DO AUDIT PARTNERS SUCCUMB TO PRESSURE FROM IMPORTANT CLIENTS?

Gopal V. Krishnan*
Department of Accountancy
Bentley University
Waltham, MA 02452
Phone: 781-891-2477
Email: gkrishnan@bentley.edu

Sarowar Hossain
School of Accounting
UNSW Business School
UNSW Sydney
NSW 2052, Australia
Phone: 612 9385 6352
Email: s.hossain@unsw.edu.au

April 25, 2017

*Corresponding author.

DO AUDIT PARTNERS SUCCUMB TO PRESSURE FROM IMPORTANT CLIENTS?

Abstract

We find that audit partners are more likely to issue a going concern opinion to important clients. We also find that client importance to the audit partner is negatively associated with discretionary accruals, suggesting lower earnings management. Further, there is no difference in earnings persistence between more important clients and other clients. Overall, these findings support the notion that audit partners do not succumb to pressure from important clients. We also provide evidence that client importance to the audit partner has a greater effect on audit quality than does client importance to the audit office.

Key words: client importance; going concern; discretionary accruals; earnings persistence; benchmark beating.

JEL: M42, M48

Data availability: All data are publicly available from the sources indicated**.**

I. Introduction

Regulators and investors are concerned about the potential threat to auditor independence posed by large and influential clients.[1] Prior research has examined the effect of important clients on auditor independence and audit quality (DeAngelo 1981; Wallman 1996; Reynolds and Francis 2001; Craswell et al. 2002; Chung and Kallapur 2003; and Chen et al. 2010). We contribute to this literature by providing empirical evidence on the relation between client importance to an individual audit *partner* and audit quality.

Our study is motivated by the limited empirical evidence on whether audit quality is conditional on the importance of the client to the audit partner. Much of the prior research on the effect of client importance on audit quality focuses at the national audit firm level or at the audit office level. We posit that a focus at the audit partner level is important because the audit partner is the epicenter of an audit. The audit partner plays a key role in client screening and acceptance, audit fee negotiation, audit planning and execution, resolution of disagreements with the client, rendering the audit opinion, and the decision to continue the relationship with the client. Further, prior research that examined client importance at the office level implicitly assumes that all partners have an equal role in influencing audit quality on a particular engagement. Also implied is the notion that the audit partner's incentives to provide a high-quality audit is uniform across her clients. In a review of research on audit partners, Lennox and Wu (2017, p. 8) state, "Overall, extant studies at the partner level provide inconclusive evidence regarding the impact of client importance on audit quality." Thus, additional research is warranted to better understand the

[1] The Cohen Commission (AICPA 1978) stated, "When one or a few large clients supply a significant portion of the total fees of a public accounting firm, the firm will have a greater difficulty in maintaining its independence." The Commission also noted that in the celebrated Equity Funding case, that company represented more than 40 percent of the fees of its auditor. Separately, the Australian Society of CPAs suggests 15 percent as a rule-of-thumb limit on the portion of revenues from a single client (see Reynolds and Francis 2001, p. 378).

relation between client importance and audit quality at the partner level. For example, we do not know whether client importance to the audit partner is informative about audit quality incremental to client importance to the audit office. Finally, prior research (see Section 2 for a summary) uses data from China and Taiwan and those findings may not be generalizable to the U.S. context due to differences in legal environment, enforcement, and other factors across these countries. We contribute to the literature by using data from Australia, a setting that is similar to the U.S.[2] We discuss how our study differs from prior research in the next section.

Ex ante, the effect of important clients on partner independence and audit quality is unclear. While on one hand, the "*economic dependence*" argument predicts that audit partners could succumb to pressure from important clients to keep them happy since the loss of important clients would have an adverse consequence to partner's reputation as well as compensation. On the other hand, the "*reputation protection"* argument predicts that market-based incentives, such as preventing litigation and protecting reputation motivate especially the Big N auditors to uphold audit quality for important clients. Consistent with this notion, Reynolds and Francis (2001) find that Big 5 auditors report more conservatively for larger clients in their practice offices.

To test which of these two scenarios prevails, we first measure client importance in two ways – importance to the audit partner and importance to the audit office. We posit that loss of important clients would result in losing both audit fees as well as non-audit fees and therefore, we use the proportion of total fees paid by a client over the audit partner's total fees from the partner's public clients as our first measure of client importance. This measure is appropriate if the partner's compensation is primarily derived from her clients. On the other hand, if a partner's compensation is based on all the clients served by the audit office, then it is appropriate to scale by total fees paid

[2] While audit partner information is available for U.S. auditors effective 2017, we use Australian data to examine our research question since audit partner information is available for a longer time period in Australia.

by all clients of that office (Lennox and Wu 2017). We use this as a measure of client importance to the audit office.

Since a universal measure of audit quality does not exist, following prior research, we use three primary measures of audit quality: going-concern opinion, discretionary accruals, and earnings persistence (see DeFond and Zhang 2014 for a review). We also use meeting or just beating earnings benchmarks as an additional measure of audit quality. Consistent with prior research, we interpret a higher likelihood of a going concern opinion, lower discretionary accruals, and higher earnings persistence as evidence of higher audit quality. We run a regression of audit quality (separately for each audit quality measure) on client importance measures, control variables, and fixed-effects for the client firm, year, and industry. Our sample consists of 11,565 to 17,245 Australian firm-year observations (depending on the audit quality measure used) representing years 2003 through 2015.

We document several key findings. First, the likelihood of issuing a going concern opinion is higher, not lower, for important clients. This finding holds for both measures of client importance. The marginal effect of client importance to the audit partner on the likelihood of issuing a going concern opinion is 6 percent and this effect appears to be economically significant. Second, both measures of client importance to the audit partner are negatively associated with discretionary accruals, suggesting lower earnings management. Third, we find that there is no difference in earnings persistence between more important clients and other clients. Overall, these findings support the notion that audit partners do not succumb to pressure from important clients and audit quality is actually higher for important clients for two of the three measures examined. Fourth, when we include both measures of client importance, only client importance to the audit partner is associated with going concern opinion and discretionary accruals. These results indicate

that client importance to the audit partner has a greater effect on audit quality than does client importance to the audit office. Fifth, for a small subset of our sample, we do find a positive relation between tendency to meet or just beat earnings benchmarks and client importance to the audit partner. Finally, we find a strong negative (positive) relation between the ratio of non-audit fees to total fees at the audit firm level and going concern opinion (discretionary accruals), suggesting that the joint provision of audit and non-audit services impairs auditor's independence. While this is not our primary focus, we believe this finding is relevant to Australian regulators and others interested in enhancing auditor independence and credibility of financial reporting.

The rest of this paper is organized as follows. Section two summarizes related research and develops our hypothesis. Section three discusses measures of client importance and audit quality and the empirical models. Section four describes the sample selection procedure and descriptive statistics. Section five presents the empirical findings followed by summary and conclusions.

2.0 Related research and hypotheses development

2.1 Prior research on client importance and audit quality

While prior research has examined the influence of important clients on auditor independence and audit quality, most of this research is conducted at the audit firm or office level and only a few studies have examined this issue at the audit partner level. We first discuss the former stream of research. Reynolds and Francis (2001) document that Big 5 auditors report more conservatively for larger clients in their practice offices, i.e., a higher likelihood of issuing a going concern opinion. Further, larger clients have less variance in accruals than do smaller clients, suggesting larger clients exhibit less discretion in reported earnings. Using Australian data, Craswell et al. (2002) find that auditor fee dependence measured at both the national audit firm level and at the local office level does not affect auditor's propensity to qualify their audit opinions.

Using data for the year 2000, Chung and Kallapur (2003) do not find a relation between client importance and abnormal accruals, their proxy for audit quality. On the other hand, Ferguson et al. (2004) use a sample of U.K. firms and find that client importance measured at the office level is positively associated with discretionary accruals and financial restatements, suggesting lower auditor independence. Hunt and Lulseged (2007) examine the relation between client size and audit reporting decisions for non-Big 5 auditors and find that non-Big 5 auditors do not allow their larger clients greater leeway to manage earnings. Further, there is no difference in the likelihood of issuing a going concern opinion between larger and smaller clients. Gaver and Paterson (2007) examine a sample of firms in the property-casualty insurance industry and find that though financially weak insurers tend to under-reserve, this behavior is diminished when the firm is important to the local audit office. This finding is consistent with the notion that auditors do not allow greater accounting discretion to their larger clients. Ghosh et al. (2009) is one of the few studies to examine capital market perceptions of client importance. They find a negative relation between earnings response coefficient and client importance, consistent with impaired auditor independence in the eyes of the investors. Finally, Li (2009) observe no significant relation between fee ratios and the auditor's propensity to issue a going-concern opinion in the pre-SOX period (2001); however, during the post-SOX period (2003), she finds a positive relation between audit fee ratio and total fee ratio, suggesting that client importance does not impair auditor independence. In summary, the above line of research has produced mixed results.

