

*Mikko Zerni*

# ESSAYS ON AUDIT QUALITY

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OECONOMICA

FACULTY OF ECONOMICS AND BUSINESS ADMINISTRATION,  
DEPARTMENT OF ACCOUNTING AND FINANCE,  
UNIVERSITY OF OULU





ACTA UNIVERSITATIS OULUENSIS  
G Oeconomica 39

**MIKKO ZERNI**

**ESSAYS ON AUDIT QUALITY**

Academic dissertation to be presented with the assent of  
the Faculty of Economics and Business Administration of  
the University of Oulu for public defence in Auditorium  
TA105, Linnanmaa, on 20 November 2009, at 12 noon

OULUN YLIOPISTO, OULU 2009

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Acta Univ. Oul. G 39, 2009

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ISBN 978-951-42-9291-0 (Paperback)  
ISBN 978-951-42-9292-7 (PDF)  
<http://herkules.oulu.fi/isbn9789514292927/>  
ISSN 1455-2647 (Printed)  
ISSN 1796-2269 (Online)  
<http://herkules.oulu.fi/issn14552647/>

Cover design  
Raimo Ahonen

OULU UNIVERSITY PRESS  
OULU 2009

**Zerni, Mikko, Essays on audit quality.**

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*Acta Univ. Oul. G 39, 2009*

Oulu, Finland

***Abstract***

The only observable outcome of the audit process is normally the issued audit report, which, at least in its standard form, does not contain much information about audit quality (Balsam et al. 2003). Auditor quality is multidimensional and inherently unobservable, and there is no single auditor characteristic that can be used as a proxy for it. In the absence of direct measures for quality, audit consumers must assess the quality by using quality surrogates, or the overall reputation of an auditor (e.g. Shapiro 1983, Riley 2001).

The purpose of this dissertation is to enhance our understanding of the determinants and implications of quality-differentiated audits through four inter-related essays. The findings of the essays shed light on the various ways in which client firms strive to signal high audit and consequent earnings quality. From the supply-side perspective, the essays of this dissertation provide evidence how some (individual) auditors have been able to establish a reputation higher than the generic reputation.

Importantly, this dissertation adds to the ongoing debate about the regulator changes and initiatives in the European Union and the U.S.A. requiring disclosure of engagement partner identity. The rationale behind such a requirement is that it could bring within investors' reach greater transparency and accountability in the auditing process thereby helping to restore investor confidence in the capital markets. Consistent with this rationale, the results of this dissertation support the view that audit markets (and/or firm insiders) infer audit quality, at least to some extent, from the characteristics of the individual audit partner in charge.

*Keywords:* audit fees, audit partner, audit quality, auditing, auditor independence, auditor size, auditor switches, legal liability environment, nonaudit services



## Acknowledgements

First of all, I want to express my gratitude to the supervisors of my thesis, Professor Juha-Pekka Kallunki and Professor Petri Sahlström for their help and advice. Thank you for your dedication to my research and for your genuine interest in improving it. Great thanks go to Professor in Statistical Sciences Markku Rahiala. He is the person in the whole university of Oulu I most admire. Not only because his brilliance in statistics, but by the virtue of his character. His integrity and willingness to help and advice whenever necessary has really made my academic journey easier. I will gratefully remember that for the rest of my life.

I am also very grateful to the official pre-examiners, Professor Lasse Niemi and Professor Stefan Sundgren. Their valuable comments and suggestions have improved the quality of the thesis considerably. Your comments helped me to see many issues from different and wider viewpoints.

I also want to thank Professor Markku Vieru for his comments and support. I appreciate the help Professor Jukka Perttunen has given me in solving some complicated SAS-coding issues. I am also very grateful to Henrik Nilsson for his comments and help during my dissertation project. I would like to give my common express all those colleagues who have furthered this thesis with many insightful comments and suggestions. Thank you my dear colleagues during past years. I especially have enjoyed our time in the office with Risto Tuppurainen, Juha Joenväärä, Mika Pirmeskoski, Henry Jarva and Hannu Kahra. I also want to thank Anna-Maija Lantto who has become a dear friend of mine during the last couple of years. Her holistic view of the world has provided much comfort in handling the ups and downs of writing this dissertation. I wish to thank faculty's administrative people, especially Marketta Holmberg, Päivi Nylund, Katja Hannula, Virpi Virta and Sirkku Horsma for always kindly offering their help. Special thanks goes to Jukka Maamäki for providing me with the opportunity to have ergonomic chair and table to ease my working hours that sometimes have drawn out rather late. "Don" Maamäki is the heart of faculty's football, which members all deserve thanks. Physical exercise has acted as a good counterbalance to office work.

Warm thanks go to my parents for their support and help during my entire life. Without you this thesis would not have been possible. I also wish to thank my sister Sanna and brother Jussi for their love and support. Life is also more than just a work. I have many good friends who have given me the opportunity to

forget the thesis for a while. Thank you Teemu, Petri K, Pertti, Tuomas, Aki, Mikko Y, Teemu R., just to name few. Thank you for being there.

For English editing I am very grateful for M.A. Virginia Mattila. Her help has eased my work greatly. I wish to express my thanks to Ville Varjonen and Dr. Seppo Eriksson for the editorial advice and technical support in editing of the thesis. I gratefully acknowledge the financial support for this research provided by the Research Foundation of the OP Group, the University of Oulu foundation, the Finnish Foundation for Economic Education, Finnish Foundation for the Advancement of Securities Markets, Marcus Wallenberg Foundation, Alfred Kordelin Foundation, Kaute, The Finnish Savings Banks Group Research Foundation, Tauno Tönning Foundation, Nordea Bank Foundation, Oscar Öflunds Stiftelse, and the North-Ostrobothnia Cultural Foundation. Without their support this thesis would not have been possible.

