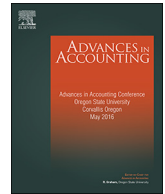




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The audit market effects of disputing a GAAP-deficient PCAOB inspection report

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ABSTRACT

As part of its charter, the Public Company Accounting Oversight Board (PCAOB) has the authority to inspect and review the workpapers of all accounting firms that provide auditing services to publicly traded companies. The PCAOB summarizes their findings in publicly available inspection reports available on its website. Prior research suggests that the accessibility, variation and source creditability of the inspection reports creates a publicly available audit quality signal that is used by various auditor choice stakeholders. This is particularly true for triennially inspected auditors that receive a GAAP-deficient report (Abbott, Gunny, & Zhang, 2013). In a GAAP-deficient inspection report, the PCAOB alleges that the auditor failed to identify departures from generally accepted accounting principles (GAAP) in the clients' financial statements. In this paper, we investigate whether and to what extent the *auditor's response* – which is also encapsulated in the inspection report – impacts the reaction to GAAP-deficient inspection reports. We create a sample of 113 GAAP-deficient inspection reports that correspond to 100 unique auditors. For these 100 auditors and their 805 audit clients, we find auditors that dispute the PCAOB findings are less likely to be dismissed by their clients when the client has an audit committee with accounting-related financial expertise. Collectively, our results indicate that auditor choice stakeholders weigh both the PCAOB- and auditor-assessments of auditor performance.

1. Introduction

In response to corporate accounting and auditing failures at companies such as Enron and WorldCom, the Sarbanes-Oxley Act (SOX) of 2002 was enacted. One of the more salient regulatory aspects of SOX was the creation of the Public Company Accounting Oversight Board (PCAOB). The PCAOB - which replaced the prior peer-review regime - is charged with the responsibility of “auditing the auditors.” More specifically, SOX grants the PCAOB with the authority to inspect and review the workpapers of all accounting firms that provide auditing services to publicly traded companies. The PCAOB summarizes its findings in publicly available inspection reports available on its website and does so on an annual (triennial) basis for auditors with at least 100 (< 100) audit clients. The accessibility, variation and source creditability of the reports suggests their possible use as audit quality signals. Extant studies have generally documented stakeholder response to GAAP-

deficient inspection reports in the context of the auditor dismissal decision (Abbott et al., 2013; Abbott, Brown, & Higgs, 2016; Daugherty, Dickins, & Tervo, 2011).¹ More specifically, prior research finds that GAAP-deficient, triennially inspected auditors are more likely to be dismissed vis-à-vis those triennially inspected firms that are not. However, this line of research has not yet examined the *auditor's response* to a GAAP-deficient PCAOB inspection report and any corresponding effect on the auditor dismissal decision.

When presented with a GAAP-deficient inspection report, the auditor has three response disclosure strategies: ignore, acknowledge or dispute.² In the cases of ignoring, the PCAOB inspection report contains the PCAOB inspection team findings and the report is devoid of any meaningful, auditor-generated communications. In the case of acknowledgement, the auditor usually expresses its respect for the inspection process and acknowledges the audit engagement and/or quality control deficiencies cited by the PCAOB within the inspection

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¹ A GAAP-deficient report states that the firm failed to identify departures from generally accepted accounting principles (GAAP) in the clients' financial statements (Abbott et al., 2013).

² Part of the auspices of the PCAOB's creation is the ability of an auditor to express its confidence or lack thereof in the PCAOB inspection process and/or the conclusions reached by the inspection team.

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report. In cases of dispute, the auditor explicitly states a difference of opinion with respect to the inspection process and/or inspection report findings. In this paper, we investigate whether and to what extent an auditor's dispute disclosure strategy impacts the likelihood of dismissing a GAAP-deficient, triennially inspected auditor.

We predict a dispute strategy enables a GAAP-deficient auditor to signal that it correctly interpreted GAAP and employed GAAS-compliant audit procedures. Thus, a dispute strategy has a twofold effect of (a) diminishing the PCAOB inspection findings and (b) reducing the likelihood of dismissal. We also argue a dispute strategy acts as a form of client advocacy. More specifically, GAAP-deficient PCAOB inspection reports often contain the phrases 'the (reported audit) deficiencies related...to an aspect...the issuer revised in a restatement subsequent to the primary inspection procedures' or 'failed to identify material departures from GAAP.' By disputing the PCAOB's findings, an auditor may also be defending the client's accounting treatments and decisions. That is, if the pre-audited financial statements did not contain a material misstatement, the PCAOB would render a GAAS-deficient inspection report. In a GAAS-deficient inspection report, the PCAOB implies that the financial statements audited by the auditor are free of material error and the auditor's opinion is correct. However, the manner in which the auditor collected audit evidence to support his/her (ultimately correct) audit opinion did not comply with GAAS. Consequently, when a GAAP-deficient auditor employs a dispute strategy, the auditor may be shielding both the audit firm and its clients from potential litigation. An acknowledgement strategy may actually exacerbate litigation concerns as it may confirm the PCAOB's contention that the financial statements contained a material error.

As our research question centers on stakeholder perception/consequences of a dispute strategy, we also test if the sophistication of the stakeholder impacts any potential dispute strategy effect. In particular, we investigate if an audit committee that possesses accounting-related, financial expertise differentially alters the reaction to a dispute disclosure strategy. Prior research suggests that these audit committees exhibit the task-specific knowledge necessary to distinguish between two potentially different interpretations of GAAP: one by the auditor and one by the PCAOB (DeZoort & Salterio, 2001; Dhaliwal, Naiker, & Navissi, 2010). A higher degree of accounting sophistication is necessary when evaluating the relative merits of these competing GAAP interpretations (DeFond and Hu 2005). Moreover, prior survey-based research conducted at the individual audit partner level indicates substantial disagreement between auditors and the PCAOB with respect to GAAP interpretations (Johnson, Keune, & Winchel, 2017). Differences in GAAP interpretations are also present at the audit firm level as evinced by the surprising degree of pervasiveness of dispute disclosures. We thus argue that audit committees with accounting-related financial expertise have both the requisite knowledge and confidence in their judgments to be less likely to dismiss a GAAP-deficient auditor that disputes the PCAOB's findings.

We conduct our tests on the audit clients of GAAP-deficient, triennially inspected auditors. Our sample focus is predicated on three factors endemic to the inspection reports of triennially inspected auditors. First, clients of these auditors are generally quite small, reducing auditor switching costs. Second, the inspection reports have a three-year duration, which allows auditor switching costs to be amortized across a three-year period. Finally, none of the Big 4 auditors (or national auditors) are included in the triennially inspected auditor sample, thereby eliminating the consideration of auditor brand name during the auditor dismissal process. Consistent with prior research, all three factors create a more elastic auditor switching environment, generating a more powerful test setting in which to examine the impact of an auditor's dispute strategy on the auditor dismissal decision (Abbott et al., 2013).

Following Abbott et al. (2013), we form client rosters of GAAP-deficient auditors. This yields 805 clients associated with 113 GAAP-

deficient inspection reports.³ We then conduct logistic regressions utilizing a dichotomous dependent DISMISS variable, coded "1" in instances where the GAAP-deficient auditor is dismissed and "0" otherwise. However, unlike Abbott et al. (2013), we include an additional DISPUTE independent variable coded "1" in instances where a GAAP-deficient auditor employs a dispute strategy and "0" otherwise.⁴ Multivariate analyses is conducted both with a broad audit committee effectiveness variable per Abbott et al. (2013), labeled ACE, and a more specific audit committee effectiveness variable contingent upon the presence of audit committee, accounting-related financial expertise, labeled FIN_ACE (Dhaliwal et al., 2010).

Consistent with our predictions, our univariate tests reveal that a dispute disclosure strategy reduces the likelihood of auditor dismissal. In our multivariate tests, we find that this result is primarily driven by the dispute strategy's interaction with our FIN_ACE variable. That is, when a GAAP-deficient, triennially inspected auditor employs a dispute disclosure strategy, that auditor is much less likely to be dismissed if the audit committee possesses accounting-related financial expertise. When we perform a similar analysis incorporating the broader ACE variable, the interactive effect is no longer present. Collectively, this suggests that audit committee, accounting-related financial expertise critically and differentially impacts the reaction to an auditor's dispute disclosure strategy, consistent with Dhaliwal et al. (2010).

Our paper contributes to the extant literature along three dimensions. First, we provide initial empirical evidence on the frequency of and reaction to an auditor's dispute strategy. Perhaps surprisingly, of the 113 GAAP-deficient inspection reports, 35 contain a dispute disclosure, whereas 28 (50) of GAAP-deficient auditors contain an acknowledge (ignore) disclosure. Interestingly, an overwhelming majority of the disputes disclosures reference accounting disputes, with 30 of the 35 disputes referencing GAAP interpretations. This compares to 17 of the 35 disputes referencing differences in GAAS interpretations. Our evidence is consistent with dispute strategies having a strategic aspect to them. Our results also suggest that more sophisticated stakeholders may analyze *both* sides of differing GAAP and GAAS interpretations. This is important as the PCAOB admits that the inspection reports are not necessarily to be used as audit quality signals, but nevertheless has instructed audit committees to be wary of auditor attempts to de-emphasize PCAOB inspection findings (PCAOB, 2012).

Second, our research regarding audit committee perceptions of auditor responses has important implications for members of the PCAOB and those in practice. The PCAOB may be interested to find that audit committees with accounting-related expertise frequently consider the auditor's perspective and side with the auditor when they feel that the PCAOB criticisms may not have been warranted. The PCAOB may consider modifying the content of its reports and possibly provide more detail on its interpretations of GAAP. Additionally, audit firms may be interested to learn which responses to PCAOB criticisms carry the most credibility among audit committees, particularly those with accounting-related financial expertise. Supporting the economic importance of this inference, we document a non-trivial 22% of sample audit committees possessing accounting-related, financial expertise. This is a surprising result given that the mean total assets of the firms in our sample are less than \$25 million. In providing this evidence, our paper extends the prior literature on the impact that audit committee, financial expertise has on various financial reporting and auditing issues (DeZoort & Salterio, 2001; Dhaliwal et al., 2010; Krishnan & Visvanathan, 2008).

Finally, we also contribute to the voluntary disclosure literature. Virtually all prior voluntary disclosure research has concentrated on disclosures originated by management. Our paper is the first to show

³ These 113 inspection reports relate to 100 unique, triennially inspected auditors.

⁴ We also restrict our analysis to only those triennially inspected auditors that are GAAP-deficient since auditors that do not receive a GAAP-deficient inspection report do not have incentive to nor do they employ a dispute disclosure strategy.

the audit market effects of an *auditor-based* disclosure strategy. The commonality with the disclosure literature stems from the fact that both management- and auditor-originated disclosures (1) are voluntary in nature, (2) can be used to signal to market participants a potentially self-serving explanation of events, and (3) are publicly available via a regulatory website. Our paper indicates that auditors can strategically employ disclosures that are unrelated to financial reporting to effectively manage perceptions of their firm's audit quality.