To the best of our knowledge, only two studies have examined the relation between client importance and audit quality at the partner level. Using a sample of Chinese firms, Chen et al. (2010) find that at the individual auditor level, the propensity to issue modified audit opinions is negatively related to client importance during 1995 through 2000. However, after institutional

reforms were introduced in 2001, a positive relation between modified opinions and client importance is observed during the years 2001 to 2004. This is consistent with auditors responding to changes in the institutional environment. Chi et al. (2012) examine the relation between client importance and abnormal accruals using a sample of Taiwanese firms for the years 1990 through 2009. They find evidence that non-big N audit partners compromise independence for important clients but this finding does not hold for audit partners of Big N audit firms. They also use the likelihood of issuing a modified audit opinion and meeting or beating earnings benchmarks as alternate proxies for auditor independence and find similar results.

Our study differs from prior research in several ways. While Chen et al. (2010) use a single measure of audit quality (modified opinions), we use multiple measures. In addition to using more recent data, we measure client importance to the audit partner in two ways using actual fees paid rather than total sales or assets as in Chen et al. (2010) and Chi et al. (2012).[3] Finally, as noted earlier, there are significant differences between the U.S. and China and Taiwan with regard to the legal environment and enforcement mechanisms and thus, findings from those countries may not be generalizable to the U.S. context.[4] We believe findings based on audit partners in Australia are relevant to the U.S. setting.

2.2 Hypothesis

Threats to auditor independence due to *economic dependence* on the audit client has been a longstanding concern to regulators and others (Mautz and Sharaf 1961). Consistent with this notion, DeAngelo (1981, p. 190) states, "… client-specific quasi-rents lower auditor independence

[3] Another feature of the Chinese audit market is that non-audit services are negligibly small (Chen et al. 2010). In our setting, non-audit fees are a significant component of total fees and likely to increase client importance to the audit partner.

[4] Chen et al. (2008) note that in Taiwan audit firms must be formed as unlimited liability partnerships or proprietorships whereas in the U.S., U.K., and Australia audit firms are formed as limited liability partnerships. They also note that the legal enforcement mechanism in Taiwan is weaker relative to those in Western countries.

with respect to a particular client because they provide an incentive to "cheat" in order to retain the client in future periods." The *economic dependence* argument predicts that audit partners could succumb to pressure from important clients to keep them happy since the loss of important clients would have an adverse consequence to partner's compensation. Further, Chi et al. (2012) state that retaining an important client provides private benefits to the audit partner (job security, promotion opportunities, and intra-organizational power). In addition, loss of important clients could also impair an audit partner's credibility and reputation with adverse implications for future client retention and compensation. In summary, the above line of argument predicts that audit partners could succumb to pressure from important clients resulting in lower audit quality.

On the other hand, the *reputation protection* argument predicts that market-based incentives, such as preventing litigation and protecting reputation motivate especially the Big N auditors to uphold audit quality for important clients. The demise of Arthur Andersen illustrates that reputation effects are large (Ball 2009). Consistent with this notion, Reynolds and Francis (2001) find that Big 5 auditors report more conservatively for larger clients in their practice offices. Further, important clients are expected to demand a high-quality audit to preserve their own reputation. Given these opposing arguments, we propose the following null hypothesis to test the relation between client importance to the audit partner and audit quality:

Hypothesis: *Client importance to the audit partner is not associated with audit quality.*

3.0 Research design

We describe below our measures of client importance as well as measures of audit quality followed by the empirical models to test our hypothesis.

3.1 Client importance

We measure client importance in two ways: importance to the audit partner and importance to the audit office. We posit that loss of important clients would result in losing both audit fees as well as non-audit fees and therefore, we use the proportion of total fees paid by a client over the audit partner's total fees from the partner's public clients as our first measure of client importance (Li 2009). We refer to this measure as *CLIENTIMP_P*. This measure is expected to capture the partner's incentives to retain the client assuming that the partner's compensation is primarily based on fees paid by her clients. On the other hand, if a partner's compensation is based on all the clients served by the audit office, then it is appropriate to scale by total fees paid by all clients of that office (Lennox and Wu 2017). This measure captures the importance of the client to the audit office. We use this as an alternate measure of client importance and refer to this as *CLIENTIMP_O*. We believe that our first measure is a better measure of client importance to the audit partner for the following reasons. While the audit partner's compensation could be a function of fees generated by her own clients as well as fees generated by other clients in the same office, it is likely that the former pool of fees could be weighted more in determining the partner's share of profits. In addition, there are *non*-financial reasons, such as job security, promotion opportunities, credibility, and prestige associated with certain engagements which could motivate the audit partner to keep important clients.

3.2 Measures of audit quality

We use multiple measures to capture audit quality. Our first measure is the likelihood of issuing a going concern opinion to financially distressed firms (Reynolds and Francis 2001; DeFond et al. 2002; Carey and Simnett 2006; and Li 2009). Consistent with prior research, we interpret a higher likelihood of issuing a going concern as evidence of higher audit quality. While

going concern opinion is extensively used in prior research to measure audit quality, it applies to only financially distressed firms and may indicate auditor conservatism rather than audit quality (Thoman 1996). Next, we use the absolute value of discretionary (abnormal) accruals following Kothari et al. (2005) as our second measure of audit quality (Ashbaugh et al. 2003 and Larcker and Richardson 2004). Unlike going concern opinions, discretionary accruals are a continuous measure and can be estimated for a larger set of firms. We use absolute values of discretionary accruals to capture both income-increasing and income-decreasing earnings management by managers. Consistent with prior research, we regard higher audit quality is associated with lower absolute discretionary accruals. However, we note that estimation of discretionary accruals is subject to measurement error (McNichols 2000). Since our measures of audit quality have some shortcomings, we employ multiple measures to triangulate our findings. Our third measure of audit quality is earnings persistence, the relation between current earnings and future earnings (Schipper and Vincent 2003; Dechow and Schrand 2004). Dichev et al. (2013) find that CFOs rank sustainable and persistent earnings as the most common measure of earnings quality. We interpret higher earnings persistence as evidence of higher audit quality (Abernathy et al. 2016). As part of additional analyses, we also use meeting or just beating earnings benchmarks as an additional measure of audit quality. Next, we describe the empirical models used to test our hypothesis.

3.3 Empirical models

Our going concern model follows prior research (DeFond et al. 2002; Carey and Simnett 2006; and Ping et al. 2011). We include client (firm) size (*LTA*) and age (*LAGE*) and prior research finds that the likelihood of issuing a going concern opinion is lower for larger and older firms. We also include the following measures of audit risk: probability of bankruptcy (*PBANK*), leverage (*LEVERAGE*), performance (*LOSS*, *RETURN*, and *CFO)*, investments (*INVESTMENTS*). A

positive coefficient is expected on *PBANK, LEVERAGE, LOSS* and a negative coefficient is expected on *RETURN, CFO,* and *INVESTMENTS.* We include auditor type (*BIG4)* and prior research finds that the Big 4 auditors are more likely to issue a going concern opinion than non-big 4 auditors. Finally, we include the ratio of non-audit fee divided by total of audit and non-audit fees (*NFEERATIO*) measured at the audit firm level as a control following Carey and Simnett (2006) and Ping et al. (2011). Thus, we estimate the following logistic regression model on a sample of financially distressed firms to test our hypothesis (for brevity, firm and year subscripts are not reported):

$$\begin{aligned} GC = {} & \gamma_0 + \gamma_1 CLIENTIMP\_P + \gamma_2 LTA + \gamma_3 PBANK + \gamma_4 LAGE + \gamma_5 LEVERAGE \\ & + \gamma_6 RETURN + \gamma_7 LOSS + \gamma_8 INVESTMENTS + \gamma_9 BIG4 + \gamma_{10} CFO \\ & + \gamma_{11} NFEERATIO + Firm\ FE + Year\ FE + Industry\ FE + \varepsilon \end{aligned} \quad (1)$$

See Appendix for definitions of variables. The variable of interest is *CLIENTIMP_P*. A positive (negative) coefficient on γ_1 will be consistent with the notion that audit partners are more (less) likely to issue a going concern opinion to important clients. We estimate an alternate version of model (1) by replacing *CLIENTIMP_P* with *CLIENTIMP_O*, capturing client importance to the audit office. In all of our models, we also estimate a specification where we include both *CLIENTIMP_P* and *CLIENTIMP_O* to shed light which of these two measures of client importance has a greater effect on audit quality. Since our objective is to isolate the effects of attributes of the audit partner on going concern opinion from attributes of the audit client, we include firm (audit client) fixed-effects in our models along with fixed-effects for year and industry.

