

“Do as I Say, Not as I Do”: Audit Firm Leadership
and Engagement-Level Risk

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ABSTRACT

This study examines the “off-the-job” behavior of individuals in office-level leadership positions across the Big 4 audit firms in the U.S. In their leadership role, the managing partner is responsible for setting the tone at the top of an office through formal communication of firm-wide policies and an informal example through their behavior and preferences. Given this role, I predict that engagements conducted within offices led by individuals who are willing to break the rules will exhibit characteristics synonymous with increased audit risks. Relying on their history of legal infractions to identify rule-breaking behavior, I find managing partners with prior infractions are associated with engagements that reflect increased misstatement risk and detection risk (i.e., lower auditor effort). Additional tests reveal that the results are concentrated in offices that are located further away from alternative governance mechanisms within the same audit firm. Importantly, after controlling for the risk of misstatement, I find the pricing of misstatement risk declines significantly on engagements in offices with infraction managing partners. The results are robust to alternative measures of managing partners’ prior infractions and the use of entropy balancing techniques, along with several other robustness tests. Collectively, my study contributes to our limited knowledge of the quality control structures in place at large audit firms and provides a potential mechanism for tone at the Big 4 audit firms to vary across offices.

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GENERAL AUDIENCE ABSTRACT

In their leadership role, office managing partners are the “top executive” appointed to lead the Big 4 audit offices across the U.S. While audit firms have reputation and litigation incentives to provide high quality audits, these incentives do not necessarily apply to individual auditors. Therefore, audit firms are required to formalize a system of quality controls—including leadership and tone at the top—to ensure promote professional skepticism, stress quality service, and reduce overall audit risk on engagements. Relatedly, during inspections, the PCAOB examines whether the actions and communications by managing partners in local leadership positions demonstrate a commitment to audit quality and compliance with applicable regulations and professional standards.

Grounded in revealed preference theory, I rely on a managing partner’s history of legal infractions to identify offices led by partners with impulsive, risk-taking, and present-oriented personalities. Criminology and psychology research empirically validate the cross-situational consistency of individual behavior and decisions over time and in different settings. In other words, individuals who commit legal infractions—including less severe traffic violations such as parking tickets—exhibit a preference or propensity to break the rules. To the extent that an individual’s leadership style is influenced by their personal ethics, values, and attitudes, I expect variation in a managing partner’s history of legal infraction to reflect variation in their leadership style and office tone towards audit risk on engagements.

Consistent with this prediction, I find managing partners with prior infractions are associated with engagements that reflect increased misstatement risk and detection risk (i.e., lower auditor effort). Additional tests reveal that the results are concentrated in offices that are located further away from alternative governance mechanisms within the same audit firm. Importantly, after controlling for the risk of misstatement, I find the pricing of misstatement risk declines significantly on engagements in offices with infraction managing partners. The results are robust to alternative measures of managing partners’ prior infractions and the use of entropy balancing techniques, along with several other robustness tests. Collectively, my study contributes to our limited knowledge of the quality control structures in place at large audit firms and provides a potential mechanism for tone at the Big 4 audit firms to vary across offices.

DEDICATION

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CHAPTER 1: INTRODUCTION

This study examines whether managing partners' rule-breaking behavior reflect variation in office tone associated with an increase in engagement-level audit risk. While audit firms have reputation and litigation incentives to provide high quality audits, these incentives do not necessarily apply to individual auditors. Therefore, audit firms are required to formalize a system of quality controls—including leadership and tone at the top—to ensure auditors comply with professional and firm standards. Although not included as a separate quality control element, practitioners and regulators emphasize leadership and tone at the top to be “crucial aspects” of the control framework within which all auditors and other quality control elements operate (PCAOB 2019, 14).¹ Often referred to more broadly as culture, the tone set by leadership is intended to exercise behavioral control over rank-and-file employees (Guiso et al. 2015; Jenkins et al. 2008; Schein 1985). Unique to auditing, organizational climate and culture are particularly important because of the unique tension among being a regulated profession, a for-profit organization, and performing independent audits on behalf of the public interest (Alberti et al. 2020; Andiola et al. 2020). Therefore, regulators require individuals in audit firm leadership positions set a tone that promotes professional skepticism, stress quality service, and reduce overall audit risk on engagements (AICPA 2021; Jenkins et al. 2008; PCAOB 2019).²

¹ The PCAOB proposed an updated standard on quality controls in 2019 that explicitly include leadership and governance as a separate control element. Recent comments from academics on this proposal highlight the need to address additional details about individuals in leadership roles including their ethics, values, and attitudes (Brown et al. 2020).

² The PCAOB defines audit risk in AS 1101.04 as “the risk that the auditor expresses an unqualified audit opinion when the financial statements are materially misstated” (PCAOB 2010). More generally, audit risk is a function of a client's inherent risk and control risk, along with the auditor's detection risk. Inherent risk and control risk capture characteristics of the client while detection risk is a function of the audit process and is within the auditor's control (Hogan and Wilkins 2008; PCAOB 2010).

In their leadership role, office managing partners are the “top executive” appointed to lead the Big 4 audit offices across the U.S. (Mowchan 2016). Prior research highlights how the Big 4 are decentralized organizations with autonomy and decision-making dispersed throughout their offices (Beck et al. 2019a; Francis and Yu 2009; Reynolds and Francis 2000). Therefore, the managing partner is responsible for communicating and enforcing firm policies at the office-level where engagements are conducted. In addition, they play a large role in personnel management (Mowchan 2016) and allocating firm resources to engagements (Dodgson et al. 2020). Collectively, managing partners are responsible for setting the tone at the top of an office to “get it right” (Conway 2020, 77) through formal communication of firm-wide policies and informally through the example set by their behaviors and preferences (TAC 2007). Relatedly, during inspections, the PCAOB examines whether the actions and communications by managing partners in local leadership positions “demonstrate a commitment to audit quality and compliance with applicable regulations and professional standards” (Aobdia 2020, 2885).