Finally, the deepest, sincerest and most loving thanks go to my loving wife Mari. Thank you Mari, for always encouraging me in everything I do. You and our beautiful daughter Aino give the meaning to my life. I love you.

Oulu, October 2009

Mikko Zerni



## List of the original articles

The thesis includes the following separate studies.

- I Zerni M (2009) Audit Partner Specialization, Audit Fees, and Auditor-Client Alignments. Manuscript.
- II Kallunki J-P & Nilsson H & Zerni M (2009) The Entrenchment Problem, Corporate Governance Mechanisms and Firm Value. Manuscript.
- III Kallunki J-P & Sahlström P & Zerni M (2008) Propensity to Switch Auditors and Strictness of Legal Liability Environment: The Role of Audit Misspricing. *International Journal of Auditing* 11(3): 165–185.
- IV Zerni M (2008) Do Client Firms Manage the Perception of Auditor Independence? Evidence from the Nonaudit Service Market. Manuscript.

The thesis contains two articles that are co-authored with Professors Petri Sahlström, Juha-Pekka Kallunki and Henrik Nilsson. The collaboration was carried out in such a way that Zerni's contributions to the co-authored papers were substantial as well as clearly identifiable. In these essays, Zerni contributed to the study in all research phases. In particular, he participated in planning and designing the study, as well as, analyzing and interpreting the results and writing the manuscript. Furthermore, in the second essay Zerni acted as the corresponding author.



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# 1 Introduction

## 1.1 Background

*“Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another the advisability of some kind of check upon the fidelity of the former would become apparent.”*(Brown 1986.)

As noted in the above alluded quotation the demand for auditing existed long before any mandatory requirements. Some forms of auditing dates back to Greece as early as 500 BC (Costouros 1978). Demand for monitoring inherently evolves from the incomplete and asymmetric information whenever a principal hires an agent. In economics these conflicting interests are collectively referred to as agency conflicts. There are numerous reasons why the goals of these self-interest parties may not coincide. Agents may be more risk averse than principals, and due to differential risk profiles they may exhibit tendency to be more optimistic about the economic performance of an entity or their performance under a contract even more than would be justified by the real world. In the context of corporate finance, agency costs most often occur when managers and/or other firm insiders (are expected to) pursue personal benefits and power rather than the profitability of the firm (i.e. moral hazard). Given that the principals may lack trust in their agents, they need to establish some mechanisms to make sure that principals are doing what they are hired to do. This is normally attempted to achieve through two broad categories of governance mechanisms: better alignment of incentives and monitoring. The focus of this thesis is on the latter mechanism, monitoring, and in particular, the monitoring performed by external auditors.

Governance mechanisms are needed to make sure that agents do not “steal” or otherwise “misuse” the capital the principals’ supply (Schleifer & Vishny 1997). As noted above, one way to address agency conflicts is to try align the interests of a risk- and effort-averse agents with those of the principals through establishment of performance-based contracts e.g., stock performance-based compensation packages. However, contracts designed to align incentives have well-known limitations. First, contracts can never be complete (Hart 1995) and, secondly, agents typically control both effort and (at least to some degree) the reporting of their effort (firm performance). Performance measures typically rely on accounting numbers (and/or stock price development or on a combination of

both), which creates incentives for agents to bias real performance and other financial information flows of the entity (Watts & Zimmermann 1986).<sup>1</sup> Because of the pervasive differences between incentives of principals and agents monitoring mechanisms such as auditing are put in place to monitor both agents and contracts (Jensen & Meckling 1976).

Auditing, as a monitoring mechanism, serves principals by providing a reasonable assurance that management's financial statements are free from material misstatements. By reducing information asymmetry and agency costs auditing potentially benefits both the principal and agent (if agent is honest). Even though auditing is only one monitoring mechanism in corporate governance mosaic, the extensive presence of auditing suggests that auditing is the most cost-effective form of monitoring. For instance, while audits are nowadays required by law, prior empirical evidence in audit literature suggests that existence of financial statement auditing was pervasive long before statutory requirements. Specifically, in the U.S. in 1926 before any audit regulation, independent auditors audited as much as 82 percent of the companies on the New York Stock Exchange (Benston 1969, Chow 1982). This observation clearly indicates the fundamental importance of auditing as a cost-effective external governance mechanism providing protection for investors and other users of financial statements.

## **1.2 Purpose of the dissertation**

The purpose of this dissertation is to contribute to the audit literature through four separate essays. These four empirical essays seek answers to following questions: Is the Big-4 audit product and consequent pricing differentiated at the individual partner-level? Are there returns for auditor specialization? Does the (perceived) audit quality affect outside investors' information risk? Does the quality of corporate governance practices affect financial performance? Whether and how does audit price affect auditor switches? Does the legal liability environment affect the propensity to switch auditors due to audit fee under or/and overpricing? And do agency cost proxies explain the auditors' provision of consulting services? However, it should be noted that the above list of research questions do not represent an exhaustive list of all questions and subjects addressed in the current

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<sup>1</sup> For instance, using survey responses of 177 large U.S. firms Murphy (2000) finds that 91% of his sample firms use accounting measures in their bonus plans.

thesis. Each of the four essays makes its unique contributions which are described more specifically in the next section and in the review section of the essays.