Next, we describe our model to test the relation between absolute value of discretionary accruals (*DA*) based on Kothari et al. (2005), our second measure of audit quality and client

importance to the audit partner. Following Carey and Simnett (2006) and Ping et al. (2011), we estimate the following model:

$$\begin{aligned} DA = {} & \gamma_0 + \gamma_1 CLIENTIMP\_P + \gamma_2 LTA + \gamma_3 BIG4 + \gamma_4 PQUAL + \gamma_5 LEVERAGE \\ & + \gamma_6 PBANK + \gamma_7 LOSS + \gamma_8 NFEERATIO + \gamma_9 ROA + \gamma_{10} LAGE + \gamma_{11} GROWTH \\ & + \gamma_{12} CFO + Firm\ FE + Year\ FE + Industry\ FE + \varepsilon \end{aligned} \quad (2)$$

Variable definitions are in the Appendix. Following prior research, we expect a positive relation between *PQUAL, LEVERAGE, LOSS, LAGE,* and *GROWTH* and *DA* and a negative relation between *LTA, BIG4, PBANK, ROA,* and *CFO* and *DA.* The variable of interest is *CLIENTIMP_P*. A positive (negative) coefficient on γ_1 will be consistent with the notion that audit partners tolerate or allow more (less) accruals-based earnings management to important clients. Once again, we estimate an alternate version of model (2) by replacing *CLIENTIMP_P* with *CLIENTIMP_O.*

Finally, we use the following model to examine the relation between earnings persistence and client importance to the audit partner (Abernathy et al. 2016):

$$\begin{aligned} EARN\_LEAD = {} & \gamma_0 + \gamma_1 EARN + \gamma_2 LOSS + \gamma_3 LOSS \times EARN + \gamma_4 STDROA \\ & + \gamma_5 STDROA \times EARN + \gamma_6 SIZE + \gamma_7 SIZE \times EARN + \gamma_8 HIGH\_CLIENTIMP\_P \\ & + \gamma_9 EARN \times HIGH\_CLIENTIMP\_P + Firm\ FE + Year\ FE + Industry\ FE + \varepsilon \end{aligned} \quad (3)$$

EARN_LEAD is net income in year *t+1* scaled by market value of equity at the beginning of year *t+1*. *EARN* is net income in year *t* scaled by market value of equity at the beginning of year *t*. We control for losses, earnings variability, firm size as well as their interactions with *EARN*. Consistent with prior research, we expect a positive coefficient on *EARN* and *SIZE* and a negative coefficient is expected on *LOSS, STDROA* and *STDROA*×*EARN* (Abernathy et al. 2016). We partition the observations at the median value of *CLIENTIMP_P* and the variable *HIGH_CLIENTIMP_P* (representing "high client importance" observations) equals 1 for

observations above or equal to the median value of *CLIENTIMP_P* and 0 otherwise. No prediction is offered for *HIGH_CLIENTIMP_P*. The variable of interest is *EARN*×*HIGH_CLIENTIMP_P*. A positive (negative) coefficient will be consistent with the notion that earnings persistence is higher (lower) for more important clients relative to less important clients. In other words, a positive (negative) coefficient on γ_9 is consistent with higher (lower) audit quality. Once again, we estimate an alternate version of model (3) by replacing *HIGH_CLIENTIMP_P* with *HIGH_CLIENTIMP_O* (equals 1 for observations above or equal to the median value of *CLIENTIMP_O* and 0 otherwise).

4.0 Sample

Our sample search begins with an initial sample of 22,455 firm-year observations representing all firms listed on ASX for the years 2003 through 2015. We obtain financial data from the *Morningstar DatAnalysis Premium* database. We hand collect data on audit fee, audit firm, audit partner name, name of the city, and audit opinion directly from companies' annual reports using *Connect4* and *Morningstar DatAnalysis Premium* databases. Out of this initial sample, we identify three sub-samples to perform analyses using our three measures of audit quality – going concern opinion, discretionary accruals, and earnings persistence. Next, for each of these sub-samples we apply a set of common as well as separate criteria to identify our samples. We exclude observations from the financial industry (GICS 40) and overseas firms not disclosing audit partner identity. Our sample selection process is summarized in Table 1. Our final sample consists of 11,565, 17,245, and 12,566 firm-year observations respectively, for the going concern, discretionary accruals, and earnings persistence analyses.

[Insert Table 1 about Here]

4.1 Descriptive statistics

Panels A, B, and C of Table 2 provide descriptive statistics respectively, for the variables used in going concern, discretionary accruals, and earnings persistence analyses. We winsorize all the continuous variables at the top and bottom 1% to mitigate the effect of extreme observations on our results. We first discuss the results in Panel A. On average, over our sample period, about 26 percent of the sample received going concern opinions. The mean (median) values of *CLIENTIMP_P* and *CLIENTIMP_O* are, respectively, 21 (9.0) percent and 7.5 (1.60) percent. The mean value of *LTA* is 16.315. About 96.3 percent of the sample reported a loss in the prior year. This is not surprising since we focus on financially distressed firms for going concern analysis. About 34.7 percent of the sample firms were audited by Big 4 auditors. These findings are consistent with prior research (Carson et al. 2015).[5] Finally, the mean value of *NFEERATIO*, the proportion of non-audit fees over total fees is 15.2 percent. Turning to Panel B, the mean value of absolute discretionary accruals is about 10.2 percent of beginning total assets. The mean values of scaled current year and next year earnings in Panel C are, respectively, -0.191 and -0.179.

[Insert Table 2 about Here]

4.2 Correlation coefficients

Table 3 presents the Pearson correlations among our variables of interest, *CLIENTIMP_P* and *CLIENTIMP_O*, *GC* and *DA* and control variables. We do not include *EARN_LEAD* and *EARN* in Table 3 in the interest of brevity.[6] We find that the correlations between *GC* and the client importance variables are negative and significant, indicating that audit partners are less likely to issue a going concern opinion to important clients. On the other hand, the correlation between *DA*

[5] Mean values of going concern opinion, proportion of loss firms, and the number of firms audited by the Big 4 auditors for the period 2005 through 2014 in Carson et al. (2015) are, respectively, 29.8 percent, 93.4 percent, and 34.6 percent.
[6] The correlations between *EARN_LEAD*, *CLIENTIMP_P*, and *CLIENTIMP_O* are, respectively, 0.135 and 0.036 (both are significant at the 0.01 level).

and *CLIENTIMP_P* is negative and significant at the 0.01 level, indicating that abnormal accruals are decreasing in client importance, suggesting lower earnings management. The correlation between *DA* and *CLIENT IMP_P2* is not significant. Turning to control variables, *LTA*, *ROA*, *INVESTMENTS, CFO, BIG4, RETURN*, and *GROWTH* are significantly and negatively correlated with *GC*. We also find a significant negative relation between *NFEERATIO* and *GC*. Consistent with prior research, *PBANK*, *LEVERAGE*, *LOSS*, and *DA* are positively correlated with GC. *DA* are negatively correlated with *LTA, LEVERAGE, RETURN, BIG4, CFO, NFEERATIO, CFO*, and *ROA* and positively correlated with *GC, PBANK, LOSS, INVESTMENTS, PQUAL,* and *GROWTH*. Next, we turn to multivariate analyses to test our hypothesis.

