Audit Partners’ Role in Material Misstatement Resolution: Survey and Interview Evidence

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ABSTRACT

Auditors are expected to identify and resolve material misstatements (“MMs”) in management’s financial statements. However, the audit process is opaque, providing limited public information beyond the audit opinion. While prior studies reveal some correlates of MMs, there is scant evidence about how auditors resolve MMs and the resulting consequences to the partner or audit relationship. We will shed light on these topics by first surveying both current and former audit partners, who have contemporary experience but are less constrained by firm policies. Next, we will interview small samples of audit partners, CFOs, and audit committee members. We have conducted semi-structured interviews with five highly experienced former Big 4 partners and found significant variation in how partners identify and resolve MMs. For example, interviewees report sometimes using qualitative factors to dismiss quantitatively material misstatements; frequently relying on the national office to help resolve MMs; that most MMs are identified in estimates; and that the frequency of identified MMs relates to ownership structure, industry, and management culture. We expect our survey responses and interviews to expound on these points, shedding new insights into the auditor’s role in corporate financial reporting that will be of interest to academics, practitioners, and regulators.
1. Introduction

Longstanding interest surrounding the auditor’s role in the financial reporting process has grown over the past two decades. This growing interest stems in part from audit failures in the early 2000s, which triggered both scholarly examination of questions about auditor independence (Frankel, Johnson, Nelson 2002; Ashbaugh, LaFond, and Mayhew 2003; Healy and Palepu 2003) and unprecedented legislative and regulatory overhauls of the public company audit standard setting and oversight functions (Ball 2009; Coates and Srinivasan 2014; Leuz and Wysocki 2016). Persistent opacity around the audit process also fuels this growing interest. Despite recent efforts to identify audit quality indicators (e.g., AE 2016; CAQ 2016; CPAB 2018), academics, investors, and regulators ordinarily learn little about auditors’ work, except in rare instances in which auditor litigation or regulatory enforcement is public.

We will address this gap by first surveying audit engagement partners (henceforth “audit partners”) about their role in the corporate financial reporting process and then by conducting follow-up semi-structured interviews with audit engagement partners, CFOs and audit committee chairs. Existing work suggests that auditors influence reporting quality through the identification of audit adjustments, only some of which management subsequently records (Lennox, Wu, and Zhang 2016; Choudhary, Merkley and Schipper 2019; Lennox, Wang, and Wu 2020). We aim to extend this research by asking questions about how audit partners assess material misstatement (“MM”) risk, identify MMs, and dismiss potential MMs.¹ Specifically, we plan to ask partners about the circumstances under which MMs are most likely to arise and characteristics of identified

¹ Based on our review of auditing standards and our discussions with audit partners, we define a MM as an individual or aggregate material difference identified between (1) an account balance or disclosures as reported in management’s financial statements, and (2) an account balance or disclosures that are required for them to be in accordance with the applicable financial reporting framework. This definition acknowledges that there often multiple acceptable ways for management to meet these requirements.
MMs. We also seek evidence on the process partners use to resolve MMs, both with client management and within the audit firm (e.g., how often and under what circumstances does client management disagree that a MM exists, and how frequently are the national office or specialists involved in resolving disagreement?). Last, we will ask about the consequences of identifying, failing to identify, and resolving MMs to partners and audit relationships.

Much of the data we seek are impracticable for academics to obtain archivally. Publicly observable signals including auditor engagement and dismissals, fee disclosures, and audit report modifications are laden with boilerplate discussion and limited in informativeness of the auditor’s role in identifying and resolving MMs. Regulator-provided data offers an inside, albeit limited, perspective on how often management records or waives proposed adjustments. Existing evidence from these sources indicates a range of estimates around the frequency with which audits identify proposed adjustments, depending on the location and nature of the engagement (e.g., whether the audit occurred in the U.S. or was the target of a risk-based PCAOB inspection) (Kinney and Martin 1994; Lennox, Wu, and Zhang 2016; Choudhary et al. 2019). This range underscores the importance of understanding the context in which MMs are discovered, including circumstances that are neither recorded by existing datasets nor easily codified, as well as the unfolding of the resolution process that is unobservable to researchers.\(^2\) Moreover, the audit regulation environment has changed considerably over the past two decades, providing opportunity to revisit earlier findings. In terms of consequences of identifying and resolving MMs, Dechow, Ge, and Schrand (2010) explain: “while the basic premise that auditors could mitigate misstatements is straightforward, compelling empirical evidence is limited because auditor effort/effectiveness and

\(^2\) As Choudhary et al. (2019) explain, “inspected audits are selected based on expert judgments of ex post audit risk” (p. 1305), and therefore figures from PCAOB inspected audits may not generalize. Further how the MM resolution process unfolds remains opaque to regulatory inspectors to the extent their work occurs with a significant lag from audit fieldwork and relies on auditors’ stylized documentation of the MM resolution process (Peecher et al. 2013).
incentives are unobservable, and data to create proxies for these constructs are often unavailable” (p. 383; emphasis added).

Overall, little information exists in the public domain to assess the extent to which and conditions under which auditors exert influence on companies’ financial reporting process. Thus, we use the survey method, enhanced by follow-up interviews, to unearth new evidence on MM risk factors, the resolution of MMs, and consequences of MMs. Our survey will include both recently retired partners, who have contemporary experience but whose participation and responses are unconstrained by firm policies, and current partners, because of their understanding of the most recent audit practices and trends. Inviting these partners to participate in our survey on a confidential basis will allow us to obtain a broad firm-independent sample of responses from partners at a variety of Big 4 and non-Big 4 audit firms.

We organize our survey around three topics. Our first topic focuses on the factors affecting the perceived probability a client will have a MM and the auditor’s role in detecting MMs. A key focus will be examining MM risk factors and engagement circumstances that are not easily codified and by design have been difficult for archival work to study. For example, we will ask how the risk assessment changes when executives have aggressive personalities or when the auditor-client relationship is tenuous, and how often management consults the national office or applied higher professional skepticism when determining an MM is present. We will also survey partners’ observations on what circumstances are more frequently present both when they detect a MM and when they audit estimates—an area especially prone to misstatements and auditor-client disagreements (Martin, Rich, and Wilks 2006; Cannon and Bedard 2017).

To probe the role of qualitative factors, we will examine how partners evaluate misstatements that fall just below the quantitative threshold of planning materiality, depending on
the circumstances surrounding these misstatements (e.g., the misstatement’s effect on income, and whether the misstatement appears to be due to an honest error versus a dishonest irregularity). Further, we will investigate how audit partners’ assessment of MM risk is informed by management’s earnings-increasing strategic actions prior to year-end, as examined in prior surveys of management by Graham et al. (2005) (e.g., delaying discretionary spending or investments).

Our second topic focuses on the auditor’s role in resolving identified MMs. We will ask partners about how often disagreement with client management depends on the consequences of correcting the MM to the financial statements, including its influence on income and whether the correction necessitates a “Big R” vs. a “Little r” restatement (Tan and Young 2015).³ As for waiving decisions, we will ask how often errors above quantitative materiality are waived based on whether the errors relate to estimates, what part of the financial statements are affected, and whether a critical audit matter discussion is required. We will also ask partners about how often various circumstances make resolving a MM with the client more contentious, including the client’s fundamentals, culture, reporting history, and whether they provide significant audit and/or non-audit service revenue to the audit firm. Last, we will ask partners about how they resolve MMs, focusing on both tactics examined by audit research (e.g., negotiations, audit committee involvement) and less explored tactics that partners we interviewed identify as important (e.g., national office involvement).

Our final topic focuses on consequences of identifying and resolving a MM to the audit partner and the audit relationship. Because resolving MMs often involves income-decreasing adjustments, we ask about the consequences of the partner taking a strong stand against management. Specifically, we will ask about the likelihood that the audit relationship continues,

³ “Big R” restatements require clients to notify investors and reissue past financial statements, whereas in “Little r” restatements, clients update past financial statements without notifying investors.
and, if so, how the partner assignment and fees change. We also ask about MM resolution consequences that are not publicly observable, including national office consultations, materiality thresholds, and risk assessments for future engagements, as well as pay and relationships with supervisors (e.g., are partners punished or rewarded for taking a stand?). Importantly, our response options will allow us to assess which consequences tend to be more likely.

We created the first draft of our online survey based on our review of the academic literature and professional auditing standards. We refined this draft by conducting in-depth semi-structured interviews of five highly experienced former Big 4 audit partners. In these pre-survey interviews, the partners discuss significant cross-sectional variation in the frequency of MMs related to ownership, industry, and management culture; that they identify most MMs in estimates; and that contrary to the widely accepted conservative interpretation of SAS 99 guidance they routinely use qualitative factors to rationalize that quantitatively material misstatements are immaterial. The partners also indicate that they frequently involve the national office when resolving MMs with clients to leverage their firm’s support in advocating the appropriate position to the client management. Last, the partners report that their firms strongly support them standing up to the client, as long as they follow the firm’s process for resolving MMs. These interviews provided insights that we used to develop and pre-test our survey, to ensure that we do not omit relevant topics from the survey, and that all survey questions are clear.

