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Client Conservatism and Auditor-Client Contracting

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Abstract: Auditors risk costly litigation and loss of reputation when they are associated with clients that engage in substandard financial reporting, and prior research argues that accounting conservatism reduces managements' tendency to misreport. Thus, we predict that client conservatism affects auditor-client contracting by reducing auditor litigation and reputation risk. Consistent with our predictions, we find that conservative audit clients are less likely to trigger auditor litigation or issue accounting restatements; and that auditors of conservative clients charge lower audit fees, issue fewer going concern opinions, and resign less frequently. Taken together, these findings are consistent with client accounting conservatism playing an important role in auditor-client contracting and outcomes.

Keywords: accounting conservatism; auditor litigation; auditor reputation; audit pricing; audit opinion; auditor resignation; accounting restatements

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I. INTRODUCTION

Auditing researchers argue that litigation risk and reputation risk are the primary factors incentivizing auditors to provide high quality audits (e.g., Francis and Wang 2004; Hope and Langli 2010). Litigation risk exposes auditors to direct financial penalties, while lost reputation impairs the auditor's ability to retain existing clients and attract new clients. Auditors are exposed to costly litigation and loss of reputation when they are suspected of allowing substandard reporting, and prior research argues that accounting conservatism acts as a governance mechanism that reduces managements' tendency to misreport (e.g., Watts 2003; LaFond and Watts 2008). This suggests that conservative clients are likely to impose lower litigation and reputation risk on their auditors. If so, we expect this reduced risk to be reflected in audit fee negotiations, the audit opinion formulation process, and auditors' client retention decisions. Thus, the purpose of this study is to test whether client conservatism is associated with lower audit fees, the issuance of fewer going concern modified audit opinions, and less frequent auditor resignations.

We begin our investigation by first testing whether conservative clients expose auditors to lower levels of litigation and reputation risk. We measure litigation risk using the incidence of auditor litigation, and reputation risk using the incidence of accounting restatements that correct a prior year's earnings overstatement (i.e., "income-decreasing" restatements). [1] We measure conditional conservatism using the firm-year specific

[1] We use income-decreasing restatements because they do greater damage to shareholder value when compared to other restatements (e.g., Palmrose et al. 2004), and hence are more likely to impair auditors' reputation.

measure developed in Khan and Watts (2009 hereafter KW), and perform our tests using all available data from 2000-2007. Consistent with our hypotheses, we find that conservative clients are less likely to trigger auditor litigation and to issue income-decreasing accounting restatements. Importantly, we also find that client conservatism reduces reputation risk independently of its affect on litigation risk, indicating that client conservatism mitigates auditors' reputation risk beyond simply its effect on litigation risk.[2] Thus, our first set of tests provide evidence that conservative clients impose lower levels of both litigation and reputation risk on their external auditors.

Next, we test whether the reduced litigation and reputation risk associated with conservative clients is reflected in auditor-client contracting and outcomes. We posit that if less conservative clients impose greater litigation and reputation risk, auditors are likely to employ strategies to mitigate this risk. One such strategy is to charge higher audit fees, which compensates auditors for bearing this higher risk and for the additional audit effort that is likely to be associated with auditing less conservative clients (Johnstone and Bedard 2004; Matsumura and Tucker 1992). We also expect auditors to mitigate litigation and reputation risk by lowering the threshold for issuing going concern modified audit opinions to their less conservative clients. This is because the issuance of a modified audit opinion potentially protects the auditor in the event of litigation (Krishnan and Krishnan 1996). In addition, because less conservative clients are more likely to mask poor performance by misreporting, issuing a going concern opinion reduces the auditor's risk of inappropriately issuing a clean opinion (Francis and

[2] While we examine the effect of client conservatism on auditor reputation risk after controlling for auditor litigation risk, we do not examine the reverse (i.e., the effect of client conservatism on auditor litigation risk after controlling for auditor reputation risk). This is because, as noted in prior studies, auditor litigation necessarily impairs auditor reputation. This confound is the motivation for Weber et al. (2008) and Skinner and Srinivasan (2011) to examine settings that are free from litigation risk.

Krishnan 1999). Finally, we expect auditors to reduce litigation and reputation risk by resigning more frequently from less conservative clients (Pratt and Stice 1994; Krishnan and Krishnan 1997; Shu 2000). Thus, we hypothesize that auditors of conservative clients charge lower audit fees, issue fewer going concern audit opinions, and resign less frequently.[3]

Our tests support all three of our auditor-client contracting hypotheses regarding audit fees, auditor opinions and auditor resignations. We also perform multiple tests that examine whether these results are solely explained by the fact that client conservatism reduces litigation risk. This is important because while prior studies argue that conservatism benefits auditors by reducing litigation risk (Basu 1997; Watts 2003), we are also interested in whether conservatism benefits auditors by reducing reputation risk. This analysis finds that our results continue to hold after we include an auditor litigation risk control variable, restrict our sample to firms and industries with low litigation risk, and repeat our audit fee and modified opinion tests using data from four countries with essentially no auditor litigation risk. (We are unable to repeat our auditor resignation test in these countries due to lack of data.) Overall, these results suggest that client conservatism affects auditor-client contracting through litigation and reputation risk, and that the effects of reputation risk are independent of the effects of litigation risk. Finally, we find that endogeneity does not explain our findings and that our results are robust to a host of alternative research design choices.

Our findings make several contributions. One contribution is to the literature that examines the consequences of accounting conservatism. This literature suggests that

[3] Because it is unclear whether auditors employ all three strategies or some subset, we test all three predictions independently. If auditors employ only a subset, it reduces our chances of finding empirical support for our predictions.

conservatism benefits auditors, and we provide evidence on this assertion by finding that client conservatism is predictably associated with audit fees, audit opinion choice, and auditor resignations. Our findings also suggest that litigation and reputation risk are channels through which conservatism influences auditor-client contracting and outcomes. While the conservatism literature has long argued that conservatism benefits auditors through reduced litigation risk (e.g., Basu 1997; Watts 2003), we are the first to empirically document this association. Although Ettredge et al. (2012) also finds that conservatism is associated with fewer accounting restatements, we build on this finding by identifying the auditor-client contracting implications of this association. Evidence on the economic implications of accounting conservatism is particularly important given that standard-setters have eliminated conservatism as a qualitative characteristic of financial reporting (FASB 2010).

We also contribute to the literature on auditors' incentives to produce high quality audits. While a large body of research investigates issues related to auditor litigation risk, there is little evidence on how reputation risk affects auditor-client contracting or auditor decision-making, particularly in the US. Further, of the studies that do conclude that reputation risk affects auditor behavior, it is often difficult to rule out litigation risk as an alternative explanation (Weber et al. 2008; Skinner and Srinivasan 2011).[4] In contrast, our tests that focus on reputation risk employ a variety of procedures that control for the potentially confounding effects of litigation risk. Thus, we contribute to the auditing literature by providing evidence that reputation risk affects auditor-client behavior independently of the effects of litigation risk.

[4] For example, Chaney and Philipich (2002) acknowledge that the loss in value of Andersen's clients after the collapse of Enron may result from Andersen's inability to "insure" (via litigation) its remaining clients.

Finally, we add to the studies that use accounting conservatism as a measure of audit quality (Qiang 2007; Ruddock et al. 2006; Krishnan 2005, 2007). While these studies generally assume that auditors determine the level of conservatism for their clients, our evidence suggests that auditors also respond to the level of conservatism chosen by their clients. This is consistent with auditors having a constrained ability to determine clients' conservatism because managers have primary responsibility for firms' financial reporting choices associated with the implementing GAAP.[5] In addition, as discussed above, our endogeneity tests show that our results are not driven by auditors' influencing their clients' level of conservatism.[6]

The remainder of the paper is structured as follows. The next section develops our hypotheses and the third section discusses variable measurement and our empirical models. The fourth section describes our sample and presents our empirical findings and the fifth section presents findings from sensitivity and robustness tests. The sixth section provides evidence from non-US countries, and the final section summarizes our study and findings.

II. HYPOTHESIS DEVELOPMENT

Accounting Conservatism and Auditor Litigation

Prior research suggests that managers respond to litigation concerns by making conservative financial reporting choices to reduce their expected legal liability (e.g., Ball and Shivakumar 2005; Chung and Wynn 2008). However, while prior research focuses

[5] In line with this argument, Qiang (2007) and Li et al. (2009) find that hiring Big N auditors is not associated with greater client conservatism after controlling for underlying client characteristics.

[6] While we explicitly perform tests to rule out the effects of endogeneity in Section V, we also believe that this potential problem is mitigated by our research design, which uses a one-year lagged measure of conservatism, rather than contemporaneous conservatism, as a test variable in each model. In other words, it is unlikely that auditors' decisions (such as charging audit fees, issuing going concern opinions and resigning from audit engagements) in the current year will affect the level of accounting conservatism in the previous year.

primarily on whether litigation incentivizes *managers* to report conservatively, we investigate how *auditors* respond to managers' conservatism choices. Just as conservative financial reporting reduces litigation risk to firms and managers, it is also expected to reduce litigation risk to auditors (Basu 1997; Watts 2003). Conservatism, which results in timelier recognition of bad news than good news, is likely to reduce auditor litigation risk because auditors are primarily sued for failing to reflect bad news timely in financial reports (St. Pierre and Andersen 1984; Carcello and Palmrose 1994). Conservative accounting practices make it difficult for plaintiffs to argue that audited financial reports do not provide adequate warning of impending problems (especially losses). In addition, conservative accounting is also likely to reduce client business risk. Specifically, prior research suggests that conservatism facilitates more efficient *ex ante* investment decisions and greater *ex post* monitoring of managers' investment decisions, leading to better allocation of capital (Ahmed and Duellman 2011; Watts 2003; Francis and Martin 2010). Since firms in poorer financial health are more likely to be sued (Palmrose 1987), better capital allocation is expected to reduce the incidence of auditor litigation. Based on the above arguments, we expect auditors of clients with relatively more conservative accounting to be sued relatively less frequently. Thus, our first hypothesis is (in alternative form):

H1: Conservative audit clients are less likely to trigger litigation against auditors.

Accounting Conservatism and Auditor Reputation

Prior research finds that managers have stronger incentives to overstate earnings than to understate earnings (Watts 2003). This is consistent with Kothari et al. (2009) who find evidence that career concerns and compensation contracts provide incentives

for managers to withhold and delay the disclosure of bad news but quickly reveal good news to investors. LaFond and Watts (2008), however, argue that conditional conservatism is likely to reduce the incidence of financial misreporting. Specifically, they suggest that conditional conservatism requires lower verification for the recognition of bad news than good news, and that this asymmetric verifiability acts to offset managements' natural tendency to hide the release of bad news and accelerate the release of good news. By limiting managers' tendency to systematically overstate reported earnings, conservatism is conjectured to act as a governance mechanism that curbs substandard financial reporting.

Auditors risk losing reputation capital when market participants become concerned that they allow their clients to misreport, and a variety of events can raise such concerns. For example, research finds that auditors lose market share, and that their clients lose share value, following negative press reports and the announcement of government investigations related to large audit failures (Weber et al. 2008; Skinner and Srinivasan 2011). Auditors also suffer reputational losses for behavior that falls short of major audit failures. For example, Hennes et al. (2011) find that auditors are more likely to be dismissed following accounting restatements; Hillary and Lennox (2005) find that auditors lose market share following negative AICPA peer review reports; Firth (2000) finds that auditors lose market share following government-agency inspection reports that criticize outside auditors; and Abbott et al. (2008) find that auditors are more likely to be dismissed following negative PCAOB inspection reports. Thus, research suggests that a variety of events can raise concerns among market participants that auditors allow substandard financial reporting among their clients.

We focus on a particularly salient event that suggests the auditor has allowed substandard reporting: accounting restatements that correct prior year earnings overstatements. Restatements are unequivocal evidence that the auditor failed to prevent misreporting and the Securities and Exchange Commission considers them "the most visible indicator of improper accounting" (Schroeder 2001). We examine income-decreasing restatements because they harm shareholders relatively more than income-neutral or income-increasing restatements (Palmrose et al. 2004; Srinivasan 2005; Agrawal and Cooper 2009).[7] Hence they are more likely to impair auditors' reputation capital and thereby increase the power of our tests.[8] However, we are not suggesting that accounting conservatism is merely an instrument for "restatement risk." Rather, we are arguing that conservatism affects reputation risk, where reputation impairment can result from a variety of outcomes (as discussed above), one of which is the issuance of a restatement. Based on the above discussion, our second hypothesis is (in alternative form):

> **H2**: Conservative audit clients are less likely to issue income-decreasing accounting restatements.

Two other studies also test for an association between conservatism and restatements. Givoly et al. (2007) examine a sample of restatements over the period 2000-2001 but fail to find a significant association between conservatism and restatements. In a follow up study, Ettredge et al. (2012) use a larger sample from 1999-2005 and find that restatement firms are significantly less conservative during the misstatement year. Our analysis is performed using data from 2000-2007 and thus

[7] Consistent with this argument, Callen et al. (2006) find that the market response to income-increasing restatement announcements is not significantly different from zero.

[8] Higher reputational penalties for the correction of income-decreasing restatements are also consistent with market participants inferring that such overstatements are opportunistic, since managers have greater incentives to overstate earnings than to understate earnings (Watts 2003).

significantly overlaps with the time period examined in Ettredge et al. (2012). While the results in Ettredge et al. (2012) suggest that we are likely to find evidence supporting our second hypothesis, there are research design differences in our study that make this difficult to predict. One difference is that our tests include several control variables that are not included in Ettredge et al. (2012). This is a potentially important difference because Cao et al. (2012) find that restatements are determined by a variety of client firm characteristics such as financing activity and operating complexity.

Accounting Conservatism and Audit Fees

If accounting conservatism reduces auditors' litigation and reputation risk, we expect auditors to engage in strategies that limit their risk exposure to less conservative clients. One such strategy is to charge higher audit fees. This is consistent with research that finds that auditors protect themselves by charging higher fees to riskier clients, including clients that pose higher litigation and reputation risk (e.g., Bell et al. 2001; Johnstone and Bedard 2004). While a large body of empirical research finds that litigation risk is a priced risk factor reflected in audit fees (e.g., Simunic 1980), charging higher fees to clients that pose higher reputational risk is consistent with theoretical research that concludes that auditors are more likely to exert greater effort in auditing clients who have a greater likelihood of misstatement or fraud in an attempt to preserve their reputation capital (Matsumura and Tucker 1992; Hillegeist 1999), and with experimental research that finds that less risky clients require less audit effort (Davis et al. 1993). Thus, our third hypothesis is (in alternative form):

H3: Auditors are likely to charge lower fees to their conservative clients.

The two published studies that examine the association between audit fees and

restatements find mixed results, neither of which is suggested by our prediction. Specifically, while Kinney et al. (2004) find that the association between audit fees and restatements is generally insignificant, Feldman et al. (2009) find that audit fees increase following restatements. In addition, working papers by Lobo and Zhao (2011) and Choy and Gul (2008) find that auditors charge lower audit fees prior to restatements, which is contrary to our prediction.[9] Thus, our prediction that auditors *ex ante* price protect by charging higher audit fees to less conservative clients has not been documented in prior literature.[10]

Accounting Conservatism and Going Concern Opinions

Prior research suggests that auditors can also limit their risk exposure by lowering their threshold for issuing going concern modified audit opinions. In particular, several studies find that auditors increase the propensity to issue going concern opinions to clients with high litigation risk (Krishnan and Krishnan 1996; Francis and Krishnan 1999; Geiger and Raghunandan 2001). This reduces the auditor's risk exposure because the issuance of a going concern modified audit report prior to bankruptcy substantially lowers the incidence of auditor litigation and the magnitude of settlements against the auditor in the event of litigation (Palmrose 1988; Carcello and Palmrose 1994). Going concern opinions are also likely to mitigate auditors' reputation risk because less conservative clients are more likely to mask poor performance by overstating earnings. Thus, lowering the threshold for issuing a going concern opinion reduces the auditor's risk of inappropriately issuing a clean opinion when a modified opinion is appropriate

[9] These studies argue that lower audit fees are consistent with lower auditor effort, which in turn leads to greater risk of audit failure (Dye 1993; Hillegeist 1999).

[10] As reported in Section V, we also perform sensitivity tests that drop sample firms that actually issue accounting restatements and find that our results are not explained by the presence of firms in our sample that issue restatements.

(Francis and Krishnan 1999).

Using going concern opinions to mitigate reputation risk is also consistent with the literature that suggests auditors increase their independence in response to reputation concerns (Benston 1975; Reynolds and Francis 2000; DeFond et al. 2002). In addition, because conservatism facilitates efficient investment decisions and better monitoring of managers' investment decisions (Ahmed and Duellman 2011; Watts 2003; Francis and Martin 2010), conservative clients are inherently less likely to have going concern problems, which further reduces auditors' incentives to issue going-concern audit opinions. Thus, our fourth hypothesis is (in alternative form):

> **H4**: Auditors are less likely to issue going concern opinions to their conservative clients.