### **1.3 Contribution and structure of the dissertation**

This dissertation contributes to the audit literature through four inter-related essays. The first essay contributes to the growing number of “local” audit studies analysing the behaviour of auditors in city-based, local engagement offices. Specifically, several recent studies provide evidence that the reputations and pricing of audit engagements are affected by the office-level industry specialization and size of the office-level clientele (e.g., Ferguson *et al.* 2003, Francis *et al.* 2005, Basioudis & Francis 2007, Choi *et al.* 2007). The first essay extends this line of research by pushing the local analysis still one step further, i.e. examining whether audit product differentiation and consequent pricing reaches the engagement partner-level.

In the aftermath of major accounting scandals such as Enron, WorldCom and Parmalat, regulators and investment communities have been seeking to restore investor confidence in the capital markets. The response worldwide has been increases in regulation and in these reforms accounting and auditing have been identified as priority areas to “fix”. For instance, with respect to audit market transparency, the amended European Union (EU) 8th Directive requires disclosure of engagement partner identity. Currently, the Public Company Accounting Oversight Board (PCAOB) in the U.S.A. is considering requiring engagement partner signature. On October 6, 2008, the U.S. Treasury’s Advisory Committee on the Auditing Profession (ACAP) issued its final report, which recommends, among other things, “urging the PCAOB to undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report.” (ACAP Report, October 6, 2008, at VII:19). According to the ACAP recommendation, the requirement for the engagement partner to sign the audit report could improve audit quality in two ways: “First, it might increase the engagement partner's sense of accountability to financial statement users, which could lead him or her to exercise greater care in performing the audit. Second, it would increase transparency about who is responsible for performing the audit, which could provide useful information to investors and, in turn, provide an additional incentive to firms to improve the quality of all of their engagement partners.”

Swedish engagement partner(s) sign the audit report making it possible to construct individual partner “clienteles”. In this study, I am able to utilize information on the sizes and compositions of the complete Big-4 audit partner-specific client portfolios. Analysis of this unique data provides an interesting opportunity to contribute to a more thorough understanding of an auditor’s specialization, the engagement partner’s role in the audit and, in particular, whether the perceived audit quality is affected not only by the brand-name of the firm, but by the characteristics and reputation of the engagement partner.

The second essay contributes to the literature on entrenchment discounts by exploring whether corporate governance devices, namely the board of directors and auditors, can effectively mitigate these discounts. While prior research has documented the existence of entrenchment discounts (Morck *et al.* 1988, McConnell & Servaes 1990, Claessens *et al.* 2002, Lins 2003, Cronqvist & Nilsson 2003) and the channels through which private benefits are derived at the expense of outside shareholders (Johnson *et al.* 2000, Masulis *et al.* 2008), only one study, Fan & Wong (2005), examines the potential bonding and monitoring mechanisms that may affect the magnitude of outside shareholders’ anticipated wealth loss. The results of this study shed further light on this important issue. Second, one of the central, but yet unresolved, issues in the governance debate has been the proper design of compensation schemes for corporate directors. The findings of this study contribute to this debate by enhancing the understanding of the effectiveness of director compensation.

The third essay contributes to the auditing literature in the following ways. First, the third essay contributes to the audit fee studies by corroborating the findings of Taylor & Simon (1999) and Choi *et al.* (2008a) that the audit risk and consequent pricing are positively related to the stringency of the legal environment of the country. Second, and more importantly, this essay expands the prior audit literature on the determinants of auditor realignments (e.g. Johnson & Lys 1990 and Beattie & Fearnley 1995) by investigating whether the overpricing of auditing services is one underlying reason for switching auditors. The third essay also contributes to the growing body of literature on international auditing (e.g. Taylor & Simon 1999, Francis & Wang 2008, Choi *et al.* 2008a, Choi *et al.* 2008b) by investigating if the threshold level of the mispricing of auditing services that leads to a switch of auditors is higher in countries with a stringent legal environment than it is in countries with a lax legal environment.

The fourth and final essay of the dissertation contributes to the group of studies examining the perceptions about joint provision of audit and nonaudit



services. A growing number of recent audit studies consistently report evidence that the auditors' joint provision of audit and nonaudit services is perceived negatively by investors (Krishnan *et al.* 2005, Francis & Ke 2006, Khurana & Raman 2006, Eilifsen & Knivsflå 2008). The fourth essay of the dissertation adds to this line of research by providing evidence that client firms proactively respond to these (potential) investor concerns. Specifically, the empirical findings of this essay indicate that higher levels of agency cost proxies are significantly negatively related to both absolute and relative nonaudit fees but, at the same time, significantly positively related to the level of outside consulting services purchased from non-incumbent auditors. Together these results strongly support the view that client firms with agency problems protect the appearance of their auditor's independence.

Collectively, the empirical results of this thesis expand our understanding of the determinants and implications of quality-differentiated audits. The findings of the first essay are important especially for demonstrating that audit markets (or firm insiders) infer audit quality, at least to some extent, from the characteristics of the individual audit partner in charge. These findings add to the current debate related to the regulator changes and initiatives in the European Union and the U.S.A. requiring disclosure of engagement partner identity. The rationale behind such a requirement is that it could to bring within investors' reach a greater transparency and accountability in the auditing process. Consistent with this rationale, the results of this dissertation support the view that engagement partner identity affects the market-assessed perception of *ex ante* audit quality.

