UNIVERSIDADE CATÓLICA PORTUGUESA

Pay to Win? The Impact of Accounting Conservatism on Audit Quality Through the Lens of Audit Fees

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Abril, 2025

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Trabalho Final na modalidade de Dissertação

apresentado à Universidade Católica Portuguesa

para obtenção do grau de mestre em Auditoria e Fiscalidade

Realizado por

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Abril, 2025

Agradecimentos

Primeiro de tudo, queria agradecer ao professor Aviner Augusto Manoel por todo o apoio, motivação e empenho na orientação da minha tese. Sem os seus conhecimentos e colaboração este trabalho não teria sido possível.

Agradeço à Universidade Católica Portuguesa pela oportunidade de pertencer a esta turma de mestrado e a todos os professores que seguiram a minha trajetória.

Aos meus pais, pelo apoio incondicional e por serem a pedra basilar da estabilidade necessária para a realização deste trabalho.

Aos meus amigos, pela motivação e apoio nos tempos difíceis.

Resumo

Este estudo investiga a relação entre o conservadorismo contabilístico e a qualidade da auditoria, analisando se a reversibilidade assimétrica dos resultados, em que as perdas tendem a reverter com maior frequência do que os ganhos, constitui um indicador de complexidade de auditoria, refletido em honorários de auditoria mais elevados. Embora o conservadorismo seja amplamente estudado como um mecanismo para restringir a gestão dos resultados e melhorar a qualidade da informação financeira, o seu impacto no planeamento da auditoria e na alocação de recursos permanece pouco explorado. Utilizando uma amostra de empresas cotadas nos Estados Unidos entre 2010 e 2024, este estudo expande o modelo de Basu (1997) ao introduzir interações com os honorários de auditoria, com o objetivo de testar se os resultados reconhecidos de forma conservadora influenciam a perceção de risco e complexidade por parte dos auditores. Verifica-se uma associação positiva e estatisticamente significativa entre os honorários de auditoria e a reversibilidade assimétrica dos ganhos, sugerindo que os auditores respondem ao reporte conservador com um esforço adicional de verificação. Estes resultados mantêm-se robustos após o controlo por efeitos fixos anuais. Esta investigação contribui para a literatura existente ao estabelecer uma ligação entre o comportamento de reporte financeiro e os desfechos da qualidade da auditoria, posicionando o conservadorismo como um fator que molda o esforço e os procedimentos de auditoria e não apenas como um reflexo da disciplina contabilística. O estudo oferece implicações práticas relevantes para auditores, reguladores e contabilistas, ao evidenciar como o reporte conservador influencia a avaliação de risco e os honorários de auditoria, direcionando os procedimentos de verificação para áreas baseadas em estimativas, onde o caráter de reversibilidade das perdas requer maior escrutínio.
Palavras-chave: Qualidade da auditoria; Conservadorismo contabilístico; Reversibilidade dos resultados; Honorários de auditoria;

Abstract

This study investigates the relationship between accounting conservatism and audit quality, examining whether the asymmetric reversibility of earnings—where losses tend to reverse more quickly than gains—can be used as an indicator of audit complexity, reflected in higher audit fees. While conservatism is widely studied as a mechanism for constraining earnings management and enhancing financial reporting quality, its impact on audit planning and resource allocation remains underexplored. Using a sample of U.S. listed firms between 2010 and 2024, this study extends the Basu (1997) model by introducing interactions with audit fees to test whether conservatively recognized earnings influence auditors' perception of risk and complexity. The findings reveal a positive association between audit fees and the asymmetric reversibility of gains, suggesting that auditors respond to conservative reporting with increased verification effort. These results remain robust after controlling for year fixed effects. This research contributes to the existing literature by establishing a link between financial reporting behavior and audit quality outcomes, positioning conservatism not merely as a reflection of accounting discipline, but as a factor that shapes audit effort and procedures. The study offers relevant practical implications for auditors, regulators, and accountants by showing how conservative reporting affects risk assessment and audit fee determination, by directing verification procedures toward estimate-based areas where the reversibility of losses requires heightened scrutiny.

Key words: Audit quality; Accounting conservatism; Earnings reversability; Audit fees;

Conteúdo

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Abreviações

- US - United States
- GAAP - Generally Accepted Accounting Principles
- IFRS - International Financial Reporting Standards
- IASB - International Accounting Standards Board
- FASB - Financial Accounting Standards Board
- SFAC - Statement of Financial Accounting Concepts
- ROA - Return on Assets
- KAMs - Key Audit Matters
- ISA - International Standards on Auditing
- PCAOB - Public Company Accounting Oversight Board,
- NAS - Non-Audit Services

1 - Introduction

Financial statements should not be viewed merely as technical outputs, as they shape investor confidence, inform market valuations, and, most importantly, guide auditors´ work in assessing financial integrity. However, how accountants present that information, particularly the timing and manner in which firms recognize gains and losses, can influence how external parties interpret financial statements (Watts, 2003; DeFond & Zhang, 2014; LaFond & Watts, 2008).

Accounting conservatism, usually defined as the tendency to recognize losses more promptly than gains, is one of the most influential behaviors in financial reporting (Watts, 2003). In recent years, conservatism has continued to attract scholarly attention, with a particular focus on its influence on audit outcomes (Ramzan, 2019; Hall, Judd & Sunder, 2023). While extensively studied for its influence on earnings management and investor protection, its impact on audit quality, specifically through auditors´ perceptions of risk, remains underexplored.

This study aims to explore that connection. Although audit quality is traditionally defined as the auditors´ ability to detect and report material misstatements (DeAngelo, 1981), more recent literature emphasizes that the effectiveness of audit work depends not only on the auditor's independence and competence but also on the informational environment in which the audit takes place (DeFond & Zhang, 2014). This means that, beyond auditor expertise, the audit process is influenced by how preparers conduct financial reporting. When a firm adopts a conservative reporting approach—characterized by the timely recognition of losses and the recognition of gains only when they are verifiable-it can affect how auditors assess risk, direct their attention, and make judgments regarding management's assertions (Hall et al. 2023).

Prior research has demonstrated that conservatism plays a role in reducing earnings management (Ball & Shivakumar, 2005), improving the informativeness of financial statements (LaFond & Watts, 2008), and lowering the risk of litigation and restatements (Ahmed & Duellman, 2007; Francis & Wang, 2008). However, these outcomes have generally been treated as downstream effects of sound reporting rather than as elements that actively shape the audit process itself. The literature has not yet fully evaluated whether conservative financial reporting changes how audits are planned, executed, or assessed—particularly when viewed through the lens of earnings persistence and reversibility.

The relevance of this study to audit quality lies in its potential to uncover how the asymmetric recognition of earnings, influenced by conservatism, may affect how auditors plan and perform audit procedures. Despite the extensive literature exploring the impact of conservatism on restricting managerial discretion and enhancing financial reporting (Watts, 2003; Ball & Shivakumar, 2005; LaFond & Watts, 2008; Ahmed & Duellman, 2007; Francis & Wang, 2008; Basu, 1997), its effect on audit quality—particularly through the lens of earnings reversal tendencies—remains underexplored. This study contributes by proposing that the reversibility of earnings may serve as a previously unobserved indicator of how conservatism influences the audit process, particularly in how auditors assess risk and verify the information presented in financial statements.

Suppose negative earnings changes tend to reverse more frequently due to conservative reporting. In that case, this may improve auditors' risk identification and planning, as supported by recent findings indicating that auditors adjust their procedures when in the presence of reports prepared using conservative principles (Hall et al. 2023). Exploring this dynamic adds depth to the literature by offering a more detailed understanding of how conservatism

affects audit quality beyond its already documented role in mitigating managerial opportunism.

If these reversals occur systematically and are driven by conservative recognition practices, they may reduce the uncertainty surrounding the estimates evaluated by auditors, thereby enhancing both the efficiency and the focus of the audit process (Ramzan, 2019). From a practical perspective, the ability to anticipate the reversal of conservatively recognized losses can support auditors in several important ways. First, it allows for improved audit planning by enabling auditors to direct greater attention to areas where losses have been recognized conservatively but lack strong verifiability. A clearer understanding of these reversals helps auditors assess risk more accurately and tailor audit procedures accordingly (Francis, 2004; Hall et al. 2023).

