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Are disclosed auditor materiality thresholds informative of firms' earnings quality? – Evidence from the revised ISA 700 audit report

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Are disclosed auditor materiality thresholds informative of firms' earnings quality? – Evidence from the revised ISA 700 audit report*

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Key words: Materiality threshold, audit report, earnings quality

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Abstract

Under the Financial Reporting Council's presumption that mandating new disclosure requirement in the audit report would provide information useful to investors, we examine whether the auditor disclosed materiality threshold is associated with the firm's earnings quality. We document that a lower threshold of materiality level is associated with a higher earnings quality, as measured by lower discretionary accruals, higher accruals quality, and less earnings smoothing. We also find some evidence that the negative association between auditor disclosed materiality threshold and earnings quality is more pronounced when the auditor is more independent, when management's incentive to manage earnings is higher, and when there is lower information uncertainty. Overall, our results are useful to investors who rely on the new audit report disclosures to gain insights into the audit process and more importantly to infer the quality of the firm's reported earnings. Our results could also be relevant to regulators, such as the PCAOB and IAASB, who are contemplating whether to impose similar materiality threshold disclosure requirements in audit reports.

Key words: Materiality threshold, audit report, earnings quality

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Introduction

Materiality is an important concept in auditing work, and is also an area of particular interest to investors given its potential impact on the scope of an audit and the evaluation of audit findings. In response to increasing investors' demands for more information on a firm's auditing process, the Financial Reporting Council (FRC) recently revised International Standards on Auditing (UK and Ireland) 700 (ISA 700) to require auditors to report how they applied the concept of materiality in performing the audit and how this affected the scope of their audits. The new standard is effective for audits of financial statements for periods commencing on or after 1 October 2012. The revised ISA 700 represents the first time that risk assessment and materiality planning in the audit process will be incorporated in the audit report. Hence, for the first time, we are able to examine the informativeness of auditor disclosed materiality thresholds in the new audit report.

Anecdotal evidence suggests that users of the audit report would find the materiality threshold information useful in assessing the quality of the audit. For example, in the consultation paper "Requiring the auditor's report to address risks of material misstatement, materiality and a summary of the audit scope" (FRC 2013a), a UK asset manager commented: "We firmly believe that there should be a greater focus on auditing judgments in the auditor's report – issues about which it is appropriate for the auditor to make initial disclosures. By auditing judgments, we mean a disclosure of … the materiality threshold, both overall and in terms of performance materiality. All of these are vital insights into the quality of the audit and enable investors to assess the value they are getting for the money they are paying for the audit, as well as providing a helpful basis for dialogue between investors and those charged with governance." In the same consultation paper, the FRC also highlighted that "investors believe that the auditor's report could usefully provide a

platform of information about the audit which they could use as a basis for engagement about the audit. The proposed information about the auditor's assessment of risks and materiality and how the scope of the audit was responsive to these assessments would make the company-specific application of the auditing standards more transparent." Hence, the FRC's underlying presumption in mandating this new disclosure requirement is that the disclosed materiality threshold will be informative about the quality of the audit, and by extension, the earnings quality of the financial statements. The objective of this study is to shed light on this presumption by examining whether the disclosed materiality threshold is associated with the firm's earnings quality.

A priori, it is not clear how the auditor disclosed materiality threshold is associated with the firm's earnings quality. On the one hand, a low material threshold results in a greater likelihood that an error detected will be deemed as material by the auditors. Consequently, the auditor needs to perform more work and procedures to obtain reasonable assurance that the financial statements are not materially misstated. As a result of more extensive audit procedures that are performed, and combined with a lower tolerable misstatement, the likelihood of detecting accounting errors increases and more accounting errors are likely to be corrected. Furthermore, the disclosure of materiality threshold can increase scrutiny from investors, and hence auditors' accountability with respect to quantitative materiality assessment under the revised ISA 700. The increased accountability can in turn lead auditors to expend greater audit effort or become more conservative in their audit judgements (Hoffman and Patton 1997; Asare et al. 2000; DeZoort et al. 2006). As such, they may be less willing to tolerate a major misstatement that exceeds the threshold (i.e., allow waiver of misstatement adjustment) because this can increase the likelihood of a challenge by investors that the auditor fails to require management to correct the misstatement when a restatement occurs subsequently. Based on the above arguments, we should expect a lower auditor

materiality threshold to be associated with a higher earnings quality.

On the other hand, standard setters have opted to view materiality as a matter of professional judgment and stress the importance of both qualitative and quantitative materiality considerations (Staff Accounting Bulletin (SAB) No. 99). Hence, even when the auditor discloses a materiality threshold, the auditor still has the discretion to waive a major misstatement that exceeds the disclosed quantitative threshold on the grounds that the misstatement is immaterial based on qualitative factors, especially when the auditor is not fully independent and caters to management's financial reporting pressures. Furthermore, the disclosure of quantitative materiality threshold could have the countervailing effect of reducing the litigation risk of the auditor, and hence their inclination to rely strictly on quantitative materiality threshold in their misstatement adjustment decisions (Jennings et al. 1991; Doxey 2013).[1] To the extent that auditor's legal liability is reduced when they disclose explicit quantitative materiality thresholds, we expect auditors to be more willing to tolerate material misstatements that exceeds the threshold and allow waiver of such misstatements. Consequently, we may not observe a lower auditor materiality threshold to be associated with higher earnings quality.

We empirically test the link between disclosed auditor materiality threshold and earnings quality based on 432 firm-year observations for UK premium listed firms over 2013 and 2014. We directly measure auditors' threshold of materiality by hand-collecting the monetary value of the materiality threshold reported by the auditor in the audit report. We find that a lower threshold of materiality level is associated with a higher earnings quality, as measured by lower discretionary

[1] For example, Jennings et al. (1991) examine the effect of disclosing quantitative materiality thresholds on judges' assessments of auditor liability for uncorrected misstatements in an experimental setting. They find that adding language to the auditor's report that listed an explicit materiality threshold (e.g., 10% of net income) significantly reduced the judges' liability judgments against the auditors, even when the auditors found the error but fail to disclose it.

accruals, higher accruals quality, and less earnings smoothing. This result is robust to the control of auditor fixed effects to capture inherent differences in audit practices across different auditors. It is also robust to the inclusion of industry and time fixed effects to control for across industry and over time variation in earnings quality.

Finally, we conduct a series of cross-sectional tests and find that the negative association between auditor disclosed materiality threshold and earning quality is stronger when auditor independence is higher and when managers' incentives to manage earnings is higher. These results suggest that when the economic dependence on the client is high, the auditor could be more tolerant towards the client's opportunistic behavior and less likely to use quantitative materiality thresholds assessments to curtail aggressive manager choices. In addition, when managers have stronger incentives to manage earnings, the likelihood of potential misstatement increases and hence auditors are likely to be more conservative in evaluating materiality decisions and use quantitative materiality thresholds to curb earnings management. Finally, we find that the negative association between auditor disclosed materiality threshold and earning quality is weaker when information uncertainty is higher. This result suggests that when there is greater information uncertainty about accounting estimates, auditors are less likely to deem a misstatement as being sufficiently material to require an audit adjustment and therefore more likely to waive such adjustments. Consequently, the materiality threshold becomes less informative about the quality of the audit and hence the firm's earnings quality.

This paper makes several important and novel contributions. First, the new audit report as required by the revised ISA 700 auditing standards reflects the UK accounting standard setter's expectation that disclosure of the auditor's materiality threshold will better enable financial statement users to assess the reliability of the financial statements and the quality of the audit. To

the best of our knowledge, this paper is the first to comprehensively examine the link between materiality threshold and firm's earnings quality. The results in this study would be relevant and important to investors who rely on the auditors' materiality threshold to gain insights into the audit process and more importantly to infer the quality of the firm's reported earnings. Our results could also be useful to regulators, such as the PCAOB and IAASB, who are contemplating whether to impose similar materiality threshold disclosure requirements in audit reports.