[Insert Table 3 about Here]

5.0. Results

5.1 Relation between going concern and client importance

Results on the relation between going concern opinion and client importance are in Table 4.[7] Results are presented in two columns. While column 1 includes *CLIENTIMP_P*, column 2 includes *CLIENTIMP_O*. The coefficient on *CLIENTIMP_P* is 0.407 (significant at the 0.01 level), indicating that audit partners are more likely to issue a going concern opinion for important clients. The marginal effect of *CLIENTIMP_P* on the likelihood of issuing a going concern opinion is 6.80 percent and this effect appears to be economically significant. Recall that the mean rate of a going concern opinion for our sample is about 26 percent. The coefficient on *CLIENTIMP_O* is 0.355 (significant at the 0.10 level) and the marginal effect is 6 percent. Overall, these findings reject the null hypothesis and support the notion that audit partners do not succumb

[7] We also use an alternate sample consisting of firms receiving a first-time going concern opinion and those results are discussed in a later section. However, this restriction reduces the sample by about 26%. Therefore, we perform our main tests using the larger sample.

to pressure from important clients and audit quality is higher for important clients. Interestingly, we find a strong negative relation between *NFEERATIO* and going concern opinion, suggesting that the joint provision of audit and non-audit services impairs audit partner's independence. This finding is consistent with Ye et al. (2011). To further probe the relation between client importance and going concern opinion, we reestimate model (1) with both *CLIENTIMP_P* and *CLIENTIMP_O* and untabulated results indicate that the coefficient on *CLIENTIMP_P* is positive and significant at the 0.01 level while the coefficient on *CLIENTIMP_O* is positive and insignificant. These results indicate that client importance to the audit partner has a greater effect on audit quality than does client importance to the audit office. These findings underscore the importance of examining client importance at the audit partner level. Turning to other control variables, consistent with prior research, the likelihood of issuing a going concern opinion is negatively related to firm size (*LTA*) and performance (*RETURN)* (both are significant at the 0.01 level). On the other hand, the likelihood of issuing a going concern opinion are positively related to the probability of financial distress (*PBANK*), leverage (*LEVERAGE*), loss (*LOSS*), and auditor type (*BIG4*). Contrary to our expectations, firm age (*LAGE*) is positively related to going concern opinion though this finding is consistent with Carey and Simnett (2006).

[Insert Table 4 about Here]

5.2 Relation between discretionary accruals and client importance

Turning to our second measure of audit quality, results on the relation between absolute discretionary accruals and client importance are in Table 5. As before, we present the results in two columns. The coefficient on *CLIENTIMP_P* is -0.017 (significant at the 0.01 level), suggesting that absolute discretionary accruals are decreasing in client importance. The coefficient on *CLIENTIMP_O* is -0.015 (significant at the 0.10 level). These findings also reject the null

hypothesis and support the notion that lower earnings management is associated with important client. In other words, audit partners do not succumb to pressure from important clients and audit quality is higher for important clients. These findings are consistent with the results in Table 4. We find the coefficient on *NFEERATIO* is positive and significant at the 0.01 level in both columns, indicating that the joint provision of audit and non-audit services is associated with earnings management, suggesting lower audit quality. This finding is also consistent with the results in Table 4. Turning to control variables, consistent with prior research, absolute values of discretionary accruals are negatively related to *LTA*, *ROA*, and *CFO* and positively related to *PUQAL*, *LEVERAGE*, *LAGE*, and *GROWTH* (all are significant at the 0.01 level). Contrary to expectation, *LOSS* is negatively related to *DA*. We also reestimate model (2) with both *CLIENTIMP_P* and *CLIENTIMP_O* and those results indicate that the coefficient on *CLIENTIMP_P* is negative and significant at the 0.01 level while the coefficient on *CLIENTIMP_O* is negative and insignificant. These results are consistent with the results in Table 4 and support the notion that client importance to the audit partner has a greater effect on audit quality than does client importance to the audit office.

[Insert Table 5 about Here]

5.3 Relation between earnings persistence and client importance

Turning to our third measure of audit quality, results on the relation between earnings persistence and client importance are in Table 6. Consistent with prior research, the coefficient on *EARN* is positive and significant at the 0.01 level in both columns, indicating current earnings are informative about next year's earnings. The coefficient on *LOSS* is negative and significant at the 0.01 level. The coefficient on *SIZE* is positive and significant at the 0.01 level. These are consistent with Abernathy et al. (2016). The variables *HIGH_CLIENTIMP_P* and *HIGH_CLIENTIMP_O*

represent respectively, observations above or equal to the median value of *CLIENTIMP_P* and *CLIENTIMP_O*, i.e., more important clients. The coefficients on our variables of interest, *HIGH_CLIENTIMP_P×EARN* and *HIGH_CLIENTIMP_O×EARN* are not significant. These findings fail to reject the null hypothesis and indicate that there is no difference in earnings persistence between more important clients and other clients. These results are important because lower persistence in earnings would suggest that audit partners succumb to pressure from important clients and audit quality is lower for important clients.

[Insert Table 6 about Here]

5.4 Additional analyses

We perform several additional analyses to further explore the relation between client importance and audit quality as well as to assess the robustness of our results to alternate samples, model specifications, and an additional measure of audit quality. We discuss these results below.

***Big 4 vs. non-big 4 Auditors*:**

We estimate the models separately for clients served by the Big 4 and non-big 4 auditors. We find that for Big 4 auditors, in models (1) and (2), the coefficient on *CLIENTIMP_P* and *CLIENTIMP_O* is not significant, indicating that client importance is not a driver of going concern opinion. For non-Big 4 auditors, *CLIENTIMP_P* is positively associated with going concern opinion (significant at the 0.01 level). With regard to absolute discretionary accruals (model 2), client importance variables are not significant for the Big 4 sample. On the other hand, for non-Big 4 auditors, both *CLIENTIMP_P* and *CLIENTIMP_O* are negative and significant at the 0.05 level, indicating that lower earnings management is associated with important clients. These findings suggest that client importance has a greater and positive influence on audit quality for non-Big 4 audit partners.

Office size:

Next, we examine whether the relation between client importance and audit quality is moderated by the size of the audit office. This analysis is important since audit partners in small offices could face more pressure from important clients to tolerate earnings management or resist a going concern opinion relative to audit partners in large offices. We first calculate the total number of clients per office by state and then calculate the median number of clients per year. We code those offices where the number of clients is greater than or equal to the median as large and the remaining offices as small. We find that client importance variables are not associated with going concern opinion for large offices. On the other hand, for small offices, in model (1), both *CLIENTIMP_P* and *CLIENTIMP_O* are positive and significant at the 0.01 and 0.10 levels, respectively. With regard to model (2), for large offices, *CLIENTIMP_P* is not associated with absolute discretionary accruals but we find a positive relation between absolute discretionary accruals and *CLIENTIMP_O* (significant at the 0.05 level), suggesting lower audit quality. On the other hand, for small offices, we find a negative relation between absolute discretionary accruals and *CLIENTIMP_P* (significant at the 0.01 level) and *CLIENTIMP_O* (significant at the 0.05 level). Finally, for large offices, we find that the coefficient on *HIGH_CLIENTIMP_P×EARN* is positive and significant at the 0.01 level, indicating higher earnings persistence clients that are important to the audit partner. Overall, these findings consistently indicate that higher audit quality is associated with important clients in small offices. On the other hand, results are generally insignificant or mixed for large offices. These results are interesting in that contrary to the notion that audit partners in small offices might be more vulnerable to client pressure, our results suggest the opposite, i.e., audit partners in small offices are more likely to issue a going concern opinion and constrain accruals-based earnings management.

Non-mining firms:

Second, mining companies are financially vulnerable and may have more going concern opinions than other industries. We exclude mining companies and reestimate models (1) and (2). We lose about 49.35% and 38.24% of the respective samples and the results (not tabulated) indicate that the coefficient on *CLIENTIMP_P* is positive and significant at the 0.05 level while *CLIENTIMP_O* is positive but not significant. For model (2), the coefficient on *CLIENTIMP_P* is negative and significant at the 0.05 level while *CLIENTIMP_O* is not significant.

First-time going concern opinion:

We reestimate model (1) using sample of 8,568 observations receiving a first-time going concern opinion. The coefficient on *CLIENTIMP_P* is positive and significant at the 0.05 level. The coefficient on *CLIENTIMP_O* is not significant.