The remainder of the paper is as follows. The next section summarizes the PCAOB inspection process and related research. This is followed by our hypotheses development section. The ensuing sections discuss sample selection and research design and results, respectively. The final section concludes.

2. The PCAOB inspection process and related research

2.1. The PCAOB inspection process

The PCAOB inspects auditors of publicly traded companies to ensure that auditors maintain sufficiently high audit quality and perform audits that meet professional standards. These inspections involve examining audit workpapers and firm communications for evidence that engagements were completed in accordance with PCAOB auditing standards. Inspections also involve examining the sufficiency of firm-wide quality control policies (CAQ, 2012). Inspections are performed on an annual (triennial) basis for auditors with at least (less than) 100 publicly-traded clients.

After completion of fieldwork, the PCAOB issues its inspection report. Part I of the inspection report identifies any audit deficiencies where the auditor did not gather sufficient audit evidence to support the audit opinion (PCAOB, 2012).⁵ If there are no audit deficiencies, these reports are typically classified as “clean”. Inspection reports that only contain audit deficiencies are generally categorized as GAAS-deficient (Gunny & Zhang, 2013). In some instances, the inspection report will also describe instances where the auditor failed to detect departures from Generally Accepted Accounting Principles. These reports are referred to as a GAAP-deficient per Gunny and Zhang (2013). Part II summarizes identified deficiencies in the firm's system of quality control (PCAOB, 2012). Part I of the PCAOB inspection report is available for all audit firms on the PCAOB's website. The PCAOB is prohibited from releasing Part II findings unless the firm does not sufficiently address the quality control deficiencies within twelve months of issuance of the inspection report (PCAOB, 2012).

A GAAP-deficient PCAOB inspection report indicates that the auditor failed to detect a material misstatement (Abbott et al., 2013; Gunny & Zhang, 2013). This publicly available signal of poor audit quality can have adverse effects on a company's cost of capital (Buslepp & Victoravich, 2014).⁶ To demonstrate that they value audit quality, clients of GAAP-deficient auditors are likely to dismiss their auditor in favor of a higher quality auditor. Daugherty et al. (2011) find that clients are more likely to dismiss their triennial auditor following the release of a GAAP-deficient audit report in favor of a triennial auditor without GAAP deficiencies. Abbott et al. (2013) show that this effect is magnified in the presence of an effective audit committee. These studies suggest inspection reports are audit quality signals and are used by audit committees and others to evaluate auditors and audit quality.

⁵ Hermanson et al. (2007) perform a detailed analysis of Part I of the inspection report and indicate that audit deficiencies are primarily related to substantive procedures (insufficient analyses and documentation).

⁶ As audit quality is inherently unobservable, auditor choice stakeholders usually rely upon publicly available signals of audit quality such as auditor brand name and PCAOB inspection reports (Abbott et al., 2013).

2.2. The public portion of audit firms' responses

The inspected audit firm has the right to formally respond to any and all of the findings in the inspection report and to have any non-confidential pieces of the response included in the final inspection report (PCAOB, 2012). The public portion of a firm's response letter may describe the firm's view of the inspection results or changes that the firm implemented in response to the PCAOB inspection. Response letters provide the audit firm an open-ended, unstructured forum to express their views about the inspection process and findings. A few firms use the response letter to express their gratitude when the inspection report finds no deficiencies, but firms more frequently respond to unfavorable inspection findings (Hermanson, Houston, & Rice, 2007).⁷

There are three basic formats of the response letters of GAAP-deficient firms (examples of which are found in the Appendix A):

1. *The auditor does not acknowledge or ignores the GAAP deficiency in the response to the PCAOB* – The response is a form letter that typically states that the auditor is supportive of the inspection process, is committed to audit quality and that it has reviewed the findings in the inspection report and has taken appropriate actions. The form letter is non-committal and devoid of any verbiage that either confirms or denies the inspection report findings. In the case of ignoring, there is no form letter.
2. *The auditor acknowledges the mistake in the response to the PCAOB* – The response typically discusses: (a) the GAAP deficiency, (b) how the company/auditor addressed the issue (e.g., subsequent restatement of the financials) and (c) changes to the audit procedures to ensure compliance with future inspections.
3. *The auditor disputes the findings in the inspection report* – The response typically states that the audit was performed in accordance with PCAOB standards. The GAAP deficiency identified by the inspection team relates to a highly subjective area and that the PCAOB inspection involves examining the audit with a perfect knowledge of the future (i.e., hindsight bias).

The PCAOB suggested that auditors disputing the report's findings may make assertions that create uncertainty or confusion in the reader's mind concerning the importance of inspector-identified deficiencies (PCAOB, 2012).⁸ The Board suggests that audit committees view such assertions with skepticism. Since client loss is a costly consequence of unfavorable inspection findings, response letters are likely written strategically to influence audit committee decisions about auditor retention/dismissal. Nonetheless, empirical evidence on the efficacy of the response disclosure strategy of GAAP-deficient, triennially inspected auditors does not yet exist.

2.3. Audit committee duties and audit committee financial expertise

Two of the most prominent audit committee duties are assessing the appropriateness of the firm's financial reporting and evaluating the external auditor. These duties were disclosed and executed well before the creation of SOX and continue to the present. Section 407 of SOX required companies to appoint at least one audit committee financial expert and to disclose the identity of this director.⁹ Section 407 was

⁷ Hermanson et al. (2007) find that < 1% of registered audit firms without PCAOB identified deficiencies provide any response beyond a generic “Pleased/No Comment” letter.

⁸ The United Kingdom's Audit Inspection Unit (AIU) has expressed similar concerns that audit committee chairs sometimes had difficulty in assessing the significance of some of the matters raised by the AIU in their audit firm inspections. Some of the difficulty may be related to the way accounting firms characterized inspection findings as related to documentation issues rather than the underlying audit evidence and judgments (AIU, 2011).

⁹ Section 407 allows firms to be in noncompliance, but non-complying firms must disclose why the audit committee fails to include a financial expert.

premiered upon the notion that financial expertise afforded audit committees the task-specific knowledge needed to more effectively execute their oversight duties.

Determination of whether someone meets the qualification of an audit committee is subjective. Stock market exchanges are responsible for enforcement of Section 407. NYSE left the interpretation of financial expertise to the board of directors. NASDAQ and AMEX rules described a financial expert as having past employment or other comparable background such that an individual is financially sophisticated. In addition to work experience as a public accountant, auditor, principal financial or accounting officer or controller, a current or former CEO or other senior executive with financial oversight responsibilities may also qualify as “a financial expert.” Therefore, the listing requirements leave considerable latitude to companies in retaining an audit committee financial expert.

Given the latitude in appointing audit committee financial experts and the resultant variation in audit committee financial expertise, prior research has investigated whether different levels of audit committee financial expertise influences accounting- and audit-related outcomes. In an experimental setting mimicking an audit committee scenario, [McDaniel, Martin, and Maines \(2002\)](#) compared judgments between audit managers (a proxy for accounting-related financial expertise) and executive MBA students (a proxy for non-accounting financial expertise). These authors document the audit managers' frameworks for evaluating financial reporting quality were more theoretically appropriate. [Dhaliwal et al. \(2010\)](#) investigate the association between three types of audit committee financial expertise (accounting, finance and supervisory expertise) and accruals quality. They only find a significant positive association between accounting-related, financial expertise and accruals quality and no such association for the other types of expertise. Finally, [DeZoort and Salterio \(2001\)](#) find that audit committee directors with relevant accounting-related, financial expertise are more likely to support and agree with auditors during financial reporting disputes.

The extant research highlights two issues germane to our research setting. First, there remains considerable variation in the type of audit committee financial expertise. Second, the different types of audit committee financial expertise differentially affect the execution of audit committee duties. These two findings provide the motivation for our second hypotheses which is developed in the succeeding section.

3. Hypothesis development

3.1. Disputing a GAAP-deficient inspection report and corresponding client reaction

[Robertson and Houston \(2010\)](#) explain that the response following the PCAOB's draft report is a “strategic activity intended to minimize negative reactions, restore trust, and maintain or rebuild a positive reputation.” Trust is an integral component of the auditor-auditee relationship because, as [Causholli and Knechel \(2012\)](#) demonstrate, auditing is a credence good. A credence good is a good whose utility impact is difficult or impossible for the consumer to ascertain. Consequently, repairing trust is essential in maintaining perceived audit quality among auditor choice stakeholders. Just as important, because audit quality and financial reporting quality are intertwined and inherently unobservable by outside parties ([DeFond & Zhang, 2014](#)), it is difficult for outside stakeholders such as shareholders to disentangle the two elements. Therefore, perceived audit quality may be equated to financial reporting quality by outside shareholders.

Using the impression management and crisis management literatures as background, [Robertson and Houston \(2010\)](#) examine investors' perceived credibility of future audit opinions – a proxy for perceived audit quality – following PCAOB inspections. Using a sample of 142 participants acting as surrogates for investors, [Robertson and Houston \(2010\)](#) document that investors anticipate more improvement in the credibility of future audit opinions when audit firms respond to the

reports with concessions/apologies rather than disputes. These authors posit concessions signal an auditor's desire to make future corrections to their audit approach. Interestingly, [Robertson and Houston \(2010\)](#) also find that subjects perceived a higher likelihood of material misstatement during the period under inspection for audit firms issuing a concession.

[Kim, Dirks, Cooper, and Ferrin \(2006\)](#) posit there are instances when a dispute disclosure strategy may be preferable to an apology/acknowledgement strategy. In a behavioral setting, Kim et al. conduct an experiment whereby a tax accountant made an error filing a tax return in her last job and participants were asked to rate the applicant's trustworthiness after she explained what happened. Kim et al. then manipulate two constructs, whether the error is reflective of a competence failure or an integrity failure, as well as an acknowledge/dispute strategy. Kim et al. find that trust was repaired more successfully when the job applicant (1) acknowledged/apologized for violations concerning matters of competence but denied culpability for violations concerning matters of integrity and (2) had apologized for violations when there was subsequent evidence of guilt, but had denied culpability for violations when there was subsequent evidence of innocence.

There are three salient findings of [Kim et al. \(2006\)](#) that pertain to the focus of our study. First, [Kim et al. \(2006\)](#) note that when assessing competence, individuals place greater weight on positive information than negative information. This is particularly germane as the dispute strategy represents the auditor's positive defense of their audit approach, in contrast to the negative PCAOB report. [Abbott et al. \(2016\)](#) argue that a PCAOB inspection report generally acts as a process-based assessment of auditor competence, rather than auditor independence. Second, denial may be more effective than acknowledgement/apology because it may lead individuals to give the accused party the benefit of the doubt. This is critical due to the credence good aspect of auditing, combined with the judgment-based aspect of inherently unobservable auditor competence and/or audit quality. Third, disputes can signal intended redemption (especially in cases where there is subsequent proof of innocence), and that this redemption is weighed more heavily for matters of competence than integrity. The results of [Kim et al. \(2006\)](#) suggest there are risks to a dispute strategy, but there are potential benefits as well.

