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# The challenges of the EU POB inspections beyond the sustainability of the ethical dilemmas

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## ABSTRACT

*The aim of Public Oversight Bodies (POBs) is to improve firms' audit quality through inspections of audit engagements. Nonetheless, the effectiveness of specific actions of POBs is yet to be documented in the literature. By using hand-collected data on the inspection characteristics from 14 European countries, I am able to provide novel evidence that disclosing the results of POB inspection affects audit quality. Specifically, after controlling for firm-level heterogeneity, I find that the number of national inspections and inspection characteristics is positively associated with the audit quality (proxied by abnormal accruals) of companies whose auditors are inspected by POBs. Overall, this research documents that the disclosure of annual reports is relevant for auditors and the effect of national inspections augments the audit quality.*

**Keywords:** audit quality, financial reporting, risk disclosure, transparency.

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## 1. INTRODUCTION

Over the last decade, the quality of audit services has been debated due to the high number of economic frauds, and a significant number of countries has agreed to set up an independent supervisory authority to verify the national audit profession. Starting with 2002, the "Public Company Accounting Reform and Investor Protection Act" has changed significantly the audit regulation by replacing audit self-regulation with audit independent public oversight. In the US, the Public Company Accounting Oversight Board (PCOAB) was the basis of independent public oversight, being a model for other POBs (Public Oversight Bodies) and performing independent inspections

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for entities (Harris, 2010). The implementation of the inspections program by POBs represents the key reform which has improved the relationship between financial audit under ISA and financial reporting under IFRS.

Based on a sample of international listed companies in 14 countries, from 2010 through 2019, we outline a number of new results to the specialized literature, by testing our expectations drawing on 48,048 observations. We measure the quality of auditing by using the common proxies as abnormal accruals, working capital, discretionary revenues, the incidence of small profits and timely loss recognition of audit companies' client firms.

We identified that, even if the inspection regime represents the main key of POBs plan, there are some characteristics which influence the dynamics of audit quality. In this study, we examine two categories of inspection characteristics. The first category, named POB I, includes similar inspection characteristics as Carson et al. (2017) survey. All the analysed countries have a direct supervisory body that carries out national inspections related to the inspection regime. Further, the frequency inspection is required for all public interest entities of EU countries. Some countries elect to disclose the inspection results at the audit firm level and the report issues an aggregated review based on inspection results. POBs have also the ability to impose directly sanctions on audit companies based on national inspection regime, through a professional accountancy body or may not have the direct charge for enforcement measures against audit firms. The second category, named POB II, includes another set of inspection characteristics which emphasize the disclosing of inspection characteristics as the number of POBs' members, the number of POBs' members who worked for Big 4 companies, the gender of POBs' members, the allocated budget, the number of fines, the sum of fines, the market share of Big 4 companies and the market share of the top of Big 4 companies. All the analysed countries disclose the number of members of POBs. Some countries elect to public the number of member of POBs who worked in Big 4 companies and the gender of members of POBs. The allocated budget is not also disclosed for all the countries. The number of fines and the sum of fines are publicly available only for a specified number of countries. The market share of Big 4 companies and the market share of the top of Big 4 companies are divulged for the majority of the examined countries.

First, we find that for a sample of listed companies from 14 countries during the period 2010-2019, main accruals, as abnormal total accruals working capital accruals, together with discretionary revenues significantly decrease for companies whose auditors become subject to inspection programs compared with the companies whose auditor is not subject to inspections by POBs. Second, we find that the firms who are inspected by POBs are associated

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with more timely loss recognition than the firms who are not. Third, we find that the Incidence of Small Profit (0%-3%) is more pronounced for firms who are inspected by POBs. Additionally, a Factor Analysis (FA) was developed to emphasize the effect of inspection characteristics performed by POB on the quality of audit services.

## 2. RESEARCH AND METHODOLOGY

This paper aims to make multiple contributions to the emerging literature, by providing novel evidence on the audit quality of POBs inspections. First, our results attest the positive association between the analysed inspection characteristics and the audit quality improvements. Second, disclosing the results of annual reports affects the quality of audit services. Third, our analyses are also useful for POBs and regulators concerning the effect of public oversight across European countries. Taken together, these results suggest that the following characteristics of POB activity and inspections have a positive impact on audit quality.