Accounting Conservatism and Auditor Resignations

A third way for auditors to manage litigation and reputation risk is to resign from the audit engagement. This is consistent with prior studies that document a positive association between client risk and auditor resignations (e.g., Johnston and Bedard 2004; Shu 2000), and suggests that auditors are more likely to resign from clients that adopt relatively less conservative financial reporting practices. In addition, while Hennes et al. (2011) find that clients are more likely to dismiss their auditor following restatements, dismissals are fundamentally distinct from auditor resignations and capture a different conceptual construct. Specifically, auditor dismissals are associated with clients' incentives to fire the auditor, while auditor resignations are associated with auditors' incentives to fire the client. Auditor dismissals are initiated by clients who tend to be motivated by events such as changes in client firm size or ownership structure, which lead to efficiency gains from auditor-client realignment (Johnson and Lys 1990; Francis

and Wilson 1988; DeFond 1992). In contrast, auditor resignations are initiated by auditors who tend to be motivated by reducing client risk (e.g., DeFond et al. 1997; Shu 2000). Based on the above discussion, our fifth hypothesis is (in alternative form):

H5: Auditors are less likely to resign from conservative clients.

III. VARIABLES MEASUREMENT AND MODEL SPECIFICATIONS

Measuring Accounting Conservatism

We measure firm-year specific accounting conservatism using the *C_Score* developed in KW. The traditional model from Basu (1997) is typically used to estimate either an *industry-year* measure (using a cross-section of firms in an industry), or a *firm-specific* measure (using a time-series of firm-years). KW argues that the *C_Score* improves upon the traditional conservatism measure from Basu (1997) by capturing both cross-sectional and inter-temporal variations in the conservatism of individual firms without requiring a long time series of data. The construct validity of the *C_Score* is well documented in KW, and the procedures for calculating *C_Score* are summarized in Appendix 2. Following Zhang (2008) and Louis et al. (2012), we rank the *C_Score* by deciles in each year to reduce noise in the estimates. We label the resulting variable *CONSV*, which is standardized between zero and one, with observations in the bottom decile valued zero and those in the top decile valued one.

Auditor Litigation Model

We test whether *CONSV* is associated with auditor litigation risk using a logit model to estimate the following auditor litigation risk model adapted from Shu (2000), where detailed variable definitions are presented in Appendix 1:

$$LITIG = \alpha_0 + \alpha_1 CONSV + \alpha_2 Ln\_Assets + \alpha_3 Inventory + \alpha_4 Receivable + \alpha_5 ROA$$

$$+ \alpha_6 \, Current + \alpha_7 \, Leverage + \alpha_8 \, Sales\_Growth + \alpha_9 \, Return + \alpha_{10} \, Volatility$$
$$+ \alpha_{11} \, Beta + \alpha_{12} \, Turnover + \alpha_{13} \, Delist + \alpha_{14} \, Tech\_Dummy + \alpha_{15} \, GCM$$
$$+ \alpha_{16} \, BM + \alpha_{17} \, Signed\_DA + e \quad (1)$$

The dependent variable (*LITIG*) is an indicator variable that equals 1 if the auditor is named as the defendant in a lawsuit during the year, and 0 otherwise. *CONSV* and all control variables are measured in the year prior to the lawsuit. A negative coefficient on *CONSV* is consistent with more conservative financial reporting reducing the likelihood of auditor litigation. We add two more control variables, *BM* and *Signed_DA*, to the original model in Shu (2000). *BM* is included following the suggestion in KW.[11] *Signed_DA* is added because Heninger (2001) reports that auditor litigation is associated with upward earnings management through discretionary accruals. The regression model is estimated using two separate control groups: one consisting of all non-litigation firms and the second consisting of all non-litigation firms in the same Fama and French (1997) 48 industries as the litigation firms.

Restatement Model

To test whether accounting conservatism is associated with the incidence of accounting restatements, we estimate the following logistic model adapted from Cao et al. (2012), where detailed variable definitions are presented in Appendix 1:

$$RESTATE = a_0 + a_1 \, CONSV + a_2 \, ProbLit + a_3 \, Size + a_4 \, Volatility + a_5 \, BM$$
$$+ a_6 \, Leverage + a_7 \, ROA + a_8 \, LOSS + a_9 \, BigN + a_{10} \, MERGER$$
$$+ a_{11} \, FINANCE + a_{12} \, NSEG + a_{13} \, FOPS + a_{14} \, Inv\_Rec$$
$$+ a_{15} \, Return + Year \, Dummies + e \quad (2)$$

[11] KW suggest that studies using *C_Score* as an independent variable should also directly control for firm size, leverage, and the book-to-market ratio because failing to do so may result in finding an association between conservatism and the variable of interest where there is no association. As reported in sensitivity tests in Section V, we find that our conclusions are insensitive to dropping these three variables from the model.

RESTATE is an indicator variable that is valued 1 if the earnings for the firm-year or any quarter in the firm-year are subsequently restated downward, and 0 otherwise. Thus, *RESTATE* captures the misstatement year that is subsequently restated. All independent variables are measured in the concurrent year except *CONSV,* which is measured in the previous year. We include the control variables from Cao et al. (2012), which finds that restatements are associated with a variety of factors such as leverage, financing activity and operational complexity. A negative coefficient on *CONSV* is consistent with conservatism reducing the incidence of restatements.

Audit Fee Model

To test whether accounting conservatism is associated with audit fees, we estimate the following OLS model based on prior research (e.g., Simunic 1980; Whisenant et al. 2003; Ashbaugh et al. 2003), where detailed variable definitions are presented in Appendix 1:

$$\begin{aligned} LAUDIT = {} & \gamma_0 + \gamma_1 CONSV + \gamma_2 ProbLit + \gamma_3 Size + \gamma_4 Quick + \gamma_5 Loss + \gamma_6 ROA \\ & + \gamma_7 Leverage + \gamma_8 Inv\_Rec + \gamma_9 BM + \gamma_{10} NSEG + \gamma_{11} SPITEM + \gamma_{12} FOPS \\ & + \gamma_{13} Merger + \gamma_{14} Finance + \gamma_{15} Pension + \gamma_{16} BigN + \gamma_{17} GCM \\ & + \gamma_{18} Busy + Industry \ \& \ Year \ Dummies + e \end{aligned} \quad (3)$$

The dependent variable (*LAUDIT*) is measured as the log of audit fees in thousands of dollars. All independent variables are measured in the year concurrent with the audit fees except *CONSV*, which is measured in the previous year. A negative coefficient on *CONSV* is consistent with auditors charging lower fees to their conservative clients.

Going Concern Opinion Model

To test whether accounting conservatism is associated with the issuance of going concern modified audit opinions, we estimate the following logistic model adapted from DeFond et al. (2002), where detailed variable definitions are presented in Appendix 1:

$$OPIN = \lambda_o + \lambda_1 CONSV + \lambda_2 ProbLit + \lambda_3 ZScore + \lambda_4 Size + \lambda_5 Ln\_Age + \lambda_6 Beta + \lambda_7 Return + \lambda_8 Volatility + \lambda_9 Leverage + \lambda_{10} CLeverage + \lambda_{11} LLoss + \lambda_{12} Investment + \lambda_{13} Cashflow + \lambda_{14} Future\_Finance + \lambda_{15} BigN + \lambda_{16} BM + Year\ Dummies + e \quad (4)$$

The dependent variable (*OPIN*) is an indicator variable that takes a value of 1 if a client firm receives a going concern audit report for the first time, and 0 otherwise. All independent variables are measured in the concurrent year except *CONSV,* which is measured in the previous year. Following prior literature (e.g., DeFond et al. 2002), we estimate the model using a sample of distressed firms, defined as firms that report either negative net income or negative operating cash flows during the current fiscal year. A negative coefficient on *CONSV* is consistent with auditors issuing fewer going concern modified audit opinions to their conservative clients.

Auditor Resignation Model

To test whether accounting conservatism is associated with auditor resignations, we estimate the following logistic regression model adapted from Landsman et al. (2009), where detailed variable definitions are presented in Appendix 1:

$$RESIGN = \beta_0 + \beta_1 CONSV + \beta_2 ProbLit + \beta_3 Asset\_Growth + \beta_4 Abs\_DA + \beta_5 Inv\_Rec + \beta_6 GCM + \beta_7 Clean + \beta_8 Tenure + \beta_9 ROA + \beta_{10} Loss + \beta_{11} Leverage + \beta_{12} Cash + \beta_{13} Disagree + \beta_{14} Rep\_Event + \beta_{15} BigN + \beta_{16} Ln\_Assets + \beta_{17} Merger + \beta_{18} BM + e \quad (5)$$

Consistent with prior studies (e.g., Landsman et al. 2009; Kim and Park 2009), we estimate this model using auditor switch firms and measure all of the independent variables in the year prior to the auditor switch. The dependent variable (*RESIGN*) is an indicator variable that equals 1 if the auditor resigns and 0 otherwise (i.e., if the auditor is dismissed). A negative coefficient on *CONSV* is consistent with auditors resigning less frequently from their conservative clients.

IV. SAMPLE AND EMPIRICAL RESULTS

Data

We collect data for audit-related information and restatements from the Audit Analytics database for the period 2000-2007.[12] Because our conservatism measure and control variables in some models are one-year lagged, they are estimated for the period 1999-2006. Consistent with prior research, we remove firms in the financial sector (SIC codes 60-69) and trim all continuous variables at the top and bottom one percent to remove extreme values.

Empirical Results

Results for Auditor Litigation Tests

The sample for our auditor litigation test consists of all data from the Auditlegal database of Audit Analytics. After limiting the sample to firms with data in CRSP and Compustat, our final sample consists of 79 auditor lawsuits. This is a reasonably large sample when compared to other auditor litigation studies. For example, Heninger (2001), Stice (1991), and Lys and Watts (1994) examine 67, 49, and 40 auditor lawsuits, respectively. We perform our tests using two non-litigation control groups: (1) a full sample of all available firm-year observations without auditor litigation (n=17,882) and (2) all available firm-year observations matched on industry (n=6,092).

The results from estimating our litigation model are presented in Table 1. Panel A provides descriptive statistics for the variables used in the auditor litigation test, for both the treatment and control firms, along with mean t-tests and median Wilcoxon z-tests of

[12] Audit Analytics includes restatements made by public companies to correct accounting that does not conform to GAAP. Thus, it excludes restatements due to changes in accounting principles, GAAP-to-GAAP changes, and changes in estimates. Our sample period ends in 2007 because Cheffers et al. (2010) shows that the average time lag between the original financial statement release and a restatement is roughly about two years.

differences across the two types of firms. The mean and median *CONSV* for the litigation firms (*LITIG* = 1) are significantly smaller than those for the control firms (*LITIG* = 0) in both the full and industry-matched samples. While this is consistent with conservative clients triggering less litigation against auditors, we defer to our multivariate analysis to formally test our first hypothesis. Panel A also finds that the litigation firms tend to be larger in size (*Ln_Assets*), less liquid (*Current*), more leveraged (*Leverage*), have greater systematic risk (*Beta*), have higher stock turnover (*Turnover*), and have a lower book-to-market ratio (*BM*). Table 1, Panel B presents Pearson correlation statistics. Because *C_Score* is estimated by a linear transformation of size, leverage, and the market-to-book ratio, the correlations between *CONSV* and these variables are reasonably large.[13]

The results of the auditor litigation test are presented in Table 1, Panel C. Columns (1) and (2) report the results where the control firms consist of the full sample of firm-year observations without litigation, and columns (3) and (4) report the results where the control firms consist of the industry-matched sample. The model is estimated with robust standard errors clustered by firm to correct for heteroscedasticity and serial dependence (Petersen 2009). When the regression model is estimated without conservatism (*CONSV*) in columns (1) and (3), the results are generally consistent with those in Shu (2000). Also, consistent with Heninger (2001), we find in the industry-matched sample that signed discretionary accruals are positively related to auditor litigation. When *CONSV* is included in columns (2) and (4), the coefficients on *CONSV* are negative and statistically significant at $p<0.01$ (two-tailed). Thus, the results find that

[13] As a result of the relatively high correlations between *CONSV* and some of our control variables, we perform several sensitivity tests on all of our multivariate models. As reported in Section V, these tests indicate that multicollinearity is unlikely to influence our results.

accounting conservatism is associated with a lower incidence of auditor litigation, consistent with our first hypothesis.

Results for Restatement Tests

Since we are interested in whether conservatism is associated with reputation risk independent of its effects on litigation risk, we restrict our restatement sample to restatements that do not result in subsequent auditor litigation. In addition, in this and all of our subsequent tests we control for litigation risk in the following three ways: (1) we specifically include a variable capturing the probability of auditor litigation (*ProbLit*), which is fitted using the parameters and variables in Table 3 of Shu (2000). Including *ProbLit* in our tests will inform us whether *CONSV* has explanatory power beyond its effects on auditor litigation risk; (2) we repeat our analysis after limiting the sample to the firms with the lowest decile of the probability of auditor litigation (*ProbLit*) among all firms listed in Compustat in each year; and (3) we repeat our analysis after limiting the sample to firms in industries that have a low probability of litigation as identified in LaFond and Roychowdhury (2008).[14]

We begin our restatement analysis by identifying 2,357 restatement firm-year observations with data available in Compustat and CRSP, where the restatement dependent variable is measured during the year of the original misstatement. We then exclude restatements that trigger litigation against auditors (112 observations), restatements that have a positive impact on income (349 observations), a zero impact on income (612 observations), and restatements with a trivial income effect, defined as those with less than a one million dollar impact on income (370 observations). This yields a

[14] Specifically, low litigation industries are defined as industries other than the following high litigation risk industries: biotechnology (SIC codes 2833–2836), computers (SIC codes 3570–3577 and 7370), electronics (SIC codes 3600–3674), and retailing (SIC codes 5200–5961).

final sample of 914 restatements. The control sample includes 14,853 non-restated firm-year observations during the sample period.

Table 2, Panel A presents the means and medians of the variables used in the restatement model partitioned on the dependent variable. Panel A reports that the mean and median value of *CONSV* is smaller for the restatement firms (*RESTATE* = 1) than those for the control firms (*RESTATE* = 0) with the differences significant at $p<0.01$. This univariate test indicates that conservative clients are less likely to issue income-decreasing restatements, although we defer to our multivariate analysis to formally test our second hypothesis. Not surprisingly, Panel A also indicates that the restatement firms have a higher mean and median probability of auditor litigation. Panel B of Table 2 presents the Pearson correlations between the variables in the restatement test. The correlations find that *CONSV* is negatively correlated with *RESTATE* (-0.04), consistent with the result in Panel A. The highest correlations are between *SIZE* and *ProbLit* (0.53), and *ROA* and *Loss* (-0.53).

Table 2, Panel C presents multivariate results for our restatement tests. Columns (1) and (2) report the full sample results and find that the coefficient on accounting conservatism (*CONSV*) is significantly negative at $p<0.01$. This indicates that conservative clients are less likely to issue income-decreasing restatements, consistent with our second hypothesis. This result is also consistent with Ettredge et al. (2012), which shows that Basu-based conservatism metrics are significantly lower for periods of overstated earnings. Column (2) reports that the coefficient on *CONSV* remains significantly negative at $p<0.01$ after controlling for the probability of auditor litigation (*ProbLit*). Column (3) reports that the coefficient on *CONSV* is significantly negative at

p<0.05 after limiting the sample to clients in the bottom decile of auditor litigation risk, and column (4) reports that the coefficient on *CONSV* is significantly negative at p<0.01 after limiting the sample to clients in low litigation industries. Thus, consistent with our second hypothesis, we find that conservative audit clients are less likely to issue income-decreasing restatements.[15]

The coefficients on the control variables indicate that firms with higher book-to-market ratios (*BM*), higher leverage (*Leverage*), higher stock return volatility (*Volatility*), larger inventories and receivables (*Inv_Rec*), and foreign operations (*FOPS*), are more likely to restate. These results are largely consistent with those reported in Cao et al. (2012).

Results for Audit Fees Tests

Our audit fee sample consists of 18,824 firm-year observations. Table 3, Panel A reports the means and medians of the variables used in the audit fee model partitioned on the median audit fee of $514,000. This analysis finds that mean and median *CONSV* is significantly lower in the high audit fee partition than in the low audit fee partition, at p<0.01. This suggests that on a univariate basis, auditors charge lower fees to their conservative clients. Consistent with prior research, Panel A also indicates that our control variables capture a variety of factors that influence audit fees. Table 3, Panel B presents the Pearson correlations between the variables in the audit fee test. The correlations find that *CONSV* is negatively correlated with logged audit fees, *LAUDIT* (-0.38), consistent with the results in Panel A. Not surprisingly, the highest correlations

[15] In untabulated analysis we also perform a test to examine whether *CONSV* is associated with *income-increasing* restatements by estimating the restatement model after replacing the dependent variable by an indicator variable that is valued 1 if the earnings are subsequently restated upward, and 0 otherwise. We find that the coefficient on *CONSV* is not significantly associated with income-increasing restatements for all four models presented in Table 2, Panel C.

among the independent variables are between *LOSS* and *ROA* (-0.64), and *SIZE* and *ProbLit* (0.62).