Due to their experimental settings, neither [Robertson and Houston \(2010\)](#) nor [Kim et al. \(2006\)](#) address an aspect that is unique to an auditing failure per a GAAP-deficient inspection report. That is, audited financial statements are a joint product of management's pre-audited financial statements and the audit process ([DeFond & Zhang, 2014](#)). A GAAP-deficient inspection report indicates that non-GAAP compliant, audited financial statements were disseminated to the security markets. Therefore, the GAAP-deficient auditor failed to prevent/detect a material error or omission *originated by the client and the client's accounting information system*.¹⁰

In the aforementioned scenario, an auditor providing an acknowledgement/apology is simultaneously indicting the clients that were audited. Conversely, when an auditor utilizes a dispute disclosure strategy, the client may view the retention of the GAAP-deficient auditor as a signal that its own accounting treatments were correct. In this case, a GAAP-deficient auditor employing a dispute strategy would be less likely to be dismissed as it provides a rationale for the auditee's own accounting treatments. This could communicate to the market confidence in the auditee's accounting treatments and potentially reduce litigation threats arising from accusations of material accounting misstatements. Underscoring this precept is the commonplace nature of different GAAP interpretations and accounting treatments arising from

¹⁰ Our setting also differs from [Robertson and Houston \(2010\)](#) and [Kim et al. \(2006\)](#) in that there may be extensive prior interactions between the auditee and auditors. [Robertson and Houston \(2010\)](#) investigate outside investors' perceptions of audit quality, whereas [Kim et al. \(2006\)](#) focus on cases in which parties have had limited prior interaction and/or the relationship is in the emergent stages.

differences in judgments (DeZoort & Salterio, 2001).

Given the inherently unobservable traits of both audit quality and financial reporting quality, firms are faced with managing perceptions of both their own financial reporting quality and audit quality. We predict that firms are more likely to retain a GAAP-deficient auditor utilizing a dispute disclosure strategy to mitigate litigation concerns and to communicate to shareholders (and potential litigants) confidence in its own accounting treatments and judgments. This leads to our first hypothesis, stated in alternative form:

Hypothesis 1. A GAAP-deficient auditor is less likely to be dismissed if the auditor employs a dispute disclosure strategy.

3.2. The impact of audit committee financial expertise on reaction to a dispute disclosure

We posit that there are two, non-mutually exclusive reasons why audit committees with accounting-related financial expertise may be less prone to dismissing an auditor that utilizes a dispute disclosure strategy. First, these audit committees could be susceptible to confirmation bias. Confirmation bias is the tendency to search for, interpret, favor, and recall information in a way that confirms one's pre-existing beliefs or hypotheses, while giving disproportionately less consideration to alternative possibilities (Pennington, Schafer, & Pinsky, 2017). It is important to note that audit committees - at a minimum - made a decision to retain/endorse the auditor in executing her/his audit committee duties, as well as reviewed the appropriateness of financial reporting policies. In many cases, these audit committees also have disclosed that they reviewed and approved the current audit plan. In this case, the audit committee with accounting-related financial expertise is given the opportunity to rationalize its pre-existing beliefs by citing the auditor's dispute disclosures, especially those disclosures containing details about why the auditor believed the client correctly interpreted GAAP.

Second, audit committees with accounting-related financial expertise have the capacity to properly compare two, competing GAAP (and GAAS) interpretations. If an audit committee lacks this level of expertise, the most expedient course of action may be to simply defer to the PCAOB's interpretation of GAAP. If pressured for a rationale to maintain the auditor, an audit committee with accounting-related financial expertise may be better equipped to defend its choices and because the committee members are better able to understand the auditors' perspective, they may be more likely to defend the auditor (DeZoort & Salterio, 2001).

Given these effects, our second hypothesis (stated in the alternative form) is as follows:

Hypothesis 2. Audit committees with accounting-related financial expertise are less likely to dismiss a GAAP-deficient auditor employing a dispute disclosure strategy.

4. Sample selection, research design and results

4.1. Sample selection

Details regarding the sample selection process are shown in Table 1. The initial sample consists of all inspection reports for audit firms with GAAP deficiencies, available on the PCAOB website as of December 2014.¹¹ We remove auditors not found in Audit Analytics and auditors that did not audit an issuer company in the year prior to the release of

¹¹ A client dismissal may be the result of a strategic decision by the auditor (e.g., withdrawing from the public audit market). We end our sample period in December 2014 to allow adequate time (i.e., a three-year window) to evaluate whether the firm withdrew its PCAOB registration.

the PCAOB inspection report. We also remove audit firms that are not located within North America.

As mentioned previously, we exclude annually inspected audit firms because: (1) the perception of homogeneity among large firms, (2) the inelasticity of auditor dismissal decisions for annual firms and (3) the limited variation in client audit committees. To ensure that dismissals in our sample are not the result of audit firms "going dark", we exclude all audit firms that do not have subsequent PCAOB inspections.^{12,13} To ensure data availability for our regression model variables, we remove shell/blank check companies, regulated companies, funds and trusts. Finally, clients that change auditors prior to the release of the inspection report and clients who provide a valid reason for changing auditors are excluded.¹⁴ The final sample consists of 805 client companies accompanied by 113 GAAP-deficient inspection reports. The 113 GAAP-deficient inspection reports correspond to 100 unique auditors. This suggests a fairly low "recidivism rate" of 13% (or 13 auditors of the 100 unique auditors had multiple GAAP-deficient inspection reports).¹⁵

Table 2 reports the 113 GAAP-deficient inspection reports included in our sample and the responses to the PCAOB's findings. For comparative purposes, we discuss the differences between our sample and the Abbott et al. (2013) sample. There is significant overlap across the samples, 40 of 57 GAAP-deficient auditors found in Abbott et al. (2013) are included in our sample. However, the Abbott et al. (2013) sample includes 16 GAAP-deficient auditors that went dark following their initial PCAOB inspection.¹⁶ Our sample also includes 61 GAAP-deficient auditors that were initially inspected after the end of the Abbott et al. (2013) sample period (December 31, 2007). The remaining difference can be attributed to how the sample was collected. Abbott et al. (2013) used the SEC's extended search function to identify companies audited by GAAP-deficient firms. Our sample was identified using Audit Analytics' Audit Opinion file.

Table 2 also displays the number of clients reported in the PCAOB inspection reports and the number of publicly held clients that filed a 10-K or 10-KSB with the SEC. Differences between the two numbers can be attributed to companies excluded during the selection process (bankrupt companies, funds, trusts, etc.) and clients with fewer than 500 shareholders that are not required to file annual statements (Abbott et al., 2013). As a result, we can obtain complete data for only 805 of the 2494 potential clients of GAAP-deficient auditors. This data availability rate is lower than that of Abbott et al. (2013) and is primarily attributable to the data requirement for inclusion in our sample.

4.2. Regression model and descriptive statistics

Our research question focuses on whether and to what extent a dispute strategy affects the impact of a GAAP-deficient PCAOB inspection report. We recognize that a dispute disclosure may serve to mitigate or exacerbate the auditor dismissal reaction documented in Abbott et al. (2013). Therefore our research model is based off of

¹² Requiring the audit firms in our sample to have multiple inspection reports likely restricts our sample to larger, higher quality auditors.

¹³ Seven GAAP-deficient auditors in our sample merged with another audit firm between the release of the initial PCAOB inspection report and the subsequent inspection by the PCAOB (see Dixon Hughes merges with Goodman & Company LLP). We include the pre-merger audit firm in our sample if the post-merger audit firm is registered with the PCAOB and continues to audit publicly traded clients. We find similar results if we exclude these observations from our sample.

¹⁴ We remove the client from our sample if it identifies any of the following reasons for the change in auditors: the auditor was banned by the PCAOB or SEC; the auditor is not registered with the PCAOB; the client declared bankruptcy; the auditor is exiting the market for public audits; or the auditor lacks independence.

¹⁵ Our results are not affected if we delete the observations pertaining to any subsequent, GAAP-deficient inspection reports. No auditor had more than two GAAP-deficient inspection reports.

¹⁶ When we reviewed Abbott, Gunny and Zhang (2013) results, we find one mistake in their sample. There is no evidence that the PCAOB cited Akin, Doherty Klein and Feuge for a GAAP deficiency.

Table 1
Sample selection.

Sample attrition	PCAOB inspections reports	Client companies
PCAOB Inspection reports issued between February 2005 and December 2014 containing a GAAP deficiency	291	81,134
Less: Auditors not found in the Audit Analytics database	(2)	(0)
Less: Auditors that did not audit an issuer in the year prior to the release of the PCAOB inspection report	(38)	(0)
Less: Auditors and companies not located in North America	(8)	(6118)
Less: Inspection reports issued to annual auditors	(40)	(71,396)
Less: Auditors that withdrew from the PCAOB or had their registrations revoked	(55)	(1004)
Less: A subsequent PCAOB inspection report within twelve months of the report	(5)	(84)
Less: Companies that did not issue audited financials after the release of the inspection report	(15)	(1265)
Less: Financial service companies ^a	(0)	(10)
Less: Other ^b	(15)	(452)
Final Sample	113	805

Table 1 presents our sample reconciliation and data screening process used in determining the sample available for our auditor dismissal tests. We present separate calculations for our sample of PCAOB inspection reports and our sample of client companies.

^a Shell/blank check companies, funds, trusts, and regulated companies, etc.

^b Companies that did not issue 10-K or 10KSB, companies with no assets, etc.

Abbott et al. (2013) and is as follows:

$$\begin{aligned}
 \text{DISMISS} = & \beta_0 + \beta_1 \text{DISPUTE} + \beta_2 \text{FINACE} + \beta_3 \text{DISPUTE} * \text{FINACE} \\
 & + \beta_4 \text{INOWN} + \beta_5 \text{LEVERAGE} + \beta_6 \text{SIZE} + \beta_7 \text{BLOCK} \\
 & + \beta_8 \text{FINANCE} + \beta_9 \text{GOINGCON} + \beta_{10} \text{FEWCLIENT} \\
 & + \beta_{11} \text{RESTATE} + \beta_{12} \text{FEECUT} + \beta_{13} \text{FIRMSIZE} + \beta_{14} \text{SYEAR} \\
 & + \varepsilon
 \end{aligned} \quad (1)$$

where:

DISMISS = An indicator variable coded “1” for companies that dismissed their triennially inspected incumbent auditor within one year after the PCAOB inspection report was publicly disclosed, and “0” otherwise.

