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Abstract

The dissertation consists of three essays that delve into the effects of regulatory changes in three different contexts.

The first essay uses the Australian setting, where two governmental bodies implemented regulations pertaining to the disclosure of the financial impact of climate risks in financial reports. The essay investigates the relationship between auditor expertise and the quality of climate risk disclosures, revealing that companies audited by auditors possessing relevant expertise are more likely to provide higher-quality climate risk disclosures.

The second essay explores the impact of a regulatory change aimed at enhancing the financial performance of European football clubs and addressing the soft budget constraint problem within the industry. The findings indicate that, following the issuance of the regulation in 2009, football club profitability improved, but losses persisted. Moreover, the owners continued to inject equity, and the financial position of football clubs remained weak. Consequently, while the regulation led to some financial performance enhancement, it did not completely resolve the soft budget constraint problem.

The third essay examines the consequences of a new regulation extending audit reports to include the disclosure of critical audit matters (CAMs). Specifically, the focus is on whether this regulation has influenced the value relevance of intangible assets. The results reveal that intangible assets are more value-relevant in firms where auditors have disclosed CAMs related to intangible assets.

In summary, the three essays collectively suggest that the effectiveness of regulatory changes is contingent on various factors. Furthermore, successful implementation of cross-national regulations requires careful consideration of differences in enforcement mechanisms across jurisdictions.

Keywords climate, emissions, risk disclosure, auditor specialization, FFP, soft budget constraint, audit matters, intangibles, value relevance

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“A journey of a thousand miles begins with a single step”.

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Espoo, 5 December 2023

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<tr>
<td>AASB</td>
<td>Australian Accounting Standards Board</td>
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<td>AUASB</td>
<td>Auditing and Assurance Standards Board</td>
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<td>CAMs</td>
<td>Critical audit matters</td>
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<td>IAASB</td>
<td>International Auditing and Assurance Standards Board</td>
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<tr>
<td>ITCV</td>
<td>Internal Threshold for Confounding Variables</td>
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<td>ISA</td>
<td>International Standard on Auditing</td>
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<td>FFP</td>
<td>Financial Fair Play</td>
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<td>KAMs</td>
<td>Key audit matters</td>
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<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<td>TCFD</td>
<td>Task Force on Climate-Related Financial Disclosures</td>
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<td>SBC</td>
<td>Soft Budget Constraint</td>
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<td>UEFA</td>
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List of Essays

This doctoral dissertation consists of a summary and of the following essays which are referred to in the text by their numerals.


Author’s Contribution

**Essay 1:** Pham, Ly; Hay, David; Miihkinen, Antti; Myllymäki, Emma-Riikka; Niemi, Lasse; Sihvonen, Jukka. Climate Risk Disclosures and Auditor Expertise. Unpublished Manuscript.

Ly Pham is the lead author of the paper. The research idea is initiated by her. She wrote the literature review and developed the hypotheses, linking them to the theoretical framework. She was responsible for research design, data management, and all the analyses. She wrote the early drafts of the paper and continued to be heavily involved in writing the paper together with other co-authors.


Ly Pham was responsible for the data collection, data management, and empirical analysis. She conducted the literature review and was involved in developing the research idea, research design, and writing the paper.


Ly Pham is the sole contributor of the essay.
PART I: DISSERTATION OVERVIEW
1. Introduction

This dissertation consists of three essays studying the consequences of three different regulatory changes in different contexts. The first essay studies a new requirement for companies to evaluate and report the financial impacts of climate risks on their financial statements. The requirement is outlined in the Joint Bulletin issued by the Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AUASB). The second regulatory change – the so-called Financial Fair Play (FFP) regulation by the Union of European Football Association (UEFA), attempts to govern and improve the financial health of European football clubs. The third regulation expands audit reports by requiring auditors to disclose critical audit matters (CAMs). This requirement is the major content of the auditing standards AS 3101 by the U.S. Public Company Accounting Oversight Board (PCAOB).

