Maastricht University

Economic consequences of public oversight of the auditing profession

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Appendix 4: Valorization-addendum

With rising importance of global capital markets, mechanisms designed to secure their proper functioning become increasingly important. External financing is based on the concept that firms can credibly communicate their true economic performance by means of audited financial statements. If investors lose confidence in the reliability of audited financial information, market participation and the availability of capital decrease, harming financial stability.

Public oversight of the auditing profession represents a mechanism intended to ensure high audit quality and was installed in response to investor loss of confidence resulting from high-profile financial reporting scandals in which auditors were also blamed. It is considered as one of the most profound changes in the history of audit regulation. The US set the tone in 2002 by creating the Public Company Accounting Oversight Board (PCAOB) putting an end to self-regulation of the auditing profession, which was the dominant model for many decades. Subsequently, many other countries (including all EU member states) followed the US example of installing independent public oversight in varying forms and stages of development. The central aim of independent audit regulators is to ensure trust in the financial markets and enhance the protection of investors and the public interest through audit oversight, enforcement and improving audit quality.

Since the creation of the PCAOB, the value of stock trading and audit fees have only further increased, which makes the relevance of independent public oversight on the auditing profession even more important for regulators, audit firms as well as investors. For example, from 2002 to 2015, the total value of stock traded in the US increased from US$ 17 trillion to US$ 42 trillion (World Federation of Exchanges 2016). Similarly, total audit fees paid by public listed companies have increased from US$ 2,902 million in 2002 to US$ 8,146 million in 2015 (AuditAnalytics 2016).

Motivated by the debate on the effectiveness of public oversight, which is not uncontested, and the paucity of empirical evidence, my dissertation investigates economic consequences of public oversight and specifically the impact of disclosure of inspection outcomes on information asymmetry and the cost of capital in the equity and debt market, and auditor behavior. The findings from this dissertation can inform capital market participants in their decision-making and provide insights to public oversight bodies on their impact on the capital and audit market.

Specifically, the findings in Chapter 2 suggest that stock market liquidity in the small audit firm market segment decreases on average after the publication of the first PCAOB inspection reports regardless of the inspection outcome, implying an increased cost of capital, which would be opposite to the regulatory intention of improving investor confidence. However, liquidity increases after the publication of the second round inspection reports for clients audited by clean auditors and deficient auditors who do not disagree with the PCAOB's findings, while there appears to be no change in liquidity after the third inspection. By means of comparison, it is shown that stock market liquidity increases after the publication of the first

inspection reports for the large audit firms. Overall, these findings suggest that PCAOB inspection reports change investors' perceptions of future audit quality and that there is a learning process in the capital market when it comes to the interpretation of inspection reports. These findings have implications for regulators in terms of considering providing more guidance for investors to understand the inspection process as well as the findings, and being aware that investors appear to react differently to inspection results of large versus smaller audit firms.

The findings in Chapter 3, which investigates the behavior of smaller audit firms after the publication of the PCAOB inspection findings, are relevant for both investors and regulatory bodies. For investors, the results suggest that the audit firms' reactions to the quality control findings (i.e. Part II inspection outcomes) provide more useful information on future audit quality compared to the engagement related findings (i.e. Part I inspection outcomes). By utilizing this information effectively, investors may make better decisions. For regulators, the findings of the study suggest that there is an important group of client companies in the smaller audit firm market segment that appear to have a stronger interest in demanding lower audit fees rather than audit quality. As regulators are using a "one size fits all" approach in implementing public oversight, they should consider treating large and small audit firms differently to achieve better performance. Furthermore, by knowing that Part II of the inspection reports are more informative for companies in choosing their auditors, regulators may want to pay particular attention to consider disclosing more, and potentially also more timely, information on the audit firm quality control system, after having carefully evaluating the costs and benefits.

Finally, Chapter 4 examines how investors react to the publication of the Dutch AFM inspection findings and penalty announcements. In contrast to the findings in Chapter 2 relating to the US setting, it appears that the information is much less valued in the Netherlands. Hence, regulators need to be aware of the institutional factors affecting investor perception of public oversight.

Overall, the findings of this dissertation can help improve public oversight on the auditing profession, with the ultimate goal to improve audit quality. In particular, the dissertation provides innovative insights that regulators need to pay more attention to the inherent differences between large and small public accounting firms in designing the public oversight system, and the impact of institutional differences. Although the dissertation suggests that there is room for further improvement of public oversight, this does not come without costs. Specifically, it is questionable whether the costs of public oversight can be offset by the potential benefits of increased audit quality, especially in the presence of a low audit quality demand for certain type of companies in the market. Future research on this matter is warranted.