DISPUTE = An indicator variable coded “1” if the auditor disagrees with the PCAOB’s inspection report, stating that the firm failed to address a material misstatement in the financials, and “0” otherwise.

FINACE = Audit committee effectiveness variable coded “1” for an audit committee composed entirely of independent directors and having at least one financial expert as evidenced by work experience as certified public accountants, chief financial officers, vice presidents of finance or financial controllers, and “0” otherwise (from proxy statements).

INOWN = cumulative percentage of voting stock shares held by managers and directors.

LEVERAGE = The ratio of long-term debt to total assets (from 10-K or 10-KSB).

SIZE = The natural logarithm of the client company’s total assets in millions (from Audit Analytics).

BLOCK = The cumulative ownership percentage of voting stock shares held by blockholders that are unaffiliated with management and hold at least 5% of the outstanding common shares (from proxy statements)

FINANCE = Total cash received from equity or debt issuances for the two years after receipt of the PCAOB inspection report, scaled by total assets (from 10-K or 10-KSB).

GOINGCON = An indicator variable coded “1” if the client company received a going-concern modification in the year prior to the release of the PCAOB inspection report, and “0” otherwise (from Audit Analytics).

FEECUT = An indicator variable coded “1” for client companies receiving a fee reduction in the year following the PCAOB inspection report, and “0” otherwise (from Audit Analytics).

FEWCLIENT = An indicator variable coded “1” in instances where the incumbent auditor audits fewer than five publicly held companies, and “0” otherwise (from PCAOB inspection report).

RESTATE = An indicator variable coded “1” in instances where the company has experienced at least one restatement in the two-year

period prior to the inspection report date, and “0” otherwise (from Audit Analytics).

FIRM_SIZE = The natural logarithm of the number of audit firm partners (from PCAOB inspection report).

Our approach departs from Abbott et al. (2013) along four important dimensions. First, we limit our sample to only those clients of GAAP-deficient auditors. This is because clean or GAAS-deficient auditors do not face the economic consequences of a GAAP-deficient inspection report. Therefore, these auditors do not have incentive to employ nor do they utilize a dispute disclosure strategy to the degree that GAAP-deficient auditors do.¹⁷ Second, we include in our model a DISPUTE variable, which is coded “1” in instances where a GAAP-deficient, triennially inspected auditor employs a dispute disclosure strategy and “0” otherwise. Third, our FINACE variable is used in lieu of the more general “ACE” variable found in Abbott et al. (2013) as we wish to determine the impact that accounting-related, audit committee financial expertise has on the auditor dismissal decision. Fourth, to control for any difference in size between disputing and nondisputing auditors, we augment the Abbott et al. (2013) model by including the natural logarithm of the number of partners at the audit firm (FIRM_SIZE).

Our variables of interest for tests of hypotheses one and two are DISPUTE and FINACE * DISPUTE, respectively. We predict negative coefficient estimates for both of these variables. However, for our individual, stand-alone FINACE variable, we expect that a company with an audit committee exhibiting accounting-related financial expertise is more likely to dismiss a GAAP-deficient auditor, consistent with Abbott et al. (2013).

Our control variables are adapted primarily from Abbott et al. (2013). Abbott et al. (2013) utilize agency theory to generate predictions between the likelihood of auditor dismissal and many of their control variables. INOWN measures the degree of alignment between shareholders and management and helps to ensure that management “thinks like an owner”. Therefore, we predict a negative relation between increasing levels of inside ownership and the likelihood of dismissing a GAAP-deficient auditor. LEVERAGE is predicted to increase the potential conflicts between management and shareholders, increasing management’s need to signal interest in audit quality. We therefore anticipate a positive association between LEVERAGE and auditor dismissal. SIZE reduces the observability of management actions, increasing potential agency conflicts, thereby increasing the need

¹⁷ Abbott et al. (2013) document a 44.3% dismissal rate of GAAP-deficient auditors. This dismissal rate is significantly higher than that of GAAS-deficient and clean triennially inspected auditors, who have dismissal rates of 20.5% and 17.9%, respectively. The difference in dismissal rates between clean and GAAS-deficient auditors is not statistically significant.

Table 2
Distribution of observations by auditor.

GAAP-deficient auditor	Date of inspection report	Response	Clients per inspection report	Sample clients
Ahearn, Jasco + Company, P.A.	June 23, 2005	A	3	1
BDO Canada LLP	February 2, 2012	A	46	7
Beard Miller Company LLP	September 30, 2008	I	78	5
Bedinger & Company	April 6, 2006	I	3	2
Berenfeld, Spritzer, Shechter & Sheer	February 28, 2008	A	10	6
Berman & Company, P.A.	January 31, 2013	D	32	4
Bernstein & Pinchuk LLP	April 6, 2006	D	3	3
Brimmer, Burek, Keelan LLP	December 16, 2010	NA	7	1
Brown Armstrong Accountancy Corporation	January 31, 2013	A	5	1
Brown Smith Wallace, L.L.C.	October 26, 2006	A	4	1
Brown Smith Wallace, L.L.C.	December 16, 2010	I	10	1
Buckno Lisicky & Company	January 25, 2007	NA	1	1
Cacciamatta Accountancy Corporation	April 29, 2011	I	8	1
CF & CO., L.L.P.	September 28, 2005	D	5	3
Chisholm, Bierwolf & Nilson, LLC	July 25, 2005	NA	67	42
Clancy and Co., P.L.L.C.	March 9, 2006	D	16	5
Clay Thomas, P.C.	August 2, 2012	NA	2	1
Cordovano and Honeck, P.C.	April 6, 2006	A	47	23
Creason & Associates, P.L.L.C.	May 21, 2009	A	3	2
Daszkal Bolton LLP	October 22, 2009	A	13	4
Davidson & Company LLP	March 31, 2011	I	27	4
De Visser Gray LLP	May 24, 2012	D	8	1
DeCoria, Maichel & Teague P.S.	April 19, 2007	D	8	8
Dixon Hughes Goodman LLP	August 1, 2013	I	54	4
Dixon Hughes PLLC	October 23, 2008	A	59	6
DNTW Chartered Accountants, LLP	October 27, 2011	NA	7	3
Dohan and Company, CPA's P.A.	April 2, 2009	D	19	1
Donahue Associates LLC	December 16, 2010	D	4	1
Drakeford & Drakeford, LLC	March 9, 2006	D	2	1
Dudley, Hopton-Jones, Sims & Freeman, PLLP	January 21, 2005	I	1	1
E. Randall Gruber, CPA, PC	July 13, 2006	NA	9	10
Earl M. Cohen, C.P.A., P.A.	August 29, 2005	NA	9	1
Ehrhardt, Keefe, Steiner & Hottman, P.C.	May 21, 2008	D	40	22
Eisner LLP	February 2, 2006	A	57	40
Enterprise CPAs, Ltd.	December 5, 2011	I	5	2
Farber, Hass, Hurley, McEwen LLP	December 18, 2007	A	16	6
Farmer, Fuqua & Huff, P.C.	November 30, 2012	I	4	1
Ferlita, Walsh & Gonzalez, P.A.	October 1, 2009	D	3	2
Freedman & Goldberg, C.P.A.'s, P. C.	November 30, 2006	A	3	2
Freedman & Goldberg, C.P.A.'s, P. C.	October 1, 2009	D	1	1
GBH CPAs, PC	July 29, 2010	A	33	25
Gruber & Company, LLC	January 21, 2010	A	58	5
James Stafford, Inc.	April 26, 2012	I	13	1
John Kinross-Kennedy CPA	February 2, 2012	D	13	10
Johnson, Miller & Co., C.P.A., P.C.	November 30, 2006	I	3	2
Jones Simkins, P.C.	December 16, 2010	D	4	2
Kabani & Company Inc.	July 29, 2010	NA	57	8
Kabani & Company, Inc.	January 31, 2013	D	46	6
KBL, LLP	February 24, 2011	D	21	14
Kempisty & Company, Certified Public Accountants,	November 21, 2008	NA	18	9
Kim & Lee Corporation, Certified Public Accountant	April 29, 2011	NA	2	1
KMJ Corbin & Company LLP	September 30, 2010	I	31	7
Kyle L. Tingle, CPA, LLC	July 25, 2005	I	7	5
Lake & Associates CPA's, LLC	December 21, 2009	D	14	9
Lake & Associates, CPA's LLC	June 28, 2012	I	40	5
Lane Gorman Trubitt, L.L.P.	November 19, 2009	D	9	5
Larry O'Donnell, CPA, P.C.	July 30, 2009	NA	21	4
Liebman Goldberg & Hymowitz, LLP	May 27, 2010	NA	6	1
M&K, CPA, PLLC	December 22, 2011	I	95	13
MacKay LLP	April 29, 2010	NA	14	5
Maddox Ungar Silberstein, PLLC	December 21, 2009	D	36	27
Madsen & Associates, CPA's Inc.	December 21, 2009	A	51	44
Madsen & Associates, CPA's Inc.	June 28, 2012	A	72	31
Mahoney Sabol & Company, LLP	February 2, 2006	D	3	3
Manning Elliott LLP	June 24, 2010	D	88	17
Manning Elliott LLP	August 3, 2011	I	55	3
Marcum LLP	August 3, 2011	I	84	38
Mayer Hoffman McCann P.C.	August 29, 2005	A	15	10
Mayer Hoffman McCann P.C.	September 23, 2011	A	52	20
McGovern, Hurley, Cunningham, LLP	October 29, 2010	NA	2	1
Michael F. Albanese CPA	April 29, 2011	D	2	3
Michael F. Cronin, CPA	March 9, 2006	D	8	6
Mintz & Partners LLP	June 14, 2007	A	8	1
Moore & Associates, Chartered	October 27, 2005	A	3	7

(continued on next page)

Table 2 (continued)