The reform of POBs represents a primary reaction to the loss of faith in financial reporting and capital markets triggered by external circumstances (Bengtsson, 2011). As a societal importance, a high audit quality represents a key determinant of the efficient distribution of the capital. PCAOB signed the change in the audit regulation, by shifting auditing, from self-regulation to independent public oversight. Following PCAOB model, the majority of countries around the world has created independent POBs in order to supervise the national inspection program of audit companies.

*Considering the fact that companies present their data only following the requests of government institutions or the requests of bodies in the field, but also the lack of public data in this field, we analyzed the data that are public for the period 2010-2019. The reasons why the data are not public in this field are multiple: the scope of the audit activity involves the existence of contracts with third parties that are classified as confidential, secret, service secret, so the publication of annual reports may lead to the violation of the provisions of some contracts, and these contractual violations are sanctioned with very large fines, criminal cases and unilateral termination, also another reason was the fact that the publication of internal indicators reveals the financial situation in front of competitors on the market.*

*The year 2018 represents the reference system for my sample taking into consideration the recent activity of the majority of UE countries in publishing the annual reports of national inspections by POBs (Public Oversight Bodies). The present sample covers only countries from EU (European Union) that*

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*chose to embrace a public oversight system in time. U.K. is still included in this research taking into consideration that in the last analysed year, it was not yet apart from European Union. For the selected period of time, the unbalanced panel comprises a total of 48,041 observations from 14 European countries and the data were processed with STATA analysis software.*

World Scope database was used to gather the financial data for all the listed companies for the selected countries. The most important dates concerning characteristics for each of POBs were gathered from EC website, IFAC website, IFIAR website, INTOSAI website, World Bank website and POBs website.

*In order to accomplish the second hypothesis, all the annual reports were translated in the native language to have the possibility to gather all the necessary information concerning the characteristics of national inspections. Another official sources as European directives and national laws were consulted to complete the inconclusive information about audit publications. In the case of Romania, only the synthesis of inspections is available on the official website and no annual report issued by POB.*

The four key data items were checked to be available, as the following: total assets, sales, operating and net income. For the independent variables from equations [1]-[4], the observations with insufficient financial data were excluded, in order to compute the dependent variables. More, some observations are missed due to the truncation of variables in equations [1] and [3], at the 1st and 99th percentile, eliminating the extreme observations, following the model Francis et Michas [2013] and Carson [2017], respectively.

Regarding the international framework in the POB field and the specialized literature on the effect of inspections on audit quality, we base our research on the following hypotheses:

*H1: There is a positive association between audit quality and the number of national inspections by POBs;*

*H2: The effect of inspection characteristics influences the positive association between audit quality and the number of national inspections by POBs;*

To empirically test these hypotheses, an empirical model on previous literature was built in order to define earnings quality proxies. Specifically, it was measured the level of abnormal accruals using Jones model (Jones [1991]; Dechow et. [1995]; Kothari et al. [2005]; Kwon et al. [2007]; Francis et al. [2013]; Carson et al. [2017]). The following regression was computed for:

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$$TA_{i,t} = \beta_0 + \beta_1 (1/ASSETSi,t-1) + \beta_2 (\Delta REVi,t - \Delta ARi,t) + \beta_3 PPEi,t + \beta_4 ROAi,t + \text{Country / Industry / Year Fixed Effects} + \varepsilon$$

**TA<sub>i,t</sub>** = represents total accruals in moment t (determined as the difference between a change in non-cash current assets, a change in current liabilities without the current long-term debt, depreciation and amortisation), scaled by lagged total assets; **ASSETSi,t-1** represents total assets in the previous year t-1; **ΔREVi,t** = represents the difference between sales in year t sales in year t-1. **ΔARi,t** represents the difference between accounts receivable in year t and accounts receivable in year t-1, scaled by lagged total assets; **PPEi,t** = represents net property, plant and equipment in year t, and the last one, **ROAi,t** represents net income before extraordinary items in year t, scaled by lagged total assets. For an entity, the unadjusted abnormal accruals present the firm-specific residuals. In my analysis, the dependent variable is the total value of abnormal accruals of incomes (decreasing or increasing).

Completing the accrual-basis measures of audit quality, the revenue manipulation computed by McNicholas and Stubben [2008] is estimated and used as a proxy in audit quality (Minutti-Meza [2013]). More, the discretionary revenues are calculated as the total value of the residuals following the regression below:

$$\Delta ARi,t = \beta_0 + \beta_1 \Delta REVi,t + \text{Country / Industry / Year Fixed Effects} + \varepsilon$$

**ΔARi,t** = represents the difference between accounts receivable in year t and accounts receivable in year t-1, scaled by lagged total assets.

