In the name of Power and Reputation: Their Adverse Effects on Audit Quality as Evidenced from Government Audits

ABSTRACT: In this paper we investigate the effects of auditor power and auditor reputation on audit quality. Using audit adjustments to student loan loss provisions in government audits to construct a new measure, "excessive audit conservatism", we show that auditor power leads to excessively conservative audit adjustments to the provisions and, thus, to lower audit quality. We also examine the effect on audit quality of a positive shock to auditor reputation. We find that before the increase to their reputation, monopolistic auditors, compared to auditors in a competitive market, require more conservative, yet not excessively conservative, adjustments. However, after the reputation increase, the adjustments become excessively conservative. This result suggests that the combination of strong auditor position and high auditor reputation leads to excessive auditor conservatism. Consistent with the excessive nature of the adjustments, we find no significant association between the adjustments and future student loan write-offs. We also find that the excessive adjustments are negatively associated with future student lending, hence, bearing real adverse consequences on potential loan takers. To our knowledge, our study is the first to link self-serving behavior of auditors to audit quality.

Keywords: Auditor power; excessive conservatism; government audit; auditor reputation; audit adjustments

JEL: H81, L12, L51, M41, M42, M48

1. Introduction

Power dynamics are pervasive in social interactions, and power balance between the actors involved will affect the outcomes of these interactions (Emerson 1962). Actors with greater interdependence, or relatively less power in the relationship, will most likely experience the weaker outcome (Gulati and Sytch 2007). The effect of power on exchange outcomes has been studied in many business contexts, such as along the supply chain (Zhao et al. 2008; Terpend and Ashenbaum, 2012; Nyaga et al. 2013; Pulles et al. 2014), and in the interaction between a company's manager and board of directors (Bebchuk et al. 2002; Bebchuk and Fried 2003; 2004). For example, using a meta-analysis of CEO compensation, Van Essen et al. (2015) find that CEOs that have power over the pay-setting process receive significantly higher levels of total cash compensation and total overall compensation. In contrast, when boards have more power, CEOs receive lower total cash and total compensation. Auditor power and its effect on financial reporting outcomes has been mostly overlooked by the audit literature. The literature, for the most part, assumes that auditors and clients engage in an arm's length exchange where power dynamics are not deemed to be important. The auditors are believed to act professionally and use their authority to resist client pressure to ensure the faithful representation of the financial statements (Goldman and Barlev 1974). In addition, it is assumed that auditors only react to unfavorable changes in the exchange with the client. For example, auditors respond to an increase in audit portfolio risk by shedding riskier clients (Johnstone and Beadard 2004) and lobbying for reduced legal liability (Geiger and Raghunandan 2001). Audit firms respond to higher client risk by assigning specialized personnel to the engagement (Johnstone and Beadard 2003), charging higher engagement fees to reflect increased audit effort (Schelleman and Knechel 2010) or increased audit risk (Danielsen et al. 2006; Bell et al. 2008). Auditors, however, are not assumed to use their power to their advantage. If anything, regulators and researchers are often concerned with issues that may weaken auditor power and the ability to resist client pressure to allow questionable accounting choices, such as reduced

auditor independence (e.g. Frankel et al. 2002; Ashbaugh et al. 2003; Chen et al. 2005) and opinion shopping (Lennox 2000; Chen et al. 2016; Choi et al. 2019).[1]

The possibility that auditors may use their power to their advantage has received only limited attention in the literature, and only in the context of charging higher audit fees. Mayhew and Wilkins (2003) and Numan and Willekens (2012) find that specialization allows auditors to charge a fee premium. In this regard, DeFond and Zhang (2014) ask whether the premium Big 4 auditors charge their clients is due to their monopoly power, or higher audit quality. They stress the need for more evidence for the latter explanation but overlook the need to better understand the former. In this study, we delve deeper into this conundrum to study the relationship between auditor power and audit quality.

The effect of auditor power on audit quality is non-trivial. On the one hand, more power may allow auditors to affect the outcome of the engagement. For example, auditors may use their power to restrain clients and enforce more conservative accounting and achieve higher audit quality. This in turn will lower auditor litigation risk, because auditors are not sued for understating assets. Auditors might, however, use their power to require their clients to recognize excessively conservative adjustments which will further reduce their litigation risk. Excessive conservatism will result in lower, rather than higher, audit quality because the financial statements will move away from reflecting economic reality. Though more powerful auditors may attempt excessive conservatism, clients may push back against this auditor bias because increased conservatism lowers income, a result which is unlikely to align with clients' interest. In addition, auditors are subject to professional inspections such as PCAOB inspections and peer reviews, and for government auditors, their assurance work is inspected by their board of accountancy and peer-reviewed by government auditors from other jurisdictions. These forces combined, will constrain auditors' ability to

[1] Another line of research, mostly experimental, examines the auditor-client management negotiation and the resolution of disagreements. It focuses on negotiation strategies and tactics and examines how various parameters (e.g. preparation and past experience) will affect the negotiation outcome. See for example, Brown and Wright (2008), Brown and Johnstone (2009), Hatfield et al. (2008), Hatfield et al. (2010), and Salterio (2012).

take advantage of their power and act in a self-serving manner. Overall, a priori it is not clear how auditor power will affect audit quality.

We identify a setting where auditors enjoy relatively more power and examine how this affects audit quality. Specifically, we compare the audit quality provided by Canadian government auditors to that provided by U.S. audit firms that also audit the government. The former operate in a monopolistic audit environment and therefore enjoy more power over their clients, while the latter, operate in a competitive audit environment, and therefore do not possess as much power.[2] We recognize that audit quality is a broad concept. Therefore, we focus on the impact of auditor power on financial reporting conservatism, which is a particularly important issue, inasmuch as regulators have a bias in favor of conservative reporting (DeFond and Francis 2005). Our analysis focuses on the provision for student loan losses because government guidelines regarding the expected losses allow us to infer the audit adjustments to that account. We construct a new measure for excessive conservatism—excessive student loan loss provision adjustments—and examine whether enhanced auditor power leads to *excessive conservatism*. Examining the student loan loss provision is advantageous because it allows us to compare an account that is quite large and relatively standard across provinces and states and is part of similar subnational governmental loan programs (Canada's provincial departments of education and U.S. state-supported student loan authorities). The annual student loans of the loan authorities in our sample in 2018 were $6.9 billion in Canada and $19.7 billion in the U.S.[3]

When examining the entire sample period 1999–2019, we find that monopolistic government auditors make more conservative adjustments to student loan loss provisions than auditors who operate in a competitive market and, more importantly, that the adjustments are *excessive*, as they exceed the

[2] In the Research Design section, we explain the motivation for the use of U.S. audits as the control group.
[3] An alternative research design would be to compare total loan loss provisions. However, at that level, loan compositions will vary considerably in their risk profiles across provinces and states based on the major industries in each of them, which will introduce additional noise. We therefore believe that a focus on a single large and standard account is more advantageous.

component materiality threshold on average by $53.4 million.[4] We interpret the excessive adjustment as lower audit quality because they render the financial statements less informative and may ultimately influence the financial statement user to make suboptimal resource allocation decisions. Consistent with the adjustments being excessive and uninformative of future losses, we find that they are not predictive of future student loan write-offs. Moreover, we find real negative consequences of the auditor's behavior, as the future student loans are negatively associated with the adjustments, implying credit rationing. These results are consistent with government auditors taking advantage of their strong bargaining power to act in a self-serving manner by demanding excessively conservative financial measurements in order to mitigate the risk of audit failure that can undermine their reputations and their careers.[5]

We extend our analysis of the auditor power by examining how a positive change to auditor reputation affects excessive auditor conservatism. The following quote from DeFond and Zhang (2014, p. 278) helps motivate this examination:

> "Similarly, while increased GCs and reduced DAC are consistent with higher audit quality, they are also consistent with excessively conservative auditors seeking to avoid litigation, which impairs audit quality. Thus, given the strong theoretical prediction that reputation and litigation risk improves audit quality, we are surprised that the evidence is not more conclusive. Going forward, a potentially fruitful area is to more firmly establish whether reputation and litigation risk actually translates into higher audit quality."

Our analysis aims to advance this suggested path by examining the effect of an increase in auditor reputation on excessive conservatism, our inverse measure of audit quality. Extant literature provides some evidence that auditor reputation is positively associated with audit quality, but only in the context of (following) a negative reputation shock; still, the evidence, according to DeFond and Zhang (2014), is not sufficiently conclusive. Moreover, these results might not extend to a *positive* reputation shock, especially

[4] Component materiality refers to a threshold set for a component to guide auditors in planning and performing audit procedures to achieve the desired audit-risk level for that component (Glover et al. 2008). Audit adjustments exceeding the materiality threshold attest to the significance of the adjustment in relation to the component (item) audited.
[5] In untabulated results, we find that career concerns would encourage more conservative behavior within the auditor general. Our analysis shows that promotions of provincial government auditors to more prestigious positions are associated with lower restatement rates in the last two years of their tenure in their pre-promotion jobs.

when the auditor has a strong position, given that increased reputation may translate into more power to further reduce audit failure risk by increasing the already elevated degree of audit conservatism.

We fill this gap by identifying a positive shock to the reputation of Canadian government auditors. In 2004, the auditor general was commended for the discovery of improper transfer of $100 million of public funds to communication agencies connected to the governing Liberal Party (Office of the Auditor General [OAG] 2003). Using a difference-in-difference research design, we find that in the pre-reputation shock period, Canadian government auditors require more conservative, yet not excessively conservative adjustments to the student loan loss provisions compared to their U.S. counterparts. However, after the reputation increase, the adjustments become excessive. Thus, we conclude that higher auditor power and increased reputation lead to excessive conservatism, such that the student loan loss provisions do not reflect economic reality.

We conduct several supplementary analyses that further expand our findings. Bebchuk et al. (2002) argue that managerial power is not unlimited and will be constrained by "outrage" and the need to receive board approval. We draw parallels with managerial power theory and suggest that excessive conservatism will also be constrained. First, the audit work of the government auditor is regularly reviewed by their provincial board of accountancy and peer-reviewed by external government auditors from other jurisdictions. Second, Peltzman (1992) and Brender and Drazen (2008) show that voters reward fiscal discipline such that incumbents increase their probability of reelection if they report a budget surplus. Hence, we expect resistance ("outrage") from provinces to increase, the more negative their budgetary balance is. Consistent with this prediction, we find that excessive conservatism decreases as pre-auditor adjustment budget balance becomes more negative. We also show that in our setting, it is unlikely that the government influences the adjustment amount to the provision. Finally, we conduct additional tests to confirm the robustness of our results.