Second, most prior studies that examine how the auditors' materiality thresholds affect audit outcomes are conducted using experimental data (e.g., Libby and Kinney 2000; Ng and Tan 2003, 2007), surveys (e.g., Nelson et al. 2002, 2003), or limited archival data (Wright and Wright 1997; Keune and Johnstone 2012). Our study is able to rely on the publicly disclosed materiality threshold in the revised audit report to directly test the link between materiality thresholds and earnings quality, thus complementing and increasing the generalizability of the results documented in prior studies.

Finally, prior studies examining the link between auditing and earnings quality generally focused on auditor attributes such as auditor size, industry specialization, auditor tenure, and non-audit fees (DeFond and Zhang 2014). In contrast, there is limited archival evidence documenting the audit process, primarily due to data limitations. In their review of the recent archival audit research, DeFond and Zhang (2014) call for more archival research on the black box of the audit process using creative settings and research designs in light of the data limitations (p.304). Recently, studies begin to examine how the auditing process influences audit quality using novel settings. For example, Lennox et al. (2016) examine how year-end audit adjustments are related to earnings quality using proprietary data from China. Given that the materiality threshold is an important part of the auditor's risk assessment and planning process, our study responds to DeFond

and Zhang's (2014) call for more archival research into the audit process and thus extends and contributes to this line of literature.

The remainder of our paper proceeds as follows. The next section discusses the related literature and develops hypotheses. Section 3 describes the data and research methodology. Section 4 presents the primary analyses and Section 5 presents the additional analyses. Section 6 concludes.

2. Related literature and hypothesis development

2.1 Background of ISA 700 (Revised)

The Financial Crisis of 2008 heightened investors' and other stakeholders' concerns about the reliability of financial reporting and how the audit process can be enhanced to increase the usefulness of financial statements. In particular, investors and other users of financial statements have criticized that the current "pass/fail" model of the audit report provides little information on the audit process and how the auditor addressed the risks of material misstatements. In response, the UK Financial Reporting Council (FRC) introduced new requirements for auditor's reports on companies with effect for periods commencing on or after 1 October 2012. Specifically, ISA (UK and Ireland) 700 (Revised) ("ISA 700") requires auditors to include within their audit reports (a) a description of those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team; (b) an explanation of how the auditor applied the concept of materiality; and (c) a summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement described in (a) and the applied materiality as described in (b).

Even before ISA 700 was revised, financial statement users have repeatedly called for

auditors to disclose quantitative materiality thresholds in the audit report (e.g., Mock et al. 2013; PCAOB 2011a, 2011b; IAASB 2011; Carcello et al. 2011; IAASB 2012). Although there was no such requirement for auditors, ISA (UK and Ireland) 320 ("ISA 320") "establishes standards and provide[s] guidance on the concept of materiality" (FRC 2009, p. 2). Along with the disclosure of auditor's materiality thresholds under the new ISA 700, the Public Company Accounting Oversight Board (PCAOB) and the International Auditing and Assurance Standards Board (IAASB) have issued proposals to call for similar requirements (IAASB 2013; PCAOB 2013). For instance, in June 2011, the PCAOB issued a Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements (PCAOB 2011a). The concept release proposed four potential changes to audit reporting, including the addition of an "Auditor's Discussion and Analysis" (AD&A) section to the audit report that would allow the auditor to discuss, among others, materiality levels. In May 2011, the IAASB issued the Consultation Paper "Enhancing The Value Of Auditor Reporting: Exploring Options For Change" to solicit views among users of financial statements on whether including the level of materiality applied by the auditor during the audit engagement in the standard auditor's report would provide useful information about the audit.

Concurrent studies examine the effects of the new audit report requirements under ISA 700. For instance, Reid et al. (2015a) find that abnormal trading volume significantly increased following the implementation of the new disclosure regime, and that abnormal trading volume increased more for companies with weaker information environments. Reid et al. (2015b) find that although audit fees marginally increased after the reporting changes, the increase is not significantly different from the fee increase documented in the prior year, which suggests a possible time trend of increasing fees unrelated to the new reporting requirements.

Gutierrez et al. (2016) find that the new report resulted in a pre-post adoption increment in audit fees of approximately seven percent for adopter companies, compared to non-adopter companies. However, they do not find evidence that the new report had an immediate one-year effect on audit quality or investors' reaction. Lennox et al. (2017) find that the valuation coefficients on earnings and net assets are smaller for companies where auditors report a greater number of risks of material misstatement, consistent with the new disclosures reliably communicating the uncertainty in accounting measurements. However, inconsistent with the disclosures being incrementally informative, they find that the valuation coefficients are not significantly different in the year that the new audit reports become publicly available as compared with the prior year.

Most relevant to this paper, two studies examine the disclosure of materiality thresholds in the audit report. Amiram et al. (2017) find that the firm's reliance on debt financing and the extent of insider shareholding are associated with lower auditor materiality thresholds. In addition, they also find that the difference between the earnings multiples of high and low materiality threshold firms decreases after the disclosure of the thresholds, consistent with low materiality threshold firms benefiting from the disclosure that auditors apply a more stringent threshold, and hence improving the perceived relative reliability of their financial statements. Gutierrez et al. (2016), in a supplementary analysis, find that materiality is positively associated with absolute discretionary accruals, suggesting that comparatively smaller materiality is associated with higher audit quality. However, their study only examines one measure of earnings quality, and they only examine the immediate one-year effect of the new regulation. We provide more comprehensive evidence on whether the disclosed materiality thresholds are informative about three proxies of earnings quality and how this relation is moderated by auditor independence, management incentives to manage

earnings, and the firm's information uncertainty.

2.2 Hypothesis Development

The FASB, in Financial Accounting Concepts Statement No. 2, Qualitative Characteristics of Accounting information, defined materiality as "the magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." At the planning phase of an audit, the auditor decides on the overall magnitude of materiality ("planning materiality") that is used to plan and define the scope of the audit. In determining the amount of planning materiality, the auditor considers the company's earnings and other relevant factors such as the nature and complexity of the business. The auditor then "allocate" a portion of the planning materiality to account balances or classes of transaction to determine the amount of tolerable misstatement "for purposes of assessing the risks of material misstatement and planning and performing audit procedures at the account or disclosure level" (AS No. 11). The tolerable misstatement represents the materiality threshold below which misstatements can occur and not be considered material.

When errors or misstatements are detected during the course of the audit, the auditor will compare the amount of these misstatements with the tolerable materiality threshold to determine if they are material. In considering whether a misstatement is material, the auditor may also consider qualitative characteristics of the misstatement (SAB No. 99). If the detected misstatement is deemed to be material enough to require adjustment of the client's books, the auditor informs the client management and the audit committee of the misstatement, and these parties must reach agreement about whether managers are required to correct the misstatements prior to issuing the financial statements. Managers may be waived from correcting misstatements if the auditor and

audit committee conclude that the misstatements do not render the financial statements materially incorrect. The ultimate decision to book or waive adjustment is influenced by managers' incentives, auditors' incentives, and audit committee characteristics (Keune and Johnstone 2012).

Because of the importance of materiality on the scope and effectiveness of an audit, the FRC proposed that the materiality threshold of an audit be disclosed in the audit report so that users can assess the reliability of the financial statements and the quality of the audit. For instance, the revised ISA 700 (para 19B) states that "the explanations of the matters required to be set out in the auditor's report by paragraph 19A (which includes assessed risks of material misstatement, the auditor's application of the concept of materiality, and the scope of the audit) shall be described so as to enable a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements." In the consultation paper "Requiring the auditor's report to address risks of material misstatement, materiality and a summary of the audit scope" (FRC 2013b, para 11), the FRC opines that shareholders and other users of financial statements may derive considerable benefit from being provided with information about the auditor's assessment of materiality. Hence, the FRC's underlying presumption is that the disclosed materiality threshold will be informative about the quality of the audit, and by extension, the earnings quality of the financial statements. Our study sheds light on this presumption by examining whether the disclosed materiality threshold is associated with earnings quality.