The rest of the thesis is organized as follows. Sections 2.1 and 2.2 briefly describe the distinct characteristics of the audit product and underlying theoretical framework. Following sections of Chapter 2 then each describe the underlying theoretical framework which are relevant to the four essays of this thesis Section 2.3 presents theoretical background of audit pricing and auditor switches, which provide the underlying theoretical background for the third essay studying the propensity of client firms to switch auditors due to audit fee under or/and overpricing. Section 2.4 describes theories and prior empirical research related to the provision of nonaudit services. Section 2.5 reviews briefly some prior empirical findings on audit product differentiation between local audit practice offices and presents arguments for audit product differentiation at the partner level. As the previous research is remarkably voluminous and since the four essays cover various dimensions of audit research it is not possible to review literature in detail in this introductory part. Thus, references are made only to the

studies that are most relevant to the current thesis. Section 3 reviews the empirical essays. Finally, the original essays are presented at the end of the thesis.

## 2 Theories

### 2.1 Audit product and audit quality

Often cited definition of the auditing by the American Accounting Association Committee on Basic Auditing Concepts is as follows:

*Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to interested users.*

Audit product is unique among professional services due to at least two reasons. First, auditors are hired and paid by the client, but their product is really used by the third-parties (e.g., investors), to whom they owe a standard of care. Second, the quality of an audit cannot be directly observed prior contracting and, in general, not even after the audit is conducted. The only observable outcome of the audit process is the issued audit report, which, at least in its standard form, does not contain much information about the audit quality. Thus, in absence of direct measures for quality, audit consumers must assess the quality by using quality surrogates, or the overall reputation of an auditor (e.g. Shapiro 1983, Riley 2001).

Auditor size has been the most commonly used quality surrogate and it has been employed in a vast body of prior audit research. DeAngelo (1981b) analytically shows that auditor likelihood of reporting breaches (i.e. independence) increases with audit firm size. She defines audit quality as a market-assessed joint probability that an auditor will discover an error or irregularity in the accounts and that the auditor will report the breach to shareholders and other parties required under contracts or by law. Thus, according to the DeAngelo's framework, audit quality is a function of the (market-assessed) competence and independence of the auditor. She proposes that the auditor's investments (start-up costs) in the client relationships enable the incumbent auditor to earn client-specific quasi-rents and that these quasi-rents represent the collateral that is lost if 'promises' are not kept (i.e. in case of audit failure). According to this framework, auditors with a larger number of clients possess greater total collateral and as a consequence of avoiding audit failure arguably report a more independent opinion on client's accounts (DeAngelo 1981b).

One can distinguish between two types of audit qualities: audit quality in fact; and market perceived audit quality. DeAngelo's (1981b) definition is a definition

of perceived audit quality since it emphasizes the role of the market in assessing audit quality. A relevant question then is “does the market perceived audit quality capture actual audit quality?” Consistent with DeAngelo’s (1981b) framework, a vast amount of prior empirical research typically employ a dichotomous Big 8/6/5/4 vs. non-Big 8/6/5/4 indicator as a proxy for auditor size and tend to find a positive relationship between different proxies for audit quality. For instance, clients of large name-brand audit firms are reported to have higher earnings response coefficients (Teoh & Wong 1993) and lower levels of discretionary accruals (Becker *et al.* 1998). They are able to charge higher audit fees (Hay *et al.* 2006), are sued less often (Palmrose 1988), and give more informative signals of financial distress (Vanstraelen 2002, Knechel & Vanstraelen 2007).

It should though be noted that even when the empirical evidence shows very convincing evidence on the positive association between auditor size and audit quality, we are still unable to come to a conclusion whether the linkage is causal from the auditor size to audit quality. An alternative explanation is endogeneity. “Good” companies may more likely choose good (Big-4) auditors, in which case selection bias may explain outcomes, not audit(or) quality. Only few studies have examined endogeneity but in general, the results of these studies support the view that there is a positive relationship between auditor size and audit quality (see for instance Hogan 1997, Ireland & Lennox 2002 and Weber & Willenborg 2003). However, as noted by Larcker & Rusticus (2005) and Francis & Lennox (2008), appropriate instrumental variables are very difficult to find, especially in accounting research, making the task of correcting the biases due to endogeneity notoriously difficult.

## **2.2 Demand for auditing**

Demand for auditing arises from signalling needs (Titman & Trueman 1986, Datar *et al.* 1991) and, as noted above, needs to mitigate agency costs (Jensen & Meckling 1976). Auditing plays a valuable role in monitoring the contractual relationships between the entity and its stockholders, managers, debt holders and employees.

Financial theory suggests that more credible financial reporting reduces the cost of equity capital by lowering bid-ask spreads and increasing market liquidity due to adverse selection and increasing the stock price by reducing investors’ information risk (Jensen & Meckling 1976, Amihud & Mendelson 1986, Coles & Lowenstein 1988, Diamond & Verrecchia 1991, Botosan 1997, Leuz & Verrecchia

2005). Thus, in theory, by lowering the information risk auditing may provide a concrete benefit for the audit client, e.g., in form of lower cost of equity capital. Given the costs and benefits associated with “more auditing”, audit clients are, in general, expected to be willing to increase the audit scrutiny whenever the amount of reduced agency costs will outweigh the increased costs (e.g. fees). Moreover, because agency problems vary across firms, the level of monitoring required to address these problems are also likely to vary.

There is a large body of audit research investigating the demand for financial statement audits. One stream of literature investigates the demand for auditing before statutory audit requirement. These studies, in general, provide evidence that agency costs, indicated by greater size, higher debt leverage or lower managerial ownership, are positively associated with demand for external auditing. Specifically, by using U.S. data before statutory audit requirement, Chow (1982) found support for the positive effects of leverage and client size on voluntary demand for auditing. In another study, Abdel-Khalik (1993) found a positive relationship between voluntary demand for auditing and firm size, but found only weak positive association between leverage and auditing.