Going concern model with additional controls:

Our going concern model follows Carey and Simnett (2006) and Ye et al. (2011). We augment our model by including additional variables. We control for systematic risk (Beta) as well as stock return volatility and under this specification, the coefficient on *CLIENTIMP_P* continues to be positive and significant at the 0.01 level while the coefficient on *CLIENTIMP_O* is significant at the 0.10 level. Prior research finds that auditors might be more vulnerable to client pressure during the first two years of the audit (shorter tenure) than when the tenure is long (Johnson et al. 2002). We include a dummy variable for new audits, i.e., audits during the first two years to model (1). We find that this variable is not significant and the coefficients on *CLIENTIMP_P* and *CLIENTIMP_O* continue to be significant.

***CLERP Act of 2004*:**

We examine whether the relation between client importance and audit quality has changed following the passage of the CLERP Act of 2004.[8] We create an indicator variable *(CLERP*) that equals 1 for years 2004 and above and 0 otherwise and include interactions of this variable with *CLIENTIMP_P* and *CLIENTIMP_O* and reestimate our models. The interaction variable is not significant for going concern opinion. However, the coefficient on *CLIENTIMP_P*×*CLERP* is negative and significant in model (2), suggesting that accruals-based earnings management is lower for important clients after the passage of the CLERP Act.

Meeting or beating of earnings benchmarks:

Finally, we use meeting or just beating earnings benchmarks by audit clients as an additional measure of audit quality. Prior research finds that meeting or just beating earnings benchmarks is consistent with earnings management (Burgstahler and Dichev 1997) and this measure has been used to evaluate auditor independence and audit quality (Gul et al. 2009; Reichelt and Wang 2010; and Chi et al. 2012). While discretionary accruals and earnings persistence are broader measures of audit quality, meeting or just beating earnings benchmarks is observable and suited to our context of examining client importance on audit quality. Prior research (Reichelt and Wang 2010 and Chi et al. 2012) finds that the likelihood of meeting or just beating earnings benchmarks is positively associated with client size and the objective of this analysis is to test whether the likelihood of meeting or just beating earnings benchmarks is higher for important clients relative to other clients. We do not use this measure as a primary measure of audit quality or in the robustness analyses described in this section due to sample size restrictions (see below).

[8] The Corporate Law Economic Reform (CLERP 9) Act (2004) introduced changes to improve investor confidence in relation to Australian listed corporations and their financial reports.

To test the relation between client importance to the audit partner and meeting or just beating of earnings benchmarks, we adapt the model from Reichelt and Wang (2010) and estimate the following probit model:

$$\begin{aligned} EM = {} & \gamma_0 + \gamma_1 CLIENTIMP\_P + \gamma_2 LTA + \gamma_3 STDROA + \gamma_4 LEVERAGE + \gamma_5 BM + \gamma_6 PBANK \\ & + \gamma_7 ROA + \gamma_8 BIG4 + \gamma_9 TACC + \gamma_{10} \Delta CFO / CFO + Firm\ FE + Year\ FE \\ & + Industry\ FE + \varepsilon \end{aligned} \quad (4)$$

EM is one of the three earnings benchmarks: zero earnings, prior year's earnings, and analysts' forecasts (Phillips et al. 2003).[9] Variable definitions are in the Appendix. The variable of interest is *CLIENTIMP_P*. A positive (negative) coefficient on γ_1 will be consistent with the notion that audit partners allow (constrain) meeting or just beating of earnings benchmarks by important clients. We also estimate model (4) by replacing *CLIENTIMP_P* with *CLIENTIMP_O*. Following prior research, we expect a positive relation between *EM* and *LTA, ROA, TACC, CFO,* Δ*CFO* and a negative relation between *EM* and *STDROA, LEVERAGE, BM, PBANK,* and *BIG 4* (Phillips et al. 2003 and Reichelt and Wang 2010). Results of model (4) are in Table 7.

The number of observations available for this analysis is considerably smaller than the samples used in our primary analyses because by design we are focusing on firms that meet or just beat earnings benchmarks. Results are presented separately for each of the three EM measures and for each measure, we report the results separately based on *CLIENTIMP_P* and *CLIENTIMP_O*. For EM1 (meeting or just beating last year's earnings) neither *CLIENTIMP_P* nor *CLIENTIMP_O* is significant. For EM2 (meeting or just beating zero earnings), the coefficient on *CLIENTIMP_P* is positive and significant at the 0.05 level while *CLIENTIMP_O* is not significant. Finally, for EM3 (meeting or just beating analysts' forecast), *CLIENTIMP_P* is not significant and

[9] Holland and Ramsay (2003) recommend scaling by beginning value of total assets instead of beginning market value of equity for Australian firms. Therefore, we scale by beginning value of total assets.

CLIENTIMP_O is marginally significant at the 0.10 level. Thus, in one out of three cases, client importance to the audit partner is positively related to meeting or just beating earnings benchmarks. Turning to control variables, *LTA* is negatively associated with EM1 while *ROA* is positively associated with EM3 and negatively associated with EM1. *LEVERAGE* is positively related to EM2 and negatively related to EM3.

[Insert Table 7 about Here]

5.5 Discussion

While the result in Tables 7 seem to be at odds with the results in Tables 4 through 6, it is important to keep in mind the following. First, that the results in Table 7 are sensitive to the measure used to capture meeting or just beating earnings benchmarks, i.e., results hold for EM2 but not for EM1 and EM3. Second, when we scale by beginning market value of equity none of the EM measures are significant, indicating that our results are sensitive to the deflator used. Third, by design the number of observations used is a fraction of the sample used in our primary analyses.[10] When we reestimate model (4) and compare observations meeting or just beating earnings benchmarks with all other observations (not just those that narrowly missed meeting or just beating benchmarks), results are insignificant. Finally, prior research notes that this measure of audit quality is subject to certain limitations. Campbell et al. (2015) note that in the following scenarios meeting or just beating analysts' forecasts may not necessarily imply lower financial reporting quality. The company's actual economic performance was truly in line with analysts' expectations or the management guided their analyst forecasts towards a reasonable expectation (Richardson et al. 2004). However, taking the findings at face value, our findings do suggest that

[10] For example, the number of observations for which EM2 equals 1 is less than one percent of the observations used in the analyses of discretionary accruals and earnings persistence.

for a small subset of our sample, audit partners appear to be tolerant of benchmark beating behavior by important clients.

6.0 Summary and conclusion

Regulators and investors are concerned about the potential threat to auditor independence posed by large and influential clients. We contribute to this literature by examining the relation between client importance to the audit partner and multiple measures of audit quality. Also, prior research is silent on whether client importance to the audit partner is informative about audit quality incremental to importance of the client to the audit office. We find that the likelihood of issuing a going concern opinion is higher, not lower, for important clients and the marginal effect of client importance to the audit partner on the likelihood of issuing a going concern opinion appears to be economically significant. We also find that client importance is negatively associated with discretionary accruals, suggesting lower earnings management. With regard to earnings persistence, for the overall sample, we find that there is no difference in earnings persistence between more important clients and other clients though for large audit offices, earnings persistence is higher for clients that are important to the audit partner. For a small subset of our sample, we find a positive relation between tendency to meet or just beat earnings benchmarks and client importance to the audit partner. Overall, these findings support the notion that audit partners do not succumb to pressure from important clients and audit quality is actually higher for important clients for two of the three measures examined. The primary contribution of this study is to provide empirical evidence on the relation between client importance at the audit partner level and audit quality. Further, we contribute by providing evidence that client importance to the audit partner has a greater effect on audit quality than does client importance to the audit office.

Our findings have important implications for practice. First, our findings are reassuring to investors, regulators, audit clients, and others in that audit partners uphold audit quality for important clients. These findings are consistent with market-based incentives motivating auditors to protect their reputation and independence. However, we caution that regulators, analysts, and investors need to be mindful of possible influence by important clients especially those meeting or just beating earnings benchmarks. Second, the findings might be relevant to countries where currently audit partner identity is not publicly disclosed. Our findings suggest that such disclosures could be useful to assess audit partner's independence from influential clients. Finally, our finding of a strong negative (positive) relation between the ratio of non-audit fees to total fees at the audit firm level and going concern opinion (discretionary accruals), suggests that the joint provision of audit and non-audit services impairs auditor's independence. While this is not our primary focus, we believe this finding is relevant to Australian regulators and others interested in enhancing auditor independence and credibility of financial reporting.[11]

This study is subject to the following limitations. As common in other empirical research, we document associations rather than causality, between client importance to the audit partner and audit quality measures. We calculate client importance based on fees paid by a partner's listed clients. Audit partners may also have non-listed clients and our measures of client importance exclude these clients due to non-availability of data. Thus, our measures of client importance may be incomplete when partners have large non-listed clients. Future research could replicate ours in other settings where information about audit partners is available. Also, future research could examine investor perceptions of the effect of client importance to the audit partner on audit quality.