Grounded in revealed preference theory, I rely on a managing partner’s history of legal infractions to identify offices led by partners with impulsive, risk-taking, and present-oriented personalities (e.g., Davidson et al. 2015, 2020; Pittman et al. 2022; Wright et al. 2004).^{3,4} Criminology and psychology research empirically validate the cross-situational consistency of individual behavior and decisions over time and in different settings (e.g., Dohmen et al. 2011; Ehrlich 1973).⁵ In other words, individuals who commit legal

³ Revealed preference theory refers to using observable actions or choice behavior to infer an individual’s preferences and characteristics (Hanlon et al. 2021; Mas-Colell et al. 1995).

⁴ For a detailed review of the literature on managers’ off-the-job behavior, refer to Ge and Moon (2021).

⁵ For example, Dohmen et al. (2011) report evidence that an individual’s traffic behavior and infractions are correlated with their willingness to accept risk in their careers.

infractions—including less severe traffic violations such as parking tickets—exhibit a preference or propensity to break the rules. To the extent that an individual's leadership style is influenced by their personal ethics, values, and attitudes (Bertrand and Schoar 2003), I expect variation in a managing partner's history of legal infraction to reflect variation in their leadership style and office tone.

Consistent with leadership and tone at the top varying across audit offices, Francis and Michas (2013) find an audit failure on one engagement can be indicative of underlying, pervasive issues across other engagements within the same office. In addition, the audit process is comprised of non-standardized, complex tasks that require subjective judgments and decision-making under uncertainty (Bonner 2008). Auditors must implement a risk-based strategy during the audit such that there always remains a residual amount of audit risk and unknown level of assurance (Causholli and Knechel 2012). Therefore, the inherent subjectivity and discretion during the audit process is likely to underscore the importance of managing partners and their revealed preferences and attitudes towards risk.

Indeed, well-known audit failures such as Enron and the response from the Houston engagement office provide a compelling anecdote of how local office leadership can promote dysfunctional behavior on audit engagements (Batson et al. 2003; Jenkins et al. 2008). Interviews with partners within the Houston office suggest the Houston managing partner was able to convince them to ignore any conflicting advice from the national office, suggesting tone at the top may be more salient at the office-level (Chaney and Philipich 2002; Krishnan 2005). Despite the implied link, there is a paucity of publicly disclosed information on individuals in leadership positions at the large audit firms and how their

characteristics may vary across the audit firm to influence auditors on engagements (Aobdia 2020; Lennox and Wu 2018).

In addition to limited empirical evidence, several factors unique to the audit setting suggest managing partners with prior infractions may not capture variation in office tone or that variation in tone may not be associated with engagement-level audit risk. First, a managing partner's behavior outside of work may be unrelated to his/her workplace attitude or job performance given that inferences from criminology and behavioral economics are primarily drawn from the broader population; thus, these findings may not generalize to executives who undergo a socialization process as they are promoted within the firm (Hambrick and Mason 1984; Hanlon et al. 2021). Next, the managing partner might be more ceremonial or short-term in nature such that variation in their behavior and preferences may not manifest in a different office tone.⁶ Further, auditors are governed by professional standards and code of conduct such that they may not be susceptible to any underlying variation in leadership or office tone. Finally, the Big 4 firms have robust, multi-layered quality control systems that are inspected and intended to reduce heterogeneity in the production of audit services at the engagement-level (Andiola et al. 2020; Beck et al. 2019a; Pittman et al. 2022). Therefore, it remains an empirical question whether managing partners with prior infractions reflect variation in office tone associated with increased audit risk on engagements.

To overcome data limitations, I hand-collect the identity of managing partners appointed to lead the Big 4 audit offices in the U.S. from public audit firm announcements

⁶ For example, interview evidence from the Financial Reporting Council's thematic review of audit culture suggests auditors at large accounting firms consider that all leaders within the audit firm are "visibly living and demonstrating the firm's core values" (FRC 2018, 8).

and press releases.⁷ Once their identities are known, I collect additional information on their employment history and all available personal characteristics. I use LexisNexis “People Search” to match 97% (601/618) of the original managing partners from which I can find their identity. My final sample covers 81.8% (3,364/4,113) of the active Big 4 office-years from Audit Analytics for my sample period.⁸ The LexisNexis online public records database provides comprehensive information on individuals in the U.S. and is used extensively in academic research on finance executives and mutual fund managers (e.g., Ahern 2017; Bai et al. 2019; Yonker 2017). Through LexisNexis, I collect additional background information on each managing partner including their gender, date of birth, and history of legal infractions.

I develop a measure of managing partner’s rule-breaking behavior based on the presence of prior legal infractions. Descriptively, my data reveal that 33% (200/601) of managing partners exhibit a preference to break the rules. This is consistent with the majority of office leaders being generally conservative, risk-averse individuals who self-select into accounting and tend to become more conservative during their experience in public accounting (Brief 1975; Hoitash et al. 2016; Trotman et al. 2009). Similarly, 92% (383/415) of the infractions relate to traffic violations with the exception of 14 managing partners with 19 more egregious crimes such as obstruction of justice, prostitution, and driving under the influence. The presence of even a small number of severe infractions is

⁷ Restricting my sample to Big 4 audit firms provides at least two advantages. First, the roles and responsibilities of leaders can vary across audit firms, and smaller firms are more likely to require individuals in leadership positions to “wear many hats.” By focusing on office managing partners within audit firms of similar size, I am in a better position to make meaningful comparisons across individuals within these roles. Second, focusing on the Big 4 audit firms alleviates some concern that my results are driven by systematic differences in the client composition across different sized audit firms (Lawrence et al. 2011).