Another stream of audit research investigates quality-differentiated audits with statutory audit requirements. This stream of audit literature relies on DeAngelo’s (1981b) theory and argues that larger audit firms provide higher-quality service and are more likely to be employed to undertake the audit of companies facing a higher level of agency conflict (e.g., Simunic & Stein 1987, Francis & Wilson 1988, Johnson *et al.* 1990, DeFond 1992). In general, the documented evidence in these studies provides support to this view. Specifically, these studies tend to find evidence suggesting that, the higher the level of agency costs, the higher the level of assurance (and audit quality) needed to confirm the integrity of financial disclosures. The most robust finding from this stream of auditor selection literature has regarded the propensity of large companies and firms needing new external finance to select large international audit firms with brand name reputations.

Although private firms predominate in the economy worldwide, there is much less research of auditor choice (and demand) among private firms. Knechel *et al.* (2008) analyze the auditor choices for a sample of 2,333 predominantly small and mid-sized Finnish firms. In general, the methodology employed in all auditor choice studies implicitly assumes that ‘differences’ in demand for audit quality exist and can be inferred by observing the outcome ‘who audits whom’. While all audits are assumed to meet the legal minimum, this stream of research

focuses on audit quality above and beyond the legal minimum. Accordingly, the empirical findings in Knechel *et al.* (2008) suggest that the benefits of the audits are sensitive to different segments of the market for audit services. More specifically, they model the likelihood of client firm to choose from four types of audit firms: first tier international firms (Big-4), first tier national firms, second tier local auditors and non-certified auditors. They find evidence that in the lower end of the audit market the need for a higher quality auditor is driven mainly by client complexity. This finding suggests that there may be a lack of competence in accounting related issues among managers of smaller private companies which induce them to seek access to expert advice from high quality auditor in order to improve e.g. the effectiveness of internal operations. In the segment of mid-size companies the higher-quality auditor selection is affected by their debt levels, while in the upper end of the audit market, among the largest companies, listing status (public/non-public) and clients' need for external finance are the main reasons for selecting a higher quality auditor.

## **2.3 Audit pricing and auditor switching**

### **2.3.1 Audit pricing**

In his seminal work, Simunic (1980) describes the auditor's risk and consequent audit fee as follows:

$$E(C) = cq + E(d)E(l), \quad (1)$$

where  $E(C)$  is the auditor's expected total cost,  $c$  is the per unit factor cost of external audit resources;  $q$  is the quantity of resources expended by the auditor in performing the audit;  $E(d)$  is the expected present value of possible litigation costs or other losses (e.g. loss of reputation) possibly due to this period's audited financial statements, while  $E(l)$  denotes the likelihood that such losses are actually realized from this period's audited financial statements. An auditor's expected cost function thus consists of a conventional resource cost component  $cq$  and a liability loss component  $E(d)E(l)$ . Obviously,  $E(d)E(l)$  is decreasing with  $cq$ .

A potential conflict of interests always exists between the auditors and the insiders of the enterprise under audit. Potential conflict arises because insiders might want to present the company in the best possible light, while auditors must provide a reasonable assurance that the information about the company's financial

condition is presented fairly. According to the model, auditors are expected to respond to the higher probability of any irregularities or accounting misstatements by increasing audit effort (and billing rate) which ultimately leads to higher fees. Moreover, auditor must incorporate expected losses into the audit fee because the audit fee cannot be adjusted retrospectively. An important notion though is that auditors are not held responsible for detecting *all* fraud and misstatements in the accounts. It is enough for auditors to demonstrate that they followed applicable Generally Accepted Accounting Principles (GAAS) and performed their audits with due professional care.

Since Simunic's (1980) paper, numerous published studies have investigated firm-specific factors affecting audit fees. Some studies test Simunic's model by analyzing data from different time periods and industries, while others investigate the firm-specific determinants of the audit fee in different countries and institutional environments (e.g. Chung & Lindsay 1988, Craswell *et al.* 1995, Hay *et al.* 2006). The results of these studies support the view that the audit fee increases as the litigation risk associated with the client firm increases.

### **2.3.2 Auditor switching**

Audit literature has identified several reasons for auditor realignments, including cost savings resulting from audit fee reductions, changes in management, a need for additional services or better expertise, takeovers and poor working chemistry (e.g. Carpenter & Strawser 1971, Bedingfield & Loeb 1974, Beattie & Fearnley 1995, Addams *et al.* 1996). Other studies have reported that the changes in firm characteristics, financial distress and a need to receive unqualified audit opinion ("opinion shopping") are reasons for switching auditors (e.g., Healy & Lys 1986, Simunic & Stein 1987, Schwartz & Menon 1985, Chow & Rice 1982, Craswell 1988). Johnson & Lys (1990) suggest that client firms tend to purchase auditing services from the least cost supplier (at given level of perceived audit quality). Thus audit firms have to tailor their services to ensure a competitive supply of auditing services for their clientele. A common finding in this literature is that from the firms' perspective the cost savings resulting from audit fee reductions are among the main reasons for auditor realignments. For instance, Beattie and Fearnley (1995) report that 66 percent of the listed UK companies considering changing their auditor state that the level of the current audit fee is the reason for this consideration. However, it should be noted that in the wake of recent accounting scandals that considerably increased the focus on corporate

governance including auditing, the determinants of auditor switches and their relative importance might be altered.