Our paper makes several contributions to the audit literature. First, to the best of our knowledge, we are the first to examine the effect of auditor power on audit quality. We isolate the adjustments auditors require their clients to make in their financial statements during year-end audits and we show that one adverse consequence of high auditor power is excessive conservatism. Second, our analysis of the effect of positive shock to auditor reputation on audit quality fills a gap in the audit quality literature, which has only examined the effect of negative reputation shock (DeFond and Zhang 2014). We find that an increase to auditor reputation can lead to an undesired consequence—excessive conservatism and, thus, lower audit quality. Third, a challenge in the audit quality literature is to distinguish between high audit quality and excessive auditor conservatism. DeFond and Zhang (2014, p. 287) assert the following:

> "Auditors have incentives to issue more GCs than are appropriate because they reduce the auditor's liability in court (Kaplan and Williams 2013). The risk of erroneously interpreting excessive auditor conservatism as increased audit quality is a problem that affects all output-based audit quality proxies, including restatements and DAC."

The new audit quality measure we develop—excessive audit adjustment to student loan loss provision—allows us to distinguish between conservative adjustments that may be interpreted as a responsible approach by the auditor and adjustments that are excessive and render the financial statements less informative, and therefore reduce audit quality. While our measure of excessive conservatism is specific to our setting, we hope it will inspire researchers to develop similar measures for other settings. Finally, while the earnings management literature predominantly focuses on the effect of managerial actions on financial reporting, we show an effort to affect the financial outcome motivated by another actor, namely, the auditor.

There are two limitations to our study. First, our study uses government audits; thus, our findings on the effect of auditor power might not extend to the private market. However, while in the private market auditors do not enjoy monopoly status, some auditors might enjoy a strong bargaining position. It is reasonable to assume that Big 4 auditors, industry specialist auditors and long-tenured auditors enjoy more power than other auditors, and that in turn, might lead to excessive conservatism and adversely affect audit

quality.[6] Consistent with this assertion, Iyer and Rama (2004) report that short auditor tenure and the importance of their company to the audit partner increased the beliefs of CFOs of their ability to persuade the auditor of their position. Thus, it is possible that our findings extend to the private audit market. Second, we examine a single, albeit quite large account—student loans. Our focus on a single account is similar to Kido et al. (2012), and that allows us to generate a clean measure of audit quality that avoids the confounding influence of non-audit factors such as company innate characteristics and financial reporting incentives, which can also affect financial reporting quality (Francis et al. 2005; Lennox et al. 2016). This, in turn, should increase the reliability of our findings.

The remainder of the paper proceeds as follows. In Section 2, we provide background information, review the literature, and develop our hypotheses. We describe our research design in Section 3 and present the main results in Section 4. Section 5 presents supplementary analyses and robustness checks and Section 6 concludes the study.

2. Background, Literature Review, and Hypothesis Development

2.1. Power Theory and Social Exchange

Historical sociologists treat power as a foundational cause of social interaction outcomes (Mahoney 2004). Power theory focuses centrally on conflict between collective actors, with an outcome emerging from the conflict of multiple actors motivated to pursue competing ends. Power is frequently defined as one party's ability to enforce its will on another party (Emerson, 1962). Power theory does not require that one actor exercises full domination over another; rather, differences among actors in the level of power reflect differential contributions to outcomes. Power-dependence reasoning suggests that power asymmetries translate directly into use of power (Emerson, 1972a; 1972b). Interorganizational research focuses on interdependence among parties, where interdependence and its implications are closely identified with

[6] In the U.S. for example, Big 4 auditors account for the audits of 497 out of the 500 S&P companies (https://www.auditanalytics.com/blog/auditor-market-share-of-the-sp-500/), and the average auditor tenure among the Dow Jones 30 companies (for which we hand collected the data) is 57.7 years.

power (Pfeffer and Salancik 1978; Gulati and Sytch 2007).[7] If an actor's net dependence is negative, then the actor is assumed to have the dependence advantage and thus to be in a position of relative power (Emerson, 1962). In other words, the performance benefits of the stronger, dependence-advantaged actor, are expected to come at the expense of the weaker, dependence-disadvantaged partner (e.g., Cook, 1977; Pfeffer and Salancik 1978; Aldrich 1979; Kim et al. 2004).

As in society in general, the concept of power is also often used to explain economic outcomes. In supply chain relationships, power may be used to claim a higher share of the value that is available in the exchange between two firms (Crook and Combs 2007). Gulati and Sytch (2007) argue that when the supplier holds the dependence advantage, the performance of the manufacturer will suffer. Bebchuk et al. (2002) follow the intuition of power theory to introduce 'managerial power theory'. This theory focuses on managerial power in shaping executive pay, and states that managers will extract rent when endowed with excess power. Bebchuk and Fried (2003) further argue that the greater the CEO's power, the higher the rents will be. Other forms of managerial power include empire building (Williamson 1964), the retention of excess cash inside the company when no investment opportunities for these cash exist (Jensen 1986), and entrenchment which makes it difficult to remove a manager for poor performance (Schleifer and Vishney 1989). Some empirical studies provide support for managerial power theory. Core et al. (1999) show that CEOs with greater power over the board of directors (based on the quality of the company's corporate governance) receive higher compensation levels which are also less sensitive to performance. Cyert et al. (2002) show that CEOs that also serve as the chairmen of the board enjoy higher executive pay. Van Essen et al. (2015) find that CEOs with power over the pay setting process receive significantly higher levels of total cash and total compensation. On the other hand, when the board has more power, CEOs receive significantly lower levels of total cash and total compensation. The stronger boards are also able to establish stronger links between CEO compensation and firm performance. Research also shows

[7] Interdependence refers to the situation where an actor does not entirely control all of the conditions necessary for achieving an action or for obtaining a desired outcome from the action" (Pfeffer and Salancik 1978).

how companies benefit from power (e.g. Porter 1980). Mills et al. (2013) for example, find that politically sensitive firms with greater bargaining power incur fewer tax-related political costs than politically insensitive firms with smaller bargaining power.

While studies show the effect of power in many business contexts, evidence regarding auditor use of power is very limited and only focuses on audit fees. A few studies show that specialist auditors use their bargaining power to charge a fee premium and that this premium disappears as the clients gain power (Castrella et al. 2004; Huang et al. 2007; Fung et al. 2012; Numan and Willekens 2012).[8] In this study we examine how auditor power may affect audit quality.

In Canada, national and subnational governments grant monopoly power over the audits of their consolidated financial statements to the government audit agency.[9] Government auditors are granted limited legal liability and public funding to conduct their audit work (The Provincial Auditor Act 2015). Moreover, legislation prohibits the government from replacing a government auditor unless there is evidence of misconduct or neglect. As a result, those auditors retain relatively high degree of power. With these safeguards, threats to auditor independence are significantly minimized. Combined with the fact that government auditors wish to perform well so as to maintain their reputation capital in order to enhance their future career prospects (Holmström 1999; Sundgren and Svanström 2014), this status grants the government auditors sufficient latitude and the motivation to challenge their clients' reporting practices. Thus, government auditors in our setting have a greater degree of power relative to auditors that operate in a more competitive environment, allowing government auditor to require higher levels of financial reporting conservatism.

[8] Mayhew and Wilkins (2003) provide similar evidence for the IPO market.
[9] Government auditors are granted monopolistic audit power over the consolidated provincial financial statements, the level at which the student loan loss provision is audited. However, certain provincial agencies and corporations, are generally granted legislative power to appoint an auditor other than the government auditor if they wish to do so.

However, when the balance of power shifts because the auditor has strong bargaining power, they may use this power to bias the financial statements in a way that will benefit them. One such a way is by becoming excessively conservative. This in turn will further reduce the primary audit risk—the overstatement of net assets (Hirst 1994), which will reduce the risk of audit failure. However, auditors might find it difficult to enforce excessive conservatism on their clients. First, if the excessive audit adjustments conflict with the client's reporting objectives, the client might resist those adjustments. In this regards, several studies (e.g. Peltzman 1992; Brender 2003; Brander and Drazen 2008; Drazen and Eslava 2010) show that reporting a budget surplus increases the incumbent's election likelihood. In addition, the work of government auditors is subject to practice reviews by peers and regulatory bodies which might prevent the auditor from employing excessive conservatism. We therefore state our first hypothesis in the null form as follows:

H1: *There is no difference in the level of conservatism demanded by auditors operating in a monopolistic environment and in a non-monopolistic environment.*

2.2. Positive Reputation Shock

Our second hypothesis is about the effect of a positive shock to the auditor's reputation on audit quality. A negative shock to auditor reputation can have grave consequences. Krishnamurthy et al. (2006) and Cahan et al. (2009) document a negative market reaction to Arthur Andersen's clients around key dates leading up to Andersen's demise. Nagy (2014) shows that public disclosure of Part 2 of the inspection report by the PCAOB (which is issued when the audit firm failed to satisfactorily remediate the quality control deficiencies found in the audit within 12 months) leads to a loss of market share to the audit firm. In an international setting, Weber et al. (2008) study an accounting scandal involving one of KPMG's public clients in Germany. They find that the rate of client attrition was twice as high in the year the scandal was revealed, relative to its three-year average (15.7% versus 7.7%). In addition, the authors find that KPMG's clients sustained cumulative negative abnormal stock returns of about 3% around events that publicized the

scandal. In Germany, it is difficult for investors to sue auditors and there is a cap on auditor civil liability to shareholders. Therefore, the authors conclude that the scandal was unlikely to affect KPMG's viability as a source of assurance to investors and, instead, that the market reaction was likely the result of KPMG's loss of reputation as a high-quality auditor. Skinner and Srinivasan (2012) study the consequences of a failed audit in Japan by ChuoAoyama, a PwC Japanese affiliate and one of Japan's largest audit firms. They find that about one-fourth of ChuoAoyama's clients defected following the event.