⁸ Coverage increases to 96% (2,040/2,115) of the active Big 4 office-years from Audit Analytics when I limit the sample to more recent periods (i.e., fiscal years 2011 through 2019).

surprising and highlights the lack of empirical evidence on partner promotions (Lennox and Wu 2018) and informal monitoring within the large audit firms.⁹

In my main analysis, I examine whether managing partners with prior infractions are associated with an increase in engagement-level audit risk as measured by the risk of misstatement and detection risk. First, I operationalize three different versions of the F-score which provide a “signal of the likelihood of earnings management or misstatement” (Dechow et al. 2011, 18). An advantage of the F-score is that it represents the risk trade-off for auditors inherent to the audit model (Dechow et al. 2011).¹⁰ Across all three measures, I find a positive and statistically significant association between managing partners with prior infractions and the risk of misstatement at the engagement-level. Next, I separately analyze the level of detection risk on engagements using audit fees as a proxy for auditor effort (e.g., Aobdia 2019; Lobo and Zhao 2013). If managing partners with prior infractions reflect variation in office tone and auditor fortitude to get it right, I predict overall auditor effort to be lower on engagements in their offices.¹¹ In addition, partners in offices led by managing partners with prior infractions may be more susceptible to client incentives (i.e., client retention) to lower overall effort on engagements and increase profitability in the short-term without raising fees. Consistent with these predictions, I find

⁹ Anecdotal evidence from a conversation with a Big 4 managing partner indicates the audit firms do not have a formal background check process after auditors are admitted to the partnership. Instead, audit firms rely on self-disclosure and monitoring by state licensing boards. This information suggests there is no formal mechanism in place to monitor off-the-job behaviors of individuals promoted to leadership positions.

¹⁰ Dechow et al. (2011) provides insights into an auditor’s general risk trade-off during the audit between Type I and Type II errors considering their costs are likely to vary considerably. For example, a non-misstating firm suspected by the auditor to be a misstating firm (Type I error) could cost the auditor the loss of the client and their subsequent audit fees. However, as shown by prior research, when a misstating firm goes undetected and is then revealed (Type II error) the audit firm can be sued by investors and/or sanctioned by regulatory bodies (Dechow et al. 2011).

¹¹ For example, auditors conducting engagements in offices led by managing partners with prior infractions may be more willing to accept higher levels of detection risk and subsequently fail to, or inadequately adjust the nature, timing, or extent of their audit procedures in response to changes in client risk.

engagements in offices with infraction managing partners are associated with 3.7% lower audit fees on average relative to engagements in offices with non-infraction managing partners.

I extend my main analyses by performing two cross-sectional tests to examine the role of alternative governance mechanisms on the relationship between managing partner infractions and engagement-level audit risk. Recent research documents that an office's geographic proximity to the national office is associated with superior monitoring (Amin et al. 2021; Chen and Choudhary 2021). Consistent with this research, I find that my results are concentrated in offices further away from the audit firm's national office. Similarly, research suggests larger offices engender higher audit quality (Francis and Yu 2009) and more monitoring amongst audit partners (Beck et al. 2019a).¹² Therefore, I drop large offices in my sample and find my results are concentrated in smaller offices that are located further away from a large office. Collectively, this cross-sectional evidence is consistent with the managing partner being an important component of an audit firm's multi-layered quality control structure to reduce audit risk.

Next, I conduct additional analysis to isolate the pricing of misstatement risk on engagements. Controlling for the client's risk of misstatement following prior research (e.g., Amir et al. 2014; Beck et al. 2019a), my results indicate that the sensitivity of audit fees to client misstatement risk decreases by nearly 29% for engagements in offices led by infraction managing partners. In other words, auditors working in these offices charge their clients a smaller fee per unit of misstatement risk relative to other offices without managing

¹² For example, some offices may have the lead engagement partners report to an audit market leader that sits within the same office (Beck et al. 2019a). This market leader provides an additional layer of quality controls likely to mitigate the influence of the managing partner on auditor behavior.

partners that exhibit risky off-the-job behavior. I interpret this result as consistent with rule-breaking managing partners and office tone weakening firm controls over the pricing of misstatement risk on engagements.

I perform several robustness tests such as entropy balancing techniques and alternative measures of managing partners' prior infractions. I also exploit the PCAOB's mandatory disclosure of the lead engagement partner towards the later part of my sample (PCAOB 2015). Using this limited sample, I find that offices with infraction managing partners are positively correlated with lead engagement partners that also exhibit risky off-the-job behavior. Moreover, for the 714 lead engagement partners assigned during the sample period, infraction managing partners assign 36% (70/193) compared to managing partners without infractions assigning only 21% (112/521) suggesting that they assign or attract more partners with similar risky off-the-job behavior to public client engagements. Given the findings in Pittman et al. (2022) that lead engagement partners with prior infractions are associated with lower audit quality, it is possible my results are driven by the behavior and risk preferences of the engagement partner alone.¹³ Therefore, I drop engagements in which the lead engagement partner has a prior infraction and find that my core evidence continues to hold.

My study contributes to extant literature on the organizational structure of audit firms and has several practical and regulator implications. The evidence in this study adds to our limited understanding of an audit firm's quality control system (Aobdia 2020; Francis 2011; Lennox and Pittman 2010). To date, research on the variation in the

¹³ Importantly, Pittman et al. (2022) find the relationship between audit partners with prior infractions and audit quality is concentrated at smaller, non-Big 4 audit firms suggesting the influence of their behavior may be constrained by more robust quality controls (i.e., such as the managing partner) at the Big 4 audit firms.

production of audit services at the firm- and office-level focuses on immutable or difficult to alter characteristics such as larger audit firms' reputation or litigation costs (Francis 2011). The variation in office-level leadership and tone set across the audit firm is separate from client-based characteristics (such as the size of an office based on audit fees). Therefore, this study should be of interest to audit firms as they consider practical implications when appointing firm leadership to local offices across the U.S. For example, audit firms may wish to consider using background checks when promoting individuals to office-leadership positions similar to boards of directors who conduct routine background checks on potential executive candidates to discern individuals that exhibit risk-seeking behavior (Bower 2020).

My findings should also be of interest to regulators as they consider updates to the quality control standards in the U.S. (PCAOB 2019). In particular, my study provides one potential explanation for the contagion effect across the quality of audit services within the same office documented by Francis and Michas (2013). In addition, my results provide empirical support to recent comments from academics to explicitly address characteristics of those charged with governance in the PCAOB's proposed quality control standards (Brown et al. 2020). Existing research on the audit risk model and auditors' responses has typically focused on client characteristics such as their reporting complexity (Hoitash and Hoitash 2018) or control deficiencies (Hogan and Wilkins 2008; Hoitash et al. 2008). These studies largely ignore the quality controls within audit offices—including the managing partner—intended to safeguard against audit risk. My collective results provide a potential indicator for offices led by managing partners that fail to exhibit a fortitude, or attitude, to

get it right and reduce audit risk across engagements and weaken the application of audit firm quality controls.