## **2.4 Nonaudit services and audit quality**

The cornerstone of the audit function is auditor independence. Numbers of financial statements are meaningless unless they faithfully represent actual transactions, assets and liabilities of the entity. One of the most researched issues in accounting over recent years has been the effect of nonaudit services (NAS) on auditor (perceived) independence (e.g. Frankel *et al.* 2002, DeFond *et al.* 2002, Ashbaugh *et al.* 2003, Chung & Kallapur 2003, Francis & Ke 2006). Opponents of auditor-provided nonaudit services argue that an audit firm's economic dependence on the client could undermine independence and reduce the auditor's willingness to resist client-induced biases in reported financial disclosures (e.g. Levitt 2000). On the other hand, proponents of auditor-provided nonaudit services argue that performing nonaudit tasks may facilitate exposure to relevant information and hence improve audit quality via knowledge spillovers (e.g., Arruñada 1999, Copeland 2000).

Prior research has attempted to reconcile these two disparate views by investigating the relationship between NAS and different proxies for earnings quality (or the auditor's propensity to issue going-concern audit opinions) (e.g. Frankel *et al.* 2002, DeFond *et al.* 2002, Ashbaugh *et al.* 2003, Chung & Kallapur 2003). Specifically, this stream of research has attempted to assess the linkage, if any, between the auditor–client economic bond and actual impairment of auditor independence. Although Frankel *et al.* (2002) report that nonaudit fees are positively associated with the magnitude of discretionary accruals and the likelihood of reporting a small earnings surprise, later studies using different research designs suggest that there is no statistically significant association between nonaudit fees and different proxies for audit quality (e.g. Ashbaugh *et al.* 2003, Chung & Kallapur 2003). Moreover, the results in Frankel *et al.* (2002) have been found to be sensitive to sample selection and model specification (e.g. Larker & Richardson 2004). Francis (2006) concludes that the research on NAS and auditor independence shows no “smoking gun” evidence linking the provision of nonaudit services with audit failures.

However, as noted by Levitt (2000): “It is not enough that the accountant on an engagement act independently. For investors to have confidence in the quality of the audit, the public must perceive the accountant as independent.” In other



words, an auditing environment where the public has faith in the auditing product requires both actual and perceived independence. This was also the assumption made by regulators in passing the Sarbanes Oxley Act 2002 in the U.S. (US Congress 2002). Consistent with the regulators view, recent empirical research has provided consistent evidence suggesting that the perception of an auditor independence problem might be just as severe as the factual impairment of independence. For instance, according to the Brand Finance plc survey of analysts and representatives of companies listed on the London Stock Exchange, 94% of analysts believe that significant nonaudit fees are likely to compromise audit independence. Furthermore, 83 percent of analysts believe that “objectivity is threatened even when the nonaudit fee is less than the audit fee” (SEC 2001). In another study, Khurana & Raman (2006) use the client-specific ex ante cost of equity capital as a proxy for investor perceptions of financial reporting credibility and find that both nonaudit and total fees are perceived negatively by investors (i.e. significantly positively associated with increases in the ex ante cost of equity capital). Moreover, Krishnan *et al.* (2005) and Francis & Ke (2006) both report that U.S. firms with higher levels of NAS fees have significantly lower earning response coefficients. Finally, Eilifsen & Knivsflå (2008) use Norwegian data and report that annual stock market returns are less responsive to reported earnings when auditor’s provision of nonaudit services to the reporting firm is relative high. They attribute the finding to investors’ negatively perceiving the audit quality when the incumbent auditor provides also substantial nonaudit services.

Given that the increases in economic bonding may jeopardize the appearance of independence, having potential adverse consequences, it may also affect the client firms’ willingness to purchase NAS. In order to avoid potential adverse consequences client firms might have incentives to protect (also) the perceived integrity of the audit process. Consistent with this view, Parkash & Venable (1993), use U.S. data to report that client firms recognize the potential for independence impairment and voluntarily manage the amount of recurring nonaudit services purchased. Furthermore, Firth (1997) uses U.K. data and finds evidence that companies with high agency costs restrict the joint provision of audit and nonaudit services.

## **2.5 Audit partner-level product differentiation**

Prior audit research literature is dominated by firm-wide analyses treating the whole accounting firm as the focal point and investigating whether and how audit

firm characteristics such as size and industry specialization at national firm-level affect the auditor-client relationship (e.g., Simunic & Stein 1987, Becker *et al.* 1998, Francis & Krishnan 1999). All these studies implicitly assume that through standardized firm-wide policies and knowledge sharing (e.g., training materials, industry-specific databases, internal benchmarks for best practices, audit system programs, and audit assignment structures) all audits across practice offices and audit partners within an audit firm (and within same tier audit firms) are uniform. However, in practice, it is the individual audit partners from city-level practice offices who are creating and taking care of the relationship, contracting with the client, administering the audit engagement, directing the audit effort, interpreting the audit evidence, and finally issuing the appropriate audit report (Francis *et al.* 1999). The multilevel organization structure begs for questions: “what is an accounting firm”, “how do clients’ perceive audit firm”, “what is the engagement partner’s role in auditing” and, in particular, “is the audit partner expertise transferable to other partners and offices across the audit firm?”

