

Economic consequences of public oversight of the auditing profession

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Summary

Being one of the most profound changes in the history of the auditing profession, public oversight receives considerable attention from academics, regulators, stakeholders and society at large. Prior literature has focused on investigating the impact of public oversight on accounting quality and auditor reporting behavior of big audit firms in the US. In this dissertation, I extend this stream of literature by examining various effects of public oversight in the US, both from the investor perspective and the audit firm perspective. Additionally, using the public oversight setting in the Netherlands, I study how the publication of inspection reports affects investors' perceived audit quality in a non-US setting.

The results of my first study, described in chapter 2, provide some indication that inspection reports issued by the PCAOB are value relevant for capital market investors. More specifically, I find that stock market liquidity decreases after the publication of the first inspection reports, regardless of the inspection results. This suggests that the effect of the changed perceived audit quality is dominating after the first inspection. After the second inspection, liquidity increases and the increase is driven by clients with deficient auditors who do not contest the PCAOB inspection findings. In other words, the expected benefits of disclosing the results of audit firm inspections only seem to become visible after the disclosure of the second round inspection reports. Combined with the finding that liquidity first decreases, the results suggest that there is a learning effect in incorporating the information conveyed in the inspection reports and it helps to close the information gap after the first inspection. However, the results show that liquidity does not significantly change after the third inspection, suggesting that the informational value of inspection reports appears to fade out after the third inspection round.

While my first study investigates how investors value PCAOB inspection reports, my second study, described in chapter 3, focuses on whether publicly disclosed

inspection findings can shape auditor behavior. The intended goal of PCAOB inspections to improve audit quality can only be achieved if inspection outcomes can provide sufficient incentives for audit firms to adjust their behavior. Hence, I examine whether inspections affect audit fees of smaller audit firms, which is viewed as a proxy for the input factor of audit quality, conditioning on the content of the inspection reports.

The results of my second study indicate that audit fees increase on average after all first three rounds of inspection. I conjecture that incentives stemming from litigation risks and reputation damage affecting perceived competence following public disclosure of inspection findings can shape the magnitude of audit fees changes. For audit firms with deficient inspection findings, litigation risks and the possibility to get regulatory sanctions are arguably higher than those with clean inspection reports, which leads to more incentives for deficient audit firms to improve audit effort. In a competitive market, increased audit effort should be reflected in audit fees. At the same time, deficient audit firms' ability to raise their fees are largely constrained by reputation loss if clients value the information provided in inspection reports. I further show that the increase in audit fees is driven by audit firms without engagement or disclosed quality control deficiencies. In contrast, audit firms with disclosed quality control deficiencies experience decreases in audit fees, suggesting that clients perceive Part II of PCAOB inspection reports to be better indicators of audit quality.

In addition, in my second study, I provide insights regarding the impact of inspections on audit firms by investigating the change in personnel decisions and number of public clients. The results show that deficient audit firms experienced a decrease in the number of CPAs, which may suggest a seeking for lower labor cost. On the contrary, for clean audit firms, I document an increase in the number of CPAs, which would be consistent with higher audit effort. However, the number of public clients decreases for clean audit firms. Collectively, my second study suggests that there appears to be a strong focus of public clients on negotiating for the lowest possible audit

fee instead of searching for higher audit quality, based on the assumption that PCAOB inspection reports signal audit quality accurately. However, while my first and second study suggest that PCAOB inspections lead to important changes in stock market liquidity as well as audit firm behavior, it does not provide direct evidence that the benefits outweigh the cost of public oversight.

As indicated in the introduction of the dissertation, more and more countries are implementing public oversight in the footsteps of the PCAOB. Even though my first study presented in chapter 2 finds that investors value the information provided in PCAOB inspection reports, it remains an empirical question to what extent these findings can be generalized to other countries with different formats of inspections and different institutional environments. Hence, in my third study, presented in chapter 4, I use the public oversight setting in the Netherlands, which shares some similarities and presents some important distinctions with the PCAOB inspections, to shed some light on this question.

The similarities between the AFM inspections in the Netherlands and the PCAOB inspections in the US include their fully independent nature and their inspection processes. The differences pertain to aspects including inspection coverage, disclosure formats and institutional environment such as litigation risks. I argue that these differences may affect the impact of inspection findings on investors' perceived audit quality. In my third study, I find that the capital market does not react significantly to the publication of AFM inspection reports regardless of their findings, even if these inspection reports disclose quality control deficiencies in the audit firms and thus potentially convey even more information than PCAOB inspection reports.