Table 3, Panel C reports the multivariate results for our audit fee tests. Column (1) shows that the coefficient on *CONSV* is significantly negative at p<0.01, consistent with auditors charging lower audit fees to their conservative clients. Columns (2), (3) and (4) report that the coefficient on *CONSV* remains significantly negative at p<0.01 after controlling for the probability of auditor litigation (*ProbLit*), after limiting the sample to clients in the bottom decile of auditor litigation risk, and after limiting the sample to clients in low litigation industries, respectively. Hence the evidence reported in Table 3 supports our third hypothesis.

Consistent with prior research, most of the control variables in Panel C are significantly associated with audit fees at p<0.01. Specifically, audit fees are higher among clients that are larger (*Size*), have higher operating risk (*Loss* and *Leverage*), have greater complexity (*NSEG*, *SPITEM*, and *FOPS*), have December year-ends (*Busy*), that are less profitable (*ROA*), that engage in mergers and acquisitions (*Merger*), that have Big N auditors (*BigN*), and when auditors issue a going concern opinion (*GCM*).

Results for Going Concern Modified Opinion Tests

Our going concern sample consists of 7,049 firm-year observations of distressed firms that report either negative net income or negative operating cash flows.[16] Of these observations, 8 percent (541 observations) receive a going concern opinion for the first

[16] In order to conserve sample size for the distressed firms in our going concern opinion tests we do not impose the data filters in estimating *C_Score*. Footnote 11 of Khan and Watts (2009) indicates that their results are generally robust to including those filters when estimating *C_Score*. When we perform sensitivity analyses for all of our other tests (auditor litigation, restatement, audit fees, and auditor resignation tests) with this less restrictive *C_Score* estimation procedure, the results are qualitatively identical.

time during the sample period, which is consistent with DeFond et al. (2002) and Reynolds and Francis (2000), where the proportions are 9 and 8 percent respectively.

Table 4, Panel A reports the means and medians of the variables used in the going concern model, partitioned on whether the client receives a going concern opinion. This analysis finds that the association between *CONSV* and going concern opinions is not significant at conventional levels. Panel A also finds that there are significant differences across each of the control variables, highlighting the importance of controlling for these variables in our multivariate hypothesis tests. We rely on the multivariate analysis to test our prediction because the univariate tests do not control for other factors associated with the issuance of going concern opinions.[17] Table 4, Panel B presents the Pearson correlations between the variables in the going concern test and reports that the highest correlations among the independent variables are between *Leverage* and *Cleverage* (0.73), *SIZE* and *Beta* (0.53), and *CONSV* and *Beta* (-0.53).[18]

Table 4, Panel C reports the multivariate results of our going concern opinion tests. Column (1) reports that the coefficient on *CONSV* is significantly negative at $p<0.01$, indicating that auditors are less likely to issue going concern opinions to conservative clients. Columns (2), (3) and (4) report that the coefficient on *CONSV* remains significantly negative at $p<0.10$ after all of our controls for litigation risk. Overall, the results presented in Table 4 supports our fourth hypothesis.

[17] In untabulated analysis we also perform univariate tests that match each going concern firm with a non-going concern firm based on its expected probability of receiving a going concern opinion in the same year. We estimate the expected probability of receiving a going concern opinion using equation (4) after excluding *CONSV*. This analysis finds that both mean and median *CONSV* is significantly lower among the going concern firms than among the matched non-going concern firms (at $p<0.01$), consistent with our fourth hypothesis.

[18] While these correlations are relatively large, sensitivity tests reported in Section V indicate that multicollinearity is unlikely to influence our results.

In addition, the results for the control variables reported in Panel C are generally consistent with prior literature. Specifically, firms receiving going concern opinions tend to have higher bankruptcy scores (*ZScore*), smaller size (*Size*), higher leverage (*Leverage*), higher stock return volatility (*Volatility*), losses (*LLoss*), poorer operating cash flows (*Cashflow*), lower liquidity (*Investment*).

Results for Auditor Resignation Tests

Our auditor resignation sample consists of 1,936 firm-year observations that change auditors, excluding clients of Andersen during 2001-2002. Fifteen percent (300 observations) of the changes are auditor-initiated resignations while the remaining are client-initiated auditor dismissals. The smaller proportion of auditor resignations relative to dismissals is consistent with prior studies (e.g., Landsman et al. 2009; Kim and Park 2009).

Table 5, Panel A reports the means and medians of the variables used in the auditor resignation model, partitioned on whether the auditor resigned or was dismissed from the audit engagement. This analysis finds that *CONSV* does not significantly differ across resignation and dismissal firms at conventional levels. Panel A also shows that there are significant differences across most of the control variables for the two groups. For example, resignation firms exhibit a higher probability of auditor litigation (*ProbLit*), are smaller in size (*Ln_Assets*), are less likely to be audited by Big 4 or Big 5 auditors (*BigN*), are more likely to report losses (*Loss*), have Form 8-K reportable events (*Rep_Event*), and are more likely to receive a going concern opinion (*GCM*). Thus, it is important to control for these variables in our multivariate hypothesis tests.[19]

[19] In untabulated analysis we also perform univariate tests that match each resignation firm with a dismissal firm based on its expected probability of resignation in the same year. We estimate the expected probability

Table 5, Panel B presents the Pearson correlations between the variables in the resignation test. Consistent with Panel A, the correlation between *CONSV* and auditor resignations is positive but not significant. Panel B also reports that the highest correlations among the independent variables are between *Ln_Assets* and *ProbLit* (0.52), and *Loss* and *ROA* (-0.60).

Table 5, Panel C reports the multivariate results of our resignation tests. Column (1) reports that the coefficient on accounting conservatism (*CONSV*) is significantly negative at $p<0.01$, indicating that auditors are less likely to resign from their conservative clients, consistent with our fifth hypothesis. Columns (2), (3) and (4) reports that the coefficient on *CONSV* remains significantly negative at $p<0.05$ after all of our controls for litigation risk. Thus, the results presented in Table 5 support our fifth hypothesis.

Consistent with prior research, the control variables in Panel C also indicate that auditors are more likely to resign from clients with shorter tenure (*Tenure*), higher leverage (*Leverage*), more reportable events (*Rep_Event*), larger absolute discretionary accruals (*Abs_DA*), smaller size (*Ln_Assets*), and when they are smaller auditors (*BigN*).

V. SENSITIVITY AND ROBUSTNESS TESTS

Conservatism Estimated over the Previous Three Years

We measure *CONSV* during the year immediately preceding the year in which the dependent variables are measured. However, Givoly and Hayn (2000) argue that conservatism in one period can lead to non-conservative results in subsequent periods. Thus, we repeat our analyses after estimating *CONSV* over the previous three years

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of resignation using equation (5) after excluding *CONSV*. This analysis finds that both mean and median *CONSV* is significantly lower among the resignation firms than among the matched dismissal firms (at $p<0.01$), consistent with our fifth hypothesis.

(*CONSV_3YR*). We report the results in Panel A of Table 6. Since this measure requires data for at least three years, the sample size is reduced in each test. To conserve space, we only report the coefficients for *CONSV* and *ProbLit*. Consistent with our primary results, the coefficients on *CONSV_3YR* are negative and significant at $p<0.01$ in all of our tests.

Alternative Measure of Adjusted Conservatism

KW shows that higher *C_Score* values are associated with higher probabilities of litigation, longer investment cycles, higher idiosyncratic uncertainty, lower firm age, and higher information asymmetry. Since these are potentially omitted correlated variables in our analysis, we perform sensitivity tests using a measure of adjusted conservatism (*ADJ_CONSV*), following KW, which is orthogonal to these variables. These estimation procedures are summarized in Appendix 3. We report the results using this alternative measure in Panel B of Table 6. Since this measure requires additional data, the sample size is reduced. The results indicate that the coefficients on *ADJ_CONSV* are negative and significant at $p<0.05$ in all of our tests.

Alternative Measure of Conservatism based on Givoly and Hayn (2000)

While we use the *C_Score* developed in Khan and Watts (2009) to capture firm-level conditional conservatism, an alternative measure is non-operating accruals suggested by Givoly and Hayn (2000). Thus, we repeat our analyses using this alternative measure (*CONSV_NOA_3YR*).[20] The results, reported in Panel C of Table 6 find that the coefficient on *CONSV_NOA_3YR* is negative and significant for the auditor litigation,

[20] To estimate *CONSV_NOA_3YR*, we first compute non-operating accruals annually as follows (all items deflated by beginning total assets):
Non-operating accruals = Total accruals (before depreciation) − Operating accruals
= [(Net Income + Depreciation) − Cash flow from operations] − (Δ Accounts receivable + Δ Inventories + Δ Prepaid expenses − Δ Accounts payable − Δ Taxes payable).
Non-operating accruals are multiplied by negative one so that the value increases with the level of conservatism. To mitigate the effect of temporary non-operating accruals that reverse in subsequent years, we take the average of non-operating accruals over the previous three years.

restatement, audit fee and auditor resignation tests. For the going concern test, the coefficient on *CONSV_NOA_3YR* is negative and insignificant at p<0.10 in two-tailed tests but is significant in one-tailed test (p = 0.082), consistent with our one-tailed prediction. Therefore, overall, our results are robust to using this alternative measure of conservatism.

Multicollinearity

We include firm size, leverage, and the book-to-market ratio in each model that includes *CONSV* because Khan and Watts (2009, p.148) argue that failing to do so may result in finding an association between conservatism and the variable of interest where there is none. However, the correlation matrix for each model shows that *C_Score* tends to have a high correlation with firm size, leverage, and the book-to-market ratio. Thus, we perform the following analysis to gain comfort that multicollinearity is not influencing our results. First, we check the variance-inflation factors (VIF) for the independent variables in each model. We find that the highest VIF value is 7.3 for *SIZE* in the restatement analysis.[21] Since Neter et al. (1996) indicates that multicollinearity is not a concern for VIF factors of less than 10, this suggests that multicollinearity is unlikely to influence our results. Second, we repeat our analysis after excluding firm size, leverage, and the book-to-market ratio from our regressions. As documented in Panel D of Table 6, the coefficients on *CONSV* remain significant at p<0.10 (two-tailed).[22] Thus, it does not appear that multicollinearity influences our results.

Endogeneity

[21] We compute VIFs using OLS for our models that are estimated using logit.
[22] We also compute the VIF factors for these models (without firm size, leverage and book-to-market ratio) and find that the highest VIF is 2.05, which is also below the threshold of 10 suggested in Neter et al. (1996).

While our tests implicitly assume that auditors respond to the level of conservatism chosen by the client, it is also possible that auditors influence the level of conservatism (i.e., reverse causality). As discussed previously, however, our research design, which uses one-year lagged measures of conservatism, alleviates concerns about endogeneity to some degree. Nevertheless, we also perform formal tests to assess whether our dependent variables (namely, *LITIG*; *RESTATE; LAUDIT*; *OPIN*; and *RESIGN*) are affected by endogeneity using the two-stage instrumental variable approach employed in the Durbin–Wu–Hausman test (David and MacKinnon 1993). In the first stage, following KW, we estimate conservatism using the probability of litigation (*ProbLit*), idiosyncratic uncertainty (*Volatility*), length of the investment cycle (*Cycle*), firm age (*Age*), and information asymmetry (*Spread*), together with all of the other control variables used in the respective regression models. Because *ProbLit* and *Volatility* are used as control variables in most of our models, we employ the other three variables (*Cycle*, *Age*, and *Spread*) as instrumental variables. As suggested in Larcker and Rusticus (2010), we also formally test the strength of our instrumental variables by computing partial F-statistics of the instruments used in the first stage regressions. The partial F-statistics range from 27.56 to 114.60, much higher than the minimum benchmark of 12.83 for models with three instruments as reported in Larcker and Rusticus (2010). Thus, we conclude that our model does not suffer from problems associated with the inclusion of weak instruments.

We then augment equations (1) through (5) by including the residuals (*RES*) from this first stage regression. The significance of *RES* tests for the potential existence of endogeneity. The results reported in Panel E of Table 6 show that the residuals obtained from the auditor litigation, going concern opinion, and auditor resignation models are all

insignificant, indicating a lack of endogeneity. However, *RES* is significant at p<0.01 for the restatement and audit fee models, suggesting that endogeneity may be a concern. Hence, we use the predicted value of conservatism (*Predict_CONSV*) from the first stage regression to replace *CONSV* in the restatement and audit fee models. The results indicate that the coefficients on *Predict_CONSV* are still negative and significant at p<0.01 in both models. This indicates that even after controlling for the endogeneity, conservative clients are less likely to restate and that auditors charge lower fees to conservative clients.[23]

Controlling for Earnings Management

Following prior literature, we control for signed discretionary accruals (*Signed_DA*) in our litigation model, and absolute discretionary accruals (*Abs_DA*) in our resignation model. However, discretionary accruals may also be important variables in our other models. Thus, to provide more consistent and comprehensive evidence on whether discretionary accruals are likely to explain our findings, we repeat each of our tests using three different measures of discretionary accruals: signed discretionary accruals, absolute discretionary accruals, and a model specifically capturing income-increasing discretionary accruals. The results, reported in Panels F, G, and H of Table 6, find that the coefficients on *CONSV* continue to be significantly negative at p<0.01 after

[23] We also note that the direction of the possible endogeneity bias may be in the opposite direction of our hypotheses, which biases against our findings. Specifically, higher audit fees may be associated with higher conservatism *if* the auditor were to choose the level of conservatism, because imposing greater conservatism on the client by the auditor is expected to require greater auditor effort. Similarly, restatements may be associated with higher conservatism *if* the auditor were to choose the level of conservatism, because the changes that are likely to follow restatements (e.g., such as improvement in governance, Srinivasan 2005) are expected to encourage auditors to impose greater conservatism.

including these controls.[24]

Results with Sub-sample of Big N Clients Only

Although our models include a control for Big N auditors, the choice of Big N auditors and their higher exposure to litigation and reputation risk may potentially confound our results. Thus, we repeat our analysis after restricting the sample to client firms audited by Big 4 or Big 5 auditors. The results are reported in Panel I of Table 6 and find that the coefficient on *CONSV* is significantly negative at $p<0.01$ in all of our tests.

Controlling for Corporate Governance

Lara et al. (2009) find that firms with stronger corporate governance exhibit a higher degree of accounting conservatism. In addition, prior research suggests that stronger governance is associated with higher audit fees (Carcello et al. 2002), a lower likelihood of receiving a going concern opinion (Carcello and Neal 2000), and a lower likelihood of auditor resignations (Lee et al. 2004). Thus, to ensure that governance is not an omitted correlated variable, we repeat our analysis after including the following variables that control for corporate governance (following Lara et al. 2009): the G-index (*Gindex*) (Gompers et al. 2003); whether CEO is chairman (*Duality*), proportion of top executives on the board (*Executive*), and number of board meetings during the year (*Meeting*).[25] The results are reported in Panel J of Table 6 and find that the coefficients on *CONSV* remain significantly negative at $p<0.01$ in all of our tests.

[24] In order to compare all discretionary accruals measures across all models in a single table, we repeat the results in Table 1, Panel C (for our litigation model) and the results in Table 5, Panel C (for our resignation model) in Panels F and G of Table 6.

[25] The external governance data (*Gindex*) is obtained from Andrew Metrick's web page and the internal governance data is from the Execucomp and Investor Responsibility Research Center (IRRC) databases. Due to missing governance data, we use the 'modified zero-order regression' method suggested by

Controlling for Restatement Firms in Audit Fee Tests

Feldman et al. (2009) find that audit fees increase following restatements. While it is unclear how this might potentially impact our audit fee analysis, we repeat our audit fee test currently reported in Table 3, Panel C, column (2) after dropping all firms (for all years) that report a restatement during our sample period. For completeness, we also repeat our litigation, going concern and resignation tests in Tables 1, 4 and 5 (Panel C, column (2)). The results, which are not tabled, continue to find that the coefficient on *CONSV* is significantly negative at $p<0.01$ in all of the tests.

