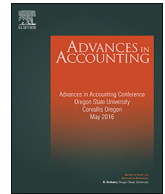




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Contents lists available at ScienceDirect

Advances in Accounting

journal homepage: www.elsevier.com/locate/adiac

The audit market effects of disputing a GAAP-deficient PCAOB inspection report

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ARTICLE INFO

Keywords:

PCAOB inspection reports

Audit committee financial expertise

Auditor dismissal

ABSTRACT

As part of its charter, the Public Company Accounting Oversight Board (PCAOB) has the authority to inspect and review the workpapers of all accounting firms that provide auditing services to publicly traded companies. The PCAOB summarizes their findings in publicly available inspection reports available on its website. Prior research suggests that the accessibility, variation and source creditability of the inspection reports creates a publicly available audit quality signal that is used by various auditor choice stakeholders. This is particularly true for triennially inspected auditors that receive a GAAP-deficient report (Abbott, Gunny, & Zhang, 2013). In a GAAP-deficient inspection report, the PCAOB alleges that the auditor failed to identify departures from generally accepted accounting principles (GAAP) in the clients' financial statements. In this paper, we investigate whether and to what extent the *auditor's response* – which is also encapsulated in the inspection report – impacts the reaction to GAAP-deficient inspection reports. We create a sample of 113 GAAP-deficient inspection reports that correspond to 100 unique auditors. For these 100 auditors and their 805 audit clients, we find auditors that dispute the PCAOB findings are less likely to be dismissed by their clients when the client has an audit committee with accounting-related financial expertise. Collectively, our results indicate that auditor choice stakeholders weigh both the PCAOB- and auditor-assessments of auditor performance.

1. Introduction

In response to corporate accounting and auditing failures at companies such as Enron and WorldCom, the Sarbanes-Oxley Act (SOX) of 2002 was enacted. One of the more salient regulatory aspects of SOX was the creation of the Public Company Accounting Oversight Board (PCAOB). The PCAOB - which replaced the prior peer-review regime - is charged with the responsibility of “auditing the auditors.” More specifically, SOX grants the PCAOB with the authority to inspect and review the workpapers of all accounting firms that provide auditing services to publicly traded companies. The PCAOB summarizes its findings in publicly available inspection reports available on its website and does so on an annual (triennial) basis for auditors with at least 100 (< 100) audit clients. The accessibility, variation and source creditability of the reports suggests their possible use as audit quality signals. Extant studies have generally documented stakeholder response to GAAP-

deficient inspection reports in the context of the auditor dismissal decision (Abbott et al., 2013; Abbott, Brown, & Higgs, 2016; Daugherty, Dickins, & Tervo, 2011).¹ More specifically, prior research finds that GAAP-deficient, triennially inspected auditors are more likely to be dismissed vis-à-vis those triennially inspected firms that are not. However, this line of research has not yet examined the *auditor's response* to a GAAP-deficient PCAOB inspection report and any corresponding effect on the auditor dismissal decision.

When presented with a GAAP-deficient inspection report, the auditor has three response disclosure strategies: ignore, acknowledge or dispute.² In the cases of ignoring, the PCAOB inspection report contains the PCAOB inspection team findings and the report is devoid of any meaningful, auditor-generated communications. In the case of acknowledgement, the auditor usually expresses its respect for the inspection process and acknowledges the audit engagement and/or quality control deficiencies cited by the PCAOB within the inspection

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¹ A GAAP-deficient report states that the firm failed to identify departures from generally accepted accounting principles (GAAP) in the clients' financial statements (Abbott et al., 2013).

² Part of the auspices of the PCAOB's creation is the ability of an auditor to express its confidence or lack thereof in the PCAOB inspection process and/or the conclusions reached by the inspection team.

<https://doi.org/10.1016/j.adiac.2018.03.001>

Received 27 September 2017; Received in revised form 20 February 2018; Accepted 1 March 2018
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report. In cases of dispute, the auditor explicitly states a difference of opinion with respect to the inspection process and/or inspection report findings. In this paper, we investigate whether and to what extent an auditor's dispute disclosure strategy impacts the likelihood of dismissing a GAAP-deficient, triennially inspected auditor.

We predict a dispute strategy enables a GAAP-deficient auditor to signal that it correctly interpreted GAAP and employed GAAS-compliant audit procedures. Thus, a dispute strategy has a twofold effect of (a) diminishing the PCAOB inspection findings and (b) reducing the likelihood of dismissal. We also argue a dispute strategy acts as a form of client advocacy. More specifically, GAAP-deficient PCAOB inspection reports often contain the phrases 'the (reported audit) deficiencies related...to an aspect...the issuer revised in a restatement subsequent to the primary inspection procedures' or 'failed to identify material departures from GAAP.' By disputing the PCAOB's findings, an auditor may also be defending the client's accounting treatments and decisions. That is, if the pre-audited financial statements did not contain a material misstatement, the PCAOB would render a GAAS-deficient inspection report. In a GAAS-deficient inspection report, the PCAOB implies that the financial statements audited by the auditor are free of material error and the auditor's opinion is correct. However, the manner in which the auditor collected audit evidence to support his/her (ultimately correct) audit opinion did not comply with GAAS. Consequently, when a GAAP-deficient auditor employs a dispute strategy, the auditor may be shielding both the audit firm and its clients from potential litigation. An acknowledgement strategy may actually exacerbate litigation concerns as it may confirm the PCAOB's contention that the financial statements contained a material error.