We then presented this first survey draft at two seminars and solicited feedback from our colleagues who conduct audit and reporting research and/or are survey experts. We also received feedback from the Editor and an anonymous reviewer prior to the conference. We used this feedback to refine our survey and approach to identifying and contacting potential participants.

Bloomfield et al. (2016) explain how pre-survey efforts “such as talking with practitioners” not only help researchers “gather data more intelligently” but also “provide useful guidance for readers” (p. 374).
(described below). After the conference, we will further revise our survey and approach following participants’ comments. In other words, our survey will be conducted only after receiving extensive feedback from both highly experienced audit partners and academics, which helps ensure the survey questions are clear and designed to provide evidence that is most relevant to researchers. Currently, the survey consists of 12 questions designed to examine our three topics, as well as 15 demographic questions about the partners’ experience, their audit firm, and the typical clients they covered. The survey instrument is presented in Appendix A and will be administered using Qualtrics.

We plan to use a major professional networking website and email databases available to us to identify and invite thousands of audit partners to participate in our survey on a confidential basis. We will invite current partners because their responses are likely to be incrementally informative with respect to current practices, the regulatory environment, and trends in evaluating MM risks, MM resolution, and MM consequences. We will also invite former partners because their participation is less constrained by their audit firm, we expect them to be more forthcoming, and they generally have more availability. Though this approach is unlikely to result in as high of a response rate as typically obtained by surveys distributed by firm leadership (e.g., 16% reported by Nelson, Elliott, and Tarpley 2002), it will allow us to obtain a meaningful firm-independent sample of survey responses from partners at a large set of Big 4 and non-Big 4 audit firms. To assess the generalizability of our results, we will compare the background, experience, specialization, and demographic characteristics of our participants to the partners covered by AuditAnalytics.

Importantly, as part of our analyses for each of the three topics, we will also conduct cross-sectional tests to examine how participants’ responses differ based on auditor, client, and
engagement characteristics (e.g., industry specialization, average client size, and inherent risk). This will allow us to explore the responses more fully and connect our results to the empirical literature on these characteristics. Furthermore, in the final stage of our study, we will conduct approximately 20 follow-up semi-structured interviews—approximately 10 more with current or former audit partners to further explore the results as they relate to our three broad topics and approximately 10 with CFOs and audit committee chairs and/or members to obtain their perspectives on our findings. These interviews will provide a balanced view and additional context for our findings as well as help us clarify any unexpected or ambiguous survey responses we may identify.

Our study will extend the literature on the financial reporting process (for reviews, see Beyer et al. 2010 and DeFond and Zhang 2014) by shedding light on how auditors identify and resolve MMs and on the consequences of identifying, failing to identify, and resolving MMs. More broadly, our study helps overcome historic impediments to researchers observing MMs that have constrained our understanding the role of auditors in the reporting process and, as a result, led to several unresolved debates in the literature. One view (“conflict of interest” hypothesis) portrays auditors as captured by client management (Goldman and Barlev 1974; Frankel et al. 2002). Another view (“reputation” hypothesis) assumes auditors’ primary incentive is to maintain independence, avoid litigation, and protect their reputation for quality (DeAngelo 1981; Antle 1984; Skinner and Srinivasan 2012; Weber, Willenborg and Zhang 2008; Cook et al. 2020). A third view emphasizes the signaling role of audits (Datar, Feltham, and Hughes 1991). And while most archival audit research is conducted at the firm level, there is growing evidence that individual partner attributes and decisions shape audit outcomes (Gul, Wu, and Yang 2013; Knechel, Vanstraelen, and Zerni 2015; Mowchan 2016). However, partner interactions with the
national office are not observable, which makes it difficult to know how and when the national office gets involved in engagements.

While we do not expect our findings to resolve these debates, our analysis will inform them with new evidence from a large number of highly experienced partners. We expect our results to provide relevant and interpretable evidence on the topics we examine regardless of what the ultimate findings may be.\(^5\)

The results of our project are also likely to be of interest to regulators and practitioners. Standard setters seek to incorporate academic research into their agendas (e.g., Geoffroy and Lee 2021), particularly with respect to detecting, failing to detect, and resolving MMs (Christensen et al. 2016). For example, the PCAOB’s website prominently defines the regulator’s key objective as “Driving continuous improvement in audit quality.”\(^6\) Thus, our evidence on how auditors evaluate MM risks and resolve MMs will be useful to audit regulators. Regulators are also likely to be interested in survey and follow-up interview responses surrounding the consequences of MMs to audit partners, insofar as these consequences affect partner judgment. In terms of practitioners, our pre-survey interviews revealed substantial heterogeneity in MM correlates, resolution, and the consequences to the partner. Thus, our survey will provide new evidence that could inform firms’ audit methodology, MM resolution tactics, and partner incentive structure.

The remainder of this proposal is organized as follows. Section 2 motivates our study and provides an overview of the key research relevant to the three topics we examine, highlighting our contribution to this literature. Section 3 outlines our survey method, describing why it is best suited

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\(^5\) In his meta-analysis of over 1,000 surveys covering a range of topics, including deviant behavior, Vanette and Krosnick (2018) report that surveys regularly provide accurate evidence based on validating responses against external sources. Thus, while surveys are subject to limitations, a well-executed survey can provide useful and accurate evidence.

for our research objectives. Section 4 discusses preliminary evidence we have gathered to inform our survey instrument: key responses from our interviews of five highly experienced former audit partners, as well as relevant audit research and professional audit standards. Section 5 concludes.

2. Prior Literature and Motivation

In this section, we review the literature related to each of our three research topics and motivate our survey by highlighting its anticipated contributions to the respective literature.

2.1. Evaluation of Material Misstatement Risks

Our first topic examines how audit partners evaluate MM risk and identify MMs. Research on MMs can be categorized into 1) non-waived adjustments or “adjustments” (MMs detected and corrected during the engagement), 2) adjustments waived by management (MMs detected but not corrected during the engagement), and 3) restatements (MMs either undetected or waived during the engagement and detected and corrected after the engagement). Early work on non-waived adjustments focused on the determinants of these adjustments, typically using audit working papers provided by an individual audit firm (see Kinney and Martin 1994 for a review). One key finding from this work is that adjustments typically reduce income and assets, suggesting auditors discipline management’s desire to overstate performance.

As data from the PCAOB and international sources has become more readily available, researchers have revisited questions related to the determinants of audit adjustments. For example, Choudhary et al. (2019) study a sample of U.S. audits selected for PCAOB inspection and find looser materiality thresholds are associated with both fewer proposed adjustments and a greater incidence of restatements.\(^7\) Lennox, Wu, and Zhang (2016) examine engagement data from audits in China, and report that 68% of engagements contain non-waived adjustments. Further, they find

\(^7\) See also Asare, van Buuren, and Majoor (2019), who find that 65% of audits in the Netherlands uncovered a MM.
income-decreasing adjustments are far more common than income-increasing adjustments, and that adjustments reduce earnings volatility. Using similar data from audits in China, Lennox, Wang, and Wu (2018) show that engagement partners’ equity incentives are negatively or insignificantly associated with audit adjustments, consistent with audit quality being harmed by pressure to satisfy clients.

When auditors conclude that proposed adjustments are not material, they may allow management to waive them by not conditioning an unqualified opinion on requiring management to record the proposed adjustments. Kinney and Martin (1994) report that roughly half of all proposed adjustments are waived, and Choudhary, Merkley, and Schipper (2020) find that a larger percentage of waived adjustments is associated with restatements. Keune and Johnstone (2012) find that audit committee financial expertise and auditor reputation concerns are associated with fewer waived adjustments by management.

While a lack of data limits research on auditor proposed adjustments and on booked-versus-waived adjustments, the third literature on restatements is much larger because restatements are publicly disclosed. Research has investigated the association between restatements and audit committee expertise and independence, auditor effort, non-audit fees, management compensation, and firm fundamentals (among others, see Abbott, Parker, and Peters 2004; Agrawal and Chadha 2005; Burns and Kedia 2006; Larcker, Richardson, and Tuna 2007; Armstrong, Jagolinzer, and Larcker 2010; Dechow et al. 2011; Lobo and Zhao 2013). Restatements are often followed by management turnover and significant share price declines (Srinivasan 2005; Palmrose and Scholz 2004) but occur relatively infrequently compared to adjustments. In recent years, there have been several hundred restatements annually (affecting roughly 5% of publicly held firms) (CAQ 2021; Wahlen et al. 2020), while the above work suggests that a much larger number of engagements—
roughly two-thirds—involves adjustments that are not publicly observable. Given much less work has investigated adjustments, our survey primarily focuses on adjustments rather than restatements.

