Auditor lobbying on accounting standards

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Abstract

We examine how Big N auditors' changing incentives impact their comment-letter lobbying on U.S. GAAP over the first thirty-four years of the FASB (1973–2006). In particular, we focus on the influence of auditors' lobbying incentives arising from two basic factors: managing expected litigation and regulatory costs and catering to clients' preferences for flexibility in GAAP. We find evidence that auditor lobbying is driven by prevailing standards of litigation and regulatory scrutiny, but we find no evidence that catering to clients' preferences for flexibility in GAAP drives auditor lobbying. Broadly, our paper offers the first large-sample descriptive analysis of the role of Big N auditors in the accounting standard-setting process.

Keywords: Auditors, FASB, GAAP, lobbying

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1. Introduction

Corporate accounting standards are an important basis for the measurement of firm and managerial performance and for the stewardship of corporate assets in a market economy. The political process underlying corporate accounting standard setting is a critical area of study for accounting researchers (e.g., Kothari, Ramanna, and Skinner, 2010). Understanding the process that culminates with the creation of accounting standards can provide insights into both their procedural legitimacy and how they will eventually be used. In this paper, our goal is to advance the literature on the role of auditors in the accounting standard-setting process through a longitudinal study of the varying nature of auditor comment-letter lobbying at the Financial Accounting Standards Board (FASB).

Over the past several years, a number of empirical studies have explored various dimensions of the political process in corporate accounting standard setting in the United States. These include studies of the role of corporate lobbying (e.g., Watts and Zimmerman, 1978; Francis, 1987; Deakin, 1989; Dechow, Hutton, and Sloan, 1996; Ramanna, 2008), the role of the standard setters at the Financial Accounting Standards Board (FASB) (e.g., Allen and Ramanna, 2013; Chakravarthy, 2014; Jiang, Wang, and Xie, 2015), the role of agenda setting at the FASB (Leftwich, 1995; Allen, 2013), and the role of congressional involvement in accounting standard setting (Farber, Johnson, and Petroni, 2007; Ramanna, 2008).

Auditors play a crucial role in the functioning of capital markets by serving as independent agents who attest that companies, in preparing their financial reports, conform to generally accepted accounting principles (GAAP). However, auditors' role is hardly restricted to scrutinizing firms' financial statements. Rather, auditors participate in the standard-setting process via comment-letter lobbying and thus influence financial reporting standards at their very

genesis (e.g., Watts and Zimmerman, 1986; Zeff, 2003a, b). Empirical evidence on the role of auditors in this political process is limited. In a recent review of empirical research on standard setting, Gipper, Lombardi, and Skinner (2013) note that with the exception of this paper there has been no empirical work focused on the role of auditors in accounting's political process in the United States since research on the subject in the early 1980s (e.g., Watts and Zimmerman, 1982; Puro, 1984).[1]

Auditors' opinions in comment letters are likely shaped not just by the nature of the proposed standards but also by their own prevailing incentives. Indeed, Watts and Zimmerman (1982) and Puro (1984) find evidence consistent with opportunistic auditor lobbying in the FASB due process. Both studies rely on an analysis of comment letters filed by auditors on a limited sample of six FASB proposals each. We contribute to the literature via a systematic characterization of auditors' incentives and an examination of how those incentives influence auditor lobbying across nearly every financial reporting standard issued from 1973 through 2006.

We focus on the group of auditors most likely to consistently lobby across standards and over time: the "Big N" firms. Since at least the inception of the FASB in 1973, the audit market in the U.S. has functioned as an oligopoly, with a few large firms providing audit services for the vast majority of public companies. The number of audit firms in this oligopoly – the Big N – has varied from eight through the 1980s to four by the early 2000s (see Appendix 1). The Big N auditors have consistently represented an influential and economically significant fraction of

[1] Mian and Smith (1990) study auditor lobbying on SFAS 94 (mandated changes regarding consolidation). However, their analysis of auditor lobbying is part of a broader effort to understand client-firm incentives in lobbying on SFAS 94, and much of their auditor lobbying analysis is univariate in nature.

auditing activity in the United States, and a study of their lobbying behavior can generate meaningful insights.

We identify two broad, non-mutually exclusive economic factors that can shape auditors' lobbying incentives over time. First, given the fiduciary nature of the auditors' responsibilities toward capital market participants, we expect disciplinary forces such as litigation and regulation to be important in shaping auditors' incentives (see, e.g., St. Pierre and Anderson, 1984; Kothari, Lys, Smith, and Watts, 1988; Lys and Watts, 1994; and Dechow, Sloan, and Sweeny, 1996). Second, since auditors are dependent on their clients for revenue generation, clients' preferences are likely to be a significant influence on Big N auditor lobbying (see, e.g., Puro, 1984). In particular, we are interested in testing whether auditors lobby for more flexible standards in the interest of their clients.

Because we seek to compare auditor lobbying over a long time series spanning a number of different accounting issues, we require a common dimension of proposed standards that auditors are likely to comment on consistently. Additionally, we require that auditor lobbying along this common dimension varies with auditors' incentives in a predictable manner. With these objectives in mind, we focus on auditor lobbying over the "reliability" of proposed accounting standards. Reliability is a "fundamental qualitative characteristic" of accounting, as identified by the FASB in its own original conceptual framework, which was in effect through most of our sample period (FASB, 1980).[2] Numerous basic accounting textbooks (e.g., Stickney, Weil, Schipper, and Francis 2010) recognize reliability as a central accounting concept.

[2] The FASB in 2010 modified its conceptual framework, deemphasizing "reliability" as a fundamental accounting characteristic in favor of "representational faithfulness." Since this change went into effect after our sample period (1973–2006), we use "reliability" not "representational faithfulness" in our analyses.

Reliability limits managers' discretion in accounting choice to reporting methods that are verifiable, while additionally being representationally faithful. More reliable standards demand objectivity in accounting estimates, facilitating audits and potentially reducing litigation and regulatory costs by restricting client firms' flexibility in accounting choices and hence their ability to misreport. Thus, depending on the relative strength of their incentives to promote reliability versus flexibility, auditors are likely to vary the extent to which they emphasize reliability while commenting on proposed standards. Our use of reliability is not to suggest that it is the sole focus of auditors or that other primitive accounting characteristics such as "relevance" or "comparability" could not also be used in an empirical study such as ours. Rather, we simply note that reliability matters to both accounting and auditing, and auditor lobbying along this metric is predictably influenced by their incentives.

Across our time series, we examine how the Big N auditors' propensity to express concerns about decreased reliability in proposed accounting standards varies with prevailing litigation and regulatory regimes and with client preferences for flexibility. However, to do so in a regression setting, we must control for the possibility that auditors' propensity to highlight decreased reliability in proposed standards is driven by substantive issues with the standards themselves. Thus, we generate a benchmark measure of decreased reliability that represents, in principle, the "true" concern over decreased reliability on a given proposed standard. This benchmark is based on evaluations of the proposed standards by two highly experienced research assistants blind to the study's objective (the data are from Allen and Ramanna, 2013).[3] The correlation between Big N auditors' mentions of decreased reliability and this benchmark capture

[3] Our use of this benchmark presumes no systematic hindsight bias in research assistants' evaluations of exposure drafts.

the extent to which auditors' comments "truthfully" reflect whether a proposed standard actually decreases reliability. The changing correlations between the Big N auditors' mentions of decreased reliability and the benchmark provide a measure of the auditors' changing incentives. We examine how these correlations vary across the various factors conjectured to have influenced the nature of Big N auditor lobbying over the thirty-four years in our sample.

We first investigate whether the Big N auditors' lobbying varies in response to changing litigation and regulatory exposure. We find that the proportion of lawsuits against auditors and the level of SEC enforcement on accounting and auditing issues are predictably associated with the nature of auditor lobbying. In periods with higher incidence of lawsuits and more intense levels of SEC enforcement, we find a higher correlation between Big N auditors' expressed concerns about decreased reliability and the "true" incidence of decreased reliability. Put differently, big audit firms more truthfully mention decreased reliability when faced with higher litigation and regulatory exposure. These results are consistent with a large body of research on auditors mitigating their litigation risk (see DeFond and Zhang, 2014, for a review). However, while this research has conjectured that auditors attenuate their litigation risk via lobbying activities, DeFond and Zhang's (2014) review suggests that there is little direct empirical evidence to this point. Instead, the evidence on auditor lobbying is either anecdotal or implied from an analysis of the economic consequences of regulatory changes (e.g., Geiger and Raghunandan, 2001; Lee and Mande, 2003). Thus, our study also adds to the literature by providing direct large-sample evidence of auditor lobbying to mitigate litigation risk.

We next investigate whether Big N auditors lobby for greater flexibility in standards in the interest of their clients. In certain circumstances – e.g., high expected litigation – clients may desire reduced accounting flexibility. However, the literature points out that clients often prefer

standards that allow flexibility to choose the most appropriate reporting method for a given transaction (e.g., Watts and Zimmerman, 1986; Zeff, 2003; Folsom, Hribar, Mergenthaler, Peterson, 2015). Using firm-level characteristics that capture clients' preferences for flexibility, we find no evidence that such preferences influence auditor lobbying. Further, we identify exposure drafts where client interest in the final outcome is likely to be particularly high. We focus on proposed standards that are specific to an industry (where client interests are more likely to be concentrated) and standards that witnessed high lobbying intensity. Despite this effort to home in on settings characterized by high client interest, we observe no evidence that auditor lobbying is influenced by client preferences for flexibility. This finding is consistent with earlier conclusions by Watts and Zimmerman (1982) and Puro (1984) that auditors' lobbying behavior is driven more by their own interests than those of their clients.

Finally, we investigate how auditor lobbying varies across broad regime shifts that potentially alter the relative weight that auditors place on their various incentives. We find that the changing legal principles on auditor liability in the United States affect Big N auditors' lobbying over decreased reliability in predictable ways. Specifically, in regimes in which legal precedents offer a lower bar for auditor liability, there is a greater association between the benchmark measure of decreased reliability and the Big N auditors' assessments. We also consider the possibility that the changing nature of the Big N auditor oligopoly itself – e.g., eight versus four Big N firms – could have influenced auditor lobbying. Fewer Big N audit firms imply a different competitive dynamic vis-à-vis clients and regulators and therefore may impact auditors' incentives to manage litigation/regulatory risk versus their clients' preference for flexibility. We find evidence that the changing nature of the Big N auditor oligopoly – in particular, the tightening of the oligopoly through a decrease in the number of Big N players – is

associated with the auditors' lobbying behavior. As the oligopoly tightens, surviving auditors' assessments of decreased reliability are more in line with what the benchmark would indicate. This finding is consistent with the political costs hypothesis – the fewer surviving Big N auditors are more visible targets for both regulatory action and litigation and thus prefer enhanced reliability in accounting standards. The finding is inconsistent with claims that the Big N auditors perceive themselves as "too big to fail," which would predict the Big N auditors are at best agnostic with respect to decreased reliability in proposed standards.

