

THE CONTAGION EFFECT OF OFFICE-LEVEL AUDIT FAILURES

Paul Nicholas Michas

Dr. Jere R. Francis, Dissertation Supervisor

ABSTRACT

I investigate if the presence of an audit failure in an auditor office location in a given fiscal year indicates the presence of a *contagion effect* on the quality of other concurrent audits conducted by the office. Audit quality is inferred by cross-sectional differences in clients' audited earnings, specifically, abnormal accruals. I find that the presence of at least one audit failure (defined as a downward restatement of net income by a client) is indicative of contagion within the office. Specifically, for offices with one or more client restatements, abnormal accruals of other clients in the office are significantly larger (on average) than in those offices that have no restatements. This result holds for offices of both Big Four and non-Big Four auditors. Further analysis indicates the contagion in Big Four offices occurs in smaller offices and in Big Four offices where a low percentage of audits are conducted in those industries in which an office is the city-level industry leader (irrespective of office size).