Furthermore, the analysis of loss reversals contributes to a more refined application of professional skepticism. Auditors may recognize that not all reported losses reflect a true decline in financial performance but may instead result from prudent and cautious reporting choices. This understanding permits auditors to adjust their level of skepticism based on the nature and context of the financial information presented by management (DeFond & Zhang, 2014). In addition, by studying earnings reversal patterns, auditors are better equipped to identify situations where risk may be overstated or understated, thereby reducing the likelihood of issuing an inaccurate audit opinion. These enhancements align with widely accepted definitions of audit quality, particularly those that emphasize the auditor's ability to detect and report material misstatements (DeAngelo, 1981).

Considering that conservatism increases the predictability and reliability of reported losses—and given that such losses tend to reverse in a systematic manner—these observations support the hypothesis that conservatism contributes to improved audit quality, not only by limiting the scope for earnings manipulation but also by making the audit process more effective and focused.

Recent findings corroborate this interpretation by showing that auditors adjust their procedures in response to conservative reporting environments, which they perceive as both risk-reducing and judgment-intensive (Hall et al., 2023).

For regulators, investors, and audit professionals, this research emphasizes the importance of viewing financial reporting and auditing not merely as isolated mechanisms but as interdependent processes in which accounting behavior can shape audit performance. By analyzing this relationship, the study offers a new perspective on how conservatism functions not only as a safeguard against opportunism but also as a mechanism that enhances risk-based auditing by improving the informational cues available to auditors.

This work is structured as follows: Section 2 reviews the existing literature on audit quality and accounting conservatism, and develops the research hypothesis. Section 3 deconstructs the empirical methodology, including the sample, variable definitions, and the proper regression model. Section 4 presents and discusses the regression results. Finally, section 5 concludes the study by summarizing the main findings and their implications

2 – Literature Review

2.1 - What do we know about audit quality?

The measurement of audit quality presents itself as a challenge because of its hidden nature. The main research uses a combination of direct and indirect tests to evaluate the quality of the work presented by the auditors as shown by Francis et al. (2004) and DeAngelo (1981). Audit quality can be framed as a theoretical continuum ranging from very low to very high. The first generally accepted definition of audit quality was developed by DeAngelo (1981), which stated that audit quality could be labeled as the probability of an auditor detecting and reporting material errors on financial statements. This definition focuses itself on the technical ability of the auditor as well as its independence.

Despite still being one of the first definitions to come up when talking about audit quality, recent literature has raised questions about the adequacy of the proposed framework in capturing the full scope and evolving nature of the auditing practice. Several studies have emphasized that audit quality is inherently multidimensional, influenced not only by auditor competence and independence but also by contextual and institutional factors (Knechel et al., 2015). Moreover, the emergence of new technologies, regulatory expectations, and expanded stakeholder needs has led researchers to argue for broader definitions that incorporate audit judgment, communication quality, and responsiveness to client risk (Christensen et al., 2021; IAASB, 2014).

In an effort to overcome this difficulty in framing audit quality, researchers have developed input and output measurements and proxies that try to define audit quality (Knechel et al. 2013).

2.1.1-Firm size and industry specialization

The size of the audit firm is one of the most commonly used proxies for audit quality, primarily based on the comparison between the Big Four (PwC, Delloite, EY and KPMG) and other audit firms. The rationale behind this hypothesis is that Big Four firms possess greater industry expertise, stronger reputational incentives, and higher quality control standards, all of which contribute to superior audit quality (DeAngelo, 1981; Francis, 2004).

Larger firms have greater capacity to attract top talent and develop advanced technological resources, enabling them to achieve higher levels of industry specialization and more rigorous audit processes (Francis & Wang, 2008). The Big Four invest substantially in training their professionals and developing sophisticated risk detection methodologies, which enhance the detection of material misstatements and reduce financial restatements (Lennox, 1999; Krishnan, 2003). As a result, larger firms are more likely to possess

specialized industry knowledge, allowing for a deeper understanding of complex accounting issues related to specific sectors (Francis & Yu, 2009)

Empirical research supports this perspective. Dunn and Mayhew (2004) found that firms audited by industry-specialist auditors exhibit lower levels of discretionary accruals and reduced earnings manipulation, both of which are indicators of a more disciplined financial reporting process. Furthermore, larger audit firms face greater reputational risks as they are subject to higher levels of public and media scrutiny. A single audit failure can significantly damage their reputation and affect their market share (Francis & Krishnan, 1999).

In addition, larger firms tend to adopt more conservative auditing postures, as they are subject to greater regulatory scrutiny and higher litigation risks. Palmrose (1988) proves that companies audited by Big Four firms experience lower litigation costs, reflecting the higher quality of audits performed. Similarly, Francis and Yu (2009) argue that larger auditors are less likely to allow earnings manipulation aimed at inflating a company's financial position.

The significance of audit firm reputation is further evidenced by Chaney and Philipich (2002), who found that the market reacted negatively to firms previously audited by Arthur Andersen, the firm involved in the high-profile Enron scandal. This demonstrates the substantial impact that media exposure and reputational risks have on larger audit firms, reinforcing the idea that their audit quality is driven not only by technical expertise but also by their need to maintain public trust.

Thus, larger firms may also encourage more conservative reporting practices due to reputational and litigation concerns, as previously discussed. This behavior could indirectly enhance audit quality by reducing the likelihood of aggressive financial reporting. This aligns with the view that audit firm size may influence not only audit inputs but also the way clients report their financial

information, fostering a more conservative reporting environment that supports audit effectiveness (Francis & Krishnan, 1999; Gul et al 2003).

Despite the substantial evidence supporting this argument, some scholars contend that firm size alone is not a sufficiently strong proxy for audit quality. Ball, Jayaraman, and Shivakumar (2012) argue that the market dominance of the Big Four may lead to complacency and the standardization of audit procedures, which could, in turn, diminish audit quality. The authors suggest that the oligopolistic nature of the audit market may reduce incentives for innovation and increase reliance on routine audit processes, potentially overlooking firm-specific risks.

Similarly, Lennox (1999) observed that while larger firms generally provide higher audit quality, there are still significant variations in quality among them. This suggests that factors beyond size—such as the experience and expertise of the audit partner, audit engagement characteristics, and firm culture—also play critical roles in determining audit effectiveness. These findings highlight the limitations of using firm size as the sole determinant of audit quality, emphasizing the need for a more comprehensive approach that considers additional audit quality indicators.

2.1.2-Abnormal Accruals and earnings management

It is important to differentiate between earnings management and earnings manipulation. Earnings management involves the use of accounting discretion within the boundaries of Generally Accepted Accounting Principles (GAAP) to influence reported earnings. This practice is often driven by the need to meet certain benchmarks or to shape stakeholders' perceptions (Healy & Wahlen, 1999). While this approach may raise ethical concerns, it is not inherently illegal. In contrast, earnings manipulation refers to the intentional misstatement or omission of information that violates accounting standards or laws, with the goal of misleading the users of financial statements. This behavior is considered

fraudulent and can result in restatements, penalties, or even legal consequences (Dechow et al., 2010). While both practices impact the reliability of financial reporting, only the latter constitutes a violation of legal and professional standards.

Abnormal accruals and earnings management capture the extent to which financial reporting has been influenced by managerial decisions. The underlying hypothesis is that higher audit quality, by constraining opportunistic financial reporting, leads to lower levels of such discretionary adjustments. A high-quality audit imposes restrictions on aggressive accrual adjustments, promoting more transparent financial reporting. Francis and Krishnan (1999) support this hypothesis, demonstrating that firms audited by high-quality auditors are less likely to engage in accrual-based earnings manipulation, providing a sense of reassurance and confidence in the auditing process.