CHAPTER 2: PRIOR LITERATURE AND HYPOTHESES DEVELOPMENT

Audit Firm Quality Controls

Auditors face choices and ethical dilemmas that cannot be regulated ex ante (Guiso et al. 2015; Kreps 1989; O'Reilly 1989). Despite their important role in protecting the public interest, auditors themselves are not constrained by the same reputation and litigation mechanisms as audit firms (Andiola et al. 2020; Aobdia 2020; Jenkins et al. 2008). Moreover, evidence suggests the performance evaluation system within audit firms are subjective and can encourage potentially problematic auditor behavior on engagements. For example, it may discourage auditor skepticism during field work when additional effort does not reveal a misstatement (Brazel et al. 2016). In addition, an audit firms' evaluation system and compensation structure may inadvertently encourage partners to exert less effort (i.e., shirk) on providing high-quality audit services, which can be difficult to observe, in order to focus on building new and maintaining existing client relationships (Lennox and Wu 2018). In the extreme case, problematic auditor behavior such as shredding documentation to cover up inadequate audit procedures can be so pervasive and detrimental as to force Arthur Anderson, one of the largest audit firms at that time, to dissolve (Gendron and Spira 2009; Jenkins et al. 2008; Krishnan 2005).

To mitigate these concerns, audit firms are required by regulators and professional standards to formalize and maintain a system of quality controls to govern auditor behavior and reduce audit risk on engagements (AICPA 2021; Jenkins et al. 2008; PCAOB 2019). In general, a firm's system of quality controls is multi-layered and established at both the

organization-level and engagement-level (Lennox and Wu 2018). If properly designed, it should provide reasonable assurance that auditors' work will meet professional and regulatory standards (PCAOB 2019). Specifically, a firm's system of quality controls will promote professional skepticism, stress quality service, and reduce overall audit risk on audit engagements (AICPA 2020; Jenkins et al. 2008; PCAOB 2019). While it is not designed to prevent every deficiency on an audit, an effective system of quality controls should reduce the risk of audit failure (i.e., audit risk) across all engagements as well as repeated instances of similar "type" of deficiencies (PCAOB 2008).¹⁴

The PCAOB evaluates the Big 4 system of quality controls annually but only reveals detail about their findings if the audit firm fails to take remediation action (Aobdia 2020; Lennox and Pittman 2010). In fact, due to the paucity of information available, empirical evidence on specific quality control elements is generally limited.¹⁵ As noted by Francis (2011, 138):

Research on the relation between accounting firms and audit quality is severely limited by the availability of data on characteristics of accounting firms. To date, research on this topic has relied on variables that can be constructed from public disclosures such as client-based measures of industry expertise or office size. However, these measures do not go inside the "black-box" of the accounting firm's organizational structure and operations.

¹⁴ For example, not every deficiency at the engagement-level indicates a firm's system of quality controls is insufficient; however, repeated instances of similar deficiencies (e.g., underauditing) may indicate a significant defect in a particular element or component of a firm's quality control system "even if the deficiency has not resulted in an insufficiently supported audit opinion" (e.g., nonreliance restatement) (PCAOB 2008).

¹⁵ In a recent exception, Aobdia (2020) obtains proprietary data from PCAOB inspections of high-risk engagements and finds that Part I engagement-level deficiencies are correlated with the Part II firm-level quality control deficiencies, including audit firm leadership and tone at the top. In another exception, a concurrent working paper examines 147 instances in which an audit or tax office managing partner is replaced by an advisory managing partner and reports a subsequent increase in non-audit fees; however, there is no perceptible association with the change in auditor effort on engagements (Mowchan 2016).

Existing empirical evidence on audit firms' quality controls is generally restricted to the engagement-level where the PCAOB has implemented new disclosures in the U.S. to identity of the lead engagement partner.¹⁶ This line of research suggests partners exhibit a stable style, or fixed effect, across engagements. Despite showing significant variation in partner style, Gul et al. (2013) document that audit partners' readily observable characteristics such as gender, age, education, and political affiliation explain only around 3% of the variation in a partner's style on engagements in China. Similarly, in the U.K., Cameran et al. (2020) find that partner style is not explained by readily observable characteristics and call for additional studies on other characteristics such as their risk-taking preferences. Indeed, notable concurrent research reports that U.S. engagement partners with a history of risky off-the-job behavior are associated with lower quality audits but finds their results are generally concentrated at smaller firms (Pittman et al. 2022). This evidence suggests that the larger audit firms (i.e., Big 4 firms) may have more robust quality controls—such as local office leadership and tone at the top—to constrain partner characteristics and decision-making on engagements.

Office-Level Leadership and Tone at the Top

Consistent with significant autonomy and tone variation across offices, the Big 4 audit firms in the U.S. are decentralized with decision making and engagement operations dispersed throughout their offices (Beck et al. 2019a; Francis and Yu 2009; Reynolds and Francis 2000). As such, extensive empirical evidence shows audit quality varies systematically across office-level characteristics, such as size and expertise (Francis and Yu 2009; Reichelt and Wang 2010). Moreover, Francis and Michas (2013) suggest an audit

¹⁶ The PCAOB started requiring audit firms to disclose the identity of the engagement partner on audits of public clients with reports issued on or after January 31, 2017 (PCAOB 2015).

failure on one client can be indicative of underlying, pervasive issues across all engagements within the office. The PCAOB highlights local office leadership and the tone at each audit office as crucial elements of an audit firm's quality controls during their annual inspections (Aobdia 2020). Therefore, one potential reason for the variation in the production of audit services across offices is the influence of individuals in office-level leadership positions.