GAAP-deficient auditor	Date of inspection report	Response	Clients per inspection report	Sample clients
Morrill & Associates, LLC	December 20, 2012	D	17	8
Moss Adams LLP	November 19, 2009	I	92	26
MS Group CPA L.L.C.	May 26, 2011	NA	3	1
MSPC Certified Public Accountants and Advisors, P.C.	May 26, 2011	NA	18	3
Pannell Kerr Forster of Texas, P.C.	July 2, 2010	D	7	2
Paritz & Company, P.A.	July 30, 2009	A	16	14
Paritz and Company P.A.	May 24, 2012	I	31	8
Patrizio & Zhao, LLC	February 2, 2012	D	12	1
Perrella & Associates, P.A.	April 6, 2006	A	8	1
Peter C. Cosmas Co., CPA	August 29, 2005	D	2	2
Pritchett, Siler & Hardy, P.C.	April 24, 2008	A	40	17
R.R. Hawkins & Associates	August 2, 2012	NA	12	2
Raich Ende Malter & Co., LLP	August 9, 2011	I	23	1
Rehmann Accounting LLC	August 3, 2011	I	13	2
Robison, Hill & Co., A Professional Corporation	January 30, 2009	NA	67	8
Ronald R. Chadwick, P.C.	April 6, 2006	A	4	4
Ronald R. Chadwick, P.C.	August 2, 2012	NA	51	1
S.E. Clark & Company, P.C.	October 1, 2009	D	3	1
S.W. Hatfield, CPA	September 28, 2005	NA	18	9
Sam Kan & Company	December 5, 2011	A	17	7
Saturna Group Chartered Accountants LLP	December 20, 2012	I	20	2
Scharf Pera & Co., PLLC	November 19, 2009	D	2	1
Schwartz Levitsky Feldman LLP	April 19, 2007	D	19	13
Schwartz Levitsky Feldman LLP	December 20, 2012	A	22	4
Seligson & Giannattasio, LLP	May 11, 2006	I	6	4
SF Partnership, LLP	August 3, 2011	A	13	1
Sherb & Co., LLP	March 31, 2011	D	84	26
Singer Lewak Greenbaum & Goldstein LLP	September 30, 2008	I	35	17
Smythe Ratcliffe LLP	May 26, 2011	I	18	1
Stan J. Lee	March 31, 2010	I	33	5
Tarvaran Askelson & Company, LLP	August 9, 2011	I	8	4
Traci J Anderson	April 24, 2008	I	12	2
Turner, Jones & Company, P.L.L.C.	May 11, 2006	D	2	2
Turner, Jones and Company PLLC	September 27, 2012	D	3	1
Turner, Stone & Company, L.L.P.	August 9, 2011	D	19	5
Turner, Stone & Company, LLP	July 25, 2005	D	10	6
Weinberg & Company, P.A.	December 20, 2012	I	35	7
Wiener, Goodman & Company, P.C.	May 11, 2006	NA	4	2
WithumSmith + Brown, A Professional Corporation	February 2, 2006	A	12	5
Total			2494	805

Table 2 presents the distribution of the 805 observations on an individual auditor basis. The column entitled “Response” is coded as follows for the three types of disclosure strategies: I/NA = the auditor either ignores the GAAP deficiency in the inspection report or fails to include any communication in the inspection report; D = when the auditor disputes the PCAOB findings; A = when the auditor acknowledges the GAAP deficiency. The columns entitled “Clients per Inspection Report” and “Sample Clients” include the numbers of audit clients for that auditing firm as in the sampled PCAOB inspection report and the number of audit clients for that auditing firm that were included in our sample.

to dismiss a GAAP-deficient auditor. Conversely, auditee size may proxy for auditor switching costs, which would suggest a negative association between it and the likelihood of dismissing a GAAP-deficient auditor. Consequently, we do not provide a prediction for the relation between auditee size and the likelihood of dismissing a GAAP-deficient auditor. BLOCK is designed to capture the incentives of blockholders who depend upon the audited financial statements to monitor management. We expect this to intensify the demand for higher quality financial information and predict a positive relation between it and the likelihood of auditor dismissal. FINANCE is hypothesized to increase the agency conflicts arising from adverse selection (Jensen & Meckling, 1976). Thus, we predict a positive association between FINANCE and our dependent variable.

In addition to the agency-related demand for audit quality, there are several audit-engagement and auditor-specific variables that may affect the likelihood of dismissing a GAAP-deficient auditor, many of which are found in Abbott et al. (2013). GOINGCON is added to our model as auditees may engage in opinion shopping and dismiss a GAAP-deficient auditor in order to obtain a more favorable audit opinion from another auditor (Abbott et al., 2013). Auditees may also dismiss their auditors as a means of procuring initial-year “lowball” audit fees. Hence, FEECUT is included in our model, and it is predicted to have a positive association with auditor dismissal. If the GAAP-deficient auditor only has a few public clients (and simultaneously auditors with fewer clients

are more/less likely to employ a dispute disclosure strategy), the identity of the client may be more apparent. We expect that our FEWCIENT variable will intensify the likelihood of dismissing a GAAP-deficient, triennially inspected auditor (Abbott et al., 2013). Consistent with Abbott et al. (2013), we include RESTATE to ensure dismissals are not driven by the presence of earnings restatements instead of GAAP-deficient PCAOB inspection reports. More specifically, prior research finds that clients that restate their financial statements are more likely to dismiss their auditors. To ensure that our results are not driven by the size of the auditor, we include FIRM_SIZE as well. We do not provide a prediction for our FIRM_SIZE variable. Finally, we include year indicator variables to control for changes in dismissal rates across time.

Descriptive statistics for the 113 GAAP-deficient inspection reports and their corresponding clients are reported in Table 3. Panel A displays the distribution of auditor responses. In 50 of the 113 inspection reports, the auditor chose to ignore or not acknowledge the PCAOB's findings. In 28 of the 113 inspection reports, the auditor chose to acknowledge the PCAOB's findings. Lastly, there were 35 GAAP-deficient inspection reports – or 31% of total auditor responses – whereby the auditor disputed the PCAOB's findings.

Auditor characteristics are reported in Panel B of Table 3. Univariate differences in auditor characteristics between disputing (those not disputing) GAAP-deficient auditors are presented in separate columns. We find evidence that GAAP-deficient auditors disputing the

Table 3
Descriptive statistics.

Panel A: Type of response		Number of firms	
Ignore/not acknowledged		50	(44%)
Acknowledges		28	(25%)
Dispute		35	(31%)
Total		113	(100%)

Panel B: Accounting firm characteristics	Dispute	No dispute	Difference (t-value)
Offices	1.46	4.87	2.55 ^b
Partners at the firm	5.29	25.40	3.01 ^c
Staff members at the firm	21.77	122.30	2.78 ^c
Number of clients	16.14	24.73	1.81 ^a
N	35	78	

Panel C: Client characteristics	Dispute	No dispute	Difference (t-value)
DISMISS	0.09	0.13	1.62 ^a
ACE	0.26	0.35	2.57 ^b
FIN_ACE	0.17	0.24	2.39 ^b
NONFIN_ACE	0.09	0.11	0.88
INOWN (%)	36.73	33.91	1.34
LEVERAGE	0.15	0.21	2.54 ^b
SIZE (millions)	20.22	25.19	1.12
BLOCK (%)	8.95	9.58	0.43
FINANCE	0.11	0.11	0.27
GOINGCON	0.59	0.61	0.41
FEWCLIENT	0.10	0.05	2.32 ^b
RESTATE	0.14	0.12	0.60
FEECUT	0.30	0.33	0.96
FIRM_SIZE (number of partners)	8.71	43.87	10.69 ^c
N	222	583	

Table 3 presents descriptive statistics for our sample firms. Panel A presents descriptive statistics for our sample of Accounting Firms. Panel B presents descriptive statistics of the types of responses given by the firms in our Accounting Firm sample. Panel C presents descriptive statistics for our client firm sample, partitioned by whether or not the auditor disputes the “GAAP Deficiency” criticism within their initial inspection report. DISMISS is an indicator variable coded “1” for companies that dismissed their triennially inspected incumbent auditor within one year after the initial PCAOB inspection report was publicly disclosed, and “0” otherwise; ACE (Audit committee effectiveness) is an indicator variable coded “1” if the company has an audit committee composed entirely of outside directors and has at least one financial expert as designated by SOX, and “0” otherwise (from proxy statements); FIN_ACE is an indicator variable coded “1” if the company has an audit committee composed entirely of outside directors, at least one financial expert as designated by SOX, and at least one member of the audit committee has an accounting background and “0” otherwise (from proxy statements); NONFIN_ACE is an indicator variable coded “1” if the company has an audit committee composed entirely of outside directors, at least one financial expert as designated by SOX, but no member of the audit committee has an accounting background and “0” otherwise (from proxy statements); INOWN is the cumulative percentage of voting stock shares held by managers and directors (from proxy statements); LEVERAGE is the ratio of long-term debt to total assets in the year prior to the release of the PCAOB inspection report; SIZE is total assets in millions in the year prior to the release of the PCAOB inspection report; BLOCK is the cumulative ownership percentage of voting stock shares held by blockholders that are unaffiliated with management and hold at least 5% of the outstanding common shares (from proxy statements); FINANCE is total cash received from equity or debt issuances for the two years after receipt of the PCAOB inspection report, scaled by total assets; GOINGCON is an indicator variable coded “1” if the company received a going-concern modification in the year prior to the release of the PCAOB inspection report and “0” otherwise (from AuditAnalytics); FEWCLIENT is an indicator variable coded “1” in instances where incumbent auditor audits fewer than five publicly held companies, and “0” otherwise (from PCAOB inspection report). RESTATE is an indicator variable coded “1” in instances where the company has experienced at least one restatement in the two-year period prior to the inspection report date, and “0” otherwise (from AuditAnalytics). FEECUT is an indicator variable coded “1” for clients that receive a fee reduction in the year following the PCAOB inspection report, and “0” otherwise. FIRM_SIZE is the number of partners at the audit firm.

All continuous variables are winsorized at the top and bottom 1%.

^a Statistical significance at a 10% level one-tailed (when predicted, otherwise two-tailed).

^b Statistical significance at a 5% level one-tailed (when predicted, otherwise two-tailed).

^c Statistical significance at a 1% level one-tailed (when predicted, otherwise two-tailed).

PCAOB's findings are smaller than GAAP-deficient auditors that do not dispute the PCAOB's findings. Auditors disputing the PCAOB's findings have fewer offices, partners and staff than auditors that do not dispute the PCAOB's findings. We also find weak evidence that disputing auditors have a lower number of clients than those auditors that do not dispute.¹⁸ As discussed later, we adjust our model to account for any

possible impact auditor size may have on results.

Panel C of Table 3 displays the descriptive statistics for our sample of client companies. In this case, it is instructive to note that 35 (or 31%) of the 113 GAAP-deficient inspection reports contained a dispute disclosure. As previously mentioned, we document a slightly significant difference in the number of clients audited by each category of disclosure strategy. More specifically, of the 805 observations, 222 of them pertain to dispute disclosures. This corresponds to 27.5% of the total observations, which closely resembles the 31% of inspection reports that included a dispute disclosure. Therefore, our data availability

¹⁸ These inferences remain substantively the same if we delete the 13 auditors that had two GAAP-deficient inspection reports. These 13 auditors did not display a distinct pattern of disclosures. Of the initial 13 GAAP-deficient inspections, there were five disputes, five acknowledge and three ignore/not acknowledge. For the 13 subsequent GAAP-deficient inspections, there were four disputes, four acknowledge and five ignore/not acknowledge. Of the 13 combination of initial/subsequent inspection report disclosures, only four were consistent across both inspection report, which two dispute/dispute

(footnote continued)

disclosure strategies and two acknowledge/acknowledge disclosure strategies.

requirements do not appear to systematically bias against inclusion or exclusion of the clients of GAAP-deficient auditors who disputed the PCAOB's findings.