The evidence in these studies suggests that reputation concerns should motivate auditors to provide high-quality audits, insomuch as that reputation can affect their ability to attract and retain clients (Barton 2005). DeAngelo (1981) argues that auditors with more prominent reputations supply a higher level of audit quality in order to protect their reputation capital. However, direct evidence on the relations between reputation and audit quality is rare (DeFond and Zhang 2014), and the aforementioned studies only provide indirect evidence[10] and focus on events involving a negative shock to auditor reputation. Empirical evidence on the effect of a positive shock to auditor reputation on audit quality does not exist (DeFond and Zhang 2014).

2.3. Sponsorship Scandal

We identify an external event that led to an increase in auditor reputation. Specifically, the 2003 Canadian Federal Government Sponsorship Program audit report, publicly released in 2004, suggested that $100 million of public funds were transferred to communication agencies connected to the governing Liberal Party (OAG 2003). The report of the Auditor General of Canada Sheila Fraser criticized public officials for their "blatant misuse of public funds" and for breaking "just about every rule in the book" (CBC News 2004; 2011). This breach of public trust (Free and Radcliffe 2009) exposed by the report resulted in a 14% decrease in support for the government (Whittington 2004). Furthermore, 64% of the

[10] One exception is Baugh et al. (2019) that examines the U.S. Department of Justice's 2005 Deferred Prosecution Agreement (DPA) with KPMG for marketing questionable tax shelters. The authors do not find a change in the audit quality provided by KPMG following the DPA.

voters indicated that the audit findings would influence their voting decision (Policy Options 2005). Eventually, the audit findings were a significant factor in the defeat of the incumbent party in the 2006 election, after being in power for more than 12 years (Elections Canada 2006).

While the government suffered reputation damage, the reputation of government auditors improved. The auditor general was lauded as being a "national hero" for shining light on "the mismanagement, incompetence and corruption that (…) [the] government has been trying to hide for a decade" (Baird 2006; Bryden 2014). After releasing the report, the government audit agency became the third most trusted Canadian institution, lagging only after the Supreme Court and the Department of Defense (Bozinoff 2014). Malsch and Morin (2017) show that the Auditor General Sheila Fraser was able to sustain the power gained from exposing the Sponsorship Scandal in the following seven years until her mandate ended in 2011. This suggests that the reputation gain was not a short-living phenomenon. This increase in the reputation of federal auditors also increased the reputation of subnational government auditors. In its risk management report, the OAG of Manitoba began to recognize auditor reputation as a risk factor (OAG Manitoba 2007). In addition, the Province of Ontario recognized the increase in the provincial government auditors' reputation by changing the name of the institution from the *Provincial Auditor of Ontario* to the *Auditor General of Ontario* to show the "respect the auditor truly deserves" (Sorbara 2004). Total media references to government auditors in Canada's 16 major newspapers increased from an annual average of 384 references until the year prior to the release of the sponsorship report, to 1,789 annual references after the release of the sponsorship report. Exhibits 1.1-1.3 present evidence that media coverage not only increased but also became more positive.

It is a priori unclear how a positive shock to auditor reputation will affect audit quality. Improved auditor reputation enhances the auditors' political clout, which would increase their bargaining power, allowing them to demand more conservative financial reporting, leading to higher audit quality. In addition, with an elevated level of reputation, auditors will have even more to lose from reputation loss, and should provide further motivation to maintain high audit quality. However, the increased reputation may also allow

auditors to use their newfound bargaining power to further reduce audit failure risk and reputation risk by increasing the already elevated degree of audit conservatism to the point it becomes excessive. This will cause financial statements to become less informative, thereby reducing audit quality. DeFond and Zhang (2014) point to the fact that despite strong priors, it is unclear whether reputation concerns improve audit quality. Because of these opposing possibilities, we state our second hypothesis in the null form:

H2*: An increase in auditor reputation does not result in excessively conservative financial reporting.*

3. Research Design

3.1. Sample Selection

To test the first hypothesis on how the level of auditor power affects the level of conservatism demanded by auditors, we use a between-subjects research design to compare the audit quality provided by monopolistic government auditors who enjoy a strong bargaining position, and auditors who compete in the open audit market and therefore do not enjoy similar power. To test the second hypothesis on the effect of positive change in auditor reputation on the demand for conservative reporting, we use a between-subjects, between-periods research design (difference-in-difference), using the same sample and control groups. We construct the sample group by reading the audited financial statements for all ten Canadian provinces from 1999 to 2019. We start in 1999 because this is the year the Canadian government started to use accrual accounting. Within the financial statements, we focus on the student loan program and the provision for the expected loss on those loans. We exclude three provinces (British Columbia, Manitoba, and Newfoundland) because their student loan loss provisions are aggregated with other loan loss provisions. This leaves us with 105 firm-year observations for the sample group.

For the control group, we use provisions for student loan losses on loans by government and non-government authorities from the Education Finance Council and the U.S. Department of Education. We use the U.S. as a control for our Canadian sample for several reasons. First, the two economies are highly

related. Over the period of 1999–2018, the correlation of GDP growth (based on World Bank data) of the two countries was 87.0%. Canada is the U.S.'s largest business partner, accounting for nearly 16% of its total trade (U.S. Census Bureau 2015). In addition, the two countries are very similar in terms of their business and investment environments (Baginski et al. 2002) and regulations (Bargeron et al. 2010). The only major difference between the two countries is that litigation risk is more elevated in the U.S.[11] However, with respect to government audits in both countries, litigation risk due to client failure (but not due to audit failure) is extremely low. The last time a U.S. state declared bankruptcy was in 1933 (Federal Reserve Bank of Cleveland 2016) and the only provincial bankruptcy in Canadian history occurred in 1936 (Bird and Tassonyi 2003). In addition, litigation risk due to audit failure for *conservative* financial reporting is also extremely low because auditors are unlikely to face litigation for understating the value of assets (Lys and Watts 1994). Thus, this institutional difference seems vastly irrelevant to our setting.[12] Not surprisingly, some studies use Canadian companies as control groups for their U.S. samples (e.g., Baginski et al. 2002; Khurana and Raman 2004; Bargeron et al. 2010; Singer and You 2011; Baloria et al. 2017) or group together U.S. and Canadian companies in international tests (e.g., Ali and Hwang 2000).[13] We start with a list of 35 governmental and non-governmental student loan authorities. To ensure that our control group matches the institutional setting of provincial governmental student loans in the Canadian sample, we exclude ten student loan authorities that are either non-governmental or affiliated with municipal governments. Two additional authorities are excluded due to lack of data, leaving us with 23 student loan authorities, 18 (5) of which are audited by non-Big 4 firms (Big 4 firms).[14] We then hand collect each of the available audited financial statements and we obtain a sample of 284 firm-year observations for the

[11] If litigation risk has an effect on our results, it is likely to cause U.S. auditors to be more prudent and the provisions for losses in the U.S. to be larger. Thus, it increases the likelihood that the U.S. auditors will be more conservative,

[12] While both countries use a common-law legal system, in Canada, the province of Quebec uses a civil-law legal system. To ensure that this institutional difference does not affect our results, we repeat all our tests after removing Quebec and the results remain unchanged.

[13] Baginski et al. (2012) explain that U.S. and Canadian companies are similar on so many dimensions, and Kurana and Raman (2004) note that "…the role of the auditor in other Anglo-American countries is similar to that in the U.S.".

[14] Because Big 4 audit firms are known to provide higher quality audits (DeFond and Zhang 2014), to ensure that audit quality differences between the sample and control groups are not driven by the Big 4 auditors, we repeat our tests after excluding the Big 4 audits. Our results (untabulated) remain unchanged under this specification.

control group. In total, our sample has 389 observations. Table 1 presents the yearly distribution of observations. The number of yearly observations is very small in the early years of the sample period, and then gradually increases. No single year accounts for more than 7% of the observations. It is important to note that this research design uses a homogenous unit of analysis; in both cases, the same account is audited, and the same subnational governmental program is involved.[15]

[INSERT TABLE 1 ABOUT HERE]

3.2. Excessive Conservatism—A Measure of Audit Quality

We measure excessive conservatism using the following formula:

$$Excessive\ Conservatism\ (EC) = \frac{(Actual\ Provision - Estimated\ Provision) - Materiality}{Total\ Population} \quad (1)$$

EC is the difference between the actual student loan loss provision and the estimated pre-audit provision, minus the materiality threshold, scaled by the total province (state) population for the Canadian (U.S.) sample. To measure the estimated student loan loss provision for the sample group, we obtain the Canadian government student loan loss provisioning rate, which is used by the government to prepare statutory reports. This rate is prepared by the Chief Actuary of Canada which is separate from the provinces and therefore unlikely to be biased. The rate utilizes past collection experience of the national student loan pool to determine future expected losses and varies over time. During our sample period, the rate ranged from 9.0% to 14.2%.[16] We then multiply the outstanding student loan amount as of the end of the year by the loan loss rate. The estimated provision represents the expected student loan loss provision, given the

[15] Public sector accounting standards (PSAS) in Canada are governed by the CPA Canada Public Sector Accounting Handbook, which prescribes the accounting standards that apply to all public sector entities (governments, government components, government organizations, and certain government partnerships) that issue general purpose financial statements. In the U.S., state and local governments follow PSAS that are issued by the Governmental Accounting Standards Board. The PSAS of both countries are broadly consistent with International Public Sector Accounting Standards (IPSAS).

[16] We also perform the tests using the actual year t+1 three-year student loan cohort default rate that varies by province and over time and the results continue to hold as reported. The Chief Actuary of Canada states that 80% of student loan defaults occur within three years of the start of the repayment.

government guidelines, or the pre-audit provision. We obtain the actual provision from the provincial government financial statements and then calculate the auditor's adjustment to the provision as the difference between the actual provision and the estimated provision. The availability of the government loss provisioning rates allows us to isolate the audit adjustment or, in other words, to empirically examine the audit process black box. A positive (negative) difference between the actual and estimated provision will suggest that the audit process adjusted the provision upward (downward), relative to the government's guidance. This finding will indicate whether the adjustment was conservative or aggressive. The difference is then compared to the materiality amount, a quantitative threshold the auditor uses to assess materiality when considering the errors detected in the financial statements during the audit. The comparison to materiality allows us to assess the significance of the audit adjustments. To standardize the measure across observations, we then scale it by population, the recommended deflator in the government accounting literature (Beck 2018).[17] A positive difference that is even greater than the materiality threshold will be viewed as excessive conservatism, suggesting that the adjustments deviated significantly from the government methodology. In our tests, we also use the binary variable *EC_DUM*, which takes the value of 1 when *EC* is positive and 0 otherwise, and the unscaled excessive conservatism, *EC_UNSC* so we can assess economic significance.