**ΔREVi,t** represents the difference between sales in year t sales in year t-1. The data limitations is confronting, as in equation [1] and in equation [3], by adding country, industry and year fixed effects to observe the variation of discretionary accruals.

Additionally, the incidence of small profits on audit quality is estimated to provide evidence about earnings dispensation. Burgstahler and Dichev [1997] show the importance of small profits in income-increasing earnings management and diminishing the losses. My hypothesis suggests that the inspection regimes by POBs reach up to zero-earnings benchmark earnings management. Small profits fall between 0% and 1% of ROA (Gul et al. [2013]).

At last, the model of timely loss recognitions estimated in order to observe the dispatch in recognising economic losses. Ball et al. [2003] defines

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this model as an important role of auditor incentives. Through timely loss recognition it was possible to examine if the inspection regimes by POBs increase conservative financial reporting regarding the auditor stimulus. One model by Ball and Shivakumar [2005] interprets the asymmetric relationship between accruals and firm performance that economic losses are cough by accruals in less time than gains.

Therefore, the effect of inspection characteristics may influence the positive association between the number of national inspections by POBs and audit quality. There are several reasons which augment the direct effect of inspection characteristics on audit quality. Related to this, the disclosure of such inspection characteristics (Number of POBs' members, Number of POBs' members who worked for Big 4 companies, Gender of POBs' members, Allocated budget, Number of fines, Sum of fines, Market share of Big 4 companies, Market share of the top of Big 4 companies) denotes more appropriate information which leads to more transparency for supervisors. Specifically, disclosing details from the inspection process, the future expectations of POBs will be easier to identify. In this sense, an increased number of national inspections by POBs, together with the disclosure of inspection characters, lead to a higher level of audit quality.

Additionally, the two main hypothesis are examined by using Factor Analysis in order to emphasize whether there is any association between audit quality and the effect of national inspections by POBs.

The empirical question concerning the influence of the number of inspection by POBs and the effect of differing inspection characteristics on audit quality is still going on the research field, taking into consideration their pro and contra arguments.

In the first part, there is presented an overview - by country - with details of national inspections regimes split in two sections. The first section is in line with Carson (2017), having the following variables: the number of listed firm-year observations, the effective date of mandatory IFRS adoption, the initiation of supervision and other inspection characteristics. The second section comprises more granular, hand-collected characteristics of the analysed POBs, by coding inspection characteristics for each analysed country. I effectuate a number of sensitivity analysis including several regressions and multilevel analysis, in order to express the effects of disclosure of annual reports on financial reporting under IFRS and audit quality. The characteristics of inspections by POBs are split in two dimensions in order to demonstrate the hypothesis mentioned above. One set of characteristics respecting the model Carson et al. (2017) is analysed in order to check the first hypothesis which demonstrates that the transparency of financial reporting increases when the annual reports of national inspections

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are publicly disclosed by POBs. The second set of inspection characteristics is used to check the second hypothesis and to analyse if the effect of national inspections is positive associated with the audit quality of companies whose auditors were inspected by POBs. All the available data was collected from annual reports of each analysed POB. Concerning the two sets of characteristics of national inspections by POBs, all available information per country were coded in Table 1, respectively in Table 2.

In the second part of the thesis, all the selected proxies as the mail accruals, discretionary revenues, the incidence of small profit and timely loss recognition measure the transparency of financial reporting under IFRS and the quality of auditing.

### **3. RESULTS OF THE RESEARCH**

In the Table 1, we can see the descriptive statistics of the number of inspections and the absolute value of the methods used to assess the quality level of the financial audit, namely: the value of abnormal total adjustments, the abnormal value of working capital, the value of discretionary income and the incidence of profits. small, for each country analyzed, in the period 2010-2019. In the total sample, the countries with the highest number of inspections are Austria, the United Kingdom and the Netherlands. The largest number of national POB inspections (214 inspections) was carried out in Austria, 160 audit firms were inspected by the POB in the United Kingdom, and 149 companies were inspected in the Netherlands. The lowest number of inspections was found in Greece and Italy, and for Poland and Romania there is no public information in this research context. At the level of Greece and Italy, an equal number of 46 POB inspections were registered. The average POB inspection is 84.14 inspections, and countries such as Germany, Sweden, Bulgaria and Belgium have recorded the average number of POB inspections.