In their leadership role, the managing partner of an office is responsible to set the tone at the top of each office. Often referred to more broadly as organizational culture, the tone set within an office is intended by leadership to exercise behavioral control over rank-and-file employees and reflects a system of shared norms, standards, and rewards (Schaubroeck et al. 2012; Schein 1985). Specific to auditing, organizational culture is particularly important because of the unique tension among being a regulated profession, a for-profit organization, and performing independent audits on behalf of the public interest (Alberti et al. 2020; Andiola et al. 2020). Therefore, managing partners are responsible to formally communicate and enforce firm policies and procedures across the office where audit engagements are managed (Aobdia 2020). As a supervisor, the managing partner can significantly influence auditor evaluations through what they stress as important during the periodic performance review process (Mowchan 2016). Managing partners can also set an informal example by their individual preferences and attitudes that are observable to auditors within the office through their behavior (PCAOB 2013; TAC 2007). Finally, interview evidence on the partner-client assignment process at large audit firms suggests managing partners play a large role in assigning both the lead engagement partner and a second partner to provide an additional layer of review (Dodgson et al. 2020). Therefore,

the managing partner is in a position to reward (punish) partners with more (less) desirable clients through client re-assignments and the mandatory partner rotation process.

Prior research theoretically links office-level leadership and tone at the top with the potential to exercise influence over auditor behavior on engagements (Jenkins et al. 2008). In the extreme case, poor office tone at Arthur Anderson's Houston office has been associated with such dysfunctional auditor behavior as misrepresenting national standards group recommendations (Schmidt 2002) and the destruction of audit workpapers (Jenkins et al. 2008; Krishnan 2005).¹⁷ Despite the implied importance of individuals in leadership positions across audit firms, existing standards contain limited references to or explicit requirements for members in this type of supervisory role. Indeed, recent comments on the PCAOB's proposed quality control standard highlight the need to more explicitly address these individuals in leadership positions (Brown et al. 2020, 4).

Managing Partners with Prior Infractions

An individual's leadership style and tone are shaped by their characteristics, values, and attitudes (Bertrand and Schoar 2003). Therefore, I collect available data on the managing partner's personal characteristics with a focus on their prior legal infractions. My focus on legal records as a reflection of managing partners' leadership style is grounded in revealed preference theory or using observable actions or choice behavior to infer an individual's preferences and characteristics (Hanlon et al. 2021; Mas-Colell et al. 1995). In addition, criminology and psychology research generally support a link between individuals with greater propensities to commit legal infractions and risk-taking, impulsive,

¹⁷ In fact, legal filings suggest the Houston office managing partner played a significant role in the destruction of audit workpapers for the Enron audit during the accounting scandal (Batson, Enron Corp., and United States 2003; Mowchan 2016).

and present-oriented natures (Gottfredson and Hirschi 1990; Wright et al. 2004). In particular, Gottfredson and Hirschi (1990) argue that low self-control captures an individual's preference for short-term rewards over the potential for long-term losses. Consistent with these theories, empirical evidence suggests that personality traits such as impulsivity and low self-control are positively correlated with various forms of risk-taking (Dohmen et al. 2011; Keane et al. 1993; Mishra and Lalumière 2011; Samuels et al. 2004). Further, individuals with a track record of legal infractions, including traffic tickets, tend to be risk-takers (Burns and Wilde 1995; Iversen and Rundmo 2002; Schwebel et al. 2007).¹⁸

Recent research draws on upper echelon theory (Hambrick and Mason 1984) to view organizations as a reflection of its top executive and extends this framework to professionals. Specifically, Davidson et al. (2015) find firms led by executives with prior infractions are more likely to commit fraud. Similarly, investors and financial advisors with prior infractions undertake riskier investment and corporate activities (Grinblatt and Keloharju 2009; Law and Mills 2019). Collectively, these studies empirically validate the cross-situational consistency of individuals who speed, ignore traffic rules, and commit other infractions as individuals with a relatively less regard for social norms and rules as well as an underlying higher appetite for risk.¹⁹

Unique to the audit setting, auditors must apply a risk-based methodology and complete non-standardized, complex tasks that require subjective judgments and decision-making under uncertainty (Bonner 2008). Moreover, on an engagement, the exact amount

¹⁸ For example, diplomats are more likely to receive a parking ticket while in the U.S. if the individual is originally born in a country where bribery is common or accepted (Fisman and Miguel 2007).

¹⁹ The higher appetite for risk includes an underappreciation for the long-term, adverse consequences of their actions.

of residual audit risk and assurance level is unknown (Causholli and Knechel 2012). The inherent subjectivity and discretion ubiquitous to the audit process is likely to underscore the importance of managing partners and their observable preferences and behaviors to the level of acceptable audit risk on an engagement. Therefore, I predict managing partners with prior infractions to be positively associated with audit risk on engagements. Stated in the alternative form:

H₁: Managing partners with prior infractions are associated with audit engagements that exhibit higher levels of audit risk.

Examining the implications of managing partner infractions amounts to a joint test of whether their history of legal infractions reflect variation in office tone that is more tolerant of risk, and whether that variation in office tone is associated with higher audit risk on engagements. Several factors suggest that managing partners with prior infractions may not be associated with increased engagement-level audit risk. First, a managing partner's behavior outside of work may be unrelated to his/her job performance. Given that insights from criminology and behavioral economics are primarily drawn from the broader population, they may not generalize to professionals in leadership positions who are inherently different or undergo a socialization process as they are promoted within the firm (Hambrick and Mason 1984; Hanlon et al. 2021). In addition, interview evidence from Mowchan (2016, 37) suggests audit firms may select partners for the office-level leadership role who intend to use it as an interim step to a national leadership position. In addition, interviewees indicate the possibility that some partners at large offices are "groomed" before being appointed as managing partner. Both of these factors could minimize the reflection of individual behaviors or preferences on the office tone. Next, regardless of the office tone, auditors are governed by professional standards and/or other quality control

mechanisms (e.g., supervision and review) which may limit the role of leadership style within the large audit firms (Andiola et al. 2020). Indeed, the role of the managing partner may be extremely limited particularly on public company engagements that have large teams of auditors and multi-level reviews (e.g., Aobdia 2018; Carter and Spence 2014; Hu et al. 2021; Pittman et al. 2022).