Broadly, the evidence in this paper provides a window into the nature of auditor lobbying in U.S. accounting standard setting, particularly how such lobbying has varied across numerous factors that are likely to have affected the auditing industry over the past forty years. We caution that the nature of our tests prevents us from making causal statements in this regard. Nevertheless, given that it has been nearly thirty years since a focused empirical study of auditor lobbying in U.S. GAAP and given the centrality of Big N auditors to accounting and capital markets, we submit that the descriptive evidence in this paper is an important added insight into accounting's political economy. Collectively, our evidence suggests that the auditors' own incentives play a prominent role in their lobbying activities on U.S. GAAP.

The remainder of this paper is organized as follows. Section 2 explores the economic factors likely to shape auditors' lobbying on proposed accounting standards, in particular, their lobbying on decreased reliability in the proposed standards. Section 3 describes the data and research design. Section 4 presents and interprets the results. Section 5 concludes with a discussion of the study's implications.

2. Factors influencing auditor lobbying on reliability

As noted in the introduction, we identify two non-mutually exclusive economic factors that we expect will shape Big N auditors' incentives over time, particularly their incentives when lobbying the FASB on proposed accounting standards. In this section, we discuss these factors and explore their likely impact on Big N auditor comments about decreased reliability in proposed accounting standards. The implicit premise is that the auditors lobby in their self-interest, which is consistent with Kinney's (1986) findings on lobbying at the Auditing Standards Board. Of course, auditors' lobbying behavior may very well be "neutral"; that is, their comments are driven entirely by the nature of the proposed standards. Our empirical analysis, discussed in the following section, controls for this possibility.

The first factor we study arises from the certification role that auditors play in capital markets. Auditors certify to users of corporate financial statements that financial reports are prepared in accordance with GAAP and other relevant statutory requirements and that such reports disclose relevant material information. This certification is offered under penalty of varying civil and criminal liabilities and under regulatory scrutiny by the government. Capital market constituents such as investors and regulators can subject auditors (and their clients) to significant penalties for negligence, misrepresentation, and fraud. The penalties include the litigation costs of class-action lawsuits by the investing community (e.g., Kothari et al., 1988; Lys and Watts 1994) and the political costs of enhanced scrutiny, fines, and imprisonment by regulatory authorities (e.g., Feroz, Park, and Pastena, 1991; Karpoff, Lee, and Martin, 2008; Files 2012). To mitigate litigation and political costs, auditors are likely to prefer accounting standards that allow less room for client discretion.

Accounting choices of clients are easier to audit when they are verifiable, making misinterpretations and improper implementation of the standards less probable ex ante. Further, verifiable accounting choices that are questioned in securities class-action or regulatory action may be more defensible ex post because they have met ex ante objectivity standards (e.g., Ramanna and Watts, 2012). Consistent with this intuition, Donelson, McInnis, and Mergenthaler (2012) document that securities class-action involving accounting rules that are less flexible and provide more guidance for implementation are associated with fewer incidences of litigation. The above arguments suggest that expected litigation and regulatory costs will, ceteris paribus, incentivize Big N auditors to seek (oppose) accounting rules that enhance (decrease) verifiability and objectivity, key elements of reliability as defined by the FASB in its original conceptual framework.[4] Thus, in our time series, we expect under conditions where expected litigation and regulatory costs are particularly high, Big N auditors are more likely to truthfully emphasize concerns about decreased reliability in their lobbying.

The second factor likely to shape Big N auditor incentives when lobbying the FASB is the preferences of their clients. In a competitive equilibrium, an auditor's wealth is eventually dependent on that of its clients. In practice, the management and boards of the client companies make the decisions on hiring and firing auditors, so the latter have an incentive to keep these decision makers at client companies happy (e.g., Watts and Zimmerman 1982; Puro 1984).

Clients typically encounter a heterogeneous range of transactions in their operations. Ceteris paribus, they would thus prefer standards that allow them flexibility to choose the most

[4] "Reliability" is a term frequently discussed in comment letters while its components such as "verifiability" and "objectivity" are referenced less frequently. For example, the raw incidence of reliab* across Big N letters in our sample is 137, while that of verifiab* is 32.

appropriate reporting method for a given transaction, conditional on the economic circumstances underlying that transaction. Zeff (2003a) points to a manifest demand from clients for accounting flexibility in reporting standards as far back as the 1960s. The intense lobbying that preceded APBO 4 on the treatment of investment tax credits (1963) is one such example. Another example would be the "ferocity" (Zeff, 2003a) of lobbying by US corporations against Accounting Principles Board proposals to restrict flexibility in accounting choice in business combinations and the treatment of goodwill (1968–1970). Clients' preference for greater choice was also evident in their activism in favor of flexibility in the accounting treatment of stock option compensation (1994–95). A recent example of clients' demand for flexibility is Apple's successful lobbying for a revision of accounting standards that permits the company to recognize a discretionary (and larger-than-before) fraction of the revenue stream from an iPhone at the point of sale (Brochet, Palepu, and Barley 2011).

More broadly, Watts and Zimmerman (1986) argue that managers choose accounting methods to suit their firms' contracting, information, regulatory, and tax environments. Kothari et al. (2010, 277) argue that "accounting is of strategic importance rather than a compliance tool," so there are "rents to be earned" by firms from customizing their accounting metrics. Both studies provide arguments suggesting that firms, on average, would prefer greater accounting flexibility.

It is entirely possible that in certain circumstances, e.g., to harm competitors or to forestall high expected litigation and regulatory costs, clients would desire reduced accounting flexibility. In such instances, clients' preferences would align with auditors' incentives arising out of litigation and regulatory risk. But in our second set of tests, we are interested in investigating whether incentives to cater to their clients' interests motivate Big N auditors to

lobby for *more* flexible standards. Such flexibility is facilitated by accounting discretion, which can come at the expense of objectivity, a key component of reliability. Thus, ceteris paribus, clients' preferences for flexibility in accounting standards can provide Big N auditors incentives to support accounting rules that can compromise reliability. In our time series, we expect that the Big N are less likely to be in concert with the "true" incidence of decreased reliability when presented with greater incentives to cater to their clients' preferences for flexibility.

3. Data and research design

3.1. Measuring decreased reliability in proposed accounting standards

Big N auditors' assessments of decreased reliability

The FASB's due process provides constituents the opportunity to weigh in on a proposed standard by submitting comment letters. Prior research suggests that comment letters are meaningful indicators of constituent views and have a significant impact on final standards (e.g., Watts and Zimmerman, 1978; Zeff, 2003a, b). We construct our measure of Big N auditors' assessments of decreased reliability using the comment letters written by the auditors on FASB exposure drafts. Our sample begins with the 171 exposure drafts issued by the FASB from 1973 through 2006 that resulted in one or more SFAS: these data are based on Allen and Ramanna (2013, hereafter AR). We find Big N auditor comment letters on all but 22 of these exposure drafts.[5] In theory, if each of the Big N firms in existence in a given period commented on all the exposure drafts of that period, we would have 1,195 Big N comment letters. In practice, there are

[5] We manually examined the 22 exposure drafts for any discernable similarities in accounting issues (revenue recognition, impairment etc.), similar industries (e.g., service, financial, etc.), and similar procedural issues (e.g., delaying implementation dates, excluding certain firms, etc.). We were unable to identify any obvious pattern among the 22 exposure drafts.

865 Big N auditor comment letters covering 149 exposure drafts (and 157 eventual SFAS) over our sample period. This suggests that there is a Big N auditor participation rate of 72.4%. This rate is very high relative to the participation rate of other FASB constituents such as smaller auditors, large companies, and industry associations (all under 50%). Moreover, of the "missing" 330 Big N comment letters (i.e., 1,195 minus 865), one hundred and five are attributable to a single Big N firm, Arthur Young, which existed in the Big 8 era. This firm only commented on two of a possible 107 exposure drafts, suggesting it had a policy not to comment. Excluding Arthur Young, the average Big N auditor participation rate is over 80%. See Table 1.

We measure Big N auditors' reported evaluations of decreased reliability as follows. A paper copy of each Big N auditor comment letter was obtained from the FASB public library in Norwalk, Connecticut, digitized using optical character recognition and manual transcription, and analyzed using a custom-designed Perl script, which extracted all sentences containing the word stem "reliab." Next, using the output from Perl, a research assistant blind to the intent of our study but trained in accounting principles manually examined the extracted sentences from each comment letter to assess the substance of the auditors' reference. Based on this evaluation, comment letters where auditors reported decreased reliability as a result of the exposure draft were identified. See Appendix 2 for further details.

Using the above procedure we find that 98 (10.8%) of the Big N auditors' comment letters express the opinion that an exposure draft will decrease accounting reliability. Following AR, our construction of the proxy for the auditors' assessment, called *dec_relb_aud*, is given by:

$$\boldsymbol{dec\_relb\_aud_{ij}} = \mathbf{1} - \frac{\boldsymbol{WC_{dec_{relb}\ ij}}}{\boldsymbol{WC_{\ ij}}} \qquad (\mathbf{1})$$

In Equation (1), $WC\_dec\_relb_{ij}$ is the word count of the first instance of the word stem "reliab" used in the context of decreasing reliability in comment letter *i* on exposure draft *j*; and WC_{ij} is the total word count of comment letter *i* on exposure draft *j*. By construction, *dec_relb_aud* is bounded [0,1] and is intended to capture the relative importance a Big N auditor places on its assessment of decreased reliability by using relative word position as a proxy for sentiment intensity. As discussed in AR, this linguistic assumption is justified by the propensity of comment letters to begin with an introductory paragraph that highlights key issues. The variable construction should result in higher values of *dec_relb_aud* for comment letters in which the auditor views reliability as sufficiently important in her overall evaluation of an exposure draft to allude to it earlier in the comment letter.[6]

Benchmark assessment of decreased reliability

To draw inferences on how auditors' comments are influenced by their incentives, we must first condition the Big N auditors' concerns about decreased reliability on some benchmark measure of the "true" incidence of decreased reliability. To create a benchmark of an exposure draft's "true" impact on reliability that is independent of auditor incentives, we utilize the variable *manual_dec_relb* from AR, which we rename *benchmark* for clarity of interpretation in our setting. This variable is constructed from the evaluations of two highly experienced research assistants who were instructed to manually assess each exposure draft's impact on reliability relative to the status quo of GAAP at the time of issuance. The research assistants employed in

[6] *dec_relb_aud* is based on the *location* in comment letters of auditors' concerns about reliability. As a robustness measure, we construct an alternative dependent variable that simply captures the *incidence* of auditor concerns about decreased reliability (i.e., the variable is independent of location). Our primary results using this alternative binary dependent variable are consistent with those we obtain with *dec_relb_aud* (Table 6). The rest of the paper discusses results using *dec_relb_aud* because it captures more granular variation in the emphasis auditors place on reliability concerns.

this task had a combined total experience in the fields of accounting and finance of over 30 years, as well as MBA degrees from top ranked U.S. business schools. In their professional careers, the two assistants worked for different Big N accounting firms and for both individuals the time spent in the Big N was small relative to their total experience. These facts mitigate concerns that the research assistants were somehow biased by their experience for a given Big N firm. The research assistants were also blind to the objectives of the study. We use the standard dual-coder model in having the research assistants evaluate the exposure drafts. That is, the research assistants first independently evaluate each exposure draft and then collectively reconciled any differences without interference from us. See Appendix 3 for further details.