History shows that regulatory changes are often triggered by financial crises or large-scale corporate scandals (Banner, 1997; Bushman & Landsman, 2010; Reinhart & Rogoff, 2008). That is also the case for three regulatory changes studied in this dissertation. In general, regulatory changes may have both intended and unintended consequences. Intended consequences are those that are consistent with the set objectives of the regulation. Unintended consequences are those that differ from the set objectives of the regulation, and they can be positive and negative. These consequences depend on various factors. The three essays in this dissertation study the consequences of the regulatory changes in three different settings, aiming to enhance understanding of the
The complex interplay between regulation and the economic behavior of actors in the market.

The first essay touches upon the climate change crisis which is happening in every corner of the globe (United Nations, 2020). Climate change poses a serious threat to the global economy across many economic sectors (TCFD, 2017). According to TCFD (2017), climate-related risks can be classified into two groups: the physical impacts and the transition risks. The first category of climate risks comes from extreme weather events, which can disrupt supply chains, damage infrastructure, and delay operations. The United Nations (2020) reported that the majority of disasters are now climate-related and cause damage costing hundreds of billions of dollars annually. The second category of climate risks relates to the transition process to a low-carbon economy. The risks involved can include policy and legal risks, technology risks, market risks, and reputation risks (TCFD, 2017).

In the context of the climate change crisis, investors increasingly demand more information on climate change so they can direct their funds to more sustainable businesses. They want to know which companies are at risk, which companies are preparing for the risks, and how companies are coping with them. As a result, recent years have seen many frameworks developed to guide companies on reporting sustainability issues in general and climate-related issues in particular. In terms of financial disclosures, the Australia Join Bulletin issued by two governmental bodies (AASB and AUASB) is one of the first to provide guidance on how to report climate risks in financial reports. In addition, it emphasizes the role of external auditors regarding these disclosures (AASB & AUASB, 2018).

The second essay studies the set of new rules that can be seen as a regulatory response to the deteriorating financial condition of European football clubs (Lago et al., 2006; Storm & Nielsen, 2012). In 2010, more than half of European football clubs in the top divisions had operating losses due to their extensive
spending on player salaries or transfers (Nielsen & Storm, 2017). For example, in Italy, the accumulated loss was EUR 1.4 billion and the players’ salaries increased more than 700% within ten years (1996–2006) (Baroncelli & Lago, 2006; Hamil et al., 2010).

Despite their loss-making status, the survival rate among these football clubs is very high (Szymanski, 2017). Prior research has explained this paradox by reference to a phenomenon called Soft Budget Constraint (SBC) (Storm & Nielsen, 2012), which refers to a situation when the firms’ operations are not profitable, but they expect to be rescued by stakeholders (Kornai, 1986). These stakeholders can be governments, other companies, or wealthy owners. In the football industry, SBC has triggered irresponsible and excessive risk-taking behavior by football club managers, who spend huge sums on player transfers and remuneration activities in the hope of achieving instant on-field success (Storm & Nielsen, 2012).

In 2009, the UEFA introduced the FFP regulation as a remedy for the deteriorating financial condition of European football. The FFP regulation has two important rules: the break-even rule and no overdue payables (UEFA, 2012, 2015, 2018). The first rule requires clubs to balance their spending with revenue and to avoid accumulating losses, while the second rule requires clubs to prove that they have no overdue debts toward other clubs, players, or other stakeholders (UEFA, 2012, 2015, 2018). By stipulating that football clubs should spend only as much as they earn, FFP can be expected to alleviate the SBC problem in the football industry.

