Audit Partner Disclosure: Potential Implications for Investor Reaction and Auditor Independence

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ABSTRACT

We explore potential, unanticipated, effects of a proposed PCAOB standard that would require disclosure of the external audit partner’s identity in the audit report (2011). Proponents of the standard contend that partner disclosure will increase information transparency and audit partner accountability, both of which are expected to lead to improved audit quality and investor protection. We use existing research to examine how investors (and others) might react to partner disclosure and explore potential ramifications for audit partners’ incentives and independence. More specifically, we propose that: (1) partner name disclosure will result in a fusing of the individual partner’s reputation with the audit client; (2) this reputation fusing may shift partners’ (real or perceived) incentive structures; and, (3) an incentive structure shift has implications for audit partner independence, which affects audit, and financial reporting, quality. We present experimental evidence to test our first proposition – i.e., partner disclosure will result in a fusing of partner reputation to the client. Specifically, we use an incomplete 2 x 2 between-participants design in which we manipulate partner disclosure as present or absent. We also manipulate whether the audit report was modified in a way that is intended to reduce investor reaction to partner disclosure. We present experienced investor participants with summary information on several investment options within the same industry (some of which also share the same audit firm). As predicted, we find that investors are less likely to invest in (and allocate resources to) a peer firm linked to a restating firm via partner disclosure than when there is no disclosure. Contrary to our expectation, the audit report modification language does not appear to alleviate this effect. We perform additional analyses to examine why, and which types of, investors appear to react to partner disclosure in this way. Finally, we provide conclusions that should be of interest to academics, investors, regulators, auditors, and others interested in exploring potential ramifications of mandating audit partner disclosure.
1. **Introduction**

The PCAOB recently issued two successive concept releases which seek feedback on a proposal that would require audit partner identity disclosure in the standard audit report (hereafter, “partner disclosure”) (PCAOB [2008, 2009, 2011]). The purpose of this study is to examine whether such disclosure might have unanticipated implications for audit partner independence. To this end, we consider whether the way investors (and others) are likely to react to and use partner disclosure might have implications for audit partners’ motivation and incentives. Finally, we contend that a shift in audit partners’ incentive structure is likely to have implications for audit partner independence, and therefore, audit and financial statement quality.

The motivation behind the proposed standard is to increase transparency and audit partner accountability (which is expected to result in increased audit quality). The increase in accountability is expected to occur both as a direct result of the act of signing and as an indirect result of increased transparency (ACAP [2008], PCAOB [2008, 2009, 2011]). In other words, if the audit partner’s identity is easily and publicly available, then interested parties (e.g., regulators, investors, analysts, academics) can use the information in order to attempt to evaluate individual partner behavior. Based on a review of the comment letters posted in response to the proposal, investors and investor groups generally support the idea and welcome the opportunity to investigate the experience and “track record” of individual audit partners (PCAOB [2011]). Public accounting organizations and firms claim that the proposed requirement will *not* increase partners’ sense of accountability (i.e., they argue it is already at a maximum level). They also express strong concerns related to audit partner

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1 According to the podcast of the Standing Advisory Group (SAG) meeting (available at [http://pcaobus.org/News/Webcasts/Pages/10112011_OpenBoardMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/10112011_OpenBoardMeeting.aspx)), the audit partner is typically available to answer questions from shareholders at the annual shareholders meeting (and thus, partner identity is ascertainable to shareholders). This meeting, however, is not usually well attended. In addition, while shareholders may be able to ascertain the identity of the audit partner who audits the particular company in which they invest, they will not have knowledge of the rest of that partner’s profile and, therefore, would have little on which to base judgments regarding the partner’s ability or reputation.
exposure to increased legal liability and to risk of personal damage (e.g., from disgruntled shareholders). Further, they express concern that third parties will collect the information in order to make ill-informed inferences about audit quality (PCAOB [2011]). Academics who have commented on the proposal, have generally noted the potential positive effects of increased accountability and transparency; however, a few caution that the requirement may lead to incorrect inferences being drawn about audit quality and that existing research is not clear as to whether the proposed requirement would, in fact, enhance audit quality (PCAOB [2011]).

We draw from existing literature to provide a model that suggests one course along which partner disclosure might not, in fact, result in enhanced audit quality. First, we contend that partner disclosure will lead to a fusing of the audit client’s and audit partner’s reputations. That is, we predict that information about each audit client will bind, or affix, to the individual audit partner in such a way that parties external to the auditor/client-management relationship (e.g., academics, regulators, investors) will use the identity of the audit partner as a proxy, or heuristic, to make inferences about the quality of a particular audit partner and/or a particular audit engagement.

Second, we suggest that this may result in audit partners being held accountable, to external parties, based on metrics that do not necessarily reflect audit quality or individual partner performance. That is, defining and measuring audit quality is complex (Francis [2004]). Measures, or proxies, that are most readily available to external parties are likely to be very highly correlated with measures currently used to assess CEO/client management performance. Thus, we argue, if external parties begin to hold audit partners accountable for their performance, based on the same (or similar) measures used to hold the CEO/client management accountable for performance (e.g., EPS, earnings forecasts, etc.), we expect this to shift audit partner incentives so that they are more closely aligned with those of management (as opposed to those of shareholders and other stakeholders).
Third, aligning partner incentives more closely with management performance is likely to impair audit partner independence. For example, consider the context of an obvious departure from GAAP that results in a material and objective income-increasing financial statement misstatement. In such a situation, we agree that partner identity disclosure is likely to have its intended effect on a partner’s decision of how much time, effort, and client-relationship capital to devote to pursuing correction. That is, a partner will likely determine that the potential negative reputation costs of being associated with an audit failure will outweigh the potential negative reputation costs incurred by being associated with a client who may, for example, underperform market expectations. Therefore, the partner will likely incur the cost of further investigation, and/or a potential straining of the relationship with the client, in order to protect against audit failure.

However, oftentimes an audit partner is faced with a situation in which the course of action is less clear. For instance, a partner may have to use sensitive judgment in deciding whether to seek additional evidence related to a potential material misstatement due to “aggressive accounting practices” (c.f., GAO [2002]), or how to interpret the qualitative aspects of a known error that is quantitatively immaterial (Messier et al. [2011]). We contend that if the reward/incentive structures that partners face are not calibrated well enough to reflect the use of due diligence and professional skepticism, partners will be confronted with a different conflict of interest than in the current audit environment. Partners will be forced to weigh the implications of the transfer of negative information/news (from the current engagement) to his or her own reputation and client portfolio.

Following the development of our model, we further motivate, and present results of an incomplete 2 x 2 between-participants experiment designed to test the first proposition in our model: that partner disclosure will lead to the fusing of the partner’s reputation with that of the audit client. More specifically, we examine whether investors consider information about one company (i.e., the
existence of a restatement) when making investment decisions related to a peer company known to have the same audit partner as the former company. We manipulate whether the audit partner’s identity is disclosed and whether the audit report is altered in such a way that might be expected to reduce partner-based information transfer.\(^2\) We predict and find that investors are less likely to invest in, and that they allocate fewer resources to, a peer firm (linked to a restating firm) in the presence of partner disclosure than when partner identity is not disclosed. Contrary to our expectations, modifying the audit report does not appear to reduce partner-based accounting information transfer.