We posit that lower disclosed materiality threshold in the revised ISA 700 is associated with higher earnings quality. First, a low level of material threshold results in greater likelihood that an error detected will be deemed as material by the auditors. Consequently, the auditor needs to perform more work and procedures to obtain reasonable assurance that the financial statements

are not materially misstated. As a result of more extensive audit performed, and combined with a lower tolerable misstatement, the likelihood of detecting accounting errors increases and more accounting errors are likely to be corrected. Hence, there are fewer accounting errors remaining in the financial statements and the risk of material misstatement decreases. Further, prior studies document that the misstatement amount relative to the planning materiality threshold is an important factor in the auditor's decision whether to book or waive detected misstatements (Icerman and Hillison 1991; Wright and Wright 1997). Therefore, we expect earnings quality to be higher when disclosed materiality threshold is lower.

Second, the disclosure of materiality threshold can increase scrutiny from investors, and hence auditors' accountability with respect to quantitative materiality assessment under the revised ISA 700. Supporting this notion of increased accountability from disclosure, Carcello and Li (2013) find that the requirement for the engagement partner to sign on the audit report increases the partner's accountability. Reid et al. (2015b) argue that the enhanced disclosures by auditors in the new audit report will increase the transparency of the audit work performed and hence increase the accountability of the auditors to stakeholders. The increased accountability can in turn lead auditors to expend greater audit effort or become more conservative in their audit judgements (Hoffman and Patton 1997; Asare et al. 2000; DeZoort et al. 2006).[2] When auditors disclose their quantitative materiality threshold in the audit report, they may be less willing to tolerate a major misstatement that exceeds the threshold (i.e., allow waiver of misstatement adjustment) because this can increase the likelihood of a challenge by investors that the auditor fails to require

[2] For example, Hoffman and Patton (1997) find that accountability led to more conservative fraud risk judgments. Asare et al. (2000) find, in an experimental setting, that accountability increases the breadth and nature of the work performed by auditors, which the authors associate with better performance. More related to our study, DeZoort et al. (2006) find that auditors under higher levels of accountability pressure (i.e., justification pressure, feedback pressure) were more conservative and less variable in their materiality judgments than auditors under lower levels of pressure (i.e., anonymity, review pressure).

management to correct the misstatement when a restatement occurs subsequently. Consistent with this notion, Deloitte commented the following in their comment letter to the revised ISA 700 (Deloitte 2013):

"Reporting of the overall threshold used by the auditor is likely to reduce the circumstances in which a classification error that is larger than planning materiality (after revision) can be determined to be immaterial (paragraph A15 of ISA (UK and Ireland) 450), even where this does not affect key ratios or other metrics of interest to shareholders. The risk of subsequent challenge would be too great for an auditor to accept this situation. Reporting of the threshold used for the reporting of unadjusted differences to the audit committee will result in there being no such unadjusted differences. As shareholders may well ask the CFO and/or audit committee chair at the AGM to confirm whether or not there were any such differences, the CFO will be driven to book them. This may be appropriate for factual errors, but for an extrapolated error close to the threshold it may be less so."

Therefore, to the extent that the disclosed quantitative materiality thresholds make auditors more careful and conservative in their materiality judgments and less likely to waive misstatement adjustments, we conjecture a lower disclosed materiality threshold to result in more misstatements being detected, more audit adjustments required, fewer errors, and hence higher earnings quality.

Notwithstanding the above arguments, we may not observe earnings quality to be higher when disclosed materiality threshold is lower for the following reasons. First, standard setters have opted to view materiality as a matter of professional judgment and stress the importance of both qualitative and quantitative materiality considerations (SAB No. 99). For example, SAB No. 99, *Materiality*, states that auditors should not strictly rely on quantitative measures when assessing materiality. Rather, auditors should also consider several qualitative considerations pertinent to assessing the materiality of an accounting error, such as whether the error masks a change in earnings or other trends, hides a failure to meet Wall Street analysts' consensus sales or earnings forecasts, changes a loss into profit, increases management compensation, affects compliance with loan covenants, contracts, or regulatory requirements, involves concealment of an unlawful

transaction, and whether management or the outside auditor expects that the known error may result in a significant positive or negative stock market reaction. This hence affords auditors with greater flexibility in determining whether a detected misstatement is material or not.

There has been empirical evidence that auditors seem to apply qualitative materiality considerations so as to allow management to realize accounting outcome opportunistically, especially when the auditor is not fully independent and caters to management's financial reporting pressures. For example, Libby and Kinney (2000) and Ng (2007) document that quantitatively immaterial earnings misstatements are less likely to be corrected if they would cause reported earnings to fall below analysts' consensus forecast. Ng and Tan (2007) show that auditors are less likely to require correction of a quantitatively immaterial audit difference that affects the company's ability to meet analysts' consensus forecasts when the manager expresses concern about the adverse consequences for failing to meet earnings expectations. Hence, to the extent that auditor's materiality judgements are influenced by their desire to help management achieve reporting objectives, auditors may still allow material misstatements to be waived even when the materiality threshold is publicly disclosed. In other words, auditors acquiescing to management's pressure to meet or beat earnings benchmarks may garble the informativeness of disclosed materiality thresholds. Thus, we may not observe earnings quality to be higher when disclosed materiality threshold is lower as expected.

Second, the disclosure of quantitative materiality threshold could have the countervailing effect of reducing the litigation risk of the auditor, and hence their inclination to rely strictly on quantitative materiality threshold in their misstatement adjustment decisions. As highlighted earlier, because regulators do not define the ideal level of materiality threshold, auditors and users differ substantially on their views of what constitutes a material fact ("expectation gap"). This

expectation gap has been partially blamed for the large number of lawsuits and judgments against auditors (Porter 1993). The disclosure of materiality threshold can potentially reduce this expectation gap and hence decrease auditor legal liability. Supporting this notion, Jennings et al. (1991) examine the effect of disclosing quantitative materiality thresholds on judges' assessments of auditor liability for uncorrected misstatements in an experimental setting. They find that adding language to the auditor's report that listed an explicit materiality threshold (e.g., 10% of net income) significantly reduced the judges' liability judgments against the auditors, even when the auditors found the error but fail to disclose it. Doxey (2013) uses an experiment to test the effect of a quantitative materiality disclosure on investors' materiality judgments. He finds that investors anchor their materiality judgments on the threshold explicitly disclosed by the auditor, which represents a qualitative and quantitative change in the determination of materiality. This, in effect, reduces the expectations gap between auditors and users and hence resulting in greater agreement with the audit report, even when uncorrected misstatements below the auditor's threshold are subsequently disclosed. Therefore, to the extent that auditor's legal liability is reduced when they disclose quantitative materiality thresholds, we expect auditors to be more willing to tolerate material misstatements that exceeds the threshold and allow waiver of such misstatements to acquiesce to management's pressure. Consequently, we may not observe earnings quality to be higher when materiality thresholds are lower.

Based on the above discussions, whether disclosed materiality threshold is related to earnings quality is ultimately an empirical question. Hence, we formulate the following hypothesis in null form:

H1: The auditor's disclosed materiality threshold level under the revised ISA 700 is not associated with the firm's earnings quality.

