# Three essays on institutional conditions that enable audit quality

Bosman, T.

**Publication date**
2024

# Chapter 5

# English Conclusion

This dissertation presents three essays on institutional conditions that enable audit quality. Audit partnerships have substantial agency costs, as partner effort and the residual risk from an audit are mostly unobservable, inviting shirking and free riding. Consequently, audit quality and peer monitoring can suffer (Huddart and Liang 2005). Any damage from low-quality audits is borne by the entire audit firm, including nonnegligent partners, the profession, and society, while the benefits accrue to a few shirking auditors (Pruijssers, Heugens, and van Oosterhout 2020, 154). An important example of this phenomenon is the collapse of the Big Five audit firm Arthur Andersen in 2002, attributed to overly commercial incentives, dysfunctional peer monitoring, and other control deficiencies (Wyatt 2004; Gendron and Spira 2009). Moreover, audit failures, such as the long unidentified fraud at Wirecard, manifest themselves in the long run (Rödl & Partner 2021). And while it is hard to observe the quality provided by auditors in the short term, it is easy to monitor, control, and incentivize their commercial success. Indeed research documents significant commercial incentives for audit partners (Knechel, Niemi, and Zerni 2013; Vandenhaute, Hardies, and Breesch 2020; Dekeyser, Gaeremynck, Knechel, and Willekens 2021; Che, Langli, and Svanström 2021). Enabling audit quality is, therefore, a difficult and important societal topic.

In Chapter two, I research the consequences of introducing the Dutch audit partner clawback. This is a monetary incentive in the form of a penalty contract for low-quality audits. Using a stacked difference-in-differences design, I find that partners primarily reduce their compensation risk by de-risking and find little evidence of quality improvements. Confronted with clawbacks, partners accept fewer and less risky clients, initially audit longer, and issue more modified audit opinions (qualified, disclaimer, or adverse). Nevertheless, following the clawback introduction, partners do not experience fewer restatements, are not more accurate or strict in going concern reporting, and do not reduce earnings management. Meanwhile, partner income and audit fees increase, and clients switch to less competent auditors.

In Chapter 3, my Ph.D. supervisors and I investigate the auditor selection model. Auditors are selected and paid for by the organizations they audit. According to theory and recent findings, this auditor selection model incentivizes auditors to avoid reporting adverse audit outcomes to ensure client retention. Therefore, policymakers are concerned about auditor independence. We study local subsidiary audits conducted by the big-4 under International Auditing Standards, where audit partners are either assigned to audit subsidiaries or self-selected by the subsidiaries' management. We find that auditors assigned to a subsidiary rather than appointed by the subsidiary receive less information from the auditee, are less likely to constrain earnings management (i.e., higher accruals), issue fewer going concern opinions, and identify and correct fewer material misstatements than self-selected partners. Moreover, assigned auditors provide less effort, fewer non-audit services, and charge lower fees. Our findings suggest that assigned auditors may become too independent of auditees at the cost of client knowledge and their access to audit evidence.

In Chapter 4, I focus together with my Ph.D. supervisors on an often discussed but little-researched relationship between audit firm culture and audit quality. We hypothesize and empirically find a significant and positive relation between audit firm culture and audit quality measured as the auditors' propensity to issue a modified or a going concern audit opinion – decisions reflecting audit quality under the direct control of the auditor. We further hypothesize that culture, theorized as a social control mechanism, is more salient in audit settings where not all contingencies can properly be regulated ex ante given the credence nature and rich judgment and decision-making context of audit services. That is, we find that the relation between culture and audit quality is more pronounced in more complex audit settings where auditors face increased ambiguity and uncertainty. Social controls could provide significant audit quality incentives.