

Auditor Regulation and Financial Reporting Quality of Financial Institutions: Evidence from the Staggered Implementation of the 2006 EU Audit Directive

Ines Simac, KU Leuven

Marleen Willekens, KU Leuven and BI Norwegian Business School

Abstract:

The audit profession has been subject to increased regulation over the past decades, but the effects of auditor regulation on financial reporting quality are hard to examine because of other concurring events. Our study uses the staggered implementation of the European Union (EU)'s Statutory Audit Directive (i.e. Directive 2006/43/EC) to assess whether this regulation influenced the financial reporting quality of banks and other types of financial services companies in the EU countries. We define bank financial reporting quality as the extent of capital and/or earnings management via a bank's biggest accrual, i.e. loan loss provisions. We hypothesize that the full implementation of Directive 2006/43/EC into domestic law is associated with improved financial reporting quality, measured by lower capital management as well as lower earnings management. For our tests we use a sample of European financial institutions across 27 EU Member states covering the period 2005-2014. Our difference-in-differences method finds support in favor of our predictions. Additional analyses show that the effect is primarily driven by countries with a weaker prior regulatory and/or auditing regime. This suggests that the Statutory Audit Directive essentially harmonized the remaining differences in bank financial reporting quality across EU Member States.

Keywords: statutory audit directive; staggered implementation; financial institutions; financial reporting quality; capital management; earnings management.