By construction, *benchmark* is a binary indicator for each exposure draft, which takes a value of one for exposure drafts categorized by the research assistants as decreasing accounting reliability. Of the 171 exposure drafts in our population, 145 were available to us from the FASB archives for manual evaluation. Merging this sample of 145 manually evaluated exposure drafts with the 149 exposure drafts for which we have Big N auditor comment letters yields a common sample of 127 exposure drafts. There are 737 auditor comment letters on these 127 exposure drafts. See Table 1.

Summary statistics

Table 2 provides summary statistics for our dependent variable (*dec_relb_aud*) partitioned by our benchmark variable (*benchmark*) across our sample period. As seen in Table 2, the benchmark assessment takes a value of 1 for 208 (28.2%) of observations in our sample. The mean value of *dec_relb_aud* is 0.20 for observations with *benchmar*k = 1 and 0.03 for observations with *benchmark* = 0. Figures 1 and 2 present the time-series plots of *dec_relb_aud*

and *benchmark*, respectively, averaged by year across our sample period. For both variables we observe substantial time-series variation.

3.2. Regression model and proxies for factors affecting auditor lobbying incentives

As a starting point, we estimate the correlation between the Big N auditors' assessments of decreased reliability and the benchmark incidence of the same, that is, *dec_relb_aud* and *benchmark*, respectively. This correlation captures how well the Big N auditors' assessments map to the "true" assessments. Further, *changes* in this correlation capture how the auditors' assessments are *varying* with respect to the truth. Note that when this correlation decreases, this could be a result of (a) big auditors' references to decreased reliability occurring *less* frequently than they should when a standard actually decreases reliability or (b) big auditors' references to decreased reliability occurring *more* frequently than they should when a standard actually does not decrease reliability.

We expect the auditors' changing incentives to drive (in part) changes in the correlation between *dec_relb_aud* and *benchmark*. Accordingly, in a regression we estimate how changes in the correlation between the auditors' assessments of exposure drafts and the benchmark assessments vary with the basic factors predicted to shape Big N auditors' incentives; namely expected litigation and regulatory costs, and client preferences for flexibility. Formally, we are interested in the coefficients $\delta_1 \ldots \delta_n$ from the following regression:

$$dec\_relb\_aud_{ij} = \begin{bmatrix} \alpha_1 \\ \alpha_2 \\ \vdots \\ \alpha_t \end{bmatrix}' * yr\_dummies + \begin{bmatrix} \beta_1 \\ \beta_2 \\ \vdots \\ \beta_t \end{bmatrix}' * yr\_dummies * benchmark_j$$

$$+\begin{bmatrix}\gamma_1\\ \gamma_2\\ \vdots\\ \gamma_n\end{bmatrix}' * \begin{bmatrix}proxy_{j1}\\ proxy_{j2}\\ \vdots\\ proxy_{jn}\end{bmatrix} + \begin{bmatrix}\delta_1\\ \delta_2\\ \vdots\\ \delta_n\end{bmatrix}' * \begin{bmatrix}proxy_{j1} * benchmark_j\\ proxy_{j2} * benchmark_j\\ \vdots\\ proxy_{jn} * benchmark_j\end{bmatrix} \qquad (2)$$

In the above regression, the subscript *j* represents a given exposure draft and the subscript *i* represents a given Big N auditor comment letter on that exposure draft. The variables $proxy_1 \ldots proxy_n$ represent the set of empirical measures that variously capture each of the factors predicted to shape Big N auditors' lobbying incentives. These proxies are calculated for each exposure draft *j* in the sample. The coefficients $\delta_1 \ldots \delta_n$ represent how Big N auditor lobbying on decreased reliability varies with these proxies, conditional on the "true" incidence of decreased reliability (*benchmark*).

In the above regression, *yr_dummies* is a *t* x 1 vector of year dummies, which allows variation across the intercept and *benchmark* slope estimates by year. There are a variety of factors (e.g., macroeconomic and market conditions) that can impact Big N auditors' mentions of *dec_relb_aud* in ways that may be unrelated to the true incidence of decreased reliability. These factors are likely to vary by exposure draft and time, and their impact in Equation (2) is captured by the alphas. By interacting *yr_dummies* with the *benchmark* variable in the above regression, we generate separate beta estimates of the correlation between Big N auditors' assessments and "true" assessments for each year in our sample. This ensures that the coefficients $\delta_1 \ldots \delta_n$ do not capture secular variation in the correlation between *dec_relb_aud* and *benchmark* that is unrelated to underlying time-series variation in $proxy_1 \ldots proxy_n$. For ease of interpretation we include a full set of year dummies and interactions, and accordingly omit a constant term and the main effect on *benchmark*.

Our proxies for the factors expected to shape Big N auditors' lobbying incentives are as follows. First, we measure expected litigation and regulatory costs using two separate variables – *civil_lit* and *aaers*. The variable *civil_lit* represents a count of all civil litigation cases filed against Big N auditors in the twelve months preceding a given exposure draft, scaled by the total number of Compustat firms audited by Big N auditors in those twelve months. This variable is intended to capture time-series variation in the intensity of civil litigation (and therefore expected litigation costs) against Big N auditors, controlling for the size of the Big N's client base. The variable *aaers* represents a count of auditing and accounting enforcement actions filed by the SEC in the twelve months preceding a given exposure draft, scaled by the total number Compustat firms in those twelve months. This variable is intended to capture time-series variation in the intensity of regulatory enforcement (and therefore expected regulatory costs) on accounting and auditing issues.[7]

Our second auditor-incentive factor is client preferences for flexibility. Ideally, we would measure this factor using the sentiments expressed by the auditors' clients in their own comment letters. This would involve manually evaluating tens of thousands of client letters. Given the costs of this approach, we develop three alternative variables to capture client preferences for flexibility. First, we attempt to directly measure the demand for flexibility among the extant client base of Big N audit firms in the twelve months preceding a given exposure draft. We expect larger clients with more complex operations, clients with more growth options, clients with a longer operating cycle, and clients with more volatile stock returns to demand greater flexibility of the accounting system to better reflect the complexity and changing economics of

[7] *Civil_lit* and *aaers* are constructed at an aggregate level rather than at the audit firm level in order to proxy for overall perceived risk of the audit firms' operating environment. Civil suits and SEC actions are publicly visible and therefore salient to more than just the named audit firm in their calculation of litigation/regulatory risk.

their businesses. Thus, for each twelve-month period preceding a given exposure draft, we compute a factor using principal component analysis of the following four variables: the median total assets (normalized to 1973 dollars) of all firms that are clients of the Big N auditors; the median Tobin's q of such clients; the median operating cycle of such clients; and the median stock return volatility of such clients. This variable is denoted *flexibility*.[8]

One drawback with *flexibility* is that it homogenizes the dispersed nature of clients' preferences for flexibility. To address this limitation, for our second measure of client preferences, we focus on proposed standards that are industry-specific. We define an indicator variable, *industry_ED* to identify such proposed standards. In cases where *industry_ED*=1, we expect client interests to be more concentrated. Big N auditors particularly dependent on an industry might have especially strong incentives to lobby for client preferences on industry-specific standards. Thus, we define a second indicator, *aud_specialization*, to identify industry-dependent auditors lobbying on industry-specific standards. To construct *aud_specialization*, "industry-dependent auditors" is defined as auditors with an above market weighted-average proportion of clients in each of twelve Fama-French industries.[9]

As a third variable capturing client preferences for flexibility, we measure overall client lobbying intensity on a given exposure draft. The premise here is that if clients feel so strongly on an issue as to directly lobby the FASB, their auditors are more likely to represent the clients'

[8] By relying on median firm characteristics, our flexibility variable is less susceptible to outliers. However, if auditors are most influenced by their largest clients this may diminish the power of our tests. Accordingly, we construct a second factor variable (*flexibility2)* which uses asset-weighted mean values in lieu of median values. Regression inferences are unaltered when we use this alternative proxy.

[9] Market share is computed by weighting by the natural log of total assets, consistent with prior literature on the determinants of audit fees (e.g., Palmrose, 1986). The results are also robust to using simple averages as in Hogan and Jeter (1999) and to a more restrictive definition of industry dominance that, following Reichelt and Wang (2010), defines an industry specialist as an audit firm having the greatest market share by at least a 10-percentage point margin over the second-largest industry leader.

view in their own lobbying. The number of comment letters specifically written by Big N auditors' clients could proxy for client lobbying intensity, but data limitations prevent us from isolating this number. (It is prohibitively costly to manually determine the number of client letters for each exposure draft in our sample.) So we use the total number of comment letters filed on an exposure draft as a proxy for client lobbying intensity. The natural logarithm of this value is denoted *num_letters*. In general, most of the comment letters on any given exposure draft are written by industrial and financial firms that constitute auditors' clients, which suggests *num_letters* can be a reasonable proxy for the desired construct.

For completeness, we also include in our regression two control variables (*pct_fin_fasb* and *manual_inc_relv*) that AR find are significantly associated with auditor references to decreased reliability in an exposure draft. *pct_fin_fasb* is a continuous variable equal to the proportion of FASB members in office at the issuance of a given exposure draft who were employed in the financial-services industry immediately prior to their appointment to the board.[10] The indicator variable *manual_inc_relv* takes the value of one for exposure drafts that increase the use of fair values for asset write downs, asset recognition and measurement, liability recognition and measurement, recognition in the income statement, or any audited disclosure.[11]

[10] In their construction of *pct_fin_fasb* AR (2013) only classify as "financial" those members coming from institutional investment banking/ investment management. Frank Block, who served on the FASB from 1979-1985, is not coded as having a "financial" background in AR because his prior employment was as a financial analyst for a predominately retail oriented brokerage firm, Bache Haley. The inferences in this paper are identical if we re-classify Frank Block as having a "financial" background.

[11] *manual_inc_relv* in AR is constructed by two seasoned research assistants who evaluate exposure drafts for their use of fair values along the five dimensions described above. Further details on this variable are provided in Appendix B of AR.