Collectively, existing research provides estimates of the preponderance of MMs and correlates board and auditor characteristics and firm fundamentals with MM risk. Our survey will confirm and extend this work in two key ways. First, as Choudhary et al. (2019) emphasize, the regulatory environment has changed significantly over the past two decades, providing an opportunity to revisit findings from the pre-SOX and pre-PCAOB inspection era. As an example, Keune and Winchel (2019) conduct interviews with experienced audit partners, who report spending significant effort and resources to increase the likelihood of positive PCAOB inspection outcomes. Such behavior can alter audit planning and execution and, thus, alter the likelihood of identifying MMs. In some cases, partners may direct so much incremental audit effort to areas of higher inspection risk that they reduce effort on areas of higher misstatement risk (Maksymov et al. 2021). As a result of these new dynamics in the audit environment, some prior archival findings may not generalize to the current environment, warranting a follow-up examination.

In terms of more recent work studying either non-U.S. engagements or accessing data from audits selected for PCAOB inspection, our approach of surveying a broad cross section of U.S. partners allows us to triangulate evidence across settings. In particular, our research adds to evidence from China by investigating waived adjustments, and by focusing on plausible determinants of MMs that are likely to be influenced by institutional features. For example, there is significantly lower civil litigation risk and a higher prevalence of state-owned enterprises in China than in the U.S. Demand for audit quality is greater and audit regulation is stricter in the U.S. than in China, though evidence points to these differences shrinking over the past several
decades (for further discussion, see Lennox and Wu 2021). Our survey also adds to the recent evidence using PCAOB data by accessing a broader sample of engagements (i.e., privately held clients as well as publicly held clients regardless of whether they are selected for inspection).

A second critical objective of topic 1 is to develop evidence on factors affecting MM risk and on circumstances present when MMs are identified that are not easily codified due to their nature, and by design have been (and will likely continue to be) difficult for archival work to study. Datasets covering audit adjustments are more amenable to exploring objective characteristics (e.g., board composition, client size, or profitability) than softer factors such as the nature of the auditor-client relationship or the auditor’s perception of the client’s behavior. Additionally, there are engagement choices—such as the involvement of the national office or a valuation specialist—that could help identify MMs but have been understudied due to lack of data. Behavioral research has used qualitative and experimental methods to examine the auditor-client relationship and the auditor-client dynamics that affect audit quality (see reviews by Nelson and Tan 2005; Trotman et al. 2011; and Knechel et al. 2013). We extend this literature by directly examining partners’ views about the determinants of MM risk and identification of MMs.

We highlight several aspects of the five questions in topic 1 that explore softer factors and engagement choices:

- Question 1 explores how the partner’s assessment of MM risk changes when executives have aggressive personalities, when the partner has a strong rapport with management, when the partner perceived the audit committee as weak, and when the auditor-client relationship is tenuous.

- Question 2 explores circumstances surrounding MMs and characteristics of MMs, including whether the partner consulted the national office, applied higher professional skepticism, or applied new technology.

- Question 3 explores circumstances present when the partner audits accounts subject to significant degree of estimation, such as whether the auditor or client involved a
valuation specialist, and whether the management estimate was at the more aggressive end of the acceptable range.

- Question 4 asks about how various factors affect whether the partner concludes an MM exists when uncorrected misstatements are close to, but not quite quantitatively material. The factors include whether the misstatements increase or decrease income, and whether the misstatements are due to an error or irregularity.

- Question 5 explores how the auditor’s assessment of MM risk would change after management engaged in opportunistic behavior to beat earnings targets examined in related work (Graham et al. 2005), such as decreasing discretionary spending, delaying projects, or altering accounting assumptions within GAAP.

2.2. Resolution of Material Misstatements

Our second topic focuses on the auditor’s role in resolving identified MMs. Compared to estimating MM risk and the correlates of identified MMs, there is far less archival research on this topic. A key barrier is that relevant data are not publicly available and mechanisms of resolving MMs are generally observable only to the participants in the resolution process—notably, audit partners themselves. Thus, examination of this process lends itself particularly well to a survey. For example, surveys provide evidence that auditor-client negotiation issues are typically about material items (Gibbins, Salterio, and Webb 2001), and that most CFOs report participating in negotiations with auditors over accounting issues (Gibbins, McCracken and Salterio 2007).

Archival research can draw on behavioral studies to design and interpret analyses of MM resolution process using available data. For example, Keune and Johnstone (2012) draw on reputation protection theory and report results consistent with auditors’ being less likely to allow management to waive MMs as audit fees increase because higher audit fees tend to reflect higher MM risk and greater audit effort. Research can also extend this evidence from those rare cases in which researchers have (partial) access to US audit working papers. For example, Joe, Wright, and Wright (2011) report that audit adjustments are more likely to be waived when auditors have had
a longer relationship with the client, although the authors conclude that additional evidence suggests this higher rate of waiving adjustments does not arise from favoring these clients.

As Lennox and Wu (2018) discuss, there is a burgeoning literature on audit partner- and office-level research, which raises new questions about the organizational design of audit firms and the degree of partner independence. However, archival research is limited in its ability to examine how and when partners interact with the national office.\(^8\) Our proposed survey provides a unique opportunity to explore national office-partner interactions surrounding MM resolution that are not recorded in public or regulator datasets.

Our four survey questions for the second topic focus on the aspects of the MM resolution process that have received little attention in the literature because they are not publicly observable:

- Question 6 explores *how often management disagrees with auditors who conclude that there is a MM*, based on whether correcting the MM would decrease net income, or would require reissuance of financial statements (i.e., a “Big R” restatement).

- Question 7 asks about *circumstances that make resolving MMs more difficult*, including whether the client provides significant non-audit service revenue to the audit firm, the client’s poor financial performance, the client’s executives having aggressive personalities, or the MM pertaining to an estimate.

- Question 8 explores *determinants of successful resolution of MMs*, such as involvement of the national office or audit committee, strategic concessions by auditors about what particular MMs will be corrected and when the correction will take place, and assertions that if the MM is not corrected the auditor will not renew the relationship.

- Question 9 asks about *how frequently partners waive errors just above quantitative materiality*, based on whether the error relates to an estimate, affects the financial statements versus just the notes or management discussion & analysis, or would not need to be discussed in critical audit matters.

2.3. Consequences of Material Misstatements

\(^8\) For interview-based evidence, see Aghazadeh et al. (2021).
As we discuss above, there is a large literature examining the consequences of MMs that are discovered after the audit is completed, leading to a restatement. Archival research on this topic tends to examine the associations between observable audit quality metrics and client retention (e.g., Barton 2005; Weber et al. 2008; Skinner and Srinivasan 2012). For example, Haislip et al. (2017) examine revisions of unaudited earnings numbers, and find these revisions are associated with auditor dismissals. Recent work also examines this question in the setting of audits in China and finds evidence that partners whose clients go through a restatement have their opinion signing privileges revoked (Chen et al. 2021). In our survey, we seek to complement this work by investigating the consequences of MMs that are identified and resolved during the engagement.

There are several studies using behavioral methods that have shed light on the consequences auditors may face when resolving MMs, including client satisfaction. For example, Sanchez et al. (2007) conduct an experiment and find that auditors perceive greater client satisfaction and retention prospects when they allow management to waive immaterial adjustments. McCracken et al. (2008) provide questionnaire-based evidence that audit partners view themselves as being responsible for keeping the client “happy” and that firms remove partners with “poor” client relationships from their engagements.

While the empirical work on this topic is relatively scarce, we note that research finds most booked adjustments are income-decreasing (Kinney and Martin 1994), and such adjustments sometimes make it more difficult for the firm to meet earnings expectations and can lead to lower management compensation. This evidence suggests that the partner and client may disagree over whether an adjustment is necessary. Our survey seeks to provide evidence on whether clients may threaten to dismiss the auditor or complain to the partner’s superiors when MMs are proposed. Further, partners may perceive personal career risk to taking a strong stand against management
when an MM arises, and such perceptions are central to understanding auditor independence. Conversely, audit partners may believe that their firm leadership will support their high integrity stands on accounting issues. Additionally, how MMs are resolved can affect not only compensation and opinion signing privileges, but also the partner’s promotion prospects and how they plan for the next engagement. Our three questions investigate these possibilities.

- Question 10 explores what happens when partners and the national office take an uncompromising position that there is an MM despite the client’s strong disagreement, such as whether the firm rewards the partner for taking a stand, adds a more senior partner to the engagement, rotates the partner early from the engagement, or ends the audit relationship (as well as any consulting relationship) altogether.

- Question 11 explores consequences of a MM for the subsequent year’s audit of the client, including changes in inherent and control risk assessments, involvement of industry or functional specialists, consultations with the national office, the audit time budget, and the controller/CFO vetting key accounting judgments with the partner.

- Question 12 investigates the consequences of a restatement for the partner who signed an unqualified opinion, such as compensation and promotion prospects, rapport with client management, and selection of future engagements for internal control review or PCAOB inspection.

3. Method

In this section, we (1) provide an overview of the survey approach as it relates to our three topics, (2) explain our strategy for developing a participant pool, (3) describe our survey instrument, and (4) describe the survey data analyses and post-survey interviews to contextualize survey responses.