Since conservatism reduces managerial discretion over accruals, firms with more conservative approaches to financial reporting are likely to exhibit lower discretionary accruals, often associated with higher audit quality (Ball & Shivakumar, 2005).

However, like other measures, using accruals as a proxy for audit quality has its limitations. Accruals naturally fluctuate due to firm-specific factors, such as industry dynamics and macroeconomic conditions (Hribar & Collins, 2002). Moreover, auditors may tolerate certain levels of earnings management if they fall within GAAP, making it more difficult to assess audit quality with precision. This underscores the need for a critical and cautious approach when using accruals as a measure of audit quality.

2.1.3-Material errors as restatements

Material errors as restatements are often used as output proxies for assessing audit quality Ahn S. et al. (2022). This metric offers specific advantages, particularly in identifying severe deficiencies in the work performed, thus aiding

in the detection of cases where the audit fails to meet established minimum standards.

Despite its usefulness in identifying critical flaws, this approach has significant limitations. The proxy primarily provides information on severe audit deficiencies and functions as a binary indicator—indicating whether an audit meets minimum standards or not. While it identifies whether an audit falls within or outside a basic quality spectrum, it does not allow for a more detailed or nuanced analysis of the overall quality of the work. Specifically, this metric is not comprehensive enough to distinguish between audits classified as high-quality and those that merely meet minimal regulatory requirements (Rajgopal et al., 2021).

Moreover, the occurrence of material misstatements may be influenced by external factors beyond the auditor's efforts, such as the complexity of the company's business, the quality of internal controls, and management pressure to manipulate results. This limitation restricts the ability to identify best practices or specific areas for improvement, thereby diminishing the proxy's role in promoting advancements in the auditing field, Ahn et al. 2022.

Importantly, accounting conservatism has been identified as a strategy to reduce the likelihood of financial restatements, as it constrains earnings management and requires more timely recognition of losses. Research by Ahmed and Duelman (2007) shows that firms with higher levels of accounting conservatism experience fewer restatements and lower litigation risks. In a similar vein, Francis and Wang (2008) argue that conservatism enhances the credibility of financial reporting, especially in high-litigation environments. These findings indicate that conservatism fosters a more disciplined reporting environment, which improves the efficiency of the auditing process and decreases the likelihood of audit failures. Thus, when firms adopt a conservative reporting approach, they provide auditors with a more transparent and less

aggressive financial foundation, consequently enhancing audit quality by reducing the risk of undetected misstatements and restatements.

2.1.4-Auditor Communication

Auditor communication plays a crucial role in enhancing transparency and trust in financial reporting. Components such as written reports and verbal interactions significantly influence how users perceive the reliability of audits. The introduction of Key Audit Matters (KAMs) under ISA 701 has added value by emphasizing areas that demand greater auditor attention, including complex estimates and revenue recognition. Firms that undergo higher-quality audits typically disclose KAMs in a more detailed and specific manner (Gutierrez et al., 2018). Conversely, the use of generic or boilerplate KAMs has been found to diminish the effectiveness of this communication (Lennox et al., 2022).

Going concern opinions also serve as vital indicators of communication quality, especially when they demonstrate timely recognition of financial distress (Carson et al., 2013). If auditors fail to issue these opinions when appropriate, it can undermine the credibility of the audit (Palmrose, 2008). High-quality audits are generally expected to proactively identify material risks (Kausar et al., 2016).

In addition to external disclosures, effective internal communication with audit committees and management is equally important. Research has shown that strong and consistent communication minimizes internal control weaknesses and enhances the accuracy of financial reporting (Carcello et al., 2011; Schneider et al., 2006).

However, this indicator has its limitations. If auditor independence is compromised, communication may focus more on regulatory compliance rather than genuine transparency (Velte, 2020). Therefore, while auditor communication is an important indicator, it should always be interpreted alongside other measures of audit quality.

2.1.5 – Auditor Independence and professional skepticism

Auditor independence and professional skepticism are crucial for ensuring audit quality, as they significantly influence the auditor's ability to analyze financial statements and detect material misstatements (DeAngelo, 1981; Hurtt et al., 2013). Auditor independence refers to the auditor's capacity to conduct the audit without external pressures or conflicts of interest, thereby ensuring an objective evaluation of financial reporting (DeFond & Zhang, 2014). Independence is generally categorized into two types: independence in fact and independence in appearance (Mautz & Sharaf, 1961). Independence in fact refers to the auditor's ability to remain objective throughout the audit process, while independence in appearance deals with how the public perceives the auditor's objectivity and integrity. Even if an auditor maintains independence, the perception of conflicts of interest—such as long-term relationships or financial ties—can negatively affect trust in the audit report (Dopuch, King & Schwartz, 2003).

In this context, non-audit services (NAS) provided by auditors to their clients can compromise independence. Ashbaugh, Lafond and Mayhew (2003) found that firms generating high revenues from NAS are more likely to overlook earnings management, suggesting that excessive relationships can influence audit quality. Additionally, Frankel et al. (2002) showed that companies engaging in more services from their auditors tend to have higher discretionary accruals, which undermines the credibility of auditor independence. To address these threats, regulators have implemented measures like the Sarbanes-Oxley Act of 2002, which prohibits auditors from providing certain types of services to their clients. Furthermore, mandatory audit partner rotation, which is enforced in both the United States and the European Union, aims to prevent excessive relationships that could compromise objectivity (Cameran et al., 2016).

Professional skepticism encompasses a mindset of doubt, critical observation, and the ability to challenge management's assertions. This mindset enables auditors to identify fraud and potential misstatements (Hurtt et al., 2013). Auditors who apply this principle are more likely to detect earnings management and other manipulations (Quadackers et al., 2014). Both individual characteristics of auditors and external factors can influence skepticism. Auditors with extensive experience and forensic training tend to develop procedures with stricter parameters, demonstrating a higher level of skepticism (Bowlin et al., 2015). Conversely, pressures from clients and time constraints can negatively affect skepticism, thereby reducing audit quality (Hurtt et al., 2013).

The International Auditing and Assurance Standards Board (IAASB, 2018) underscores the importance of skepticism, stating that auditors must be critical and objective when assessing fair value measurements and impairment tests. Furthermore, Beasley et al. (2010) confirm that auditors have failed to exercise sufficient skepticism in major fraud cases, such as Enron, which facilitated financial reporting manipulations. This highlights the need for auditors to maintain a healthy level of doubt when reviewing financial statements.

Given the significance of professional skepticism and independence, regulators have introduced measures to reinforce these principles, such as the disclosure of high-risk areas through KAMs and mandatory auditor rotation, which requires entities to change auditors every ten years, along with strict guidelines to prevent conflicts of interest (PCAOB, 2010). However, despite the relevance of these measures, using them in isolation is ineffective, as auditor independence and skepticism are challenging to assess directly (Hurtt et al., 2013). Moreover, auditors may confront external pressures to relax audit procedures to maintain business relationships with clients (DeFond & Zhang, 2014).

2.1.6 – Audit Technology and Data Analytics

The role of technology in auditing has rapidly expanded in recent years, significantly enhancing how auditors assess risk and detect misstatements. Data analytics allows for a more comprehensive analysis of transactions, facilitating the detection of irregularities such as fraudulent activities, errors in financial statements, or unusual patterns that might be overlooked using traditional manual sampling methods (Brown-Liburd et al., 2015; Issa et al., 2016). Additionally, tools like artificial intelligence and blockchain have improved efficiency and transparency in audit procedures, particularly regarding fraud detection and transaction validation. For instance, blockchain technology can provide greater transparency by recording transactions in a manner that is difficult to alter. Some experts believe that this might even reduce the reliance on traditional confirmation methods (Rozario & Thomas, 2019).

While technological innovations are transforming auditing, they do not lessen the importance of auditor judgment. Overreliance on automation can potentially hinder critical thinking, and many firms are still struggling to integrate these technologies due to a lack of expertise (Alles, 2015; Christensen et al., 2021).