Furthermore, the first table shows that in a group of countries which is taking place a public oversight system, there is a variation in the organisations of POBs. Concerning the type of oversight system can be direct a combination, through oversight, and no POBs. All the analysed countries respect the same direct system, and the inspections are directly performed by POBs. So, there is no country which has the inspections through the oversight of the professional accountancy body where the auditors are inspected by POBs and by the professional accountancy body with the oversight indirectly of POBs or a combination of these systems. The frequency of inspections is directly for all the countries and it remains the same for the entire analysed period of time. More, the frequency is requested to be 3 years for PIE audit firms for all

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the EU countries. The disclosure of inspection results is public and the same for all the analysed countries except for Romania which status is non- public. The disclosure type of all the countries is aggregated annual report for 13 countries, without Romania where there is no information available. Lastly, the enforcement ability of sanctions can be direct enforcement, through oversight, no enforcement or no POBs. For Austria and France, there is no enforcement right and for Germany and Poland, there is thought oversight of the professional body and for Romania, there is direct enforcement and through oversight at the same time. For the rest of the countries (Belgium, Bulgaria, Finland, Greece, Italy, Netherlands, Spain, Sweden and U.K.), there is the same direct enforcement. Altogether, the inspection process by POBs can vary substantially and it differs for every country and for every period of time. Regarding the date mandatory of IFRS adoption, the starting year is 2005, for all the analysed countries.

In addition, the average of the dependent variables for equations [4] and [5] allows a comparison of the average dependent variables for each country analyzed. Regarding the total discretionary adjustments, for Romania, the average of the total adjustments is -0.035 compared to the average of -0.042, for all existing countries in the sample. In the Netherlands, the average of the total discretionary adjustments is -0.063, and in Austria and the United Kingdom, the average is -0.050 and -0.082, respectively. For the countries Greece and Italy, which recorded the lowest number of POB inspections, the average of the total discretionary adjustments is -0.059 and -0.047, respectively. In this context, the lowest value of total abnormal adjustments was recorded by the United Kingdom, amounting to -0.082, and the highest value of total discretionary adjustments was recorded by Bulgaria, amounting to -0.022. Taking into account the values recorded above, it can be seen that the high number of national POB inspections decreases the total value of discretionary adjustments at the level of each country analyzed.

The average of the sample for the variable of the abnormal total adjustments is 0.122 and for the variable of the abnormal working capital aids, the average is 0.155. In Romania, there is a value of the total abnormal adjustments of 0.132, and the abnormal aid related to the working capital is 0.115, a value equal to the average of the entire analyzed sample. At the level of the Netherlands, the value of the total abnormal adjustments is 0,108 and 0.164 respectively, and the value of the abnormal working capital aids is 0.066 and 0.093 respectively. For the countries Greece and Italy, which recorded the lowest number of POB inspections, the value of total abnormal adjustments is 0.099 and 0.1 respectively and the value of abnormal working capital adjustments is 0.832 and 0.831 respectively. The values highlighted in the



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table below show that the number of POB inspections has a direct influence on the total abnormal adjustments and on the total value of the abnormal working capital adjustments. The lowest value of total abnormal adjustments is recorded in Austria, at 0.088 and the highest value is recorded in Poland, at 0.185. In the case of abnormal working capital aid, the lowest value of 0.053 is also recorded in Austria and the highest value of 0.153 is also recorded in Poland. Thus, both the values of the abnormal total adjustments and the abnormal working capital aids are significantly influenced by the POB inspections.

The average value of discretionary income | DR |, for the entire sample studied, in the period 2010-2019, is 0.058. At the level of Romania, the value of discretionary income is 0.058 as the general average of the analyzed sample. At the level of the Netherlands and the United Kingdom, the discretionary income is 0.057 and 0.068, respectively, and at the level of Austria, the discretionary income is 0.051. Greece and Italy have a discretionary revenue value close to the general average, ie 0.053 and 0.071 respectively. The lowest value of discretionary income is 0.051 (Austria) and the highest value is 0.126 (Poland). Thus, I conclude that the value of total discretionary revenues decreases as the number of POB inspections increases.