Panel C of Table 3 also documents that approximately 9% of clients who employed a disputing, GAAP-deficient auditors dismissed these auditors. For comparison, 13% of clients who employed a GAAP-deficient auditors that did not dispute the PCAOB findings dismissed their auditors. This provides univariate support for our first hypothesis, and suggests that a dispute disclosure may mitigate the client-loss inducing effect of a GAAP-deficient PCAOB inspection report. In general, Panel C describes clients as very small and financially distressed, with close to 60% of our sample clients receiving a going concern modification. This client profile is consistent with prior research on triennially inspected auditors. Panel C also reveals that the clients of disputing GAAP-deficient auditors tend to have fewer effective audit committees per the Abbott et al. (2013) definition of audit committee effectiveness, as well as fewer effective audit committees that have accounting-related financial expertise. Finally, clients of disputing auditors have lower leverage, are more likely to be part of small client roster and employ a relatively smaller auditor (as measures by the number of audit partners).

Panel C of Table 3 reports that the overall GAAP-deficient auditor dismissal rate is approximately 11.9%, or 96 auditor dismissals in 805 observations. This compares to an overall GAAP-deficient dismissal rate of 44.3% for Abbott et al. (2013), or 168 dismissal in 379 observations. However, there are several sample differences that explain the disparity in dismissal rates. First, we note that of the 379 observations of Abbott et al. (2013), 91 correspond to auditors that subsequently “went dark”. In these cases, there was likely to be extremely high dismissal rates within one year of the inspection report. Assuming a 100% “dismissal” rate for the clients of GAAP-deficient firms that “went dark” creates 91 auditor dismissals that may not be truly reflective of a voluntary auditor dismissal. These leaves 77 dismissals remaining out of 288 observations, resulting in a voluntary dismissal rate of 26.7%. It is also instructive to note that Abbott et al. (2013) include shell companies, which generally have no assets and therefore have virtually no auditor switching costs, another factor that helps to explain the much larger auditor dismissal rate of Abbott et al. (2013). Finally, our sample requirement of inclusion in the Audit Analytics opinion file generally results in a set of larger clients. This would increase auditor switching costs and therefore depress our dismissal rate as compared to Abbott et al. (2013).

Table 4 displays the correlations among the variables. Most salient is the general lack of correlation between the DISPUTE variable and other variables. While DISPUTE is negatively correlated with DISMISS, it is on the cusp of statistical significant ($p < 0.11$, two-tailed). Not surprisingly, there is a high degree of correlation (0.76) between the FIN_ACE variable and the ACE variable of Abbott et al. (2013). However, because the FIN_ACE variable is more stringent, the correlation is, by design, $< 100\%$. The remaining variables appear to be correlated in the predicted directions, with relatively larger GAAP-deficient auditors (FIRM_SIZE) being positively correlated with larger clients, more effective audit committees and higher levels of blockholder ownership. While some variables are highly correlated ($\rho > 0.50$), none of our results change when we drop them from the model.

5. Results

To determine whether the auditor's dispute disclosure strategy impacts the auditor dismissal decision, we estimate the logistic regression model described in Eq. (1).^{19,20}

The model is designed to test whether a board of directors/audit committee can be influenced by the auditor's response to a GAAP-deficient PCAOB inspection report. Our coefficients of interest are β_1 and β_3 , which relate to our DISPUTE and DISPUTE * FIN_ACE variables. As discussed in our hypothesis development section, we predict negative coefficient estimates pertaining to DISPUTE and DISPUTE * FIN_ACE. Following Abbott et al. (2013), we predict that, as a stand-alone variable, FIN_ACE will be positively associated with the likelihood of dismissing a GAAP-deficient auditor.

The results of estimating Eq. (1) are reported in Table 5. Column (1) displays the results excluding the indicator variable for the auditor's response. The logistic regression model reveals that firms with higher levels of inside ownership and leverage are more likely to dismiss a GAAP-deficient auditor, irrespective of its disclosure strategy. Audit committees with accounting-related financial expertise are also more likely to dismiss a GAAP-deficient auditor, which is generally consistent with Abbott et al. (2013). The other coefficient estimates are statistically insignificant. In Column (2) of Table 5, we include the DISPUTE indicator variable. The coefficient on DISPUTE is significantly insignificant as a stand-alone variable, whereas the coefficient estimates and their statistical significance generally remain stable across the two specifications. Column (3) displays the results of estimating our full model, which includes the interaction between our DISPUTE and FIN_ACE variables. When the interaction variable is included in the model, we find that GAAP-deficient auditors are much less likely to be dismissed in the presence of an audit committee with accounting-related financial expertise. This provides multivariate support for Hypothesis 2 and indicates that the univariate support of Hypothesis 1 is driven primarily by the reaction of audit committees with accounting-related financial expertise to a dispute disclosure strategy.

The consistently, positive coefficient estimate for FIN_ACE demonstrates that when an auditor employs an ignore or acknowledge disclosure strategy, audit committees with accounting-related financial expertise are more likely to dismiss these auditors. However, should the GAAP-deficient auditor utilize a dispute disclosure strategy, the dominant effect is that the auditor is far more likely to be retained, rather than dismissed. As a point of reference, of the 37 observations involving a disputing, GAAP-deficient auditor in the presence of an audit committee with accounting-related financial expertise, there was only one auditor dismissal.

In contrast, there were 140 observations where the GAAP-deficient auditor did not dispute the PCAOB findings, and the audit committee possessed accounting-related, financial expertise. In 14 of those instances, the auditor was dismissed. It should be noted that there is ample representation in both the dispute and non-dispute segments. The dispute segment includes 14 different auditors and the non-dispute segment contains 35 different auditors. Together with the results of Table 5, this evidence suggests that the efficacy of a dispute disclosure strategy is greatly impacted by the audience that reviews the inspection report.

The evidence of Table 5 is consistent with financially expert audit committees assessing two different interpretations of GAAP and GAAS. Moreover, in 36 of the 37 instances, these financially expert audit committees concurred with the auditor, rather than the regulator. Given that the PCAOB is an ostensibly objective arbiter of audit quality, this result may appear somewhat surprising. However, recent survey-based research by Johnson et al. (2017) indicates that many auditors view the inspection process with suspicion and question whether the inspection focus is more on compliance than on quality.²¹ If a particular

²¹ Johnson et al. (2017) conduct a series of semi-structured interviews with audit partners to obtain their perceptions of the PCAOB inspection process. Many voiced frustrations with the audit process with one partner stating “They (the PCAOB) seem to have forgotten that part of executing audits requires judgment and sampling and the evaluation of a reasonable outcome and a reasonable financial statement presentation and disclosure.” Another partner unequivocally stated that “...you could say I don't agree with

¹⁹ None of our findings change if we use a probit regression model.

²⁰ To control for possible correlation of residuals among companies audited by the same firm, our regression results are reported using robust standard errors clustered by auditor.

Table 4
Correlation matrix.

	DISMISS	DISPUTE	ACE	FIN_ACE	INOWN	LEVERAGE	SIZE	BLOCK	FINANCE	GOING CON	FEW CLIENT	RESTATE	FEECUT	FIRM_SIZE
DISMISS		−0.06	−0.12	−0.06	0.10	0.08	−0.16	−0.06	0.11	0.12	−0.04	−0.03	−0.02	−0.18
DISPUTE	−0.05		−0.09	−0.08	0.05	−0.10	−0.04	−0.07	0.00	−0.01	0.09	0.02	−0.03	−0.09
ACE	−0.12	−0.09		0.76	−0.16	0.15	0.66	0.29	0.01	−0.53	−0.06	0.08	0.08	0.54
FIN_ACE	−0.06	−0.08	0.76		−0.10	0.12	0.52	0.21	0.02	−0.42	−0.04	0.08	0.05	0.45
INOWN	0.09	0.05	−0.19	−0.13		−0.08	−0.22	−0.30	−0.01	0.07	0.02	0.01	−0.05	−0.15
LEVERAGE	0.15	−0.08	−0.05	−0.04	−0.03		0.19	0.02	0.11	−0.02	−0.05	0.05	0.10	0.15
SIZE	−0.15	−0.03	0.55	0.43	−0.25	−0.02		0.33	0.00	−0.70	0.04	0.13	0.10	0.56
BLOCK	−0.06	−0.02	0.15	0.13	−0.32	−0.06	0.14		−0.07	−0.27	0.01	−0.05	0.08	0.27
FINANCE	0.05	0.01	0.00	0.02	0.02	−0.04	−0.11	−0.02		0.04	0.01	−0.02	−0.04	−0.04
GOINGCON	0.12	−0.01	−0.53	−0.42	0.10	0.19	−0.59	−0.14	−0.01		−0.04	−0.05	−0.01	−0.47
FEWCLIENT	−0.04	0.09	−0.06	−0.04	0.01	−0.07	0.06	0.01	0.01	−0.04		0.09	0.00	−0.17
RESTATE	−0.02	0.02	0.08	0.08	0.01	0.00	0.14	−0.04	−0.02	−0.05	0.09		0.01	−0.02
FEECUT	−0.02	−0.03	0.08	0.05	−0.05	0.05	0.11	0.10	−0.05	−0.01	0.00	0.01		0.08
FIRM_SIZE	−0.15	−0.16	0.57	0.49	−0.19	−0.01	0.50	0.16	−0.04	−0.48	−0.17	−0.04	0.10	

Table 4 presents bivariate correlations between variables used in our analyses. DISMISS is an indicator variable coded “1” for companies that dismissed their triennially inspected incumbent auditor within one year after the initial PCAOB inspection report was publicly disclosed, and “0” otherwise; DISPUTE is an indicator variable coded “1” if the auditor disagrees with the PCAOB’s report stating that the firm failed to address a material misstatement in the financials and “0” otherwise; ACE (Audit committee effectiveness) is an indicator variable coded “1” if the company has an audit committee composed entirely of outside directors and has at least one financial expert as designated by SOX, and “0” otherwise (from proxy statements); FIN_ACE is an indicator variable coded ‘1’ if the company has an audit committee composed entirely of outside directors, at least one financial expert as designated by SOX, and at least one member of the audit committee has an accounting background and ‘0’ otherwise (from proxy statements); NONFIN_ACE is an indicator variable coded ‘1’ if the company has an audit committee composed entirely of outside directors, at least one financial expert as designated by SOX, but no member of the audit committee has an accounting background and ‘0’ otherwise (from proxy statements); INOWN is the cumulative percentage of voting stock shares held by managers and directors (from proxy statements); LEVERAGE is the ratio of long-term debt to total assets in the year prior to the release of the PCAOB inspection report; SIZE is total assets in millions in the year prior to the release of the PCAOB inspection report; BLOCK is the cumulative ownership percentage of voting stock shares held by blockholders that are unaffiliated with management and hold at least 5% of the outstanding common shares (from proxy statements); FINANCE is total cash received from equity or debt issuances for the two years after receipt of the PCAOB inspection report, scaled by total assets; GOINGCON is an indicator variable coded ‘1’ if the company received a going-concern modification in the year prior to the release of the PCAOB inspection report and ‘0’ otherwise (from AuditAnalytics); FEWCLIENT is an indicator variable coded ‘1’ in instances where incumbent auditor audits fewer than five publicly held companies, and ‘0’ otherwise (from PCAOB inspection report). RESTATE is an indicator variable coded ‘1’ in instances where the company has experienced at least one restatement in the two-year period prior to the inspection report date, and ‘0’ otherwise (from AuditAnalytics). FEECUT is an indicator variable coded ‘1’ for clients that receive a fee reduction in the year following the PCAOB inspection report, and ‘0’ otherwise. FIRM_SIZE is the number of partners at the audit firm. All continuous variables are winsorized at the top and bottom 1%. Pearson (lower left) and Spearman (upper right) correlations significant at p-value less than or equal to 0.05 are in **bold**.

inspection had a suboptimal focus on compliance rather than quality, the dispute disclosures could serve to counteract that bias. Therefore, it stands to reason that audit committees with accounting-related financial expertise would be uniquely qualified to distinguish between what constitutes both accounting and audit quality vis-à-vis accounting and auditing compliance.