To further explore investor judgments related to partner disclosure, we perform two supplementary analyses. First, we find that the impact of partner disclosure is partially mediated by investors’ perception of the likelihood that the peer firm will experience a restatement in the future. Based on this, we conclude that our results may be partially due to investor use of the representativeness heuristic. Representativeness refers to a “rule of thumb” whereby a person ignores base rates (e.g., the frequency with which firms experience restatements) and determines the probability that a specific object (e.g., the peer firm) is stereotypical of other known members of a class (e.g., the class of restating firms) based on the degree to which that object is similar to other known members of this class (e.g., the restating firm) (Tversky and Kahneman [1984], Tversky and Kahneman [1974]). In other words, we provide evidence that, within the partner disclosure condition, investors are less likely to invest in the peer firm due to the increased number and specificity of links between the peer and restating firms. Second, we find that the judgments and decisions of investors

\(^2\) Our variable selection results in an incomplete design. We exclude the condition in which there is a report modification but no partner disclosure. In addition, we note that the PCAOB has issued a concept release that proposes changes to the auditor reporting model (Docket 034, Release No. 2011-003). If regulators determine that the benefits of partner disclosure outweigh its risks and proceed with the requirement, the PCAOB may wish to consider requiring disclosures, within the audit report, such that a reasonable user would have information that might be more useful in assessing the partner’s use of professional judgment, due diligence, and adherence to professional and regulatory standards.
who report having \textit{work-related} experience preparing or analyzing financial information do not appear to be influenced by partner disclosure. This suggests there is the potential that investor groups will be differentially affected by issuance of the standard.\footnote{The primacy of protecting unsophisticated investors has been, historically, preserved and ingrained in U.S.-based regulation ranging from the Securities Acts of 1933 and 1934, Regulation FD, and the Dodd-Frank Act (Kang [2012]). See Kang [2012] for a more thorough discussion.}

We contribute to the literature in several ways. First, we examine whether the PCAOB’s proposed standard might have unintentional, potentially negative, implications for audit partner independence. This evidence should be of use to the PCAOB in their current standard-setting process, other regulatory bodies tasked with considering the consequences of similar regulation in the future, audit firms seeking to identify ramifications of the proposed requirement, and others interested in auditor independence, audit quality, and investor protection. Second, we provide initial, direct evidence to experimentally examine the impact of partner disclosure on investor decision making. Third, we provide a framework that might be useful for future researchers interested in exploring additional positive and negative implications of partner disclosure.

The remainder of our paper is organized as follows. We further explore the background of the proposed concept release and propose our model in Section 2. In Section 3 we review the relevant literature and motivate hypotheses for our experiment. We describe the methods and results of our experiment in Sections 4 and 5. Finally, we offer conclusions and discuss implications, limitations, and suggestions for future research in Section 6.
2. Background and Model

2.1 PCAOB CONCEPT RELEASE AND COMMENT LETTERS

Our paper is motivated by a concept release issued by the PCAOB in July of 2009, readdressed in October of 2011, which proposes that audit engagement partners should sign their names to the audit report, in addition to their audit firms’ names (PCAOB [2009]). The PCAOB originally issued the concept release as a response to a recommendation by the Advisory Committee on the Audit Profession (ACAP [2008], PCAOB [2008, 2009, 2011]). The ACAP report expressed the committee’s belief that such a requirement would increase accountability and transparency (ACAP [2008]). The PCAOB’s concept release also expressed an expectation that the act of signing the report may increase the audit partner’s sense of personal accountability, which should have a positive effect on partner behavior, and presumably, audit quality (PCAOB [2009]). The PCAOB contends that the requirement will provide useful information to investors and that disclosing the information will be an additional incentive for firms to improve engagement partner, and audit, quality.4

Investors and investor groups who commented on the original release generally supported the idea, and agreed that the amendment would enhance accountability and transparency. Supporters referred to academic research that suggests accountability reduces auditor bias in information processing, enhances consensus and effort, and improves audit quality (e.g., DeZoort et al. [2006], Kennedy [1993], Johnson and Kaplan [1991]). Investor groups also welcome the opportunity to investigate the experience and “track record” of particular engagement partners due to such increased transparency. For example, the Council of Institutional Investors stated, “Armed with valuable

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4 In the 2011 release, the PCAOB also seeks comment regarding whether to amend current standards to require disclosure of (a) the name of the engagement partner, and (b) other independent public accounting firms or other persons who took part in the audit (PCAOB [2011]). In this study, we focus solely on the proposed disclosure of audit partner identity.
information provided by the lead auditor’s signature, investors and boards will demand skilled engagement partners… By more explicitly tying the lead auditor’s professional reputation to audit quality, requiring the engagement partners to sign the audit report will further result in better supervision of the audit team and the entire audit process” (PCAOB [2011]).

Public accounting firms and organizations (e.g., New York State Society of Public Accountants, California Society of Certified Public Accountants) assert that an audit partner signature requirement will not increase accountability because existing factors (e.g., the firm’s quality control system, regulatory requirements, and potential litigation costs) already induce a sufficiently strong sense of accountability in lead engagement partners (PCAOB [2011]). Detractors of the amendment express concerns that enhanced transparency will increase partners’ potential legal liability and exposure to personal risk from disgruntled shareholders and/or the public. They also voice concern that third parties will collect engagement statistics in order to make inferences about audit quality. For example, Ernst and Young (EY) argue that:

The general public does not have access to information to allow them to make informed judgments as to the significance of the audit partner's association with the company with financial reporting difficulties, whether actual, alleged, or rumored… If a partner is repeatedly tasked with handling the toughest of audit engagements, the public may gain an inaccurate impression of the partner due to a perception of guilt-by-association with companies with financial reporting difficulties (EY [2009]).

Some accounting researchers support the concern that the amendment could lead to incorrect inferences about a given partner’s audit quality (PCAOB [2011]). Specifically, they acknowledge the positive effects of increased transparency and tend to agree that personal accountability effects would be positive; however, they caution that existing research is not clear as to whether the proposed

See http://pcaobus.org/Rules/Rulemaking/Pages/Docket029Comments.aspx for all of the comment letters related to the 2009 concept release (the comment period related to the 2011 concept release was open through January 9, 2012). We note that this sentiment assumes the premise that “investors and boards” will be able to accurately assess audit quality.
requirement would enhance audit quality (PCAOB [2008, 2011]). In sum, based on respondents’ comments, it does not appear that opponents of the regulation dispute the idea that audit partner disclosure might lead to an increase in an audit partner’s sense of personal accountability. However, it is unclear, as the PCAOB also inquires, whether “… disclosure of engagement partner’s name in the audit report [will] enhance investor protection?” (PCAOB [2011]).

Toward this end, we develop a model aimed at more directly exploring audit independence, audit quality, and investor protection ramifications of partner disclosure. Our model provides a framework to show, theoretically, how partner identity disclosure might lead to audit partner independence impairment. Drawing from prior literature, our three-proposition model (presented in Figure 1) contends that partner disclosure will (1) lead to a fusing of partners’ reputations to their audit clients, (2) which will affect partners’ motivations and incentives, so that, in some circumstances, they may be more closely aligned with management, and, (3) this may impair the independence of the audit partner.