CHAPTER 3: SAMPLE AND VARIABLE MEASUREMENT

Sample

My sample selection process begins with the active Big 4 audit office-years between calendar years 2003 and 2019 that have at least one client with audit fees (Francis and Yu 2009). Focusing on this time period ensures the regulatory and reporting requirements of the audit firms' quality control systems are post-SOX and the establishment of the PCAOB. It also allows sufficient time for engagement-level data to be available from several commonly used sources (Audit Analytics, Compustat, CRSP, etc.).²⁰ Next, I use audit firm press releases and websites announcements to identify 618 managing partners and their appointment start and end date.²¹ For each managing partner, I use LexisNexis "People Search" to match 97% (601/618) of the individuals in my original sample of managing partners. LexisNexis provides an online public records database with demographic information on individuals and detailed information on their history of

²⁰ In addition, ending my sample period in 2019 prevents any confounding macroeconomic events related to the COVID-19 pandemic.

²¹ Appendix B provides an example of the typical press release which details the incoming managing partner and various background information, appointment date, and the individual they succeeded.

criminal filings used extensively in academic research on finance executives and mutual fund managers (e.g., Ahern 2017; Bai et al. 2019; Yonker 2017).²²

Panel A of Table 1 summarizes the selection for active Big 4 offices and a final sample of 601 office managing partners. Besides losing observations for missing managing partners, I also eliminate client-year observations that operate in the financial or utility industries (SIC codes 4400-4999; 6000-6999) or with a missing CIK. My final sample comprises 25,893 client-year observations spanning 3,364 office-years. In Panel B of Table 1, I provide details on the number of audit offices by calendar year in my final sample before- and after- dropping observations with missing information on the managing partners from LexisNexis. To summarize, after dropping observations with missing control variables for my analysis, the identity and person report was available in LexisNexis for 81.8% (3,364/4,113) of my initial sample of office-years.

[Insert Table 1 here]

Measuring Managing Partner Leadership Style and Office Tone

I obtain information for legal infractions in the managing partner's record from LexisNexis. The data reported for each managing partner includes legal infractions such as traffic violations, driving under the influence of alcohol, reckless endangerment, and other serious charges such as domestic violence, prostitution, and obstruction of justice. Rather than specifically related to the managing partner's auditing skills or other job performance, these infractions represent a revealed preference or observable behavior (Hanlon et al. 2021; Mas-Colell et al. 1995), consistent with risk-taking and impulsive, rule-breaking

²² Additional demographic information provided by LexisNexis on individuals in the U.S. include gender, birth date, employers, and professional licenses. Importantly, all acquisition and use of the data conform to requirements from LexisNexis that all results must be aggregated such that no individual information is disclosed

behavior (Davidson et al. 2015, 2020; Lennox and Wu 2018; Pittman et al. 2022; Wright et al. 2004). Appendix B provides further details on these data collection steps.

Table 2 reports descriptive statistics on the quantity and type of infraction reported by LexisNexis. A total of 415 legal infractions were committed by 200 managing partners. Around 5% (19/415) of the infractions relate to more severe crimes including prostitution, falsifying information, domestic abuse, and severe traffic charges such as driving under the influence. In addition, the vast majority (95%) relate to traffic incidents of varying degree of seriousness (e.g., parking tickets, speeding tickets, reckless driving tickets). Although a small percentage, the presence of severe infractions among office managing partners is somewhat surprising given the prominence of these leadership positions within the audit firms. In my primary tests, I define *MP_INFRACTION* as an indicator variable that equals one if the managing partner has any infractions in their legal record, and zero otherwise.

[Insert Table 2 here]

Table 3 reports descriptive statistics for all managing partners in my sample (Panel A) and by the existence of at least one infraction (Panel B). Given the paucity of evidence on audit firm leadership beyond the partner-level, I begin by analyzing the descriptive statistics of all managing partners' observable characteristics such as their gender (*MP_FEMALE*), age (*MP_AGE*), education attainment (*MP_MASTERS*), professional experience (*MP_SERVICE_AUDIT*), and appointment length (*MP_TENURE*). On average, partners are promoted to managing partner at 47 years old and serve almost seven years in this leadership role. Interestingly, a majority (59.6%) of managing partners are promoted from the audit service line, 19.5% are female, and only 20.3% have an advanced accounting degree. In Panel B, I show that these other characteristics appear to be relatively

similar for managing partners with and without infractions with the exception of gender. This univariate comparison shows that female managing partners are less likely to have an infraction relative to their male counterparts consistent with prior research that finds female partners tend to be associated with risk-averse behaviors and decision-making (Lee et al. 2019; Lennox and Wu 2018; Meyers-Levy 1986).

Panel C of Table 3 presents managing partner appointments by infraction and calendar year. My final sample of managing partners includes 90 total managing partners appointed before 2003 for those still active during calendar year 2003 (i.e., the start of the sample period). The remaining 511 managing partners in my final sample were appointed between 2003 and 2019, ranging from 12 to 45 new appointments in a given calendar year. Finally, panel D of Table 3 presents details of the distribution of infraction managing partners by state and audit firm with no obvious clustering or concentration in any one firm or across the U.S. Specifically, the average number of infraction managing partners appear uniformly distributed across the U.S and audit firms. For example, the average infraction managing partners is 27% within each state while the sample average is 33%. I also provide details on the percentage of managing partners that incur an infraction during their appointment, within seven years of their appointment, and that are more severe (e.g., felony, reckless, or driving under the influence). A total of 14 partners (untabulated) in the sample committed an egregious crime such as the obstruction of justice, prostitution, destroying documents and driving under the influence. Although some may have occurred at an early age, almost 29% (4/14) of the serious infraction incurred within seven years of

the managing partner appointment and almost 80% (11/14) showed evidence of recidivism within seven years of the start date.²³

[Insert Table 3 here]