5.1. Sensitivity analysis

Our sensitivity analyses center on six distinct issues: the relation between the number of PCAOB inspection report findings and disclosure strategy, the impact of individual audit firms, growth strategies of audit firms, the impact of “repeat GAAP-deficient offenders”, the impact of an acknowledge disclosure strategy and alternative definitions of financial expertise for audit committee directors. Each of these issues will be discussed in separate paragraphs.

5.1.1. The relation between the number of PCAOB inspection deficiency and disclosure strategy

Audit firms with fewer PCAOB report findings may be more likely to employ a dispute disclosure strategy. That is, the number of PCAOB report findings may be negatively correlated with the DISPUTE variable. Consequently, firms are less likely to dismiss a dispute disclosure auditor not because of the dispute strategy but because these auditors have fewer report findings. To investigate this alternative explanation, we created a variable to capture the total number of disclosed PCAOB findings, as well as the total number of disclosed PCAOB findings that resulted in a “material departure from GAAP.” We find that for the 113

(footnote continued)

you (PCAOB). I’m going to be adversarial in this, and I’m going to do what I want to do. So, the impact on our firm is that we’ve been on the side of ... in my mind, we’ve done everything they’ve asked...we haven’t fought back enough.’

inspection reports in our sample, dispute/acknowledge/ignore disclosure strategies had, on average 3.86/3.79/3.74 overall disclosed PCAOB findings on their inspection reports. Therefore, there was no significant differences in the total number of inspection report findings among the three types of disclosure strategy categorizations. In terms of number of material GAAP departure findings on inspection reports, dispute/acknowledge/ignore auditors had, on average 1.40/1.29/1.31 findings, respectively. After controlling for audit firm size, these differences are statistically insignificant. Therefore, there was no significant differences in the number of “material GAAP departure” inspection report findings among the three types of disclosure strategy categorizations. We therefore conclude that the number of PCAOB findings is unrelated to the disclosure strategy employed by auditors and unlikely to impact our results.

5.1.2. The impact of individual audit firms on our results

To ensure that our results are not driven by the presence of any one auditor, we conducted our analysis by excluding observations pertaining to one auditor at a time. The omission of sample observations belonging to any particular GAAP-deficient auditor did not qualitatively alter our results. When auditors with just one client received deficient PCAOB reports, the deficiency can be attributed to the specific client with certainty. As such, clients may be extremely reluctant to dismiss their GAAP-deficient auditors as this could potentially signal culpability with respect to misstatements in the client-prepared/GAAP-deficient auditor audited financial statements. To ensure that our results are not driven by these one-client auditors, we excluded one-client auditors from the analysis and obtained results similar to those in Table 5. We also deleted observations corresponding to the four largest audit client rosters in our sample.²² Exclusion of these observations did

²² The auditors with the largest number of sample observations are: Chisholm, Bierwolf & Nilson (n = 42), Eisner LLP (n = 40); Madsen & Associates (n = 44) and

Table 5
The likelihood of auditor dismissal for GAAP-deficient auditors conditional on the auditor's response and financial expertise on the audit committee.

Variable	Sign	(1)	(2)	(3)
Intercept	(?)	-1.472 (-2.02) ^b	-1.331 (-1.79) ^a	-1.327 (-1.79) ^a
DISPUTE	(-)		-0.391 (-1.16)	-0.254 (-0.71)
FIN_ACE	(+)	0.570 (1.64) ^b	0.551 (1.57) ^a	0.748 (1.92) ^b
FIN_ACE * DISPUTE	(-)			-1.335 (-1.72) ^b
INOWN	(-)	0.009 (1.85) ^a	0.009 (1.87) ^a	0.009 (1.90) ^a
LEVERAGE	(+)	1.020 (3.48) ^c	1.020 (3.48) ^c	0.974 (3.37) ^c
SIZE	(?)	-0.050 (-1.54)	-0.050 (-1.58)	-0.049 (-1.55)
BLOCK	(+)	-0.003 (-0.27)	-0.003 (-0.32)	-0.003 (-0.30)
FINANCE	(+)	0.511 (1.14)	0.508 (1.12)	0.494 (1.09)
GOINGCON	(+)	0.096 (0.22)	0.054 (0.12)	0.035 (0.08)
FEECUT	(+)	-0.006 (-0.02)	-0.011 (-0.04)	-0.028 (-0.10)
FEWCLIENT	(+)	-0.572 (-1.09)	-0.523 (-0.99)	-0.563 (-1.06)
RESTATE	(+)	-0.285 (-0.71)	-0.277 (-0.68)	-0.243 (-0.58)
FIRM_SIZE	(?)	-0.246 (-1.49)	-0.261 (-1.64) ^a	-0.286 (-1.78) ^a
Control for year		Yes	Yes	Yes
Pseudo R ²		0.118	0.121	0.125
Auditor change		96	96	96
No auditor change		709	709	709
Total		805	805	805

Table 5 presents the results of estimating a logistic regression of the likelihood of auditor dismissal on an indicator variable for dispute, an audit committee financial expertise indicator variable and control variables. Our full model specification is:

$$DISMISS = \beta_0 + \beta_1 DISPUTE + \beta_2 FIN_ACE + \beta_3 DISPUTE * FIN_ACE + \beta_4 INOWN + \beta_5 LEVERAGE + \beta_6 SIZE + \beta_7 FINANCE + \beta_8 BLOCK + \beta_9 GOINGCON + \beta_{10} FEWCLIENT + \beta_{11} RESTATE + \beta_{12} FEECUT + \beta_{13} FIRM_SIZE + \Sigma YEAR + \epsilon$$

DISMISS is an indicator variable coded "1" for companies that dismissed their triennially inspected incumbent auditor within one year after the initial PCAOB inspection report was publicly disclosed, and "0" otherwise; DISPUTE is an indicator variable coded "1" if the auditor disagrees with the PCAOB's report stating that the firm failed to address a material misstatement in the financials and "0" otherwise; FIN_ACE is an indicator variable coded "1" if the company has an audit committee composed entirely of outside directors, at least one financial expert as designated by SOX, and at least one member of the audit committee has an accounting background and "0" otherwise (from proxy statements); INOWN is the cumulative percentage of voting stock shares held by managers and directors (from proxy statements); LEVERAGE is the ratio of long-term debt to total assets in the year prior to the release of the PCAOB inspection report; SIZE is total assets in millions in the year prior to the release of the PCAOB inspection report; BLOCK is the cumulative ownership percentage of voting stock shares held by blockholders that are unaffiliated with management and hold at least 5% of the outstanding common shares (from proxy statements); FINANCE is total cash received from equity or debt issuances for the two years after receipt of the PCAOB inspection report, scaled by total assets; GOINGCON is an indicator variable coded "1" if the company received a going-concern modification in the year prior to the release of the PCAOB inspection report and "0" otherwise (from AuditAnalytics); FEWCLIENT is an indicator variable coded "1" in instances where incumbent auditor audits fewer than five publicly held companies, and "0" otherwise (from PCAOB inspection report). RESTATE is an indicator variable coded "1" in instances where the company has experienced at least one restatement in the two-year period prior to the inspection report date, and "0" otherwise (from AuditAnalytics). FEECUT is an indicator variable coded "1" for clients that receive a fee reduction in the year following the PCAOB inspection report, and "0" otherwise. FIRM_SIZE is the number of partners at the audit firm. All continuous variables are winsorized at the top and bottom 1%. T-values using robust standard errors clustered by accounting firm are shown in parentheses below the coefficient.

^a Statistical significance at 10% levels one-tailed (when predicted, otherwise two-tailed).

^b Statistical significance at 5% levels one-tailed (when predicted, otherwise two-tailed).

^c Statistical significance at 1% levels one-tailed (when predicted, otherwise two-tailed).

not materially impact our results.

5.1.3. The impact of auditor growth strategies

Our dependent variable is auditor dismissals, and our research design investigates the impact of a dispute strategy on the likelihood of dismissal. However, there is the potential that the auditor's growth/exit

strategy – for publicly held clients – may be a determining factor in both the auditor's disclosure strategy and the dismissal decision. For example, Cordovano and Honeck went from 47 clients listed in its initial inspection report to 34 clients in its second report. The firm's initial response to the GAAP-deficient inspection report was to acknowledge the PCAOB's findings. If acknowledgement is a tacit, auditor-specific strategy of reducing its publicly held client market presence, our inferences may be jeopardized.²³ To control for client growth, we

(footnote continued)

Marcum LLP (n = 38). Combined these auditors represent 164 observations, or slightly > 20% of our sample observations.

²³ Similarly, Maddox Ungar went from 36 clients listed in their initial report to 82

Table 6
The likelihood of auditor dismissal for GAAP-deficient auditors conditional on the auditor's response and an effective audit committee.