[Please insert Figure 1 about here]

2.2 MODEL

2.2.1. Proposition 1: Partner Identity Disclosure will Fuse Partner Reputation with the Client. The increased accountability that is expected to result from partner disclosure is, at least in large part, likely to be a result of public scrutiny – that is, the increased sense of accountability that audit partners are expected to feel is, specifically, accountability toward external parties (i.e., outside

6 While the PCAOB has discussed several potential consequences to disclosing the name of the engagement partner (e.g., litigation concerns), to date there has been little to no discussion of potential independence concerns. It is interesting to note that a search of the SAG transcripts for mentions of independence implications elicits only one – an audit partner arguing that concurring review partners should be shielded from name disclosure because, “Concurring reviews in our firm – we want to keep those people insulated really, a higher level of independence than what the -- an engagement partner operates at” (PCAOB [2008] p. 126). This suggests there may be an unexpressed and unevaluated intuitive concern among interested parties regarding potential negative independence implications of identity disclosure.
of the auditor/client management relationship). While it may be that audit partners should be held accountable to such parties, the fact remains that the public does not have measures available that are calibrated enough to adequately assess audit quality (Francis [2004]), except, perhaps in cases of extreme audit failure (i.e., discovery proceedings). In other words, due to the boilerplate language used in audit reports, audit partners could be faced with the unprecedented pressure of being held accountable, by name, to parties without detailed confidential client/audit information. Presumably, this information would be necessary to accurately judge partners’ adherence to professional and regulatory standards during the performance of their audits. Lacking the information necessary to accurately assess partner performance, external parties are likely to evaluate and judge audit partners according to metrics (hereafter, “external measures”) that may be misleading with regard to whether a partner applied professional judgment and adhered to professional standards and regulations on a particular audit. It is likely that partner performance, as gauged against such external measures, will directly affect audit firm staffing decisions. For example, in the debate surrounding the proposal, it is freely acknowledged and expected that audit committees and investors may request, or even demand (directly, and indirectly through investment decisions), the assignment of specific engagement partners based on their assessment of partners’ reputations (PCAOB [2011]).

As noted earlier, both audit firms and academics have expressed apprehension that partner disclosure could result in incorrect inferences concerning individual partners’ performance; however,

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7 Audits offer reasonable assurance that the financial statements are free of material misstatements as absolute assurance is cost prohibitive (Messier et al. [2011]). It is possible that a partner may conduct an audit with professional skepticism and due care, in accordance with Generally Accepted Auditing Standards (GAAS), yet that audit client could still experience an event that is perceived negatively by investors (which could affect their opinion of the engagement partner’s reputation).

8 This is in contrast to those to whom the audit partner is currently held accountable. That is, the client, the audit committee, and legal and regulatory bodies would have access to the detailed confidential auditor and client information necessary to evaluate a partner’s performance on a specific audit.
they do not elaborate upon how that concern might impact audit quality (PCAOB [2008, 2011]).

Existing archival/markets-based research provides theory which suggests one way in which an increased fusing of the auditor/client relationship may manifest. Specifically, the theory of “accounting information transfer” (c.f., Gleason et al. [2008]) suggests that information, or news, about one reporting entity (e.g., an accounting restatement, a going concern opinion) can affect investors’ reactions to different reporting entities with similar characteristics. For example, Schaub [2006] observes accounting information transfer based on shared external audit firms, and Chen and Goh [2010] observe accounting information transfer based on common directors. Thus, one meaningful way in which investors may react to inferences they draw (based on partner disclosure) is through their investment decisions regarding other, peer, firms that are audited by the same partner.

One potential explanation for this type of “contagious” transfer of information is investor use of the representativeness heuristic. Kahneman [2011] describes use of this heuristic as, “The question about probability (likelihood) was difficult, but the question about similarity was easier, and it was answered instead.” In other words, some investors may heuristically process the disclosure because they find it easier to simply assume that reporting entities with similar characteristics (e.g., those with the same partner) are all members of the same class (e.g., restating firms). In general, the more salient the link, the more a decision maker will assume that the two entities share similar qualities. Thus, both the accounting information transfer, and the representativeness heuristic, streams of literature suggest that partner disclosure will increase partner-based information transfer of

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9 Additional studies can explore other ways in which inferences by external parties may affect audit quality. For example, audit committee members may avoid audit partners who would otherwise be a good fit; or, an increase in public scrutiny may reduce the attractiveness of public accounting as a career path.

10 Use of this heuristic has traditionally been attributed to biased decision making, (e.g., insensitivity to base rates, sample size, and predictability; Tversky and Kahneman [1974]). However, more recent literature suggests that such “fast-and-frugal” decision rules can be rational and sometimes lead to equal or better performance than more systematic weighting of options (Gigerenzer and Goldstein [1996], Read and Grushka-Cockayne [2011]).
information. Partner-based transfer of information, we argue, is preliminary evidence of the fusing of the partner’s reputation with the audit client.

2.2.2. Proposition 2: The Fusing of Partner Reputation with the Client may Result in a Shift of Audit Partner Incentives. We expect the fusing of the audit partner’s and audit client’s reputations to result in the collection of ill-informed measures of audit quality (e.g., a partner’s “track record”), which is likely to increase the prominence of individual audit partner’s motivation to maintain his or her own professional reputation and individual self-interests. In addition to external reputation concerns, partners may even fair worse on performance measures used internally by audit firms (e.g., billable hours, client load, and business development), if they are unable to maintain their client load due reputation concerns held by external parties. For example, as EY [2009] expressed, if a partner is repeatedly tasked with handling the toughest of audit engagements, the public may form an inaccurate opinion of the partner due to a perception of guilt-by-association. Partners in situations such as these might not be considered “in demand” based on investor/audit committee requests, and will have difficulty maintaining their portfolio of clients. Baker and Hall [1988] contend that compensation incentives determine a large extent of individual behavior within an organization. If these external measures affect audit firm’s internal measures (or, individual partners perceive that they do), it is likely that the partner disclosure will result in a shift in partners’ incentives.

In fact, it may be that some external parties evaluate audit partner performance using the same measures as they use in assessing CEO/management performance (in which case, partner and client management incentives would be perfectly aligned, at least with respect to performance on these measures). For example, academics use archival data to create diverse external measures, such as discretionary accruals, restatements, auditor size, issuance of qualified audit opinions, auditor litigation, and earnings benchmarks, to proxy for audit quality (Caramanis and Lennox [2008],
Kinney et al. [2004], Krishnan [2003], Myers et al. [2003], Francis and Krishnan [1999], Becker et al. [1998]). Further, many of these same measures are also used in academic research to make inferences about financial statement/earnings quality and/or to make inferences about CEO performance (e.g., Jones [1991], Bartov et al. [2000], Desai et al. [2006], Bergstresser and Philippon [2006], Cheng and Farber [2008]). If audit partners are motivated to achieve many of the same goals as management, in order to protect their client portfolio then partner disclosure may result in the audit partner’s immediate, short-term, incentives being more closely aligned with client management’s.

2.2.3. Proposition 3: Audit Partner Incentive Structure and Independence. It is generally accepted that the auditor’s role in financial reporting is to reduce information risk that arises from the combination of conflicting incentives and information asymmetry that exists between management and shareholders (Messier et al. [2011]). Further, professional standards require auditors to be independent of management, in both fact and appearance, and stipulate that auditors should not have incentives that conflict with shareholders (Messier et al. [2011]). For example, in an environment where the partner’s identity is disclosed, a financial statement restatement is likely to have negative reputational effects for both the restating client and the individual audit partner. However, as discussed above, we contend that within the context of the current auditor reporting model, increasing the prominence of the individual audit partner’s professional reputation may lead to situations in which the audit partner’s incentives are more aligned with client management than with the firm,

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11 We do not wish to suggest such proxies are not good for large sample, academic research for making cautious generalizations about audit quality (as they are typically used in academic research). We simply suggest such measures may be less appropriate for examining the extent to which a particular audit partner adhered to professional standards.

12 In fact, it is reasonable to assume that an auditor may most strongly perceive the pressures of his/her externally evaluated reputation when faced with forming an opinion that requires the more sensitive audit judgment (e.g., evaluating a qualitative materiality of a misstatement). In other words, in situations where it is most desirable that the auditor acts in a professionally skeptical manner, he or she may, instead, engage in motivated reasoning in order to come to a desired conclusion (i.e., one that might have less negative shorter-horizon reputational costs).
shareholders, and other stakeholders. This increased prominence, combined with an aligning of partner incentives more closely with management, may give an implied permission for partners to act in their own self-interests (Hunton et al. [2011]). Thus, the partners may be faced with a new conflict of interest when deciding, for example, how much time and effort to spend critically assessing management’s assertions. This may even encourage auditors to act in a way that is motivated by a desire to protect their own reputations, at the cost of audit quality.