3.1 Overview of Survey Approach

Although the topics we pursue are central to the audit literature, substantive examination has proved elusive primarily due to the difficulty of accessing relevant audit working paper or archival data, particularly in the U.S. Bloomfield, Nelson, and Soltes (2016) note that accounting
research on some topics is at the point where studies based on collection of original data, such as those using a survey method, can be paramount to moving the literature forward. In discussing the need for more work that uses original data, they cite Vatter (1966):

One of the real limitations of empirical research is that we tend to work on problems we are able to study because data are available; we thereby tend to overlook problems that we ought to study, if data for such problems are not easy to obtain. …Gathering direct and original facts is a tedious and difficult task, and it is not surprising that such work is avoided. (p. 232)

In recent years there have been multiple original data studies published in top accounting research journals, including influential surveys of experts, that have deepened our understanding of issues less conducive to examination by other methods (e.g., Dichev et al. 2013, Brown et al. 2015; Brown et al. 2019). Importantly, survey studies do not develop or test theory—instead, they provide new evidence that is useful for interpreting extant theory and aiding theory development and testing.

Generally, the survey method is the most suitable approach to obtaining views of a select group of experts on a subject of interest in a quantifiable form—an objective that is exceedingly difficult to accomplish using other research methods (Dillman, Smyth, and Christian 2014; Lune and Berg 2017). In addition, a long stream of research suggests that auditor knowledge of event frequencies experienced during their careers likely is accurate, especially their knowledge of comparative frequencies—e.g., which survey response options occur more often than others in the same question (Zacks et al. 1982; Ashton 1991; Nelson 1993; Hertwig and Hoffrage 2002; Zacks and Hasher 2002; Kochetova-Kozloski et al. 2010; Mathews et al. 2011; Woltz et al. 2012; Nelson and Skinner 2013; Vannette and Krosnick 2018; De la Rosa and Tully 2020; Mayne 2021). We will use the survey method and triangulate our findings with pre- and post-survey interviews to obtain evidence on MMs that has been difficult for archival researchers to observe. Thus, an
important feature of our proposed study is that our results will provide new, triangulated evidence on the topics we examine.

3.2 Participant Pool

We will develop our participant pool in three steps, some of which we have already completed. First, we obtained the list of 861 public accounting firms registered with the PCAOB as of 2021 from the PCAOB’s website.\(^9\) Second, we accessed a professional networking website and searched for “audit partner” in conjunction with three built-in filters: “People,” “Company,” and “Location.” The first filter does not require specification. For the last two filters, we will specify each firm on the list obtained in the first step and “United States” as the location. We have identified more than 10,000 current and former partners using the professional networking website. For individuals whose profiles indicate that they are formerly or currently audit partners, we will exclude those whose profiles indicate that their primary focus was on auditing non-profit or government entities. For the remaining partners, we expect to obtain matching emails for at least 4,000. Of the partners for whom we will not be able to obtain an email address, we will randomly invite 1,000 via the networking website’s messaging system to increase representativeness of our sample. Thus, we expect to invite at least 5,000 partners qualified to participate in our survey.\(^10\)

Third, we will use public sources to collect these partners’ email addresses. The partners whose email addresses we obtain will receive a survey invitation via email. For the remaining partners, one of the coauthors will send a survey invitation via the professional networking website messaging system. We will record the method of contact (email vs. professional networking

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\(^9\) See https://pcaobus.org/oversight/registration/registered-firms?firmcountry=United%20States

\(^{10}\) For these partners, we will collect the following information to the extent it is provided in their profile: name, current title, current location, former and/or current audit firm(s), year retired from the last audit firm, years in public accounting, degrees, and universities attended.
website message) for each partner.\textsuperscript{11} Several highly cited surveys related to ours employ a similar approach of contacting participants via the web (e.g., Nelson et al. 2002; Brav et al. 2005; Graham et al. 2005, 2014; Brown et al. 2019). Comparing features of the prior surveys with ours, we expect our final response rate to be in the 6 to 10\% range, resulting in 300-500 responses.\textsuperscript{12} Though methodological guidance does not specify the minimum required number of participants for a survey like ours, the acceptable number of participants in audit surveys has been around 100-150 (Gibbins, McCracken, and Salterio 2007; Christensen et al. 2016; Frank et al. 2021).\textsuperscript{13}

We developed our survey design and planned analyses to minimize nonresponse bias, which occurs “when those who do not respond are different from those who do respond in a way that influences the [response]” (Dillman et al. 2014, p. 3). Meta-analyses of survey studies have provided evidence that nonresponse bias does not tend to associate with nonresponse rates, suggesting that it is more important to minimize nonresponse bias than to minimize the nonresponse rate (Groves 2006; Groves and Peytcheva 2008).

To minimize nonresponse bias in our study, we identified six design features and analyses from best practices suggested in seminal methodological survey research (Dillman et al. 2014; Miles, Huberman, and Saldana 2018; Vannette and Krosnick 2018). First, in addition to using current partners, we will also use former partners because their participation is not constrained by

\textsuperscript{11} All partners will receive the same invitation message regardless of the platform via which they are contacted. See Appendix B for a draft of the invitation message we will send to each partner.


\textsuperscript{13} Prior to distributing our survey to all participants, we will run a pilot by emailing a survey invitation to a subset of the participant pool (150-250 partners) to ensure that all components of the survey instrument function properly. This approach is consistent with the admonition of Story and Tait (2019) who note that a “survey should be distributed among a small subset of the intended audience before it is administered to the larger group” (p. 198).
their (former) audit firm. Second, after the initial invitation to participate, we will send nonrespondents an additional invitation to reduce potential nonresponse bias due to busy season timing, hesitation to participate, etc. Third, we will compare the responses of partners who participated early to the responses of partners who participated late. Fourth, we will interview partners who did not participate in our survey to contextualize and further explore our survey results. Fifth, we will send the initial draft of our paper to all survey participants to give them an opportunity to identify potentially spurious results. Sixth, we will ascertain the extent to which proportions of respondents representing different firm sizes are similar to the proportions of reported partners at the firms of those sizes (e.g., the proportion of Big 4 partners in the participant sample compared to the proportion of Big 4 partners in the participant pool who were invited to participate).

3.3 Survey Instrument

We developed our survey instrument in three stages to ensure that we covered the key topics of interest to academics and professionals. First, we established three main survey topics and drafted questions after reviewing extant research literature to identify the areas where evidence on MMs is lacking and surveys could provide new insights. Second, we interviewed five experienced, recently retired audit partners to gather their feedback on our three topics and questions. These interviews also enabled us to clarify and obtain contextual understanding relevant to the evidence we assembled from academic research. Using partners’ feedback, we refined the preliminary survey questions and response options. Then, we asked five audit partners to complete the preliminary survey questionnaire, recording their comments as they went through the questionnaire. We had a Zoom call with each audit partner to discuss their impressions, confusion, and suggestions. We subsequently revised the survey. Third, we presented our survey and proposal
in academic workshops at Arizona State University and MIT, and refined our questions based on feedback, in particular from audit and reporting researchers and survey methodology experts, as well as from our Editor and an anonymous reviewer. Overall, this process allowed us to design a survey instrument that made us comfortable that the survey contains relevant topics and is worded in a way that is clear to audit partners.

Our survey instrument consists of 12 primary questions, each with multiple response options.\(^{14}\) We organize these questions in three topics: (1) evaluation of MM risks (five questions), (2) resolution of MMs (four questions), and (3) consequences of MMs (three questions). When deploying the survey, we will randomize the order of questions within each topic and options within each question. Our instrument also includes 15 short questions on the respondent’s audit background and demographics: ten shown before the primary questions and five shown at the end. These additional questions will allow us to conduct cross-sectional analyses.

Based on our pilot, we expect partners to take 20-30 minutes to complete the survey. We plan to use Qualtrics to administer the survey and follow up via phone, email, and/or the professional networking website, as needed.\(^{15}\) To encourage participation, we will follow Brown et al. (2015 and 2019) in informing the partners that we will send them a copy of the survey results and make a donation for every completed survey to one of four charities selected by the participant.