Alternative Specification for Going Concern Opinion Tests

Currently, we follow prior literature in our going concern opinion tests by restricting our analysis to distressed firms as defined in DeFond et al. (2002). To test sensitivity of our results to this specification, we rerun our going concern opinion test in Table 4, Panel C, column (2) by altering the sample estimated in the model. First, we use an alternative definition for financially distressed firms. Following Geiger and Raghunandan (2001), we classify a firm as being in financial distress if at least one of the following criteria is met: negative working capital at the end of the fiscal year, negative retained earnings at the end of the fiscal year, or loss for the fiscal year. Second, we estimate the model with the full sample of client firms that have available data (n=18,924) without restricting the sample to the distressed firms. Untabulated results for both tests find that the coefficient on *CONSV* is significantly negative at $p<0.01$.

Alternative Specification for Auditor Resignation Tests

Maddala (1977) and Greene (2003). This method substitutes a zero for missing values and adds an indicator variable coded one if the corresponding variable is missing.

Currently, we follow prior literature in our resignation tests by restricting the sample to firms that switch auditors. To test sensitivity of our results to this specification, we repeat our auditor resignation test in Table 5, Panel C, column (2) without this restriction (n=22,358). We also exclude the variables *Disagree* and *Rep_Events* as these variables are relevant only to auditor-switching clients. The untabulated results from this test are consistent with those currently reported. Specifically, we continue to find that the coefficient on *CONSV* is significantly negative at $p<0.01$.

VI. TESTS WITH FIRMS FROM LESS LITIGIOUS NON-US COUNTRIES

Motivation and Sample

In this section we further control for the effects of auditor litigation by repeating our audit fee and modified opinion tests using data from countries where litigation against the auditor is virtually non-existent. We identify these countries using the "liability standard for accountants" index in La Porta et al. (2006). This index captures the difficulty in recovering losses from auditors due to misleading prospectus information. The risk index equals one when investors only need to prove the information is misleading; it equals two-thirds when investors must also prove reliance on the misleading accounting information; it equals one-third when investors must also prove auditor negligence; and zero when recovery from auditors is not possible or when intent or gross negligence must be proven. Our sample includes all countries with an index of zero or one-third with audit fee data available in the Global Vantage database for more than 10 observations during our sampling period 2000-2007: Germany, France, Italy, and Sweden.

Prior studies argue that it is extremely difficult or impossible to sue outside auditors in all of these countries. Weber et al. (2008) argue that it is difficult for clients and investors to sue auditors for damages in Germany because German law requires evidence that the auditor acted intentionally or with reckless disregard for the truth, and there is a relatively low cap on auditor civil liability. Piot and Janin (2007) document that the deep pockets argument is not valid in France because of the lower responsiveness of the civil law litigation system in protecting investors' rights. For similar reasons, Wingate (1997) and Choi et al. (2008) classify Italy and Sweden as countries having a low litigation risk for auditors.

Test Results

Because restatement and resignation data are not available in the Global Vantage database, we limit this analysis to the audit fee and modified opinion tests. We test the models presented in equations (3) and (4) after excluding variables not available in the Global Vantage database. Table 7, Panel A presents the mean values of the variables by country for the audit fee model, and Panel B presents the Pearson correlations. The number of observations (n=1,332) is much smaller than in our analysis of US firms reported in Table 3 (n=18,824), which should bias against finding our predicted result. We estimate *CONSV* by each country with all available data following the procedure outlined in Appendix 2.

Table 7, Panel C presents the results from estimating the audit fee model. Column (2) reports that the coefficient on *CONSV* is significantly negative at $p<0.01$, consistent with our third hypothesis. The results for the control variables are similar to those for our U.S. sample. Table 7, Panels D and E report the mean values of the variables and Pearson

correlations between the variables in the modified opinion test. As with our audit fee test, the number observations (n=2,368, including 413 modified opinions) is smaller than in our analysis of US firms reported in Table 4 (n=7,049, including 541 modified going concern opinions). Table 7, Panel F presents the results from estimating the modified opinion model. Column (2) reports that the coefficient on *CONSV* is significantly negative at $p<0.01$, consistent with our fourth hypothesis.

In summary, we continue to find that client conservatism affects audit fees and the issuance of modified audit opinions even in countries where auditors have essentially no litigation risk. This indicates that the effects of client conservatism on auditor-client contracting are not solely explained by reduced litigation risk.

VII. SUMMARY

Because accounting conservatism is expected to curb the incidence of substandard financial reporting, we predict that it affects auditor-client contracting and outcomes by lowering auditors' litigation and reputation risk. Consistent with our predictions, we find that conservative audit clients are less likely to trigger auditor litigation or issue income-increasing accounting restatements; and that auditors of conservative clients receive lower audit fees, issue fewer going concern audit opinions, and resign less frequently. Importantly, we also find that the effect of conservatism on auditor reputation risk is independent of its effect on auditor litigation risk. Overall, our findings are consistent with conditional accounting conservatism being an important determinant of auditor risk that is reflected in auditor-client contracting and outcomes.

Appendix 1: Variable Definitions

Dependent and test variables

LITIG	=	1 if the auditor is named as the defendant in the lawsuit, and 0 otherwise;
RESTATE	=	1 if the earnings for the firm-year or any quarter in the firm-year are subsequently restated downward, and 0 otherwise. In other words, *RESTATE* captures the misstatement year.
LAUDIT	=	log of audit fees in thousand dollars;
OPIN	=	1 if the firm receives a going concern opinion for the first time, and 0 otherwise;
RESIGN	=	1 if the auditor resigns, and 0 otherwise (dismissed);
CONSV	=	decile rank of conservatism score (*C_Score* in Khan and Watts 2009), scaled from 0 to 1, with higher values indicating higher conservatism.

Control variables

Ln_Assets	=	log of total assets;
Inventory	=	inventories deflated by total assets;
Receivable	=	receivables deflated by total assets;
ROA	=	income before extraordinary items deflated by total assets;
Current	=	current assets divided by current liabilities;
Leverage	=	total debts to assets ratio;
Sales_Growth	=	growth in sales;
Return	=	the compounded stock return over the fiscal year;
Volatility	=	the standard deviation of the residual from the market model over the fiscal year;
Beta	=	the slope coefficient of a regression of daily stock returns on equally weighted market returns over the fiscal year;
Turnover	=	the proportion of shares traded at least once during the fiscal year, computed as in Shu (2000);
Delist	=	1 if the firm is delisted because of financial difficulties within the next year, and 0 otherwise;
Tech_Dummy	=	1 if the firm is in a high-tech industry, and 0 otherwise. The classification of high-tech industries follows from Shu (2000);
GCM	=	1 if the firm receives a going concern opinion, and 0 otherwise;
BM	=	book-to-market ratio;
Signed_DA	=	performance-adjusted signed discretionary accruals obtained by subtracting from each firm's abnormal accrual the median abnormal accrual from the corresponding ROA-industry decile to which the firm belongs. Abnormal accrual is estimated by modified Jones model for each year and each two-digit SIC code industry with minimum 10 observations;
ProbLit	=	the probability of litigation, fitted using the parameters and variables in Table 3 of Shu (2000);
Size	=	log of market capitalization;
Loss	=	1 if firm is reporting a loss and 0 otherwise;
BigN	=	1 if the firm is audited by a Big 4 or Big 5 audit firm, and 0 otherwise;
Merger	=	1 if the firm is engaged in a merger or acquisition, and 0 otherwise;
Finance	=	1 if long term debt or number of shares increased by at least 10%, and 0 otherwise;
NSEG	=	the number of business segments;
FOPS	=	1 if firm has a foreign operation, and 0 otherwise;

Inv_Rec	=	sum of inventories and receivables, divided by beginning total assets;
Quick	=	current assets minus inventories, divided by current liabilities;
SPITEM	=	1 if the firm reports a special item, and 0 otherwise;
Pension	=	1 if the pension assets or periodic pension cost is greater than $1 million, and 0 otherwise;
Busy	=	1 if fiscal year end is December, and 0 otherwise;
ZScore	=	Zmijewski's (1984) bankruptcy score;
Ln_Age	=	natural logarithm of the age of the firm in a given year, measured as the number of years with return history on CRSP;
CLeverage	=	change in *Leverage* during the year;
LLoss	=	1 if the firm reports a loss for the previous year, and 0 otherwise;
Investment	=	cash, cash equivalents, and short- and long-term investment securities deflated by total assets;
Cashflow	=	operating cash flows deflated by total assets;
Future_Finance	=	1 if long term debt or number of shares increased by at least 10% in the following year, and 0 otherwise;
Asset_Growth	=	growth in assets;
Abs_DA	=	absolute values of performance-adjusted discretionary accruals;
Clean	=	1 if the auditor issues clean, unqualified report, and 0 otherwise;
Tenure	=	auditor tenure in years;
Cash	=	cash deflated by total assets;
Disagree	=	1 if the 8-K filing discloses an accounting disagreement with the incumbent auditor, and 0 otherwise;
Rep_Event	=	1 if the 8-K filing discloses a reportable event, and 0 otherwise;
Industry Dummies	=	industry membership as defined in Frankel et al. (2002).

Appendix 2: Estimation of Firm-year Specific Conservatism (*C_Score*)

The empirical model to estimate *C_Score* is based on the standard Basu (1997) regression specification as follows:

$$X_{i,t} = \beta_{1,t} + \beta_{2,t} D_{i,t} + \beta_{3,i,t} R_{i,t} + \beta_{4,i,t} D_{i,t} R_{i,t} + \varepsilon_{i,t} \quad \text{(A1)}$$

where *i* indexes the firm, *t* indexes time, *X* is income before extraordinary items scaled by lagged market value, *R* is annual returns compounded from monthly returns ending three month after fiscal year end; *D* is a binary variable that takes the value of one for firms with negative returns and zero otherwise, and ε is the residual.

C_Score is derived from linear functions of three firm-specific characteristics that vary with conditional conservatism: size, the market-to-book ratio, and leverage. The timeliness of good news (β_3) and the incremental timeliness of bad news relative to good news (β_4) are specified as linear functions of the three characteristics:

$$G\_Score = \beta_{3,i,t} = \mu_1 + \mu_2 Size_{i,t} + \mu_3 M/B_{i,t} + \mu_4 Lev_{i,t} \quad \text{(A2a)}$$

$$C\_Score = \beta_{4,i,t} = \lambda_1 + \lambda_2 Size_{i,t} + \lambda_3 M/B_{i,t} + \lambda_4 Lev_{i,t} \quad \text{(A2b)}$$

G_Score is the timeliness of good news, and *C_Score* is the incremental timeliness of bad news. *Size* is the natural log of the market value of equity, *M/B* is the market-to-book ratio, and *Lev* is the sum of long term and short term debt divided by market value of equity. λ_k and μ_k, *k=1-4,* are constant across firms, but vary across time.

Equations (A2a) and (A2b) are identities which are substituted into equation (A1). We also include the three firm characteristics separately as main effects because KW suggests that including them yields better accounting conservatism estimates. Thus, we obtain:

$$
\begin{aligned}
X_{i,t} = {} & \beta_1 + \beta_2 D_{i,t} + \delta_1 Size_{i,t} + \delta_2 M/B_{i,t} + \delta_3 Lev_{i,t} \\
& + D_{i,t}(\theta_1 Size_{i,t} + \theta_2 M/B_{i,t} + \theta_3 Lev_{i,t}) \\
& + R_{i,t}(\mu_1 + \mu_2 Size_{i,t} + \mu_3 M/B_{i,t} + \mu_4 Lev_{i,t}) \\
& + D_{i,t} * R_{i,t}(\lambda_1 + \lambda_2 Size_{i,t} + \lambda_3 M/B_{i,t} + \lambda_4 Lev_{i,t}) + \varepsilon_{i,t}
\end{aligned}
\tag{A3}
$$

Consistent with KW, we estimate equation (A3) by annual cross-sectional regressions to obtain year-specific parameters, λ_k and μ_k. We then substitute the λ_k into equation (A2b), along with firm size (*Size*), market-to-book (*M/B*), and leverage (*Lev*) to obtain firm-year specific *C_Score*.[26]

[26] As in KW, we delete firm years with missing data for any of the variables used in estimation, and firm years with negative total assets or book value of equity. We delete firm years with price per share less than $1, and firms in the top and bottom one percent of earnings, returns, size, market-to-book ratio and leverage each year.

Appendix 3: Estimation of Adjusted Conservatism (*ADJ_CONSV*)

To obtain adjusted conservatism (*ADJ_CONSV*), we posit the following model from Khan and Watts (2009, hereafter KW):

$$C\_Score = \alpha_0 + \alpha_1 ProbLit + \alpha_2 Volatility + \alpha_3 Cycle + \alpha_4 Age + \alpha_5 Spread + Year\ Dummies + e \quad \text{(A4)}$$

where

C_Score	=	Firm-year conservatism estimated based on Khan and Watts (2009);
ProbLit	=	the probability of litigation, fitted using the parameters and variables in Table 3 of Shu (2000);
Volatility	=	the standard deviation of the residual from the market model over the fiscal year;
Cycle	=	a decreasing measure of the length of the investment cycle, defined as depreciation expense deflated by lagged assets;
Age	=	the age of the firm in a given year, measured as the number of years with return history on CRSP;
Spread	=	the average of the daily bid-ask spreads over the fiscal year. The daily spread is scaled by the mid-point of the spread, obtained from CRSP.

The cross-sectional analyses in KW show that firms with a higher probability of litigation (*ProbLit*), longer investment cycle (*Cycle*), higher idiosyncratic uncertainty (*Volatility*), lower firm age (*Age*) and higher information asymmetry (*Spread*) are more conservative. Panel A below reports means of those characteristics by *C_Score* decile using our sample. As acknowledged in KW, these firm-level characteristics can be important omitted variables when *C_Score* is an independent variable in a multiple regression, because unadjusted conservatism (*C_Score*) is significantly correlated with those characteristics.

To address this issue, we use adjusted conservatism as an alternative test variable in our main models. We first estimate the above pooled cross-sectional and time-series model, using 17,672 firm-years between 1999 and 2006. Panel B shows coefficients and t-statistics from estimating the model. We obtain the residuals from the regression and

form deciles of the residuals for each year. We denote this decile variable as *ADJ_CONSV* and include it in our main regressions.

To assure that *ADJ_CONSV* still captures Basu's (1997) asymmetric timeliness, we estimate the standard Basu regression on the pooled data within each *ADJ_CONSV* decile (similar to Table 5 of KW) and report results in Panel C. It shows that the rank correlation between the *ADJ_CONSV* decile and the Basu's asymmetric timeliness (the coefficient on *Ret* x *D*) is significantly positive at 0.624. The difference between the coefficients for the highest and lowest *ADJ_CONSV* deciles is significant at $p<0.01$. This result suggests that *ADJ_CONSV* is still effective in distinguishing between firms with varying degrees of asymmetric timeliness of bad news although *ADJ_CONSV* is orthogonal to the firm characteristics included in equation (A4).

Panel A: Means of characteristics of *C_Score* deciles

C_Score Decile	*C_Score*	*ProbLit*	*Volatility*	*Cycle*	*Age*	*Spread*
1	-0.0101	0.0087	0.0008	0.0498	26.9943	0.0063
2	0.0581	0.0086	0.0008	0.0513	22.5608	0.0074
3	0.0863	0.0088	0.0009	0.0507	20.2168	0.0078
4	0.1070	0.0074	0.0011	0.0503	19.2630	0.0090
5	0.1266	0.0089	0.0011	0.0502	19.0062	0.0108
6	0.1456	0.0074	0.0013	0.0480	18.3181	0.0138
7	0.1652	0.0082	0.0014	0.0496	18.4717	0.0175
8	0.1875	0.0094	0.0016	0.0495	18.3181	0.0228
9	0.2176	0.0134	0.0020	0.0494	18.8559	0.0293
10	0.3055	0.0599	0.0026	0.0494	18.3866	0.0379
Rank Corr.		0.56^{*}	0.93^{***}	-0.56^{*}	-0.77^{***}	0.93^{***}
Hi-Lo	0.3156^{***}	0.0512^{***}	0.0018^{***}	-0.0004	-8.6077^{***}	0.0316^{***}
(t-stat)	(73.74)	(12.05)	(18.26)	(-0.36)	(-16.34)	(27.49)

This panel shows means of firm characteristics variables for each *C_Score* decile. The sample consists of 17,672 firm-years between 1999 and 2006. Firms are sorted annually into deciles by *C_Score*, and then the mean of the reported firm characteristics is calculated by decile. *ProbLit* is the probability of litigation, fitted using the parameters and variables in Table 3 of Shu (2000). *Volatility* is the standard deviation of the residual from the market model over the fiscal year. *Cycle* is a decreasing measure of the length of the investment cycle, and is defined as depreciation expense deflated by lagged assets. *Age* is the age of the firm in a given year, measured as the number of years with return history on CRSP. *Spread* is the average of the daily bid-ask spreads over the fiscal year. The daily spread is scaled by the mid-point of the spread, obtained from CRSP. Rank Corr. is the rank correlation between the *C_Score* decile and the sample mean of the variable, and is a measure of the monotonicity of the ranking in the table. Hi–Lo is the difference between the mean values of the variable for the highest and lowest *C_Score* deciles. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels, respectively.