There are at least four arguments why there may be partner-level differentiation in auditing product and consequent fees. First, prior research already reports that audit reputations and pricing of audit engagements vary between audit offices suggesting that the reputations and expertise of auditors may at least to some extent reside on individual auditors working in the city-level audit offices (e.g., Ferguson *et al.* 2003, Francis *et al.* 2005, Basioudis & Francis 2007, Choi *et al.* 2007, Francis & Yu 2009). While the results in these studies strongly suggest that the audit product is differentiated between local audit practice offices, they also raise a question whether the product differentiation reaches the partner-level. In some countries (e.g., currently Sweden Malaysia, Finland and Australia), each audit report discloses the name of the audit engagement partner. Thus, information on the identity of the audit partner in charge is observable to the financial statement users, and thereby potentially affects the market-assessed perception of *ex ante* audit quality (and pricing). In city-level audit markets, auditor reputation may personify into one or two well recognized partners whose clients constitute a major share of the office-level revenues. Hence, part of the auditor’s expertise and reputation may be uniquely held by individual partners through their deep personal knowledge of local clients, and this cannot be fully captured and distributed across other partners and clients within an audit firm (or office).

At least Swedish Code for Corporate Governance has taken the view that the information on engagement partner characteristics is relevant for financial

statement users in assessing the competence and independence of auditing. Specifically, the Code requires that the information on *'the audit services performed by the auditor or the auditor in charge in other large companies...and other information that may be important to shareholders in assessing the competence and independence of the auditor; or auditor in charge must be disclosed in corporate governance report on company's homepage'* (Proposal for Swedish Code for Corporate Governance Section 2.4.1, Original Code Sections 2.3.2 and 2.3.3). Corresponding rules – and even more far-reaching – about disclosure of information pertinent to the independence of the company's statutory auditors are contained in the modernized 8th EU company directive, which will be implemented in Swedish law within short as well as in other member states. The new EU directive will also oblige the disclosure of individual auditor(s) behind the engagement. Specifically, Article 28 of the directive 2006/43/EC states: *'Where an audit firm carries out the statutory audit, the audit report shall be signed by at least the statutory auditor(s) carrying out the statutory audit on behalf of the audit firm.'* Thus, the information on the individual auditors responsible for the engagement will be soon observable to the audit market in whole European Union after member states have implemented the directive in their respective laws.

Second, Carpenter *et al.* (1994: 374) argue that since audits can never be wholly commodified, local audit partners have the power to make decisions on audit engagement level. Third, even if we assume that the pricing is entirely a firm-level decision it would not necessarily produce uniform pricing. Specifically, given that there are individual auditors with differing reputations and levels of expertise, these characteristics could be implicitly reflected in the budgeted audit hours, billing rates, and consequent fees, as prepared by the bidding department. Finally, after the initial year of the engagement, the audit partner in charge is likely to have the deepest knowledge of the audit client including the level of its inherent risk. Consequently, the engagement partner's influence in budgeting audit hours and determining consequent audit fees likely increases after the initial audit year. However, if the budgeted audit hours were overestimated in the accepted bid and holding every other fee determinant constant, it is unlikely that the fees would decrease in the second auditing year. In such a situation, the audit firm is expected to hold audit fees fixed and harvest profits by charging high prices that capitalize on an existing customer relationship. On the other hand, if the budgeted audit hours were underestimated in the initial audit engagement and it is not sufficiently compensated by the production efficiencies gained through

client-specific experience during initial audit year, it is likely that audit fees will increase in the second year of the audit engagement.

This dissertation theme is similar to the one in Niemi (2004). Specifically, using data on hourly billing rates from small Finnish audit firms (sole practitioners or very small partnerships), Niemi (2004) reports evidence that auditor size is also positively associated with audit pricing among small audit firms. He interprets the finding to be consistent with the view that some of these firms have been able to establish a reputation higher than the generic reputation (i.e. higher than the minimum level required by professional standards). In a similar vein to Niemi (2004), the first essay of this dissertation attempts to examine whether there exist reputational differences among individual auditors *within* the group of large Big-4 auditors (Big-4 audit firm/office).

### 3 Summary of articles

#### 3.1 Essay 1: Audit Partner Specialization, Audit Fees, and Auditor-Client Alignments

The first essay contributes to the recent line of audit research by pushing the local analysis one step further. Specifically, the use of Swedish data makes it possible to construct individual audit partner ‘clienteles’, because, in Sweden, each audit report discloses the name of the audit engagement partner. Thus, information on the identity of the audit partner in charge is observable to the financial statement users, and thereby potentially affects the market-assessed perception of *ex ante* audit quality.

In this study, I am able to utilize information on the sizes and compositions of the *complete* Big-4 audit partner-specific client portfolios. Analysis of this unique data provides an interesting opportunity to contribute to a more thorough understanding of an auditor’s specialization, the engagement partner’s role in the audit and, in particular, whether the perceived audit quality is affected not only by the brand-name of the firm, but by the characteristics and reputation of the engagement partner.

The main empirical findings can be summarized as follows. First, the empirical findings indicate systematic differences between audit partner clienteles, suggesting audit partner specialization in different industries and in different size groups. This finding is consistent with Liu & Simunic (2005), who argue that auditor specialization could be a competitive response either by an audit firm or an individual audit partner to induce efficient audits for different types of clients, thereby gaining a limited monopoly over the clients in which they specialize. Second, consistent with a view that there are returns on investing in specialization, analyses of audit fees indicate that both audit partner industry specialization and specialization in large public companies are recognized and valued by financial statements users and/or by corporate insiders, resulting in higher fees within these engagements. Third, audit clients and audit partners are aligned in a way that is consistent with the predictions of agency theory. Specifically, higher levels of agency cost proxies are significantly positively related to all four variables used to proxy for an individual auditor’s expertise: industry specialization, size of the partner-specific overall client portfolio, specialization in publicly listed companies, and expertise gained from prior audit experience. While it is well

recognized that firms with greater monitoring needs due to higher agency costs are more likely to use audit firms that are perceived to be of higher quality, such as large Big 4 auditors or industry specialist auditors (see, for instance, Francis & Wilson 1988, DeFond 1992, Francis *et al.* 1999), the empirical results of this study suggest that agency theory can also be applied to explain auditor-client alignments *within* audit firms and local offices.