CHAPTER 4: EMPIRICAL DESIGN

Risk of Misstatement

To test H₁ and examine whether managing partners with legal infractions are associated with audit risk on engagements, I begin by examining the propensity to misstate financial statements. Specifically, I estimate the following F-score model from Dechow et al. (2011):

$$\begin{aligned}
 FSCORE / FSCORE_ONE / FSCORE_SUBST_{it} = & \beta_0 + \beta_1 MP_INFRACTION_j + \\
 & \beta_2 MP_AGE_{jt} \\
 & + \beta_3 MP_FEMALE_j + \beta_4 MP_MASTERS_j + \beta_5 MP_SERVICE_AUDIT_j \\
 & + \beta_6 MP_SHORT_TENURE_{jt} + \beta_7 AUDOFFICE_SIZE_{it} + \\
 & \beta_8 AUDOFFICE_EXPERT_{it} \\
 & + \beta_9 AUDFIRM_CHG_{it} + \beta_{10} SIZE_{it} + \beta_{11} ROA_{it} + \beta_{12} LOSS_{it} + \beta_{13} LEVERAGE_{it} + \\
 & \beta_{14} MB_{it} + \beta_{15} CFO_{it} + \beta_{16} VOLATILITY_{it} + \beta_{17} GROWTH_{it} + \beta_{18} SEGMENTS_{it} + \\
 & \beta_{19} DELAY_{it} \\
 & + \beta_{20} MW_{it} + \beta_{21} LITRISK_{it} + \text{Audit Firm, Industry, and Year Fixed Effects} + \varepsilon_{it}
 \end{aligned}
 \tag{1}$$

where j denotes the managing partner, i denotes the client, and t denotes the year. The dependent variable, *FSCORE*, is the continuous measure from model 1 in Dechow et al. (2011) that captures the predicted probability of accounting misstatements scaled by the unconditional probability of having a misstatement. In their study, Dechow et al. (2011) provide insights into an auditor's general risk trade-off during the audit and how their measure of misstatement risk (*FSCORE*) provides a signal of misstatement. As shown in

²³ Recidivism refers to an offender's tendency to commit more than one infraction over the course of their life. I use seven years following Law and Mills (2019) that suggests financial analysts are more likely to offend again within a seven-year period.

prior research, undetected misstating clients can cost the audit firm regulatory and litigation costs once the misstatement is revealed in subsequent periods (Dechow et al. 2011). Another advantage of the F-score is that it can be used to capture less egregious but problematic increases in audit risk to the financial statements. For example, while ex post restatements provide a measure of egregiously low audit quality, they are relatively rare events (DeFond and Zhang 2014). *FSCORE* values greater than one (*FSCORE_ONE*) are considered “above normal risk” of misstatement while measures greater than 1.85 (*FSCORE_SUBST*) reflect “substantial risk” of misstatement. To the extent that managing partners with legal infractions reflect an office tone more tolerant of audit risk on engagements, I expect a positive value for β_1 .

My first set of controls focus on the other managing partner characteristics with the potential shape their attitudes, values, and leadership style (Bertrand and Schoar 2003). I include controls that capture the managing partners’ age (*MP_AGE*), gender (*MP_FEMALE*), education (*MP_MASTERS*), and work experience (*MP_SERVICE_AUDIT*). In addition, I control for managing partners newly appointed within the last two years (*MP_SHORT_TENURE*) in the event their appointment is correlated with other firm initiatives across the office.²⁴ Next, since the financial statements are the joint product of the auditor and client management (Antle and Nalebuff 1991), I control for characteristics related to the client and auditor that influence financial reporting quality and misstatement risk (Carcello and Li 2013; Cunningham et al. 2019; Pittman et al. 2022; Reichelt and Wang 2010). Specifically, I control for client characteristics such as size (*SIZE*), financial condition (*ROA*, *LEVERAGE*, *LOSS*, and *MB*), capacity to manage

²⁴ Importantly, I include audit firm fixed effects in all models to control for other firm-wide quality control initiatives.

earnings (*CFO* and *VOLATILITY*), and other financial reporting characteristics such as financial reporting complexity, internal control quality, and industries with high litigation risk (*GROWTH*, *SEGMENTS*, *DELAY*, *MW*, and *LITRISK*). I also control for changes in the audit firm (*AUDFIRM_CHG*), office size (*AUDOFFICE_SIZE*), office industry expertise (*AUDOFFICE_EXPERT*).

Auditor Effort

Next, I examine whether managing partners with legal infractions are associated with audit risk by examining the overall level of audit effort on an engagement (Aobdia 2019; DeFond and Zhang 2014; Hogan and Wilkins 2008; Lobo and Zhao 2013). Recent, large sample evidence from PCAOB inspected engagements where data is available for both auditor labor hours and audit fees suggest a correlation of 0.90 (Aobdia 2019, 157). Therefore, I estimate the following model:

$$\begin{aligned}
 LN_AUDFEES_{it} = & \beta_0 + \beta_1 MP_INFRACTION_j + \beta_2 MP_AGE_{jt} + \beta_3 MP_FEMALE_j \\
 & + \beta_4 MP_MASTERS_j + \beta_5 MP_SERVICE_AUDIT_j + \beta_6 MP_SHORT_TENURE_{jt} \\
 & + \beta_7 AUDOFFICE_SIZE_{it} + \beta_8 AUDOFFICE_EXPERT_{it} + \beta_9 AUDFIRM_CHG_{it} \\
 & + \beta_{10} SIZE_{it} + \beta_{11} ROA_{it} + \beta_{12} LOSS_{it} + \beta_{13} LEVERAGE_{it} + \beta_{14} MB_{it} + \beta_{15} CFO_{it} \\
 & + \beta_{16} VOLATILITY_{it} + \beta_{17} GROWTH_{it} + \beta_{18} SEGMENTS_{it} + \beta_{19} DELAY_{it} + \beta_{20} MW_{it} \\
 & + \beta_{21} LITRISK_{it} + \beta_{22} RECINV_{it} + \beta_{23} FOREIGN_{it} + \beta_{24} BUSY_{it} \\
 & + \text{Audit Firm, Industry, and Year Fixed Effects} + \varepsilon_{it}
 \end{aligned}
 \tag{2}$$

where *LN_AUDFEES* is the natural logarithm of audit fees charged to the particular client in the current year. The control variables in this model are the same as equation (1) with the addition of three control variables following Cunningham et al. (2019). In particular, these additional controls capture audits conducted during busy season (*BUSY*), accounts requiring more effort (*RECINV*), or operations requiring more effort (*FOREIGN*). To the extent that managing partners with prior legal infractions reflect an office tone more tolerant of higher detection risk on engagements, I expect a negative value for β_1 .

