.21 **	0.30 **	0.04	0.04	0.02	-0.05		-0.16 **	-0.19 **	-0.27 **	0.30 **	-0.23 **	0.37 **
<i>11.MW</i>	-0.01	0.05	0.12 *	-0.13 *	0.07	0.02	0.05	0.02	-0.13 *	-0.14 **		0.02	0.19 **	-0.03	0.09	-0.06
<i>12.LITRISK</i>	-0.04	0.18 **	-0.06	0.01	-0.07	-0.09	-0.04	0.02	-0.24 **	-0.17 **	0.02		0.17 **	-0.13 **	0.01	-0.22 **
<i>13.LOSS</i>	-0.11 *	-0.10	0.01	0.05	0.03	0.02	-0.08	-0.08	-0.27 **	-0.18 **	0.19 **	0.17 **		0.02	0.03	-0.27 **
<i>14.SEG</i>	-0.08	-0.04	0.31 **	0.20 **	0.31 **	0.08	0.23 **	-0.11 *	-0.06	0.29 **	-0.04	-0.15 **	0.01		0.08	0.14 **
<i>15.SALESGROWTH</i>	-0.09	0.09	0.00	0.07	-0.07	0.04	0.06	0.09	-0.02	-0.19 **	0.08	0.08	-0.04	0.10		-0.07
<i>16.ASSETS</i>	0.00	0.64 **	0.68 **	0.08	0.70 **	0.02	0.13 *	0.09	0.11 *	0.37 **	-0.06	-0.22 **	-0.24 **	0.12 *	-0.08	

**Notes:** Variable definitions are located in Table 2. Pearson correlation statistics are in the upper right portion of the table. Spearman correlation statistics are in the lower left portion of the table. \* and \*\* indicate significance at  $p < 0.05$  and  $p < 0.01$  (two-tailed), respectively. N=372.

**TABLE 6**  
**Logit Regression Model 1 - Tests of H1**

$$QUANTITATIVE REV = \alpha + \beta_1 FEE + \beta_2 MIS\_TYPE + \beta_3 TENURE + \beta_4 BIG\_N + \beta_5 INVREC + \beta_6 AGE + \beta_7 MW + \beta_8 LITRISK + \beta_9 LOSS + \beta_{10} SEG + \beta_{11} SALESGROWTH + \beta_{12} ASSETS + \beta_{13} Industry_i + \beta_{14} Year_i + \varepsilon$$

		<i>LNAUDIT</i> (n=869) <sup>a</sup>			<i>ABNORMALAUDIT</i> (n=869) <sup>a</sup>			<i>FIRMAUDIT</i> (n=869) <sup>a</sup>		
Variable <sup>b</sup>	Predicted Sign	Coef.	Prob. <sup>c</sup>	Economic Effect <sup>c</sup>	Coef.	Prob. <sup>c</sup>	Economic Effect <sup>c</sup>	Coef.	Prob. <sup>c</sup>	Economic Effect <sup>c</sup>
Constant		6.705	0.003		1.829	0.187		2.631	0.045	
<i>FEE</i> <sup>d</sup>	+/- (H1)	-0.506	0.021	-3.4%	-0.377	0.078	-1.8%	-2.245	0.040	-2.6%
<i>MIS_TYPE</i>	+	0.463	0.187	1.7%	0.448	0.200	1.7%	0.444	0.205	1.7%
<i>TENURE</i>	+/-	0.056	0.858	0.2%	0.048	0.879	0.2%	0.045	0.887	0.1%
<i>BIG_N</i>	+/-	-0.767	0.086	-1.7%	-0.810	0.069	-1.8%	-1.312	0.005	-2.7%
<i>INVREC</i>	+/-	-4.499	0.000	-4.9%	-4.441	0.000	-4.9%	-4.505	0.000	-4.9%
<i>AGE</i>	+/-	-0.095	0.830	-0.3%	-0.084	0.851	-0.3%	-0.101	0.817	-0.3%
<i>MW</i>	+/-	-0.835	0.057	-1.8%	-1.142	0.015	-2.4%	-0.879	0.046	-1.9%
<i>LITRISK</i>	+	0.661	0.178	2.1%	0.558	0.240	1.8%	0.609	0.209	1.9%
<i>LOSS</i>	+	0.411	0.263	1.5%	0.201	0.574	0.7%	0.336	0.375	1.2%
<i>SEG</i>	+	-0.188	0.486	-1.0%	-0.267	0.316	-1.4%	-0.224	0.398	-1.2%
<i>SALESGROWTH</i>	+	-0.568	0.262	-0.9%	-0.542	0.280	-0.9%	-0.518	0.299	-0.8%
<i>ASSETS</i>	+/-	-0.102	0.548	-1.1%	-0.363	0.004	-3.4%	-0.164	0.262	-1.7%
<i>Industry<sub>j</sub></i>	n/a									
<i>Year<sub>i</sub></i>	n/a									
Quantitatively material N			109			109			109	
Quantitatively immaterial N			760			760			760	
Pseudo R <sup>2</sup>			0.18			0.18			0.18	

