This dissertation investigates how the quality of auditing of financial statements relates to the regulatory context in which audits are performed. In Chapter 1 the added value of (high quality) auditing for the general public is explained. Auditing is a professional service delivered by experts in which they provide assurance about the reliability of the information contained in the financial statements prepared in accordance with generally accepted accounting principles (Knechel 2001; Knechel et al. 2013). Many stakeholders are basing economic decisions on information in companies’ financial statements. Those users of financial statements, which include capital providers such as shareholders and creditors, and other stakeholders such as suppliers, customers and employees, need those statements to provide reliable information regarding the company’s financial position. Usually, they are not in a position to evaluate the reliability of the financial statements, because they do not have access to the underlying data, they lack the skills to do so, and it would be too costly. Therefore, they have an information disadvantage in comparison to the company’s management. The interests of company’s management, which is responsible for providing the information, and the users of that information, may not be aligned. In fact, it is widely agreed that these interests are often conflicting: while users of financial statements require relevant and reliable information, company’s management may have incentives, for instance personal bonuses, to present the information more favorably. Auditors are the independent professionals hired to provide a competent and objective opinion on the reliability of the information. In doing so, they improve the quality of that information and reduce the information disadvantage of the users of financial statements. Auditors thus operate primarily in the public interest.

The quality of the audits performed determines the level of assurance and added value provided to the public in general, and users of financials statements in particular. Since auditors are operating in a system with incentives that may negatively influence the quality of the audits they perform, there is a need for professional standards and regulation to ensure a constant and adequate level of auditing. A number of large audit failures and accounting scandals in the early 2000s (e.g., Enron, WorldCom, Xerox, Ahold, and Parmalat) have severely undermined public confidence in auditors and their reports. Worldwide, regulators have responded by increasing their regulatory focus on audit firms in the course of the last fifteen years. Three of those regulatory topics are at the heart of this dissertation: the introduction of independent public oversight, the
strengthening of auditor independence, and the development of audit quality indicators to increase audit firm transparency.

The purpose of this dissertation is to empirically assess how these regulatory topics (i.e., public oversight, auditor independence, and audit quality indicators) relate to audit quality. Are they informative about audit quality and do they improve audit quality? Besides contributing to the existing literature on audit quality by exploiting the unique access to proprietary data on audit firms from the Dutch public oversight body, the empirical assessment of these relationships also has practical importance and implications for audit firms and auditors, companies hiring auditors, investors, public oversight bodies, and regulators (also described in Chapter 5).

The first study, presented in Chapter 2, examines the relationship between public oversight and audit quality. After a number of high-profile corporate failures, regulators started to believe that the self-regulatory peer review system was no longer adequate and appropriately functioning. Independent public oversight was proposed instead as an alternative way of organizing audit oversight with the goal to restore confidence in and safeguard the public function of the auditing profession and the quality of its work. This study examines the effectiveness of public oversight in the Netherlands by testing whether (a) the public oversight body can differentiate audit quality in its first-time inspection round, and (b) audit quality improves after the first-time inspection round. The conclusion of this study is that the public oversight body is able to differentiate audit quality, in contrast with the prior peer review system. This positively supports regulators’ decisions to replace peer review systems with independent public oversight. Companies hiring auditors and investors relying on auditors’ opinion may also benefit from knowing the reliability of public oversight body’s assessment of audit firm quality by choosing higher quality auditors and thereby pressuring lower quality auditors to improve themselves. In light of worldwide discussions on the effectiveness and mutual recognition of audit oversight systems, insights from this study may benefit public oversight bodies across the world in further shaping their oversight systems. The additional findings in this study regarding the types of deficiencies in audit firms that are most able to distinguish audit quality provide useful information for audit firms to improve those areas and strengthen their overall quality control.