The third essay examines the regulatory change initiated in response to the public debate on the credibility of auditors following the 2008 financial crisis and recent corporate scandals (Minutti-Meza, 2021). One issue raised was the information content of the audit report, which has followed the pass-fail model for several decades and lacked transparency about the audit process (Gray et al., 2011). In response to investor demands to make the audit reports more useful,
the U.S. PCAOB issued a requirement about CAMs (PCAOB, 2017). The purpose of CAMs is to give the users of financial statements more information about the audit process, in particular, the matters that require challenging, subjective, and complex auditor judgments. In addition, PCAOB requires that CAMs should link to a material account or disclosure. Comparable regulations are issued around the world including the standards by the International Auditing and Assurance Standards Board (IAASB) and the U.K. Financial Reporting Council (FRC) (IAASB, 2016; FRC, 2013).

In sum, the three essays illustrate how three regulatory changes in different contexts aim to tackle various problems in the economy. While the third essay concludes that the regulation regarding CAMs seems to have its intended effect, the second essay shows that FFP regulation does not. The reason could be that the impact of regulation is contingent upon numerous factors. While the first essay illustrates how a company’s disclosures on climate risks depend on auditor choice, the second essay suggests that the execution of regulation is important, especially when regulation is cross-national. The enforcement mechanisms in each country should be considered so that regulations can achieve their intended effects.
2. Summary of the essays

This section summarizes the three essays comprising this dissertation. In each part, the context of the regulation that motivated the study, a short literature review, the method used, the results, and the contribution of the study are presented.

2.1 Essay 1: Climate Risk Disclosures and Auditor Expertise

This paper examines the relationship between the audit partner’s climate-related expertise and the client’s climate risk disclosures.

Climate change poses a serious threat to the global economy across many economic sectors (TCFD, 2017). For the financial market to correctly price the risks and support the investors in their investment decisions, more information about climate risks should be disclosed. In recent years, there have been many regulations and frameworks that provide companies with guidance on how to report the impact of their activities on the environment and how they are affected by climate change. One major development in this reporting landscape is the recommendation of the Task Force on Climate-related Financial Disclosures (2017) that companies disclose the financial impact of climate change in their financial reports.

Australia was one of the first countries in the world to issue a Joint Bulletin between the AASB and the AUASB in 2018 to help companies assess and dis-
close material climate risks. More importantly, the Australia Joint Bulletin emphasizes the role of external auditors in these climate disclosures. According to this guidance, external auditors should understand climate risks and consider the financial impact of climate risks when auditing financial reports. These regulation developments have put climate risks under the scope of an audit. It has motivated us to study the role of auditor expertise in client’s climate risk disclosures.

Prior literature has shown that auditor expertise is associated with higher audit quality (Knechel et al., 2013) and higher quality client disclosures (Dunn & Mayhew, 2004; Han et al., 2012; Legoria et al., 2017). Auditors accumulate expertise through training and experiences when working with firms in a certain industry (Bonner & Lewis, 1990; Solomon et al., 1999). In this paper, we argue that auditors can accumulate expertise related to climate issues when working with firms that are more affected by climate risks. In this case, auditors would be expected to have more knowledge of the related regulations and the financial implications of climate risks. Through discussions with management during their engagement, auditors could advise managers on the best practices in the field, for example, whether and how firms should disclose climate risks. In addition, auditors have incentives to do so to protect their reputation and avoid litigation (DeAngelo, 1981; DeFond & Zhang, 2014; C.-Y. Lim & Tan, 2008; Palmrose, 1988).

Using panel data from the top 500 largest firms in Australia over two years, 2018 and 2019, we find that the audit partner’s climate-related expertise is positively associated with the likelihood and quality of client climate risk disclosure. However, these results are driven by a group of industries where climate risks are material. According to TCFD (2017), these industries are energy, transportation, materials and building, agriculture, food, and forest products, banks, insurance companies, asset owners, and asset managers. These results are robust when we use alternative measures for auditor expertise and disclosures and
withstand three remedies for endogeneity concerns, including entropy balancing (Hainmueller, 2012), the Heckman selection model (Heckman, 1979), and the Internal Threshold for Confounding Variables method (Frank, 2000).