In order to calculate materiality, it is important to note that the loan loss provision is disclosed within the government's consolidated financial statements. These financial statements combine financial information from all government departments. In the planning stage, this complex financial reporting process requires auditors to first determine the consolidated financial statements' group materiality level and the maximum tolerated error/misstatement allowed by auditors for all of the consolidated financial statements. Then a proportion of the group-level materiality is assigned to each government department,

[17] All our main results consistently hold if we scale by student loans or materiality. We also could have used student population for scaling. However, this would have required us to collect full-time and part-time student population data for each state and province, in each sample year, dating back to 1999. Nonetheless, using data on full-time students in Canada from 2003 to 2019, we find a correlation of around 98% between total provincial population and provincial full-time student population. Thus, we conclude that scaling by total population is unlikely to change our results.

which is referred to as the component-level materiality. We use group materiality of 0.5% of expenditures for the Canadian sample student loans, consistent with government auditors' testimony (Public Accounts of Canada 2006) and documentary submissions to legislators (OAG Ontario 2012). The component materiality of the relevant Department of Education is calculated in accordance with Stewart and Kinney (2013)'s software,[18] utilizing their Component Materiality Calculator: GUAMcalc. In Appendix B, we provide a numerical example of an output of the calculation utilizing GUAMcalc.

For the calculation of excessive conservatism for the audits by the private sector auditors in the U.S., we start by obtaining the actual student loan balances, as recorded in the audited financial statements. The student loan authorities grant two types of loans: those that are guaranteed by the federal government (in our sample, for authorities that issue both types of student loans, 88% of the loans are guaranteed) and those that are not. To determine the estimated student loan loss provision for the guaranteed loans, we multiply the outstanding student loans by the annual student loan cohort default rate provided by the U.S. Department of Education for each state[19] and then by the loss given default rate which is equal to one minus the federal government guarantee percentage which is 97% or 98% depending on the year the loan was granted. For the unguaranteed student loans, we first obtain the student loan default rate from the U.S. Department of Education or from credit rating agencies when available. Then we multiply the default rates by the loss given default rate, which ranges from 18.2% to 85.0% during our sample period. These amounts are obtained from the Federal Reserve (Federal Reserve Bank of Kansas City 2013), bond offering information, and credit rating agency disclosures.[20] To determine the materiality level for U.S. loans, we use 3% of total assets, excluding the loan amount guaranteed, a threshold consistent with the guidance from the Financial Audit Manual of the U.S. General Accounting Office. Appendix C provides an example of

[18] For group audits, the software calculates the component materiality amount for each component entity using guidance from International Standard on Auditing 600 Special Considerations – Audits of Group Financial Statements.
[19] For the 2018 and 2019 financial years, we utilize the 2017 three-year cohort default rate. Results (untabulated) do not change if we exclude these two years.
[20] In cases where the loan authority does not disclose the volume of insured student loan data, we apply the uninsured loss given default rate.

the calculation of excessive conservatism for the Vermont Student Assistance Corporation, an entity that has both insured and uninsured student loans receivable.

3.3. Empirical Model

To empirically examine the relationship between auditor power and audit quality (Hypothesis 1), we regress our measure of excessive conservatism on the audit regulatory regime (governmental versus competitive audit) and other control variables. The model is as follows:

$$EC_{i,t}\ (EC\_DUM_{i,t}) = \beta_{0} + \boldsymbol{\beta_1}\boldsymbol{*GOV_{i,t}} + \sum\varphi * Controls_{i,t} + \Upsilon_{t} + \varepsilon_{i,t} \quad (2)$$

In (2), the dependent variable *EC* is the degree of excessive student loan loss provision, as specified in (1) above. *GOV*, our variable of interest, is a binary variable that is set to 1 for the observations of the Canadian sample and to 0 for the observations of the U.S. control group. Because *EC* is a continuous measure of conservatism, a positive and significant coefficient on *GOV* would only indicate that the Canadian auditors are relatively more conservative than their counterparts in the competitive governmental market. However, this will not necessarily indicate excessive conservatism.[21] We, therefore, also run a second specification with the dependent variable *EC_DUM* where *EC_DUM* is set to 1 when *EC* is positive. A positive and significant coefficient on *GOV* in both specifications will indicate not only a higher degree of conservatism for the Canadian group, but also the existence of excessive conservatism.

Controls is a set of variables known to be associated with audit quality and includes *SIZE, BUDGET, ELECTION,* and *GDP_GROWTH*. *SIZE* is the natural logarithm of the total province or state population (Beck 2018). We control for size because client size can affect the degree of auditor conservatism (Reynolds and Francis 2001). *BUDGET* is a scaled measure of the jurisdiction's institutional disciplinary mechanisms requiring governments to run balanced budgets. The scale ranges from 0 (no

[21] Consider a situation where *EC* is negative rather than positive for the Canadian sample, but even more negative for the U.S. sample. *GOV* would still obtain a positive coefficient without the Canadian audits being excessively conservative.

institutional controls) to 10 (strict budgetary controls). The U.S. Advisory Commission on Intergovernmental Relations (ACIR) utilizes the Balanced Budget Stringency Scale (ACIR 1987) to measure the strength of the jurisdiction's balanced budget legislation; thus, we use the ACIR score for the U.S. observations. For the Canadian observations, we apply the ACIR's criteria to calculate the strength of each province's balanced budget legislation. We include this variable because we expect higher levels of institutional control over a government's fiscal management to be associated with conservative financial reporting. *ELECTION* is an indicator variable for an election year, which we include because, in an election year, governments have a stronger incentive to manipulate financial statements for political purposes.[22] Consequently, we expect more pressure on the auditor in an election year and consequently, a negative relationship between *ELECTION* and *EC*. We also account for macroeconomic effects by including in the model *GDP_GROWTH*, the change in gross domestic product (Bargeron et al. 2010). All variables are described in detail in Appendix A. Υ_t represents year fixed effects.

To examine the effect of a positive exogenous shock to auditor reputation on audit quality (Hypothesis 2), we examine the change in the level of conservatism demanded by Canadian government auditors from before to after the public release of the Sponsorship Program audit report in 2004, using a generalized difference-in-difference research design. We employ two different model specifications:

$$EC_{i,t} = \alpha_i + \boldsymbol{\beta_1 GOV_{i,}} + \boldsymbol{\beta_2 REP_{i,}} + \boldsymbol{\beta_3 GOV_{i,t} * REP_t} + \sum \varphi * Controls_{i,t} + \varepsilon_{i,t} \qquad (3)$$

$$EC_{i,t}\ (EC\_DUM_{i,t}) = \alpha_i + \boldsymbol{\beta_1 GOV_{i,t} * REP_t} + \sum \varphi * Controls_{i,t} + C_i + \Upsilon_t + \varepsilon_{i,t} \qquad (4)$$

The binary variable *REP* is set to 1 for the post-exogenous shock period that begins in 2005, and to 0 for the pre-exogenous shock period (2004 and earlier). We then interact the auditor regulatory regime variable *GOV* with *REP*. Model (3) includes *GOV* and *REP* as dependent variables, while in model (4) we

[22] Kido et al. (2012), for example, find that certain more discretionary liability estimates in election years are systematically lower than in non-election years.

replace them with country and year fixed effects (C_i and Υ_t respectively).[23] A positive and significant coefficient on the interaction variable *GOV*REP* will indicate that an increase in the government auditor reputation capital leads to excessive conservatism and, thus, to a decrease in audit quality.[24]

If the positive shock leads to an increase in auditor conservatism, we should expect the increase to occur in the immediate years after the release of the report. For this, we repeat the model while restricting the post-reputation shock period to the first four years (2005–2008).[25]

4. Main Results

Table 2, Panel A presents information on the distribution of our three measures of excessive conservatism and the control variables we use in testing our hypotheses for the two groups together. The mean for *EC*, the scaled measure for excessive conservatism is equal to -5.203. The negative balance indicates that for the entire sample the difference between the actual and estimated loan loss provision is smaller than the materiality threshold, and thus, not excessively conservative. We also observe that the binary variable *EC_DUM* is equal to 0.278, which means that for 27.8% of the observations, the auditor adjustments are larger than the materiality threshold. As for the control variables, average state and province population is 4.2 million. The mean value for *BUDGET* is 6.224. Mean *ELECTION* is 0.278 which is expected given that elections take place about every four years, and average GDP growth is 3.3%. Table 2, Panel B presents the mean values for our measures of excessive conservatism and the control variables for each group separately. The mean of *EC* is 18.487 for the Canadian group and -13.962 for the U.S. group, and the difference between the two groups is statistically significant. *EC_UNSC*'s values indicate that on average

[23] When *EC_DUM* is the dependent variable we only use the second model specification because of multicollinearity issues.

[24] To ensure the appropriateness of the use of difference-in-difference research design, we test the parallel trends assumption in the pre-shock period required for valid inference and find that the parallel trend assumption holds (Lennox 2016). We regress EC on a time variable and an interaction of time with GOV. The coefficient on the interaction term is insignificant, implying that the assumption is met.

[25] We would have liked to keep the full sample period, create a binary variable for the period beyond the first four years, and interact it with *REP*, which would allow us to measure both the short- and long-term effects in the same model. However, this introduces a serious multicollinearity problem (VIF higher than ten), probably due to the interaction of the two binary variables. Therefore, we do not report this specification.

the provision adjustments exceed materiality by $53.4 million for the Canadian sample and are $18.9 million less than the materiality threshold for the U.S. sample. Thus, the difference between the two groups is both statistically and economically significant. The *EC_DUM* values indicate that for 68.6% of the Canadian observations the audit adjustment to the student loan provision exceeds the materiality threshold, while this frequency is only 12.7% for the U.S. sample. *SIZE* is larger for the control group, indicating that the average state in our sample is larger than the average province. Budgetary control is stricter in the U.S. The proportion of election year observations and GDP growth are not statistically different between the two groups. The insignificant difference in GDP growth speaks into the similarities of the two economies.