3. Research Methods

3.1 Sample Selection

Table 1 describes our sample selection process. We construct our initial sample firms from those companies in the London Stock Exchange Premium ("LSE") Listing for fiscal years 2013 and 2014. We further require that these companies are traded in the LSE main market, and are not in the financial industries (LSE group code 8000-8999). This procedure results in an initial sample of 579 firm-year observations. We then exclude 18 observations that are not covered in the Compustat Global, where we obtain our financial information. Next, we obtain these companies' annual reports from their corporate websites or from http://www.portalchemy.com/. For each annual report, we manually collect the materiality-related threshold data disclosed by the auditor. We exclude 23 observations where the materiality threshold information is not disclosed, and 32 observations due to missing data from Compustat Global to calculate key variables such as discretionary accruals. Finally, we drop 74 observations without auditor tenure data. These sample selection criteria lead to a final sample of 432 firm-year observations.

3.2 Research Design

To examine the association between earnings quality and auditor disclosed materiality amount, we run the following OLS model at firm-year level for sample firms over the years 2013 and 2014:

$$EQ\_Proxy_{i,t} = \beta_0 + \beta_1 \cdot logMatAmt_{i,t} + \beta_2 \cdot Size_{i,t} + \beta_3 \cdot PPE_{i,t} + \beta_4 \cdot Leverage_{i,t} + \beta_5 \cdot ROA_{i,t} + \beta_6 \cdot MTB_{i,t} + \beta_7 \cdot stdCFO_{i,t} + \beta_8 \cdot Big4_{i,t} \quad (1)$$

$$+ \beta_9 \cdot AuditTenure_{i,t} + AuditorFE + Industry\ FE + Year\ FE + \varepsilon_{i,t}$$

The dependent variable *EQ_Proxy* denotes our measures of earnings quality. Our first measure is the absolute value of discretionary accruals (*absDACC*), which is estimated using the modified Jones (1991) approach as in prior literature (Carcello and Li 2013; Dechow et al. 1995; Kothari et al. 2005; Reichelt and Wang 2010). Our second measure is accruals quality (*DDAcc*), which is a measure of accrual estimation error developed by Dechow and Dichev (2002). This measure defines the quality of accruals as the extent to which accruals map into past, current, and future cash flows. Smoothing transitory cash flows can improve earnings persistence and earnings informativeness. However, managers attempting to conceal the real variability in their firms' economic performance by smoothing reported earnings will lead to a less informative earnings number (Burgstahler et al. 2006). Hence, our third measure is a measure of earnings smoothness (*Smoothness*), which is the standard deviation of earnings divided by the standard deviation of cash flows, scaled by beginning total assets, and earnings smoothness is increasing in this measure. For all three measures, we multiply them by negative one so that higher values correspond to higher earnings quality. *logMatAmt* is our key variable of interest and is defined as the natural logarithm of the monetary value of the materiality threshold reported by the auditor in the annual report.

We include several controls variables that are commonly used in prior studies of earnings quality (e.g., Francis et al. 2004). $Size_{i,t}$ is the natural logarithm of total assets; $PPE_{i,t}$ is total property, plant and equipment divided by total assets; $Leverage_{i,t}$ is long-term debt divided by total assets; $ROA_{i,t}$ is net income before extraordinary items divided by total assets; $MTB_{i,t}$ is market value of common equity divided by the book value of equity; and $stdCFO_{i,t}$ is the standard deviation of cash flows from operations for the four years prior to year t. In addition, we include

several auditor characteristics that are associated with both earnings quality and the materiality threshold utilized. We include an indicator variable for the Big 4 auditors ($Big4_{i,t}$) as a control because of potential differences in audit quality between Big 4 and non-Big 4 auditors. We also include auditor tenure ($AuditTenure_{i,t}$) as an additional control because of potential differences in audit quality for auditors with longer tenure. Additionally, we include auditor fixed effects to capture inherent differences in audit practices across different auditors.

Finally, we include industry fixed effects (*Industry FE*) and time fixed effects (*Year FE*) to control for across industry and over time variation in earnings quality.

4. Empirical Results

4.1 Descriptive Statistics

Table 2 provides the descriptive statistics for the final 432 firm-year observations. All values are measured in British Pounds. The mean (median) materiality amount is 19.33 (4.73) million pounds, representing an average (median) 0.7% (0.5%) of firm's total assets. The mean total assets is 4,100 million pounds. On average, PPE is about 50% of total assets. The mean leverage ratio is 0.17, which suggests that the sample firm is not too highly leveraged. The sample firms are generally profitable, with a mean ROA of 0.041. The mean market-to-book ratio is 4.57 and the mean standard deviation of CFO is 0.037. About 94% of the sample firms hire the Big 4 audit firms as their auditors, which is not surprising given that our sample represents the largest firms in the UK. The average firm in our sample also retained their auditors for a long period, with average auditor tenure of 13.37 years.

4.2 Regression Results

Table 3 presents the regression results for H1 on the association between auditor materiality

threshold and earnings quality. Columns 1, 2 and 3 report results using the absolute value of discretionary accruals (*absDACC*), the Dechow-Dichev discretionary accruals quality (*DDAcc*), and earnings smoothness (*Smoothness*), respectively. Column 1 shows that the coefficient on *logMatAmt* is negative and significant (t = -2.66), which provides evidence that a lower auditor materiality amount is associated with higher earnings quality. Thus, it appears that a lower auditor materiality threshold enables auditors to more effectively constrain management opportunistic accounting behavior, resulting in lower absolute discretionary accruals.

Column 2 shows that the coefficient on *logMatAmt* is negative and significant (t = -1.92), which suggests that a lower auditor materiality amount is associated with a smaller unexplained portion of the variation in working capital accruals. Finally, Column 3 shows that the coefficient on *logMatAmt* is negative and significant (t = -2.89). To the extent that smoother earnings are a result of earnings management, this result suggests that a lower auditor materiality threshold is associated with less earnings management via income smoothing which corresponds to higher earnings quality. The relation between materiality threshold and earnings quality is also economically significant. In particular, a one standard deviation decrease in materiality amount is associated with a 58.4%, 29.6% and 39.4% increase in earnings quality, proxied by *absDACC*, *DDAcc* and *Smoothness*, respectively.[3] The results for the control variables are generally consistent with those in prior studies; firms with larger size, lower leverage, better earnings performance, lower cash flow volatility, and firms audited by the Big 4 auditors exhibit higher earnings quality.

In sum, the results from analyses of three main measures of earnings quality suggest that the

[3] The impact of a one standard deviation decrease in materiality amount (*logMatAmt*) on earnings quality, proxied by *absDACC* is computed as -0.0182 (coefficient on *logMatAmt*) × 1.7034 (the sample standard deviation of *logMatAmt*) ÷ 0.0531 (the sample mean of *absDACC*) = 58.4%. The other comparative statics are computed analogously.

materiality level is statistically and economically associated with a firm's accounting quality. It also indicates that materiality level is a crucial input in the planning process to help auditors design audit procedures and make critical audit judgment.

5. Additional Analyses

5.1 Cross-Sectional Analyses

In the main analysis, we find that a lower auditor materiality threshold level is associated with higher earnings quality. In this section, we examine how this relation is moderated by auditors' independence, management's incentives to manage earnings, and the firm's information uncertainty.

5.1.1 Auditors' independence

While prior studies have shown that auditors acquiesce to managers' financial reporting demands in their materiality decisions, this is more likely to happen when the auditor has lower bargaining power relative to the managers (Libby and Kinney 2000; Ng 2007; Ng and Tan 2007; Keune and Johnstone 2012). When the economic dependence on the client is high, the auditor could be more tolerant towards the client's opportunistic behavior and less likely to use materiality assessments to curtail aggressive manager choices. Hence, we expect the auditors to be less likely to deem an accounting error that is larger than the planning materiality as immaterial (and hence allow management to waive these errors) when they are more independent and less subject to management's influence. Consequently, the negative association between auditor materiality threshold and firm's earnings quality should be more pronounced when auditor independence increases.