4. Results

4.1. Descriptive statistics

Table 3 Panel A reports summary statistics on the proxies for the two basic factors expected to shape auditor incentives over the sample period, as well as for our control variables. Panel B reports correlation coefficients. As Panel A reports, on average 0.5% and 0.6% of all Compustat firms are subject to civil litigation (*civil_lit*) or SEC enforcement action (*aaers*), respectively, each year. Turning to variables capturing clients' preferences for flexibility, industry-specific exposure drafts constitute 23% of our sample (*industry_ED*); also, 8.5% of corresponding comment letters are written by Big N auditors having market-share dominance in the industry to which the exposure draft pertains (*aud_specialization*). On average, 176 comment letters are received in response to a FASB exposure draft (*num_letters*), however participation ranges from a low of 4 letters (SFAS 152: Accounting for Real Estate Time Sharing Transactions) to a high of 6,536 letters (SFAS 123R: Share Based Payments).[12]

Figures 3 through 6 depict time trends for our proxy variables. As shown in Figures 3 and 4, the proportion of firms subject to civil litigation and SEC enforcement action, respectively, are increasing over our sample period, but with significant time-series variation. Specifically, civil litigation appears to increase and decrease in a pattern generally consistent with the changes in auditor-litigation eras discussed in Section 4.3. Figure 5 suggests that *flexibility*, our proxy for median client demand for flexibility, has steadily risen over time. By contrast, Figure 6 suggests

[12] Note, for ease of interpretation the value of *num_letters* presented in Table 3 is prior to the log transformation.

there is no apparent time-trend to the intensity of comment-letter lobbying, our proxy for client engagement in the standard setting process (*num_letters*).

4.2. Multivariate results

Table 4 presents the results of our multivariate tests to determine how auditor lobbying incentives vary with changes in civil litigation and SEC enforcement action. The regression follows the form of Equation (2) in Section 3.2. Columns (1) and (2) of Table 4 test civil litigation and SEC enforcement separately, in Column (3) proxies for both effects are included. The regression structure includes both year fixed-effects and year fixed-effects interacted with our *benchmark* variable to control for omitted factors unrelated to litigation or regulatory costs. Statistical significance is reported based on heteroskedastic cluster-robust standard errors. The standard errors are clustered by exposure draft to account for the potential non-independence of observations by the Big N auditors on a given issue.

Table 4 suggests that correlation between big auditors' concerns with decreased reliability and the "true" decline in reliability (as captured by the benchmark) is higher when the perceived threat of civil litigation and regulatory action is higher. The variables *civil_lit*benchmark* and *aaers*benchmark* are significantly positive at a 5% level across all specifications in the table. Based on the coefficients from Column (3), a one standard-deviation increase in the proportion of firms targeted in civil litigation (SEC auditing and enforcement actions) over the twelve months preceding an exposure draft is associated with an increase in 1.61 (1.86) standard deviations of the value of *dec_relb_aud*. Thus, the marginal impacts of civil litigation and regulatory action on auditor lobbying over reliability appear to be economically significant.

Table 5 presents the results of multivariate analysis on how auditor lobbying incentives vary with changes in client preferences for flexibility. The regression structure and presentation underlying Table 5 mirrors that of Table 4. We find a significantly negative coefficient on the variable *flexibility*, suggesting that the raw incidence of Big N auditors expressing concerns about decreased reliability is lower when client demand for flexibility is higher. But the coefficient of interest – that on the interaction of *flexibility* with *benchmark*, which captures the conditional propensity of Big N auditors to express concerns about decreased reliability – is not statistically significant in Table 5. Further, we fail to find evidence that industry-specific standards and auditor specialization has a significant impact on auditors' concern with reliability. Put differently, our attempt at isolating a high-power setting to test for the impact of client preferences for flexibility on auditor lobbying does not yield significant inferences.

The only variable for client preferences that appears to significantly impact auditor incentives is *num_letters*, our proxy for the relative importance of an accounting issue to clients. But the effect is in the opposite direction as predicted. Regression coefficients (significant at the 5% level) suggest a higher association between big auditors' concerns with decreased reliability and the benchmark when accounting proposals generate significant volumes of comment letters. Assuming that lobbying activity is proportional to projected financial statement impact, this result potentially suggests that auditors are more wary of standards that decrease reliability when the projected financial statement impact of such standards is deemed more material.

Overall, Table 5 provides no support for the argument that auditor lobbying over time is driven by changing client preferences for flexibility. This finding is consistent with prior studies of auditor lobbying (e.g., Watts and Zimmerman, 1982; Puro, 1984).

In Table 6 we present results with the full multivariate model that estimates variation in auditor lobbying with the five proxy variables spanning expected litigation and regulatory costs, and client preferences for flexibility, as well as the two control variables from AR. Because audit firms may vary systematically in their preferences toward, or propensity to comment on, accounting reliability Table 6 is presented with and without auditor fixed effects.[13] Across specifications, the regression results confirm that the Big N's comment letters are more likely to be in concert with "true" declines in reliability in proposed standards when the risk of either civil litigation or regulatory intervention is more severe. The results provide no support for the hypothesis that clients' preferences for reporting flexibility influence auditor lobbying.

The increased correlation between *benchmark* and *dec_relb* in Tables 4 and 6 suggests that auditors are more likely to truthfully report their assessments of decreased reliability in the presence of heightened litigation/regulatory risk. However, as discussed in Section 3, this increased correlation may result either from (a) an increased propensity of auditor's to truthfully highlight decreased reliability when a standard actually decreases reliability (i.e. *benchmark* =1), or, (b) a diminished propensity of auditors' to falsely assert reliability concerns when a standard actually does not decrease reliability (i.e. *benchmark* =0). The former channel more closely resembles the expected mechanism in our qualitative description in Section 2 (although the latter channel cannot be ruled out and forms part of our main tests for completeness). Accordingly, we report in Table 7 the statistical significance of relevant coefficients from Tables 4-6 under

[13] Given the evolving nature of audit firms in our sample from Big 8 to Big 4, the best way to introduce fixed effects is not entirely clear. Lumping predecessor firms with their successor firm in a single fixed effect yields 5 audit "firms" in our sample, while considering each predecessor as distinct from its descendent yields 11 "firms" in our sample. We present both specifications; results are invariant to this choice.

condition (a), (i.e., when benchmark=1. In Equation 2, this would be the sum of coefficients $\gamma + \delta$.[14]

Overall, the results in Table 7 suggests that heightened litigation and regulatory risk are correlated with higher incidence of auditor concern over decreased reliability in standard setting, conditional on reliability truly decreasing. The linear combination of *aaer + aaer*benchmark* is significant at the 1% level across specifications (Columns (1) and (3)). Likewise, the linear combination of *lit + lit*benchmark* is positive significant at the 5% level in Column 1 however, it drops to one-tailed (10%) significance in Column (3). Interestingly, Column (2) provides some evidence that auditors may be *less* likely to express concerns over true instances of decreased reliability when client preferences for flexibility are heightened (*flexibility + flexibility*benchmark < 0* two-tailed 10% significance). However, this effect is not significant when tested in the context of the full regression specification (Column 3) consistent with the non-results observed in Tables 5 and 6.

Overall, the evidence from Tables 4 to 7 suggests that auditors' concerns regarding litigation and regulation, bear a greater influence on their comment-letter lobbying as it pertains to decreased reliability than do the preferences of their clients for flexibility. One caveat to this inference applies: despite our best attempts to generate proxies that (indirectly) capture clients' preferences for flexibility, data limitations preclude us from generating a more direct measure based on clients' comment letters on proposed standards. Absent these data, it would be premature to rule out the possibility that evolving client preferences for flexibility have shaped auditors' lobbying incentives over time.

[14] As an alternative test we also reran Tables 4-6 without interaction terms after dropping all observations where benchmark=0. Results (untabulated) yield the same conclusions as those presented in Table 7.

4.3. Additional tests of the changing nature of Big N auditor lobbying

As an alternative approach to examining the changing nature of Big N auditor lobbying, we investigate the time-series variation in the correlation between *dec_relb_aud* and *benchmark* across broad regime shifts that potentially alter the relative weight that auditors place on their various incentives. We look at two sets of regime shifts in particular – the changing nature of auditor liability to capital-market participants, as determined by evolving legislation and judicial precedent, and the changing industrial organization of the auditing oligopoly, specifically the gradual decline in the number of Big N auditors from eight to four. In each of these regime shift tests, we estimate the following regression in order to extract the coefficients $\beta_1 \ldots \beta_t$.

$$dec\_relb\_aud_{ij} = \begin{bmatrix} \alpha_1 \\ \alpha_2 \\ \vdots \\ \alpha_t \end{bmatrix}' * yr\_dummies + \begin{bmatrix} \beta_1 \\ \beta_2 \\ \vdots \\ \beta_t \end{bmatrix}' * yr\_dummies * benchmark_j \quad (3)$$

Then, we compare the average betas across different regime "eras" of auditor liability and auditor industrial organization (the specifics of these eras are discussed shortly). To do so, we use linear combinations of betas within a given era to calculate the era-average coefficients and standard errors per the following equations.

$$\boldsymbol{Era - Average\ Coefficient} = \boldsymbol{l'\beta} = \sum_{\boldsymbol{k=1}}^{\boldsymbol{K}} \boldsymbol{l_k \beta_k} \quad (\mathbf{4})$$

$$se(l'\beta) = [\hat{\sigma}^2 l'(x'x)^{-1} l]^{\frac{1}{2}} \quad (5)$$

In Equations (4) and (5), l is an t x 1 matrix (where t is the sample length) that has element k set to one for each β_k being averaged across a given era and zero otherwise. In Equation (5), $\hat{\sigma}^2$ is the regression's sum of squared residuals divided by the degrees of freedom

and x is the matrix of explanatory variables. Significance tests of era-averaged coefficients are based on a Student's t-distribution with n-K degrees of freedom, where n is the sample size and K is the number of regression covariates.

Note that if the Big N auditors' incentives are unchanged across eras or if the auditors are, on average, not self-serving in their lobbying, we are unlikely to find significant differences across era-averaged beta coefficients. If, on the other hand, Big N auditors' lobbying on exposure drafts is influenced by changing incentives across liability regimes or regimes of industrial organization, differences across era-averaged coefficients will be significant.

Auditor liability eras

Consider, first, the regime shifts across changing auditor liability. Following the evolution of tort law related to auditor liability in our sample period, we identify four distinct litigation eras over our 1973 to 2006 sample period.

(1) 1973–1982 constitutes our baseline period. During this period tort law governing auditor liability to non-clients for negligence was largely governed by the doctrine of "privity" or "near privity" (Feinman, 2003). Under the doctrine of privity, auditors can only be held liable for negligence to third parties with whom they have a direct contractual relationship.[15]

(2) 1983–1991 was a period marked by increase in litigation pressure felt by the large auditing firms. Two major court rulings in 1983, Rosenblum v. Adler and Citizens State Bank v. Timm Schmidt and Co., set precedents for the use of "reasonable foreseeability" rather than

[15] Kothari et al. (1988) in their discussion of auditor liability eras identify the Ernst & Ernst v. Hochfelder case in 1976 as demarking a reduction in auditor liability. Applied to our setting, this would suggest that we treat the periods 1973–1976 and 1977–1982 differently. We do not do so because we lack sufficient observations (based on limited data to construct the *benchmark* variable) to generate regression betas for the 1973–1976 period.