[INSERT TABLE 2 ABOUT HERE]

Table 3, Panel A, shows the direct impact of the auditor on the provision for student loan losses. For the monopolistic auditors, the average actual student loan loss provision is $159.1 million, whereas the average estimated pre-audited provision is $65.3 million and the $93.8 million difference, the auditor adjustment, is statistically significant (t-value = 3.852). This result provides further evidence that monopolistic auditors require large adjustments to the initial estimates. In sharp contrast, for the competitive audit group, the actual and estimated provisions are much closer to each other ($19.2 million and $15.9 million, respectively), and are not statistically different from each other (t-value = 1.370). We complete the univariate analysis by showing in Panel B of Table 3 the actual and estimated provisioning rates on the student loans. For both groups the actual rate is significantly larger than the estimated rate. This is consistent with an auditor's bias towards conservative financial reporting as the audit adjustments are significant. We can see that monopolistic auditors demand a higher degree of conservatism as compared to the competitive audit group. However, we cannot make a direct inference about excessive conservatism given that materiality is ignored in Table 3. While for the U.S. sample the audit adjustments increase the provision by 2.4%, for the Canadian sample the adjustments increase the provision by 17.4% Overall, the results reported in Tables 2 and 3 taken together provide initial evidence of excessive conservatism by auditors that operate in a monopolistic environment and enjoy more power.

[INSERT TABLE 3 ABOUT HERE]

Table 4 presents the Pearson correlation matrix for all of the variables in the tests of the hypotheses. We find that both *EC* and *EC_DUM* are positively and significantly correlated with *GOV* (correlation coefficients of 0.328 and 0.554, respectively). Consistent with the results in Table 2, Panel B, and Table 3, this finding suggests that auditors operating in monopolistic environment and enjoying enhanced power demand excessive adjustments. We also find that our measures of excessive conservatism are negatively correlated with *BUDGET*, indicating that the provisions are less conservative when the budgetary legislation is stricter. *SIZE* and *GDP_Growth* are positively and negatively correlated with *EC*, respectively, but not with *EC_DUM*. The levels of correlation among the remaining variables are moderate, alleviating multicollinearity concerns. Nonetheless, we check the variance inflation factor (VIF) in all of our tests and we find that each individual variable VIF and mean VIF for each model are below the threshold of 10 as suggested by Kennedy (2008). Overall, the correlation matrix provides further evidence of excessive conservatism of monopolistic auditors.

[INSERT TABLE 4 ABOUT HERE]

Table 5 presents the multivariate results of the association between audit quality and the different audit market regimes (Equation 2).[26] Column 1 presents the results of an OLS regression, with *EC* as the dependent variable. The coefficient on *GOV* is 51.814 and is statistically significant at the 1% level. This finding suggests that for the entire sample period, student loan loss provisions under the monopolistic environment are significantly more conservative. From column 2, when using a Logit regression and *EC_DUM* as the dependent variable, we once again observe a positive and significant coefficient for *GOV*, and the model correctly predicts the dependent variable 87.1% of the time. This finding suggests that the monopolistic auditors are more likely to require excessive adjustments. As for the control variables, *SIZE* and *BUDGET* are positively associated with the dependent variable in both model specifications. Overall,

[26] We use robust standard errors because clustering by robust standard errors will result in biased standard errors due to too few clusters (Cameron and Miller 2015).

with regards to hypothesis *H1* our results show that for the entire sample period, auditors operating in a monopolistic environment require excessive conservatism, thereby providing lower quality audits.[27]

[INSERT TABLE 5 ABOUT HERE]

To provide further evidence on the excessive nature of the audit adjustments by the Canadian auditors, we examine the relationship between the student loan loss provision adjustment and future write-offs. If the adjustments are driven by economic reality, they should be predictive of future losses, or in other words, we should observe a positive association between the adjustments and future student loan write-offs. On the other hand, if the adjustments are motivated by excessive conservatism, then the write-offs will not be sensitive to the audit adjustments. Actual losses on student loans are usually not reported separately from other loan losses. However, for 43 out of the 105 observations, or about 40% of our sample, we are able to find information on student loan write-offs. For this reduced sample, we then regress the student loan write-offs, scaled by population, in year *t+1*, on the variable *Audit_Adjustment*, the audit adjustments (the difference between the actual and the estimated provisions) in year *t*. We also include in the regression *Estimated_Allowance*, the estimated provision and the control variables and report the results in Table 6. The results reported in the first column show a positive and significant association between the write-off and the estimated provision, but an insignificant association with the auditor adjustments. These results suggest that auditor adjustments to the loan loss provisions are excessively conservative. Because of the relatively small number of observations and its effect on the degrees of freedom, we run a second specification without year fixed effects,[28] and instead include in the model the variable *UNEMPLOYMENT*,

[27] To the extent that compensation scheme differences between governmental auditors and private sector auditors might affect the auditor's performance, a mitigating factor is the fact that the career path of many government auditors includes the eventual transition to the private sector. This sentiment is echoed in the Alberta OAG 2018 Business Plan and Budget report: "*We compete with private sector auditing and consulting firms for designated accountants and other professionals with specialized technical skills.*" The report further indicates that their annual turnover target is to be less than 20% (the Ontario OAG 2018 report paints a similar picture of a fierce competition from the private sector for human resources). Thus, government auditors have a labor market incentive to supply high quality audits like their private sector counterparts. We acknowledge that individual auditor traits are likely to affect audit quality and those might differ between the two groups. However, information on individual auditor traits is rarely available and is a limitation of most comparative audit studies.

[28] Because most of the write-off data is from the later years, there are only 12-year fixed effects in the model.

the change in the unemployment rate at the province-year level. We report the results of this specification in the second column and we still find an insignificant (significant) association of future write-offs and the auditor adjustments (estimated provisions). In Section 5.2 we further examine the real effects of the auditor adjustment and show that it adversely affects future lending.

[INSERT TABLE 6 ABOUT HERE]

Our second hypothesis concerns the effect of a positive shock to auditor reputation on the excessive conservatism demanded by the auditor, which we examine next. Table 7, Panel A presents our various measures of excessive conservatism for monopolistic and competitive auditors, before and after the reputation shock to the Canadian auditors. We find that in the pre-reputation shock period, for both groups, the difference between the actual and estimated student loan loss provision is within the bounds of materiality and are not statistically different from each other (-5.995 for the Canadian sample versus -3.878 for the U.S. sample, with t-value of the difference = -0.958). Thus, the univariate results show no difference in conservatism between the two groups prior to the reputation shock. However, after the increase in the reputation for the monopolistic auditors, we find that their adjustments to the loan loss provisions become excessive, as they exceed the bounds of materiality. *EC*, that was -5.995 in the pre-reputation shock period, jumps to 23.552 in the post-reputation shock period, with the difference being statistically significant (t-value = -4.395). We also note that the probability of having the adjustment to the provision exceeding the bounds of materiality (*EC_DUM* = 1) jumps from 11.1% to 80.5%. For the competitive audit group, the average difference between the actual and estimated loan loss provisions remains within the bounds of materiality, and the difference between the two periods is insignificant (t-value = 1.). There is also no significant difference for the competitive group in the probability of having the auditor adjustment larger than materiality between the two period (21.2% and 11.6% respectively, with a z-value of 1.568). To understand the difference in monetary terms, we also examine *EC_UNSC*. In the post-reputation shock period, the difference between the actual and estimated loan loss provisions exceeds the materiality

threshold by $65.1 million for the monopolistic auditors, while it is $20.0 million less than the materiality threshold for the competitive auditors.

[INSERT TABLE 7 ABOUT HERE]

[INSERT FIGURES 1 AND 2 ABOUT HERE]

Figure 1 depicts the average *EC* for each of the groups in the pre- and post-reputation shock periods and illustrates the excessive conservatism of monopolistic auditors after the reputation shock. Figure 2 depicts the trend in *EC* over the sample period. As can be seen, in the pre-reputation shock years, *EC* is negative, consistent with auditor adjustments being within the materiality bounds. However, in the years following the reputation shock, *EC* quickly becomes positive and remains positive until the end of the sample period. We do not observe such an increase for the competitive auditors during this period, as *EC* remains consistently negative.

We provide direct evidence on the auditor adjustments in Table 7, Panel B. We can see that for the monopolistic group the actual provision exceeds the estimated provision by $111.9 million after the positive shock to the auditor's reputation, which is statistically significant (t-value = 3.985). Conversely, for non-monopolistic auditors, in the post-reputation shock period, there is no significant difference between the actual and estimated provisions (t-value = 1.106). Overall, the monopolistic auditors appear to demand excessively conservative provisioning after the reputation shock, which is not the case for the control group.

In Table 8, we use various between-subjects, between-periods research designs to present multivariate results on the effect of the change in the monopolistic auditor's reputation on audit quality. In column 1 we utilize the standard difference-in-difference approach, incorporating the main effects *GOV* and *REP* without fixed effects (Equation 3) with *EC* as the dependent variable. The positive coefficient on *GOV* suggests that after controlling for other determinants, already in the pre-reputation shock period, the governmental auditors are more conservative than the private sector auditors. The significant coefficient on *GOV *REP* suggests that after the increase in their reputation, government auditors become even more

conservative relative to their counterparts. In column 2, we use the generalized difference-in-difference model and therefore replace the main effects with year and country fixed effects (Equation 4) and our variable of interest *GOV *REP* continues to be positive and significant. In Column 3 we replace *EC* with *EC_DUM* as the dependent variable and use a Logit regression and obtain similar results. Overall, our findings suggest that, after the reputation increase, monopolistic auditors demand excessively conservative loan loss provisions.

[INSERT TABLE 8 ABOUT HERE]

If the increase in auditor conservatism to the point where it becomes excessive is due to the reputation increase, the effect should start appearing already in the years immediately after the reputation shock (as we observe in Figure 4). We, therefore, repeat the tests while limiting the post-shock period to the first four years (2005–2008), and we report the results in columns 4–6. In all columns, once again, the coefficient on *GOV*REP* is positive and statistically significant.

