

The Impact of the FRC Audit Inspection Program on Audit Effort and Audit Fees

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Abstract

We investigate the effects of the UK's Financial Reporting Council (FRC) Audit Quality Review (AQR) Team inspections on audit effort measured by audit fees, auditor-reported risks (i.e., key audit matters (KAMs)), and materiality. We test (1) if auditors of clients in business sectors selected by the FRC for potential audit inspections (hereafter, priority sector clients) increase audit effort compared to other clients and (2) whether auditors whose audit was selected for inspection subsequently increase their audit effort. We do not find that auditors of priority sector clients exert more effort in anticipation of possible inspection, suggesting auditors do not perceive inclusion in a priority sector as a threat. Moreover, even after being inspected, auditors do not increase effort, on average. In additional analysis we explore effects of priority sectors membership and actual inspection on reporting quality. We document higher reporting quality only in large priority sector clients whose auditors exert higher audit effort. Otherwise, we do not find that inspections are followed by improvements in reporting quality. Overall, our findings cast doubt on the effectiveness of the current AQR Team inspections regime.

Keywords: AQR Team inspection, audit fees, audit effort

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