### **3.2 Essay 2: The Entrenchment Problem, Corporate Governance Mechanisms and Firm Value**

Prior literature documents that entrenchment of the controlling shareholders results in equity discounts (e.g., Morck *et al.* 1988, La Porta *et al.* 1999, Claessens *et al.* 2002, Cronqvist & Nilsson 2003, Masulis *et al.* 2008). The purpose of the second essay is to examine the effectiveness of two main corporate governance mechanisms, i.e. board of directors and auditing, in reducing outside investors' fear of expropriation. The main empirical findings can be summarized as follows. First, the results suggest that board members' monitoring incentives and presence of strong minority owner are significantly positively associated with the likelihood that the firm employs joint audit. This finding indicates that the board and strong minority owners exercise their influence by demanding a stringer monitoring in the form of appointing more than one audit firm. Second, our results show that appointment of higher quality auditors mitigates equity discounts due to the entrenchment problem. Specifically, while we document significant equity discounts for both clients of non-Big-4 auditors (the largest discount) and Big-4 auditors (second largest discount), we do *not* find a statistically significant discount for firms employing joint audits. These findings suggest a more complex ordering of audit quality, as compared with what one sees under the traditional single auditor approach. Third, we find that both the stock market valuation of free cash flow and the dividend payout ratio of a firm increase with major shareholders and board members ownership of cash flow rights. These results indicate that when corporate insider incentives are better aligned with those of outside shareholders, the funds of a firm are more likely to be distributed as dividends to shareholders than (over-)invested in projects with less-than-zero present value. The monitoring incentives of the board of directors appear to play a key governance role. Specifically, we find that boards where board members have invested their personal wealth in the firm demand more stringent auditing, claim higher dividends and thereby limit the agency problem

of free cash flow. In light of these results, it appears crucial to require that those in the heart of monitoring function (board members) have the same goal as those paying for that monitoring (shareholders).

### **3.3 Essay 3: Propensity to Switch Auditors and Strictness of Legal Liability Environment: The Role of Audit Misspricing.**

The third essay investigates if firms paying relatively high audit fees are more likely to switch auditors. Moreover, this study examines whether legal liability environment affects the propensity to switch auditors due to audit fee under or/and overpricing. The results suggest that there are switching costs (e.g. Klemperer 1995) for a firm when it decides to switch auditors and the level of these costs is dependent on the legal liability environment. Since firms tend to purchase given level of audit quality from the least-cost supplier, an auditor switch occurs if the reduction in the audit fee due to the auditor switch exceeds the switching costs.

The main findings of the empirical analyses of the Compustat Global Vantage data from 10 countries from 1994 to 2003 can be summarized as follows. First, the results show that both the level of audit fees and the ratio of audit fees to sales are positively related to the stringency of the legal environment of the country. Second, the results support the view that firms paying relatively higher audit fees are more likely to switch auditors. The results show that a greater degree of audit fee under-pricing is required to cause an auditor switch in countries with a stringent legal environment as opposed to countries with a lax legal environment. Overall, these results of the third essay suggest that the switching costs are higher in strict legal liability environment.

### **3.4 Essay 4: Do Client Firms Manage the Perception of Auditor Independence? Evidence from the Nonaudit Service Market.**

The fourth and final investigates whether agency theory explains the provision of non-audit services. Since NAS are not a mandatory requirement, the client retains discretion on purchase and choice of supplier. Auditor independence, or the appearance of such independence, may be at risk if the client faces high agency costs and if the auditor has a strong economic bond with the client. Accordingly, it is hypothesized that client firms facing high agency costs may have incentives to protect the perceived auditor independence by restricting the joint provision of

nonaudit and audit services. The empirical findings documented in this essay are consistent with this view. Specifically, the results indicate that higher levels of agency cost proxies are significantly negatively related to both absolute and relative nonaudit fees. I further find that higher levels of agency cost proxies are also significantly positively related to the level of outside consulting purchased from non-incumbent auditors. Together these results strongly support the view that client firms with agency problems are protecting the appearance of their auditor's independence. The results of this essay add to the growing number of audit studies investigating investors' perception of nonaudit services (e.g., Krishnan *et al.* 2005, Francis & Ke 2006, Khurana & Raman 2006, Eilifsen & Knivsflå 2008). Specifically, while these studies all report that investors perceive the auditors' provision of nonaudit services as potentially impairing auditor independence, the results documented in this essay suggest that client firms with expected agency conflicts take proactive ways to safeguard the perceived integrity of the audit process.



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## Original essays

- I Zerni M (2009) Audit Partner Specialization, Audit Fees, and Auditor-Client Alignments. Manuscript.
- II Kallunki J-P & Nilsson H & Zerni M (2009) The Entrenchment Problem, Corporate Governance Mechanisms and Firm Value. Manuscript.
- III Kallunki J-P & Sahlström P & Zerni M (2008) Propensity to Switch Auditors and Strictness of Legal Liability Environment: The Role of Audit Misspricing. *International Journal of Auditing* 11(3): 165–185.
- IV Zerni M (2008) Do Client Firms Manage the Perception of Auditor Independence? Evidence from the Nonaudit Service Market. Manuscript.

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Original publications are not included in the electronic version of the dissertation.





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ISBN 978-951-42-9291-0 (Paperback)

ISBN 978-951-42-9292-7 (PDF)

ISSN 1455-2647 (Print)

ISSN 1796-2269 (Online)

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