When the PCAOB talks, who listens? Evidence from client firm reaction to adverse, GAAP deficient PCAOB inspection reports

In an effort to increase the transparency and quality of the public auditing profession, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB). Under the Sarbanes-Oxley Act, the PCAOB was granted inspection rights to ‘audit’ auditors and their respective audit processes. The PCAOB is an independent, government-run agency that has replaced the American Institute of Certified Public Accountants peer review system. The results of PCAOB inspections are summarized in publicly-available reports that are readily accessible at the PCAOB’s website. We posit that due to the objectivity, specificity, variation and recognizability of these reports, the PCAOB has created a powerful signal of audit quality. We hypothesize that registrants with high potential agency conflicts have incentive to switch away from auditors that have received an adverse PCAOB report. In addition, we argue that effective audit committees have similar motivation to switch away from such auditors. Using logistic regressions, we document a strong agency-based demand for audit quality signals as proxied by the PCAOB inspection reports. We also show that effective audit committees are particular sensitive to the receipt of an adverse, PCAOB inspection report and are much more likely to switch auditors subsequent to the inspection report disclosure. Our evidence is consistent with key market participants using the PCAOB inspection reports as signals audit quality within the non-Big 4/non-national tier of audit firms.