[11] Using data from 2002, Ye et al. (2011) also find a negative relation between the ratio of non-audit fees to total fees and the likelihood of issuing a going concern opinion. Our findings indicate that this trend continues even during the recent years.

REFERENCES

Abernathy, J., T. Kang, G. Krishnan, and C. Wang. 2016. Is there a relation between residual audit fees and analysts' forecasts? *Journal of Accounting, Auditing and Finance* (in press).

American Institute of Certified Public Accountants. 1978. The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations.

Ashbaugh, H., R. LaFond, and B. Mayhew. 2003. Do nonaudit services compromise auditor independence? Further evidence. *The Accounting Review* 78 (3): 611-639.

Ball, R. 2009. Market and political/regulatory perspectives on the recent accounting scandals. *Journal of Accounting Research* 47 (2): 277-323.

Burgstahler, D., and I. Dichev. 1997. Earnings management to avoid earnings decreases and losses. *Journal of Accounting & Economics* 24: 99-126.

Campbell, J. L., J. Hansen, C. Simon, and J. L. Smith. 2015. Audit committee stock options and financial reporting quality after the Sarbanes-Oxley Act of 2002. *Auditing: A Journal of Practice & Theory* 34 (2): 91-120.

Carey, P., and R. Simnett. 2006. Audit partner tenure and audit quality. *The Accounting Review* 81 (3): 653–76.

Carson, E., N. Fargher, and Y. Zhang. 2015. Increased scrutiny of auditors and auditors' propensity to issue going-concern opinions. Working paper, University of New South Wales.

Chen, C.-Y., C.-J. Lin, and Y.-C. Lin. 2008. Audit partner tenure, audit firm tenure, and discretionary accruals: Does long auditor tenure impair earnings quality? *Contemporary Accounting Research* 25 (Summer): 415–445.

Chen, S., S. Y. J. Sun, and D. Wu. 2010. Client importance, institutional improvements, and audit quality in china: An office and individual auditor level analysis. *The Accounting Review* 85 (1): 127–158.

Chi, W., E. Douthett, and L. Lei. 2012. Client importance and auditor independence. *Journal of Accounting and Public Policy* 31: 320–336.

Chung, H., and S. Kallapur. 2003. Client importance, nonaudit services, and abnormal accruals. *The Accounting Review* 78 (4): 931-955.

Craswell, A., D. Stokes, and J. Laughton. 2002. Auditor independence and fee dependence. *Journal of Accounting and Economics* 33 (2): 253–75.

DeAngelo, L. 1981. Auditor size and audit quality. *Journal of Accounting and Economics* 3 (December): 183-199.

Dechow, P., and C. Schrand. 2004. *Earnings quality*. CFA Institute.

DeFond, M. L., K. Raghunandan, and K. R. Subramanyam. 2002. Do non–audit service fees impair auditor independence? Evidence from going concern audit opinions. *Journal of Accounting Research* 40 (4): 1247–1274.

_____ . and J. Zhang. 2014. A review of archival auditing research. *Journal of Accounting and Economics* 58 (2): 275-326.

Dichev, I., J. Graham, C. Harvey, and S. Rajgopal. 2013. Earnings quality: Evidence from the field. *Journal of Accounting & Economics* 56: 1-33.

Ferguson, M.J., Seow, G.S., Young, D., 2004. Nonaudit services and earnings management: UK evidence. Contemporary Accounting Research 21 (4), 813–841.

Gaver, J.J., J. S. Paterson. 2007. The influence of large clients on office-level auditor oversight: Evidence from the property casualty insurance industry. *Journal of Accounting and Economics* 43 (2–3), 299–320.

Ghosh, A., S. Kallapur, and D. Moon. 2009. Audit and non-audit fees and capital market perceptions of auditor independence. *Journal of Accounting and Public Policy* 28 (5), 369–385.

Gul, F. A., S. Y. K. Fung, and B. Jaggi. 2009. Earnings quality: Some evidence on the role of auditor tenure and auditors' industry expertise. *Journal of Accounting and* Economics 47 (3): 265-287.

Holland, D., and A. Ramsay. 2003. Do Australian companies manage earnings to meet simple benchmarks? *Accounting and Finance* 43 (1): 41–62.

Hunt, A., and A. Lulseged. 2007. Client importance and non-Big 5 auditors' reporting decisions. *Journal of Accounting and Public Policy* 26 (Mar/Apr): 212–248.

Johnson, V., I. Khurana, and J.K. Reynolds. 2002. Audit-firm tenure and the quality of financial reports. *Contemporary Accounting Research* 19 (Winter): 637-660.

Knechel, R., L. Niemi, and M. Zerni. 2013. Empirical evidence on the implicit determinants of compensation in Big 4 audit partnerships. *Journal of Accounting Research* 51: 349–387.

Kothari, K., A. Leone, and C. Wasley. 2005. Performance matched discretionary accruals. *Journal of Accounting and Economic* 39 (1): 163-197.

Larcker, D., and S. Richardson. 2004. Fees paid to audit firms, accrual choices, and corporate governance. *Journal of Accounting Research* 42 (June): 625-658.

Lennox, C. and X. Wu. 2017. A review of the literature on audit partners. Working paper, University of Southern California.

Li, C. 2009. Does client importance affect auditor independence at the office level?: Empirical evidence from going–concern opinions. *Contemporary Accounting Research* 26 (1): 201–230.

Mautz, R., and H. Sharaf. 1961. *The Philosophy of Auditing.* American Accounting Association: Sarasota, FL.

McNichols, M. 2000. Research design issues in earnings management studies. *Journal of Accounting and Public Policy* 19 (4/5): 313-345.

Phillips, J., M. Pincus, and S. O. Rego. 2003. Earnings management: new evidence based on deferred tax expense. *The Accounting Review* 78 (2): 491-521.

Reichelt, K., and D. Wang. 2010. National and office-specific measures of auditor industry expertise and effects on audit quality. *Journal of Accounting Research* 48 (Jun 2010): 647–686.

Reynolds, J. K. and J. R. Francis. 2001. Does size matter? The influence of large clients on office–level auditor reporting decisions. *Journal of Accounting and Economics* 30 (3): 375–400.

Richardson, S., S. H. Teoh, and P. D. Wysocki. 2004. The walk-down to beatable analysts forecasts: the role of equity issuance and insider trading incentives. *Contemporary Accounting Research* 21 (4): 885-924.

Schipper, K., and L. Vincent. 2003. Earnings quality. *Accounting Horizons* 17: 97–110.

Thoman, L. 1996. Legal damages and auditor efforts. *Contemporary Accounting Research* 13 (1): 275-306.

Wallman, S. 1996. The future of accounting, Part 3: Reliability and auditor independence. *Accounting Horizons* 10: 76–97.

Ye, P., E. Carson, and R. Simnett. 2011. Threats to auditor independence: The impact of relationship and economic bonds. *Auditing: A Journal of Practice & Theory* 30 (1): 121–148.