In the context of technological advancements, a conservative financial reporting environment can greatly enhance the effectiveness of these technologies. The cautious recognition of gains and the timely acknowledgment of losses—hallmarks of conservatism—help reduce noise in financial data and strengthen the signals that auditors rely on. This, in turn, enables data analytics and other tools to identify genuine risk areas more effectively, thereby supporting a more targeted and reliable audit process (Brown-Liburd et al., 2015).

Although audit quality has been examined from various perspectives—including firm size, accruals, independence, and auditor communication—

limited attention has been given to the role of the financial reporting environment itself. The manner in which entities conduct financial reporting can directly affect how auditors assess risk and make decisions (DeFond & Zhang, 2014). In this regard, conservatism, by encouraging timely loss recognition and preventing the overstatement of earnings, may enhance both the reporting environment and audit efficiency (LaFond & Watts, 2008). The following section will delve deeper into the concept of conservatism to understand how it may impact audit quality, both directly and indirectly.

2.2. - Deconstructing conservatism

Conservatism is a fundamental principle in financial reporting, ensuring that financial statements provide a true and fair representation and that the entity's assets and earnings are not overstated. The asymmetry between the recognition of gains and losses has been a cornerstone of accounting practices, playing a crucial role in investor protection and contractual agreements (Watts, 2003). Conservatism is traditionally defined by the adage "anticipate no profit but anticipate all losses" (Bliss, 1924), meaning that entities should present their financial position from a cautious rather than an optimistic perspective. The Financial Accounting Standards Board (FASB) formalized this principle in SFAC 2, stating that conservatism requires a higher degree of verifiability for the recognition of gains than for losses (FASB, 1980).

2.2.1 – The Role of conservatism in earnings management

The primary motivation for adopting conservatism in financial reporting is to limit earnings management. Earnings management occurs when administrators manage financial information to meet targets, influence investor perception, or increase their bonuses (Healy & Wahlen, 1999). Because managers have privileged access to a company's transactions, they may be incentivized to

delay recognizing losses or inflate revenues to portray a more stable financial position (Watts, 2003).

By imposing stricter criteria for verifying gains, conservatism reduces the ability of managers to recognize revenues prematurely. Conversely, it requires the immediate recognition of losses, ensuring that all financial setbacks are promptly disclosed to investors (Ball & Shivakumar, 2005). This approach limits opportunities for the manipulation of estimate-based financial items, thereby enhancing the reliability of reporting (Basu, 1997).

Consequently, conservatism leads to the quicker recognition of negative events in earnings compared to positive ones, resulting in asymmetric earnings persistence. For example, when a company holds assets that decrease in value, conservatism mandates that the impairment loss be recognized immediately. On the other hand, if an asset's value increases, the gain is only recognized once it is realized, or the asset is sold. This practice ensures that the company's financial position is not overstated based on uncertain future expectations, thus maintaining the credibility of financial reporting (Basu, 1997; Watts, 2003).

2.2.2. – Conservatism on contracting

Another key reason for the use of conservatism is its role in contractual agreements. Many commercial arrangements, such as financing contracts, supplier agreements, and executive compensation plans, rely on financial statements to establish targets and obligations (Ball et al., 2000). Financing contracts often include financial covenants that require entities to maintain specific revenue levels, asset valuations, or financial ratios. Since creditors face greater risks from financial distress than from unexpected gains, they prefer a conservative approach to ensure that losses and obligations are not understated (Ahmed et al., 2002). If revenues are overstated, lenders may inadvertently extend credit to high-risk borrowers. By mandating the timely recognition of all

losses and obligations, conservatism helps reduce the risk of manipulated financial statements that could mislead investors (Watts, 2003).

Additionally, conservatism helps limit opportunistic behavior in compensation contracts. Many executives receive performance-based remuneration, which can create incentives to exaggerate the company's financial position to secure higher compensation. Conservatism mitigates this behavior by ensuring a reliable and accurate representation of financial performance (LaFond & Watts, 2008).

2.2.3 – Regulatory Influence on Conservatism

Regulatory bodies play a crucial role in determining the level of conservatism applied in financial reporting, which directly influences how firms apply financial reporting practices. The Financial Accounting Standards Board, in Statement of Financial Accounting Concepts No. 2 (SFAC 2), recognized the principle of conservatism by defining it as a requirement for a higher level of verifiability when recognizing gains compared to losses (FASB, 1980). Similarly, the International Accounting Standards Board (IASB) acknowledges prudence—closely related to conservatism—as a fundamental principle in its Conceptual Framework, ensuring the neutrality and reliability of financial statements (IASB, 2018). However, the introduction of fair value measurement under International Financial Reporting Standards (IFRS) has sparked debates regarding whether regulatory frameworks have diminished the significance of conservatism in financial reporting (Pope et al. 2011).

The adoption of conservatism in financial reporting is significantly influenced by the legal framework of the country where firms operate. Common law countries, such as the U.S. and the U.K., generally exhibit higher levels of conservatism due to stronger investor protection mechanisms and higher litigation costs. In contrast, code law countries, such as France and Germany,

often display lower levels of conservatism, as financial reporting primarily serves the interests of taxation and creditors (Ball et al., 2000).

The litigation environment is another critical factor affecting the adoption of conservatism. Legal disputes can arise when firms overstate assets or understate liabilities, leading to negative consequences for investors. The risk of litigation encourages a conservative approach (Watts, 2003), as entities in high-litigation environments tend to exhibit higher levels of conservatism to mitigate legal repercussions (LaFond & Watts, 2008).

By the late 20th century, there was a growing demand for the comprehensive recognition of liabilities that had previously been omitted from financial disclosures. The FASB introduced mandatory recognition of long-term obligations, such as pensions and post-retirement health benefits, which reinforced conservatism and ensured the timely acknowledgment of liabilities (Dechow & Skinner, 2000). Accounting standards such as IAS 36 (Impairment of Assets) and Statement of Financial Accounting Standards No. 142 (SFAS 142) (Goodwill and Other Intangible Assets) require periodic impairment tests, promoting a cautious approach to recognizing potential losses (Francis et al., 2004).

Although regulatory frameworks have historically supported conservatism, certain changes have triggered debates about its ongoing relevance. The use of fair value measurement, implemented under IFRS and U.S. GAAP, relies on market-based estimates, which can increase the volatility of financial statements and reduce the asymmetry in recognizing gains and losses (Ball, 2006). Despite these changes, conservatism remains a cornerstone of financial reporting, with regulatory bodies continuing to acknowledge its role in enhancing the reliability of financial statements. For instance, the implementation of IFRS 9, which introduced the forward-looking expected credit loss model, aligns with the principle of timely loss recognition integral to conservatism (Goh & Li, 2019).

2.3 – Hypothesis Development

Although the literature extensively explores the role of conservatism in enhancing financial reporting quality and constraining earnings management (Watts, 2003; LaFond & Watts, 2008), its direct impact on audit quality remains underexplored. Basu (1997) proposed that the application of the conservatism principle results in an asymmetric recognition of earnings, whereby losses are recognized immediately, while gains are only recognized once a more robust level of verifiability is achieved. This asymmetry has implications for auditing, as it directly influences the informational environment in which the auditor operates (DeFond & Zhang, 2014). Recent research has further emphasized how the use of conservative reporting can influence the decision-making and auditor focus, particularly in the context of heightened risk (Hall et al. 2023).

A considerable body of literature suggests that audit fees serve as a reliable proxy for audit quality, as they reflect the auditor's effort, the complexity of audit tasks, and the perceived level of audit risk (Wahyuni et al. 2024). Hall et al. (2023) argue that higher audit fees are associated with more extensive and rigorous audit procedures, increasing the likelihood of detecting and reporting material misstatements.

Based on this reasoning, it is expected that firms exhibiting greater asymmetry in earnings recognition—a hallmark of conservatism—are subject to higher levels of audit complexity and risk (Hall et al., 2023). Consequently, such firms tend to incur higher audit fees due to the need for more intensive and detailed audit procedures (Abbott et al., 2006).

