ABSTRACT

One of the main roles of the PCAOB is to detect audit deficiencies and to strengthen auditors' incentives to perform diligent audits. We study the effects of PCAOB inspections on audit quality when firms' financial statements consist of two audit components. The two components differ in that one is more complex and hence more difficult (costly) for the auditor to examine than the other. We find that higher regulatory scrutiny (i.e., a higher probability of inspections) does not necessarily induce the auditor to spend more audit effort, but instead can weaken audit quality. We also show conditions under which the regulator's optimal strategy is to investigate only the less complex audit component and to neglect the complex component, although in our model inspections do not involve any direct costs to the regulator.

(Copies of the paper are available in the AOIS Department offices)