5. **Supplementary Analysis**

5.1. Limitation of Government Auditors' Power

In the context of managerial power theory, Bebchuk et al. (2002) argue that their theory does not imply that managers enjoy unlimited power. An important factor they identify to limit managerial power is the degree of "outrage" the manager's proposed pay package would create. We draw parallels with the managerial power theory to suggest that excessive conservatism will also be constrained. Clients might show "outrage" if the adjustments are excessive and conflict with their own reporting incentives. In a large scale study of 74 countries and 350 election campaigns at the national level, Brender and Drazen (2008) show that in developed countries and established democracies, incumbents decrease their reelection probability if they

report a budget deficit in an election year and over the incumbent's term of office.[29] Kido et al. (2012) show that in an election year, the liability for compensated absences and the unfunded pension liability (two liabilities that allow for the use of discretion) of state governments are abnormally small. Thus, we expect resistance ("outrage") from provinces to the auditor's adjustment to increase the more negative their budgetary balance is. In other words, we expect a positive association between the extent of excessive conservatism and the pre-adjustment budgetary balance. To test this conjecture, we regress *EC* on the variable *BALANCE*, the province's budgetary balance before the auditor's adjustment to the student loan loss provision and on other controls. The results reported in Table 9 show, consistent with this prediction, a positive and significant coefficient on *BALANCE*.[30]

[INSERT TABLE 9 ABOUT HERE]

5.2. Real Consequences of Excessive Conservatism

We examine if the excessive provisions to student loan losses affect student lending, or in other words whether they lead to credit rationing. Such a finding will entail real adverse economic consequences of the auditor's self-serving behavior. We regress student lending in year t+1 on audit adjustments in year t and other control variables. We add to the model the variable *TUITION*, the average provincial undergraduate tuition fees for all fields of study. We report on both level and change specifications in Table 10 (columns 1 and 2, respectively). Under both specifications *Audit_Adjustment* obtains a negative and significant coefficient, consistent with excessive audit adjustments leading to smaller future student lending.[31]

[INSERT TABLE 10 ABOUT HERE]

[29] Peltzman (1992), Brender (2003), and Drazen and Eslava (2010) find that voters at the state and local level in a single country (the United States, Israel, and Colombia, respectively) punish—rather than reward—incumbents for loose fiscal policies in general, as well as in election years.

[30] Our results are similar if we use the auditor adjustments as the dependent variable instead.

[31] The number of observations for this test is 98 because we do not have future lending data for the last year of our sample.

5.3 Does the Government Affect the Provision?

In our analysis, we assume that the government records the student loan loss provision according to the provisioning rate guidance and that the difference between the actual and estimated student loan loss provision is due to the auditor intervention. Beck (2018) documents that municipal governments in the U.S. pursue a break-even budget. To the extent that provincial governments in Canada also pursue a break-even budget, and if they attempt to influence the actual student loan loss provision amount, we will expect the adjustments to bring the budget closer to a break-even point. Our analysis shows that the adjustments actually increase budget deficits, suggesting that it is unlikely that the government plays an active role in influencing the actual provisioning amount. We find that in 61 out of the 105 cases (58.1%), the actual provision brings the deficit further away from zero relative to the estimated provision (untabulated). Furthermore, if the government attempts to influence the provision, it would be more motivated to do so in an election year. However, we find that in election years in 62.1% of the cases, the actual provision brings the deficit further away from zero (untabulated). Finally, Beck (2018) reports that in addition to presenting a balanced budget, municipal governments prefer to avoid reporting a deficit. We find that in 3 out of the 105 cases the adjustment to the provision shifts the budget from a surplus to a deficit and we find no cases of a shift from a deficit to a surplus. We conclude that the government is unlikely to play a significant role in influencing the actual provision, and that it is reasonable to assume that the difference between the actual and the estimated provision is due to the auditor adjustments.

5.4. Additional Robustness Tests

First, we want to ensure that the reputation effect on audit quality we document is driven by the sample group and not by the control group. For this, we repeat the analysis in Table 8 using only the Canadian sample with a binary variable for the post reputation period, and we obtain very similar results (untabulated). Second, we notice that the method for calculating the materiality threshold for the two groups is different. To ensure that the methodological difference does not affect the results we apply the same

materiality calculation from the control group to the Canadian sample and we obtain similar results (untabulated). Third, it is possible some U.S. auditors in the sample have experience with auditing banks and other financial lending institutions. This other experience, in turn, may affect the audit quality difference we observe. To address this possibility, we first identify each audit firm by name, location and year, and examine the Audit Analytics database to determine whether the specific audit office also audits any bank or other financial lending institution. In such a case, we remove that observation. Our results after doing so remain unchanged (untabulated).[32] Fourth, it is possible that the government guidelines for the default rates are slow to incorporate macroeconomic changes. To account for this possibility, we use one-year ahead default rates instead of current default rates and repeat our tests. Our results remain unchanged under this specification.

6. Conclusions

The effect of power on social interaction outcomes (Emerson 1962; Mahoney 2004) in general, and also on economic outcomes (Crook and Combs 2007; Gulati and Sytch 2007) has been extensively examined. Surprisingly, the issue has received very little attention in audit research. We address this issue by examining how auditor power affects one important aspect of audit quality, using a unique setting of government audits. We use a sample of student loan loss provision audits by government auditors in Canada who enjoy a high degree of power due to their monopoly status, thereby giving them the opportunity to push for audit adjustments that mitigate their ultimate audit risk—the overstatement of assets. We find that these auditors use their dominant market position to their advantage to push for excessively conservative loan loss provisions. Consistent with the excessive nature of the auditor adjustment, we find that the audit adjustments are not associated with future write-offs. We further document real adverse consequences of the excessive auditor adjustments as they are negatively correlated with future lending, suggesting that they lead to credit rationing.

[32] We thank an anonymous reviewer for suggesting this test.

Research on auditor reputation risk and its effect on audit quality is limited, and further research is needed on this fundamentally important issue (DeFond and Zhang 2014). The literature provides some evidence on the consequences of a negative shock to auditor reputation; yet, we are unaware of any study that examines the consequence of an increase in auditor reputation on audit quality. We identify such an event, the discovery by the Auditor General of Canada of a massive misuse of public funds by the governing Liberal Party in 2004. This allows us to examine the effect of a positive shock to the reputation of Canadian government auditors on the degree of conservatism they demand for adjustments to student loan loss provisions. We find that in the pre-reputation shock period, the adjustments are more conservative than those required by non-monopolist auditors, but they are not yet excessive. However, after the increase in auditor reputation, the adjustments become excessively conservative. Prior research has noted that audit quality and auditor reputation are positively related, and that increased conservatism is, in general, a sign of high audit quality (DeFond and Zhang 2014). However, in our setting, we find the opposite—a negative association—as the increase in auditor reputation leads to lower audit quality. We attribute our result to the increase in auditor bargaining power and the desire to use their newfound audit reputation to their advantage. We conclude that the combination of a strong market position and increased reputation puts auditors in a position where they can force clients to report in an excessively conservative manner.

We conduct several complementary analyses. We draw parallels with the managerial power theory of Bebchuk et al. (2002) to show that auditor power is not unlimited. We show that clients are more likely to resist the auditor and limit the excessively conservative adjustments when those conflict with the client's reporting incentives. Finally, we show that the government is unlikely to play a significant role in influencing the actual provision, lending support to our assumption that the difference between the actual and the estimated provisions is due to the auditor adjustments.

We introduce a new measure for audit quality by comparing audit adjustments to materiality, which allows us to distinguish between conservatism and excessive conservatism. We suggest that excessive conservatism results in lower financial reporting quality because the financial statements diverge from

economic reality. While we recognize that this measure is unique to our setting, we believe that the premise of the measure can be extended to other settings. Overall, we contribute to the literature by providing evidence that excessively conservative financial statements are a potential consequence of strong auditor power and elevated auditor reputation.

APPENDIX A: Variable Definitions

Variable Name	Definition
EC	The difference between the actual student loan loss provision and the estimated, pre-audit, provision, minus the materiality threshold amount, scaled by the total population of the province for the Canadian sample, and the state population for the U.S. sample.
EC_UNSC	Unscaled *EC*.
EC_DUM	A binary variable that is set to 1 if *EC* is positive, and to 0 otherwise.
GOV	A binary variable that is set to 1 for audits by governmental monopolistic auditors, and 0 for audits by private sector regulated auditors.
REP	A binary variable that is set to 1 for the post-reputation shock period (beginning in 2005), and to 0 for the pre-reputation shock period (2004 and earlier).
SIZE	The natural logarithm of provincial or state population.
BUDGET	Ordinal ranking of budget balanced legislation effectiveness, ranging from 0 (no legislative controls) to 10 (strict budgetary controls).
ELECTION	A binary variable that is set to 1 for election years, and to 0 for non-election years.
GDP_GROWTH	The provincial/state GDP growth rate.
WRITEOFF	The amount of student loans write off scaled by population.
Estimated_Allowance	The expected student loan loss provision, calculated based on the government guidelines, scaled by population.
Audit_Adjustment	The difference between the actual and the estimated loan loss provision, scaled by population.
BALANCE	The province's budgetary balance before the auditor's adjustment to the student loan loss provision, scaled by population.
UNEMPLOYMENT	The change in the unemployment rate at the province-year level.
TUITION	The average provincial undergraduate tuition fees for all fields of study.

APPENDIX B: Component Materiality Calculation

The following is an output of the component materiality, as calculated by GUAMcalc (Stewart and Kinney 2013) for the Province of Ontario. Group materiality refers to the materiality level for group-level financial statements, and component materiality refers to the materiality level assigned to the component level (Health, Education, etc.).