**Notes:** The dependent variable equals one if abs(misstatement amount / net sales using Compustat “sale”) is  $\geq 1\%$ ; 0 otherwise. All standard errors are clustered by company.<sup>a</sup> Sample includes all SAB 108 misstatements from January 1, 2003 to September 30, 2006 with requisite data.<sup>b</sup> Variable definitions are located in Table 2. <sup>c</sup> All p-values are two-tailed. Economic effects for continuous independent variables represent the effect a one standard deviation increase from the mean has on the probability of the dependent variable being one and for dummy variables represent the effect a change from zero to one has on the probability of the dependent variable being one (Greene 2002; Long and Freese 2005). <sup>d</sup> *FEE* denotes *LNAUDIT*, *ABNORMALAUDIT*, and *FIRMAUDIT*, respectively.

TABLE 7

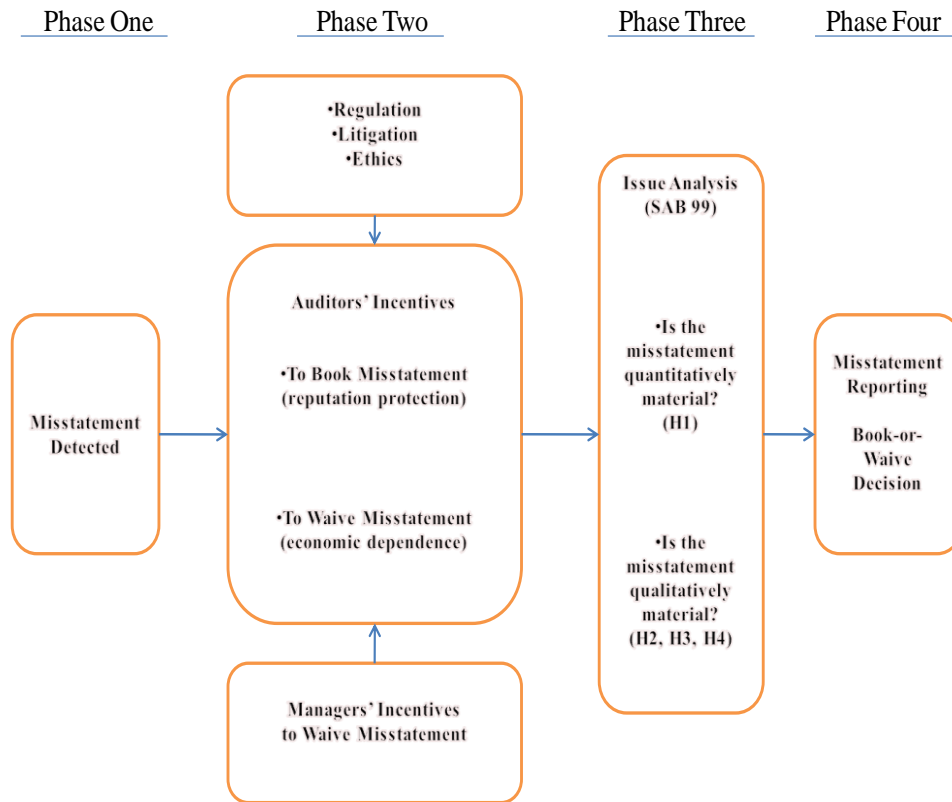
## Logit Regression Model 2 - Tests of H2, H3, and H4

$$MEETBEAT = \alpha + \beta_1 FEE\_C + \beta_2 LNNUMEST\_C + \beta_3 FEE\_C * LNNUMEST\_C + \beta_4 MIS\_TYPE + \beta_5 TENURE + \beta_6 BIG\_N + \beta_7 INVREC + \beta_8 AGE + \beta_9 MW + \beta_{10} LITRISK + \beta_{11} LOSS + \beta_{12} SEG + \beta_{13} SALES\_GROWTH + \beta_{14} ASSETS + \beta_{15} Industry_i + \beta_{16} Year_i + \varepsilon$$