Prior studies show that a client becomes more important to the auditor and the auditor's

independence is impaired when the non-audit fees are higher (e.g., Frankel et al. 2002; Ferguson et al. 2004; Gaver and Paterson 2007; Ghosh et al. 2009). Hence, our first proxy for auditor independence is non-audit fees as a proportion of total assets (*NonAudFee/TA*) (as used in Ashbaugh et al. 2003). In addition, there is some empirical evidence that a longer auditor tenure may also impair auditor independence and result in lower earnings quality (Manry et al. 2008; Chen et al. 2008; Chi et al. 2009). Hence, our second proxy for auditor independence is the number of years an audit firm is with the client (*AuditTenure*). We multiply both *NonAudFee/TA* and *AuditTenure* by negative one so that a higher value indicates greater audit independence. To examine how auditor independence affects the relation between materiality amount disclosed by the auditors and firm's earnings quality, we re-run Equation (1) by further separately including the variables *NonAuditFee/TA* and its interaction with *logMatAmt*, and the variable *AuditTenure* and its interaction with *logMatAmt* in the regression. Table 4, Panels A and B present the regression results based on *NonAuditFee/TA* and *AuditTenure*, respectively.

In Table 4 Panel A, we find that the coefficient on the interaction of *logMATAmt* and *NonAuditFee/TA* is significantly negative when we measure earnings quality using absolute value of discretionary accruals (t = -2.63) or using the unexplained portion of accruals to predict cash flows (t = -3.59). These results indicate that when non-audit fees are lower and hence when the auditor is more independent, the negative association between materiality threshold and earnings quality is stronger. There is no evidence of such effect when we measure earnings quality by the extent of earnings smoothing. Next, Table 4 Panel B shows that the coefficient on the interaction of *logMATAmt* and *AuditTenure* is significantly negative when we measure earnings quality using the unexplained portion of accruals to predict cash flows (t = -1.71). There is no evidence of such effect when we measure earnings quality by the absolute value of discretionary accruals or the

extent of earnings smoothing. Taken together, the results in Tables 4, Panels A and B provide some evidence that auditors are more likely to constrain earnings management using a lower materiality threshold when they are more independent.

5.1.2 Management incentives to manage earnings

Earlier, we argue that when materiality thresholds are disclosed in the new audit report, auditors are likely to be more conservative in evaluating materiality decisions and more reluctant to allow management to waive major misstatements or errors. Because having a stronger management incentive to manage earnings increases the likelihood of potential misstatement and errors, we expect auditors to be more careful in their materiality decisions. Hence, we expect the negative relation between auditor's materiality threshold and firm's earnings quality to be more pronounced when managers have stronger incentives to manage earnings.

We utilize several proxies for the incentives to manage earnings. Managers may have greater incentives to manage earnings prior to a forthcoming debt financing (*DebtFinancing*), hence we examine whether the association between audit materiality amount and firm's earning quality is strengthened under the circumstance of firms' forthcoming debt issuance. Prior studies also suggest that there is an additional market premium to meeting or beating earnings benchmark consistently (e.g., Kasznik and McNichols 2002), hence managers who habitually meet or beat earnings benchmark have greater incentives to manage earnings to continue meeting or beating earnings expectations. We classify a firm as a habitual benchmark beater if it reports at least two years of increasing EPS in the prior three years (*D_EPSIncr2*). Finally, prior work suggests that firms have incentives to manage earnings to avoid debt covenant violations (e.g., Dichev and Skinner 2002) or to avoid credit ratings downgrade (Jung et al. 2013). We proxy for a firm's debt-

related incentives to manage earnings using the firm's leverage ratio (*Leverage*).

We then separately include *DebtFinancing*, *D_EPSIncr2* and *Leverage* and their interaction term with audit materiality amount in model (1), and Table 5 Panels A, B and C present these results, respectively. In Table 5 Panel A, we find that the coefficient on the interaction of *logMatAmt* and *DebtFinancing* is significantly negative when we measure earnings quality using absolute value of discretionary accruals (t = -1.83) or using the unexplained portion of accruals to predict cash flows (t = -2.87). These results indicate that the association between lower materiality threshold and higher earnings quality is more pronounced when the firm has a forthcoming debt issuance. There is no evidence of such effect when we measure earnings quality by the extent of earnings smoothing. In Table 5 Panel B, we find that the coefficient on the interaction of *logMatAmt* and *D_EPSIncr2* is significantly negative when we measure earnings quality using the extent of earnings smoothing (t = -2.14), which indicates that the association between lower materiality threshold and higher earnings quality is more pronounced when the firm is a habitual benchmark beater. There is no evidence of such effect when we measure earnings quality using the absolute value of discretionary accruals or using the unexplained portion of accruals to predict cash flows. Finally, in Table 5 Panel C, we find that the coefficient on the interaction of *logMatAmt* and *Leverage* is significantly negative when we measure earnings quality using the unexplained portion of accruals to predict cash flows (t = -1.94), which indicates that the association between lower materiality threshold and higher earnings quality is more pronounced when the firm has higher leverage. There is no evidence of such effect when we measure earnings quality using the absolute value of discretionary accruals or the extent of earnings smoothing.

Overall, these results are consistent with our prediction that when management has greater incentive to manage earnings, auditors are aware of these incentives and are hence more likely to

strictly apply planned materiality to evaluate audit findings.

5.1.3 Information Uncertainty

Prior literature suggests that auditors tend to have less bargaining power in negotiating the adjustment of accounting estimates with their clients when there is significant room for judgment about an accounting issue (Deis and Giroux 1992; Magee and Tseng 1990). Accordingly, when there is greater information uncertainty about accounting estimates, auditors are less likely to deem a misstatement as being material enough to require an audit adjustment and more likely to waive such adjustments; that is, auditors are likely to rely less on materiality thresholds to curb opportunistic earnings management and the disclosed materiality threshold becomes less informative about the earnings quality of the firm. Consequently, the negative association between auditor's materiality threshold and firm's earnings quality should be weaker when information uncertainty is higher. On the other hand, prior literature suggests that auditors are more conservative in evaluating uncertain audit evidence when the cost of audit failure is high (Patterson and Smith, 2003). Moreover, Griffin (2014) find that auditors are most likely to require adjustments when fair values contain both more input subjectivity and more outcome imprecision. As such, it is possible that when there is greater information uncertainty about accounting estimates, auditors are likely to rely more on materiality thresholds to curb opportunistic earnings management; that is, the negative association between auditor's materiality threshold and firm's earnings quality would be stronger when information uncertainty is higher.

We empirically examine the ambiguous association discussed above using the average monthly bid-ask spread over the fiscal year (*Spread*) to proxy for information uncertainty and including *Spread* and its interaction term with audit materiality amount in model (1), and Table 6

presents the result. We find that the coefficient on the interaction of *logMATAmt* and *Spread* is significantly positive when we measure earnings quality using absolute value of discretionary accruals (t = 2.33) or using the unexplained portion of accruals to predict cash flows (t = 1.93). The result indicates that when information uncertainty is higher, the association between lower materiality threshold and higher earnings quality is weaker. There is no evidence of such effect when we measure earnings quality by the extent of earnings smoothing. Hence, our results provide some evidence that auditors rely less on materiality threshold in the course of their audit when information uncertainty is high, resulting in a weaker association between low materiality threshold and high earnings quality.

