What can an audit regulator do to improve welfare?

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Personal views.
Not necessarily those of PCAOB, board, board members, or staff.

Long history of belief: audits improve welfare

- Earliest public corporations (1372) – featured external audits

- Audits central to capital markets & capital markets central to welfare
→ external, independent, high-quality audits central for welfare

- Long history of mandatory audits for publicly traded corporations
  - Early belief in welfare-improving government intervention in audit markets

Audit *regulation* is a much younger discipline

- Just over 20 years since lawmakers concluded market failures affecting the market for audits are so pervasive that more nuanced government intervention is warranted
  - Hence: **What can an audit regulator do to improve welfare?**
- $60trn equity capital impacted by regulator with ~$350m budget
  - Need to identify high-impact interventions
  - Clear explanations needed for justification and effectiveness
- Exciting to contribute to early stages of this discipline

Not a collectively exhaustive list of “frictions”

- Extant regulatory intervention: mandatory audits
- Agency conflicts within issuer
- Agency conflicts within audit firm
- Freeriding by individual partners on collective reputation of audit firm
- Matching frictions between issuer and auditor
- Short-termist issuer-clients (relative to their investors)
- Asymmetric information btw issuers & investors
- “Behavioral” frictions on behalf of investors and clients
- Market power
  - In the market for audits
  - In the market for auditors
- etc.

What are the main fundamental reasons for potential audit-market failures?

1. Auditee pays auditor, whereas (some) auditees have incentives to be not fully transparent with investors and the public
2. Quality audits that discover misstatements require “effort”
3. Audit quality unobservable to principals: investors & society

→ Regulator pooling investor resources to observe a *signal* of effort audit quality may be able to address this failure & improve welfare

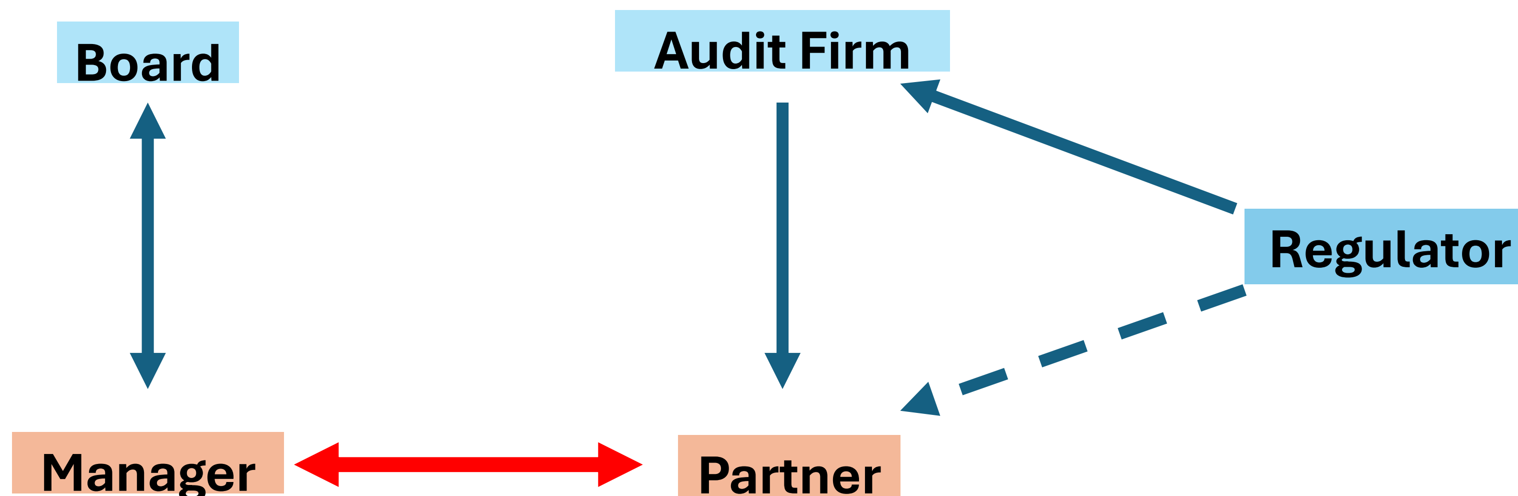
How can an audit regulator improve welfare?

1. Set standards (registration; standard setting)
2. Monitoring compliance (inspections)
3. Incentivizing compliance (enforcement by fiat or by providing market with information through rules)

- Central: regulator’s ability to observe a noisy signal of audit quality / “effort” by way of inspections
  - Key policy question: what do to with the information thus obtained
  - Is it more efficient to use it internally (enforcement) or should the emphasis be on making the information available to external stakeholders (investors)?