3. Testing Audit Partner Identity Disclosure and Partner-Based Information Transfer

We conduct an experiment to test whether partner disclosure will result in partner-based information transfer, which, we contend, provides evidence that the disclosure will result in a fusing of the reputation of the audit partner to the client. Specifically, the purpose of our experiment is to examine whether investors will make inferences about a partner (based on specifics of one engagement) that may “transfer” with the partner to other engagements (and/or future opportunities). That is, we examine whether investors are less likely to invest in a peer firm linked to a restating firm via shared audit partner than when the partner identity is not known (though other inter-firm links are known). We choose financial statement restatements as the context within which to test whether partner disclosure will lead to partner-based information transfer because, while they are generally perceived negatively, there are many circumstances in which a company may be required to restate their financial statements even when the auditor performed the audit with due professional care.\(^{13}\) Investors, however, generally react negatively to financial statement restatements (Gleason et al. [2008]). As noted previously, it is precisely in such situations that the largest concern exists for partners to be motivated to act in their own immediate, shorter-term, self-interests (e.g., to avoid the

\(^{13}\) For example, some restatements arise due to a voluntary or mandated change in accounting principle or a change in accounting estimate (Turner and Weirich [2006]).
reputational effects of a negatively perceived event). We test only the first proposition of our model due to timeliness / parsimony concerns and because understanding the type and source of client/partner reputation fusing that might result from partner disclosure is imperative for exploring its’ potential consequences.

3.1 ACCOUNTING INFORMATION TRANSFER AND REPRESENTATIVENESS

As stated previously, existing research refers to a phenomenon in which negative information about one reporting entity leads investors to alter their assessments about a different reporting entity with similar characteristics or qualities as accounting information transfer (Schaub [2006], Gleason et al. [2008]). For example, Gleason et al. [2008] find that accounting restatements induce a share price decline for non-restating “peer” firms linked to a restating firm via the same industry. They also find that shared audit firms can induce accounting information transfer. That is, they find a larger effect on the stock price of peer firms (with high earnings and high accruals) when peer firms are linked to a restating firm by way of the same external auditor than when they are not so specifically linked.

Further, Huang and Li [2009] find that companies audited by Arthur Andersen’s Houston office experienced negative stock price effects following news reports of workpaper shredding, and Weber et al. [2008] find that audit clients of KPMG Germany experienced negative market effects after a highly publicized accounting scandal. There is also evidence to suggest that accounting information transfer may manifest when firms are linked through an individual person. For example, Chen and Goh [2010] find a contagion effect through common directorships. That is, they find

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14 Existence of accounting information transfer does not necessarily represent a cognitive bias as, some argue, the contagious information may have diagnostic value. For example, Schaub [2006] argues that going concern opinion announcements result in negative stock price adjustments to firms in the same industry and concludes that market participants interpret the information provided by the audit opinion as an industry-wide problem.
negative abnormal returns, following the date of the restatement, for companies that share a director with a restating firm.

As discussed in Section 2, the representativeness heuristic may help to explain why investors allow negative information from one company to affect their investment decisions related to a (sometimes cursorily) linked company. That is, the more salient the link (e.g., same engagement partner compared to same audit firm), the more representative the object in question will appear to a decision maker. Thus, based on accounting information theory, and the potential for investors to use the representativeness heuristic, we predict that peer entities will experience partner-based “contagion” or “spillover” effects based on information related to a linked firm. That is, we expect fewer investors to invest in a peer firm linked to a restating firm when it is known that one of the links between the firms is a shared audit partner. We formally state our hypothesis, at the construal level, as follows:

$H1$: Audit partner identity disclosure will result in partner-based (reputational) information transfer between reporting entities.

3.2 MODIFYING THE AUDIT REPORT TO MITIGATE PARTNER-BASED INFORMATION TRANSFER

In the first concept release related to audit partner identity disclosure, the PCAOB [2009] requests commenters to respond with their opinion on the following, “Would requiring the engagement partner to sign the audit report make other changes to the standard audit report necessary?” Both the PCAOB and members of the PCAOB standing advisory group note that a partner signing the audit firm’s signature is considered evidence that the audit report is a product of the firm, and that the firm as a whole stands behind the report (PCAOB [2008, 2009]). Identifying the specific partner on the audit report might undermine investors’ understanding that the audit opinion, contained within the report, is a product of the firm as a whole.
Gigerenzer and Goldstein [1996] suggest that the representativeness heuristic is relied on more heavily when people make decisions with limited knowledge. Accordingly, reminding investors that the audit is a product of the firm and not simply an individual audit partner, has the potential to increase investors’ contextual knowledge of the audit process, thereby limiting the use of heuristics in their decision making. A modification of the audit report (in which the partner’s identity is disclosed), reminding readers that the audit report is a product of the firm, as a whole, might reduce partner-based information transfer.¹⁵ That is, we expect an audit report modification to cause investors’ decisions, in the presence of partner disclosure, to converge toward those without audit partner identity information. We propose the following hypotheses:

\( H2: \) Modifying the audit report with language intended to highlight the audit firm’s responsibility for the audit will reduce the amount of partner-based (reputational) information transfer resulting from audit partner identity disclosure.

4. Method

4.1 Participants

Three hundred and eighty individuals with investment experience participated in the study. We initially recruited participants through personal contacts of groups known to have investing experience (e.g., the National Association of Investors Corporation); however, we obtained the majority of our participants (approximately 88 percent) using Qualtrics – a survey software and research firm.¹⁶ Qualtrics contacted potential participants using a selection procedure that ensured participants’ demographic information was representative of the US population as a whole (as

¹⁵ Comments in response to the first concept release indicate audit firms were opposed to this type of modification on the grounds that it would only serve to emphasize or highlight the presence of the partner’s name.

¹⁶ Participant type was randomly distributed across conditions (\( p > 0.83 \)). Whether we include participant type as a control variable does not affect results. However, due to numerous differences in the method of identification and contact of participants, we control for participant type in all reported results.
determined by the most recent US census data) and allowed for matching on selectable criteria (Anagol and Gamble [2011], Wright and Carlucci [2011]). Our selection criteria required participants to be college graduates over the age of 25, who were not CPAs, and who had experience actively trading individual shares of stocks or bonds (i.e., 401k and/or mutual fund investing experience was not sufficient). ¹⁷ Our average participant was approximately 48 years-old, and had over four years of work experience preparing or analyzing financial information. Approximately 52 percent of respondents were female. Each demographic measure was randomly distributed across conditions (all $p’s \geq 0.74$). Results are robust to the inclusion of the demographic measures as controls.

4.2 TASK AND PROCEDURE

We created our experimental instrument based on Kida et al. [1998]. First, we instructed participants that they would be asked to review and provide their opinions of five hypothetical companies for long-term investment purposes. We also informed participants that they would be provided with performance measures based on each company’s most recent audited annual financial statements. ¹⁸ Finally, we noted that each company was publicly traded, within the same industry, located in the same region, and had received an unqualified financial statement opinion from one of the Big 4 accounting firms.