Panel B: Cross-sectional regression of *C_Score*

$$C\_Score = \alpha_0 + \alpha_1 ProbLit + \alpha_2 Volatility + \alpha_3 Cycle + \alpha_4 Age + \alpha_5 Spread + Year\ Dummies + e$$

Variable	Predicted Sign	Coefficient (t-stat)
ProbLit	+	0.274*** (11.43)
Volatility	+	3.604*** (4.94)
Cycle	-	-0.056** (-2.06)
Age	-	-0.001*** (-6.17)
Spread	+	1.567*** (10.29)
Intercept	?	0.113*** (38.49)
Year Dummies	?	YES
n		17,672
Adj. R^2 (%)		28.88

This panel shows coefficients and t-statistics from pooled cross-sectional and time-series regression of *C_Score* on probability of litigation (*ProbLit*), stock return volatility (*Volatility*), the length of investment cycle (*Cycle*), firm age (*Age*), and the bid/ask spread (*Spread*).The sample consists of 17,672 firm-years between 1999 and 2006. We run the OLS regression clustered by firm (Petersen 2009). Robust t-statistics are presented in parentheses. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Panel C: Coefficients from basic Basu regressions by *ADJ_CONSV* decile

ADJ_CONSV decile	*Intercept*	*D*	*Ret*	*Ret* x *D*
1	0.040	-0.017	-0.044	0.191
2	0.050	-0.003	-0.036	0.213
3	0.041	-0.009	-0.006	0.134
4	0.040	-0.006	-0.006	0.126
5	0.045	-0.013	-0.021	0.155
6	0.033	0.015	0.013	0.174
7	0.046	-0.008	-0.018	0.193
8	0.044	0.000	-0.010	0.250
9	0.055	-0.008	-0.017	0.233
10	0.043	-0.026	-0.056	0.273
Rank Corr.			0.006	0.624**
Hi-Lo			-0.012	0.082***
(t-stat)			(-0.42)	(3.58)

This panel shows coefficients from basic Basu regressions estimated by *ADJ_CONSV* decile. The sample consists of 17,672 firm-years between 1997and 2006. Firms are sorted annually into deciles by *ADJ_CONSV*, and then the following pooled regression is estimated for each decile: $X_{i;t} = \beta_1 + \beta_2 D_{i;t} + \beta_3 Ret_{i;t} + \beta_4 D_{i;t} Ret_{i;t} + e_{i;t}$
X is earnings scaled by lagged price, *D* is a dummy variable equal to 1 if returns (*Ret*) are negative, and 0 if returns are positive. The columns show the intercept, the dummy (*D*), the good news timeliness (*Ret*) and the Basu asymmetric timeliness (*Ret* x *D*) coefficients. Conservatism is increasing in the *ADJ_CONSV*. Rank Corr. is the rank correlation between the *ADJ_CONSV* decile and the coefficient ranking, and is a measure of the monotonicity of the ranking in the table. Hi–Lo is the difference between the coefficients for the highest and lowest *ADJ_CONSV* deciles. '**', and '***' denote significance at 5%, and 1% levels (two-tailed), respectively.

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Table 1: Analysis of Conservatism and Auditor Litigation

Panel A: Descriptive statistics for the Auditor Litigation Model

	Full Sample						Industry-matched sample					
	LITIG=1 (n=79)		*LITIG*=0 (n=17,882)		Difference		*LITIG*=1 (n=79)		*LITIG*=0 (n=6,092)		Difference	
	Mean	Median	Mean	Median	t-stat	Z-stat	Mean	Median	Mean	Median	t-stat	Z-stat
CONSV	0.212	0.111	0.501	0.556	-9.52***	-8.03***	0.229	0.111	0.504	0.556	-7.64***	-7.68***
Ln_Assets	7.836	8.282	5.861	5.786	9.34***	8.12***	7.836	8.282	5.681	5.587	8.93***	8.76***
Inventory	0.117	0.030	0.141	0.097	-1.30	-2.51***	0.117	0.030	0.123	0.050	-0.32	-0.20
Receivable	0.203	0.176	0.178	0.152	1.19	0.80	0.203	0.176	0.197	0.165	0.28	0.22
ROA	0.017	0.031	0.011	0.040	0.54	-1.67*	0.017	0.031	0.000	0.035	1.51	-0.68
Current	1.970	1.508	2.536	2.032	-3.78***	-3.30***	1.970	1.508	2.625	2.113	-4.34***	-4.19***
Leverage	1.805	0.514	0.673	0.337	1.63	2.84***	1.805	0.514	0.521	0.194	1.84*	4.80***
Sales_Growth	0.173	0.110	0.134	0.082	0.90	1.21	0.173	0.110	0.120	0.082	1.32	1.42
Return	-0.018	-0.101	-0.049	-0.078	0.59	-0.20	-0.018	-0.101	-0.059	-0.087	0.77	-0.49
Volatility	0.001	0.001	0.001	0.001	1.37	0.09	0.001	0.001	0.002	0.001	2.68***	1.85*
Beta	1.125	1.075	0.808	0.736	3.90***	4.02***	1.125	1.075	0.897	0.851	2.79***	2.60***
Turnover	0.809	0.838	0.636	0.672	8.00***	5.95***	0.809	0.838	0.665	0.712	6.63***	4.83***
Delist	0.013	0.000	0.009	0.000	0.27	0.31	0.013	0.000	0.010	0.000	0.25	0.28
Tech_Dummy	0.380	0.000	0.246	0.000	2.76***	2.76***	0.380	0.000	0.411	0.000	-0.57	-0.57
GCM	0.025	0.000	0.014	0.000	0.65	0.88	0.025	0.000	0.013	0.000	0.66	0.90
BM	0.411	0.328	0.626	0.502	-7.04***	-4.65***	0.411	0.328	0.601	0.485	-6.17***	-4.11***
Signed_DA	0.003	0.001	0.001	0.000	1.81*	0.43	0.003	0.001	-0.002	-0.001	4.31***	2.25**

The full sample for the auditor litigation model consists of 79 unique cases of auditor litigation and 17,882 control firm-year observations that are all other firms not being involved in auditor litigation for the period 2000-2007. In the industry-matched sample, 6,092 control firm-year observations are all other firms that are in the same Fama and French 48 industries. This panel provides the descriptive statistics of the variables used in the model for litigation and control sample, along with mean t-tests and median Wilcoxon z-tests of differences across the two groups. Detailed definitions of the variables are provided in Appendix 1. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 1: Analysis of Conservatism and Auditor Litigation (continued)

Panel B: Pearson's Correlations

	LITIG	*CONSV*	*Ln_Assets*	*Inventory*	*Receivable*	*ROA*	*Current*	*Leverage*	*Sales_Growth*	*Return*	*Volatility*	*Beta*	*Turnover*	*Delist*	*Tech_Dummy*	*GCM*	*BM*	*Signed_DA*
LITIG	1.00																	
CONSV	-0.10	1.00																
Ln_Assets	0.13	-0.60	1.00															
Inventory	0.00	0.14	0.00	1.00														
Receivable	0.00	0.11	-0.13	0.01	1.00													
ROA	0.01	-0.20	0.30	0.13	0.16	1.00												
Current	-0.04	0.02	-0.22	-0.03	-0.15	-0.05	1.00											
Leverage	0.12	0.08	0.18	0.06	-0.03	-0.03	-0.22	1.00										
Sales_Growth	0.02	-0.08	0.03	0.03	0.12	0.07	-0.04	0.01	1.00									
Return	0.01	-0.01	0.14	0.00	0.06	0.23	-0.01	-0.06	0.11	1.00								
Volatility	-0.02	0.29	-0.46	-0.02	0.02	-0.39	0.03	0.02	-0.05	-0.16	1.00							
Beta	0.04	-0.37	0.30	-0.15	-0.15	-0.03	0.18	-0.12	0.04	0.09	-0.07	1.00						
Turnover	0.06	-0.45	0.37	-0.08	-0.08	0.06	0.10	-0.08	0.13	0.11	-0.05	0.58	1.00					
Delist	0.00	0.07	-0.09	0.01	0.02	-0.10	-0.04	0.05	-0.02	-0.09	0.14	-0.06	-0.06	1.00				
Tech_Dummy	-0.01	-0.05	-0.19	-0.30	-0.03	-0.14	0.18	-0.17	0.00	-0.01	0.15	0.24	0.18	-0.01	1.00			
GCM	0.01	0.06	-0.10	-0.03	-0.03	-0.16	-0.03	0.03	-0.01	-0.09	0.13	-0.04	-0.04	0.07	0.00	1.00		
BM	-0.05	0.38	-0.08	0.18	-0.03	-0.07	0.04	0.01	-0.15	-0.35	0.13	-0.26	-0.29	0.07	-0.16	0.03	1.00	
Signed_DA	0.03	0.02	0.16	0.19	-0.13	-0.06	-0.15	0.20	-0.11	0.02	-0.12	-0.11	-0.10	0.00	-0.30	-0.01	0.14	1.00

This panel provides the Pearson's correlation between variables used in the regression model that contains the industry-matched sample. The variables used in the regression model are as defined in Appendix 1.

Table 1: Analysis of Conservatism and Auditor Litigation (continued)

Panel C: Logistic Regression of Auditor Litigation Model

$$LITIG = \alpha_0 + \alpha_1 CONSV + \alpha_2 Ln\_Assets + \alpha_3 Inventory + \alpha_4 Receivable + \alpha_5 ROA + \alpha_6 Current + \alpha_7 Leverage + \alpha_8 Sales\_Growth + \alpha_9 Return + \alpha_{10} Volatility + \alpha_{11} Beta + \alpha_{12} Turnover + \alpha_{13} Delist + \alpha_{14} Tech\_Dummy + \alpha_{15} GCM + \alpha_{16} BM + \alpha_{17} Signed\_DA + e$$

Variable	Predicted Sign	Full Sample		Industry-matched Sample	
		(1)	(2)	(3)	(4)
CONSV	-		-1.696***		-2.155***
			(8.82)		(10.85)
Ln_Assets	+	0.620***	0.507***	0.670***	0.586***
		(34.77)	(19.98)	(42.95)	(25.43)
Inventory	+	0.030	0.058	0.466	0.627
		(0.00)	(0.00)	(0.20)	(0.40)
Receivable	+	1.817***	1.880***	1.599**	1.237
		(6.68)	(7.09)	(3.76)	(2.01)
ROA	-	-0.807**	-0.985***	-1.032**	-0.554
		(4.68)	(8.97)	(4.44)	(1.53)
Current	-	-0.098	-0.136	-0.067	-0.161
		(0.77)	(1.35)	(0.32)	(1.96)
Leverage	+	0.085**	0.125**	0.114	0.249***
		(4.46)	(3.88)	(2.22)	(10.67)
Sales_Growth	+	0.010	0.007	0.183	0.030
		(0.00)	(0.00)	(0.30)	(0.01)
Return	-	-0.322	-0.059	-0.320	-0.014
		(0.52)	(0.02)	(0.71)	(0.00)
Volatility	+	133.3***	142.6***	131.0***	134.8***
		(10.28)	(9.97)	(6.40)	(6.43)
Beta	+	0.351	0.437	0.197	0.312
		(0.69)	(1.05)	(0.23)	(0.59)
Turnover	+	1.672	1.513	1.431	2.025*
		(2.43)	(1.91)	(1.83)	(3.30)
Delist	+	0.424	0.408	1.144	0.781
		(0.07)	(0.06)	(0.67)	(0.29)
Tech_Dummy	+	0.772**	0.677*	0.059	-0.108
		(4.02)	(2.84)	(0.02)	(0.07)
GCM	+	1.132	1.372*	1.386*	1.002
		(2.29)	(2.79)	(2.98)	(1.47)
BM	?	-1.254**	-0.645	-1.382***	-0.591
		(5.08)	(1.84)	(6.29)	(1.45)
Signed_DA	+	0.001	0.001	0.138*	0.187**
		(0.05)	(0.11)	(3.57)	(4.90)
Intercept	?	-11.313***	-10.182***	-10.051***	-9.434***
		(59.90)	(43.67)	(47.12)	(38.98)
n		17,961	17,961	6,171	6,171
Wald-statistic		159.78***	135.15***	108.98***	111.51**
Pseudo R^2 (%)		15.69	16.80	18.88	18.61
Percent Concordant		78.1	79.1	81.2	81.5

The variables used in the regression model are as defined in Appendix 1. We run the logistic regression clustered by firm (Petersen, 2009). For each variable, we report the regression coefficient, followed by the robust Wald statistic in parentheses. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 2: Analysis of Conservatism and Restatements

Panel A: Descriptive statistics for the Restatement Model

Variable	*RESTATE*=1 (n=914)		*RESTATE*=0 (n=14,853)		Difference	
	Mean	Median	Mean	Median	t-stat	z-stat
CONSV	0.419	0.444	0.469	0.444	-5.28***	-4.59***
ProbLit	0.011	0.009	0.010	0.006	3.23***	7.47***
SIZE	6.226	6.317	5.859	5.815	7.32***	7.02***
Volatility	0.001	0.001	0.001	0.001	-9.17***	-4.19***
BM	0.555	0.478	0.592	0.478	-2.66***	-1.16
Leverage	0.485	0.207	0.461	0.165	0.90	1.72*
ROA	0.020	0.041	0.001	0.038	4.25***	1.33
Loss	0.243	0.000	0.276	0.000	-2.21**	-2.21**
BigN	0.870	1.000	0.830	1.000	3.48***	3.16***
Merger	0.216	0.000	0.200	0.000	1.15	1.15
Finance	0.363	0.000	0.346	0.000	1.05	1.05
NSEG	2.121	1.000	2.150	1.000	-0.52	-0.85
FOPS	0.194	0.000	0.210	0.000	-1.19	-1.19
Inv_Rec	0.272	0.237	0.272	0.245	-0.04	-0.18
Return	0.045	-0.050	0.030	-0.042	0.88	-0.09

The restatement test includes 15,767 firm-year observations for the period 2000-2007. Of these firm-year observations, a total of 914 observations were misstated and subsequently restated. This panel provides the descriptive statistics of the variables used in the model by restatement type, along with mean t-tests and median Wilcoxon z-tests of differences across the two groups. Detailed definitions of the variables are provided in Appendix 1. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 2: Analysis of Conservatism and Restatements (continued)

Panel B: Pearson's Correlations

	RESTATE	*CONSV*	*ProbLit*	*SIZE*	*Volatility*	*BM*	*Leverage*	*ROA*	*Loss*	*BigN*	*Merger*	*Finance*	*NSEG*	*FOPS*	*Inv_Rec*	*Returns*
RESTATE	1.00															
CONSV	-0.04	1.00														
ProbLit	0.02	-0.39	1.00													
SIZE	0.05	-0.41	0.53	1.00												
Volatility	0.05	0.25	-0.21	-0.45	1.00											
BM	-0.02	0.41	-0.13	-0.43	0.17	1.00										
Leverage	0.01	0.07	0.24	0.11	-0.06	0.01	1.00									
ROA	0.03	-0.16	0.20	0.28	-0.37	-0.03	0.00	1.00								
Loss	-0.02	0.20	-0.20	-0.27	0.34	0.03	-0.01	-0.53	1.00							
BigN	0.03	-0.35	0.20	0.37	-0.10	-0.03	0.09	0.04	-0.07	1.00						
Merger	0.01	-0.12	0.14	0.15	-0.06	-0.04	0.06	0.05	-0.09	0.06	1.00					
Finance	0.01	-0.04	0.07	0.07	0.05	-0.10	0.11	-0.11	0.02	0.00	0.23	1.00				
NSEG	0.00	-0.06	0.17	0.17	-0.12	0.04	0.10	0.09	-0.11	0.05	0.09	0.02	1.00			
FOPS	0.01	-0.11	0.18	0.15	-0.08	-0.06	-0.04	0.05	-0.03	0.06	0.06	-0.02	0.02	1.00		
Inv_Rec	0.00	0.23	0.16	-0.24	0.06	0.17	-0.13	0.18	-0.15	-0.11	-0.05	-0.05	0.04	0.08	1.00	
Return	-0.01	0.04	-0.04	0.20	-0.02	-0.30	-0.02	0.18	-0.04	0.03	0.01	0.09	0.02	0.01	0.02	1.00

This panel provides the Pearson's correlation between variables used in the regression model. The variables used in the regression model are as defined in Appendix 1.