3.4 Additional Analyses and Data Collection

After collecting responses, we will perform cross-sectional analyses and conduct follow-up interviews with a different set of audit partners than those participating in our pre-survey

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\(^{14}\) We limit our survey to 11 questions, given that participants spend increasingly less time per question as more questions are added (Miles et al. 2018; Vannette and Krosnick 2018). The combined number of our response options for the 11 primary survey questions is comparable to those in prior accounting research surveys (Nelson et al. 2002; Brav et al. 2005; Graham, Harvey, and Rajgopal 2005; Graham et al. 2014; Brown et al. 2019)

\(^{15}\) Because our study involves human participants, we have obtained an approval from our respective IRBs to conduct this survey online.
First, we will explore cross-sectional variation in survey responses across a variety of dimensions potentially associated with detection, resolution, and consequences of MMs. For example, our background and demographic questions cover the revenues, industries, and inherent risk rating for the clients the partner typically covered. We will also ask partners about the size of the audit firm where they had their primary experience, how often their audits identified a MM, and how often the potential MM was not an actual MM.16

Second, following methodological guidance, we plan to interview audit partners to further contextualize and explore our survey results (Nelson and Skinner 2013; Miles et al. 2018).17 Miles et al. (2018) note that an effective research design for a survey study “alternates the two kinds of data collection, beginning with exploratory [interview-based] fieldwork and leading to the development of… a [survey] questionnaire, [whose] findings can be further developed… with the next round of [interview-based] work” (pp. 43-44). We will ask interview questions to shed additional light on the main survey findings. Each coauthor will review the survey results, identifying areas where additional discussion could increase the usefulness of the result in interpreting prior research or informing future research. The coauthors will then discuss and agree upon the interview questions. Consistent with the best practices in interview-based qualitative research in accounting, we intend to interview approximately 10 additional partners and 10 CFOs and audit committee members or until additional interviews provide little incremental benefit (Malsch and Salterio 2016). In selecting partner participants for interviews, we will make efforts to have our interview sample resemble our survey participants (Nelson and Skinner 2013). We will

16 While reasonable caution about accuracy of point estimates is always prudent, excessive concerns are unwarranted, as meta-analyses of survey studies show that well-designed surveys reflect objective phenomena remarkably well (Vannette and Krosnick 2018). With respect to the design of these questions, we follow the best practice elaborated in this prominent methodological text: “If what you want is a number just ask for the number” (p. 450).

17 Importantly, the purpose of interviews in survey studies like ours is to provide contextualization of the survey results (Miles et al. 2018; Brown et al. 2015; Brown et al. 2019) rather than, e.g., extend a theory, as is typically done in qualitative interview-based studies (Power and Gendron 2015; Malsch and Salterio 2016).
also select CFOs and audit committee members from companies that resemble those audited by our survey respondents to ensure that the interviewees speak to the same issues as those considered by our partner respondents in the survey (Miles et al. 2018). We also will record whether these CFOs and audit committee chairs have prior experience as audit partners and assess whether such experience affects their views.

We will take several steps to increase the credibility of the post-survey interview responses (Nelson and Skinner 2013; Miles et al. 2018; Malsch and Salterio 2016; Lune and Berg 2017; Yin 2018). First, we will code the post-survey interviews to systematize and discipline quote selection. Second, we will examine our post-survey interview data for potential inconsistencies with our results by conducting deviant case analysis and disclosing material exceptions to notify readers about the boundaries of the inferences that can be drawn from our findings.18 Last, we will share the manuscript with the interviewees to verify that the quotes we used accurately represent their statements. Importantly, the participants will not be granted the right to veto anything in the paper.

4. Interview Evidence to Further Survey Development

Following Miles et al. (2018) and Vannette and Krosnick (2018), we conducted in-depth pre-survey interviews of five highly experienced audit partners to provide context and strengthen the motivation for our survey questions and response options (see Tomy and Wittenberg-Moerman 2021 for a recent application). The interviews lasted between 45 and 60 minutes and focused on the partners’ experiences with MMs. At the beginning of each interview, we obtained permission to quote the partner on an anonymous basis. Two co-authors independently coded the interview

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18 One coauthor will examine the transcripts for deviant cases—any data that “do not support, or appear to contradict, patterns of explanations that are emerging from data analysis” (Malsch and Salterio 2016, p. 13)—and analyze any quotes that will appear to match this qualification. The author will then document their judgments regarding whether any of the quotes comprise a deviant case and need to be disclosed in the paper upon thorough analysis of each quote and its context. Other coauthors will review this analysis and suggest revisions until all the authors concur.
transcripts, mapping each response to one of our three topics: detection, resolution, and consequences of MMs.\textsuperscript{19}

While we found rich material throughout all five transcripts, we include over 30 particularly interesting quotes below and discuss the relevant quote prior to each of our 12 survey questions. These excerpts were useful in either developing or refining the question and its accompanying options, and in several cases, led us to reconsider inclusion of questions or options that we had established before the interviews and to include additional questions or options.\textsuperscript{20} To preserve anonymity, we refer to the five partners as P1 to P5.

\textbf{4.1 Evaluation of Material Misstatement Risks (Topic #1)}

Partners reported that the risk of MM depends on a range of factors, including client ownership type and industry. One partner contrasted public and private companies: “I would submit every private company that is audited has a MM… but in a public company arena, it's a small percentage [for] larger public companies [because] their internal controls are good enough [and] within the population of accelerated filers, it's certainly less than half [of the audits]” (P1).

Another partner highlighted differences across industries: “There are definitely some industries out there that [have higher risk of MMs]. ...I did banks. …There were definitely some clients where I did not make any adjustments to, but that is more of the exception than the norm” (P3). To examine inherent risk factors and circumstances around MMs further, we ask partners to indicate how various factors suggested by the literature and our interviews affect their assessment of MM risk and identification of MMs (Questions 1 and 2).

\textsuperscript{19} The inter-coder agreement Kappa was 0.72, indicating a high level of agreement (Landis and Koch 1977). The coauthors reconciled all inter-coder differences.

\textsuperscript{20} We selected these quotes using a three-step process. First, within each topic, one co-author identified quotes that are noteworthy. Second, a different co-author reviewed the list of quotes using the same criteria. Third, all co-authors agreed upon the final list of quotes to be included in the proposal.
As suggested by prior research (Martin et al. 2006; Cannon and Bedard 2017), partners noted that most MMs occur in estimates: “I would say almost 90% of [MMs] were estimates” (P5). As one partner explained, “... it really is kind of... two audits going on. [One,] you have [the testing] of the routine transactions and the testing of controls, and [two,] you've got all these high-level adjustments being made for all these estimates going into financial statements” (P3). The degree of judgment involved makes it challenging to have convincing evidence that there is a MM in an estimate: “When it comes to an estimate, which is where most of the issues come up... that's where they feel they have the best chance of persuading you” (P5). To examine these issues, we ask a question about circumstances surrounding estimates (Question 3).

Partners also stated that they occasionally concluded a misstatement is material based on qualitative factors, consistent with the requirements of SAS 99: “I would say maybe 80 [percent of the time] quantitative, 20 [percent of the time] qualitative” (P5). It is important to understand what qualitative factors auditors use to deem an error material because clients often use qualitative factors to achieve the opposite effect: “No public company believes they have a MM …no matter how [large the misstatement is] quantitatively, they will try to justify it qualitatively as immaterial” (P1). We therefore explore how characteristics of the misstatement and company affect auditors’ conclusions about materiality of the misstatement when the uncorrected misstatement is close to, but not quite quantitatively material (Question 4). Additionally, we explore the qualitative factors suggested by the literature and our interviews by presenting partners with an earnings management scenario used by Graham et al. (2005) and asking them to evaluate how management’s various earnings management actions (e.g., decreased discretionary spending, delaying projects, altering accounting assumptions) affect partners’ assessments of MM risk (Question 5).

4.2 Resolution of Material Misstatements (Topic #2)
Research examines factors affecting auditor-client negotiation using experimental (Sanchez, Agoglia, and Hatfield 2007; Hatfield, Agoglia, and Sanchez 2008), survey (Gibbins, Salterio, and Webb 2001), and interview-based (McCracken, Salterio, and Gibbins 2008) methods. However, our understanding of how partners resolve MMs with management remains limited, especially outside of the formal negotiation discussion setting examined in the prior literature (e.g., Keune and Johnstone 2012; Asare, van Buuren and Majoor 2019). Thus, we asked partners about how they resolve MMs and what challenges they face in the process. Partners noted that management of public companies tend to resist correcting MMs more aggressively than management of private companies because “the egos [are] more on the public side than the private side” (P3). One of the partners explained this as follows:

[Management of] private [companies], [does not] necessarily have a lot of external commitments that they've made around numbers, so the penalty to them personally [is small]. If you've got a CFO out there who's made some earnings guidance statements to analysts, et cetera, they get more worked up about changes to their numbers. (P2)

Partners also added that the resistance to correcting a MM is particularly great if the company has already released its earnings: “If [the client has] already done their earnings release and… then we find something after earnings release, obviously the pressure is a lot greater [for the client to resist a correction]” (P5). Thus, we plan to ask about how often various circumstances are associated with the client disagreeing with auditors (Question 6).