Appendix: Variable Definitions

Test variables:

CLIENTIMP_P	Client importance to the audit partner calculated as total fees (audit fees and non-audit fees) paid by a client divided by total fees earned by the partner from all of her clients;
CLIENTIMP_O	Client importance to the audit office calculated as total fees paid by a client divided by the total fees from all clients of the office where the partner is assigned;
HIGH_CLIENTIMP_P	Equals 1 for observations above or equal to the median value of *CLIENTIMP_P* and 0 otherwise;
HIGH_CLIENTIMP_O	Equals 1 for observations above or equal to the median value of *CLIENTIMP_O* and 0 otherwise;

Dependent variables:

GC	Equals 1 if going concern opinion for a financially distressed company, 0 otherwise;
DA	Absolute value of discretionary accruals using Kothari, Leone, and Wasley (2005) model;
EARN_LEAD	Net income in year t+1 scaled by market value of equity at the beginning of year t+1;

Control variables in the going concern model:

LTA	Natural log of total assets;
PBANK	The probability of bankruptcy as measured by adjusted Zmijewski score;*
LAGE	Natural log of number of years the company has been listed in the Australian Securities Exchange (ASX);
LEVERAGE	Total liabilities divided by total assets;
RETURN	Market-adjusted return over the fiscal year;
LOSS	Equals 1 if the client reported a loss in the previous year, 0 otherwise;
INVESTMENTS	Short- and long-term investment securities (including cash and cash equivalents) divided by total assets;
BIG4	Equals 1 if the audit firm is a Big 4, 0 otherwise;
CFO	Operating cash flow deflated by total assets;
NFEERATIO	Non-audit fee divided by total of audit and non-audit fees;

Control variables in the discretionary accruals model:

LTA	Natural log of total assets;
BIG4	Equals 1 if the audit firm is a Big 4, 0 otherwise;
PQUAL	Equals 1 if auditor has issued a going concern opinion in the previous year, 0 otherwise;
LEVERAGE	Total liabilities divided by total assets;
PBANK	The probability of bankruptcy as measured by adjusted Zmijewski score;
LOSS	Equals 1 if the client reported a loss in the previous year, 0 otherwise;
NFEERATIO	Non-audit fee divided by total of audit and non-audit fees;
ROA	Earnings before interest and taxes divided by total assets;
LAGE	Natural log of number of years the company has been listed in the Australian Securities Exchange (ASX);
GROWTH	Assets growth from previous year;
CFO	Operating cash flow deflated by total assets;

Control variables in the earnings persistence model:

EARN	Net income in year t scaled by market value of equity at the beginning of year t;
LOSS	Equals 1 if the company had a negative ROA and 0 otherwise;
STDROA	The standard deviation of ROA for the period of 5 years (year t-4 to year t); and
SIZE	The natural log market value of equity.

***** Consistent with Carcello et al. (1995), we calculated Zmijewski (1984) score as b = -4.803 -3.6(net profit after tax divided by total assets) + 5.4(total liabilities divided by total assets) – 0.1(current assets divided by current liabilities).

TABLE 1

Sample Selection

	Firm-year Observations		
	Going concern sample	**Discretionary accruals sample**	**Persistence sample**
Initial sample for the period 2003-2015	22,455	22,455	22,455
Less: observations with missing data to estimate the respective models	692	1,202	1,202
Less: observations with missing stock return information	974	--	--
Less: Overseas firms not disclosing audit partner identity	667	667	667
Less: non-distressed firms	5,216	--	--
Less: observations in financial industry	3,341	3,341	3,341
Less: observations with missing lag values of control variables	--	--	4,679
Final sample	**11,565**	**17,245**	**12,566**

This table summarizes sample selection process for our three sub-samples.

TABLE 2
Descriptive statistics

Panel A: Going concern sample (N = 11,565)

Variable	Mean	Median	Std. Dev.
GC	0.260	0.000	0.439
CLIENTIMP_P	0.210	0.090	0.276
CLIENTIMP_O	0.075	0.016	0.182
LTA	16.315	16.214	1.730
PBANK	-1.566	-3.294	8.765
LAGE	2.158	2.197	0.800
LEVERAGE	0.374	0.134	0.771
RETURN	1.355	-19.350	73.924
LOSS	0.963	1.000	0.188
INVESTMENTS	1.561	0.303	4.907
BIG4	0.347	0.000	0.476
CFO	-0.294	-0.112	0.567
NFEERATIO	0.152	0.054	0.197

Panel B: Discretionary accruals sample (N = 17,245)

Variable	Mean	Median	Std. Dev.
DA	0.102	0.142	0.298
CLIENTIMP_P	0.278	0.136	0.313
CLIENTIMP_O	0.083	0.018	0.191
LTA	17.141	16.844	2.244
BIG4	0.450	0.000	0.498
PQUAL	0.182	0.000	0.386
LEVERAGE	0.401	0.253	0.674
PBANK	-1.892	-3.052	7.562
LOSS	0.721	1.000	0.449
NFEERATIO	0.180	0.111	0.205
ROA	-0.358	-0.089	0.985
LAGE	2.272	2.303	0.806
GROWTH	-0.159	0.036	1.146
CFO	-0.176	-0.047	0.527

Panel C: Persistence sample (N = 12,566)

Variable	Mean	Median	Std. Dev.
EARN_LEAD	-0.191	-0.068	0.506
EARN	-0.179	-0.068	0.512

This table presents the descriptive statistics for our three sub-samples. See the Appendix for variable definitions. Sample represents non-financial firms for the years 2003 through 2015.

TABLE 3
Correlation Coefficients

		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1	*GC*	1.000																
2	*CLIENTIMP_P*	-0.081	1.000															
		0.000																
3	*CLIENTIMP_O*	-0.017	0.433	1.000														
		0.028	0.000															
4	*LTA*	-0.302	0.412	0.057	1.000													
		0.000	0.000	0.000														
5	*PBANK*	0.290	0.162	0.072	-0.053	1.000												
		0.000	0.000	0.000	0.000													
6	*LAGE*	0.015	0.152	0.009	0.190	0.089	1.000											
		0.062	0.000	0.233	0.000	0.000												
7	*LEVERAGE*	0.120	0.345	0.127	0.286	0.794	0.171	1.000										
		0.000	0.000	0.000	0.000	0.000	0.000											
8	*RETURN*	-0.178	0.074	0.015	0.107	-0.070	0.048	0.049	1.000									
		0.000	0.000	0.057	0.000	0.000	0.000	0.000										
9	*LOSS*	0.279	-0.383	-0.122	-0.586	-0.051	-0.167	-0.371	-0.204	1.000								
		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000									
10	*INVESTMENTS*	-0.018	-0.267	-0.083	-0.462	-0.187	-0.148	-0.324	0.011	0.320	1.000							
		0.021	0.000	0.000	0.000	0.000	0.000	0.000	0.184	0.000								
11	*BIG4*	-0.111	0.167	-0.481	0.469	0.072	0.175	0.218	0.087	-0.316	-0.197	1.000						
		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000							
12	*CFO*	-0.314	0.350	0.093	0.689	-0.142	0.164	0.262	0.207	-0.653	-0.355	0.308	1.000					
		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000						
13	*NFEERATIO*	-0.128	0.254	0.078	0.293	0.049	0.047	0.158	0.086	-0.232	-0.109	0.239	0.208	1.000				
		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000					
14	*ROA*	-0.342	0.363	0.102	0.702	-0.239	0.161	0.252	0.237	-0.720	-0.370	0.307	0.825	0.226	1.000			
		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000				
15	*PQUAL*	0.518	-0.080	-0.009	-0.308	0.222	0.050	0.097	-0.076	0.265	0.036	-0.128	-0.283	-0.115	-0.289	1.000		
		0.000	0.000	0.275	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000			
16	*GROWTH*	-0.195	0.042	0.048	0.254	-0.265	-0.043	-0.048	0.119	-0.154	-0.031	0.024	0.226	0.090	0.351	-0.084	1.000	
		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.003	0.000	0.000	0.000	0.000		
17	*DA*	0.058	-0.099	0.009	-0.217	0.021	-0.010	-0.026	-0.016	0.085	0.101	-0.109	-0.301	-0.050	-0.091	0.092	0.112	1.000
		0.000	0.000	0.232	0.000	0.008	0.196	0.001	0.043	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	

This table presents Pearson correlations among our variables of interest, audit quality measures, and control variables. See Appendix for variable definitions. Sample represents non-financial firms for the years 2003 through 2015.

TABLE 4
Results of Regression on the Relation between Going Concern Opinion and Client Importance

Variable (Expected Sign)	**Coefficient (*z* statistic) [marginal effect]**	**Coefficient (*z* statistic) [marginal effect]**
Constant	0.351	0.170
	(0.735)	(0.355)
CLIENTIMP_P (?)	0.407***	--
	(3.472)	
	[0.068]	
CLIENTIMP_O (?)	--	0.355*
		(1.810)
		[0.060]
LTA (-)	-0.219***	-0.206***
	(-8.915)	(-8.450)
	[-0.037]	[-0.035]
PBANK (+)	0.038***	0.039***
	(5.253)	(5.307)
	[0.006]	[0.007]
LAGE (-)	0.259***	0.260***
	(5.906)	(5.913)
	[0.043]	[0.044]
LEVERAGE (+)	0.167**	0.165*
	(1.983)	(1.955)
	[0.028]	[0.028]
RETURN (-)	-0.003***	-0.003***
	(-9.287)	(-9.228)
	[-0.001]	[-0.001]
LOSS (+)	1.322***	1.318***
	(6.173)	(6.133)
	[0.221]	[0.221]
INVESTMENTS (-)	-0.002	-0.002
	(-0.950)	(-0.984)
	[0.000]	[0.000]
BIG4 (+)	0.180**	0.212***
	(2.419)	(2.743)
	[0.030]	[0.036]
CFO (-)	0.017	0.018
	(0.218)	(0.228)
	[0.003]	[0.003]
NFEERATIO (?)	-0.492***	-0.462***
	(-3.219)	(-3.029)
	[-0.082]	[-0.077]
Year effects	Included	Included
Industry-fixed effects	Included	Included
Firm fixed-effects	Included	Included
No. observations	11,565	11,565
Pseudo R^2	0.1097	0.1044
Wald chi2	597.930	542.470
Prob > chi2	0.000	0.000

See Appendix for definitions of variables. Sample represents financially distressed non-financial firms for the years 2003 through 2015. *, **, and *** indicate significant at 10%, 5% and 1% respectively.