Variable	Sign	(1)	(2)	(3)
Intercept	(?)	−1.514 (−2.12) ^b	−1.369 (−1.88) ^a	−1.373 (−1.90) ^a
DISPUTE	(−)		−0.405 (−1.22)	−0.313 (−0.84)
ACE	(+)	0.029 (0.01)	−0.014 (−0.03)	0.100 (0.20)
ACE * DISPUTE	(−)			−0.611 (−0.75)
INOWN	(−)	0.008 (1.83) ^a	0.008 (1.85) ^a	0.008 (1.85) ^a
LEVERAGE	(+)	1.000 (3.34) ^c	0.964 (3.32) ^c	0.961 (3.32) ^c
SIZE	(?)	−0.042 (−1.29)	−0.044 (−1.33)	−0.042 (−1.30)
BLOCK	(+)	−0.003 (−0.26)	−0.003 (−0.31)	−0.003 (−0.32)
FINANCE	(+)	0.569 (1.27)	0.566 (1.25)	0.568 (1.25)
GOINGCON	(+)	0.027 (0.06)	−0.014 (−0.03)	−0.018 (−0.04)
FEECUT	(+)	−0.010 (−0.04)	−0.013 (−0.05)	−0.012 (−0.05)
FEWCLIENT	(+)	−0.562 (−1.10)	−0.508 (−1.00)	−0.521 (−1.01)
RESTATE	(+)	−0.250 (−0.61)	−0.242 (−0.58)	−0.240 (−0.57)
FIRM_SIZE	(?)	−0.201 (−1.17)	−0.216 (−1.30)	−0.231 (−1.37)
Control for year		Yes	Yes	Yes
Pseudo R ²		0.114	0.118	0.119
Auditor change		96	96	96
No auditor change		709	709	709
Total		805	805	805

Table 6 presents the results of estimating a logistic regression of the likelihood of auditor dismissal on an indicator variable for dispute, an audit committee indicator variable and control variables. Our full model specification is:

$$\text{DISMISS} = \beta_0 + \beta_1 \text{DISPUTE} + \beta_2 \text{ACE} + \beta_3 \text{DISPUTE} * \text{ACE} + \beta_4 \text{INOWN} + \beta_5 \text{LEVERAGE} + \beta_6 \text{SIZE} + \beta_7 \text{FINANCE} + \beta_8 \text{BLOCK} \\ + \beta_9 \text{GOINGCON} + \beta_{10} \text{FEWCLIENT} + \beta_{11} \text{RESTATE} + \beta_{12} \text{FEECUT} + \beta_{13} \text{FIRM_SIZE} + \Sigma \text{YEAR} + \varepsilon$$

DISMISS is an indicator variable coded “1” for companies that dismissed their triennially inspected incumbent auditor within one year after the initial PCAOB inspection report was publicly disclosed, and “0” otherwise; DISPUTE is an indicator variable coded “1” if the auditor disagrees with the PCAOB's report stating that the firm failed to address a material misstatement in the financials and “0” otherwise; ACE (Audit committee effectiveness) is an indicator variable coded “1” if the company has an audit committee composed entirely of outside directors and has at least one financial expert as designated by SOX, and ‘0’ otherwise (from proxy statements); INOWN is the cumulative percentage of voting stock shares held by managers and directors (from proxy statements); LEVERAGE is the ratio of long-term debt to total assets in the year prior to the release of the PCAOB inspection report; SIZE is total assets in millions in the year prior to the release of the PCAOB inspection report; BLOCK is the cumulative ownership percentage of voting stock shares held by blockholders that are unaffiliated with management and hold at least 5% of the outstanding common shares (from proxy statements); FINANCE is total cash received from equity or debt issuances for the two years after receipt of the PCAOB inspection report, scaled by total assets; GOINGCON is an indicator variable coded ‘1’ if the company received a going-concern modification in the year prior to the release of the PCAOB inspection report and ‘0’ otherwise (from AuditAnalytics); FEWCLIENT is an indicator variable coded ‘1’ in instances where incumbent auditor audits fewer than five publicly held companies, and ‘0’ otherwise (from PCAOB inspection report). RESTATE is an indicator variable coded ‘1’ in instances where the company has experienced at least one restatement in the two-year period prior to the inspection report date, and ‘0’ otherwise (from AuditAnalytics). FEECUT is an indicator variable coded ‘1’ for clients that receive a fee reduction in the year following the PCAOB inspection report, and ‘0’ otherwise. FIRM_SIZE is the number of partners at the audit firm. All continuous variables are winsorized at the top and bottom 1%. T-values using robust standard errors clustered by accounting firm are shown in parentheses below the coefficient.

^a Statistical significance at 10% levels one-tailed (when predicted, otherwise two-tailed).

^b Statistical significance at 5% levels one-tailed (when predicted, otherwise two-tailed).

^c Statistical significance at 1% levels one-tailed (when predicted, otherwise two-tailed).

included a variable coded “1” for instances where the number of publicly traded clients increased on the subsequent PCAOB inspection report and “0” otherwise. This variable is designed to control for any potential auditor-driven client growth strategies. The coefficient estimate for this variable is statistically insignificant on a stand-alone and interactive basis. Inclusion of this variable does not substantively

impact the results reported in Table 5.

5.1.4. The impact of “repeat GAAP-deficient” offenders

The 113 GAAP-deficient inspection reports correspond to 101 unique, triennially inspected auditors. Twelve of the GAAP-deficient auditors had more than one GAAP-deficient inspection report. This computes to a “recidivism” rate of 13%. To the extent that a dispute strategy is negatively correlated with a subsequent GAAP-deficient inspection report, this could potentially explain the reduced dismissal rate documented in Table 3 and the results reported in Table 5. To address this possibility, we deleted all observations (i.e., both the initial GAAP-

(footnote continued)

listed in its second report. Maddox Ungar's disclosure strategy was to dispute the PCAOB's findings.

deficient and subsequent GAAP-deficient inspection reports) corresponding to these twelve auditors. Our results are robust to their exclusion.

5.1.5. The impact of an acknowledgement disclosure strategy

Thus far, our focus has been on the impact of a dispute disclosure strategy on the likelihood of dismissing a GAAP-deficient auditor. Tables 2 and 3 show that a substantial portion of GAAP-deficient auditors employ an acknowledge disclosure strategy. As an additional analysis, we included another variable labeled ACKNOWLEDGE which is coded “1” in instances where the auditor acknowledges the PCAOB's findings and “0” else. We find that as a stand-alone variable, ACKNOWLEDGE is positively associated with auditor dismissal. Because this is an unambiguous signal of reduced audit quality (i.e., both the PCAOB and auditor agree that the auditor failed to adequately comply with the PCAOB's inspection standards), we do not find that the presence of an audit committee with accounting-related, financial expertise amplifies or mitigates this effect. Moreover, it does not impact our primary finding that a GAAP-deficient auditor that disputes the PCAOB findings is far less likely to be dismissed in the presence of an audit committee with accounting-related, financial expertise.

5.1.6. Alternative definitions of audit committee financial expertise

The SEC defines financial expert broadly to include people with accounting experience (i.e., certified public accountants (CPAs), chief financial officers (CFOs), controllers or chief accounting officers), finance experience (i.e., investment bankers, financial analysts) as well as individuals with supervisory experience (i.e., chief executive officers (CEOs) and presidents who oversee the results of financial reporting). Abbott et al. (2013) utilize this definition in constructing their audit committee effectiveness (ACE) variable. Dhaliwal et al. (2010) argue that this definition of financial expertise is too broad. Dhaliwal et al. (2010) find that only accounting-related audit committee financial expertise is positively associated with accruals quality. These authors argue that the specialized skills possessed by accounting experts make them more effective in executing the audit committee's primary responsibility of ensuring higher quality financial reporting. Dhaliwal et al. (2010) find no evidence of an association between accruals quality and the presence of finance or supervisory expertise in audit committees.

To test whether the broad, SEC definition of audit committee financial expertise impacts our results, we re-create the Abbott et al. (2013) ACE variable. ACE is coded “1” in instances where the audit committee is composed entirely of outside directors and has at least one financial expert as designated by the SEC (i.e., either accounting-, finance- or supervisory-related financial expertise) and “0” otherwise. ACE has several desirable properties in regards to the current study. ACE, by definition, incorporates all FIN_ACE observations. Consequently, ACE is highly correlated with FIN_ACE as Table 4 documents a statistically significant, 0.76 correlation coefficient. Moreover, ACE has a greater number of observations with a value of “1” than FIN_ACE, which mitigates concerns regarding the statistical power of the tests employed.

Table 6 presents our multivariate results when we substitute ACE in our Eq. (1). Table 6 reveals that the coefficient estimates for both ACE and ACE * DISPUTE are not statistically significant. This indicates the type of financial expertise is a key determinant of the reaction to a PCAOB inspection report. This finding corroborates that of Dhaliwal et al. (2010) and suggests that the qualifications of a primary PCAOB inspection report consumer critically and differentially impact the reaction to inspection reports and dispute disclosures.

6. Conclusion

Prior literature (Abbott et al., 2013; Daugherty et al., 2011) suggests that clients perceive GAAP-deficient PCAOB inspection reports to be a

signal of low audit quality and respond in the form of auditor dismissal. We investigate the effects of the auditor's response, which is also included in the PCAOB inspection report, on the auditor dismissal decision. We find that GAAP-deficient, triennially inspected auditors that dispute the PCAOB findings are far less likely to be dismissed when a client has an audit committee director with accounting-related financial expertise. Our results suggest that knowledgeable members of the audit committee read PCAOB inspection reports and consider both the PCAOB's and the auditor's perspectives when making decisions about auditor dismissal/retention.

Our study presents evidence suggesting that auditors' responses contain important information that is used by audit committees and other stakeholders to evaluate the auditor. Prior research focuses on information provided by the PCAOB (Abbott et al., 2013; Daugherty et al., 2011; Dee, Lulseged, & Zhang, 2011; Nagy, 2014). Our evidence indicates that the auditor's response is another important signal that relays the auditor's perspective on the PCAOB inspection process. Given the continually evolving nature of the auditing and inspection processes, we encourage future research on the economic, accounting and audit quality implications of the PCAOB inspection process.

Appendix A. Appendix

Example 1: *The auditor chose to not provide a written response to the criticisms (Ignore).*

November 21, 2008: Kempisty & Company, Certified Public Accountants, P.C.

http://pcaobus.org/Inspections/Reports/Documents/2008_Kempisty.pdf

Example 2: *The auditor does not acknowledge the GAAP deficiency in the response to the PCAOB (Not Acknowledge).*

September 30, 2009: Beard Miller

http://pcaobus.org/Inspections/Reports/Documents/2008_Beard_Miller.pdf

Example 3: *The auditor acknowledges that it made a mistake in the response to the PCAOB (Acknowledge).*

February 2, 2006: WithumSmith + Brown, A Professional Corporation

http://pcaobus.org/Inspections/Reports/Documents/2006_WithumSmith.pdf

Example 4: *The auditor disputes the PCAOB findings in its response to the PCAOB (Dispute).*

May 21, 2008: Ehrhardt, Keefe, Steiner & Hottman, P.C. http://pcaobus.org/Inspections/Reports/Documents/2008_Ehrhardt_Keefe_Steiner_Hottman.pdf

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