"privity" as the standard for negligence (Kothari et al., 1988; Feinman 2003). Under the doctrine of "reasonable foreseeability," auditor litigation risk is significantly increased; an auditor is potentially liable to any party that might have been reasonably expected to rely on a client's audited financial statements. Also in 1983, the U.S. courts held that auditors could be sued under the Racketeer Influenced and Corrupt Organization Act (RICO) of 1970 (Lys and Watts, 1994). Basic v. Levinson of 1988 further increased auditor liability when it introduced the "fraud on the market" (FOM) theory.[16] Under the presumption of market efficiency FOM asserts that because a firm's share price is dependent on its financials, reliance by investors on the share price is sufficient to demonstrate reliance on the financials.

(3) 1992–2002 was a period that saw a series of reforms aimed at decreasing auditor liability. In 1992 the AICPA amended Section 505 of its Code of Professional Conduct to allow member firms to incorporate as limited liability partnerships; and, the Big N firms all converted shortly thereafter (Choi, Doogar, and Ganguly, 2004). Additionally, in 1992 a California Supreme court ruling Bily v. Arthur Young and Co. and Security Pacific Business Credit v. Peat Marwick Main, reversed the precedent set in Rosenblum. Rejecting the doctrine of "reasonable foreseeability", both court cases instead applied the doctrine of "known users" (Feinman, 2003). By this standard auditor liability for negligent misrepresentation to non-clients is limited to third parties whom the auditor *knows* rely on its audit reports. In 1994, the Supreme Court eliminated auditors' liability for aiding and abetting rule 10b-5 violations (Central Bank of Denver v. First Interstate Bank of Denver). And finally, in 1995 the Private Securities Litigation Reform Act of 1995 further reduced auditor liability by limiting key aspects of their liability under the 1934

[16] 485 U.S. 224, 241-42 (1988).

Securities Act and under RICO (Ali and Kallapur, 2001). The sum effect of these changes was a reduction in litigation risk for auditors relative to the prior period.

(4) 2003–2006 was a period marked by increased litigation risk relative to the prior period. The provisions of the Sarbanes Oxley Act of 2002 (SOX) left largely untouched the private civil liability standards for auditors, but established the Public Company Accounting Oversight Board for increased oversight and visibility of Big N audit firms. Further, the high visibility of corporate accounting scandals from 2001-2002, the demise of Arthur Andersen, and the ensuing wave of investigations and penalties for public accounting firms likely heightened Big N audit firms incentives to minimize litigation risk (Cahan and Zhang, 2006).

Consistent with our earlier predictions on auditor litigation risk, we expect eras with heightened (diminished) litigation risk to increase (decrease) Big N auditors' likelihood of expressing concerns about decreased reliability. We identify litigation risk eras in two alternative ways. The first classification, which relies on Feynman's (2003) analysis of the evolution in legal liability, along with our specific predictions is summarized below:

Era	**Legal liability standard (change relative to preceding era)**	**Beta predictions relative to preceding era**
1973–1982	Privity (baseline)	Baseline
1983–1991	Reasonable Foreseeability (increase)	Increased Beta
1992–2002	Known Users and Limited Liability (decrease)	Decreased Beta
2003–2006	SOX and PCAOB (increase)	Increased Beta

Table 8 Panel A presents the results of this analysis. The underlying regression for Table 8 is given by Equation (3). The coefficients and their standard errors are calculated as in Equations (4) and (5). The first column of Table 8 reports the average beta (i.e., correlation between *dec_relb_aud* and *benchmark*) for each of the four auditor litigation eras. Differences in average coefficients for each pair of eras are presented in the second through fourth columns of Table 8.

As shown in Table 8 Panel A, litigation era coefficients increase (decrease) systematically as predicted in response to heightened (diminished) legal accountability of auditors. Big N auditor concern with decreased reliability (conditional on the true incidence of such) is lowest under the legal standard of privity, increases under the more relaxed doctrine of "reasonable foreseeability" (0.31), decreases under the more stringent standard of "known users" (0.19), and increases again post-SOX (0.36). All predicted pairwise differences across each of these era coefficients (diagonal elements) are statistically significant at the 5% level. Overall, Table 8 provides additional evidence that the Big N auditors' lobbying systematically shifts toward managing their litigation and regulatory costs in "unfriendly" litigation eras.

Doctrines of "near-privity", "known-users" and "reasonable foreseeability" while useful to defining the average prevailing litigation environment are not ubiquitous in the sense that their implementation varies across states. Accordingly, our second classification of litigation era results focuses more exclusively on changes to federal law. Specifically, we look to the 1988 Supreme Court decision in Basic v. Levinson and 1994 Supreme Court decision in Central Bank v. Denver (along with the PSLRA passed in 1995) as alternative years to demarcate increases and decreases in auditor litigation risk, respectively. Predictions based on these alternative cut points are shown below.

Era	Legal liability standard (change relative to preceding era)	Beta predictions relative to preceding era
1973–1982	Privity (baseline)	Baseline
1988–1993	Basic v. Levinson (increase)	Increased Beta
1994–2002	Central Bank & PSLRA (decrease)	Decreased Beta
2003–2006	SOX and PCAOB (increase)	Increased Beta

The results presented in Table 8 Panel B are consistent with the above predictions and with our finding in Panel A; specifically, this additional analysis supports our conclusion that changes in the litigation environment are predictably and significantly associated with changes in auditor lobbying with regards to accounting "reliability".

An alternative explanation for our results in Table 8 is that, rather than being reflective of auditor incentives, the observed association reflects pass-through concern among audit firm clients. Audit firms are often sued alongside their clients, likewise for SEC enforcement actions – ergo heightened auditor concern is possibly correlated with heightened client concern. We cannot completely rule out the possibility that variation in auditor lobbying with respect to litigation risk is (partially) motivated by correlated client concerns. However, in the context of our analysis, this association between auditor and client litigation risk is not problematic to our interpretation unless auditors (mostly) pass through the expected costs of litigation to their clients in the form of audit fees. In this case, auditors' heightened concern with decreased

reliability does not reflect auditor concern with litigation risk, but rather provides an example of auditor responsiveness to client demands.[17]

Firms were not required to publically disclose audit fees until 2000, accordingly, we are unable to simple control for the impact of audit fees throughout our sample. However, merging the 2000-2006 data from Audit Analytics with a small sample (<100) of voluntarily reporting large firms from 1980-1997 as reported in Menon and Williams (2001), we are able to compare trends in audit fee data with our specified litigation eras from Table 8 to determine whether they appear correlated.

Figures 7 and 8 show the temporal trends in audit fees from 1980-1997 and 2002-2006 as per the Menon and Williams (2000) and Audit Analytics data respectively.[18] Figure 7 reveals a steadily increasing trend from 1980-1990 with a tapering off/slightly downward trend from 1990-1997. We are unable to detect any observable spikes around the litigation events that would cause us to suspect litigation/regulatory risk is being perfectly externalized by auditors to their clients. Figure 8 reveals a dramatic uptick in audit fees between 2003 and 2004 consistent with this being the first year that companies were required to perform SOX 404 audits, while there is no observable impact in 2002 (the year SOX was enacted). Given these data it is difficult to credibly attribute the increase in audit fees with SOX entirely to heightened risk of litigation and regulatory scrutiny (which should manifest starting in 2002); the fee increases are

[17] Correlated trends are likely less of a concern for our primary analysis in Table 6 where systematic variation in audit fees should be captured in our year and year*benchmark fixed effects.

[18] The mean value of audit fees for the 1980-1997 sample is significantly higher than the 2002-2006 as the former represent a non-random sample of voluntarily disclosing (large) firms. For the 2002-2006 sample, Mean Audit Fees includes audit fees and other audit related fees as categorized in Audit Analytics.

more likely to have arisen from increased work for auditors (i.e. internal controls implementation and testing) starting 2004.

Based on the descriptive trends in Figures 7 and 8, it is unlikely that auditors are entirely externalizing litigation/regulatory risk entirely to their clients; rather, it appears that auditor concern with litigation is at least partially responsible for our findings in Table 8. Notwithstanding, we acknowledge that we cannot perfectly disentangle the impact of correlated client preferences as they pertain to litigation/regulatory risk.

Auditor industrial-organization eras

Next, we consider the eras representing regimes of the Big N's industrial organization over our sample period. The audit business in the US has since at least the 1970s functioned as a relatively tight oligopoly, with a few big firms providing a disproportionately large share of audit services. The dominance of the audit firms has been particularly pronounced among larger clients. In 1988, only eight firms collectively audited approximately 98% of all public companies by sales (82% by number). Thereafter, the concentration of audit firms increased progressively to the point that in 2002 there were only four firms auditing almost 99% of all public companies by sales (78% by number).[19] The specific consolidations that led to the emergence of the Big 4 from the Big 8 are outlined in Appendix 1. Briefly, the consolidations characterize four distinct oligopoly eras in our sample period from 1973 through 2006: the Big 8 era (1973–1989), the Big 6 era (1990–1998), the Big 5 era (1999–2002) and the Big 4 era (2003–2006).

[19] See GAO (2003), a study conducted by Government Accountability Office for the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

The primary factor driving the increasing concentration of Big N audit firms has been mergers between existing firms. The mergers, in turn, appear to have been motivated by Big N audit firms' attempts to achieve economies of scale in servicing a client base that increasingly spans diverse operational and geographic boundaries (e.g., DeAngelo, 1981; Benston, 1985). Changing litigiousness over time may have also contributed toward auditors' proclivity to merge. Bigger firms with a wider pool of resources are presumably in a better position to withstand the threats, and costs, arising from class-action lawsuits (GAO, 2008). Higher concentration does not, however, guarantee the ability to survive litigation and political threats, as the case of Arthur Andersen demonstrates. In 2002, the criminal indictment of Arthur Andersen for its culpability as auditor in the accounting fraud perpetuated by Enron Corporation led to unprecedented client flight, as well as voluntary departures of several of its partners and staff, ultimately resulting in its dissolution.

The Big N's lobbying incentives are expected to evolve with a tightening oligopoly due to a number of factors. Fewer Big N firms available to undertake audits of large and complex clients implies that the potential systemic instability and cost to the financial system that could result from the failure of a single oligopolistic audit firm rises. This can make regulators reluctant to aggressively pursue auditors in the event of irregularities, effectively rendering them "too big to fail."[20] Less fettered by the need to manage the risk of regulatory intervention, a tighter Big N oligopoly can be expected to care less about decreased reliability in accounting standards, shifting instead toward emphasizing client preferences for accounting flexibility.

[20] For example, in 2005, when the Big 4 audit firm KPMG was revealed to be "peddling illegal tax shelters" among its clients (Nocera, 2005), the U.S. Justice Department signed a deferred prosecution agreement with the firm, forcing it to admit wrongdoing but sparing it from criminal prosecution. For additional arguments on the Big N being "too big to fail," see, e.g., Dwyer (2003), Cunningham (2006), and Salmon (2011).