Accordingly, this study proposes an integrated approach by expanding Basu's (1997) original model through the interaction between the logarithm of audit fees and the explanatory variables from the original framework. This interaction enables a direct examination of whether the audit fees paid are positively correlated with the asymmetry in the recognition of losses, thereby reflecting the complexity of the firm's informational environment. This

hypothesis is grounded in the existing literature, which highlights the critical role of the information environment shaped by accounting conservatism and the significance of audit fees as a reflection of the auditor's effort and the audit's overall quality (Francis & Wang, 2008).

Hypothesis 1: Firms with higher audit fees exhibit stronger asymmetric earnings reversibility, suggesting a positive and significant relationship between audit fees and accounting conservatism.

3 – Methodology

3.1 – Sample and Data

The empirical analysis is based on a panel dataset consisting of firm-year observations from publicly traded U.S. companies on the New York Stock Exchange covering the period from 2010 to 2024. The financial data has been obtained from the Refinitiv Eikon database, which provides comprehensive and reliable financial statement information across a diverse range of industries.

To enhance the consistency and comparability of the financial information, the sample excludes firms in the financial and utility sectors. This exclusion follows standard practice in accounting research, as these industries are often subject to distinct regulatory environments and reporting standards that could affect the persistence and reversibility of earnings in ways unrelated to the conservative reporting practices under examination (Ball et al., 2000).

3.2 – Variables

This study follows the empirical framework developed by Basu (1997) to measure accounting conservatism at the firm level. The model demonstrates that firms tend to recognize economic losses in earnings more promptly than gains—a behaviour commonly referred to as asymmetric earnings timeliness. This form of conservatism implies that negative news is reflected in earnings faster than positive, which tend to be reflected more gradually and only when adequate verification exists.

In practical terms, Basu's (1997) model examines how earnings respond to stock returns, differentiating between periods of good and bad news. The methodology uses stock returns over a twelve-month window, starting nine months prior and ending three months after the fiscal year-end, with the objective to capture both market expectations and investor reactions around the earnings announcement. An interaction term between returns and a dummy for negative returns allows the model to test whether earnings are more sensitive to bad news than to good news. A stronger response to negative returns is interpreted as evidence of conditional conservatism.

This approach has been widely adopted in empirical accounting research as a standard method for capturing asymmetric earnings recognition. Studies such as LaFond and Watts (2008), Khan and Watts (2009), and García Lara et al. (2009) have built on Basu's framework to examine how conservatism relates to corporate governance, investor protection, and audit quality. In the context of the present study, the level of asymmetry identified through this model is used to quantify firm-level conservatism, which is then examined in relation to audit fees as a proxy for audit quality.

The choice is grounded in a broad stream of literature suggesting that audit fees reflect not only the scope of the audit but also the auditor's effort, perceived risk, and complexity of the client's reporting environment (Francis, 2004; Lu et al., 2024). From this point of view, higher audit fees may be an indicator of a more thorough and intensive audit process, which is commonly interpreted as a sign of higher audit quality (Wahyuni et al., 2024).

This relationship is particularly relevant when examining the role of conservatism in shaping audit conditions. Firms that exhibit stronger asymmetry in earnings recognition—as a result of more conservative reporting—may present a more complex audit environment that requires enhanced procedures and more professional judgment. As a result, auditors often respond with increased effort and risk assessment, which translates into higher fees (Hall et al.,

2023). Therefore, audit fees provide a useful and observable proxy through which audit quality can be analyzed in relation to reporting behavior.

3.3 – Final regression model

The innovative aspect of this model lies in the inclusion of audit fees and their interaction with the explanatory variables from Basu's (1999) original model, aiming to evaluate whether accounting conservatism influences audit quality. Consistent with prior literature, this study uses the natural logarithm of audit fees rather than their raw values. This transformation aims to reduce skewness and the influence of extreme values, which are common in financial variables such as fees. By compressing the distribution, the logarithmic transformation helps satisfy the assumptions of linear regression models, particularly those related to the normality of residuals and homoscedasticity (DeFond & Zhang, 2014).

Specifically, the proposed model incorporates a triple interaction term, $LogAuditFees * Rit * NEG$, which seeks to capture the hypothesis that auditors increase their effort, reflected in audit fees, in environments where losses are more likely to reverse, a pattern typical of conservative financial reporting.

A negative and statistically significant coefficient on the $Rit * NEG$ interaction is expected, indicating that losses are more reversible than gains - empirical evidence consistent with the presence of conservatism. In addition, a positive and significant coefficient on the $LogAuditFees * Rit * NEG$ interaction would suggest that the presence of conservatism is associated with greater audit effort, increased perceived complexity, and consequently, higher audit costs.

By integrating these variables, the proposed model seeks to explore a relatively underexamined relationship in the literature: how conservatism affects audit quality through auditors' perception of risk and complexity, as reflected in audit fees. In doing so, the model brings the practical dynamics of auditing closer to financial accounting by testing how accounting practices influence the scope and intensity of external verification.

$$\frac{EPS}{Pit-1} = \beta 0 + \beta 1\, NEG + \beta 2\, Rit + \beta 3 NEG * Rit + \beta 4 logAuditFees + \beta 5 LogAuditFees * NEG + \beta 6 LogAuditFees * Rit + \beta 7 LogAuditFees * Rit * NEG \quad (1)$$

To mitigate the influence of extreme values and ensure the robustness of the regression results, all continuous variables were winsorized at the 1st and 99th percentiles. This approach aligns with recent studies in the field of accounting and audit research, which apply winsorization to control for outliers and enhance the reliability of their empirical analyses (Wahyuni et al., 2024).

Table 1 provides the definitions and construction methods of all variables used in the study. It includes dependent and independent variables along with their calculation procedures. This information ensures methodological transparency and facilitates the replicability of the study

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Insert Table 1 here

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4 - Results analysis

This section presents and interprets the empirical findings regarding the relationship between accounting conservatism, which is proxied through asymmetric earnings reversals, and audit quality, measured by audit fees. The main aim is to explore whether conservative financial reporting, particularly the tendency for losses to reverse more frequently than gains, is associated with greater perceived audit risk and complexity, resulting in higher audit effort and subsequently better audit quality

4.1 – Descriptive Statistics and correlations

Table 2 provides descriptive statistics for the variables under analysis, based on 9534 firm-year observations spanning the period from 2010 to 2024. The mean of normalized earnings ($Earnings$) is (2.48), with substantial variation (SD = 5.53), reflecting a heterogeneous sample drawn from various industries,

including Industrials (24%), Consumer Discretionary (17.3%), and Energy (11.3%). The dummy variable for negative returns (NEG) is of particular interest, as it equals 1 in 38.5% of the observations, indicating that a significant portion of the sample experienced losses in at least one of the observed periods.

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Insert Table 2 and 3 here

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The variable $NEG * Rit$,which captures the asymmetry in earnings reversibility, has a negative mean (-0.09), consistent with the findings of Basu (1997) on the asymmetric timeliness of earnings—losses tend to reverse more quickly than gains. These results suggest that the firms in the sample exhibit conservative reporting behavior, with losses being recognized more promptly and thus more likely to reverse in subsequent periods (Basu 1997).

The transformed variable, $LogAuditFees$, has a mean of (6.47) and a moderate standard deviation, enabling its inclusion in interaction terms without distortion. The triple interaction variable ($LogAuditFees * Rit * NEG$), designed to capture the association between conservatism and audit quality, has a mean of (-0.59), supporting its inclusion as a meaningful factor in the analysis.

The Pearson correlation analysis, using the pairwise deletion method (Table 3), reveals patterns consistent with theoretical expectations. The negative correlation between NEG and Rit (-0.63) confirms the intuitive relationship between negative returns and underperformance. Moreover, the positive correlation between $NEG * Rit$ and $Earnings$ (0.21) suggests that the presence of conservatism—measured through asymmetric earnings reversibility—is associated with subsequent financial recovery by the reporting firms.

