

Public Abstract

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Title: The Contagion Effect of Office-Level Audit Failures

I investigate if the presence of an audit failure in an auditor office location in a given fiscal year indicates the presence of a contagion effect on the quality of other concurrent audits conducted by the office. I find that the presence of at least one audit failure (defined as a downward restatement of net income by a client) is indicative of contagion of low quality audits within the office. This result holds for offices of both Big Four and non-Big Four auditors. Further analysis indicates the contagion in Big Four offices occurs in smaller offices and in Big Four offices where a low percentage of audits are conducted in those industries in which an office is the city-level industry leader (irrespective of office size). My results should be of interest to those outside the auditor office such as regulators, standard setters, accounting firms and investors because I provide a method to infer the overall audit quality of an auditor office location through the use of easily obtainable and publicly-available information. Further, I show that the contagion persists for four years in auditor offices, which also indicates the usefulness of my findings to outsiders. Regulators can use this to identify offices where audits are more likely to be of lower quality (and perhaps even below minimum standards). Standard setters may be able to use this information to implement auditing standards that better address the determinants of audit quality at the auditor office location. Accounting firms can benefit from this method as those in charge of quality-control processes in a firm's national office can use it to identify specific offices that may not be implementing the firm's quality-control procedures appropriately. Finally, investors may be able to use it as one piece of additional information with which to infer something about the earnings quality of a particular company based on the auditor office which performs the audit.