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Regulatory oversight and auditor market share ☆

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ABSTRACT

We examine whether auditor regulatory oversight affects the value of financial statement audits. Using the PCAOB international inspection program as a setting to generate *within country variation* in regulatory oversight, we find that non-U.S. auditors inspected by the PCAOB gain 4% to 6% market share from competing auditors after PCAOB inspection reports are made public. When inspection findings reveal that an auditor has many engagement-level deficiencies, market share gains following inspection reports are significantly smaller. Our evidence suggests that regulatory scrutiny increases the assurance value of an audit and highlights the role of public regulatory oversight in the audit market.
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1. Introduction

An independent audit is a primary mechanism through which companies assure investors of the reliability and accuracy of their financial statements. Yet, much of the audit process is unobservable to investors, making it difficult for them to assess the quality of an audit. In addition, auditors are typically hired, and paid for, by the very companies whose financial statements they are supposed to verify, potentially threatening auditor independence. Under such circumstances, theory suggests that a public regulator can increase the value of an audit by inspecting the work performed by auditors and ensuring that the audit process conforms to certain standards of quality and independence (Landes and Posner, 1975; Polinsky, 1980; Pritchard, 2006; Coates, 2007). However, whether greater regulatory oversight increases the value of an audit is ultimately an empirical question. Specifically, the effectiveness of a public regulator depends on the regulator's incentives, competence, and some assurance that the regulator is not captured by special interest groups (Stigler, 1971; Mahoney, 2001).

In this paper, we examine whether regulatory oversight of auditors increases the perceived value of their audits. Specifically, we investigate whether the auditors subject to oversight by a public regulator observe an increase in their

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market share following the inception of such oversight relative to their competitors who are not subject to similar oversight.[1] Our intuition is that if clients (i.e., auditees and investors) perceive the audits performed by auditors subject to greater regulatory oversight as providing greater assurance than those performed by auditors with lesser regulatory oversight then the demand for audits from the former group will increase. Nevertheless, ex ante there are at least two reasons why greater regulatory oversight might not increase an auditor's market share even if it increases the perceived value of an audit. First, the company management or the board of directors that make the decision to hire an auditor might be unwilling to hire auditors subject to greater regulatory scrutiny because such auditors might constrain managers' ability to extract private benefits from their companies. In other words, the demand for high quality audits could be dampened by the company insiders' incentives to protect their private benefits of control. Second, auditors subject to greater regulatory oversight might respond to increases in the assurance value of their audits by increasing audit fees such that there is no increase in market share.

Testing whether regulatory oversight affects the value of an audit and thus an auditor's market share is challenging because, typically, all auditors that compete to provide audit services in a market are subject to the same level of regulatory oversight. As a result, in most cases there is no variation in the amount of regulatory oversight auditors are subject to within an audit market. We overcome this empirical challenge by identifying a setting where the auditors competing within a market (defined as a country) are subject to different levels of regulatory oversight over time. Specifically, we exploit variation in regulatory oversight generated by the Public Company Accounting Oversight Board's (PCAOB's) international inspection program.

Non-U.S. auditors that participate in the audit of a company registered with the U.S. Securities Exchange Commission (SEC) are subject to PCAOB oversight. Thus, such non-U.S. auditors that have one or more SEC registered companies as audit clients are subject to greater regulatory oversight than their peers who do not participate in the audit of any SEC registered company.[2] We use the variation in regulatory oversight created by PCAOB inspections of non-U.S. auditors to test whether PCAOB inspected auditors gain market share after their inspections from other auditors operating in the same country who are not inspected by the PCAOB.

We measure an auditor's market share as the number of public companies it audits in a year scaled by the total number of public companies in the country for that year. We employ both equal weighted and value weighted measures to capture auditor market share. To mitigate concerns that time invariant auditor characteristics or measurement error in our market share proxies affect our inferences, we employ a first differences research design that focuses on *changes* in auditor market share. As a result, the effect of auditor characteristics, such as reputation and litigation that are fairly stable from year-to-year, on auditor market share are differenced away in our analyses. In addition, we include indicator variables for each auditor and each country-year combination (i.e., country *times* year fixed effects) in all our analyses. These fixed effects control for all time-invariant auditor characteristics that affect changes in market share and all time varying and time invariant country-level factors that affect the local audit market conditions (e.g., GDP growth, local regulatory changes, etc.). Overall, the 'changes' research design along with the fixed effects structure makes it unlikely that our inferences are affected by correlated omitted variable biases. Figs. 1 and 2 graphically illustrate our design.

Using data from 36 countries over the period 2003 to 2013, we find that the change in auditor market share is significantly greater in the year after an auditor's PCAOB inspection report is released to the public compared to the change in market share for the same auditor in other years and the change in market share for auditors not inspected by the PCAOB that year. These results support our prediction that PCAOB oversight increases the assurance value of an audit, which then increases the market share of auditors subject to such oversight. In economic terms, our coefficients imply that the average auditor's market share increases by 3.5% to 6.4% after the disclosure that the auditor was inspected by the PCAOB.

A potential concern with our analyses is that auditors subject to PCAOB oversight could be systematically different than auditors not subject to PCAOB oversight, which could have systematic effects on auditor market share changes even within a country. To mitigate such concerns, we repeat our analyses on a sample of auditors that are *all* inspected by the PCAOB. Such a design is feasible because all non-U.S. auditors (except the Canadian big four) have been subject to triennial (rather than annual) inspections, thereby creating differences in the timing of auditor inspections within each country (see Fig. 2). Our tests exploit the staggering of PCAOB international inspections to mitigate concerns about selection. Using this staggered design, we again find that non-U.S. auditors gain market share following the public disclosure of their inspection. The economic magnitude of the inspection effect in this restricted sample is very similar to that observed in the full sample. Specifically, non-U.S. auditors observe a 4% to 7% increase in their market share once their inspections are made public. Fig. 3 plots the changes in market share in the years before and after PCAOB inspections.

[1] The value of an audit is not directly observable but differences in value manifest as either differences in audit fees or differences in auditor market share. Ideally, we would like to examine the effect of regulatory oversight on both audit fees and market share. However, our focus in this paper is on the effect of regulatory oversight on auditor market share because audit fee data are not available in our setting.

[2] PCAOB oversight includes periodic inspections of auditors' firm-wide practices and policies on compensation, promotion, client acceptance and retention, internal inspection, training and audit methodology. As a result, PCAOB inspections potentially increase regulatory oversight of all audits conducted by non-U.S. auditors and not just those of SEC registered clients. Supporting this argument, concurrent research finds that PCAOB inspections increase the reporting quality of both SEC registered and local clients of non-U.S. auditors (Fung et al., 2015; Shroff, 2015).

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