Table 2 presents the descriptive statistics for the variables used in the regression. Measures such as median, mean, standard deviation, minimum, and

maximum values are displayed in this section. These values help to characterize the sample and detect potential outliers or data asymmetries.

Table 3 displays Pearson correlation coefficients between the variables used. It provides insight into the direction and strength of bivariate relationships, such as those between stock returns, audit fees, and conservatism proxies.

4.2 – Baseline Regression Results

The results presented in Table 4 correspond to the baseline regression drew to test the relationship between accounting conservatism and audit quality, the latter proxied by audit fees. The structure of the model follows the published work of Basu (1997), expanded here to include relevant interactions that capture how auditors respond to conservative reporting contexts. In particular, the model introduces the main effect of the natural logarithm of audit fees and its interactions with the dummy variable $\beta 5 LogAuditFees * NEG$, stock returns $\beta 6 LogAuditFees * Rit$,and between NEG and returns $\beta 7 LogAuditFees * Rit * NEG$. These interactions allow the regression to test whether the degree of earnings conservatism, captured by the asymmetric response to bad news, is associated with variance in audit fees. This approach enables a deeper understanding of how conservatism influences perceived audit risk and auditor effort, as reflected in audit fees.

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Insert Table 4 here

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The coefficient for Rit is positive and statistically significant (β = 10.11; p < 0.01), indicating that firms with higher stock returns tend to report higher normalized earnings. This association reflects the expected sensitivity of earnings to economic performance, as previously conceptualized by Basu (1997), who

framed accounting conservatism as a form of asymmetric earnings timeliness. While Basu's model focuses on the faster incorporation of bad news into earnings, the significance of Rit confirms that good news is still reflected in earnings, even though to a lesser degree—supporting the model's ability to show the difference between the two types of informational response. This responsiveness also aligns with the broader role of financial reporting in reflecting firm performance under conditions of investor scrutiny and market efficiency, as discussed in LaFond and Watts (2008).

The coefficient for $NEG * Rit$, representing the asymmetric reversibility of earnings, is negative and statistically significant ($\beta = -22.12$; $p < 0.01$). This result is consistent with the conservative accounting principle, which states that losses are recognized more quickly than gains, thus reducing reported earnings in periods of negative performance (Watts, 2003). The results provide empirical support for the effectiveness of the $NEG \times Rit$ term as a proxy for conditional conservatism. This finding is significant because it supports the idea that conservatism functions not only as a reporting standard but also as a corporate governance tool. It helps to discipline managerial discretion and limits the tendency for earnings inflation driven by self-interest (LaFond & Watts, 2008; Ball & Shivakumar, 2005). Additionally, it confirms the theoretical assumptions made by DeFond and Zhang (2014) and Francis (2004) that conservatism changes the informational environment in which auditors operate.

The coefficient for $LogAuditFees$ is also positive and significant ($\beta = 3.52$; $p < 0.01$), indicating that firms with higher audit fees tend to report higher normalized earnings. Although this may be a mirror of scale effects such as the size of the firm or operational complexity, which are typically associated with both higher earnings and audit costs, the result also suggests that audit fees capture more than basic firm attributes. As argued by Francis (2004), audit fees are determined not only by the effort and expertise of the auditor, but also by the perceived audit risk and the complexity of the client's financial reporting

environment. This view is further supported by Wahyuni et al. (2024), who find that conservative reporting is associated with increased audit assurance, particularly in contexts of higher perceived risk. Therefore, the positive coefficient is consistent with the idea that more conservatively reporting firms—often more complex or risk-averse—demand higher audit effort and scrutiny.

The interaction terms provide direct insight into the main hypothesis. The coefficient for $LogAuditFees * Rit$ is negative and significant ($\beta = -1.74$; $p < 0.01$), suggesting that the reaction to positive returns is lower in firms paying higher audit fees. This can be interpreted as auditors playing a moderating role in the recognition of good news, a behaviour consistent with the governance-enhancing function of auditing discussed by Watts (2003) and formalized by LaFond and Watts (2008). It also aligns with recent findings by Hall et al. (2023), who demonstrate that auditors tend to apply greater prudence in the recognition of income when faced with elevated client risk or reputational exposure.

Conversely, the triple interaction term $LogAuditFees * Rit * NEG$ is positive and highly significant ($\beta = 4.20$; $p < 0.01$), indicating that in periods of bad news, ($NEG = 1$), the correlation between returns and earnings strengthens as audit fees increase. This suggests that auditors respond to the presence of losses with higher diligence and scrutiny, possibly driven by a need to validate more complex or judgment-based accruals. These results align with the framework of DeFond and Zhang (2014), who argue that audit quality is influenced by the client's financial reporting environment and the auditor's response to the perception of risk. The result also complements Wahyuni et al. (2024), who find that in conservative reporting contexts, auditors adjust their procedures to meet higher assurance expectations.

Taken together, these findings offer strong empirical support for the central hypothesis of this study. Conservatism—operationalized through asymmetric earnings responsiveness—emerges not merely as an accounting characteristic but as a factor that actively shapes audit planning and pricing. By

increasing informational complexity and the need for professional judgment, conservative reporting leads to the need for higher diligence, more extensive procedures, and, consequently, higher audit fees.

Table 4 presents the results of the baseline regression model, based on an extended version of Basu's (1997) framework with interactions involving audit fees. The estimated coefficients and their statistical significance levels are used to test the main hypothesis concerning the relationship between accounting conservatism and audit quality.

4.3 – Robustness with year fixed effects

In order to test the robustness of the baseline results, a second model was estimated with the inclusion of year fixed effects. This specification controls for macroeconomic conditions, regulatory shifts, or industry-wide events that may vary across time but affect all firms similarly. The approach follows the methodological guidance of Francis (2004) and DeFond and Zhang (2014), who emphasize the importance of controlling for temporal variation when measuring audit quality, as audit practices and risk perceptions evolve over time.

The results, presented in Table 5, remain consistent with those from the original model. The coefficient for $NEG * Rit$ remains negative and statistically significant ($\beta = -15.33$; $p < 0.05$), reinforcing the evidence of asymmetric earnings timeliness in the sample. This persistency of this asymmetry suggests that conservative reporting practices are not confined to specific years but reflect a structural feature of firms' accounting behaviour. The finding supports Basu's (1997) notion of conditional conservatism as a stable mechanism for accelerating the recognition of economic losses relative to gains.

The variable Rit continues to show a positive and significant association with $Earnings$ ($\beta = 7.29$; $p < 0.01$), even though with slightly reduced magnitude. This relationship confirms that earnings maintain their responsiveness to positive market signals across different time periods, reinforcing the underlying

assumption that financial reporting conveys relevant performance information even within conservative frameworks (LaFond & Watts, 2008).

Crucially, the interaction term $LogAuditFees * Rit$ also remains negative and significant ($\beta = -1.24$; $p < 0.01$), suggesting that auditors consistently temper the incorporation of good news in firms with higher audit fees. This is consistent with the corporate governance function of auditing, whereby auditors constrain overly optimistic reporting when in contact with higher risk environments or complexity (Watts, 2003; Hall et al., 2023). The result supports the view that audit effort is not only associated with firm characteristics, but also with the nature of the financial information being reported.

The triple interaction term $LogAuditFees * Rit * NEG$ also retains its positive and significant coefficient ($\beta = 3.12$; $p < 0.01$), indicating that auditors' heightened scrutiny in the presence of losses is consistent across years. This finding reinforces the argument by DeFond and Zhang (2014) that audit strategies are influenced by the reporting environment and the perceived asymmetry of information. It also aligns with recent empirical work drew by Wahyuni et al. (2024), who show that audit quality improves in settings where conservative reporting prevails, especially when auditors are required to validate more judgment-based accruals.

Additionally, the model's explanatory power improves with the inclusion of year fixed effects, as proved by the increase in the adjusted R-squared from 0.03 to 0.09. These results suggest that controlling for time-specific events enhances model fit without undermining the significance or direction of the core variables. The F-statistics remain significant, further validating the overall explanatory strength of the regression.