Partners also noted that the nature of the MM makes a difference in how challenging it is for them to convince management that there is a MM that needs to be corrected:

If it's a non-estimate… those are, those are easier to prove. The evidence is going to be compelling. It’s either going to be right or wrong. [E.g..] “Hey, you missed this set of invoices, you didn't book that one.” …It’s the estimates where you give them… the room to argue because there's a continuum of right answers potentially. So, you are basically telling them that you feel the answer is different and they could still be on the continuum… When it comes to an estimate, which is where most of the issues come up—that is where they feel they have the best chance of persuading you. (P5)
Additionally, a manager’s lack of confidence may make persuading them challenging:

A number of people I come across… are just not overly confident in themselves, and so when there’s an error, now they go to go tell somebody. They’ve already told their boss it’s going to be A, and now it's going to be B… So, they [push back:] ‘Is this really necessary? Why can’t it be this?’ You’re dealing a little bit with psychology [rather than with] what’s the [correct] accounting. (P2)

Interestingly, partners noted that management’s resistance may sometimes lead to a quantitatively MM being viewed by auditors as immaterial based on qualitative reasons: “There were times where I was concerned that I had a MM and through the consultative process, the decision of the [audit] firm was that it was a ‘small r’ [restatement], not a ‘Big R’ restatement” (P5). Another partner provided further detail underlying this dynamic:

There [comes] a point that quantitatively, [the misstatement] is just too big, but the reason that you see so many “small r” [restatements] as opposed to “Big R” [restatements] is because the relatively large quantitative error gets rationalized based on qualitative characteristics under SAB 99 as not material, and so it gets fixed prospectively. So that when you see the “Big R” [restatements], they generally [happen] because they are in an important metric: they’re in revenue, they’re in net income impacting EPS, [etc., so] you just can’t explain them away, although, your client will try. (P1)

Importantly, this mentality runs contrary to the widely accepted conservative interpretation of SAS 99 discussion of qualitative factors—qualitative factors are expected to be considered in deciding whether a quantitatively *immaterial* error is material. These responses prompt us to examine factors that make resolution of MMs with the client management more difficult (Question 7).

In our interviews, partners identified several best practices that tend to increase their ability to convince clients that there exists a MM. Clients “want to know of issues as soon as you believe it's an issue” (P5). One partner described an effective way to approach an issue with the client:

What the firms like to do, including the national office folks, is have a dialogue jointly with the client before [audits] get to the point where you have misstatements. [E.g.,] you've got an issue, a transaction's got tricky accounting or something unusual, let's collectively talk about it and work through the accounting together [beforehand] so that we're all on the same page when it comes time and you're actually booking those journal entries and we're
auditing what you've done. (P2)

Partners note that what makes a partner effective is the “ability to convince the client to do the right thing and make them happy about it” (P1). The consensus among partners was that forcing the client to agree to the auditor’s position is not a sustainable approach: “You can always go in and say, ‘If you don't correct the error, I'm going to give you an adverse opinion.’ That’s the sledgehammer approach. That doesn't get you very far with your client relationship, but it's effective” (P1). This partner, however, noted, “If you don't have to, you never say, ‘We just won't allow you to do it that way,’ [but] if you have to, you have to” (P1).

Overall, partners note that it is very important to have an open dialogue with the clients and understand their point of view before consulting with the national office:

I want to make sure I give the client every opportunity to respond and for me to fairly consider everything that they give me. …If I jumped that process and [went] right to the [national office], I've lost control of that situation because whatever the [national office] says for me to then unravel that [without loss of rapport with the client] is almost impossible. …So, I always made sure my clients always knew that if I ever had an issue, I would come to them first. We would work it out together so that we both agreed we could come to an agreement [before I go to the national office]. (P5)

Several partners highlighted the benefits of forming a personal relationship with the client before issues arise: “Building some level of relationship or rapport with your client helps a lot because if they have trust that you’re not trying to get them… If you don't have the relationship and have to go in and have these discussions cold, it's a lot harder [to resolve issues]” (P2). Partners typically disassociate themselves from the issue in the eyes of the client (e.g., “I tell my client, I did not create that issue. [laughs] It was there. All I did was find it” [P3]) and use the national office’s expertise to ensure they are not making atypical requests of the client:

As a partner, I never felt like I was on an island. I always had great support from the [national office]… to support me in the discussion with the clients if I felt like I needed it [and] to make sure we were being consistent with our conclusions across the industry. (P5)
Generally, partners note that framing the client’s view as atypical for the industry is a common approach to persuade clients:

The art is to say, ‘Look, I understand your point of view, client, but here's a better point of view based on your peer group. …They've seen it up there in the national office 50 times. And every time, the client chose alternative [accounting treatment] A. So, if you really want to go with [Option] B, you, you are going to be an outlier and it’s going to be noticed by the SEC and they're going to be all over it…’ And pretty soon you get the client thinking, ‘Gosh, [Option] A sure sounds better because we certainly don't want to be an outlier. (P1)

Partners also report appealing to the management’s sense of responsibility to the users of the company’s financial statements: “Another thing you can also try [is tell the management] ‘Let’s remember these financial statements are used to make decisions about the company [laughs]’” (P3). Interestingly, partners point out that audit committees serve as a natural impetus for them and management to work out an agreement on issues: “If me and the CFO turn up and we're like ‘Okay, audit committee, do your job—help us mediate.’ That’s terrible!” (P4). Together, these quotes inform our examination of drivers of successful resolution of MMs with audit clients (Question 8).

Surprisingly, partners also report that they sometimes treat quantitatively material misstatements as being immaterial based on qualitative considerations:

I've had some times where numbers are big but qualitatively… no one's going to care about this number. And so, quantitatively, it maybe exceeds a threshold you would've had in that prior audit. When you weigh the factors of what matters, and considering all the facts and circumstances you sit back and say, “…This can be kind of a small restatement,” meaning you can just disclose it in the notes, change [the previously reported number] and go forward. Sometimes it's, you know, things as simple as, you know, some classification issue in the, in the statement of cash flows. (P2)

Another partner added: “We're not supposed to do this, but if you had a misclassification, you know, between inventory and receivables, I think [audit partners] will probably look at that a little harder [to decide whether it is material]” (P3). These quotes suggest that there are some characteristics of quantitatively material errors that may prompt audit partners to treat them as being immaterial (Question 9).
4.3 Consequences of Material Misstatements (Topic #3)

Researchers are often forced to make assumptions about auditors’ incentives because we have little understanding of the consequences partners face from their efforts to resolve MMs (Dechow et al. 2010). Thus, our interviews explored these consequences. Partners noted that since the passage of Sarbanes-Oxley, the emphasis on audit quality has increased, and as a result the negative consequences to them for taking a firm position with the client have decreased:

In today’s world you have 100% support of your firm, as long as you had it well documented, …you went through the right [process], and everybody agreed. They’re going to stand behind you tall on that, even if you lose the client. That has definitely morphed over time. There was a time when you would have been at risk if you would have lost that client, but that's not true anymore. That’s an impact of SOX. (P3).

Despite the firm’s support, however, partners acknowledge that taking a firm stance may be effective, “but maybe [it will work] one time and then you're gone” (P1). One partner explained that the process of partner removal may be initiated as a result of client surveys:

Obviously, we need to do client surveys. We have an outside partner… check in with the clients and how [they] are doing and that all gets factored …into your assessment for the year... And, have partners been taken off? For sure. Or maybe they finish out their time early or we're already looking at the replacement for them and starting to massage [the] relationship with the client to fix it if [the partner] is just someone who's quite pushy [or] antagonistic. (P4)

Another partner explained that to get positive evaluations from client surveys, partners did not necessarily need to compromise their judgments, but rather be able to resolve issues in a manner perceived as being fair by the client:

We as partners were evaluated based on our client satisfaction scores. After every engagement, the firm, national [office], sent out a survey to key stakeholders within our clients to evaluate our performance—how we conducted ourselves and all that. What the firm was finding is that if you [had] a good issue resolution process… in other words, you were open-minded, you communicated well, you didn't rush the judgment, you didn't go up the chain. …generally speaking, the client was fine with that. (P5)

Partners report typically having their firm’s support even if they lose the client, as long as they pursued high audit quality: “My experience with my firm and I'm sure the other Big Four are
that way, is we were rewarded for standing firm on quality and doing the right thing even if we got fired [by the client]” (P1). The partners did note that if a client fires the firm there is typically a thorough process to investigate the causes:

Anytime that a client decides to repropose or change auditors, the firm always goes through a pretty intensive process to understand why. And there could be consequences that could come out of that depending on how you resolved that issue with the client and how the client feels about it. …You need to do your job, but you also want to do it in a way where the client feels like, ‘Okay, you gave me a chance, it was fair. I respect what you did.” (P5)

Informed by this discussion, we ask about the consequences partners face for taking an uncompromising position with their clients on a MM (Question 10).

In terms of discovering a MM before the financial statements are issued, partners asserted that there are typically no consequences to them in those situations: “If a material error arose …before the financials were issued and you were able to get the client to resolve it and then you sign the opinion …there really [are] no consequences to that” (P5). However, partners noted that MMs regularly have consequences for the clients beyond correction of the MM itself:

It's almost automatic [today] that when you have a material adjustment, it's almost always treated [by auditors] as a material weakness or at least [discussed] why it… would not be one. In today's world, that's where [SOX has led us]. In the old days, it wouldn't have been a conversation. But where it is today, when you're making an adjustment to the financials, the next question that follows is "Why did this happen? What control [caused this]? (P3)

Thus, we developed a survey question to examine the consequences of a MM to the subsequent year’s audit of the client (Question 11).