Regarding the incidence of low profit 1, low profit 2 and low profit 3, the average of the sample is 0.005 of 0.014 and 0.024 respectively. At the level of Romania, the incidence of low profit 1, low profit 2 and low profit 3 is 0.004; of 0.012; and 0.020, respectively. At the level of the Netherlands, the incidence of low profit 1, low profit 2 and low profit 3 is 0.005; of 0.015; and 0.025, respectively. Greece and Italy have approximately similar values of 0.004 for low profit 1, low profit 2 and low profit 3; of 0.0014; and 0.023, respectively. Moreover, the overall average incidence of low profit 1 (0-1%) of 0.005 is similar for Belgium, Finland, Spain, Sweden, the Netherlands, Greece and Germany. The overall average low incidence 2 (0-3%) of 0.014 is similar for Spain, Poland, Italy and Greece. The overall average of the sample regarding the incidence of small profit 3 (0-5%), amounting to 0.024, is similar only in Spain.

**Descriptive Statistics of the dependent variables, by country, for the period 2010-2019**

*Table 1*

Country	N	ATA	AWCA	DR	Small Profit (0-1%)	Small Profit (0-3%)	Small Profit (0-5%)	TA
Austria	214	0,088	0,053	0,051	0,006	0,018	0,029	-0,050
Belgium	103	0,121	0,073	0,055	0,005	0,017	0,025	-0,062
Bulgaria	60	0,126	0,126	0,063	0,004	0,013	0,022	-0,022
Finland	138	0,113	0,067	0,058	0,005	0,016	0,026	-0,054
France	142	0,113	0,070	0,066	0,004	0,015	0,025	-0,049
Germany	84	0,122	0,090	0,067	0,005	0,015	0,025	-0,045
Greece	46	0,099	0,832	0,053	0,005	0,014	0,020	-0,059
Italy	46	0,100	0,831	0,071	0,004	0,014	0,023	-0,047
Netherlands	149	0,108	0,066	0,057	0,005	0,015	0,025	-0,063
Poland	-	0,185	0,153	0,126	0,004	0,014	0,023	-0,047
Romania	-	0,132	0,115	0,058	0,004	0,012	0,020	-0,035
Spain	115	0,108	0,069	0,052	0,005	0,014	0,023	-0,046
Sweden	80	0,203	0,119	0,095	0,005	0,015	0,026	-0,060
United Kingdom	160	164,000	0,093	0,068	0,004	0,016	0,026	-0,082

Source: Own calculations using STATA program

In the Table 2, we present the descriptive statistics for the sample analyzed in the period 2010-2019, with the frequency and percentage related to each sector of activity, respectively for each year analyzed. SIC codes are divided into ten industry groups as follows: SIC 0 comprises the agriculture, forestry and fishing industries; SIC 1 includes the mining industry; SIC 2 includes the construction industry; SIC 3 includes the manufacturing industry; SIC 4 includes the transport, communications, electricity, gas and sanitation industries; SIC 5 comprises the wholesale trade industry; SIC 6 comprises the retail trade industry; SIC 7 comprises the finance, insurance and real estate industries; SIC 8 comprises the services industry, and SIC 9 comprises the public administration industry.

The construction industry and the manufacturing industry (SIC 2-3) record a majority of 44.5% of the total observations, followed by the services industry (SIC 7-8) which records 25.62% of the total observations, and the mining industry (SIC 1) records only 0.7% of the total observations existing in the analyzed sample.

**Descriptive Statistics of national POB inspections, on each sector to be activated, for the period 2010-2019**

*Table 2*

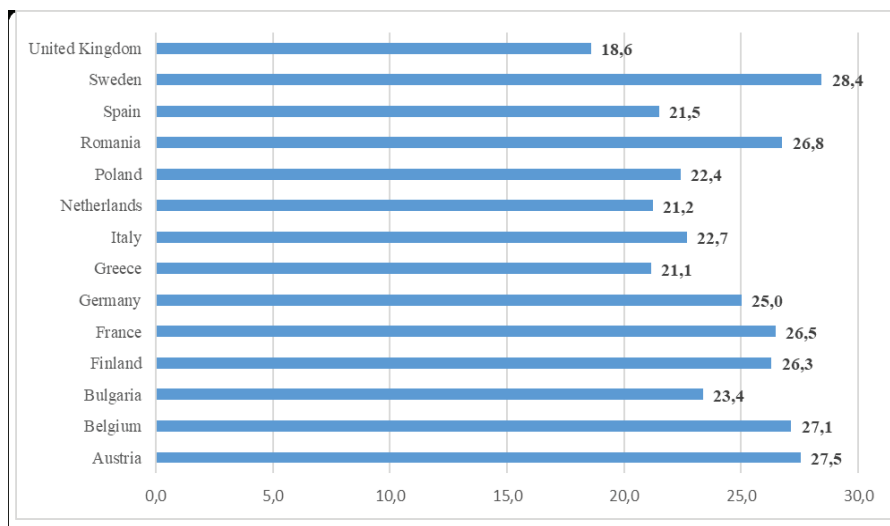
Variables	N	0	1	2	3
Number of Inspections	48.014	0,075	0,166	0,238	
Disclosure Type	48.014		0,011	0,468	
Enforcement Ability	48.014		0,642	0,131	0,284
Member of POBs	48.014		0,265	0,214	
Member of POBs - Big 4	48.014	0,088	0,036	0,354	
Member of POBs - gender	48.014	0,011	0,069	0,182	0,216
Allocated budget	48.014	0,131	0,071	0,277	
Number of fines	48.014	0,144	0,177	0,158	
Sum of fines	48.014	0,162	0,180	0,137	

