

Impact of technological development in the audit market on earnings transparency

Hamza Mirza
University of Basel
hamza.mirza@unibas.ch

Aurelio Perucca
University of Basel
aurelio.perucca@unibas.ch

April 25, 2018

Abstract

We analyze how ongoing technological developments in the audit industry impact the transparency of earnings reports through strategic earnings biases by a myopic manager. Two potential auditors differ in audit quality. The basic tension of our model is that the short sighted manager profits from a low quality auditor whereas the owner favors a high quality auditor. We show that the owner chooses a high quality auditor if preliminary earnings report is high and a low quality auditor, otherwise. Around the threshold where shareholders switch to the high quality auditor managers pool their reports in order to avoid the high quality auditor, thus reducing transparency of earnings reports. This effect is increased if the audit quality differential increases. Increasing the higher audit quality to the highest possible level reduces earnings transparency. Ongoing technological developments in the audit process should be observed carefully by the regulators as they don't necessarily increase earnings transparency.