Modeling *equilibrium* effects

- Abstract game-theoretic model (!) by Schmalz & Zame (2024)
  - Manager {honest/careful, dishonest/less careful} may misstate the true state of the world when the true state is {bad}. Partner chooses costly effort.
  - Audit regulator influences partner incentives (cost of missing a bad report)
  - Other parties influence incentives, constrained by information environment
    - Other regulators; issuer board; journalists; investors. Regulator can provide information.



What are the equilibrium effects?

- The model has two equilibrium regimes
  - In Regime I: Standards, inspection and enforcement may change auditor behavior (AQ) but not issuer behavior (FRQ)
  - In Regime II: Standards, inspection and enforcement may change issuer behavior (FRQ) but not auditor behavior (AQ)
    - Counterintuitive, yet typical in games with mixed-strategy eqm (“Cops and robbers”)
    - Also informs interpretation of empirical results
- Conclusion: audit regulator may be able to improve AQ *or* FRQ by prescribing behavior with standards and enforcement; cannot simultaneously improve both.
- Open question: *How much* can the audit regulator do with its limited resources?
  - Other stakeholders may play a more important role in incentivizing compliance.

Indirectly improving incentives with rules

- Calibration: does (costly!) enforcement *by the audit regulator* provide sufficient incentives to significantly alter auditor effort?
  - Or can other players - incl. boards & investors, and proxy advisers - play a more important role, *complementing* the regulator’s information-acquisition?

- Ongoing rule-making proposals aim at providing more information
  - Comments welcome!

Improving incentives with inspections reports

- Are regulator resources best focused on enforcement or in expanding information *acquisition* (inspections) and *provision*?
  - Recall regulator's unique ability to observe "effort" via inspections
  - Information provision *to stakeholders* addresses main cause for market failure at its core (and a likely reason the market doesn't effectively fix other failures)
- Some evidence information provided to market affects equity prices
  1. … which incentivizes issuer board & audit committee to have a duty and incentive to care about audit quality
  2. Hence, reports enable expression of investor demand for high-quality audits
  3. Demand incentivizes audit firms to provide more efficient levels of "effort"
  4. Audit firms will attempt to align auditor incentives, fix other market failures

Recent commentary points to the importance of this channel, in investors' view

CFO JOURNAL

Regulator Explores Naming Companies Tied to Auditing Deficiencies Amid Investor Pushback

Shareholders have long called for such disclosure in inspection reports, in part a bid to learn which specific audits had problems

By *Mark Maurer* Follow

May 6, 2024 1:46 pm ET

Theoretical predictions

- Removing asymmetric information with respect to audit quality would increase *most* or even *all* stock prices
  - Reduces cost of capital for firms
  - Increases efficiency of capital markets
  - Improves resource allocation
  - Improve welfare

- Stock market aligns incentives to provide socially optimal levels of auditor “effort” and audit quality
  - Vs regulator imposes standards

Counter-questions

- Yet… if issuer-level inspections reports are so crucial, then why don’t investors ask for it from their issuer boards?

- Why don’t proxy advisory firms demand the information to be disclosed by issuer boards to their investors?

- Why do (some) audit committee members not even know the information is available?
  - See Knechel (2024) commentary on Lamoreaux et al. (2024 TAR proposal)

Some potential answers to counter-questions

- Market failure in the market for information
  - Free-rider problem limits <u>incentives</u> of informed investors to request the information from boards / audit committees
  - Unawareness by “universal investors” and proxy advisory firms limits their <u>ability</u> to request the information
    - Lacking incentives to be aware of the regulator’s inspections program?
    - Lack of public pressure to become aware?

- What can academics do to raise awareness?

What can academics do?

- Contribute to our understanding of the frictions affecting auditing
  - This effort is well under way
  - PCAOB/TAR registered reports conference and other initiatives
- Comment on regulatory initiatives by regulators
- Raise awareness of extant sources of decision-helpful information

Summary

- Long list of reasons why “free” markets for audits are unlikely to feature the socially optimal level of audit quality
  - Scope for welfare-improving government intervention
- Theoretical modeling shows limits regarding how much audit regulators ***alone*** can do to improve welfare
  - More promising: regulator embedded in ecosystem
  - Crucial role of information provision by regulator
- Specifically: unique ability of regulator to observe compliance with standards (“effort”); useful to ACM/investors who set incentives
  - Attention as the critically scarce input to further welfare improvements?