TABLE 5

Results of Regression on the Relation between Absolute Value of Discretionary Accruals and Client Importance

Variable (Expected Sign)	**Coefficient (t statistic)**	**Coefficient (t statistic)**
Constant	0.468***	0.477***
	(16.38)	(16.91)
CLIENTIMP_P (?)	**-0.017*** **	--
	(-3.075)	
CLIENTIMP_O (?)	--	**-0.015***
		(-1.711)
LTA (-)	-0.017***	-0.018***
	(-12.01)	(-12.81)
BIG4 (-)	-0.004	-0.005
	(-0.861)	(-1.124)
PQUAL (+)	0.031***	0.030***
	(5.119)	(5.079)
LEVERAGE (+)	0.034***	0.034***
	(2.926)	(2.927)
PBANK (-)	-0.000	-0.000
	(-0.0138)	(-0.0301)
LOSS (+)	-0.023***	-0.023***
	(-4.977)	(-4.899)
NFEERATIO (?)	0.030***	0.028***
	(3.418)	(3.264)
ROA (-)	-0.065***	-0.066***
	(-6.686)	(-6.705)
LAGE (+)	0.006***	0.006***
	(2.665)	(2.630)
GROWTH (+)	0.055***	0.055***
	(15.08)	(15.10)
CFO (-)	-0.044***	-0.044***
	(-4.156)	(-4.142)
Year effects	Included	Included
Firm fixed-effects	Included	Included
Industry-fixed effects	Included	Included
No. observations	17,245	17,245
R^2	0.1829	0.2058
F	38.650	38.980
Prob >	0.000	0.000

See the Appendix for definitions of variables. Data are for the years 2003 through 2015.

TABLE 6
Results of Regression on the Relation Between Earnings Persistence and Client Importance

Variable (Expected Sign)	Coefficient (t-statistic)	Coefficient (t-statistic)
Constant	-0.033	-0.029
	(-1.235)	(-1.086)
EARN (+)	0.869***	0.923***
	(6.442)	(6.586)
LOSS (-)	-0.113***	-0.116***
	(-13.90)	(-14.63)
LOSS×EARN (?)	0.006	-0.005
	(0.174)	(-0.133)
STDROA (-)	0.001	0.001
	(0.785)	(0.755)
STDROA×EARN (?)	0.007*	0.006
	(1.682)	(1.613)
SIZE (+)	0.004***	0.004***
	(3.032)	(3.046)
SIZE×EARN (?)	-0.017**	-0.018**
	(-2.292)	(-2.393)
HIGH_CLIENTIMP_P (?)	0.007	--
	(1.156)	
HIGH_CLIENTIMP_P_×EARN (?)	0.048	--
	(1.401)	
HIGH_CLIENTIMP_O (?)	--	0.003
		(0.602)
HIGH_CLIENTIMP_O_×EARN (?)	--	-0.013
		(-0.410)
Year effects	included	included
Firm fixed-effects	included	included
Industry fixed-effects	included	included
Number of observations	12,566	12,566
R^2	0.4746	0.4742
F-statistic	220.70	220.420
Prob >	0.000	0.000

This table presents the estimation results of earning persistence. The dependent variable is *EARN_LEAD*. See the Appendix for variable definitions. ***, **, and * indicate significance at the 1%, 5% and 10% levels. Data are for the years 2003 through 2015.

TABLE 7
Results of Regression on the Relation Between Meeting or Just Beating of Earnings Benchmarks and Client Importance

Variable (Expected Sign)	EM1		EM2		EM3	
	Coefficient (*z*-statistic)	Coefficient (*z*-statistic)	Coefficient (*z*-statistic)	Coefficient (*z*-statistic)	Coefficient (*z*-statistic)	Coefficient (*z*-statistic)
Constant	-0.643*	-0.544	-0.994*	-1.211**	0.202	0.151
	(-1.806)	(-1.546)	(-1.811)	(-2.232)	(0.411)	(0.311)
***CLIENTIMP_P* (?)**	-0.136		0.334**		0.053	
	(-1.480)		(2.251)		(0.388)	
***CLIENTIMP_O* (?)**		-0.114		0.183		0.385*
		(-0.662)		(0.833)		(1.865)
LTA (+)	0.053***	0.047***	0.027	0.042	0.007	0.008
	(2.969)	(2.691)	(0.935)	(1.528)	(0.286)	(0.313)
STDROA (-)	0.000	0.000	0.020	0.018	-0.022*	-0.022*
	(0.00843)	(0.0168)	(1.373)	(1.268)	(-1.819)	(-1.790)
LEVERAGE (-)	0.148	0.142	0.521**	0.529**	-0.060	-0.058
	(0.849)	(0.821)	(2.105)	(2.117)	(-0.427)	(-0.414)
BM (-)	0.002	0.002	-0.002	-0.002	0.029*	0.029*
	(0.228)	(0.236)	(-0.227)	(-0.181)	(1.678)	(1.660)
PBANK (-)	0.002	0.002	-0.006	-0.005	0.003	0.002
	(0.0998)	(0.0980)	(-0.260)	(-0.199)	(0.160)	(0.113)
ROA (+)	0.727***	0.730***	0.367	0.380	-0.037	-0.043
	(3.756)	(3.773)	(1.344)	(1.375)	(-0.360)	(-0.426)
BIG4 (-)	-0.081	-0.091	0.079	0.085	0.054	0.102
	(-1.071)	(-1.111)	(0.869)	(0.873)	(0.592)	(1.087)
TACC (+)	0.183	0.193	0.848	0.848	0.086	0.073
	(0.506)	(0.536)	(1.497)	(1.487)	(0.660)	(0.557)
Δ*CFO* (+)	-0.044	-0.052			-0.002	0.008
	(-0.145)	(-0.169)			(-0.0157)	(0.077)
CFO (+)			0.450	0.457		
			(1.395)	(1.423)		
Year effects	included	included	included	included	included	included
Firm fixed-effects	included	included	included	included	included	included
Industry fixed-effects	included	included	included	included	included	included
No of observations	1,990	1,990	1,147	1,147	1,161	1,161
Pseudo R^2	0.0261	0.0255	0.0907	0.0873	0.8236	0.6562
Log likelihood	-1327	-1327	-705	-708	-789	-788
Prob >	0.000	0.000	0.000	0.000	0.000	0.000

This table presents the results of a logistic regression of earnings target (one of three EM variables) on client importance to the audit partner and control variables. ***, **, and * indicate significance at the 1%, 5% and 10% levels. *EM1* equals 1 if the scaled earnings change [(NI_t – NI_{t-1})/$TotalAsset_{t-1}$] is ≥ 0 and <0.01, and 0 if the scaled earnings change is ≥-0.01 and <0; *EM2* equals 1 if the scaled earnings [NI_t/TA_{t-1}] is ≥ 0 and <0.02, and 0 if the scaled earnings is ≥-0.02 and <0; *EM3* equals 1 if the scaled forecast error (actual EPS less median analysts' consensus forecast) is ≥0 and <0.01, and 0 if the scaled forecast error is ≥-0.01 and <0; *BM* is book value of equity divided by the market value of equity; *TACC* is total accruals scaled by total assets at the end of year *t-1*. *CFO* is cash flow from operations scaled by total assets at the end of year *t-1*. Δ*CFO* is the change in *CFO* from year *t-1* to year scaled by total assets at the end of year *t-1*. See the Appendix for definitions of other variables. Data are for the years 2003 through 2015.