Table 2: Analysis of Conservatism and Restatements (continued)

Panel C: Logistic Regression of Restatement Model

$$RESTATE = a_0 + a_1\, CONSV + a_2\, ProbLit + a_3\, Size + a_4\, Volatility + a_5\, BM + a_6\, Leverage + a_7\, ROA + a_8\, LOSS + a_9\, BigN + a_{10}\, MERGER + a_{11}\, FINANCE + a_{12}\, NSEG + a_{13}\, FOPS + a_{14}\, Inv\_Rec + a_{15}\, Return + Year\ Dummies + e$$

Variable	Predicted Sign	Full Sample Analyses		Subsample Analyses	
		(1)	(2)	(3) Low Shu's score	(4) Low litigious industry
CONSV	-	-0.835***	-0.833***	-1.908**	-0.926***
		(11.12)	(11.06)	(3.93)	(6.76)
ProbLit	+		-1.412	940.6**	0.810
			(0.17)	(3.04)	(0.04)
Size	?	-0.028	-0.022	-0.001	-0.075
		(0.45)	(0.25)	(0.48)	(1.54)
Volatility	+	70.550*	68.748*	-179.6	11.890
		(3.44)	(3.31)	(1.63)	(0.06)
BM	?	0.299***	0.301***	0.600	0.463***
		(6.88)	(7.01)	(1.97)	(9.93)
Leverage	+	0.101**	0.106**	0.633	0.055
		(4.89)	(4.95)	(0.58)	(0.57)
ROA	-	0.214	0.216	2.040**	0.076
		(0.60)	(0.61)	(4.52)	(0.03)
Loss	+	-0.016	-0.016	1.842***	0.064
		(0.03)	(0.03)	(15.74)	(0.22)
BigN	-	0.151	0.151	-0.620*	0.151
		(1.80)	(1.80)	(3.46)	(1.80)
Merger	+	0.038	0.040	-0.319	0.330***
		(0.19)	(0.22)	(0.15)	(9.32)
Finance	+	0.097	0.098	0.265	0.012
		(1.65)	(1.67)	(0.38)	(0.01)
NSEG	+	-0.033	-0.033	-0.461*	0.030
		(2.14)	(2.10)	(3.18)	(1.10)
FOPS	+	0.220***	0.217**	12.812***	0.061
		(6.14)	(5.93)	(17.56)	(0.29)
Inv_Rec	+	0.416**	0.447**	1.604	0.244
		(4.03)	(3.89)	(1.01)	(0.50)
Return	-	-0.230**	-0.225**	-0.355**	-0.290**
		(5.36)	(5.03)	(1.17)	(3.76)
Intercept	?	-2.769***	-2.809***	-4.122***	-2.807***
		(64.72)	(64.36)	(14.95)	(33.32)
Year Dummies		YES	YES	YES	YES
n		15,767	15,767	1,282	9,409
Wald-statistic		185.36	185.56	3658.93	83.08
Pseudo R^2 (%)		3.90	3.90	4.00	3.33
Percent Concordant		62.5	62.5	81.08	61.38

The variables used in the regression model are as defined in Appendix 1. In column (3), low Shu's score subsample consists of firms included in the bottom 10 percentile of annual litigation score based on Shu (2000) among all firms listed in the Compustat. In column (4), low litigious industry subsample consists of firms operating in a less litigious industry. Litigious industries are industries with SIC codes 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370, following LaFond and Roychowdhury (2008). We run the logistic regression clustered by firm (Petersen, 2009). For each variable, we report the regression coefficient, followed by the robust Wald statistic in parentheses. To conserve space, we do not report the coefficient estimates for the year dummies. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 3: Analysis of Conservatism and Audit Fees

Panel A: Descriptive statistics for the Audit Fee Model

Variable	High Audit Fees (n=9,412)		Low Audit Fees (n=9,412)		Difference	
	Mean	Median	Mean	Median	t-stat	z-stat
CONSV	0.401	0.333	0.597	0.667	-44.27***	-42.14***
ProbLit	0.017	0.013	0.005	0.003	72.98***	82.90***
Size	6.976	6.968	4.527	4.603	99.70***	85.15***
Quick	1.871	1.353	3.086	1.798	-20.63***	-24.06***
Loss	0.217	0.000	0.365	0.000	-22.58***	-22.28***
ROA	0.031	0.044	-0.028	0.029	24.18***	18.69***
Leverage	0.214	0.206	0.154	0.090	23.80***	26.57***
Inv_Rec	0.253	0.234	0.283	0.251	-11.15***	-6.05***
BM	0.504	0.437	0.658	0.519	-23.99***	-17.13***
NSEG	2.544	2.000	1.898	1.000	26.91***	22.13***
SPITEM	0.737	1.000	0.484	0.000	36.75***	35.50***
FOPS	0.295	0.000	0.131	0.000	28.10***	27.53***
Merger	0.259	0.000	0.148	0.000	19.04***	18.86***
Finance	0.365	0.000	0.336	0.000	4.09***	4.09***
Pension	0.043	0.000	0.109	0.000	-17.12***	-16.99***
BigN	0.936	1.000	0.750	1.000	36.29***	35.08***
GCM	0.006	0.000	0.019	0.000	-7.99***	-7.97***
Busy	0.690	1.000	0.614	1.000	11.07***	11.04***

The sample for the audit fee model consists of 18,824 firm-year observations for the period 2000-2007. We split the sample into high and low audit fees groups. This panel provides the descriptive statistics of the variables used in the model by audit fee group, along with mean t-tests and median Wilcoxon z-tests of differences across the two groups. Detailed definitions of the variables are provided in Appendix 1. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 3: Analysis of Conservatism and Audit Fees (continued)

Panel B: Pearson's Correlations

	LAUDIT	*CONSV*	*ProbLit*	*Size*	*Quick*	*Loss*	*ROA*	*Leverage*	*Inv_Rec*	*BM*	*NSEG*	*SPITEM*	*FOPS*	*Merger*	*Finance*	*Pension*	*BigN*	*GCM*	*Busy*
LAUDIT	1.00																		
CONSV	-0.38	1.00																	
ProbLit	0.60	-0.30	1.00																
Size	0.73	-0.38	0.62	1.00															
Quick	-0.19	-0.03	-0.20	-0.34	1.00														
Loss	-0.18	0.15	-0.19	-0.39	0.15	1.00													
ROA	0.18	-0.13	0.20	0.45	-0.12	-0.64	1.00												
Leverage	0.20	0.15	0.25	0.30	-0.23	-0.03	0.03	1.00											
Inv_Rec	-0.08	0.19	0.16	0.11	-0.20	-0.13	0.18	-0.09	1.00										
BM	-0.19	0.40	-0.12	-0.04	-0.04	0.13	-0.03	0.10	0.17										
NSEG	0.26	-0.02	0.18	0.28	-0.13	-0.10	0.10	0.16	0.03	0.04	1.00								
SPITEM	0.31	-0.09	0.19	0.23	-0.07	0.12	-0.06	0.11	-0.07	0.03	0.09	1.00							
FOPS	0.25	-0.09	0.17	0.12	-0.03	-0.03	0.05	-0.04	0.08	-0.06	0.01	0.14	1.00						
Merger	0.16	-0.11	0.14	0.13	-0.06	-0.05	0.05	0.10	-0.04	-0.04	0.08	0.09	0.05	1.00					
Finance	0.03	-0.04	0.07	0.00	-0.03	0.03	-0.10	0.18	-0.06	-0.09	0.02	-0.02	-0.02	0.22	1.00				
Pension	-0.14	0.05	-0.12	-0.22	0.07	0.18	-0.17	-0.12	-0.04	-0.03	-0.11	-0.03	-0.05	-0.03	0.00	1.00			
BigN	0.31	-0.24	0.20	0.34	-0.03	-0.06	0.04	0.09	-0.11	-0.03	0.07	0.13	0.06	0.06	0.00	-0.06	1.00		
GCM	-0.06	0.06	-0.01	-0.11	0.00	0.13	-0.18	0.02	-0.01	0.02	-0.03	0.01	-0.01	-0.02	0.02	0.06	-0.04	1.00	
Busy	0.09	-0.05	0.06	0.00	0.01	0.05	-0.07	0.11	-0.18	-0.05	0.04	0.03	0.00	0.04	0.05	0.02	0.06	0.01	1.00

This panel provides the Pearson's correlation between variables used in the audit fee sample. The variables used in the regression model are as defined in Appendix 1.

Table 3: Analysis of Conservatism and Audit Fees (continued)

Panel C: OLS Regression of Audit Fee Model

$$LAUDIT = \gamma_0 + \gamma_1 CONSV + \gamma_2 ProbLit + \gamma_3 Size + \gamma_4 Quick + \gamma_5 Loss + \gamma_6 ROA + \gamma_7 Leverage + \gamma_8 Inv\_Rec + \gamma_9 BM + \gamma_{10} NSEG + \gamma_{11} SPITEM + \gamma_{12} FOPS + \gamma_{13} Merger + \gamma_{14} Finance + \gamma_{15} Pension + \gamma_{16} BigN + \gamma_{17} GCM + \gamma_{18} Busy + Industry \& Year\ Dummies + e$$

Variable	Predicted Sign	Full Sample Analyses		Subsample Analyses	
		(1)	(2)	(3) Low Shu's score	(4) Low litigious industry
CONSV	-	-0.221***	-0.168***	-0.283***	-0.140***
		(-8.48)	(-6.90)	(-3.44)	(-5.01)
ProbLit	+		14.261***	257.402***	11.722***
			(10.37)	(3.13)	(7.51)
Size	+	0.445***	0.395***	0.104***	0.435***
		(54.53)	(43.24)	(5.93)	(43.34)
Quick	-	0.005*	0.004	0.001	0.006
		(1.80)	(1.56)	(0.41)	(1.56)
Loss	+	0.109***	0.104***	0.097**	0.123***
		(6.15)	(6.16)	(2.02)	(6.02)
ROA	-	-0.924***	-0.837***	-0.195***	-0.858***
		(-16.14)	(-15.57)	(-2.52)	(-11.07)
Leverage	+	0.022***	0.009*	-0.128*	0.004*
		(3.55)	(1.81)	(-1.65)	(0.80)
Inv_Rec	+	-0.474***	-0.637***	-0.663***	-0.773***
		(-8.78)	(-12.23)***	(-4.13)	(-12.08)
BM	-	-0.025*	-0.008	0.121***	-0.027
		(-1.65)	(-0.53)	(2.94)	(-1.49)
NSEG	+	0.047***	0.047***	0.016	0.035***
		(8.70)	(8.94)	(0.75)	(6.06)
SPITEM	+	0.167***	0.158***	0.176***	0.148***
		(13.18)	(12.90)***	(4.84)	(10.61)
FOPS	+	0.247***	0.234***	0.163***	0.231***
		(12.18)	(11.85)	(2.47)	(10.07)
Merger	+	0.096***	0.079***	0.082	0.084***
		(6.92)	(5.81)	(1.31)	(5.36)
Finance	+	0.024**	0.006	0.071*	0.005
		(2.20)	(0.56)	(1.82)	(0.39)
Pension	+	0.020	0.011	0.088	0.009
		(0.76)	(0.43)	(1.58)	(0.28)
BigN	+	0.346***	0.343***	0.530***	0.300***
		(13.50)	(13.88)	(10.24)	(10.65)
GCM	+	0.141**	0.071	-0.118	0.132**
		(2.39)	(1.26)	(-1.26)	(2.02)
Busy	+	0.134***	0.121***	0.131***	0.106***
		(7.25)	(6.71)	(2.61)	(4.91)
Intercept	?	10.880***	11.029***	11.683***	10.927***
		(162.01)	(171.28)	(85.37)	(169.93)
Industry & Year Dummies		YES	YES	YES	YES
n		18,824	18,824	1,419	13,576
Adj R^2 (%)		78.83	79.76	54.44	80.93

The variables used in the regression model are as defined in Appendix 1. In column (3), low Shu's score subsample consists of firms included in the bottom 10 percentile of annual litigation score based on Shu (2000) among all firms

listed in the Compustat. In column (4), low litigious industry subsample consists of firms operating in a less litigious industry. Litigious industries are industries with SIC codes 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370, following LaFond and Roychowdhury (2008). The industry dummies are as defined in Frankel et al. (2002). We run the OLS regression clustered by firm (Petersen 2009). For each variable, we report the regression coefficient, followed by the robust t-statistic in parentheses. To conserve space, we do not report the coefficient estimates for the industry and year dummies. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 4: Analysis of Conservatism and Going Concern Opinions

Panel A: Descriptive statistics for the Going Concern Opinion Model

Variable	*OPIN*=1 (n=541)		*OPIN*=0 (n=6,508)		Difference	
	Mean	Median	Mean	Median	t-stat	z-stat
CONSV	0.488	0.444	0.544	0.444	-1.46	-1.28
ProbLit	0.008	0.004	0.007	0.003	1.86*	1.96**
Zscore	-0.700	-1.711	-3.226	-3.459	13.18***	22.44***
Size	3.338	3.161	4.687	4.648	-20.62***	-18.82***
Ln_Age	2.394	2.303	2.499	2.398	-3.69***	-3.78***
Beta	0.702	0.586	0.877	0.806	-5.94***	-6.09***
Return	-0.354	-0.496	-0.110	-0.232	-9.93***	-13.37***
Volatility	0.005	0.004	0.003	0.002	14.21***	19.71***
Leverage	0.809	0.302	0.532	0.147	3.78***	2.87***
Cleverage	0.156	0.034	0.110	0.000	0.73	3.49***
LLoss	0.834	1.000	0.655	1.000	10.45***	8.47***
Investment	0.214	0.087	0.300	0.209	-7.32***	-8.33***
Cashflow	-0.290	-0.067	-0.031	-0.011	-2.32**	-13.39***
Future_Finance	0.421	0.000	0.481	0.000	-2.68***	-2.68***
BigN	0.643	1.000	0.769	1.000	-5.93***	-6.60***
BM	0.586	0.353	0.756	0.560	-2.62***	-7.57***

The going concern test includes 7,049 firm-year observations with financial distress for the period 2000-2007. Of these firm-year observations, a total of 541 firms received a going concern opinion for the first time. We define financially distressed firms to be firms that reports either negative net income or negative operating cash flows during the current fiscal year. This panel provides the descriptive statistics of the variables used in the model by opinion type, along with mean t-tests and median Wilcoxon z-tests of differences across the two groups. Detailed definitions of the variables are provided in Appendix 1. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 4: Analysis of Conservatism and Going Concern Opinions (continued)

Panel B: Pearson's Correlations

	OPIN	*CONSV*	*ProbLit*	*Zscore*	*Size*	*Ln_Age*	*Beta*	*Return*	*Volatility*	*Leverage*	*Cleverage*	*LLoss*	*Investment*	*Cashflow*	*Future_Finance*	*BigN*	*BM*
OPIN	1.00																
CONSV	-0.02	1.00															
ProbLit	0.04	-0.02	1.00														
Zscore	0.37	0.14	0.09	1.00													
Size	-0.22	-0.41	0.40	-0.09	1.00												
Ln_Age	-0.06	0.08	0.20	-0.06	0.11	1.00											
Beta	-0.06	-0.53	0.23	-0.01	0.53	-0.09	1.00										
Return	-0.11	0.06	-0.06	-0.11	0.29	-0.01	0.08	1.00									
Volatility	0.25	0.23	-0.13	0.18	-0.42	-0.22	-0.07	0.01	1.00								
Leverage	0.04	0.07	0.14	0.11	0.02	0.08	-0.06	-0.03	-0.01	1.00							
Cleverage	0.01	0.02	0.04	0.08	0.00	0.00	-0.02	-0.03	-0.01	0.73	1.00						
LLoss	0.11	0.02	-0.19	0.14	-0.08	-0.21	0.08	0.08	0.17	-0.07	-0.01	1.00					
Investment	-0.08	-0.28	-0.31	-0.10	0.11	-0.27	0.23	0.10	-0.01	-0.19	-0.05	0.30	1.00				
Cashflow	-0.03	-0.01	0.04	-0.02	0.05	0.03	0.01	0.00	-0.02	0.02	0.00	-0.02	-0.04	1.00			
Future_Finance	-0.04	0.00	0.04	-0.02	0.07	0.04	-0.02	0.15	-0.03	-0.02	-0.02	-0.06	-0.12	0.00	1.00		
BigN	-0.08	-0.28	0.14	0.01	0.32	-0.08	0.23	0.04	-0.05	0.03	0.02	-0.01	0.10	0.01	-0.04	1.00	
BM	-0.04	0.21	-0.06	-0.20	-0.27	0.03	-0.18	-0.20	0.07	0.10	0.02	-0.12	-0.18	0.02	-0.13	0.02	1.00

This panel provides the Pearson's correlation between variables used in the regression model for the distressed sample. The variables used in the regression model are as defined in Appendix 1.