In summary, the robustness analysis demonstrates that time-specific variations do not influence the relationship between conservative financial reporting and audit fees. Instead, it reveals a consistent connection: increased conservatism leads to greater informational complexity and requires more audit

effort, which ultimately results in higher audit fees. This finding aligns with the theoretical framework established throughout the study.

Table 5 displays the results of the robustness test utilizing year fixed effects. By accounting for macroeconomic trends, regulatory changes, and other time-specific factors, this model confirms whether the baseline findings remain consistent across the sample period.

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Insert Table 5 here

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4.4 – Interpretation and Theoretical Implications

The empirical findings presented in this study offer a theoretically grounded perspective on the relationship between accounting conservatism, measured by the asymmetric earnings recognition, and audit quality, proxied by audit fees. This relationship reflects the conceptual frameworks developed in the accounting literature, whereby conservatism alters the informational environment in which auditors operate, shaping their judgment, effort, and pricing decisions (DeFond & Zhang, 2014; Francis, 2004).

The negative mean of the coefficient (−0.09) provides strong evidence of asymmetric earnings timeliness, aligning with the model proposed by Basu (1997). His influential framework suggests that accountants recognize losses more quickly than gains, a process designed to protect users of financial statements from overly optimistic estimates. In this study, this observed asymmetry is not just a statistical artifact; it indicates a reporting behavior that is both prudent and informative. This pattern supports Basu's (1997) argument that conservative recognition has value-relevant content for stakeholders, reinforcing its role as a reliable proxy for conditional conservatism.it as a robust proxy for conditional conservatism.

Building upon this foundation, the theoretical perspective of Watts (2003) posits that conservatism serves as a mechanism that disciplines managerial discretion, thereby reducing agency costs. The observed association between conservatism and audit fees aligns with this interpretation. The positive relationship suggests that auditors perceive conservatism not only as a sign of prudent reporting but also as a marker of increased complexity and judgment. This is particularly relevant in environments where auditors face higher uncertainty in assessing prudently stated earnings figures. LaFond and Watts (2008) reinforce this view by arguing that conservatism is not only an accounting principle but also an endogenous response to information asymmetry and contracting pressures. The fact that auditors increase their effort—and therefore their fees—in more conservative environments supports the idea that conservatism imposes informational costs that must be addressed through audit work (Hall et al., 2023).

The significance of the triple interaction term strengthens this interpretation. While conservatism may reduce earnings management, it also introduces ambiguity, particularly when losses are more likely to be reversed in future periods. This reinforces the argument that conservative reporting increases estimation uncertainty and the need for greater verification, both of which are central components of audit quality (DeFond & Zhang, 2014). As Hall et al. (2023) point out, auditors respond to heightened reputational and litigation risks with more conservative and resource-intensive behavior, especially in contexts marked by earnings asymmetry and reversibility. Similarly, Wahyuni et al. (2024) provide recent evidence that firms exhibiting higher degrees of conservatism are associated with increased audit effort, as reflected in more detailed reporting on Key Audit Matters (KAMs) and superior audit fees.

Moreover, the findings reaffirm the informational environment's role as a determinant of audit fees. Francis (2004) argues that audit fees reflect more than firm size or industry complexity as they also capture the perception of risk

embedded in the client's reporting strategy. The present study supports this view by showing that auditors adjust pricing upward when conservatism introduces greater judgment, particularly in the treatment of bad news.

Finally, DeFond and Zhang's (2014) work provides a useful lens for interpreting these findings, as they suggest that audit quality is not only a function of auditor characteristics but also of the institutional and reporting context in which the audit takes place. The persistence of conservatism-related effects—especially in the asymmetric treatment of gains and losses—suggests that auditors adjust their procedures and pricing in response to the structure of reported information, not just its magnitude. Rather than simplifying the audit task, conservative helps to ship the focus to areas that need higher scrutiny and skepticism.

In conclusion, the results reinforce and extend the theoretical contributions of Basu (1997), Watts (2003), LaFond and Watts (2008), Francis (2004), and DeFond and Zhang (2014) while integrating recent empirical insights from Hall et al. (2023) and Wahyuni et al. (2024). Conservatism emerges as a dual-force mechanism, constraining managerial opportunism while enhancing corporate governance but also increasing informational complexity and audit workload. By demonstrating that audit fees rise in response to more conservative reporting behavior, the study confirms that conservatism plays an active and multidimensional role in shaping audit quality.

5 – Conclusion

This study aimed to investigate whether accounting conservatism—specifically, the asymmetric reversibility of earnings—affects audit quality, proxied by audit fees. Using an extensive dataset of publicly traded firms listed on the New York Stock Exchange and building upon an extension of Basu's (1997) model, the findings indicate a positive correlation between the presence of conservatism and audit fees. These results suggest that conservative reporting

environments, where losses are more likely to reverse than gains, demand greater effort and diligence from auditors.

The findings support the hypothesis that conservatism plays a corporate governance role in financial reporting, as proposed by Watts (2003). By promoting the timely recognition of losses and mitigating opportunistic earnings management behaviors (LaFond & Watts, 2008), conservatism enhances the reliability and verifiability of financial statements. However, these effects also lead to higher audit fees, driven by increased information asymmetry and the complexity of interpreting losses within such reporting environments.

Consistent with the work of Francis (2004), the results demonstrate that audit fees reflect not only auditor-specific factors but also the characteristics of the client's informational environment. Subsequently, DeFond and Zhang (2014) argue that audit quality is contingent upon the broader financial reporting context. The significant positive coefficient on the triple interaction term $LogAuditFees * Rit * NEG$ reinforces this notion, showing that auditors adjust both their procedures and pricing when operating in environments where financial reporting is shaped by the principle of conservatism. While the presence of this principle may indicate reduced risk in certain respects, it also requires heightened scrutiny and diligence from auditors.

Moreover, by confirming the asymmetry in earnings reversibility as hypothesized by Basu (1997), the results validate the chosen proxy for measuring conservatism and highlight its relevance within the audit domain. They further demonstrate that conservatism functions not only as an accounting principle but also as an informative signal that influences auditors' risk perception and planning.

From a practical perspective, these findings offer meaningful insights for auditors, regulators, accountants, and investors. For auditors, the results highlight the importance of taking into consideration the clients' reporting style—particularly conservative accounting behavior—in their risk assessments

and audit planning. The evidence that conservatism is associated with increased audit effort suggests that such reporting environments demand more extensive verification procedures, influencing resource allocation and audit strategy. This aligns with the view that audit quality is shaped by the client's informational environment (DeFond & Zhang, 2014; Hall et al., 2023). For accountants, the study clarifies that conservatism is not merely a principle adopted in reporting but a factor that may elevate audit scrutiny and cost.

Regulators may also find these results relevant, as they suggest that the structure of financial reporting standards—especially those promoting prudence—can influence the external assurance process and its effectiveness. For investors, conservative earnings patterns may signal not only more disciplined reporting but also a greater degree of auditor involvement and oversight, thereby enhancing the reliability of financial information (LaFond & Watts, 2008; Wahyuni et al., 2024).

The central contribution of this study lies in establishing a direct empirical link between accounting conservatism and audit quality, expanding the scope of conservatism literature by introducing the role of the external auditor into the analysis. While prior research has largely focused on conservatism as a response to agency costs, litigation risk, or governance incentives, this study demonstrates that conservatism also has implications for the audit process itself. By showing that more conservative firms tend to incur higher audit fees—interpreted as a proxy for audit effort and perceived risk—the findings suggest that conservative financial reporting reshapes the auditor's role, moving beyond passive assurance to active risk mediation. This perspective extends the academic discourse on the correlation between reporting and audit quality and invites further inquiry into how auditors interpret, challenge, or rely on conservative accounting choices.

Despite its contributions, the study faces certain limitations. The use of audit fees as a proxy for audit quality, though widely employed in the literature (Francis, 2004; Hay et al., 2006), may also capture confounding effects such as

firm size, client reputation, or market power. Moreover, the analysis is restricted to U.S. firms, where the legal environment, enforcement mechanisms, and cultural emphasis on investor protection are particularly conducive to conservative practices. As such, the findings may not generalize to countries operating under code-law traditions or IFRS frameworks, where conservatism is less institutionalized and audit dynamics may deviate.