Group Materiality: $708 Million
Desired Group Assurance: 95%

Component Name	Component Expenses	Component Size	Component Materiality
Health	$56,025	40%	$267
Education	$26,204	18%	$200
Children's and Social Services	$16,006	11%	$165
Environment, Resources & Economic Development	$12,714	9%	$151
Interest on Debt	$11,709	8%	$146
Postsecondary and Training	$10,131	7%	$138
Justice	$4,618	3%	$100
General Government and Other	$4,318	3%	$97

APPENDIX C: Calculation of Excessive Conservatism

Panel A: Information from the 2017 Vermont Student Assistance Corporation Financial Statements (in millions)

Student Loans Receivable	$883
Allowance for Loan Loss	$(28)
Total Student Loans Receivable	$855
Total Assets	$1,003
U.S. Department of Education Guarantee	$586

Panel B: Calculation of the Estimated Allowance (in millions)

	A	B	C	D = (A*B*C)
	Student Loans Receivable	**Default Rate**	**Loss Given Default Rate**	**Estimated Provision**
Insured by Department of Education	$586	5.9%	3.0%	$1
Uninsured by Department of Education	$297	11.0%	80.0%	$26
Total	$883			$27

Panel C: Calculation of Materiality (in Millions)

E	F	G = E*F
Total Assets	**Quantitative Materiality Rate**	**Materiality**
$435[33]	3%	$13

Panel D: Comparison of Excessive Conservatism (in millions)

G	H	G - H
Materiality	**(Actual Provision – Estimated Provision)**	**Difference**
$13	($28 - $27)	($12)

The Department of Education insured student loan default rate is the 2015 Vermont three-year cohort default rate (2015–2017). The uninsured Department of Education rates were obtained from S&P.

[33] 1,003 – (586 * 0.97) = 435. This is because 97% of the loan is guaranteed.

EXHIBIT 1.1: The Star Phoenix

The office of the auditor general has been deemed **infallible** since **Sheila Fraser** almost single-handedly brought down Paul Martin's Liberal government with her report on the sponsorship scandal.
Ministers whose departments have been unfortunate enough to fall foul of a critical audit have genuflected and promised to fix the problem pronto.

The Star Phoenix
1,094 words
15 June 2018
Saskatoon Star Phoenix
SSP
Early
NP5
English

EXHIBIT 1.2: WINNIPEG FREE PRESS

This watchdog barked, growled–Servant of the people, Sheila Fraser leaves with her reputation, integrity intact

[Sheila] Fraser would go on to rock-star status–flowers from people on the street, so the story goes.
I love the idea that a chartered accountant has achieved celebrity status–it's oh-so Canadian that people on the streets would recognize the auditor general who turned the language of value-for-money audits into plain English.

Catherine Mitchell
833 words
27 May 2011
Winnipeg Free Press
WFP
A15
English

EXHIBIT1.3: THE WINDSOR STAR

When Auditor General Sheila Fraser's report on the sponsorship scandal came out in 2004, accusing Liberal Party officials and friendly bureaucrats of conspiring to break "every rule in the book," there were furtive attempts to go after her as well. Whisper campaigns were put about to the effect that she was out of control, that she was embarked on a "witch hunt." We recall how that turned out. Whatever institutional power the government might have possessed, Fraser's reputational power demolished it. It wasn't even a fair fight.

Postmedia News
932 words
18 October 2012
Windsor Star
WINSTR
Final
A11
English

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FIGURE 1

This figure depicts the average excessive conservatism for the monopolistic audit group and the competitive audit group in the pre- and post-auditor reputation shock period.

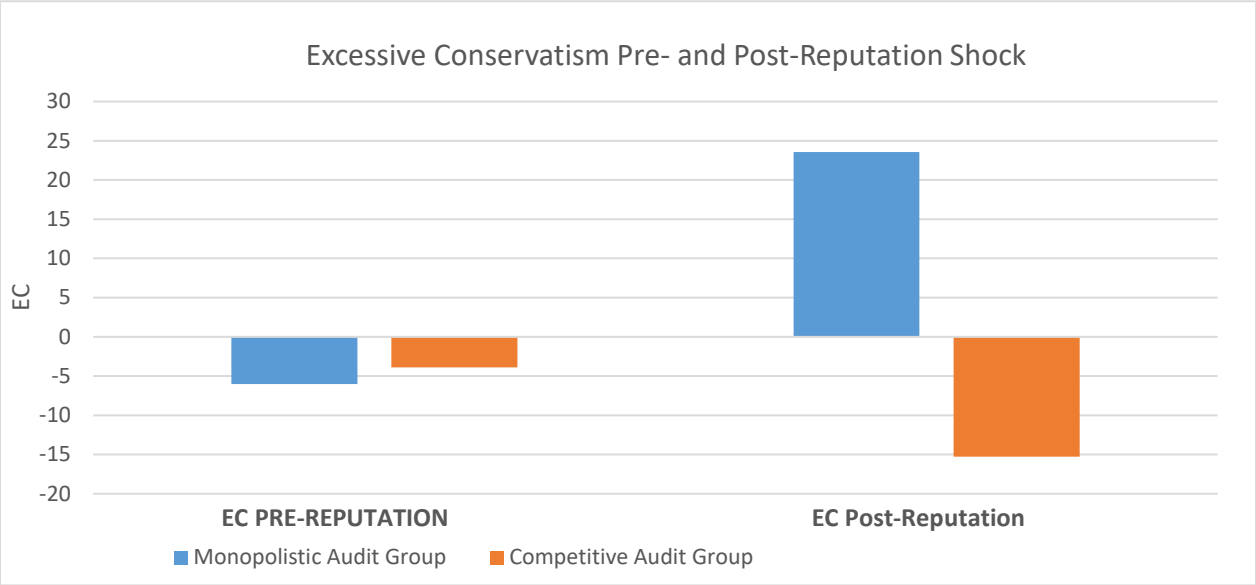

FIGURE 2

This figure depicts the parallel trends in *EC*, our measure of excessive conservatism, over time for the monopolistic and the competitive audit markets.

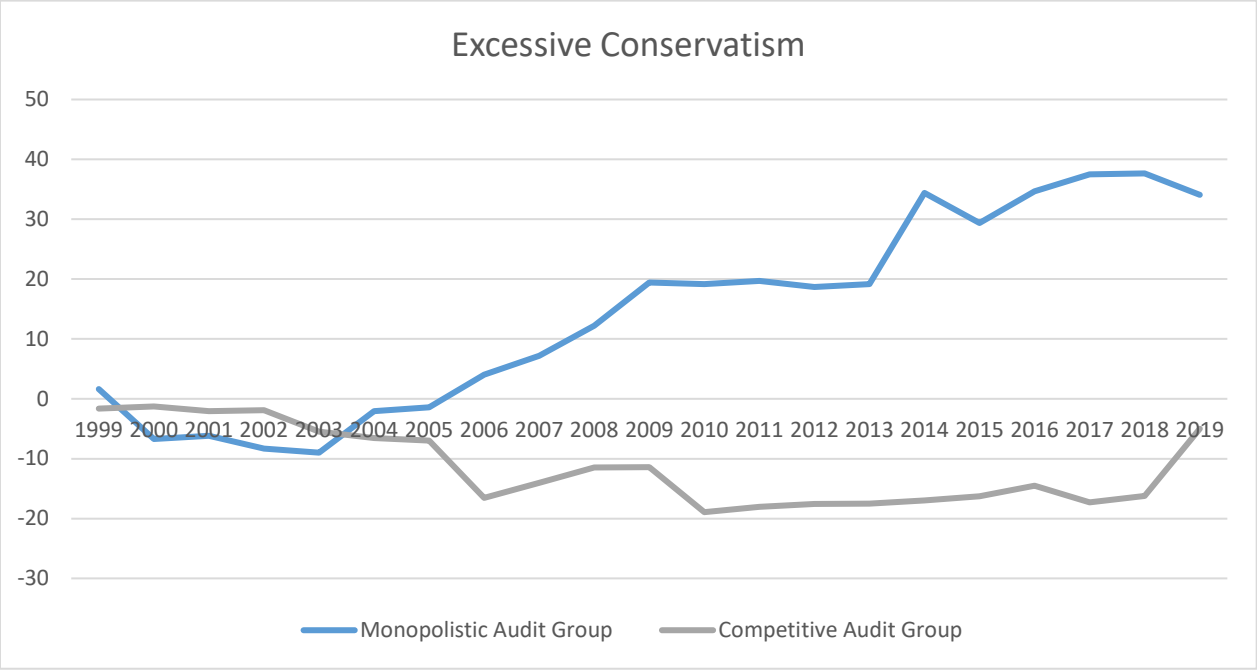

TABLE 1: Frequency of Observations by Year

Fiscal Year	**Observations**	%
1999	3	0.77
2000	7	1.80
2001	9	2.31
2002	9	2.31
2003	10	2.57
2004	13	3.34
2005	13	3.34
2006	15	3.86
2007	18	4.63
2008	21	5.40
2009	22	5.66
2010	24	6.17
2011	26	6.68
2012	25	6.43
2013	25	6.43
2014	25	6.43
2015	25	6.43
2016	27	6.94
2017	26	6.68
2018	26	6.68
2019	20	5.14
	389	100

TABLE 2

Panel A: Descriptive Statistics by distribution:

	N	Mean	P1	P25	P50	P75	P99
EC	389	-5.203	-264.463	-5.449	-2.247	0.939	85.247
EC_UNSC	389	0.618	-196.532	-17.637	-5.539	2.149	342.721
EC_DUM	389	0.278	0.000	0.000	0.000	1.000	1.000
GOV	389	0.270	0.000	0.000	0.000	1.000	1.000
SIZE	389	0.900	-1.988	-0.050	1.103	1.797	2.639
BUDGET	389	6.224	0.000	1.000	8.000	10.000	10.000
ELECTION	389	0.278	0.000	0.000	0.000	1.000	1.000
GDP_GROWTH	389	0.033	-0.089	0.021	0.034	0.046	0.164

Panel B: Univariate Statistics by Audit Market Competition

Variable	Monopolistic Audit Group	Competitive Audit Group	Difference	t-value/z-value
	Mean	Mean	Mean	
Excessive Conservatism Measures				
EC	18.487	-13.962	32.449	6.821***
EC_UNSC	53.437	-18.911	72.348	9.749***
EC_DUM	0.686	0.127	0.559	10.928***
Control Variables				
SIZE	0.187	1.163	-0.976	-7.931***
BUDGET	0.762	8.243	-7.481	-27.414***
ELECTION	0.276	0.278	-0.002	-0.039
GDP_GROWTH	0.037	0.032	0.005	1.035
N	105	284		

This table presents the univariate statistics for the variables used to test hypothesis *H1*. Panel A presents the descriptive statistics for the two samples together. Panel B reports univariate statistics for each group separately. All variables are described in Appendix A. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