As our research question centers on stakeholder perception/consequences of a dispute strategy, we also test if the sophistication of the stakeholder impacts any potential dispute strategy effect. In particular, we investigate if an audit committee that possesses accounting-related, financial expertise differentially alters the reaction to a dispute disclosure strategy. Prior research suggests that these audit committees exhibit the task-specific knowledge necessary to distinguish between two potentially different interpretations of GAAP: one by the auditor and one by the PCAOB (DeZoort & Salterio, 2001; Dhaliwal, Naiker, & Navissi, 2010). A higher degree of accounting sophistication is necessary when evaluating the relative merits of these competing GAAP interpretations (DeFond and Hu 2005). Moreover, prior survey-based research conducted at the individual audit partner level indicates substantial disagreement between auditors and the PCAOB with respect to GAAP interpretations (Johnson, Keune, & Winchel, 2017). Differences in GAAP interpretations are also present at the audit firm level as evinced by the surprising degree of pervasiveness of dispute disclosures. We thus argue that audit committees with accounting-related financial expertise have both the requisite knowledge and confidence in their judgments to be less likely to dismiss a GAAP-deficient auditor that disputes the PCAOB's findings.

We conduct our tests on the audit clients of GAAP-deficient, triennially inspected auditors. Our sample focus is predicated on three factors endemic to the inspection reports of triennially inspected auditors. First, clients of these auditors are generally quite small, reducing auditor switching costs. Second, the inspection reports have a three-year duration, which allows auditor switching costs to be amortized across a three-year period. Finally, none of the Big 4 auditors (or national auditors) are included in the triennially inspected auditor sample, thereby eliminating the consideration of auditor brand name during the auditor dismissal process. Consistent with prior research, all three factors create a more elastic auditor switching environment, generating a more powerful test setting in which to examine the impact of an auditor's dispute strategy on the auditor dismissal decision (Abbott et al., 2013).

Following Abbott et al. (2013), we form client rosters of GAAP-deficient auditors. This yields 805 clients associated with 113 GAAP-

deficient inspection reports.³ We then conduct logistic regressions utilizing a dichotomous dependent DISMISS variable, coded "1" in instances where the GAAP-deficient auditor is dismissed and "0" otherwise. However, unlike Abbott et al. (2013), we include an additional DISPUTE independent variable coded "1" in instances where a GAAP-deficient auditor employs a dispute strategy and "0" otherwise.⁴ Multivariate analyses is conducted both with a broad audit committee effectiveness variable per Abbott et al. (2013), labeled ACE, and a more specific audit committee effectiveness variable contingent upon the presence of audit committee, accounting-related financial expertise, labeled FIN_ACE (Dhaliwal et al., 2010).

Consistent with our predictions, our univariate tests reveal that a dispute disclosure strategy reduces the likelihood of auditor dismissal. In our multivariate tests, we find that this result is primarily driven by the dispute strategy's interaction with our FIN_ACE variable. That is, when a GAAP-deficient, triennially inspected auditor employs a dispute disclosure strategy, that auditor is much less likely to be dismissed if the audit committee possesses accounting-related financial expertise. When we perform a similar analysis incorporating the broader ACE variable, the interactive effect is no longer present. Collectively, this suggests that audit committee, accounting-related financial expertise critically and differentially impacts the reaction to an auditor's dispute disclosure strategy, consistent with Dhaliwal et al. (2010).

Our paper contributes to the extant literature along three dimensions. First, we provide initial empirical evidence on the frequency of and reaction to an auditor's dispute strategy. Perhaps surprisingly, of the 113 GAAP-deficient inspection reports, 35 contain a dispute disclosure, whereas 28 (50) of GAAP-deficient auditors contain an acknowledge (ignore) disclosure. Interestingly, an overwhelming majority of the disputes disclosures reference accounting disputes, with 30 of the 35 disputes referencing GAAP interpretations. This compares to 17 of the 35 disputes referencing differences in GAAS interpretations. Our evidence is consistent with dispute strategies having a strategic aspect to them. Our results also suggest that more sophisticated stakeholders may analyze *both* sides of differing GAAP and GAAS interpretations. This is important as the PCAOB admits that the inspection reports are not necessarily to be used as audit quality signals, but nevertheless has instructed audit committees to be wary of auditor attempts to de-emphasize PCAOB inspection findings (PCAOB, 2012).

Second, our research regarding audit committee perceptions of auditor responses has important implications for members of the PCAOB and those in practice. The PCAOB may be interested to find that audit committees with accounting-related expertise frequently consider the auditor's perspective and side with the auditor when they feel that the PCAOB criticisms may not have been warranted. The PCAOB may consider modifying the content of its reports and possibly provide more detail on its interpretations of GAAP. Additionally, audit firms may be interested to learn which responses to PCAOB criticisms carry the most credibility among audit committees, particularly those with accounting-related financial expertise. Supporting the economic importance of this inference, we document a non-trivial 22% of sample audit committees possessing accounting-related, financial expertise. This is a surprising result given that the mean total assets of the firms in our sample are less than \$25 million. In providing this evidence, our paper extends the prior literature on the impact that audit committee, financial expertise has on various financial reporting and auditing issues (DeZoort & Salterio, 2001; Dhaliwal et al., 2010; Krishnan & Visvanathan, 2008).

Finally, we also contribute to the voluntary disclosure literature. Virtually all prior voluntary disclosure research has concentrated on disclosures originated by management. Our paper is the first to show

³ These 113 inspection reports relate to 100 unique, triennially inspected auditors.

⁴ We also restrict our analysis to only those triennially inspected auditors that are GAAP-deficient since auditors that do not receive a GAAP-deficient inspection report do not have incentive to nor do they employ a dispute disclosure strategy.

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