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Three essays on institutional conditions that enable audit quality

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Chapter 1

Introduction

This dissertation presents three essays on institutional conditions that enable audit quality. Enabling audit quality is a complex and often discussed societal topic. I aim to contribute to our understanding of audit quality and important institutional conditions that enable its delivery. The first essay is on audit partner clawbacks, a hard monetary incentive to avoid low quality audits. The second essay is on the auditor selection model, where assigning auditors to auditees is often discussed, but empirically little researched. In the third and last essay we research the impact of audit firm culture on audit quality.

In chapter two, I study the staggered introduction of audit partner clawbacks in the Netherlands, where the first clawbacks were implemented under high political pressure in 2014. While clawbacks were not legally required, the Ministry of Finance threatened to intervene directly with legislation if the audit profession did not reform itself and set up a monitoring committee. Under the Dutch arrangement, a partner must repay up to a full year of compensation to the audit firm if societal damage is done due to the partner's negligence in the six years after the compensation was awarded. This can come into effect when, for example, an unqualified audit opinion is restated, the disciplinary court convicts an auditor, or a client bankruptcy follows an unqualified audit opinion. The audit firms' independent supervisory boards, where audit partners have no say, independently enforce clawbacks. Clawbacks have been executed several times since being introduced and credibly threaten the compensation of negligent audit partners.

It is an empirical question of whether clawbacks impact audit quality. The question matters because the clawback arrangement does not result from interactions between independent market participants but, in the Netherlands, was imposed on the profession under high political

pressure. If clawbacks were an efficient market solution in audit partnerships, why have more audit firms not already adopted them? Partners depend on each other for their future earnings and are subject to firm-internal re-assignments or fines for low-quality audits (Bik, Bouwens, Knechel, and Zou 2020; Gipper, Hail, and Leuz 2022). If partners seriously err, they will likely be expelled from the partnership, losing all future cash flows. Thus clawbacks might only make the consequences of low-quality audits worse but might not change the underlying incentive structure of the partnership. Indeed analytical work suggests that firing poor performers in multiple period settings is more efficient than penalizing through lower compensation (Stiglitz and Weiss 1983).

In chapter three my PhD supervisors and I study the auditor selection mechanism. This is a critical recurring topic in the academic and public debate about the auditing profession (U.S. Senate 1977; Healy and Palepu 2003; PCAOB 2011; AFM 2018; House of Commons 2019; CTA 2020). The Dutch audit oversight body AFM considers a model in which “*The auditee does not have the right to choose their own auditor...*” (AFM 2018, 56) to improve auditor independence. This model would eliminate auditor-client self-selection and, therefore, would significantly reform the audit market. However, the consequences of assigning rather than self-selecting auditors are a priori uncertain. Moreover, the service perspective on auditing provides important arguments in favor of the current self-selection of auditors.

Our research question in chapter three is: Are audit quality and production associated with who gets to select the audit partner: the auditee or another party? Prior lab and field experimental work shows that auditor selection and hiring plays a role in potential independence violations and audit quality (Mayhew and Pike 2004; Duflo, Greenstone, Pande, and Ryan 2013; Hurley, Mayhew, and Obermire 2019). However, archival research has not disentangled client-auditor self-selection from alternative auditor-client selection mechanisms (Minutti-Meza 2013). We fill this void by studying big-4 subsidiary audits under International

Auditing Standards (ISAs), where a local audit partner is frequently assigned to an auditee rather than self-selected by its local management.

In chapter 4 we research audit firm culture, this is a prominent topic in the professional debate regarding audit quality (IAASB 2014; IOSCO 2015; PCAOB 2015). Audit regulators worldwide identify the importance of a culture that promotes high-quality audits (FRC 2018; AFM 2020; IAASB 2020; PCAOB 2022).¹ The PCAOB has even prioritized reviews of audit firms' cultures in its 2024 inspections "to inform our understanding of audit firms' culture and the impact on audit quality" (PCAOB 2023, 11). Despite regulators' increasing attention to the subject and research efforts to strengthen our understanding of what audit firm culture entails (Jenkins, Deis, Bedard, and Curtis 2008; Andiola, Downey, and Westermann 2020; Alberti, Bedard, Bik, and Vanstraelen 2022), evidence of an empirical link between culture and audit quality is scant and inconclusive (Aobdia 2020; Mowchan 2023).

In chapter four, we theorize and consider culture a social control system (O'Reilly 1989; O'Reilly and Chatman 1996) and use that notion first to theorize and test whether an association between audit firm culture and audit quality exists. This is particularly salient given the credence nature of audit services (Causholli and Knechel 2012) and the rich judgment and decision-making process of an audit (Francis 2004, 2011) wherein not all contingencies can be properly regulated *ex ante* (Guiso, Sapienza, and Zingales 2015). Second, we hypothesize that audit firm culture as a social control becomes more salient in more complex audit settings in which auditors are confronted with increased ambiguities and uncertainties that require more interdependence and monitoring amongst colleagues to complete the more complex task (Van de Ven, Delbecq, and Koenig 1976; Kandel and Lazear 1992; Gorton, Grennan, and Zentefis

¹ For example, the IAASB expects audit firms to have "a culture that demonstrates a commitment to quality" throughout the firm (2020, 26) and the FRC "to establish, promote and embed a culture that is committed to delivering consistently high-quality audits." (2018, 4). The PCAOB states: "A firm's culture and tone, as set by leadership, can and should promote the importance of quality" (2022, 91) as a "firm's commitment to quality is an important factor in influencing the behavior of firm personnel." (2022, 93).

2022). We posit, it is in these complex audit settings that audit quality is more challenging to regulate ex ante and, hence, that audit firm culture as social control matters more in safeguarding audit quality.

Chapters five and six contain the English and Dutch conclusions, respectively.

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