Second, participants received financial data on the five potential investment companies (“American Computers”, “Computer World”, “Electronics USA”, “US Technologies”, and “Wired States”). In each condition, we provided participants with a generic Big 4 audit firm name (e.g., Firm

¹⁷ We chose not to include CPAs in our sample because, based on the reaction of public accounting firms and associations to the concept release, such participants would be more aware of the potential amendment. Thus, they are more likely to engage in hypothesis guessing and respond in such a way that would skew our results.

¹⁸ Though our participants should have been familiar with all of the performance measures we used in the study, we provided each participant with an addendum explaining each performance measure to ensure that participants understood each performance measure, and to unify the definition of each performance measure employed in the case. Participants were free to review the addendum at any time during the case.
ABC or Firm DEF) and five numerical accounting measures (i.e., current ratio, days sales of inventory, return on assets, profit margin, and market share). Similar to Kida et al. [1998], one firm was markedly better than the other four firms on all of the data dimensions provided. Specifically, US Technologies’ performance metrics were better (in every category) than each of the other four firms listed, making it the optimal investment from a quantitative financial data perspective.

Third, we informed participants that one firm, Wired States, recently restated its prior year audited financial statements. We provided participants with updated performance measures for Wired States. Fourth, we presented participants with a table summarizing the performance measures for all companies, highlighting the updated performance measures for the restating firm (presented in Figure 2). While we did not make specific mention of it to the participants, participants in every condition should be able to identify that the same audit firm that had audited the quantitatively optimal investment choice (US Technologies) also audited the restating firm (Wired States). For the conditions that contained the engagement partner’s identity, participants were also able to identify that Wired States and US Technologies shared the same engagement partner.19

[Please insert Figure 2 about here]

4.3 EXPERIMENTAL DESIGN AND INDEPENDENT VARIABLES

The experiment involved an incomplete 2 x 2 between-participants design. That is, when we presented performance measures to participants, we manipulated the information available as either

19 The experimental instrument was silent as to whether the engagement partner responsible for the engagement in the prior year (i.e., the year in which Wired States’ financial statements were restated) was the same individual responsible for the current year engagement. We made this design choice in order to ensure that information related to audit partner tenure did not vary by condition. We note that the current PCAOB concept release proposes disclosure of the name of the engagement partner responsible for the most recent period's audit only and we feel that any effect of this design choice would only bias us against finding results.
audit firm name ("FIRM" condition), or audit firm name and the partner’s identity ("PARTNER" condition). Further, when we presented the partner identity, we also manipulated whether the audit report included a note, along with the Wired States restatement information, that stated:

“Each audit firm stresses in its audit reports that while the audit opinion is signed by both the audit partner and the audit firm, the audit opinion represents that of the entire firm. Additionally, each firm notes that the audit involves many firm employees and includes technical guidance and other resources from its national headquarters.”

Thus, in our third condition ("REPORT_MOD" condition), participants are provided with both the partner name and the audit report modification. We modified the audit report using language similar to that used in the SAG transcripts discussing the first impending concept release (PCAOB [2008]).

4.4 DEPENDENT AND OTHER MEASURES

4.4.1. Dependent Variables. We use two dependent variables to test our hypotheses. Specifically, we measure (1) participants’ likelihood of choosing US Technologies (i.e., the quantitatively optimal choice “peer” firm that is linked to the restating firm via the same audit partner) as their preferred investment choice, and (2) participants’ investment allocation to US Technologies. For the preferred investment choice measure, participants chose the “ONE company that [they] would most likely choose for a long-term investment.” During this portion of the experiment, participants were able to select only one of the five potential investment choices. We code our variable of interest, INVEST_UST as 1 if investors chose to invest in US Technologies, 0 otherwise. We use this measure as our primary test of H1 and H2. Specifically, we test for significant differences in the proportion of investors who chose US Technologies as their preferred investment choice, by condition. Following the preferred investment choice, participants were asked to, “Allocate [their] funds on a percentage basis to ONE OR MORE of the companies for long-term investment purposes.” Participants were able to proceed only if the total allocated among the five
investments equaled 100 percent. We compare the amount allocated to US Technologies (ALLOCATE_UST), across conditions, as a secondary measure for testing H1 and H2.

4.4.2. Potential Mediating Factor. As discussed earlier in the paper (Section 1, the development of H1), within the context of partner disclosure, use of the representativeness heuristic may explain partner-based information transfer. That is, because the peer firm is very similar to the restating firm, investors will assume that the restating firm is “representative” of some class that also includes the peer firm. Therefore, they will expect a condition or an event at one entity to be representative of conditions or events that are likely to exist at different, “peer” reporting entities. If partner-based information transfer is due to use of the representativeness heuristic, we expect investors’ likelihood assessments that the peer firm will experience a restatement in the future to mediate the relation between our independent and dependent variables. Thus, we measure participants’ assessment of the likelihood that US Technologies will experience a restatement at some point in the next three years (RESTATE_UST) (measured on an 11-point scale where 1 = “very unlikely” and 11 = “very likely”).

4.4.3. Manipulation / Attention Checks. We asked participants two questions to assess whether they attended to our manipulations. First, we asked respondents a yes/no question as to whether the audit partner’s name was disclosed in the information provided (ATTEND_PARTNER). We then asked, “Which of the following statements below best matches the information provided to you in the case about audit reports?” (ATTEND_REPORT_MOD). Response choices included (a) “The audit report stresses that the opinion represents only that of the audit partner,” (b) “The audit report stresses that the audit opinion represents that of the entire firm (the correct response for the report modification condition),” and (c) “The case materials contained no language about how audit
firms view individual audit opinions (the correct response for the firm only and partner conditions).” Both responses were coded 1 (0) if participants responded correctly (incorrectly).

We control for both attention measures (ATTEND_PARTNER and ATTEND_REPORT_MOD) in all reported analyses rather than dropping manipulation check failures because our predicted effect depends upon the extent to which participants attend to information.\(^{20}\) We also performed all reported analyses without controlling for the attention/manipulation checks and removing those participants who responded incorrectly to the related questions. Unless otherwise specified, our reported results and inferences are not significantly affected by our treatment of these measures.

5. Results

5.1 Hypotheses Testing

Table 1 presents the results of H1 and H2 testing using our primary dependent measure – investors’ single investment choice (INVEST_UST). Our first hypothesis states that partner identity disclosure will result in partner-based information transfer. Or, more specifically given our context, there will be a larger “contagion effect” for a peer firm linked to a restating firm via audit partner (i.e., PARTNER) than for a peer firm linked solely through audit firm (FIRM). Panel A of Table 1 presents descriptive statistics and chi-square comparisons between cells. In support of H1, we find that FIRM participants (67.2 percent) were significantly (at a marginal level) less likely to choose US Technologies than PARTNER participants (58.6 percent, \(p = 0.08\)). We interpret these results as suggesting that investors are less likely to invest their resources into a company linked to a

\(^{20}\) When examining the impact of a manipulated message on an outcome, a manipulation check measured at the time of participation in the experiment is unnecessary and likely serves some other purpose, such as an attention check or an assessment of a mediating variable (O’Keefe [2003], Lambert and Agoglia [2011]). That is, when determining the impact of a manipulated message, a “failed” manipulation check does not indicate that the manipulation itself “failed”, but that participants did not consciously attend to the information (O’Keefe [2003]).
contaminated firm when the link is established through a shared audit partner than when the link is established only through a shared audit firm.