Table 4: Analysis of Conservatism and Going Concern Opinions (continued)

Panel C: Logistic Regression of Going Concern Opinion Model

$$OPIN = \lambda_o + \lambda_1 CONSV + \lambda_2 ProbLit + \lambda_3 ZScore + \lambda_4 Size + \lambda_5 Ln\_Age + \lambda_6 Beta + \lambda_7 Return + \lambda_8 Volatility + \lambda_9 Leverage + \lambda_{10} CLeverage + \lambda_{11} LLoss + \lambda_{12} Investment + \lambda_{13} Cashflow + \lambda_{14} Future\_Finance + \lambda_{15} BigN + \lambda_{16} BM + Year\ Dummies + e$$

Variable	Predicted Sign	Full Distressed Sample Analyses		Subsample Analyses	
		(1)	(2)	(3) Low Shu's score	(4) Low litigious industry
CONSV	-	-1.190*** (12.99)	-1.484*** (19.81)	-1.958* (2.76)	-1.157*** (11.62)
ProbLit	+		31.376*** (13.16)	1015.5* (4.81)	30.405*** (9.69)
ZScore	+	0.192*** (174.09)	0.484*** (163.34)	0.934*** (55.22)	0.422*** (72.97)
Size	-	-0.601*** (32.01)	-0.728*** (50.49)	-0.298 (0.60)	-0.647*** (23.52)
Ln_Age	-	0.108 (0.74)	0.084 (0.46)	-0.031 (0.01)	0.036 (0.05)
Beta	+	0.026 (0.05)	-0.056 (0.22)	0.001 (0.01)	-0.133 (0.75)
Return	-	0.046 (0.10)	0.199 (2.46)	0.206 (0.84)	0.009 (0.01)
Volatility	+	65.474*** (18.35)	60.640*** (15.81)	33.301* (2.37)	85.785*** (21.75)
Leverage	+	0.154*** (13.22)	0.145*** (11.04)	1.132** (4.12)	0.146*** (7.36)
CLeverage	+	-0.138*** (10.23)	-0.131*** (8.86)	0.072 (0.14)	-0.118** (5.06)
LLoss	+	0.677*** (21.66)	0.745*** (25.16)	0.652 (0.73)	0.741*** (18.67)
Investment	-	-1.481*** (19.38)	-1.166*** (11.56)	-0.330 (0.21)	-1.761*** (11.09)
Cashflow	-	-0.303*** (8.24)	-0.289*** (8.47)	-0.385 (0.45)	-0.175*** (1.99)
Future_Finance	-	-0.157 (1.83)	-0.150 (1.64)	-0.082 (0.09)	-0.301** (4.06)
BigN	+	-0.172 (1.14)	-0.198 (1.50)	-0.822* (3.59)	-0.162 (0.70)
BM	?	-0.001 (0.01)	0.018 (0.04)	-0.650 (0.48)	-0.051 (0.48)
Intercept	?	1.263* (2.70)	1.751** (5.74)	-0.735 (0.09)	1.426 (2.17)
Year Dummies	?	YES	YES	YES	YES
n		7,049	7,049	1,306	4,506
Wald-statistic		462.56***	491.92***	173.91***	293.23***
Pseudo R^2 (%)		32.64	33.53	50.69	31.37
Percent Concordant		84.6	85.5	91.6	84.6

The variables used in the regression model are as defined in Appendix 1. In column (3), low Shu's score subsample consists of distressed firms included in the bottom 10 percentile of annual litigation score based on Shu (2000) among all firms listed in the Compustat. In column (4), low litigious industry subsample consists of distressed firms

operating in a less litigious industry. Litigious industries are industries with SIC codes 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370, following LaFond and Roychowdhury (2008). For each variable, we report the regression coefficient, followed by the robust Wald statistic in parentheses. To conserve space, we do not report the coefficient estimates for the industry and year dummies. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 5: Analysis of Conservatism and Auditor Resignations

Panel A: Descriptive statistics for the Auditor Resignation Model

Variable	*RESIGN*=1 (n=300)		*RESIGN*=0 (n=1,636)		Difference	
	Mean	Median	Mean	Median	t-stat	z-stat
CONSV	0.507	0.556	0.498	0.444	0.42	0.42
ProbLit	0.010	0.006	0.008	0.004	3.12***	2.62***
Asset_Growth	0.132	0.050	0.110	0.036	0.74	0.65
Abs_DA	0.103	0.063	0.084	0.051	2.24**	2.89***
Inv_Rec	0.297	0.263	0.283	0.257	1.09	0.78
GCM	0.053	0.000	0.024	0.000	2.13**	2.74***
Clean	0.643	1.000	0.620	1.000	0.77	0.77
Tenure	7.167	5.000	10.719	8.000	-7.82***	-6.95***
ROA	-0.067	0.007	-0.018	0.028	-3.35***	-3.89***
Loss	0.470	0.000	0.331	0.000	4.65***	4.62***
Levrage	0.621	0.231	0.434	0.336	3.11***	-0.76
Cash	0.138	0.080	0.119	0.063	1.99**	2.77***
Disagree	0.020	0.000	0.010	0.000	1.21	1.53
Rep_Event	0.307	0.000	0.109	0.000	7.13***	9.09***
BigN	0.687	1.000	0.880	1.000	-6.89***	-8.39***
Ln_Assets	5.032	4.763	5.536	5.462	-4.54***	-4.62***
Merger	0.187	0.000	0.211	0.000	-0.95	-0.95
BM	0.549	0.463	0.649	0.530	-3.68***	-3.34***

For the auditor resignation model, we identify 1,936 firms where auditors are changed for the period 2000-2007. We exclude former Andersen clients to avoid a potential confounding effect on our results. Of these auditor changes, 300 cases represent auditor resignation sample while the remaining changes are initiated by clients. This panel provides the descriptive statistics of the variables used in the model by auditor switch type, along with mean t-tests and median Wilcoxon z-tests of differences across the two groups. Detailed definitions of the variables are provided in Appendix 1. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 5: Analysis of Conservatism and Auditor Resignations (continued)

Panel B: Pearson's Correlations

	RESIGN	*CONSV*	*ProbLit*	*Asset_Growth*	*Abs_DA*	*Inv_Rec*	*GCM*	*Clean*	*Tenure*	*ROA*	*Loss*	*Levrage*	*Cash*	*Disagree*	*Reportable*	*BigN*	*Ln_Assets*	*Merger*	*BM*
RESIGN	1.00																		
CONSV	0.01	1.00																	
ProbLit	0.06	-0.34	1.00																
Asset_Growth	0.02	-0.09	0.04	1.00															
Abs_DA	0.05	-0.02	-0.07	0.22	1.00														
Inv_Rec	0.02	0.25	0.14	-0.07	0.01	1.00													
GCM	0.06	0.08	0.01	-0.05	0.06	0.02	1.00												
Clean	0.02	0.04	-0.13	0.06	0.02	0.07	-0.17	1.00											
Tenure	-0.15	-0.13	0.21	-0.04	-0.08	0.02	-0.07	0.00	1.00										
ROA	-0.09	-0.09	0.17	0.08	-0.46	0.14	-0.23	0.04	0.13	1.00									
Loss	0.11	0.16	-0.19	-0.10	0.21	-0.10	0.16	-0.04	-0.14	-0.60	1.00								
Levrage	0.12	0.10	0.27	0.01	-0.07	0.00	0.06	-0.06	0.05	0.05	-0.02	1.00							
Cash	0.05	-0.08	-0.23	0.05	0.12	-0.22	0.02	0.07	-0.13	-0.21	0.17	-0.36	1.00						
Disagree	0.03	-0.03	0.03	0.02	0.00	0.00	-0.02	-0.02	-0.01	0.00	0.00	-0.02	0.04	1.00					
Reportable	0.21	-0.04	0.02	0.02	0.03	0.00	0.01	-0.14	-0.10	-0.01	0.08	-0.01	0.01	0.17	1.00				
BigN	-0.20	-0.18	0.16	-0.04	-0.05	-0.06	-0.03	-0.07	0.19	0.06	-0.03	0.07	-0.08	-0.04	-0.06	1.00			
Ln_Assets	-0.10	-0.41	0.52	0.10	-0.11	-0.28	-0.17	-0.12	0.26	0.22	-0.30	0.09	-0.12	0.00	0.00	0.31	1.00		
Merger	-0.02	-0.12	0.17	0.29	0.06	-0.05	-0.02	-0.01	0.02	0.02	-0.06	0.11	-0.13	0.01	0.00	0.03	0.17	1.00	
BM	-0.07	0.37	-0.10	-0.16	-0.11	0.18	0.06	0.00	0.00	0.05	0.08	0.08	-0.19	-0.02	-0.05	0.02	-0.39	-0.05	1.00

This panel provides the Pearson's correlation between variables used in the regression model for the auditor change sample. The variables used in the regression model are as defined in Appendix 1.

Table 5: Analysis of Conservatism and Auditor Resignations (continued)

Panel C: Logistic Regression of Auditor Resignation Model

$$RESIGN = \beta_0 + \beta_1 CONSV + \beta_2 ProbLit + \beta_3 Asset\_Growth + \beta_4 Abs\_DA + \beta_5 Inv\_Rec + \beta_6 GCM + \beta_7 Clean + \beta_8 Tenure + \beta_9 ROA + \beta_{10} Loss + \beta_{11} Leverage + \beta_{12} Cash + \beta_{13} Disagree + \beta_{14} Rep\_Event + \beta_{15} BigN + \beta_{16} Ln\_Assets + \beta_{17} Merger + \beta_{18} BM + e$$

Variable	Predicted Sign	Full Auditor Change Sample Analyses		Subsample Analyses	
		(1)	(2)	(3) Low Shu's score	(4) Low litigious industry
CONSV	-	-0.988***	-1.064***	-3.584***	-0.846**
		(8.70)	(9.57)	(10.32)	(4.52)
ProbLit	+		25.005**	58.557	19.588*
			(5.24)	(0.01)	(2.66)
Asset_Growth	+	0.006	0.003	-0.282	0.094
		(0.00)	(0.00)	(0.34)	(0.35)
Abs_DA	+	0.001**	0.001**	1.569*	0.001***
		(5.25)	(4.42)	(3.39)	(11.33)
Inv_Rec	+	0.506	0.881**	2.164	0.629
		(1.79)	(4.87)	(0.94)	(1.67)
GCM	+	0.339	0.467	0.811	0.653
		(0.81)	(1.53)	(0.36)	(2.45)
Clean	-	0.243	0.225	0.730	0.200
		(2.28)	(1.93)	(0.84)	(1.08)
Tenure	-	-0.037***	-0.036***	0.011	-0.037***
		(10.89)	(10.20)	(0.07)	(8.77)
ROA	-	-0.189	-0.149	-0.586	-0.113
		(0.27)	(0.16)	(0.52)	(0.05)
Loss	+	0.303*	0.323*	0.532	0.255
		(2.71)	(3.06)	(0.49)	(1.38)
Leverage	+	0.917***	1.029***	1.488	1.078***
		(37.98)	(43.25)	(1.40)	(27.35)
Cash	-	0.697	0.680	-1.029	0.559
		(2.17)	(2.03)	(1.00)	(0.69)
Disagree	+	-0.132	-0.133	14.520***	0.423
		(0.04)	(0.04)	(111.89)	(0.35)
Rep_Event	+	1.260***	1.277***	2.159***	1.174***
		(49.66)	(50.71)	(6.16)	(29.85)
BigN	-	-0.954***	-0.977***	-1.436**	-0.882***
		(27.06)	(28.43)	(5.49)	(17.58)
Ln_Assets	-	-0.174**	-0.101	-0.335	-0.167**
		(5.31)	(1.66)	(0.87)	(3.69)
Merger	?	-0.174	-0.138	-0.138	-0.066
		(0.75)	(0.47)	(0.02)	(0.07)
BM	?	-0.493***	-0.455***	-0.122	-0.381**
		(8.16)	(7.01)	(0.04)	(4.24)
Intercept	?	-0.089	-0.408	0.9036	-0.333
		(0.02)	(0.43)	(0.13)	(0.22)
n		1,936	1,936	163	1,462
Wald-statistic		190.97***	191.43***	177.67***	147.81***
Pseudo R^2 (%)		19.50	20.02	35.91	19.32
Percent Concordant		75.1	75.1	84.0	74.6

The variables used in the regression model are as defined in Appendix 1. In column (3), low Shu's score subsample consists of firms with auditor change included in the bottom 10 percentile of annual litigation score based on Shu

(2000) among all firms listed in the Compustat. In column (4), low litigious industry subsample consists of firms with auditor change operating in a less litigious industry. Litigious industries are industries with SIC codes 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370, following LaFond and Roychowdhury (2008). We run the logistic regression clustered by firm (Petersen, 2009). For each variable, we report the regression coefficient, followed by the robust Wald statistic in parentheses. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 6: Sensitivity Tests

Panel A: Conservatism measured over the three years

	Litigation test					
	Full sample	Industry-matched Sample	Restatement Test	Fee test	Going-concern opinion test	Resignation test
CONSV_3YR	-3.110***	-2.999***	-0.487***	-0.257***	-1.253***	-1.457***
	(15.77)	(15.43)	(12.46)	(-7.21)	(8.74)	(14.23)
ProbLit			0.076	13.547***	34.398**	8.609
			(0.01)	(9.15)	(22.88)	(0.70)
Controls	YES	YES	YES	YES	YES	YES
n	14,736	4,846	13,392	15,376	5,228	1,537
R-square (%)	16.56	19.06	3.80	80.22	29.88	17.75

This panel reports main regression results with conservatism measured over the three years (*CONSV_3YR*). We estimate *CONSV_3YR* by averaging *C_Score* in KW over the previous three years and then forming deciles from 0 to 1.To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Panel B: Tests with adjusted conservatism

	Litigation test					
	Full Sample	Industry-matched Sample	Restatement Test	Fee test	Going-concern opinion test	Resignation test
ADJ_CONSV	-2.211***	-1.112**	-0.443***	-0.093***	-0.640***	-0.739**
	(12.34)	(4.24)	(6.71)	(-4.17)	(7.51)	(4.95)
ProbLit			6.697**	12.603***	31.611**	6.968
			(4.09)	(8.64)	(22.75)	(0.49)
Controls	YES	YES	YES	YES	YES	YES
N	11,717	3,589	11,975	14,180	4,375	1,312
R-square (%)	16.28	17.48	3.88	80.25	30.09	17.94

This panel reports main regression results with adjusted conservatism as explained in the Appendix 3. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Table 6: Sensitivity Tests (continued)

Panel C: Conservatism measured by non-operating accruals over previous three years (*CONSV_NOA_3YR*)

	Litigation test					
	Full Sample	Industry-matched Sample	Restatement Test	Fee test	Going-concern opinion test	Resignation test
CONSV_NOA_3YR	-0.502***	-1.269**	-0.010**	-0.216***	-0.548	-0.498**
	(6.30)	(4.01)	(4.57)	(-4.13)	(1.94)	(5.51)
ProbLit			0.433***	19.092***	27.220**	1..122
			(7.40)	(13.46)	(5.86)	(0.02)
Controls	YES	YES	YES	YES	YES	YES
n	19,887	6,743	19,015	22,478	7,819	2,384
R-square (%)	14.97	16.79	3.85	76.97	43.14	18.27

This panel reports results of the litigation test, audit fee test, going-concern opinion test, and resignation test when conservatism is alternatively measured by (-1) times the average of non-operating accruals over the previous three years (*CONSV_NOA_3YR*). Based on Givoly and Hayn (2000), non-operating accruals are computed as follows (all items deflated by beginning total assets): non-operating accruals = Total accruals (before depreciation) − Operating accruals = [(Net Income + Depreciation) − Cash flow from operations] − (Δ Accounts receivable + Δ Inventories + Δ Prepaid expenses − Δ Accounts payable − Δ Taxes payable). To conserve space, we report the coefficient estimates and significances for the variable of interests only.

