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Does the PCAOB international inspection program improve audit quality for non-US-listed foreign clients?

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ABSTRACT

We examine whether the Public Company Accounting Oversight Board (PCAOB) international inspection program improves audit quality for a sample of *non*-US-listed foreign public client companies from 55 countries audited by foreign (i.e., non-US) auditors. For a sample of non-US-listed clients of PCAOB-registered foreign auditors, we find that initial PCAOB inspections improve audit quality, over and above the threat of such inspections, for foreign auditors' non-US-listed foreign clients. Our findings document the benefits of PCAOB international inspections for foreign investors in non-US-listed foreign companies which could increase the acceptability of the PCAOB international inspection program abroad.

1. Introduction

All auditors (US and foreign) who audit US-listed companies are required to register with the Public Company Accounting Oversight Board (PCAOB) and be subject to PCAOB inspections. In this study, we focus on *foreign* auditors and consider whether audit quality for *non*-US-listed foreign public clients (non-US-listed clients) is higher following the initial PCAOB inspection.[1] Our study addresses the issue of positive externality, i.e., whether the PCAOB international inspection program improves audit quality for foreign auditors' non-US-listed foreign clients even though investors in these particular foreign companies are not the intended beneficiaries of the foreign auditor inspection program.[2]

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[1] Consistent with PCAOB terminology, we use the terms "auditor" and "audit firm" interchangeably.

[2] A positive externality implies a benefit to a third party. Consistent with its mission of improving audit quality in US public securities markets, the PCAOB international inspection program seeks to improve audit quality for foreign auditors' US-listed clients. However, to the extent that the program is also associated with an improvement in audit quality for these foreign auditors' non-US-listed clients, we view the outcome as a positive externality. As an analogy, the US Food and Drug Administration (FDA) inspects pharmaceutical companies abroad to ensure the safety and effectiveness of generic drugs manufactured for export to the US. To the extent that the FDA's foreign inspections have a positive externality, the quality control improvements in the manufacture of generics abroad could benefit not only US consumers but also consumers abroad (McLain, 2014).

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The impact of the PCAOB international inspection program on audit quality abroad is ambiguous. Given the PCAOB's reputation for actively looking for auditor misconduct and taking follow-up disciplinary actions against deficient auditors (DeFond, 2010; Farrell and Shabad, 2005), the very act of registering with the PCAOB may exacerbate foreign auditors' exposure to reputation loss and provide them with an *ex ante* incentive to strengthen their *firm*-level quality controls and increase audit quality. To the extent that audit deficiencies are discovered during the initial inspection, the auditor may have an additional incentive to take appropriate remedial action and strengthen firm-level quality controls to avoid further embarrassment on subsequent inspections. The improvements in the foreign auditor's *firm*-level quality controls could increase audit quality for *all* of the firm's foreign clients US-listed or otherwise. Moreover, because the starting point for audit quality is potentially lower abroad than in the US (Choi et al., 2008; Francis and Wang, 2008), the PCAOB inspection program could have a greater impact abroad than in the US.

However, reasons exist to doubt the efficacy of PCAOB inspections in improving audit quality. Prior research (DeFond, 2010; Lennox and Pittman, 2010) indicates that PCAOB inspection reports are not useful for assessing audit quality because they merely list audit deficiencies and do not provide a summary opinion about the auditor's quality. Moreover, the effectiveness of the PCAOB's international inspections may be limited by geographic distance from the US, potential language differences, or cultural barriers. Finally, foreign auditors may follow an asymmetric approach to their US-listed and non-US-listed clients. Given that the PCAOB is primarily interested in protecting investors in US-listed companies (selecting only US-listed client engagements for inspection) and the fact that auditor litigation exposure is lower for non-US-listed clients than for US-listed clients, foreign auditors may be less incentivized to improve audit quality for their non-US-listed clients. Foreign auditors may override their firm-level quality controls and utilize less effective audit programs or assemble less qualified audit teams for their non-US-listed clients (which may be less costly). To the extent that foreign auditors follow an asymmetric approach in servicing their US-listed and non-US-listed clients, any PCAOB inspection-related improvements in firm-level quality controls may not necessarily benefit their non-US-listed audit clients. For all these reasons, the overall effectiveness of the PCAOB international inspection program in improving audit quality for foreign auditors' non-US-listed clients is far from obvious and remains an open empirical question.

Because the quality of financial reporting is a joint outcome of manager and auditor decision making, audit quality is best viewed as a continuum with higher audit quality providing greater assurance of financial reporting quality (DeFond and Zhang, 2014). Still, beyond the notion that better audit quality leads to better financial reporting quality, little or no consensus emerges in the extant literature as to how best to measure audit quality. Hence, given that all audit quality proxies have their limitations, we use multiple financial reporting quality measures (such as discretionary accruals, the propensity to just meet or beat earnings expectations, and accruals quality) that capture different dimensions of the audit quality construct. In addition, we employ a measure of auditor independence: the likelihood of the auditor issuing a modified opinion for non-US-listed clients as a proxy for audit quality. For non-US-listed clients, this metric is similar to the propensity to issue a going-concern opinion for US-listed clients, and it is generally viewed as a measure of the auditor's ability to withstand client pressure to issue a clean audit opinion (DeFond et al., 2002; Chen et al., 2010; Fung et al., 2016).

Our study covers a 13-year period (2002–2014) and includes a total of 61,612 non-US-listed client-year observations with PCAOB-registered foreign auditors from 55 non-US countries. Our sample includes observations from countries that allow as well as those that prohibit PCAOB inspections. In our difference-in-differences (DID) research design, we control for the threat of PCAOB inspections based not only on whether the observation is from a country that allows (or prohibits) PCAOB inspections (consistent with Lamoreaux (2016)) but also on a model that captures the likelihood of the client-year observation being audited by a PCAOB-inspected foreign auditor.[3] Our findings suggest that initial inspections have an incremental effect on the audit quality of the foreign auditor over and above the effect of the threat of such inspections. These findings are of particular interest because some countries (such as China) continue to disallow PCAOB inspections. Our findings are consistent with those of Aobdia and Shroff (2017) who suggest that PCAOB oversight of non-U.S. auditors with US-listed clients increases the perceived assurance value of their audits and is reflected in an increase in their market share in their home countries.

All of our results continue to hold when we re-estimate our tests using a matched sample based on the propensity score of a non-US-listed foreign client having a PCAOB-inspected foreign auditor. Further, we examine whether the strength of the positive relation between PCAOB inspections and audit quality metrics for foreign auditors' non-US-listed clients (the externality effect) varies cross-sectionally over a number of factors. The findings from our cross-sectional analyses suggest that, controlling for the threat of inspections, the impact of the initial inspection is stronger when the likelihood of a foreign auditor being inspected by the PCAOB is lower, in countries without a substantive increase in financial reporting enforcement, in countries with lower liability standards for accountants, for earlier (versus later) initial inspections, and for foreign auditors affiliated with one of the six global audit firm networks (GNs). Consistent with the notion that PCAOB inspectors share their findings and suggestions for improvement with the auditor at the time of the inspection itself without having the auditor wait for the formal inspection report (Aobdia, 2016), in additional analyses we find that the improvement in

[3] To clarify, it is the auditor (not the client) who is subject to PCAOB inspections. Further, although the PCAOB selects the audit engagements it wants to inspect, the public portion of the PCAOB inspection reports do *not* identify the clients whose audits were found deficient. In any event, it is the auditor (not the client) who faces the threat of inspection and possible disciplinary action from the PCAOB.