		<i>LNAUDIT</i> (n=372) <sup>a</sup>			<i>ABNORMALAUDIT</i> (n=372) <sup>a</sup>			<i>FIRMAUDIT</i> (n=372) <sup>a</sup>		
Variable <sup>b</sup>	Predicted Sign	Coef.	Prob. <sup>c</sup>	Economic Effect <sup>c</sup>	Coef.	Prob. <sup>c</sup>	Economic Effect <sup>c</sup>	Coef.	Prob. <sup>c</sup>	Economic Effect <sup>c</sup>
Constant		-2.801	0.340		-0.283	0.901		-0.909	0.680	
<i>LNNUMEST_C</i> <sup>d</sup>	+ (H2)	0.630	0.010	14.6%	0.628	0.013	13.1%	0.752	0.004	18.2%
<i>FEE_C</i>	+/- (H3)	-0.851	0.032	-14.7%	-0.794	0.028	-8.1%	-5.252	0.018	-14.9%
<i>FEE_C * LNNUMEST_C</i> <sup>d</sup>	+/- (H4)	-0.461	0.001	-8.7%	-0.448	0.042	-9.6%	-3.712	0.000	-64.4%
<i>MIS_TYPE</i>	+	0.789	0.026	14.9%	0.771	0.031	12.8%	0.749	0.038	14.8%
<i>TENURE</i>	+/-	0.346	0.443	6.3%	0.391	0.386	6.1%	0.295	0.517	5.7%
<i>BIG_N</i>	+/-	0.176	0.856	3.2%	0.219	0.822	3.4%	-0.574	0.456	-12.6%
<i>INVREC</i>	+/-	1.919	0.051	9.2%	2.306	0.018	10.1%	1.862	0.053	9.3%
<i>AGE</i>	+/-	-0.051	0.941	-0.3%	0.267	0.712	1.5%	-0.062	0.929	-0.4%
<i>MW</i>	+/-	0.269	0.588	5.4%	-0.346	0.498	-5.3%	0.292	0.556	6.1%
<i>LITRISK</i>	+	-0.348	0.510	-6.4%	-0.464	0.373	-7.2%	-0.443	0.397	-8.4%
<i>LOSS</i>	+	-0.575	0.216	-10.3%	-0.560	0.222	-8.7%	-0.743	0.124	-13.7%
<i>SEG</i>	+	0.309	0.330	4.9%	0.065	0.817	0.9%	0.258	0.401	4.3%
<i>SALES\_GROWTH</i>	+	-2.116	0.018	-8.5%	-1.912	0.034	-6.7%	-2.272	0.012	-9.5%
<i>ASSETS</i>	+/-	0.095	0.706	3.2%	-0.375	0.035	-8.8%	0.055	0.814	1.9%
<i>Industry<sub>j</sub> and Year<sub>i</sub></i>	n/a									
Interaction effect (z-statistic, p-value)		-1.76	0.08		-1.76	0.08		-1.82	0.07	
Qualitatively material N			91		91			91		
Qualitatively immaterial N			281		281			281		
Pseudo R <sup>2</sup>			0.16		0.14			0.15		