We next perform a logistic regression using the following model:

\[ \text{INVEST}_UST = \beta_0 + \beta_1 \text{PARTNER} + \beta_2 \text{REPORT}_MOD + \beta_3 \text{QUAL} + \beta_4 \text{ATTEND}_\text{PARTNER} + \beta_5 \text{ATTEND}_\text{REPORT}_\text{MOD} + \epsilon_i \]  

(1)

\text{INVEST}_UST is the binary variable that denotes whether the investor chose US Technologies as their single investment choice, \text{PARTNER} indicates whether the partner identity was disclosed, and \text{REPORT}_MOD identifies whether a modified audit report was provided that contained additional language explaining that the audit represents the opinion of the entire firm. \text{QUAL} is a binary variable that denotes whether the participant was recruited through Qualtrics panels. \text{ATTEND}_\text{PARTNER} and \text{ATTEND}_\text{REPORT}_\text{MOD} are control variables that indicate whether the participant correctly identified the presence of the partner name or audit report modification, respectively.

Panel B of Table 1 presents results of our logistic regression. Also consistent with H1, \text{PARTNER} is a significantly negative predictor of whether investors chose US Technologies as their single investment choice (\( b_1 = -0.561; p = 0.035 \)). This result is consistent with our earlier result that investors are less likely to invest their resources into a company linked to a restating firm when the link is established through a shared audit partner than when the link is established only through a shared audit firm.

[Please insert Table 1 about here]

We also use results of the above logistic regression for testing H2, which predicts that modifying the audit report to highlight that it is the audit firm’s responsibility for forming the opinion will reduce information transfer associated with the presence of the partner’s identity. Thus, we expect a positive significant coefficient on \text{REPORT}_\text{MOD}. Inconsistent with H2, the coefficient on
\textit{REPORT\_MOD} (Table 1, Panel B) is neither positive nor significant \((b_2 = -0.200; p = 0.486)\). Similarly, Panel A shows that there are no differences in the percentage of participants who chose US Technologies as their single investment choice when the audit report was modified than when it was not modified \((57.8\text{ percent vs. 58.6 percent, respectively; } p = 0.89)\). We conclude that \(H_2\) is not supported and suggest that modifying the audit report (in a manner similar to the wording we use in our experiment) will not significantly reduce investor reaction to the disclosure of an audit partner’s identity. Finally, in untabulated analyses, we perform a linear regression using the percentage of funds participants chose to allocate to investing in US Technologies \((\text{ALLOCATE\_UST})\) as the dependent variable (including the same independent and control variables as the model in Table 1, Panel B). In further support of \(H_1\), we find that \(\text{PARTNER}\) is a significantly negative predictor of the amount of funds that participants chose to invest in US Technologies \((b_1 = -0.118; p = 0.029)\). Again, \textit{REPORT\_MOD} is not a significant predictor of fund allocation \((b_2 = 0.036; p = 0.277)\).

In summary, we find no support for \(H_2\), which suggests that making investors aware of the fact that a financial statement audit is a product of the whole firm (rather than of the individual audit partner) does not appear to alleviate any increase in accounting information transfer due to partner disclosure in our context. We conclude that \(H_1\) is supported and provide evidence for the first proposition in our model of the potential impact of partner disclosure on audit partner independence. Specifically, whether investors \textit{should} react to disclosure of the audit partner’s identity, our results suggest that they will.

5.2 MEDIATION ANALYSIS: RESTATEMENT LIKELIHOOD

To further test our model, we perform an analysis to determine whether investors’ perceptions regarding the likelihood that US Technologies will experience a restatement in the future is the mediating mechanism behind our results supporting \(H_1\). That is, we examine whether assessments of
the likelihood that the peer firm will experience a restatement (RESTATE_UST) mediate the effect of partner disclosure on investors’ decision making. For ease of presentation and parsimony, we eliminate the report modification participants from our mediation analysis (recall that H2 was not supported). Figure 3 presents the results of our mediation analysis, which incorporates a combination of three regression models (Baron and Kenny [1986]). We first rerun our regression model from Table 1 without REPORT_MOD. Consistent with our testing of H1, we find support for the first assumption of mediation in that we find a significantly negative PARTNER coefficient (Model I, $b_1 = -0.559; p = 0.041$).

[Please insert Figure 3 about here]

Next, we find support for the second assumption of mediation, where PARTNER is significantly correlated with the mediator, RESTATE_UST (Model II, $b_2 = 0.611; p = 0.057$). Further, we find support for the third assumption of mediation as we find that the mediator, RESTATE_UST, affects the outcome variable, INVEST_UST (Model III, $p = 0.016$). Finally, when we include RESTATE_UST in Model I, while the effect of RESTATE_UST remains a significant predictor of INVEST_UST ($b_4 = -0.113; p = 0.022$), we find the effect of PARTNER on INVEST_UST reduces to marginal significance ($b_5 = -0.509; p = 0.059$). Accordingly, we conclude that investors’ assessments of the likelihood that a peer firm will experience a restatement in the future partially mediates the contagion effect (due to partner disclosure) exhibited by investors in our experiment. To

21 Unless otherwise noted throughout our discussion, including the full sample in the mediation analysis does not reduce the significance level of our results or change the inferences drawn.

22 Note that this result reduces somewhat in significance ($p = 0.075$) when we run the analysis on the full sample (i.e., including the “report modification” condition). Also, the result is not significant at conventional levels when we do not control for ATTEND_PARTNER and ATTEND_REPORT_MOD ($p = 0.127$).

23 Untabulated analyses demonstrate that the mediation requirements are satisfied using our secondary dependent measure. Specifically, “partner” is a significant predictor of “restatement likelihood” (Model II; $p = 0.057$), “restatement likelihood” is a significant predictor of “allocate US Tech” (Model III; $p = 0.003$), and when we include both variables in the model, the significance of the “partner” variable decreases in significance ($p = 0.054$).
the extent that differences in the assessed likelihood that US Technologies will experience a
restatement is reflective of use of the representativeness heuristic, we can conclude that reliance on
that heuristic partially drives our results.

5.3 SUPPLEMENTAL ANALYSIS: FINANCIAL REPORTING EXPERIENCE

Research suggests that cognitive biases that affect investors’ decision making are often
modified or eliminated when the investors are more experienced (e.g., Joyce and Biddle [1981], Kida
et al. [2010]). If the contagion effect exhibited in our study is due to bias, investors with more
financial reporting work-related experience may exhibit less of the effect than those without
experience working with financial statements (Bonner et al. [2003]). To investigate whether our
results are driven primarily by those with less experience working with financial statements (and
thus, are more likely to be attributable to biased decision making), we conduct additional analyses
partitioning the data using participants’ experience working with financial information. Specifically,
we split the sample between zero and one year (median 0 years, mean 3.69 years) according to the
post-experimental question which asks, “How much work experience do you have where you were
responsible for preparing or analyzing financial information?”24 That is, participants who responded
with a one, or higher number, of years were designated more experienced (48 percent of the sample),
while those who responded with zero years were labeled as less experienced (52 percent of the
sample). For this analysis, we remove participants that did not provide experience information.

Panels A and B of Table 2 present results of the model used to test H1 for less experienced
and more experienced investors, respectively. We find that PARTNER is significantly negative for
our participants with less experience working with or preparing financial statements ($b_1 = -0.890; p =$

24 Also note that controlling for investor experience in the analyses we perform in order to test our hypotheses (Table 1),
does not significantly affect results or change the inferences we draw from them.

25
0.032), but is not significant for our pool of more experienced participants ($b_1 = -0.380; p = 0.241$).

We obtain similar results (untabulated) for our secondary dependent measure, the percentage of funds allocated to US Technologies ($INVEST_{UST}$). Specifically, $PARTNER$ is a significantly negative predictor of $INVEST_{UST}$ for participants with less experience working with or preparing financial statements ($p = 0.009$), but not for more experienced participants ($p = 0.921$). That is, even though all of our investors had investing experience, only those with less familiarity working with financial information exhibited the contagion effect when partner identity was disclosed.\textsuperscript{25}

These results shed some interesting light on our finding that investors exhibit a stronger restatement-related contagion effect for firms linked through the same audit partner (than for firms linked through the same audit firm). Specifically, the fact that investors with less experience working with or preparing financial statements are reacting to the information while more experienced investors are not, provides further support to challenge the assumption that more disclosure always helps to level the playing field between different types of investors (Monin and Miller [2001]).

