

Title:

Once Bitten Once Shy: Learning or Risk-Aversion after Large Audit Failures?

Abstract:

I examine whether a large audit failure leads the implicated audit firm to learn from its experience. I hypothesize that alternatively, the implicated audit firm could respond to excess regulatory concern and reputational threat by becoming unduly risk-averse. Using a difference-in-difference approach, I find that after a large audit failure, the implicated audit firm shows an increase in audit quality — the average accruals at the implicated audit firm is income decreasing (a reduction in accruals of 1.34 percent of total assets), and propensity to issue going concern opinion is increasing (43 percent increase in propensity to issue going concern opinion). However, I find that this change in audit quality is driven by risk-aversion as seen by the increase in propensity to issue unwarranted going concern opinion by the implicated audit firm (propensity to issue going-concern opinion without subsequent bankruptcy increases by 38 percent). I also find that the change in audit quality is temporary — lasting only up to a year after the audit failure further supporting the risk-aversion hypothesis. Exploring the sources of risk-aversion, I posit that this response could be over-reaction of the implicated audit firm due to availability bias triggered by the ease with which an episode of audit failure could be recollected. In support of the availability bias hypothesis, I find that within the implicated audit firm, the change in audit quality is in the form of a ripple, with the audit offices closest to audit failure reacting the most, followed by offices that are more distant geographically. Together, these results suggest that following a large audit failure, the implicated audit firm becomes excessively risk-averse driven by availability bias, but only in the short-term. In the long-term, there is no change in the audit quality of implicated firm.