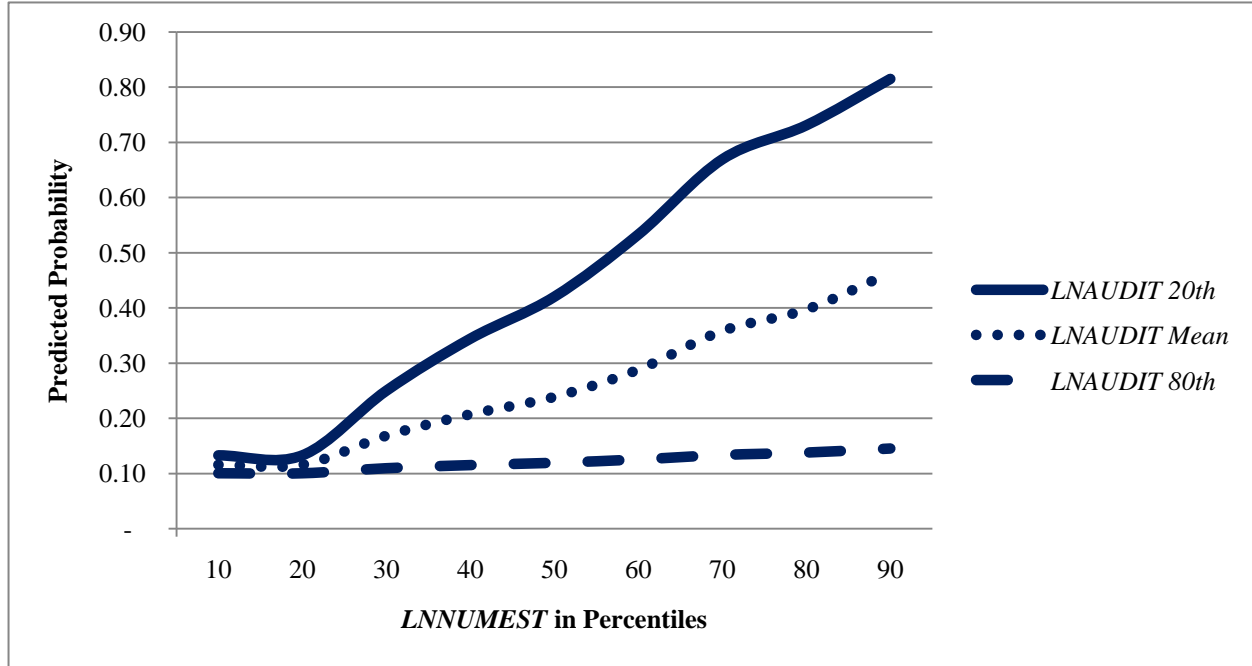
**Notes:** Dependent variable equals one if company reported basic EPS that meet or beat last analysts' median consensus forecast before earnings report, but would have missed the forecast if it corrected the misstatement; 0 otherwise. All standard errors are clustered by company. <sup>a</sup> Sample includes all SAB 108 misstatements from January 1, 2003 to September 30, 2006 with requisite data that meet or beat analysts' forecast. <sup>b</sup> Variable definitions are located in Table 2. *FEE* (denoted by *FEE\_C*) and *LNNUMEST* (denoted by *NUMEST\_C*) are mean centered. <sup>c</sup> All p-values are two-tailed, except for the directional expectation for H2. Economic effects for continuous independent variables represent the effect a one standard deviation increase from the mean (including adjusting the interaction term) has on the probability of the dependent variable being one and for dummy variables represent the effect a change from zero to one has on the probability of the dependent variable being one (Long and Freese 2005). The economic effect for the interaction term represents the marginal effect (the effect a one unit change in the interaction term has on the probability of *MEETBEAT* being one) calculated as informed by Norton and Ai (2003). <sup>d</sup> *FEE\_C* denotes mean centered *LNAUDIT*, *ABNORMALAUDIT*, and *FIRMAUDIT*, respectively.