5.2 Market Reaction to Disclosed Materiality Threshold

In a final supplementary test, we investigate whether the disclosed materiality threshold moderates investors' response to earnings surprise. In particular, we expect investors to place less weight on earnings surprise if the disclosed materiality threshold is higher and hence investors perceive earnings quality to be lower. For this analysis, we estimate the following regression model:

$$\begin{aligned} Ret_{i,t+1} = \quad & \beta_0 + \beta_1 \cdot EPSchg_{i,t} + \beta_2 \cdot logMatAmt_{i,t} + \beta_3 \cdot EPSchg_{i,t} \times logMatAmt \\ & + \beta_4 \cdot Size_{i,t} + \beta_5 \cdot Leverage_{i,t} + \beta_6 \cdot Distress_{i,t} + \beta_7 \cdot MTB_{i,t} \\ & + AuditorFE + Industry\ FE + Year\ FE + \varepsilon_{i,t} \end{aligned} \tag{2}$$

The dependent variable *Ret* is the one-month, two-month and three-month returns cumulated three months after the fiscal year end to ensure that the disclosed materiality threshold are available to investors. We proxy for earnings surprise using the annual change in earnings per share excluding extraordinary items (*EPSchg*). We include several control variables including firm size (*Size*),

leverage (*leverage*), whether the firm is in financial distress (*Distress*), market-to-book ratio (*MTB*), and auditor, industry and year fixed effects. The results of this empirical estimation are presented in Table 7.

As observed from this table, we find that investors placed significantly less weight on earnings surprise when returns are proxied by one-month (t = -1.98) and two-month returns (t = --2.54), although the results are negative but insignificant when we examine three-month returns (t = -1.39). Overall, the market reaction test corroborates our earlier findings that the disclosed materiality threshold is informative about earnings quality, and investors placed less weight on earnings surprise with higher disclosed materiality thresholds accordingly. This result also supports the UK regulators' view that the disclosed materiality threshold will better enable investors to assess the reliability of the financial statements and the quality of the audit.

6. Conclusion

The revised ISA 700 issued by the Financial Reporting Council requires auditors to report how they applied the concept of materiality in performing the audit and how this affected the scope of their audits. In this study, we examine how the materiality threshold disclosed by the auditor in the new audit report is associated with earnings quality. Based on 432 firm-year observations for UK premium listed firms over 2013 and 2014, we find that a lower threshold of materiality level is associated with a higher earnings quality, as measured by lower discretionary accruals, higher accruals quality, and less earnings smoothing, and after controlling for auditor, industry and time fixed effects. In cross-sectional tests, we find some evidence that the negative association between materiality threshold and earning quality is more pronounced when the auditor is more independent, when management's incentives to manage earnings are higher, and less pronounced when there is

higher firm's information uncertainty. Overall, our results are consistent with our prediction that a low material threshold results in a greater likelihood that an error detected will be deemed as material by the auditors, and consequently, the more extensive audit procedures performed, combined with a lower tolerable misstatement, increases the likelihood of detecting accounting errors and these errors being corrected. The result is also consistent with the disclosure of materiality threshold increasing scrutiny from investors, and hence auditors' accountability with respect to quantitative materiality assessment under the revised ISA 700, which in turn lead auditors to expend greater audit effort or become more conservative in their audit judgements.

To the best of our knowledge, this study is the first to comprehensively examine the link between materiality threshold and firm's earnings quality. Because the new audit report as required by the revised ISA 700 auditing standards reflects the UK accounting standard setter's expectation that disclosure of the auditor's materiality threshold will better enable financial statement users to assess the reliability of the financial statements and the quality of the audit, our results would be relevant and important to investors who rely on the auditors' materiality threshold to gain insights into the audit process and more importantly to infer the quality of the firm's reported earnings. Our results could also be useful to regulators, such as the PCAOB and IAASB, who are contemplating whether to impose similar materiality threshold disclosure requirements in audit reports. Our study also complement the results documented in prior studies that examine how the auditors' materiality thresholds affect audit outcomes are conducted using experimental data and surveys (e.g., Libby and Kinney 2000; Ng and Tan 2003; Ng and Tan 2007; Nelson et al. 2002, 2003). Finally, given that the materiality threshold is an important part of the auditor's risk assessment and planning process, our study responds to DeFond and Zhang's (2014) call for more archival research into the audit process and complement Lennox et al. (2016) who examine how year-end audit adjustments

are related to earnings quality using proprietary data from China.

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Appendix: Variable Definition

Variable	Definition
Dependent Variables	
absDACC	Absolute discretionary accruals, estimated based on a cross-sectional modified Jones model (Jones 1991) as described in Dechow et al (1995), multiplied by -1. The higher the value, the higher the earnings quality.
DDAcc	Accruals quality measure, estimated based on Dechow and Dichev (2002) model, multiplied by -1. The higher the value, the higher the earnings quality.
Smoothness	-1*Earnings smoothness, measured as standard deviation of earnings divided by the standard deviation of cash flows, scaled by beginning total assets, multiplied by -1. The higher the value, the higher the earnings quality.
Audit Report Variables	
logMatAmt	Materiality amount, measured as natural logarithm of the materiality threshold in million dollars disclosed by the auditors in audit reports.
NonAudFee/TA	Non-Audit fee percentage, measured as total non-audit fees divided by total assets disclosed in the annual report, multiplied by -1.
AuditTenure	Total number of years an audit firm is with the client, multiplied by -1.
Control Variables	
Size	Firm size, measured as the natural logarithm of the total assets at the end of the fiscal year.
MTB	Market-to-book ratio, measured as the market value divided by the book value of common equity of the firm at the end of the fiscal year.
ROA	Return on assets, calculated as income before extraordinary items for the fiscal year divided by total assets at the beginning of the fiscal year.
Leverage	Leverage ratio, measured as long-term debt at the end of the fiscal year divided by total assets at the beginning of the fiscal year.
PPE	Property, plant and equipment, measured as total PPE divided by total assets at the end of fiscal year.
stdCFO	Cash flow volatility, measured as the standard deviation of cash flows from operations during previous four years, scaled by beginning total assets.
D_EPSIncr2	Indicator variable equals to one if EPS increases in at least 2 years of the past 3 years, and zero otherwise.
DebtFinancing	Indicator variable equals to one if book value of debt increases more than 3% of total assets in the following year, and zero otherwise.
Spread	Bid-Ask Spread, measured as average monthly bid-ask spread ((bid price – ask price)/closing price) over the fiscal year. The higher the value, the more uncertain information environment.
Big4	Indicator variable equal to 1 if the auditor is a big 4 auditing firm, and zero otherwise.
EPSchg	Change in annual EPS (excluding extraordinary items) from year t to

	year t-1.
Distress	Indicator variable equal to 1 if firm reports a net loss in year t, and zero otherwise.
Ret1m	Cumulative one-month returns starting three months after fiscal year end.
Ret2m	Cumulative two-month returns starting three months after fiscal year end.
Ret3m	Cumulative three-month returns starting three months after fiscal year end.