However, countervailing forces exist. A decline in the number of Big N firms without a decline in their collective market share has translated into the remaining firms becoming more visible, making them more noticeable targets for litigation. The perception of deep pockets heightens motives among capital market participants, including investors, to launch class-action lawsuits against Big N auditors alleging dereliction of fiduciary duties (e.g., Calabresi, 1970; Palmrose, 1988). Increased visibility to regulators is also a potential issue, as it can conceivably increase regulators' incentives to scrutinize big audit firms more carefully. If a tightening oligopoly indeed increases auditors' visibility and as a consequence, their litigation and regulatory costs, the Big N are increasingly more likely to emphasize concerns about the decreased reliability of proposed standards when such concerns are present. Compounding the effect of higher visibility is the improved bargaining power vis-à-vis clients the Big N enjoy when their numbers decline. As Big N audit firms have fewer competitors, the market-driven need to be responsive to clients' preferences is weaker, and auditors can focus on managing their exposures to litigation and regulatory risk. This can further shift the Big N's preferences toward emphasizing concerns about decreased reliability in their comment letters.

In tests presented in Table 9, we examine these competing predictions on Big N auditors' lobbying over decreased reliability across the changing nature of the auditors' industrial organization. The regression structure and presentation for Table 9 mirror those of Table 8, except that betas (the correlation between *dec_relb_aud* and *benchmark*) are average across oligopoly eras as opposed to litigation regimes. The first column of Table 9 suggests that Big N auditor concern with decreased reliability (conditional on the true incidence of such) is increasing monotonically with increased concentration of the audit oligopoly. The second through fourth columns of Table 9 provide pairwise differences between era-averaged betas,

which are all positive and statistically significant (at the 10% level) with the exception of the Big 8 to Big 6 era comparison.

The results in Table 9 suggest that as the auditing oligopoly has tightened, Big N auditors are more likely to emphasize concerns about decreased reliability in their comment letters. This finding is consistent with the surviving Big N audit firms in the tightening oligopoly facing greater political and litigation costs attributable to their increased visibility. The finding is also consistent with decreased competitive pressure among the Big N to satisfy client preferences as the oligopoly tightens. These forces appear to dominate any increased perception by the Big N that they are "too big to fail" as the audit oligopoly tightens.

We stress that our results in this subsection are descriptive and associative in nature. They do not speak to the causes of Big N auditor consolidation, nor do they rule out that these causes themselves – rather than the consolidations per se – are driving the increasing secular focus on decreased reliability in Big N auditor lobbying.

5. Conclusion

Our paper offers a descriptive analysis of the role of auditors in accounting standard-setting, a subject on which there has been no systematic empirical study for nearly thirty years. We focus, in particular, on how auditors' changing incentives impact their comment-letter lobbying on proposed financial reporting standards over the period from 1973 through 2006. We characterize auditors' incentives arising from two distinct sources: their desire to manage their expected litigation and regulatory costs and their desire to cater to their clients' preferences for flexibility. Our empirical analysis focuses on the influential Big N auditors and a crucial property of standards that auditors commonly comment on, reliability. We are careful to control for the

component of auditor lobbying driven solely by the properties of the proposed standards themselves, via the use of a benchmark designed to capture "true" concerns regarding reliability that would be raised by a neutral assessment.

Our findings indicate support for expected litigation costs as well as the threat of regulatory scrutiny being important factors guiding auditor lobbying. In the presence of those forces, the Big N are more prone to emphasize their concerns regarding the decreased reliability of proposed standards, relative to the benchmark. Despite several attempts to increase the power of our tests, we fail to find evidence that auditor lobbying caters to their clients' preferences for flexibility, which would be hindered by reporting standards that stress reliability.

In regime-shift analyses, results confirm that Big N auditor lobbying focuses more on concerns regarding the reliability of proposed standards during litigation regimes that lower the bar for assessing auditor liability. Interestingly, we also find that the Big N have increasingly emphasized concerns regarding reliability as their oligopoly has tightened over time, i.e., as their numbers have progressively dwindled from eight to four. The findings are consistent with Big N auditors perceiving higher litigation and political costs from the increased visibility that accompanies a tighter oligopoly. The findings are also consistent with tighter oligopoly decreasing competition among the surviving Big N to satisfy client preferences in accounting standards (preferences for accounting flexibility at the expense of verifiability). The findings are not consistent with the concern that tightening oligopoly has rendered the surviving Big N "too big to fail."

Opportunities for future research abound in the general arena of auditors' role in standard-setting and the political process underlying the development of financial reporting

standards. For example, we refrain from assessing an exhaustive list of properties of financial reporting standards (e.g., comparability, consistency), primarily because they are either not referenced as frequently in comment letters or because it is difficult to predict systematic variation in the extent to which auditors emphasize their concerns regarding these properties as their incentives evolve. Nevertheless, it would be valuable to track how different parties including auditors advocate key attributes of reporting standards such as reliability, relevance, comparability and consistency in line with their own incentives. Further, while we examine how auditors' incentives around litigation and regulatory scrutiny and around client preferences for flexibility influence their lobbying, we have not directly studied whether auditors' incentives to create more business for themselves (e.g., through more audit services) also influences GAAP lobbying. Future research can address this issue. Finally, our study analyses comment letters at the audit firm level and does not attempt to isolate the incentives of specific audit partners who author these letters. The recent PCAOB requirement that audit firms disclose engagement partners suggests that the opinions those partners express in their comment letters can be linked to their personal incentives as well as the properties of the financial statements that they have audited. Our goal is to provide a stepping stone for this research by offering the first large-sample descriptive study on how Big N auditors' incentives shape their attempts to influence U.S. GAAP.

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Appendix 1:
Tightening of the Big N auditing oligopoly, 1973–2006

Big 8	**Big 6**	**Big 5**	**Big 4**
1973–1989	**1990–1998**	**1999–2002**	**2003–2006**
Arthur Andersen	Arthur Andersen	Arthur Andersen	
Arthur Young Ernst & Whinney	Ernst & Young	Ernst & Young	Ernst & Young
Touche Ross Deloitte, Haskins & Sells	Deloitte Touche	Deloitte Touche	Deloitte Touche
Peat Marwick	KPMG	KPMG	KPMG
Coopers Lybrand Price Waterhouse	Coopers Lybrand Price Waterhouse	PwC	PwC

Arthur Young and Ernst & Whinney merged in July of 1989. Deloitte, Haskin & Sells and Touche Ross merged in August of 1989. Coopers Lybrand and Price Waterhouse merged in July 1998. Arthur Andersen surrendered its CPA licenses and right to practice in August of 2002.

Appendix 2:
Details of the process for creating auditor-based measures of decreased reliability

We use a custom-designed Perl script to analyze the Big N auditors' comments letters. For each comment letter, the Perl program first identifies all instances of the word stem "reliab." The program then outputs: (1) the exact position within the comment letter where the word stem occurs (the position of a word stem is reported as its word count from the beginning of the document); (2) the entire sentence containing the identified word stem; and (3) the total word count for the letter.

Next, a research assistant (RA) trained in accounting principles, but blind to the intent of our study, manually examines the first sentence referencing "reliab." On each sentence, the RA determines whether the word stem in question is being used in: (1) a positive context, i.e., whether the letter is indicating that the proposed standard will increase reliability; (2) a negative context, i.e., whether the letter is indicating that the proposed standard will decrease reliability; or (3) a context that is irrelevant to the use of reliability as an accounting principle. What follows is an example of the RA's assessment from an actual sentence capturing decreased reliability. "We also believe the Proposed Standard exacerbates the complexities of Statement 125 and permits recognition of revenue that cannot be reliably measured." Source: Deloitte's comment letter on proposed SFAS 140.

In instances where the RA identifies the comment letter's first use of reliability as irrelevant to accounting principles, the RA proceeds to the second sentence containing the word stem in question. This process continues until the RA encounters either a positive or negative use of reliability or the RA determines that all uses of reliability in the comment letter are irrelevant to accounting principles.

Note: this appendix is adapted from Appendix A of Allen and Ramanna (2013).

Appendix 3:
Coding rubric for research-assistant-based measures of decreased reliability

The research assistants were instructed to evaluate the exposure drafts recording their perspective on whether the underlying proposal would decrease reliability, where "reliability" is defined as per the FASB as, "The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." The resulting variable is a binary indicator denoted *benchmark.*

Assessing *benchmark* requires the exercise of professional judgment. Accordingly, both research assistants employed for this task are seasoned professionals, with MBA degrees from top-ranked U.S. business schools (as per U.S. News rankings) and with combined industrial work experience in finance and accounting exceeding thirty years. We recruited both research assistants specifically to evaluate the FASB exposure drafts, and both were selected for their practical familiarity with accounting.

Of the 145 exposure drafts coded by the two research assistants, 105 received identical independent evaluations on *benchmark.* On the exposure drafts with differing evaluations, the research assistants were able to resolve all differences in subsequent discussions. (This is the standard dual-coder model.) At no point in this process were the research assistants apprised of the study's hypotheses or its independent variables. Research assistants were compensated on a flat hourly wage (i.e., no performance-based pay).

Note: this appendix is adapted from Appendix B of Allen and Ramanna (2013).

Figure 1:
Big N auditor assessments of decreased reliability in proposed standards
The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. *dec_relb_aud* is the auditors' assessment that a proposed standard will decrease accounting reliability.

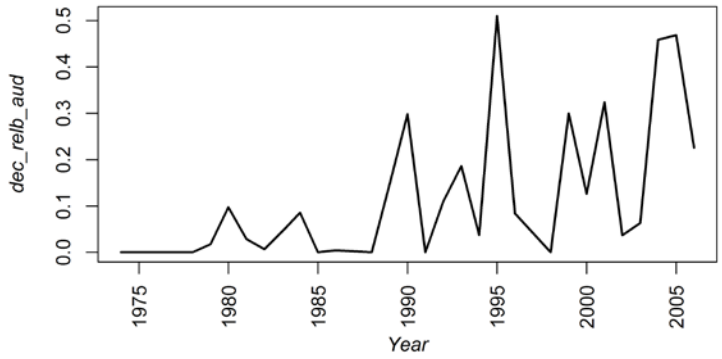

Figure 2:
Benchmark assessments of decreased reliability in proposed standards
The sample is based on 127 exposure drafts issued between 1973 and 2006. *benchmark* is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants.