However, the conclusion of this study further states that neither the peer review system nor the public oversight body appear to bring about improvement in audit quality, at least in the short term. A possible explanation could be that audit firm-specific inspection reports were not publicly disclosed in the Netherlands until 2014. The lack of quality improvement should be of primary concern to all stakeholders involved. Auditors and audit firms could question themselves why they were unable to show improvement. Companies hiring auditors, and their audit committees in particular, could incorporate more explicitly the outcomes of public oversight inspections into their hiring decisions, and thereby pressuring lower quality auditors to improve their quality. Similarly, investors could take note of the outcomes of public oversight inspections and start a dialogue, e.g., during shareholders’ meetings, with company management about the
quality of the audit, creating yet another incentive for auditors to increase the quality of their work. Public oversight bodies and regulators could evaluate the effectiveness of their oversight and other regulatory activities and innovate their approaches in order to alter the system of incentives for auditors in such a way that higher quality audits becomes more rewarding.

The second study, presented in Chapter 3, examines the relationship between independence regulation and audit quality. Regulators around the world consider independence regulation as an important instrument to safeguard audit quality. By tightening independence requirements they attempt to improve audit quality and regain public trust in the auditors’ reports. Independence requirements deal with specific circumstances and relationships that create or may create threats to independence (e.g. provision of non-assurance services to an audit client, long association of senior personnel with an audit client, employment with an audit client, fees, business relationships, financial interests, family and personal relationships, gifts and hospitality, and actual or threatened litigation). Prior research examined the relationship between a number of these circumstances and relationships on the one hand and audit quality on the other hand. The purpose of this study is to examine one of the previously unaddressed relationships, i.e., business relationships between audit firms and their audit clients. Business relationships arise from commercial relationships or common financial interests between the audit firm and the audit client. This study focuses on business relationships in which the audit firms purchases goods and services from an audit client. It examines the association between the existence of an audit firm-client business relationship and audit quality, inferred from both audit fees and earnings quality.

The results of the second study show that business relationships are consistently associated with higher audit fees and, particularly in those situations where the business relationship coincides with high non-audit fees relative to audit fees, with higher earnings quality. These findings may be of interest to the investors, who are ultimately paying for a more expensive audit. Although the findings suggest that audit firms and auditor are complying with independence regulations requiring them to increase engagement effort to safeguard audit quality, it is not entirely certain that the auditor’s independence is not at all impaired by the business relationship. Further assessment of business relationships, either by audit firms themselves or by public oversight bodies in course of their inspections, could elaborate on this study. Questions that remain to be answered are for instance: Why are audit firms procuring goods and services from audit clients when they can also procure them from other companies? Are audit firms indeed spending more audit hours or other resources on audit engagements that coincide with business relationships or are audit fees primarily indicative of risk premiums? Why are audit clients willing to pay higher audit fees when they are also selling goods or services to the audit firm?

The third study, presented in Chapter 4, examines the relationship between audit quality indicators and audit quality. Transparency of audit firms through audit quality indicators is believed to increase market participants’ ability to observe audit quality,
thus enabling differentiation and competition among audit firms on the basis of publicly available data, and providing incentives for firms to increase audit quality. The purpose of this study is to examine whether audit firm governance characteristics are useful audit quality indicators. This is done by testing whether audit firms with stronger governance mechanisms in place are less likely to be confronted with stakeholder dissatisfaction, trigger regulatory attention, or exit the audit market. Audit firm governance is operationalized by constructing organizational variables and quality control system variables. The results provide support that several audit firm governance characteristics are associated with distinct firm-level output measures of audit quality, albeit to a different extent. Further, the extensive descriptive analyses provide useful information for the ongoing public debates about audit quality indicators. Audit firms, regulators, and the investors ultimately requiring increased audit firm transparency, will need to continue their collaborative search of consistently reliable measures that adequately provide this transparency.

In the practical follow-up of all three studies, academics may facilitate stakeholders by conducting research that is aimed at increasing further understanding of the determinants of audit quality or providing support for newly proposed regulatory measures. However, in order to be of value, they will need to incorporate stakeholders’ actual underlying questions and concerns into their research hypotheses and make use of data sources that are able to depict reality as closely as possible. Particularly audit firms and public oversight authorities, but possibly also regulators and investors, could increase their collaborative efforts with academics and provide them access to new data sources. In the Netherlands, a first step in this direction was set in October 2015 with the launch of the ‘Foundation for Auditing Research’. The eight largest audit firms have affiliated themselves with the foundation by providing access to research data and research subjects and committed to an annual financial grant. This unique collaboration between science and practice is expected to increase the understanding of what determines and improves audit quality.