The interviews also revealed that partners face serious negative consequences following a “Big R” restatement: “Just a restatement alone in and of itself already is a ding [against the partner]. ‘Big R’ [restatement] is definitely a bigger ding versus ‘small r’ [restatement]...” (P4). One partner explained why restatements are viewed so negatively:

Misstatements that lead to restatement are viewed negatively within the firm [because] my credibility as a partner… is damaged if I have a restatement on any of my engagements.
Because what that says is I had a flawed process. …There's accountability for that. That accountability can come in the form of having your engagements quality reviewed on a more frequent basis, …consequences around shares in terms of increases in compensation, depending on …why the restatement occurred. …Depending on how egregious [the causes were] it could result in you losing shares [or] being removed from an engagement or having additional resources added to your engagement, like another more experienced partner, someone that would do a peer review or look over your shoulder. (P5)

This partner also explained that, even if there are no explicit consequences to the partner from the firm, there may be reputational consequences among peers due to a restatement:

There will always be some consequences [for restatements]. Even if none of those things came down, to me, there were, there's a reputational damage, there's a stature damage, you're less whole because a lot of people know about it. Those things are not kept quiet. Usually your leader, the leaders of your office, the leaders of your industry, everybody is aware of it. I wouldn't say it's like a Scarlet letter, but depending on what [the circumstances of the restatement were], it can be. So, it's not something you ever wish to go through. (P5)

Informed by this discussion, we ask partners about the consequences they face from failing to identify a MM and subsequently going through a “Big R” restatement (Question 12).

5. Conclusion

We will examine how audit partners detect and resolve MMs with their clients, and what consequences they face as a result. To investigate these topics, we interviewed highly experienced former Big 4 partners, pre-tested our survey with them, discussed the instrument with fellow audit researchers, presented the survey at two seminars, and responded to comments from our Editor and an anonymous reviewer. After conducting our survey, we will interview additional partners to provide context for our results and clarify ambiguous responses we may identify. To shed light on how audit partners’ responses align with or diverge from those of CFOs and audit committee chairs and members, we also will conduct post-survey interviews from samples from these populations. Our multi-method approach allows us to obtain new insights on the auditor’s role in the reporting process that are difficult or impossible for archival and other methods to obtain.
The preliminary evidence from our interviews indicates significant heterogeneity in MM frequency related to ownership, industry, and management culture; that most MMs are identified from estimates; and that partners routinely use qualitative factors to rationalize or dismiss misstatements that are quantitatively material. The partners also indicate that auditors frequently involve the national office when resolving MMs with clients and that their firms are supportive of them standing up to the client, as long as they follow the firm’s process for resolving MMs.

Our study is subject to limitations common to survey and interview methods. The primary limitation inherent to our study is that we cannot guarantee that audit partners are forthcoming in their responses. Our survey design, including the intentional use of frequency-oriented survey questions, and planned analyses are aimed at mitigating this limitation. First, we focus on surveying and interviewing recently retired audit partners, whom we expect to be less constrained by their firms’ policies and therefore should be more forthcoming, but will also include current partners because their views should also be informative with respect to the current audit practices and trends. Second, we will follow recent methodological guidance and conduct several analyses to evaluate the extent to which nonresponse bias can explain our findings Dillman et al. 2014; Miles et al. 2018; Vannette and Krosnick 2018). Third, we use two different methods of inquiry (survey and interview) that triangulate each other, thereby increasing the reliability of our results. In conclusion, within the boundaries of the limitations inherent to our methods, we anticipate the results of our study will provide relevant and interpretable evidence on the topics we examine, regardless of the ultimate findings.
References:


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Appendix A: Survey

First, just a few background questions about your role as an audit engagement partner.

1. What is your status as an audit engagement partner?
   a. Currently a partner
   b. Retired 1-3 years ago
   c. Retired 4-5 years ago
   d. Retired more than 5 years ago
   e. None of the above (never was a partner)

2. How many years of experience as an audit engagement partner do you have?
   a. 1-4 years
   b. 5-9 years
   c. 10-19 years
   d. 20+ years

3. Where did you get most of your experience as an audit engagement partner?
   a. Big 4 firms
   b. Large non-Big-4 firms (over $250 million in annual revenues)
   c. Midsize firms ($25 million to $250 million in annual revenues)
   d. Small firms (up to $25 million in annual revenues)

4. Which industries did your engagements typically cover?
   [check all that apply]
   
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<tr>
<th>Industry</th>
<th>Public audit clients</th>
<th>Private audit clients</th>
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<td>Retail and Wholesale</td>
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<td>Tech (Software/Biotech)</td>
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<tr>
<td>Transportation/Energy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

5. What best describes the average inherent risk rating of the clients you had?
   [select one answer in each applicable column]

<table>
<thead>
<tr>
<th>Risk Rating</th>
<th>Public audit clients</th>
<th>Private audit clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medium Risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low Risk</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6. What was the annual revenue of your primary clients?
   [select one answer in each applicable column]

<table>
<thead>
<tr>
<th>Revenue Range</th>
<th>Public audit clients</th>
<th>Private audit clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$25 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$25 million to $99 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$100 million to $499 million</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
7. On average, how many audit opinions did you sign per year? [enter one answer in each applicable column]

<table>
<thead>
<tr>
<th></th>
<th>Public audit clients</th>
<th>Private audit clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5-9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10-14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15+</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NOTE: Throughout the survey unless specified otherwise, by *material misstatement* (heretofore “MM”) we mean an individual or aggregate misstatement in the current or prior years to be covered by the audit opinion.

8. How often did the audits underlying the opinions you signed identify a MM? [0-100% of the time]

[partners see one or both types of clients below based on their responses to question 7 above]

<table>
<thead>
<tr>
<th></th>
<th>Public audit clients</th>
<th>Private audit clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-10%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11-20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21-30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31-40%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>41-50%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>51-60%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>61-70%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>71-80%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>81-90%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>91-100%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9. In evaluating identified potential MMs, how often did you conclude that the *potential* MM was not an *actual* MM? [0-100% of the time]

[partners see one or both of the options below based on their responses to question 7 above]

<table>
<thead>
<tr>
<th></th>
<th>Public audit clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-10%</td>
<td></td>
</tr>
<tr>
<td>11-20%</td>
<td></td>
</tr>
<tr>
<td>21-30%</td>
<td></td>
</tr>
</tbody>
</table>
10. Have you ever identified a MM after an audit, such that the client had to restate previously filed financial statements and warn investors that the previously filed financial statements could not be relied upon? (Y/N)

Evaluation of Material Misstatement (MM) Risks

1. **How often do the following factors increase your assessment of MM risk in the client’s unaudited financial statements?** [0=never, 3=half the time, 6=every time]

   [the item in blue will be shown only to participants who indicate they had audited public clients]

   a) The client is large.
   b) The client faces doubts about its ability to continue as a going concern.
   c) The client provides significant non-audit service revenue to the firm.
   d) The client’s executives have aggressive personalities.
   e) Executive compensation is tied to aggressive performance targets.
   f) The client is close to missing its own earnings guidance.
   g) **The client is close to missing its analysts’ earnings expectations.**
   h) The audit committee is weak.
   i) The client is close to a loss.
   j) The client’s credit rating is close to decreasing.
   k) The client is close to breaching a loan covenant.
   l) Your relationship with the client management is tenuous.
   m) You consulted the national office in the process of deciding on whether the misstatement is material.
   n) This is the first year your firm audited the client’s financial statements.
   o) The internal audit function is ineffective.
   p) You have strong rapport with the client management.

2. **When you conclude that there is a MM in the financial statements, how often do these MMs have the following characteristics?** [0=never, 3=half the time, 6=every time]
   a) The primary cause of the MM was management manipulation of financial performance.
b) The primary cause of the MM was a non-routine transaction.
c) The relevant accounting standards were vague.
d) The MM was caused by honest yet erroneous accounting.
e) The MM overstated income in the financial statements under audit.
f) The MM understated income in the financial statements under audit.
g) The MM is material based only on its magnitude.
h) The MM is immaterial based only on its magnitude but is material after also considering qualitative factors.
i) The MM was identified after applying higher level of professional skepticism.
j) The MM pertains to an estimate.
k) The MM was identified after applying new audit technology.

3. **When you audit accounts subject to a significant degree of estimation, how often are the following circumstances present?** [0=never, 3=half the time, 6=every time]
   a) The management’s estimate was at the more aggressive end of the acceptable range.
b) The management’s estimate was at the less aggressive end of the acceptable range.
c) The management’s support for the estimate was adequate.
d) The management’s support for the estimate was inadequate.
e) The controls around the estimate were more effective than other controls.
f) The controls around the estimate were less effective than other controls.
g) There was a larger misstatement in the estimate, compared to other misstatements identified during the audit.
h) There was a smaller misstatement in the estimate, compared to other misstatements identified during the audit.
i) Your engagement team involved a valuation specialist to assist in the audit.
j) The client involved a valuation specialist to develop the estimate.