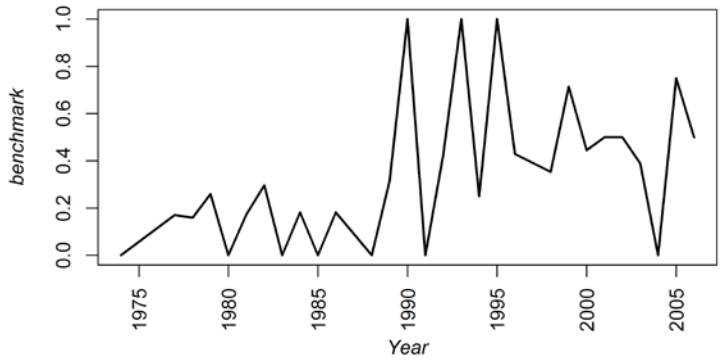

Figure 3:
Civil suits filed against Big N auditors
The sample is based on 127 exposure drafts issued between 1973 and 2006. *civil_lit* represents a count of all civil litigation cases filed against Big N auditors in the twelve months preceding a given exposure draft, scaled by the total number of Compustat firms audited by Big N auditors in those twelve months.

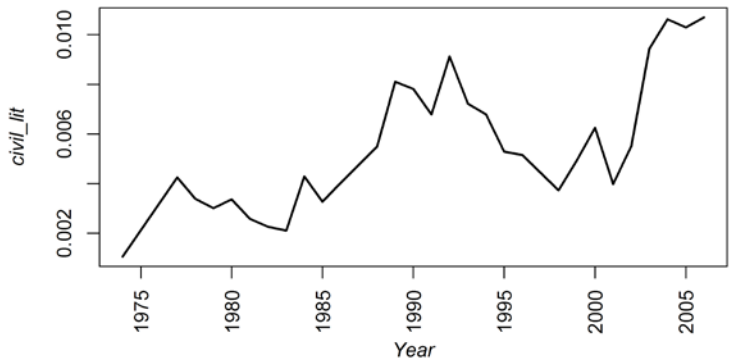

Figure 4:
SEC Auditing and Accounting Enforcement Releases
The sample is based on 127 exposure drafts issued between 1973 and 2006. *aaers* represents a count of auditing and accounting enforcement actions filed by the SEC in the twelve months preceding a given exposure draft, scaled by the total number Compustat firms in those twelve months.

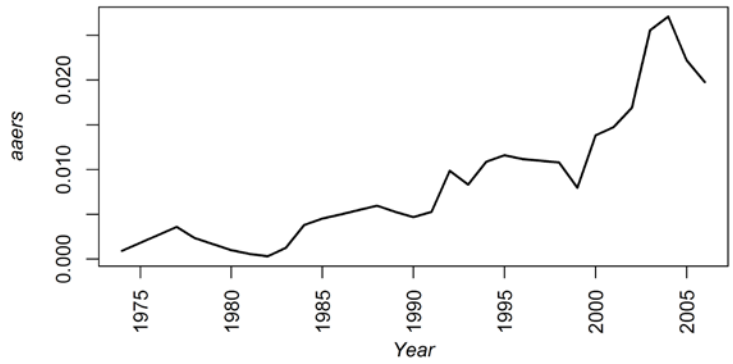

Figure 5:
Client preferences for flexibility

The sample is based on 127 exposure drafts issued between 1973 and 2006. *flexibility* is the first dimension of a principal component analysis of the following four variables, computed for each twelve-month period preceding a given exposure draft: the median total assets (normalized to 1973 dollars) of all firms that are clients of the Big N auditors; the median Tobin's q of such clients; the median operating cycle of such clients; and the median stock return volatility of such clients.

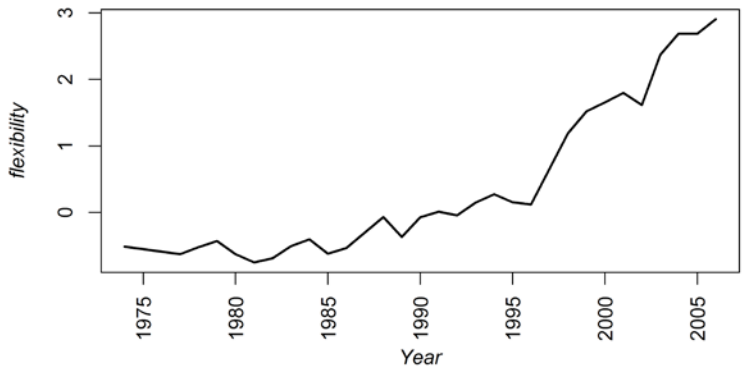

Figure 6:
Number of comment letters filed

The sample is based on 127 exposure drafts issued between 1973 and 2006. *num_letters* is the natural logarithm of the total number of comment letters filed on an exposure draft.

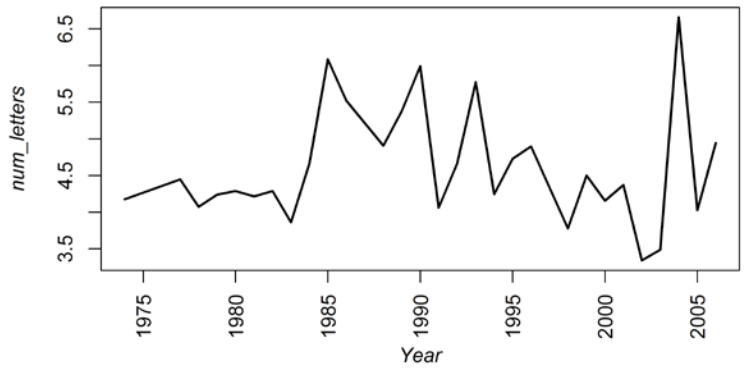

Figure 7:
Audit Fee Trends: 1980-1997
The sample is based voluntary disclosers of audit fee data in SEC filings from 1980-1997 as identified by Menon and Williams (2001). The sample is restricted to clients of Big 6 audit firms and average annual sample size is 74 clients.

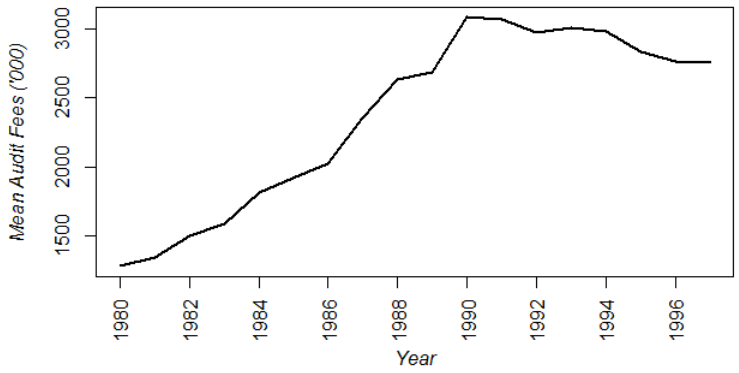

Figure 8:
Audit Fee Trends: 2000-2006
The sample is based on the universe of audit fee data available for clients of Big N audit firms from 2002-2006 as reported in Audit Analytics.

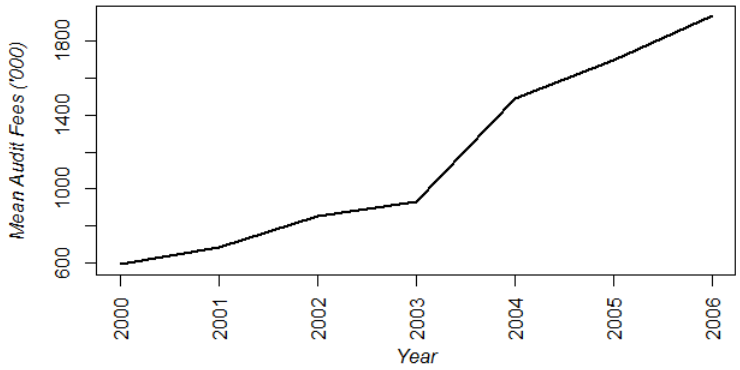

Table 1:
Description of the sample of Big N auditor comment letters and FASB exposure drafts

(A)	Number of exposure drafts leading to SFAS, 1973–2006	171
(B)	Less, exposure drafts with no comment letters by Big N auditors	22
(C)	Initial sample of exposure drafts with Big N comment letters	149
(D)	Number of Big N comment letters on exposure drafts in (C)	865
(E)	Exposure drafts in (C) unavailable for manual assessment by research assistants	22
(F)	Number of exposure drafts in the final sample	127
(G)	Number of comment letters in the final sample	737

Table 2:
Summary statistics for Big N auditor and benchmark assessments of decreased reliability
The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. *dec_relb_aud* is the auditors' assessment that a proposed standard will decrease accounting reliability. *benchmark* is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants.

Variable	*benchmark* value	n	Mean	Med	S.D.	Min	Max
dec_relb_aud	1	208	0.20	0.00	0.34	0.00	0.99
	0	529	0.03	0.00	0.14	0.00	0.98
	All	737	0.08	0.00	0.23	0.00	0.99

Table 3:
Descriptive statistics for independent variables

The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. *civil_lit* represents a count of all civil litigation cases filed against Big N auditors in the twelve months preceding a given exposure draft, scaled by the total number of Compustat firms audited by Big N auditors in those twelve months. *aaers* represents a count of auditing and accounting enforcement actions filed by the SEC in the twelve months preceding a given exposure draft, scaled by the total number Compustat firms in those twelve months. *flexibility* is the first dimension of a principal component analysis of the following four variables, computed for each twelve-month period preceding a given exposure draft: the median total assets (normalized to 1973 dollars) of all firms that are clients of the Big N auditors; the median Tobin's q of such clients; the median operating cycle of such clients; and the median stock return volatility of such clients. *industry_ED* is an indicator identifying industry-specific exposure drafts. *aud_specialization* is an indicator identifying industry-dependent Big N auditors lobbying on industry-specific standards. *num_letters* is the natural logarithm of the total number of comment letters filed on an exposure draft. *manual_inc_relv* is an indicator that takes the value one for exposure drafts determined by independent research assistants to increase the use of fair values. *pct_fin_fasb* is an exposure-draft-level measure of the proportion of extant FASB members with most-recent former employment in investment banking or investment management. Panel A provides summary statistics for our other independent variables. Panel B provides a correlation matrix with Pearson (Spearman) correlations above (below) the diagonal.

Panel A: Summary Statistics

Variable	n	Mean	S.D.	Min	25th	Med.	75th	Max
civil_lit	737	0.005	0.002	0.001	0.003	0.004	0.006	0.011
aaers	737	0.006	0.007	0.000	0.001	0.004	0.010	0.027
flexibility	737	0.000	1.000	-1.259	-0.633	-0.314	0.135	3.509
industry_ED	737	0.227	0.419	0.000	0.000	0.000	0.000	1.000
aud_specialization	737	0.085	0.280	0.000	0.000	0.000	0.000	1.000
*num_letters**	737	176.6	508.5	4.0	46.0	72	159	6536
manual_inc_relv	737	0.236	0.425	0.000	0.000	0.000	0.000	1.000
pct_fin_fasb	737	0.049	0.085	0.000	0.000	0.000	0.143	0.286

* For ease of interpretation, *num_letters* in this table is presented prior to the log transformation.