Table 1: Sample Selection

Sample selection criteria	Firm-year obs.
Companies in LSE premium listing, main market, non-financial, ordinary shares (2013 and 2014)	579
Less: Firms not in Compustat Global	(18)
Less: Firms without materiality amount as disclosed	(23)
Less: Firms without discretionary accruals measure from Jones' Model (column 1 of Table 3)	(32)
Less: Firms without auditor tenure data (column 1 of Table 3)	(74)
Final sample of firms during 2013 and 2014	432

Table 2
Summary Descriptive
(based on sample size of column 1 in Table 4)

Variable	N	Mean	S.D.	0.25	Mdn	0.75
Dependent variables						
absDACC	432	0.0531	0.0662	0.0137	0.0339	0.0649
DDAcc	377	0.0339	0.0321	0.0127	0.023	0.0436
Smoothness	432	1.4012	1.1312	0.6716	1.0352	1.7543
Control variables						
logMatAmt	432	1.4957	1.7034	0.3365	1.5546	2.6391
TotalAssets(million)	432	4100	10000	250	840	2900
Size	432	6.7183	1.8575	5.52	6.7302	7.9774
PPE	432	0.4991	0.3909	0.1665	0.3929	0.7773
Leverage	432	0.1739	0.1714	0.0071	0.146	0.2708
ROA	432	0.0408	0.1033	0.0203	0.0509	0.0873
MTB	432	4.5718	15.4203	1.4605	2.3406	4.2994
stdCFO	432	0.0374	0.035	0.0161	0.0279	0.0446
EarnVol	432	0.048	0.0567	0.0184	0.0333	0.0584
DebtFinancing	417	0.0216	0.1455	0	0	0
D_EPSIncr2	432	0.6968	0.4602	0	1	1
Spread	426	0.0108	0.0216	0.001	0.0022	0.0093
Big4	432	0.9375	0.2423	1	1	1
NonAudFee/TA	428	0.0006	0.0013	0.0001	0.0002	0.0005
AuditTenure	432	13.3681	11.8948	6	11	17
EPSchg	427	-0.052	0.3665	-0.0961	0.0053	0.0727
Ret1m	427	0.013	0.0858	-0.0343	0.006	0.0516
Ret2m	427	0.0193	0.1112	-0.0525	0.0136	0.0766
Ret3m	427	-0.0036	0.1307	-0.092	-0.0041	0.0791
Distress	432	0.1713	0.3772	0	0	1

*All variables are winsorized at 1% and 99%

Table 3
Earnings Quality and Level of Materiality Disclosed in Audit Report

	(1) absDACC	(2) DDAcc	(3) Smoothness
logMatAmt	**-0.0182*** **	**-0.0059***	**-0.3236*** **
	(-2.66)	**(-1.92)**	**(-2.89)**
Size	0.0174***	0.0088***	0.2793**
	(2.60)	(3.10)	(2.48)
PPE	0.0043	0.0059	0.0970
	(0.39)	(1.12)	(0.50)
Leverage	-0.0574**	-0.0183	-0.9096**
	(-2.49)	(-1.60)	(-2.47)
ROA	0.3091***	0.0179	3.1595***
	(4.16)	(1.10)	(4.59)
MTB	0.0003	-0.0001	0.0041
	(1.17)	(-0.70)	(1.39)
stdCFO	-0.6100***	-0.3517***	7.9715***
	(-3.71)	(-5.44)	(2.94)
Big4	0.0390**	0.0011	0.3887
	(2.08)	(0.16)	(1.56)
AuditTenure	-0.0001	-0.0000	0.0077**
	(-0.45)	(-0.17)	(2.15)
Intercept	-0.1429***	-0.0582***	-3.1495***
	(-3.78)	(-3.43)	(-4.75)
AuditorFixedEffect	Yes	Yes	Yes
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
# of Observations	432	377	432
R^2	0.481	0.395	0.386

This table reports the regression results of the relation between material threshold and proxies of earnings quality. The detailed definitions of all variables are provided in the Appendix. Coefficients on the auditor, year and industry indicator variables are not tabulated for brevity. The t-statistics reported in parentheses are based on robust standard errors controlling for heteroscedasticity. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively (two-tailed test).

Table 4
Earnings Quality and Level of Materiality Disclosed—Auditor's Independence
Panel A: Non-audit fees

	(1) absDACC	(2) DDAcc	(3) Smoothness
logMatAmt	-0.0223***	-0.0080**	-0.2274*
	(-2.66)	(-2.53)	(-1.83)
Size	0.0195**	0.0089***	0.1708
	(2.44)	(2.78)	(1.39)
PPE	0.0044	0.0070	0.0540
	(0.40)	(1.30)	(0.28)
Leverage	-0.0433**	-0.0161	-0.7391**
	(-2.41)	(-1.28)	(-2.04)
ROA	0.3071***	0.0071	2.8256***
	(3.77)	(0.43)	(4.02)
MTB	0.0002	-0.0001	0.0069*
	(0.81)	(-0.83)	(1.72)
stdCFO	-0.4628***	-0.2940***	8.8309***
	(-3.20)	(-4.75)	(2.79)
NonAudFee/TA	0.0446	0.0626***	1.3507***
	(1.01)	(2.82)	(2.74)
logMatAmt*NonAudFee/TA	**-0.0500*** **	**-0.0392*** **	**0.1202**
	(-2.63)	**(-3.59)**	**(0.51)**
Big4	0.0282*	0.0000	0.3989
	(1.74)	(0.01)	(1.63)
AuditTenure	0.0000	0.0001	0.0086**
	(0.02)	(0.43)	(2.36)
Intercept	-0.1483***	-0.0575***	-2.5795***
	(-3.40)	(-3.09)	(-3.64)
AuditorFixedEffect	Yes	Yes	Yes
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
# of Observations	428	375	428
R^2	0.501	0.432	0.400

Panel B: Auditor's tenure

	(1) absDACC	(2) DDAcc	(3) Smoothness
logMatAmt	-0.0171**	-0.0097***	-0.3386***
	(-2.40)	(-2.71)	(-2.91)
Size	0.0174***	0.0089***	0.2786**
	(2.61)	(3.11)	(2.47)
PPE	0.0048	0.0043	0.0905
	(0.43)	(0.79)	(0.46)
Leverage	-0.0572**	-0.0195*	-0.9134**
	(-2.48)	(-1.70)	(-2.48)
ROA	0.3083***	0.0210	3.1703***
	(4.16)	(1.29)	(4.57)
MTB	0.0003	-0.0001	0.0041
	(1.17)	(-0.73)	(1.39)
stdCFO	-0.6052***	-0.3669***	7.9062***
	(-3.69)	(-5.94)	(2.90)
AuditTenure	-0.0000	0.0004	-0.0060
	(-0.16)	(1.21)	(-1.30)
logMatAmt*AuditTenure	**0.0001**	**-0.0002***	**-0.0010**
	(0.68)	**(-1.71)**	**(-0.58)**
Big4	0.0375**	0.0058	0.4095
	(1.98)	(0.84)	(1.58)
Intercept	-0.1438***	-0.0564***	-3.1373***
	(-3.80)	(-3.35)	(-4.72)
AuditorFixedEffect	Yes	Yes	Yes
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
# of Observations	432	377	432
R^2	0.481	0.411	0.387

This table reports the regression results of the role of auditor independence on the relation between material threshold and proxies of earnings quality. In Panel A, auditor independence is proxied by non-audit fees and in Panel B, auditor's independence is proxied by auditor's tenure. The detailed definitions of all variables are provided in the Appendix. Coefficients on the auditor, year and industry indicator variables are not tabulated for brevity. The t-statistics reported in parentheses are based on robust standard errors controlling for heteroscedasticity. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively (two-tailed test).