4. **How would the following circumstances affect whether or not you conclude that a MM exists when uncorrected misstatements at the end of your audit engagement are close to, but not quite quantitatively material to the client’s unaudited financial statements?** [-3=decrease very much, 0=no effect, +3=increase very much]
   [the items in blue will be shown only to participants who indicate they had audited both public and private clients]
   a) The misstatements appear to be due to an honest error increasing income.
b) The misstatements appear to be due to an honest error decreasing income.
c) The misstatements appear to be due to a dishonest irregularity increasing income.
d) The misstatements appear to be due to a dishonest irregularity decreasing income.
e) The client is a public company.
f) The client is a private company.
g) Qualitative considerations increase the significance of the misstatement.
h) Qualitative considerations decrease the significance of the misstatement.

5. **When the final unaudited earnings narrowly beat the client management’s desired annual earnings target, to what extent would the following actions by management prior to year-end increase the MM risk in the unaudited earnings?** [0=not at all, 3=somewhat, 6=very much]
   a) Decreased discretionary spending (e.g., R&D, advertising, maintenance, etc.).
b) Delayed starting a new project even if this entails a small sacrifice in value.
c) Booked revenues now rather than next quarter (if justified in either quarter).
d) Provided incentives for customers to buy more product this quarter.
e) Drew down on reserves previously set aside.
f) Postponed taking an accounting charge.
g) Sold investments or assets to recognize gains.
h) Repurchased common shares.
i) Altered accounting assumptions (e.g., allowances, pensions, etc.).

Resolution of Material Misstatements (MMs)

6. When you conclude that there is a MM such that correcting it would result in one of the following outcomes, how often does the client management disagree? [0=never, 3=half the time, 6=every time]
   a) Correcting the MM would decrease net income in the financial statements being audited.
   b) Correcting the MM would increase net income in the financial statements being audited.
   c) Correcting the MM would decrease net income in the prior fiscal year and would require reissuance of the financial statements (i.e., a “Big R” restatement).
   d) Correcting the MM would increase net income in the prior fiscal year and would require reissuance of the financial statements (i.e., a “Big R” restatement).
   e) Correcting the MM would decrease net income in the prior fiscal year and would not require reissuance of the financial statements (i.e., a “Little r” restatement).
   f) Correcting the MM would increase net income in the prior fiscal year and would not require reissuance of the financial statements (i.e., a “Little r” restatement).

7. How do the following factors affect the difficulty of resolving a MM with client management? [-3=decrease very much, 0=no effect, +3=increase very much]
   a) The client is large.
   b) The client faces doubts about its ability to continue as a going concern.
   c) The client provides significant non-audit service revenue to the firm.
   d) The client’s executives have aggressive personalities.
   e) The audit committee questions or expresses skepticism about management’s position.
   f) Executive compensation is tied to aggressive performance targets.
   g) The client is close to missing its own earnings guidance.
   h) The client is close to missing its analysts’ earnings expectations.
   i) The client is close to a loss.
   j) The client’s credit rating is close to decreasing.
   k) The client is close to breaching a loan covenant.
   l) Your relationship with the client management is tenuous.
   m) This is the first year your firm audited the client’s financial statements.
   n) You have strong rapport with the client management.
   o) The MM pertains to an estimate.

8. How often does a successful resolution of a MM involve the following? [0=never, 3=half the time, 6=every time]

   [the item in blue will be shown only to participants who indicate they had audited public clients]
   a) Negotiation with the management about what misstatements they will correct.
b) Negotiation with the management about the period(s) in which they will make corrections.
c) Negotiation involving strategic concessions that the management does not need to correct small misstatements.
d) Involvement of the audit committee in negotiations.
e) Involvement of the firm’s national office in negotiations.
f) Explanation that if management does not correct the misstatement, the auditor may have to issue a qualified or adverse opinion.
g) Explanation to management that if management does not correct the misstatement, the auditor may have to resign.
h) Explanation to management that if management does not correct the misstatement, the auditor may not be able to renew the audit relationship the following year.
i) Threat from the client to not rehire the auditor the next year.
j) Explanation to management that if management does not correct the misstatement, the auditor faces greater risk of investigation by a regulator.
k) Explanation to management that if management does not correct the misstatement, the client will stick out as an outlier among its peers.
l) Explanation to management that if management does not correct the misstatement, the management could eventually face negative personal consequences.
m) Reliance on strong rapport with management

9. When an error that is just above quantitative materiality has one of the following characteristics, how often would you conclude that it can be appropriately treated as being immaterial? [0=never, 3=half the time, 6=every time]

[the item in blue will be shown only to participants who indicate they had audited public clients]

a) It is an error related to an estimate
b) It is an error not related to an estimate
c) It is a classification error affecting only the balance sheet
d) It is a classification error affecting only the income statement
e) It is a classification error affecting only the statement of cash flows
f) It is a classification error affecting only the statement of equity
g) It is an error affecting only a note to the financial statements
h) It is an error affecting only the supplemental schedules accompanying the financial statements
i) It is an error affecting only the management discussion and analysis
j) It is an error in an account or area to which the investors in the client’s industry typically do not pay much attention
k) It is an error that would not need to be discussed in a critical audit matter paragraph

Consequences of Material Misstatements (MMs)

10. When you and the national office conclude that there is a MM in the unaudited financial statements and the client management disagrees, how often do the following consequences arise? [0=never, 3=half the time, 6=every time]

a) Your firm will cease all relationships with this client.
b) Your firm will cease the audit relationship with this client and allow the consulting practice to pursue the client for projects.

c) Your firm will reward you for taking an uncompromising position in this case.

d) Your firm will maintain the audit relationship but add a more senior partner to the engagement.

e) Your firm will maintain the audit relationship but rotate you out of the engagement early.

f) The client management will give you a poor satisfaction rating in a client survey.

g) The client management will complain to your superiors.

h) You will discuss the issue in a critical audit matter paragraph.

11. How would identifying a MM in the unaudited financial statements affect the following in your subsequent year’s audit of the client? [-3=decrease very much, 0=no effect, +3= increase very much]

   a) The inherent risk in the relevant area.
   b) The control risk in the relevant area.
   c) The quantitative materiality threshold in the affected area.
   d) Use of experienced audit personnel in the affected area.
   e) Use of firm specialists in the affected area.
   f) The client’s audit fees.
   g) Your consultations with the national office.
   h) Your willingness to outsource the relevant audit work to the firm’s service center.
   i) Your willingness to outsource the relevant audit work to the client’s internal auditors.
   j) Audit time budget.
   k) The rating you receive from the client in the client satisfaction survey.
   l) Your rapport with the client management.
   m) The likelihood of the controller or the CFO vetting key accounting judgments with you going forward.

12. How would subsequently identified MMs that require restatements of previously filed financial statements (i.e., a “Big R” restatement”) for which you had signed an unqualified audit opinion affect the following? [-3=decrease very much, 0=no effect, +3= increase very much]

   [the item in blue will be shown only to participants who indicate they had audited public clients]

   a) Your ability to continue being assigned as a partner on the audit.
   b) Your firm’s ability to stay on as the auditor of the client.
   c) Your client survey satisfaction ratings for the client.
   d) Your rapport with the client management.
   e) Your compensation.
   f) Your prospects for promotion.
   g) Your career opportunities outside of the firm.
   h) Your reputation within the firm.
   i) Your subsequent audit engagements being selected for internal quality control review.
   j) Your future audit engagements being selected by the PCAOB for inspection.
   k) The combined audit fees of your audit client portfolio.
Lastly, only five remaining questions.

1. What is your experience outside of public accounting? (check all that apply)
   ___ Corporate accounting executive (CFO, Director of Finance, Controller, Director of Internal Audit, etc.)
   ___ Audit committee member or chair

2. What is your age?
   a) <30
   b) 30-39
   c) 40-49
   d) 50-59
   e) 60-69
   f) 70+
   g) Prefer not to say

3. With what gender do you identify?
   a) Female
   b) Male
   c) Other
   d) Prefer not to say

4. Please select one of the following charities where you would like us to contribute on your behalf:
   a) Alzheimer’s Association
   b) American Cancer Society
   c) Doctors Without Borders
   d) United Nations Children’s Fund

5. We would like to conduct a brief confidential follow-up with select participants via telephone or Zoom. If you are willing to be contacted to schedule a short interview, please provide an email address: [open-ended]
Appendix B: Invitation Message

Subject: invitation to participate in MIT audit study

Hi John Doe,

I’m an MIT accounting professor looking to connect with current and former audit partners. I’m collecting partners’ experiences for a new paper I’m working on about material misstatements. Our goal is to gather first-hand experiences from partners such as yourself to better understand the causes and consequences of material misstatements.

It would be tremendously helpful to us if you were to complete our survey. The survey should take no longer than 30 minutes, and your responses will be kept confidential.

We will donate up to $10,000, depending on the response to our survey. For example, if 60% of invited partners complete the survey and select this option, we will donate $6,000 to charity. Your participation in the survey and selection of this option will result in a larger donation to the charity of your choice. We will also share the results of our survey with you.

To take the survey, please click the link below or copy and paste it into a new browser window:

<link>

Many thanks for your willingness to participate in my research.

Joseph P. Weber
George Maverick Bunker Professor
MIT Sloan School of Management
https://mitsloan.mit.edu/faculty/directory/joseph-p-weber