Our study has several contributions to the literature. First, it addresses a timely topic regarding disclosing the financial impact of climate risks on financial reports. Second, we introduce a new dimension of audit partner’s expertise in addition to the traditional industry expertise, namely expertise on climate-related issues. Third, we provide evidence that an auditor can play a role in client climate risk disclosure. By doing so, we contribute to the literature on auditor expertise as an input to audit quality (DeFond & Zhang, 2014; Knechel et al., 2013).

This study also has practical implications and should be of interest to regulators, investors, and the audit profession. As investors are asking for more information about climate risks to direct their capital and firms are incentivized to disclose climate risks to get green finance, high-quality disclosures of climate risks are becoming more important. Auditors need to have a better understanding of the climate risks to assess its impact and whether related disclosures are needed. Our study also implies that management could choose audit partners that are likely to assist the firm in climate risk disclosures to meet investors’ expectations.

2.2 Essay 2: Has UEFA’s Financial Fair Play Regulation Hardened the Soft Budget Constraint in European Football? Empirical Evidence from the Big Five Leagues

This paper examines whether the major regulatory change in the European football industry – the FFP regulation – has achieved its intended consequence of hardening the budget constraint.

The European football industry has suffered from losses and poor financial health for several decades (Lago et al., 2010; UEFA, 2016). Nevertheless, the survival rate among these football clubs is very high (Szymanski, 2017). Prior
research has explained this phenomenon using the concept of SBC (Storm & Nielsen, 2012).

As an economic phenomenon, SBC describes a situation where an entity is rescued from bankruptcy by various stakeholders (Kornai, 1986). In the football industry, these stakeholders include, for example, governments, tax agencies, and banks. The bail-out from these stakeholders is one reason football club managers spend more money than they can earn in pursuit of sporting success.

To harden the soft budget constraint in the football industry and to improve the financial health and sustainability of football clubs, UEFA issued the FFP regulations in 2009 to govern different financial and sporting aspects of the clubs. The two most relevant rules of FFP are the break-even rule and the rule about no overdue payables (UEFA, 2012, 2015, 2018). The first rule requires clubs to balance their spending with revenues and to avoid accumulating losses, while the second rule requires clubs to prove that they have no overdue debts toward other clubs, players, or other stakeholders (UEFA, 2012, 2015, 2018).

In this paper, we study whether and how the FFP has alleviated the soft budget constraint problem in the European football industry. Particularly, we investigate whether these three related aspects have improved after FFP: the financial performance, the equity injection from owners, and the financial position.

We find that profitability has improved in the post-FFP period. Profitability has improved most for English clubs, less for German clubs, and has not improved for Italian, French, and Spanish clubs. When examining changes in revenues and expenses, we found that clubs have higher profitability because revenue increases outweigh increases in expenses. However, we found that club owners have not reduced their equity injection in the post-FFP period. In addition, the financial position of football clubs has not improved after FFP.
In the additional tests, we analyze the effect of the COVID-19 pandemic on clubs’ financials. We found that clubs’ profitability and long-term financial position have been hit hard by the pandemic, especially in England, Italy, and France. German and Spanish clubs were less affected by the pandemic.

This study contributes to the literature in several ways. Our study is the first empirical research that addresses the effect of FFP in all three dimensions that relate to SBC. While prior research mainly investigates the effect of FFP on clubs’ profitability, it does not discuss SBC (Ahtiainen & Jarva, 2020; Alabi et al., 2021; Caglio et al., 2019; Francois et al., 2021). As SBC is a phenomenon that could present in different industries, our contribution is not limited to the football industry.

Second, the paper extends the literature on financial statement analysis. In this study, our ten dependent variables cover all three sources of finance: internal financing through profits, the owners’ equity contributions, and loans from other stakeholders. Our regressions control for club fixed effects and use unscaled numbers, therefore the estimation results provide a straightforward interpretation of the economic effect of FFP.

The paper also shows how the regulation effectiveness is affected by an external shock in the economy, and in this case, the COVID-19 pandemic. Many games were canceled or played in empty stadiums, but our study is the first to quantify the economic impact of this external shock in ten financial measures.