Table 5
Earnings Quality and Level of Materiality Disclosed—Managerial Incentives
Panel A: Debt Financing in Following Year

	(1) absDACC	(2) DDAcc	(3) Smoothness
logMatAmt	-0.0200***	-0.0059*	-0.3876***
	(-2.65)	(-1.90)	(-3.61)
Size	0.0199***	0.0089***	0.3439***
	(2.66)	(3.12)	(3.06)
PPE	0.0088	0.0063	0.1225
	(0.77)	(1.19)	(0.66)
Leverage	-0.0590**	-0.0169	-0.9194**
	(-2.46)	(-1.47)	(-2.46)
ROA	0.3327***	0.0232	3.5278***
	(3.92)	(1.45)	(4.56)
MTB	-0.0000	-0.0001	0.0004
	(-0.21)	(-0.81)	(0.14)
stdCFO	-0.6089***	-0.3529***	7.6851***
	(-3.54)	(-5.45)	(2.95)
DebtFinancing	0.0360	0.0250***	0.7644**
	(1.17)	(3.03)	(2.34)
logMatAmt*DebtFinancing	**-0.0168***	**-0.0072*****	**-0.1696**
	(-1.83)	**(-2.87)**	**(-1.63)**
Big4	0.0307	0.0002	0.3337
	(1.62)	(0.03)	(1.19)
AuditTenure	-0.0001	-0.0000	0.0064*
	(-0.35)	(-0.17)	(1.80)
Intercept	-0.1521***	-0.0593***	-3.4196***
	(-3.60)	(-3.49)	(-5.04)
AuditorFixedEffect	Yes	Yes	Yes
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
# of Observations	417	377	417
R^2	0.499	0.401	0.427

Panel B: Reporting Increasing EPS

	(1) absDACC	(2) DDAcc	(3) Smoothness
logMatAmt	-0.0193***	-0.0055	-0.2628**
	(-2.72)	(-1.51)	(-2.43)
Size	0.0171**	0.0088***	0.2806**
	(2.56)	(3.10)	(2.50)
PPE	0.0036	0.0060	0.1180
	(0.33)	(1.13)	(0.60)
Leverage	-0.0585**	-0.0180	-0.8944**
	(-2.55)	(-1.51)	(-2.40)
ROA	0.3088***	0.0185	3.2726***
	(4.09)	(1.12)	(4.68)
MTB	0.0003	-0.0001	0.0042
	(1.07)	(-0.67)	(1.46)
stdCFO	-0.6017***	-0.3535***	7.6561***
	(-3.67)	(-5.58)	(2.79)
D_EPSIncr2	-0.0085	0.0011	0.1559
	(-0.95)	(0.19)	(1.19)
logMatAmt*EPSIncr2	**0.0023**	**-0.0006**	**-0.1038****
	(0.69)	**(-0.27)**	**(-2.14)**
Big4	0.0397**	0.0010	0.3832
	(2.15)	(0.14)	(1.51)
AuditTenure	-0.0001	-0.0000	0.0082**
	(-0.47)	(-0.16)	(2.27)
Intercept	-0.1401***	-0.0584***	-3.2153***
	(-3.73)	(-3.43)	(-4.82)
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
AuditorFixedEffect	Yes	Yes	Yes
Observations	432	377	432
R^2	0.483	0.395	0.391

Panel C: Leverage

	(1) absDACC	(2) DDAcc	(3) Smoothness
logMatAmt	-0.0217***	-0.0035	-0.3417***
	(-2.99)	(-1.05)	(-2.97)
Size	0.0169**	0.0094***	0.2767**
	(2.51)	(3.32)	(2.46)
PPE	0.0023	0.0067	0.0862
	(0.21)	(1.29)	(0.45)
Leverage	-0.0770**	0.0016	-1.0111**
	(-2.45)	(0.10)	(-2.41)
logMatAmt*Lev	**0.0207**	**-0.0163***	**0.1079**
	(1.29)	**(-1.94)**	**(0.54)**
ROA	0.3183***	0.0131	3.2075***
	(4.31)	(0.84)	(4.62)
MTB	0.0003	-0.0001	0.0040
	(1.12)	(-0.58)	(1.36)
stdCFO	-0.5885***	-0.3429***	8.0834***
	(-4.04)	(-5.42)	(2.96)
Big4	0.0415**	-0.0018	0.4018
	(2.22)	(-0.23)	(1.60)
AuditTenure	-0.0001	-0.0000	0.0076**
	(-0.52)	(-0.00)	(2.12)
Intercept	-0.1376***	-0.0636***	-3.1221***
	(-3.64)	(-3.69)	(-4.72)
AuditorFixedEffect	Yes	Yes	Yes
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
# of Observations	432	377	432
R^2	0.486	0.404	0.387

This table reports the regression results of the role of managerial incentives on the relation between material threshold and proxies of earnings quality. In Panel A, managerial incentives are proxied by debt financing in the following year, in Panel B, managerial incentives are proxied by reporting increasing EPS and in Panel C, managerial incentives are proxied by leverage. The detailed definitions of all variables are provided in the Appendix. Coefficients on the auditor, year and industry indicator variables are not tabulated for brevity. The t-statistics reported in parentheses are based on robust standard errors controlling for heteroscedasticity. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively (two-tailed test).

Table 6
Earnings Quality and Level of Materiality Disclosed—Information Uncertainty

	(1) absDACC	(2) DDAcc	(3) Smoothness
logMatAmt	-0.0209***	-0.0061**	-0.3261***
	(-2.80)	(-2.00)	(-2.83)
Size	0.0214***	0.0087***	0.3157***
	(2.65)	(2.95)	(2.61)
PPE	0.0049	0.0084	0.0859
	(0.43)	(1.54)	(0.44)
Leverage	-0.0581***	-0.0191	-0.8739**
	(-2.81)	(-1.62)	(-2.44)
ROA	0.3325***	0.0254	3.6914***
	(3.76)	(1.46)	(4.38)
MTB	0.0000	-0.0001	0.0016
	(0.12)	(-0.88)	(0.62)
stdCFO	-0.6180***	-0.3587***	7.5825***
	(-4.22)	(-5.46)	(2.77)
Spread	0.7466*	0.2385	8.9223**
	(1.94)	(1.30)	(2.00)
logMatAmt*Spread	**0.3778****	**0.2667***	**3.1577**
	(2.33)	**(1.93)**	**(1.49)**
Big4	0.0329*	-0.0078	0.3874
	(1.81)	(-0.78)	(1.43)
AuditTenure	-0.0000	0.0000	0.0082**
	(-0.16)	(0.24)	(2.23)
Intercept	-0.1925***	-0.0650***	-3.7496***
	(-3.40)	(-3.24)	(-4.61)
AuditorFixedEffect	Yes	Yes	Yes
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
# of Observations	426	372	426
R^2	0.482	0.414	0.385

This table reports the regression results of the role of information uncertainty on the relation between material threshold and proxies of earnings quality, where information uncertainty is proxied using bid-ask spread. The detailed definitions of all variables are provided in the Appendix. Coefficients on the auditor, year and industry indicator variables are not tabulated for brevity. The t-statistics reported in parentheses are based on robust standard errors controlling for heteroscedasticity. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively (two-tailed test).

Table 7
Market Reaction to Disclosed Materiality Threshold

	(1)	(2)	(3)
	Ret1m	Ret2m	Ret3m
EPSchg	0.0484*	0.0477*	0.0225
	(1.88)	(1.75)	(0.69)
logMatAmt	0.0013	0.0276**	0.0249*
	(0.15)	(2.35)	(1.96)
logMatAmt*EPSchg	-0.0200**	-0.0209**	-0.0141
	(-1.98)	(-2.54)	(-1.39)
Size	-0.0027	-0.0259**	-0.0301**
	(-0.34)	(-2.33)	(-2.36)
Leverage	0.0223	0.0467	0.0392
	(0.73)	(1.17)	(0.88)
Distress	-0.0024	-0.0049	-0.0392*
	(-0.16)	(-0.27)	(-1.86)
MTB	-0.0005**	0.0001	0.0001
	(-1.99)	(0.32)	(0.20)
Intercept	0.0148	0.1241	0.1638*
	(0.26)	(1.52)	(1.73)
AuditorFixedEffect	Yes	Yes	Yes
IndustryFixedEffect	Yes	Yes	Yes
YearFixedEffect	Yes	Yes	Yes
Observations	424	424	424
R^2	0.236	0.220	0.211

This table reports the regression results of market reaction to disclosed materiality threshold. The detailed definitions of all variables are provided in the Appendix. Coefficients on the auditor, year and industry indicator variables are not tabulated for brevity. The t-statistics reported in parentheses are based on robust standard errors controlling for heteroscedasticity. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively (two-tailed test).