Panel D: Removing book-to-market, firm size and leverage

	Litigation test					
	Full Sample	Industry-matched Sample	Restatement Test	Fee test	Going-concern opinion test	Resignation test
CONSV	-3.127***	-2.841***	-0.453***	-0.681***	-0.570**	-0.517*
	(24.15)	(19.40)	(11.72)	(-19.84)	(4.79)	(3.34)
ProbLit			1.018**	39.181***	12.147	8.007
			(4.20)	(20.14)	(1.19)	(0.77)
Controls	YES	YES	YES	YES	YES	YES
n	17,961	6,171	15,767	18,824	7,049	1,936
R-square (%)	11.53	11.56	3.72	67.05	29.92	14.74

This panel reports main regression results after excluding the book-to-market ratio (*BM*), firm size (*Size* or *Ln_Assets*) and leverage (*Leverage*) from control variables in each model. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Table 6: Sensitivity Tests (continued)

Panel E: Controlling for endogeneity

	Litigation test					
	Full Sample	Industry-matched Sample	Restatement Test	Fee test	Going-concern opinion test	Resignation test
RES	2.262	1.228	12.212***	3.040***	-3.874	0.451
	(0.24)	(0.07)	(35.19)	(5.53)	(0.67)	(0.03)
Controls	YES	YES	YES	YES	YES	YES
n	17,902	6,153	15,680	18,786	5,426	1,822
R-square (%)	16.41	18.57	4.60	79.07	27.95	19.93
Predict_CONSV			-12.815***	-3.344***		
			(39.54)	(-6.03)		
Controls			YES	YES		
n			15,680	18,786		
R-square (%)			4.52	78.96		

This panel reports the result of the Durbin-Wu-Hausman test to examine whether the dependent variable in each model is affected by the endogeneity bias. When the endogeneity cannot be rejected in the test, we perform a two-stage instrumental variable approach and use the predicted value of conservatism (*Predict_CONSV*) in the second-stage regression model. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Panel F: Controlling for signed discretionary accruals (*Signed_DA*)

	Litigation test					
	Full Sample	Industry-matched Sample	Restatement Test	Fee test	Going-concern opinion test	Resignation test
CONSV	-1.696***	-2.155***	-0.845***	-0.172***	-1.513***	-1.418***
	(8.82)	(10.85)	(11.09)	(-6.93)	(19.82)	(22.21)
ProbLit			0.478	14.298***	30.714***	16.642
			(0.02)	(10.31)	(12.44)	(2.45)
Signed_DA	0.001	0.187**	0.001	0.001**	0.002	1.222**
	(0.11)	(4.90)	(1.45)	(2.43)	(0.28)	(5.60)
Controls			YES	YES	YES	YES
n	17,961	6,171	15,318	18,293	6,918	1,936
R-square (%)	16.80	18.61	3.87	79.68	33.58	20.83

This panel reports main regression results when signed discretionary accruals (*Signed_DA*) are additionally controlled for. Performance-adjusted signed discretionary accruals (*Signed_DA*) is obtained by subtracting from each firm's abnormal accrual the median abnormal accrual from the corresponding ROA-industry decile to which the firm belongs. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Table 6: Sensitivity Tests (continued)

Panel G: Controlling for absolute discretionary accruals (*Abs_DA*)

	Litigation test		Restatement Test	Fee test	Going-concern opinion test	Resignation test
	Full Sample	Industry-matched Sample				
CONSV	-1.678***	-2.018***	-0.845***	-0.171***	-1.520***	-1.064***
	(8.73)	(9.38)	(11.09)	(-6.93)	(19.89)	(9.57)
ProbLit			0.481	14.298***	30.772***	25.005**
			(0.02)	(10.31)	(12.46)	(5.24)
Abs_DA	0.194	0.962	0.001	0.001***	0.034	0.001**
	(0.31)	(2.43)	(2.15)	(2.57)	(0.62)	(4.42)
Controls	YES	YES	YES	YES	YES	YES
n	17,961	6,171	15,318	18,293	6,918	1,936
R-square (%)	16.91	18.99	3.87	79.68	33.60	20.02

This panel reports main regression results when absolute values of discretionary accruals (*Abs_DA*) are additionally controlled for. *Abs_DA* is the absolute value of *Signed_DA*. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Panel H: Controlling for income-increasing discretionary accruals

	Litigation test				Restatement Test		Fee test		Going-concern opinion test		Resignation test	
	Full Sample		Industry- matched Sample									
	Model 1	Model 2	Model 1	Model 2	Model 1	Model 1	Model 1	Model 2	Model 1	Model 2	Model 1	Model 2
CONSV	-2.376***	-2.344***	-2.079***	-1.901***	-0.813***	-0.831***	-0.168***	-0.171***	-1.486***	-1.516***	-1.404***	-1.402***
	(15.89)	(15.18)	(10.52)	(8.41)	(10.55)	(10.79)	(-6.89)	(-6.86)	(20.25)	(20.36)	(21.78)	(21.76)
ProbLit	12.049*	12.518*	8.538*	9.720	0.909	0.188	14.178***	14.107***	31.127***	30.380***	15.037	14.952
	(2.64)	(2.80)	(1.30)	(1.74)	(0.06)	(0.00)	(10.30)	(10.22)	(12.36)	(11.63)	(2.19)	(2.17)
POS_DA	0.269	-0.151	0.491*	-0.196	0.109	0.065	0.023*	0.032**	0.049	0.045	0.189	0.191
	(0.79)	(0.20)	(2.84)	(0.33)	(1.81)	(0.56)	(1.73)	(2.38)	(0.15)	(0.12)	(1.09)	(1.11)
*POS_DA**		-0.510		-1.172*		-0.001		-0.001***		-0.001		-0.001
Signed_ DA		(0.83)		(2.73)		(1.12)		(-2.90)		(0.87)		(0.42)
Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
n	17,961	17,961	6,171	6,171	15,318	15,318	18,293	18,293	6,918	6,918	1,936	1,936
R-square (%)	17.00	17.13	18.62	19.17	3.90	3.84	79.75	79.70	33.53	33.56	20.54	20.55

This panel reports main regression results after controlling for income-increasing discretionary accruals only for the subsample with positive discretionary accruals. In model 1, we include *POS_DA*, an indicator variable that equals one if signed discretionary accruals (*Signed_DA*) is positive and zero otherwise. In model 2, we include an interaction term, *POS_DA*Signed DA*, and *POS_DA*. Performance-adjusted signed discretionary accruals (*Signed_DA*) is obtained by subtracting from each firm's abnormal accrual the median abnormal accrual from the corresponding ROA-industry decile to which the firm belongs. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Table 6: Sensitivity Tests (continued)

Panel I: Client firms audited by Big 4 or Big 5 auditors only

	Litigation test					
	Full Sample	Industry-matched Sample	Restatement Test	Fee test	Going-concern opinion test	Resignation test
CONSV	-1.791***	-2.353***	-0.961***	-0.182***	-1.501***	-1.323***
	(9.41)	(10.75)	(11.77)	(-6.77)	(12.76)	(10.02)
ProbLit			1.746	12.895***	25.751***	25.596**
			(0.23)	(8.93)	(6.54)	(4.78)
Controls	YES	YES	YES	YES	YES	YES
n	15,432	5,343	13,116	15,866	5,329	1,645
R-square (%)	19.01	19.99	4.17	79.57	35.84	18.18

This panel reports main regression results when the sample only consists of client firms audited by Big 4 or Big 5 auditors. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Panel J: Controlling for corporate governance

	Litigation test					
	Full Sample	Industry-matched Sample	Restatement test	Fee test	Going-concern opinion test	Resignation test
CONSV	-1.601***	-1.780***	-0.797***	-0.157***	-1.685***	-1.238***
	(6.74)	(7.76)	(10.00)	(-6.54)	(22.65)	(13.46)
ProbLit			1.207*	13.634***	25.058***	31.739***
			(0.12)	(9.97)	(6.14)	(6.85)
Gindex	-0.039	0.005	-0.019	0.012**	0.121	-0.010
	(0.39)	(0.01)	(0.70)	(2.01)	(0.73)	(0.02)
Duality	-0.346	-0.339	0.046	0.046**	0.259	0.262
	(1.56)	(1.30)	(0.20)	(2.12)	(0.17)	(0.68)
Executive	1.097	0.921	0.176	-0.165**	0.144	-0.077
	(1.76)	(1.26)	(0.29)	(-1.93)	(0.00)	(0.00)
Meeting	-6.019*	-6.067*	0.697	-0.843***	-8.178*	-7.826**
	(2.83)	(2.72)	(1.18)	(-4.10)	(3.13)	(4.62)
Controls	YES	YES	YES	YES	YES	YES
n	17,961	6,171	15,767	18,824	7,049	1,936
R-square (%)	17.90	20.11	4.02	79.93	37.80	21.86

This panel reports main regression results when four corporate governance variables in Lara et al. (2009) are additionally controlled for. *Gindex* is the antitakeover protection index constructed by Gompers et al. (2003). *Duality* is an indicator variable, equals 1 if the CEO is also the chair of the board and 0 otherwise. *Executive* is the proportion of executives on the board of directors. *Meeting* is the annual number of meetings of the board of directors. To conserve space, we report the coefficient estimates and significances for the variables of interests only.

Table 7: Tests with Less Litigious Countries

Panel A: Mean values of variables by country for the audit fee test

Country	n	*LAUDIT*	*CONSV*	*Size*	*Quick*	*Loss*	*ROA*	*Leverage*	*Inv_Rec*	*BM*	*FOPS*	*Finance*	*BigN*	*Busy*
Germany	41	3.691	0.398	5.176	1.810	0.146	0.057	0.648	0.360	1.069	0.171	0.390	0.634	0.927
France	288	3.957	0.461	5.237	1.486	0.302	0.024	1.073	0.405	0.624	0.031	0.382	0.438	0.837
Italy	33	3.434	0.357	5.787	1.177	0.333	-0.014	1.822	0.381	75.765	0.000	0.394	1.000	0.879
Sweden	970	3.416	0.521	4.555	1.856	0.340	-0.046	0.532	0.340	0.867	0.088	0.430	0.911	0.926
Total	1,332	3.542	0.500	4.752	1.759	0.326	-0.027	0.685	0.356	2.676	0.076	0.417	0.803	0.905

Panel B: Pearson's correlations among variables in the audit fee test

	LAUDIT	*CONSV*	*Size*	*Quick*	*Loss*	*ROA*	*Leverage*	*Inv_Rec*	*BM*	*FOPS*	*Finance*	*BigN*	*Busy*
LAUDIT	1.00												
CONSV	-0.08	1.00											
Size	0.81	-0.17	1.00										
Quick	-0.31	0.00	-0.15	1.00									
Loss	-0.34	0.12	-0.45	0.18	1.00								
ROA	0.26	-0.12	0.40	-0.07	-0.53	1.00							
Leverage	0.18	0.02	0.09	-0.16	0.02	0.01	1.00						
Inv_Rec	0.09	0.02	-0.04	-0.34	-0.13	0.14	0.03	1.00					
BM	0.10	0.04	-0.03	-0.01	-0.02	0.01	-0.01	0.05	1.00				
FOPS	0.13	-0.04	0.15	-0.03	-0.12	0.09	-0.04	0.00	-0.01	1.00			
Finance	0.09	-0.03	0.10	-0.04	0.04	-0.08	0.08	-0.11	-0.02	-0.02	1.00		
BigN	0.12	0.02	0.14	-0.02	-0.05	-0.02	-0.01	-0.09	0.01	0.09	0.02	1.00	
Busy	0.06	-0.01	0.00	0.00	0.05	-0.06	-0.02	-0.02	0.01	0.05	0.05	0.05	1.00

Panels A and B report the mean values of the variables by country, and the Pearson's correlations among variables for the audit fee test. Detailed definitions of the variables are provided in Appendix 1.

Table 7: Tests with Less Litigious Countries (continued)

Panel C: OLS Regression of Audit Fee Model

$$LAUDIT = \gamma_0 + \gamma_1 CONSV + \gamma_2 Size + \gamma_3 Quick + \gamma_4 Loss + \gamma_5 ROA + \gamma_6 Leverage + \gamma_7 Inv\_Rec + \gamma_8 BM + \gamma_9 FOPS + \gamma_{10} Finance + \gamma_{11} BigN + \gamma_{12} Busy + Industry \& Year\ Dummies + e$$

Variable	Predicted Sign	(1)	(2)
CONSV	-		-0.256***
			(-3.61)
Size	+	0.639***	0.616***
		(28.18)	(26.20)
Quick	-	-0.084***	-0.084***
		(-4.19)	(-4.19)
Loss	+	0.149**	0.154**
		(2.12)	(2.20)
ROA	-	-0.438***	-0.439***
		(-3.51)	(-3.54)
Leverage	+	1.227***	1.259***
		(4.87)	(4.98)
Inv_Rec	+	0.768***	0.768***
		(3.65)	(3.66)
BM	-	0.003***	0.003***
		(25.80)	(25.42)
FOPS	+	0.085	0.075
		(0.81)	(0.72)
Finance	+	-0.051	-0.042
		(-0.96)	(-0.79)
BigN	+	0.065	0.069
		(0.75)	(0.79)
Busy	+	0.256**	0.243*
		(1.94)	(1.88)
Intercept	?	-0.168	0.074
		(-0.84)	(0.36)
Country and Year Dummies		YES	YES
n		1,332	1,332
Adj. R^2 (%)		75.17	75.33

Panel C reports the results for the audit fee test where dependent variable is the log of audit fees in thousands of US dollars (*LAUDIT*). The OLS regression is clustered by firm (Petersen 2009). For each variable, we report the regression coefficient, followed by the robust t-statistic in parentheses. To conserve space, we do not report the coefficient estimates for the country and year dummies. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.

Table 7: Tests with Less Litigious Countries (continued)

Panel D: Mean values of variables by country for the modified opinion test

Country	n	*MOPIN*	*CONSV*	*Zscore*	*Size*	*Returns*	*BM*	*Leverage*	*LLoss*	*Investment*	*CashFlow*	*Finance*	*BigN*
Germany	962	0.123	0.520	-3.273	3.607	0.070	1.234	1.511	0.581	0.180	-0.025	0.328	0.349
France	595	0.282	0.391	-3.317	3.932	0.079	1.350	1.414	0.476	0.158	-0.031	0.429	0.392
Italy	362	0.337	0.561	-3.066	4.743	4.626	27.318	1.951	0.663	0.113	-0.008	0.420	0.674
Sweden	449	0.011	0.537	-3.255	5.690	0.366	1.035	0.541	0.688	0.245	-0.153	0.423	0.713
Total	2,368	0.174	0.580	-3.249	4.257	0.825	5.213	1.370	0.587	0.176	-0.048	0.386	0.478

Panel E: Pearson's correlations among variables in the modified opinion test

	MOPIN	*CONSV*	*Zscore*	*Size*	*Returns*	*BM*	*Leverage*	*LLoss*	*Investment*	*CashFlow*	*Finance*	*BigN*
MOPIN	1.00											
CONSV	-0.05	1.00										
Zscore	0.16	0.08	1.00									
Size	-0.14	-0.20	-0.10	1.00								
Returns	0.07	0.03	-0.02	0.12	1.00							
BM	0.07	-0.04	0.01	-0.03	-0.01	1.00						
Leverage	0.13	0.05	0.28	-0.07	0.00	0.00	1.00					
LLoss	0.06	0.15	0.10	-0.20	-0.01	0.02	0.04	1.00				
Investment	-0.08	0.06	-0.21	-0.01	0.00	-0.03	-0.16	0.19	1.00			
CashFlow	0.05	-0.05	-0.17	-0.06	0.01	-0.02	0.08	-0.10	-0.29	1.00		
Finance	0.00	-0.02	0.12	0.17	0.05	0.03	0.03	-0.07	-0.09	-0.09	1.00	
BigN	0.17	-0.04	0.08	0.22	0.08	0.05	0.05	0.07	-0.02	-0.02	0.00	1.00

Panels D and E report the mean values of the variables by country, and the correlations among variables for the modified opinion test. Detailed definitions of the variables are provided in Appendix 1.

Table 7: Tests with Less Litigious Countries (continued)

Panel F: Regression Results for Modified Opinion Model

$$MOPIN = \lambda_o + \lambda_1 CONSV + \lambda_2 ZScore + \lambda_3 Size + \lambda_4 Return + \lambda_5 Leverage + \lambda_6 LLoss + \lambda_7 Investment + \lambda_8 Cashflow + \lambda_9 Future\_Finance + \lambda_{10} BigN + \lambda_{11} BM + Year\ Dummies + e$$

Variable	Predicted Sign	(1)	(2)
CONSV	-		-0.773*** (10.39)
ZScore	+	0.262*** (18.57)	0.271*** (19.34)
Size	-	-0.204*** (23.30)	-0.229*** (26.72)
Return	-	0.023* (3.68)	0.025** (3.92)
Leverage	+	0.030* (3.40)	0.031* (3.39)
LLoss	+	-0.084 (0.41)	-0.041 (0.10)
Investment	-	-0.711* (3.34)	-0.649* (2.75)
Cashflow	-	0.487 (2.54)	0.441 (2.00)
Future_Finance	-	0.136 (1.12)	0.139 (1.17)
BigN	+	0.461*** (10.62)	0.445*** (10.19)
BM	?	0.001** (4.62)	0.001** (6.05)
Intercept	?	-2.379*** (80.95)	-1.853*** (32.95)
Country and Year Dummies	?	YES	YES
n		2,368	2,368
Wald-statistic		230.79***	229.82***
Pseudo R^2 (%)		24.24	25.00
Percent Concordant		78.0	78.3

Panel F reports the results for the modified opinion test where the dependent variable is 1 if the auditor issued modified audit opinion and 0 otherwise (*MOPIN*). The number of modified opinions included in the analysis equals 413. The logistic regression is clustered by firm (Petersen 2009). For each variable, we report the regression coefficient, followed by the robust Wald statistic in parentheses. To conserve space, we do not report the coefficient estimates for the country and year dummies. '*', '**', and '***' denote significance at 10%, 5%, and 1% levels (two-tailed), respectively.