2.3 Essay 3: The Impact of Critical Audit Matters on the Value Relevance of Intangible Assets

This paper examines the relationship between the expanded audit reports and the value relevance of intangible assets.

Following the financial crisis in 2008 and recent corporate scandals, the public has questioned the credibility of auditors (Minutti-Meza, 2021). Users of financial statements have increasingly perceived the gap between the information
that they want and the information provided in the auditor reports (Gray et al., 2011). Consequently, standard-setters in many jurisdictions embarked on reforming the audit report.

In the U.S., the PCAOB issued the auditing standard AS3101 which requires auditors to disclose CAMs in the audit reports. A CAM is matter that requires challenging, subjective, and complex auditor judgments, and should link to a material account or disclosure. This regulation became effective for large-accelerated filers in June 2019 and other companies since December 2020.

Since the main purpose of CAMs is to provide investors with more information about the audit, it is important to know how investors value these disclosures. However, research on the value relevance of CAMs using early data provides mixed results (Abbott & Buslepp, 2022; Burke et al., 2022; Klevak et al., 2022; Li & Luo, 2023).

The objective of this study is to examine whether the value relevance of intangible assets is affected by the presence of a related CAM in the audit report. Intangible assets were chosen for several reasons. First, a CAM addressing intangible assets is one of the most common, not only in the U.S. but also in the U.K. and Australia (Burke et al., 2022; Kend & Nguyen, 2020; Sierra-García et al., 2019). Second, prior research consistently shows that intangible assets are highly relevant and that relevance increases over time (Barth et al., 2023; Dahmash et al., 2009; Kallapur & Kwan, 2004; Oliveira et al., 2010; Wyatt, 2008). However, due to the nature of intangible assets, investors perceive them as less reliable than tangible assets, and therefore, investors discount their value when pricing the firm (Dahmash et al., 2009; Kallapur & Kwan, 2004; Wyatt, 2008). In that context, auditors play an important role in improving the reliability of intangible assets through independent assessment and validation (Behn et al., 2008; Dunham & Grandstaff, 2022; Huikku et al., 2017; Lee & Park, 2013). As prior research shows that investors value the information in audit reports and high audit quality, it is interesting to know if investors would weigh intangible
assets differently when facing a CAM relating to intangible assets in an audit report.

This study uses three-year panel data of listed firms in the U.S. from 2019 to 2021 and finds that the investors put more weight on intangible assets when valuing the firm that receives a CAM relating to this accounting item. However, this result is driven by the subsample of Big4 clients and is more prominent for the subsample of large firms, profitable firms, and firms in intangible-intensive industries. The results are robust to different model specifications and falsification tests. In the additional test where the price per share is replaced by the future cash flow of one year ahead, I find that firms with CAMs relating to intangible assets have a lower association between intangible assets and future cash flow.

These results suggest that investors do react to CAMs concerning intangible assets as the value relevance of intangible assets is higher when a CAM is present. I cannot be certain whether this effect is due to the higher reliability perceived by investors or because a CAM has directed investors’ attention to that specific accounting area. Both explanations are consistent with prior literature. The increasing reliability explanation is consistent with McDonough and Shakespeare (2015), who stated that if there is a channel through which investors could learn about the reliability of the fair value estimation, then its value relevance increases. In addition, the attention-directing effect is in line with Sirois et al. (2018), who found that investors would pay more attention to the accounting items when they are mentioned in the audit reports.

The contribution of this study is twofold. First, this paper adds to the literature on audit reports and CAM. It provides evidence that investors do value auditors’ disclosures, especially audit matters. Second, this paper complements the literature on intangible assets. Making use of the setting where auditors have to disclose critical audit matters on the audit report, this study provides evidence that
auditor disclosure could increase the value relevance of intangible assets, either by attracting investors’ attention or by increasing the perceived reliability.


