Context matters

Valorization Addendum

A functioning capital market is the basis of efficient allocation of resources, economic growth, and ultimately a prosperous society. High-quality and reliable financial information that investors have confidence in is the backbone of functioning capital markets. Auditing is vital for enhancing the quality and credibility of financial statements and for building confidence of users of financial information. Auditing is thus underlying the functioning of capital markets. However, the value of auditing is derived from its quality, since only a quality audit can enhance financial statement quality and build credibility in capital markets. Audit quality is thus vital for the functioning of capital markets. Audit quality is influenced by engagement-specific circumstances and the context in which audits take place.

This dissertation investigates whether and how different institutional and engagement-specific factors affect audit quality and audit outcomes. Broadly, investigating the effect of these factors on audit quality and other outcomes is of interest to users of audited financial statements, the audit profession, regulators, standard-setters and the public. All three studies of this dissertation address topics that are of current and continued interest to all stakeholders. The valorization opportunities for each chapter are addressed in the following paragraphs.

The first study of this dissertation (Chapter 2) investigates the audit quality of group audits of MNEs. Given the important role that MNEs play for the world economy and their worldwide reach, audit quality is of high importance for those companies and users of their financial information. Audit failures of group audits of MNEs have wide reaching consequences for investors and the audited companies. Examples of these major international failures are Parmalat, Royal Ahold, Satyam Corporation, and, more recently, BT. Furthermore, both regulators and standard-setters are concerned about the quality of group audits, based on inspection results of risk-based samples that have identified various shortcomings in group audits, particularly those involving component auditors and foreign component auditors (e.g., Doty [2011], [2017], IFIAR [2018]). The first chapter empirically documents audit quality and audit fee consequences for group audits of MNEs. The study shows that audit quality problems are prevalent in group audits involving component auditors, regardless of whether the component auditor is part of the network of the principal auditor or unaffiliated. The study further shows that even though standard-setters have revised the group auditing standard ISA 600, audit quality problems in group audits remain. The insights from this large-scale study are therefore of interest to standard-setters in their endeavor to improve audit quality. In particular, standard-setters that are currently revising the group audit standard (both the PCAOB and the

IAASB have current projects on their group audit standards) can benefit from the insights of this study. Users of group financial statements should be aware of audit quality problems prevalent in group audits. Further, if disclosure about involvement of component auditors is available (e.g. through Form AP in the U.S., or in annual reports of Australian listed companies), investors would be able to use this information to evaluate audit quality of group financial statements. Regulators can thus use the insights from this study when inspecting group audits and evaluating their quality, and for evaluating the need for disclosures about involvement of component auditors in group audits which users of group financial statements can benefit from. Audit practitioners can use the insights of this study to address group audit quality problems when component auditors are involved, regardless of the type of component auditor (network or unaffiliated).

The second study of this dissertation (Chapter 3) investigates one of the most profound changes in audit regulation in the last decades, the installment of public oversight of audit firms, replacing a system of self-regulation of the audit profession. Public oversight of audit firms, including regular inspection systems, was installed to counter the loss of confidence of investors in audit quality and capital markets following a number of high-profile scandals, e.g. Enron. While the US has been frontrunner in this development, public oversight boards were installed in many other jurisdictions worldwide. However, national public oversight boards have developed different characteristics in the design of inspection systems related to their work approach, disclosures of inspection results and enforcement ability. The second study describes these differences in inspection systems and evaluates changes in audit quality after commencement of inspections. The study finds evidence of audit quality improvements after commencement of inspections but shows that these improvements depend on disclosure of inspection results. These descriptives and results are of interest to public oversight boards and other regulators that have ongoing discussions about mutual recognition of public oversight across countries. Further, the results are interesting for the (re)design of public oversight boards to increase their effectiveness in safeguarding the public interest. For example, many EU countries have redesigned or established new public oversight boards recently. This study is also of interest to investors who can benefit from understanding the effectiveness of different public oversight designs for safeguarding audit quality.

The third study of this dissertation (Chapter 4) investigates the relation between litigation and regulatory risks and how these risks jointly influence auditor behavior. This provides insights into how various institutional forces interact to influence auditor conservative reporting and audit fees. This study finds evidence suggesting that the effect of litigation and regulatory risk are complementary in the U.S. setting. This study is of interest to regulators who should be aware that any regulation, such as inspections, imposed on audit firms will not exist in isolation but might have different effects in different contexts such as in different litigation environments. Given the empirical setting, this study also explores the settings under which PCAOB inspections are more or less effective which is of further interest to regulators. This study should also be of interest to investors and the public who want to evaluate the potential effectiveness of audit regulation in different contexts and litigation environments. Investors and the public should be aware that joint risk from litigation and regulation can increase auditor reporting conservatism, rather than improve audit quality, and increase audit fees, which might not be reflective of higher audit effort. This result is not socially desirable.

Overall, the findings of this dissertation shed light on engagement-specific and contextual factors that influence audit outcomes. The different research questions in this dissertation are of concern to regulators, standard-setters, practitioners and the public at large and are timely topics that are under current or continued discussion.