[Please insert Table 2 about here]

6. Discussion, Limitations and Suggestions for Future Research

The motivation behind the PCAOB’s potential new requirement for audit partner disclosure is to increase accountability on the part of the audit partner and transparency for interested parties who rely upon the financial statements (ACAP [2008], PCAOB [2008, 2009, 2011]). We present an exploratory model that considers a potentially negative, unintended consequence of such disclosure.

\textsuperscript{25} We find similar results when we partition the data using other classifications of experience. We separated experience using a mean split of the experience variable (mean $= 3.69$ years). We also partitioned that data using a median split of participants’ responses to both their familiarity with the financial information presented in this case (median $= 8$ on an 11-point scale) and their familiarity with auditing procedures (median $= 7$ on an 11-point scale). In all cases, $PARTNER$ remained significant ($p < 0.05$ for all cases) for less experienced investors and not significant ($p > 0.15$ for all cases) for more experienced investors, suggesting that our findings are robust to multiple, alternative, classifications of experience.
Specifically, our three-proposition model contends that partner disclosure will first result in the fusing of partner reputations with their clients. Second, without modifications to the current auditor reporting model, this may increase audit partners’ sense of accountability to external parties without the information to make informed judgments about the quality of the work of a particular partner on a particular engagement. Being assessed, publicly, by external parties based on measures that are not highly correlated with audit quality (and may be correlated with metrics used to assess management performance) is likely to impact audit partners’ incentives. Third, this increase in the prominence of partner’s individual reputation may, unintentionally, align partner incentives more closely with those of client management, resulting in impaired independence. That is, if stakeholders evaluate audit partners using external measures similar to those used to evaluate management (e.g., restatements), partner disclosure binds partners’ reputations to management’s financial statements in such a way that could create a conflict of interest for a partner considering whether, for example, the disclosure of negative financial statement information (e.g., a restatement) is warranted.

Further, we design and perform an experiment to test the first proposition in our model. In so doing, we find that investors are significantly less likely to invest in, or allocate resources to, a peer firm linked to a contaminated firm in the presence of partner disclosure than when partner identity is not disclosed. Contrary to our expectations, modifying the audit report in order to attempt to reduce this increased information transfer (based on partner disclosure) does not significantly affect investors’ decisions. Our supplementary analyses show that (a) increased information transfer, in our context, is partially mediated by investors’ perception of the likelihood that the peer firm will experience a restatement in the future, and (b) investors with less experience working with or preparing financial statements are more likely to react to partner disclosure. We interpret both of
these additional analyses as evidence that increased accounting information transfer, due to partner disclosure, may be a result of biased or heuristic-based processing.

Our results contribute to the literature in several ways. First, our model and experimental results provide theoretical and empirical evidence to examine whether the PCAOB’s proposed partner identity disclosure standard might unintentionally raise new audit partner independence concerns. Our evidence is of use to the PCAOB in their current standard-setting process, as well as to other regulatory bodies that might consider similar regulations in the future. Second, we provide initial evidence that investors transfer negative accounting information to peer firms via the audit partner’s identity, even after being informed that the audit opinion represents that of the entire firm. Third, because we only test our first proposition, our paper provides a theoretical basis for future researchers to further investigate both the remaining propositions in our model, as well as other concerns related to the effect of identity disclosure on partner reputation, incentives, and independence.

Our results should be interpreted in light of a few limitations. One limitation is that we only present empirical evidence testing the first proposition in our model from the perspective of one user group – investors. Due to the timeliness of this issue, and the fact that almost none of the debate and discussion surrounding the proposed change to the audit report examines potential auditor independence ramifications, we choose to rely upon existing research to support the second and third link of our model at this time. We expect and encourage future research to further test our propositions. Further, our findings concerning the audit report modification should be cautiously interpreted because while we did not find an effect of modifying the language in the report, the result could have been an artifact of the modified language or its prominence/positioning in the experiment.
We conclude that our study does not indicate that partner disclosure should, definitively, not be enacted. Future research should weigh the potential benefits of such disclosure (i.e., increased accountability and transparency) against the potential costs (some of which) we have proposed in this paper. In addition, future studies should examine additional disclosures that might allow investors, audit committees, academics, and other interested parties to develop better measures in order to assess audit quality. We note that, if audit quality was more easily accessible, using publicly available information, then many of the audit independence concerns outlined in this paper would cease to exist.
REFERENCES


Proposition 1 (P1): Partner identity disclosure will fuse partner reputation with the client.
Proposition 2 (P2): The fusing of partner reputation with the client may result in a shift of audit partner incentives.
Proposition 3 (P3): A shift in audit partner incentives may result in potential audit independence impairment.

FIG. 1 – Model of audit partner disclosure reaction.
<table>
<thead>
<tr>
<th>Big 4 Audit Firm</th>
<th>American Computers</th>
<th>Computer World</th>
<th>Electronics USA</th>
<th>US Technologies</th>
<th>Wired States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm ABC</td>
<td>Firm ABC</td>
<td>Firm DEF</td>
<td>Firm DEF</td>
<td>Firm DEF</td>
<td>Firm DEF</td>
</tr>
<tr>
<td>Audit Partner</td>
<td>David Lastings</td>
<td>David Lastings</td>
<td>James Keaton</td>
<td>Thomas Edwards</td>
<td>Thomas Edwards</td>
</tr>
<tr>
<td>Current Ratio</td>
<td>2.35</td>
<td>2.25</td>
<td>2.37</td>
<td>2.38</td>
<td>2.23 → 1.97</td>
</tr>
<tr>
<td>Days Sales of Inventory</td>
<td>28</td>
<td>32</td>
<td>27</td>
<td>25</td>
<td>39 → 65</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>12.3</td>
<td>9.8</td>
<td>12.6</td>
<td>12.9</td>
<td>8.1 → 4.8</td>
</tr>
<tr>
<td>Profit Margin</td>
<td>14.5</td>
<td>11.4</td>
<td>14.7</td>
<td>14.8</td>
<td>8.3 → 5.0</td>
</tr>
<tr>
<td>Market Share</td>
<td>8.41</td>
<td>6.74</td>
<td>8.5</td>
<td>8.7</td>
<td>5.53 → 5.22</td>
</tr>
</tbody>
</table>

**Audit Opinion Note.** Each audit firm stresses in its audit reports that while the audit opinion is signed by both the audit partner and the audit firm, the audit opinion represents that of the entire firm. Additionally, each firm notes that the audit involves many firm employees and includes technical guidance and other resources from its national headquarters.\(^b\)

**FIG. 2 – Final presentation of investment options.**

\(^a\) Audit Partner name was only included in the two partner conditions.

\(^b\) The audit opinion note was only present in the report modification condition.
Mediation analysis, where $b_1$ through $b_5$ are estimated coefficients from the following linear and logit regression equations:

I: $INVEST_{UST} = \beta_{0I} + \beta_1 PARTNER + \varepsilon_I$

II: $UST_RESTATE = \beta_{0II} + \beta_2 PARTNER + \varepsilon_{II}$

III: $INVEST_{UST} = \beta_{0III} + \beta_3 UST_RESTATE + \varepsilon_{III}$

IV: $INVEST_{UST} = \beta_{0IV} + \beta_4 UST_RESTATE + \beta_5 PARTNER + \varepsilon_{IV}$

$PARTNER$ is the treatment variable manipulated at two levels whether the firm or partner name were provided in the audit report (0 = firm name; 1 = partner name). Note: for the purposes of this analysis, we exclude the audit report modification condition.