Table 3 (continued)

Panel B: Correlation Matrix

	Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1)	*dec_relb_aud*	1	0.34	0.27	0.27	-0	0.06	0.22	0.24	0.46	0.27
(2)	*benchmark*	0.33	1	0.26	0.25	-0	0.06	0.14	0.26	0.56	0.27
(3)	*civil_lit*	0.28	0.26	1	0.89	-0.1	0.05	0.16	0.69	0.46	0.56
(4)	*aaers*	0.29	0.25	0.8	1	-0.1	0.04	0.1	0.8	0.47	0.76
(5)	*flexibility*	0.01	-0	0.03	-0	1	0.56	-0.2	-0.1	0.02	-0
(6)	*industry_ed*	0.08	0.06	0.08	0.04	0.57	1	-0.1	0.03	0.08	0.06
(7)	*aud_specialization*	0.2	0.16	0.11	0.01	-0.3	-0.1	1	0	0.24	-0.1
(8)	*num_letters**	0.26	0.24	0.64	0.89	-0.1	-0	-0.1	1	0.5	0.88
(9)	*manual_inc_relv*	0.31	0.56	0.18	0.27	-0.1	-0	0.26	0.5	1	0.28
(10)	*pct_fin_fasb*	0.28	0.25	0.61	0.9	0.01	0.06	-0.1	0.88	0.28	1

Table 4:
Big N auditor lobbying to manage their expected litigation and regulatory costs

The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. The dependent variable, *dec_relb_aud*, is the auditors' assessment that a proposed standard will decrease accounting reliability. *benchmark* is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants. *civil_lit* represents a count of all civil litigation cases filed against Big N auditors in the twelve months preceding a given exposure draft, scaled by the total number of Compustat firms audited by Big N auditors in those twelve months. *aaers* represents a count of auditing and accounting enforcement actions filed by the SEC in the twelve months preceding a given exposure draft, scaled by the total number Compustat firms in those twelve months. The notations *** and ** denote statistical significance at the 1% and 5% levels, respectively, based on heteroskedastic cluster-robust standard errors.

	(1)		(2)		(3)	
civil_lit	-27.12				-36.11	**
*civil_lit*benchmark*	206.14	**			152.89	***
aaers			22.80	**	29.68	**
*aaers*benchmark*			99.15	**	80.07	**
Year fixed effects	Yes		Yes		Yes	
Year fixed effects * *benchmark*	Yes		Yes		Yes	
Std. errors cluster	ED		ED		ED	
N	737		737		737	
R-sq.	0.39		0.41		0.41	

Table 5:
Big N auditor lobbying to cater to clients' preferences for flexibility

The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. The dependent variable, *dec_relb_aud*, is the auditors' assessment that a proposed standard will decrease accounting reliability. *benchmark* is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants. *flexibility* is the first dimension of a principal component analysis of the following four variables, computed for each twelve-month period preceding a given exposure draft: the median total assets (normalized to 1973 dollars) of all firms that are clients of the Big N auditors; the median Tobin's q of such clients; the median operating cycle of such clients; and the median stock return volatility of such clients. *industry_ed* is an indicator identifying industry-specific exposure drafts. *aud_specialization* is an indicator identifying industry-dependent Big N auditors lobbying on industry-specific standards. *num_letters* is the natural logarithm of the total number of comment letters filed on an exposure draft. The notation ** denotes statistical significance at the 5% level, based on heteroskedastic cluster-robust standard errors.

	(1)		(2)		(3)		(4)	
flexibility	-0.049	**					-0.047	**
*flexibility*benchmark*	-0.115						-0.114	
industry_ed			-0.027				-0.005	
aud_specialization			0.080				0.068	
*aud_specialization*benchmark*			0.003				0.007	
num_letters					0.011		0.013	
*num_letters*benchmark*					0.095	**	0.098	**
Year fixed effects	Yes		Yes		Yes		Yes	
Year fixed effects * *benchmark*	Yes		Yes		Yes		Yes	
Std. errors cluster	ED		ED		ED		ED	
N	737		737		737		737	
R-sq.	0.39		0.41		0.41		0.39	

Table 6:
Consolidated analysis of Big N auditor lobbying

The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. The dependent variable, *dec_relb_aud*, is the auditors' assessment that a proposed standard will decrease accounting reliability. *benchmark* is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants. *civil_lit* represents a count of all civil litigation cases filed against Big N auditors in the twelve months preceding a given exposure draft, scaled by the total number of Compustat firms audited by Big N auditors in those twelve months. *aaers* represents a count of auditing and accounting enforcement actions filed by the SEC in the twelve months preceding a given exposure draft, scaled by the total number Compustat firms in those twelve months. *flexibility* is the first dimension of a principal component analysis of the following four variables, computed for each twelve-month period preceding a given exposure draft: the median total assets (normalized to 1973 dollars) of all firms that are clients of the Big N auditors; the median Tobin's q of such clients; the median operating cycle of such clients; and the median stock return volatility of such clients. *industry_ed* is an indicator identifying industry-specific exposure drafts. *aud_specialization* is an indicator identifying industry-dependent Big N auditors lobbying on industry-specific standards. *num_letters* is the natural logarithm of the total number of comment letters filed on an exposure draft. *manual_inc_relv* is an indicator that takes the value one for exposure drafts determined by independent research assistants to increase the use of fair values. *pct_fin_fasb* is an exposure-draft-level measure of the proportion of extant FASB members with most-recent former employment in investment banking or investment management. The notations ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively, based on heteroskedastic cluster-robust standard errors.

	(1)		(2)		(3)	
civil_lit	-43.51	***	-42.576	***	-43.630	***
*civil_lit*benchmark*	120.30	**	122.352	**	128.209	**
aaers	14.92		14.595		14.102	
*aaers*benchmark*	98.55	***	97.251	***	96.883	***
flexibility	-0.048	**	-0.015		-0.018	
*flexibility*benchmark*	-0.121		-0.129		-0.114	
industry_ed	-0.002		-0.003		-0.001	
aud_specialization	0.069		0.075		0.069	
*aud_specialization*benchmark*	-0.005		-0.012		-0.014	
num_letters	-0.013		-0.011		-0.012	
*num_letters*benchmark*	0.060		0.058		0.057	
manual_inc_relv	0.212	***	0.210	***	0.215	***
*manual_inc_relv*benchmark*	-0.221	*	-0.217	*	-0.219	*
pct_fin_fasb	0.270		0.344		0.394	
*pct_fin_fasb*benchmark*	-2.910	***	-2.976	***	-3.030	***
Year_FE	Yes		Yes		Yes	
*Year_FE*benchmark*	Yes		Yes		Yes	
Audit firm fixed effects	No		5 firms		11 firms	
SE Cluster	ED		ED		ED	
N	737		737		737	
R-sq	0.47		0.47		0.49	

Table 7:
t-tests of linear combinations of coefficients from Tables 4-6

The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. Columns (1) – (3) present t-tests on linear combination of coefficients estimated in Tables 4-6 respectively. The dependent variable, *dec_relb_aud*, in Tables 4-6 is the auditors' assessment that a proposed standard will decrease accounting reliability. *benchmark* is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants. *civil_lit* represents a count of all civil litigation cases filed against Big N auditors in the twelve months preceding a given exposure draft, scaled by the total number of Compustat firms audited by Big N auditors in those twelve months. *aaers* represents a count of auditing and accounting enforcement actions filed by the SEC in the twelve months preceding a given exposure draft, scaled by the total number Compustat firms in those twelve months. *flexibility* is the first dimension of a principal component analysis of the following four variables, computed for each twelve-month period preceding a given exposure draft: the median total assets (normalized to 1973 dollars) of all firms that are clients of the Big N auditors; the median Tobin's q of such clients; the median operating cycle of such clients; and the median stock return volatility of such clients. *industry_ed* is an indicator identifying industry-specific exposure drafts. *aud_specialization* is an indicator identifying industry-dependent Big N auditors lobbying on industry-specific standards. *num_letters* is the natural logarithm of the total number of comment letters filed on an exposure draft. The notations ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively, for a two-tailed test based on heteroskedastic cluster-robust standard errors.

t-Test for linear combination of coefficients on:	(1)		(2)		(3)	
*civil_lit + civil_lit*benchmark*	116.777	**			84.579	
*aaer + aaer*benchmark*	109.752	***			110.985	***
*flexibility + flexibillity*benchmark*			-0.161	*	-0.132	
*industry_ed + aud_specialization + aud_specialization*benchmark*			0.070		0.054	
*num_letters + num_letters*benchmark*			0.111	***	0.045	
Table Reference	Table 4		Table 5		Table 6	
Column Reference	3		4		3	

Table 8:
Big N auditor lobbying across different litigation eras

The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. The dependent variable, *dec_relb_aud*, is the auditors' assessment that a proposed standard will decrease accounting reliability. The primary independent variable, *benchmark*, is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants. Era-average coefficients and heteroskedastic robust standard errors are obtained using a linear combination of annual values as detailed in Section 4.3. The notations *** and ** denote statistical significance at the 1% and 5% levels, respectively.

PANEL A:

Auditor litigation era			Foreseeability		Known users		SOX	
Near - Privity, 1973–1982	-0.03		0.34	***	0.22	***	0.39	***
Foreseeability, 1983–1991	0.31	***			-0.12	***	0.05	
Known users, 1992–2002	0.19	***					0.17	**
SOX, 2003–2006	0.36	***						
	(1)		(2)		(3)		(4)	

PANEL B:

Auditor litigation era			Foreseeability		Known users		SOX	
Baseline, 1973–1987	0.04		0.31	***	0.14	***	0.32	***
Basic v. Levinson, 1988–1993	0.35	***			-0.16	**	0.01	
Central Bank v. Denver & PSLRA, 1992–2002	0.18	***					0.18	**
SOX, 2003–2006	0.36	***						
	(1)		(2)		(3)		(4)	

Table 9:
Big N auditor lobbying across different oligopoly eras

The sample is based on 737 Big N auditor comment letters on 127 distinct exposure drafts issued between 1973 and 2006. The dependent variable, *dec_relb_aud*, is the auditors' assessment that a proposed standard will decrease accounting reliability. The primary independent variable, *benchmark*, is an assessment that a proposed standard will decrease accounting reliability determined by two seasoned, independent research assistants. Era-average coefficients and heteroskedastic robust standard errors are obtained using a linear combination of annual values as detailed in Section 4.3. The notations *** and * denote statistical significance at the 1% and 10% levels, respectively.

Big N oligopoly era		Big 6	Big5	Big4
Big 8, 1973–1989	0.09 ***	0.06	0.15 ***	0.27 ***
Big 6, 1990–1998	0.14 ***		0.09 *	0.22 ***
Big 5, 1999–2002	0.24 ***			0.12 *
Big 4, 2003–2006	0.36 ***			
	(1)	(2)	(3)	(4)