TABLE 3

Panel A: Actual and Estimated Provisions for Student Loan Loss by Audit Market Competition

Variable	Actual Provision	Estimated Provision	Difference	t-value for difference
	Mean	Mean	Mean	
Monopolistic Audit Group	159.101	65.343	93.758	3.852***
Competitive Audit Group	19.214	15.878	3.336	1.370

Panel B: Actual Default Rate and Estimated Provisioning Rate for Student Loan Loss by Audit Market Competition

	Actual Provision Rate	Estimated Default Rate	Difference	t-value
Monopolistic Audit Group	28.8%	11.4%	17.4%	11.838***
Competitive Audit Group	7.8%	5.4%	2.4%	2.063**

Panel A presents the difference between the average actual and estimated student loan loss provisions. Panel B compares the actual and the estimated default rates for non-guaranteed student loans. *, **, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

TABLE 4: Pearson Correlation Matrix

	EC	***EC_DUM***	***GOV***	***SIZE***	***BUDGET***	***ELECTION***	***GDP_ GROWTH***
EC	1.000						
EC_DUM	0.386***	1.000					
GOV	0.328***	0.554***	1.000				
SIZE	0.127**	-0.041	-0.374***	1.000			
BUDGET	-0.196***	-0.354***	-0.812***	0.444***	1.000		
ELECTION	-0.007	-0.013	-0.002	-0.016	-0.056	1.000	
GDP_ GROWTH	-0.121**	0.044	0.053	-0.091*	-0.020	0.029	1.000

This table presents the Pearson correlation matrix for the variables used for testing our hypotheses. *,**, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

TABLE 5: Association between the Regulatory Audit Environment and Excessive Conservatism

	EC	***EC_DUM***
GOV	**51.814*** **	**11.226*** **
	(8.665)	(7.626)
SIZE	9.921***	0.413**
	(3.783)	(2.203)
BUDGET	1.238***	0.864***
	(2.698)	(5.369)
ELECTION	0.392	-0.083
	(0.063)	(-0.207)
GDP_GROWTH	-174.901	5.877
	(-1.136)	(0.988)
Intercept	-28.711**	-10.695***
	(-2.122)	(-6.66)
YEAR FIXED EFFECTS	YES	YES
Adj or Pseudo R-Sq.	0.150	0.287
Observations Correctly Predicted	NA	87.1%
N	389	389

This table presents multivariate results of the effect of the regulatory environment on excessive conservatism (hypothesis *H1*). Column 1 presents the results of an OLS regression with *EC* as the dependent variable. Column 2 presents the results of a Logit regression with *EC_DUM* as the dependent variable. t-values and z-values are presented in parentheses. No individual VIF exceeds 10 the threshold suggested by Kennedy (2008). See Appendix A for variable definitions. *, **, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

TABLE 6: Association between Auditor Adjustments to Student Loan Loss Provisions and Future Loan Write-Offs

	WRITEOFF	***WRITEOFF***
Estimated_Allowance	**0.524*** **	**0.455*** **
	(3.994)	(2.963)
Audit_Adjustment	**0.080**	**0.123**
	(1.128)	(1.393)
SIZE	-1.376	-2.089***
	(-1.545)	(-3.035)
BUDGET	-0.554	-3.249*
	(-0.260)	(-1.955)
ELECTION	1.073	0.549
	(0.274)	(0.124)
GDP_GROWTH	30.290	57.935
	(0.840)	(1.490)
UNEMPLOYMENT		4.305
		(1.127)
INTERCEPT	-18.479*	-3.145
	(-1.812)	(-0.481)
Year Fixed Effects	YES	NO
Adj. R-sq.	0.555	0.418
N	43	43

This table presents the multivariate results of an OLS regression on the association between student loan write-offs in year t+1 and the estimated student loan loss provisions and the audit adjustments to the provisions in year *t*. t-values are presented in parentheses. No individual VIF exceeds 10, the threshold suggested by Kennedy (2008). See Appendix A for variable definitions. *, **, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

TABLE 7

Panel A: Excessive Conservatism for the Pre- and Post-Reputation Shock by Audit Market Regulatory.

Variable	Entire Sample	Monopolistic Audit Group	Competitive Audit Group	Difference	t-value/z-value
	Mean	Mean	Mean	Mean	
EC — Pre	-4.625	-5.995	-3.878	-2.117	-0.958
EC — Post	-5.290	23.552	-15.287	38.839	7.076***
Difference	0.665	-29.547	11.409		
t-value	0.100	-4.395***	1.353		
EC_DUM — Pre	0.176	0.111	0.212	-0.101	-0.904
EC_DUM — Post	0.293	0.805	0.116	0.689	12.170***
Difference	-0.117	-0.694	0.096		
z-value	-1.731*	-5.769***	1.568		
EC_UNSC — Pre	-7.928	-3.043	-10.593	7.550	1.705*
EC_UNSC— Post	1.907	65.122	-20.004	85.126	10.071***
Difference	-9.835	-68.165	9.411		
t-value	-0.904	-2.451**	1.396		

Panel B: Actual and Estimated Student Loan Loss Provisions in the Pre- and Post-Reputation Shock by Audit Market Regulatory.

Variable	Actual Provision	Estimated Provision	Difference	t-value
	Mean	Mean	Mean	
Monopolistic Audit Group-Pre	10.058	4.190	5.868	1.930*
Competitive Audit Group-Pre	8.085	2.118	5.967	2.493**
Monopolistic Audit Group-Post	189.938	77.996	111.942	3.985***
Competitive Audit Group-Post	20.677	17.687	2.990	1.106

This table presents the univariate results for the variables used to test hypothesis *H2*. Panel A presents the level of excessive conservatism by audit market structure in the pre- and post-reputation shock environment. Panel B presents the actual and estimated student loan loss provisions for the pre- and post-reputation shock by audit market structure. *, **, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

TABLE 8: Association between the Increase in Auditor Reputation and Excessive Conservatism

	Long Window			Short Window		
	EC	***EC***	***EC_DUM***	***EC***	***EC***	***EC_DUM***
GOV	**25.193*** **			**28.959*** **		
	(4.715)			(5.103)		
REP	-10.501***			-4.909*		
	(-3.023)			(-1.847)		
GOV*REP	**30.737*** **	**29.938*** **	**4.502*** **	**13.687*** **	**13.375*** **	**8.852*** **
	(6.430)	(6.330)	(5.095)	(3.525)	(3.367)	(3.414)
SIZE	9.148***	9.134***	0.404*	10.446***	10.677***	7.709*
	(3.533)	(3.462)	(1.796)	(6.889)	(6.609)	(1.850)
BUDGET	1.231***	1.297***	0.931***	1.416***	1.451***	1.785**
	(2.883)	(2.827)	(5.218)	(3.349)	(3.086)	(2.420)
ELECTION	0.518	0.139	-0.226	-1.234	-1.391	-0.646
	(0.119)	(0.023)	(-0.599)	(-0.402)	(-0.493)	(-0.320)
GDP_GROWTH	-148.089	-177.583	6.696	-54.056	-68.348	38.130*
	(-1.174)	(-1.155)	(0.920)	(-0.987)	(-0.977)	(1.790)
INTERCEPT	-20.859***	-29.288**	-11.509***	-28.343***	-27.079***	-27.533**
	(-2.929)	(-2.181)	(-6.347)	(-6.484)	(-5.004)	(-2.389)
YEAR FE	NO	YES	YES	NO	YES	YES
COUNTRY FE	NO	YES	YES	NO	YES	YES
Observations Correctly Predicted	N/A	N/A	86.1%	N/A	N/A	93.2%
Adj or Pseudo R-Sq.	0.195	0.160	0.331	0.477	0.455	0.432
N	389	389	389	118	118	118

This table presents multivariate results on the effect of increase in auditor reputation on excessive conservatism. Columns 1, 2, 4 and 5 present the results of OLS regressions, with t-values presented in parentheses. Columns 3 and 6 present the results of Logit regressions, with z-values presented in parentheses. Our variable of interest is *GOV*REP*, the interaction between the audit market regime and the post-reputation shock period. Columns 4, 5 and 6 analyze the change in excessive conservatism in a short four-year window immediately after a reputation shock (2005-08). No individual VIF exceeds 10 the threshold suggested by Kennedy (2008). See Appendix A for variable definitions. *, **, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

TABLE 9: Association between Excessive Conservatism and Budgetary Balance

	EC
BALANCE	**0.010****
	(2.225)
SIZE	-0.297
	(-0.129)
BUDGET	-10.996***
	(-2.950)
ELECTION	-1.536
	(-0.227)
GDP_GROWTH	42.659
	(0.804)
Intercept	46.725***
	(3.922)
YEAR FIXED EFFECTS	YES
Adj. R-sq.	0.222
N	105

This table presents the multivariate results of an OLS regression on the association between the budgetary balance before the audit adjustment to the student loan loss provisions, *BALANCE* and excessive conservatism, *EC*. No individual VIF exceeds 10 the threshold suggested by Kennedy (2008). See Appendix A for variable definitions. *, **, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.

TABLE 10: Association between Future Student Loans and Auditor Adjustment

	$Loans_{t+1}$	$\Delta Loans_{t+1}$
Audit_Adjustment	**-13.096*** **	**-0.314***
	(-5.209)	(-1.793)
SIZE	530.615***	-1.728
	(11.778)	(-0.817)
BUDGET	-255.500***	7.293
	(-2.971)	(1.213)
ELECTION	-107.435	0.381
	(-0.744)	(0.056)
GDP_GROWTH	725.119	-170.135*
	(0.704)	(-1.902)
TUITION	0.269***	0.001
	(5.138)	(0.234)
Intercept	-74.729	37.857
	(-0.137)	(1.548)
YEAR FIXED EFFECTS	YES	YES
Adj. R-sq.	0.723	0.040
N	98	98

This table presents the multivariate results of an OLS regression on the association between the level and change in future student loans (dependent variables $Loans_{t+1}$, $\Delta Loans_{t+1}$) and the audit adjustments. No individual VIF exceeds 10 the threshold suggested by Kennedy (2008). See Appendix A for variable definitions. *, **, and *** denote statistical significance at the 10%, 5% and 1% levels, respectively.