$INVEST_{UST}$ indicates dichotomously whether a participant invested in US Technologies (1 = invested in US Technologies; 0 = invested in other choice). US Technologies was audited by the same audit partner (firm) as the restating firm.

$RESTATE_{UST}$ is the participant’s response to the likelihood of US Technologies experiencing a restatement in the near future (recorded on an 11-point scale where 0 = “very unlikely” and 10 = “very likely”).

All regression equations include the following control variables: QUAL, ATTEND_PARTNER and ATTEND_REPORT_MOD. See Table 1 for variable definitions.
### T A B L E  1

*Investment Choice*

**Panel A: Investment choice**

<table>
<thead>
<tr>
<th>Firm Name</th>
<th>Partner Name</th>
<th>Report Modification</th>
<th>( \chi^2 ) Comparison Between Groups Significance Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Computers</td>
<td>10.1%</td>
<td>9.0%</td>
<td>14.1%</td>
</tr>
<tr>
<td>Computer World</td>
<td>3.4%</td>
<td>4.5%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Electronics USA</td>
<td>14.3%</td>
<td>17.3%</td>
<td>18.8%</td>
</tr>
<tr>
<td>US Technologies(^b)</td>
<td>67.2%</td>
<td>58.6%</td>
<td>57.8%</td>
</tr>
<tr>
<td>Wired States(^c)</td>
<td>5.1%</td>
<td>10.5%</td>
<td>5.5%</td>
</tr>
</tbody>
</table>

\(\chi^2\) Firm v. Partner: 0.77, 0.64, 0.51, 0.08\(^d\), 0.11
\(\chi^2\) Partner v. Report Mod.: 0.20, 0.81, 0.76, 0.89, 0.13

(n=119) (n=133) (n=128)

**Panel B: Logistic regression on investment in US Technologies**

\[
INVEST\_UST = \beta_0 + \beta_1 PARTNER + \beta_2 REPORT\_MOD + \beta_3 QUAL + \beta_4 ATTEND\_PARTNER + \beta_5 ATTEND\_REPORT\_MOD + \epsilon_i
\]

<table>
<thead>
<tr>
<th>Variable</th>
<th>Expected Sign</th>
<th>Coefficient (S.E.)</th>
<th>(p)-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>+</td>
<td>0.916 (0.519)</td>
<td>0.039</td>
</tr>
<tr>
<td>PARTNER(^f)</td>
<td>-</td>
<td>-0.561 (0.310)</td>
<td>0.035(^d)</td>
</tr>
<tr>
<td>REPORT_MOD(^g)</td>
<td>+</td>
<td>-0.200 (0.287)</td>
<td>0.486</td>
</tr>
<tr>
<td>QUAL(^h)</td>
<td>?</td>
<td>-1.020 (0.473)</td>
<td>0.031</td>
</tr>
<tr>
<td>ATTEND_PARTNER(^i)</td>
<td>?</td>
<td>0.675 (0.277)</td>
<td>0.015</td>
</tr>
<tr>
<td>ATTEND_REPORT_MOD(^j)</td>
<td>?</td>
<td>1.051 (0.519)</td>
<td>&lt; 0.001</td>
</tr>
</tbody>
</table>

\(^a\) Percentage breakdown of single investment choice.
\(^b\) Firm with the highest ranked performance measures; same audit firm / same audit partner as the restating firm.
\(^c\) Restating firm.
\(^d\) One-tailed \(p\)-value.
\(^e\) INVEST\_UST = a binary variable indicating if investor chose US Technologies; 1 if investors choose to invest in US Technologies, 0 otherwise.
\(^f\) PARTNER = indicator variable of whether the partner name was present.
\(^g\) REPORT\_MOD = indicator variable of whether the audit report contained additional language explaining that the audit represents the opinion of the entire firm.
\(^h\) QUAL = indicates whether the participant was recruited through Qualtrics panels.
\(^i\) ATTEND\_PARTNER = indicates whether the participant correctly identified presence of partner name.
\(^j\) ATTEND\_REPORT\_MOD = indicates whether the participant correctly identified whether or not the audit report contained the modification language.
**Table 2**

Logistic Regression on Invested in US Technologies\(^a\) by Investor Experience\(^b\)

\[
\text{INVEST\_UST} = \beta_0 + \beta_1 \text{PARTNER} + \beta_2 \text{REPORT\_MOD} + \beta_3 \text{QUAL} + \beta_4 \text{ATTEND\_PARTNER} + \beta_5 \text{ATTEND\_REPORT\_MOD} + \varepsilon_i
\]

Panel A: **Less experienced investors**\(^b\)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Expected Sign</th>
<th>Coefficient (S.E.)</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>+</td>
<td>1.589 (0.871)</td>
<td>0.034</td>
</tr>
<tr>
<td>PARTNER(^c)</td>
<td>-</td>
<td>-0.890 (0.481)</td>
<td>0.032(^h)</td>
</tr>
<tr>
<td>REPORT_MOD(^d)</td>
<td>+</td>
<td>0.273 (0.435)</td>
<td>0.531(^h)</td>
</tr>
<tr>
<td>QUAL(^e)</td>
<td>?</td>
<td>-1.401 (0.793)</td>
<td>0.077</td>
</tr>
<tr>
<td>ATTEND_PARTNER(^f)</td>
<td>?</td>
<td>0.891 (0.404)</td>
<td>0.028</td>
</tr>
<tr>
<td>ATTEND_REPORT_MOD(^g)</td>
<td>?</td>
<td>0.646 (0.871)</td>
<td>0.086</td>
</tr>
</tbody>
</table>

Panel B: **More experienced investors**\(^b\)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Expected Sign</th>
<th>Coefficient (S.E.)</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>+</td>
<td>0.533 (0.716)</td>
<td>0.241</td>
</tr>
<tr>
<td>PARTNER</td>
<td>-</td>
<td>-0.380 (0.540)</td>
<td>0.241(^h)</td>
</tr>
<tr>
<td>REPORT_MOD</td>
<td>+</td>
<td>-0.930 (0.500)</td>
<td>0.063</td>
</tr>
<tr>
<td>QUAL</td>
<td>?</td>
<td>-0.474 (0.635)</td>
<td>0.455</td>
</tr>
<tr>
<td>ATTEND_PARTNER</td>
<td>?</td>
<td>0.542 (0.502)</td>
<td>0.280</td>
</tr>
<tr>
<td>ATTEND_REPORT_MOD</td>
<td>?</td>
<td>1.602 (0.431)</td>
<td>&lt; 0.001</td>
</tr>
</tbody>
</table>

\(^a\) \text{INVEST\_UST} \text{ is an indicator variable as to whether the participant invests in US Technologies.}

\(^b\) Investor Type = 294 of the 380 participants provided their experience working with financial information (mean = 4.69 years, median = 0 years). This subsample was split so that zero years of experience represents less experienced investors while one or more years of experience represents more experienced investors.

\(^c\) PARTNER = indicates whether the partner name was present.

\(^d\) REPORT\_MOD = indicates whether the audit report contained modification language.

\(^e\) QUAL = indicates whether the participant was recruited through Qualtrics panels.

\(^f\) ATTEND\_PARTNER = indicates whether the participant correctly identified the presence of the partner name.

\(^g\) ATTEND\_REPORT\_MOD = indicates whether the participant correctly identified the audit report modification.

\(^h\) One-tailed p-value.