Future research could investigate whether this correlation persists across institutional settings, particularly in jurisdictions with weaker legal enforcement or differing norms regarding prudence. Additionally, it would be valuable to investigate whether the observed effects are moderated by auditor characteristics, such as industry specialization or affiliation with the Big 4, or client attributes, including firm lifecycle stage or ownership structure. Future studies could also examine alternative proxies for audit quality, including audit report lag or Key Audit Matter disclosures, to assess whether the influence of conservatism on audit judgment extends beyond the fees. Such work would provide a more comprehensive understanding of how conservative reporting environments interact with external audit practices and contribute to the broader architecture of financial accountability.

Declaração de IA generativa e tecnologias assistidas por IA no processo de redação

Durante a elaboração do meu trabalho escrito/dissertação, Pay to Win? The Impact of Accounting Conservatism on Audit Quality Through the Lens of Audit Fees, foi utilizado ChatGPT para tarefas de tradução e pesquisa de artigos pertinentes para a matéria em estudo, tendo sido utilizadas as prompts listadas no final do documento na secção Lista de Prompts. Após a utilização desta ferramenta/serviço, revi e editei o conteúdo conforme necessário e assumo total responsabilidade pelo conteúdo do trabalho apresentado. Declaro ainda conhecer e respeitar o Código de Conduta de Inteligência Artificial da Católica Porto Business School.

Lista de Prompts

"Ajuda-me na tradução do seguinte texto"; "Procede à verificação gramatical do seguinte texto"; "Ajuda-me na busca de artigos pertinentes sobre a qualidade da auditoria"; "Ajuda-me na busca de artigos pertinentes sobre o conservadorismo contabilístico"

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Appendix

Table 1 - Description of the variables

Variables	Abbreviation	Operational Definition
Earnings per share	EPS	Net income after tax divided by total shares outstanding
Price close	$Pit-1$	Price close of the stock on the prior year
Dummy negative return	NEG	An indicator of negative returns =1; otherwise = 0
Earnings	$EPS/(Pit-1)$	Earnings per share normalized by the stock price at the end of last year
Stock Returns	Rit	Firms accumulated return between 9 months before and 3 months after the end of the fiscal year
Logarithm of audit Fees	LogAuditFees	Logarithm of the fees paid for auditing services

Notes: Table 1 provides detailed definitions and construction methods for all variables used in the empirical analysis. The table includes the dependent variable (normalized earnings) and the key independent variables (e.g., stock returns, negative return dummy, Logarithm of audit fees). All financial data were retrieved from Refinitiv Eikon. The definitions follow prior literature, including Basu (1997), LaFond and Watts (2008), and Wahyuni et al. (2024).

Table 2 - Descriptive Statistics

Variables	Observations	Mean	Standard Deviaton	Min	Max
ID	9534	576.17	329.29	1.00	1142.00
Year	9534	2017.65	3.96	2010.00	2024.00
Industrials	9534	0.24	0.43	0.00	1.00
Information Technology	9534	0.07	0.26	0.00	1.00
Health Care	9534	0.08	0.27	0.00	1.00
Consumer Discretion	9534	0.17	0.38	0.00	1.00
Real Estate	9534	0.13	0.33	0.00	1.00
Materials	9534	0.09	0.29	0.00	1.00
Consumer Staples	9534	0.06	0.24	0.00	1.00
Communication Services	9534	0.04	0.18	0.00	1.00
Energy	9534	0.11	0.32	0.00	1.00
Audit Fees	9534	8070000.00	2.500e+08	2530.00	2.436e+10
Earnings	9534	1.79	51.30	1968.48	2847.47
NEG	9534	0.39	0.49	0.00	1.00
Rit	9534	0.19	0.84	-1.00	53.24
NEG*Rit	9534	-0.09	0.17	-1.00	0.00
LogAuditFees	9534	6.47	0.48	3.40	10.39
LogAuditFees*NEG	9534	2.48	3.15	0.00	8.78
LogAuditFees*Rit	9534	1.20	5.51	-7.42	359.79
LogAuditFees*Rit*NEG	9534	-0.60	1.10	-7.42	0.00
Earnings	9534	2.48	5.53	-20.51	28.91
NEG	9534	0.39	0.49	0.00	1.00
Rit	9534	0.16	0.51	-0.75	2.50
NEG*Rit	9534	-0.09	0.17	-0.75	0.00
LogAuditFees	9534	6.47	0.47	5.06	7.60
LogAuditFees*NEG	9534	2.47	3.14	0.00	7.40
LogAuditFees*Rit	9534	1.07	3.30	-4.85	16.09
LogAuditFees*Rit*NEG	9534	-0.59	1.08	-4.85	0.00

Notes: Table 2 reports descriptive statistics for the variables used in the regression models, based on 9,534 firm-year observations from 2010 to 2024. Variables are winsorized at the 1st and 99th percentiles to reduce the impact of outliers. The table shows the mean, standard deviation, minimum, and maximum values, offering an overview of the sample's distribution and variance. Variable definitions are provided in Table 1.

Table 3 – Pearson Pairwise Correlations

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(1) Earnings	1.00							
(2) NEG	-0.10	1.00						
(3) Rit	0.03	-0.63	1.00					
(4) NEG*Rit	0.21	-0.70	0.60	1.00				
(5) LogAuditFees	0.17	-0.05	-0.02	0.09	1.00			
(6) LogAuditFees*NEG	-0.09	0.99	-0.62	-0.69	0.01	1.00		
(7) LogAuditFees*Rit	0.03	-0.63	0.99	0.60	0.01	-0.62	1.00	
(8)LogAuditFees*Rit*NEG	0.20	-0.70	0.60	0.99	0.05	-0.69	0.61	1.00

Notes: Table 3 displays the Pearson Pairwise correlation coefficients among the main variables used in the analysis. The correlations help assess the direction and strength of linear relationships, as well as potential multicollinearity. All correlations are computed using the pairwise deletion method. Variable definitions are reported in Table 1.

Table 4 - Baseline Regression Results

Earnings	Coef.
Constant	-19.70***
	(0.00)
Rit	10.11***
	(0.00)
NEG*Rit	-22.12***
	(0.01)
LogAuditFees	3.52***
	(0.00)
LogAuditFees*NEG	-0.10
	(0.75)
LogAuditFees*Rit	-1.74***
	(0.00)
LogAuditFees*Rit*NEG	4.20***
	(0.00)
Observations	9534
p value	0.00
Year fixed effects	No
Adjusted R^2	0.03

Notes: Table 4 reports the results from the baseline OLS regression estimating the relationship between asymmetric earnings reversibility (proxy for accounting conservatism) and the logarithm of audit fees (proxy for audit quality). The model extends Basu (1997) by introducing interaction terms between the logarithm of audit fees and the explanatory variables. Robust standard errors clustered at the firm level are reported in parentheses. , *, **, *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Table 5 – Results with fixed year effects

Earnings	Coef.
ConstanT	-3.54
	(0.29)
NEG	0.83
	(0.69)
Rit	7.29***
	(0.00)
NEG*Rit	-15.33**
	(0.05)
LogAuditFees	0.76
	(0.15)
LogAuditFees*NEG	-0.12
	(0.71)
LogAuditFees*Rit	-1.24***
	(0.00)
LogAuditFees*Rit*NEG	3.12**
	(0.01)
Observations	9534
p value	0.00
Year fixed effects	Yes
Adjusted R^2	0.09

Notes: Table 5 reports regression results with year fixed effects to control for macroeconomic trends, regulatory changes, and other time-specific shocks affecting all firms in the sample. The specification tests the robustness of the baseline results from Table 4. The dependent variable is normalized earnings, and the key variables are the ones presented in Table 1. Robust standard errors clustered at the firm level are in parentheses. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.