Source: Own calculations using STATA program

One of the most important indicators for companies in a country is the gross fixed capital formation, so as we can see in Figure 1, the countries with the highest share of gross fixed capital formation in GDP are: Sweden, Austria, Belgium, Romania and the countries with the lowest share are: the United Kingdom, Netherlands and Greece.

**Gross capital formation (% of GDP) in 2022, in 14 European countries analysed**

*Figure 1*



Source: World Bank, 2022

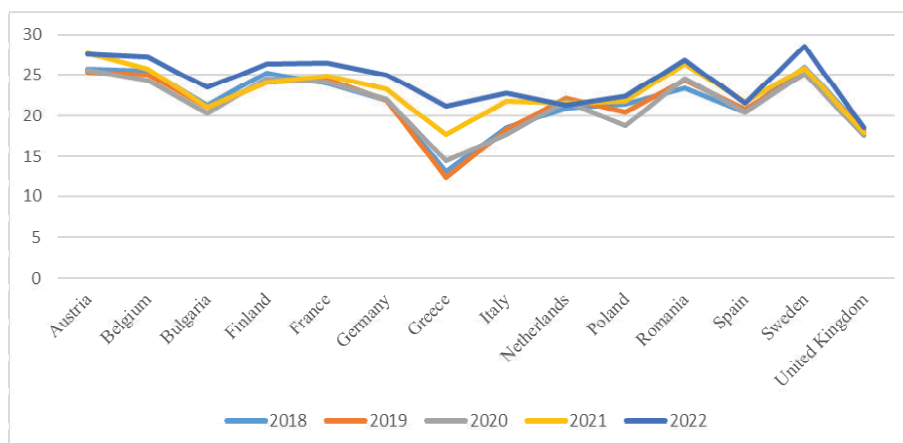
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In the Figure 2 we can see the constant evolution of the share of gross capital formation in GDP.

Declines were recorded in the first quarter of 2020 as economic activity collapsed in mid-March as most European governments began implementing drastic measures to reduce the effects of the Covid-19 pandemic. That's why investment started to fall three weeks earlier, at the end of February, when financial market volatility rose sharply in Europe. Gross fixed capital formation in the European Union fell by almost 4% compared to the first quarter of 2019, with countries in Western and Northern Europe showing the same trend. as previously noted, the contraction was largely due to lower investment in machinery and equipment.

### Evolution of Gross capital formation (%of GDP) during 2018-2022

Figure 2



Source: World Bank, 2022

## 4. CONCLUSIONS

Following the analysis carried out on a sample of 14 European states over a period of 9 years and in which two hypotheses were proposed, it resulted that there is a positive association between the quality of the audit and the number of national inspections carried out by the POB. Regarding the second hypothesis, it turns out that the effect of inspection characteristics does not influence the positive association between audit quality and the number of national inspections by the POB.

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The lack of standardized reports by POBs leads to a deficiency of information across countries. Further, trying to collect data about sanctions imposed and disciplinary procedures, the access appears to be limited, taking into consideration the country's official language. POBs annual reports seem to disclose information only about the quantity of investigations and the quality of assurance reviewers. Still, firm specific details are partially not-publicly disclosed, and the disciplinary systems appear to be dependent on harmonizing audit quality. More, the harmonization of the annual reports by POBs represents the main clue in comparing the results of national inspections across different oversight bodies. Overall, the scope of national inspections it appears to be unaccomplished in some countries due to the unstandardized annual reports by POBs.

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