**FIGURE 1**  
**The Manager-Auditor Resolution Process for Detected Misstatements**





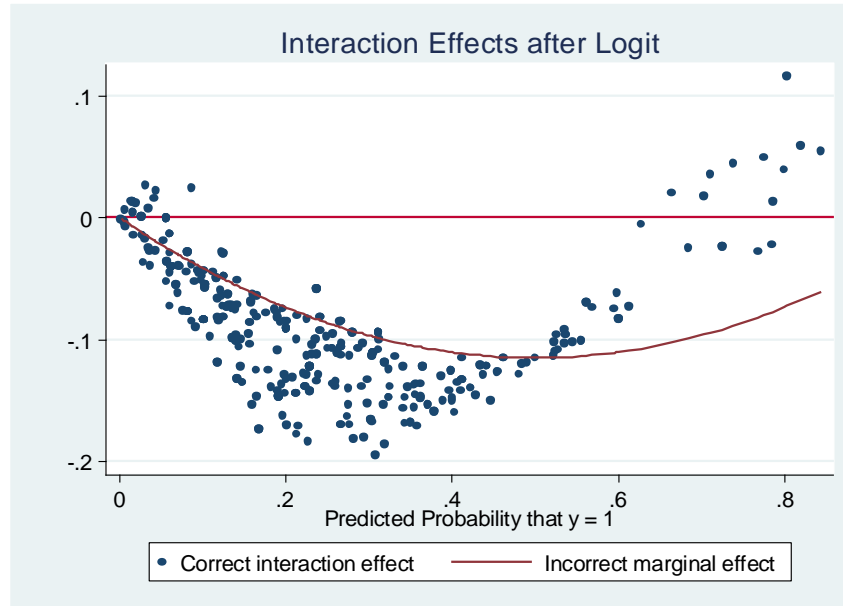
**FIGURE 2**  
**Illustration of *LNAUDIT* by *LNNUMEST* Interaction**



**Note:** The figure illustrates the effect that increasing *LNNUMEST* from the 10<sup>th</sup> to the 90<sup>th</sup> percentiles at three levels of *LNAUDIT* (the 20<sup>th</sup>, Mean, and 80<sup>th</sup>) has on the probability of *MEETBEAT*=1, when considering the effect of all other variables in the model at their means and the model constant. For example, when *LNAUDIT* is low (i.e., the 20<sup>th</sup> percentile) and *LNNUMEST* is high (i.e., the 80<sup>th</sup> percentile) the company has a high probability (approximately 80%) of using a qualitatively material waived misstatement to achieve its analysts' consensus forecast.

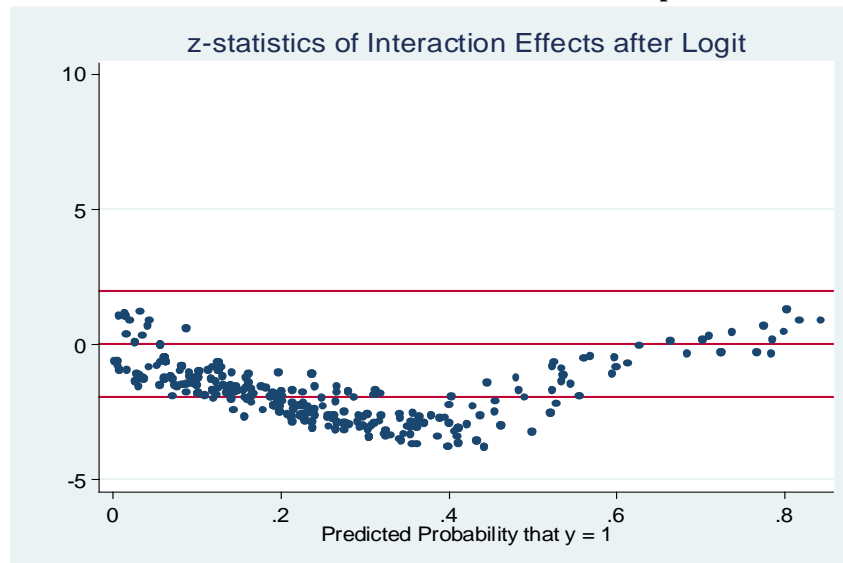
**FIGURE 3**  
**Illustration of *LNAUDIT* by *LNNUMEST* Interaction Effects**

**Panel A: Interaction effects of individual observations in sample**



**Note:** This figure produced by the “inteff” command in Stata (Norton et al. 2004) plots the *LNAUDIT* by *LNNUMEST* interaction effects for the observations in the Model 2 sample. The figure illustrates that an increase (a decrease) in the *LNAUDIT* by *LNNUMEST* interaction and related terms primarily results in a decrease (an increase) in the probability of *MEETBEAT*=1.

**Panel B: Z-statistics of interaction effects of individual observations in sample**



**Note:** This figure produced by the “inteff” command in Stata (Norton et al. 2004) plots observation level z-statistics for the *LNAUDIT* by *LNNUMEST* interaction effects in the Model 2 sample. The figure illustrates that Model 2 interaction effects are primarily significant and negative (i.e., below the lowest line) when the probability that *MEETBEAT*=1 ranges from approximately 0.2 to 0.6.