In all tests, I cluster standard errors by company as recommended by Peterson (2009) and include fixed effects to control for unobserved heterogeneity related to industries and years (Gormley and Matsa 2014). Importantly, I also include audit firm fixed effects to control for other quality control elements across the audit firm. Finally, to mitigate the influence of potential outliers, I winsorized all continuous variables at the 1st and 99th percentile.

CHAPTER 5: RESULTS

Descriptive Statistics

Table 4 reports descriptive statistics for the variables in my models. The univariate analysis in panel B provides some initial evidence consistent with my predictions; specifically, the mean values for *FSCORE* (*LN_AUDFEES*) are significantly higher (lower) in the subsample where *MP_INFRACTION*=1 relative to the subsample where *MP_INFRACTION*=0. In addition, partners with infractions manage smaller offices (*AUDOFFICE_SIZE*) and offices more likely to obtain industry expertise status (*AUDOFFICE_EXPERT*). Among the client-related control variables, it is worth noting there is no discernable difference for client size (*SIZE*) across subsamples, which is reassuring since size is highly correlated with auditor effort (DeFond and Zhang 2014; Hay et al. 2006). Finally, the clients in offices with infraction managing partners appear to have lower operating risk (e.g., *ROA*, *LOSS*, *MB*, *CFO*, *VOLATILITY*, and *GROWTH*).

[Insert Table 4 here]

Multivariate Evidence

Table 5 reports the regression results for the primary tests of the association between managing partners with infractions, client risk of misstatement, and auditor effort.

Models (1) through (3) report results for the risk of misstatement using the three F-score measures previously discussed. In all three specifications of the F-score, I find engagements in offices managed by partners with prior infractions are associated with a higher risk of misstatement ($p < 0.05$).²⁵ Economically meaningful, an engagement is 1.1 (1.3) times more likely to exhibit above normal (substantially high) misstatement risk if it is conducted in an audit office led by an infraction managing partner.²⁶ This evidence is consistent with the prediction in H_1 that managing partners that exhibit risk-seeking behavior promote higher levels of acceptable audit risk on engagements. Related to the control variables in Table 5, other managing partner characteristics appear to be insignificant with the exception of negative and significant coefficients ($p < 0.05$) for gender and education in one specification (*FSCORE_ONE*). However, other control variables such as client size and those related to operating risk and reporting complexity are statistically significant and consistent with directional predictions suggested by prior research. For example, in most specifications, client characteristics such as financial condition (*ROA*, *LOSS*, and *MB*), capacity to manage earnings (*CFO* and *VOLATILITY*), and other financial reporting characteristics such as financial reporting complexity, internal control quality, and industries with high litigation risk (*GROWTH*, *SEGMENTS*, *DELAY*, *MW*, and *LITRISK*) are all significant.

Although the above results support my hypothesis, it does not preclude the possibility that audit effort also increases to address the heightened misstatement risk.

²⁵ Untabulated, I replace these with Dechow et al. (2011)'s measure of extreme high risk of misstatement (*FSCORE_HIGH* = 2.45) and find my main results hold using this more extreme signal of misstatement.

²⁶ The odds ratio, or the multiple of odds that the financial statements exhibit above normal or substantially high risk of misstatement, is calculated as the exponent of β_1 in equation 1, or $[\exp(0.121)]$ and $[\exp(0.151)]$, respectively.

Using audit fees as a proxy for auditor effort (Aobdia 2019; DeFond and Zhang 2014; Hogan and Wilkins 2008; Lobo and Zhao 2013), I find that *MP_INFRACTION* is negative and significant ($p < 0.05$) in model (4) of Table 5. On average, audit engagements at offices with infraction managing partners have 3.7% lower audit fees relative to engagements performed out of offices led by managing partners without prior infractions.²⁷ This finding suggests that auditors in offices with managing partners exhibiting risky off-the-job behavior lower effort on engagements, presumably in an attempt to retain the client or allocate time to attract new clients (Lennox and Wu 2018). Related to the control variables in model (4), other managing partner characteristics appear to be insignificant with the exception of the positive and significant coefficient for female managing partners. In addition, other characteristics of the audit office (e.g., *AUDOFFICE_SIZE* and *AUDOFFICE_EXPERT*) are also positive and significant (Choi et al. 2010; Francis et al. 2005). Finally, audit firm changes are negative and significant consistent with firms low-balling to attract new clients (DeAngelo 1981; Dye 1991). Client characteristics such as size, financial reporting complexity, operating risk, and control risk are also positive and significant as expected.

[Insert Table 5 here]

Cross-Sectional Analysis

In a series of cross-sectional tests, I build on my main findings by considering the role of alternative firm-level governance mechanisms and additional analysis across offices of similar size. Table 6 presents the results using separate subsamples, including Chi-squared tests for the coefficient difference across subsamples. Panel A presents the results

²⁷ Auditor effort is the log of audit fees; therefore, economic significance is calculated as the exponent of β_1 from equation 2, or $[\exp(-0.038)-1]$.

after I bisect the sample into close versus distant offices based on the median distance to the audit firm's national office. Recent research suggests heightened monitoring of engagement offices for offices that are located closer to the firm's national office (Amin et al. 2021; Chen and Choudhary 2021). Indeed, I find that *MP_INFRACTION* remains significant and in the expected direction for all regressions using the subsample further away from the national office. In contrast, the coefficients for *MP_INFRACTION* are insignificant in settings where the office is located within closer proximity to national office with one exception. In model (1) using the continuous measure of the *FSCORE* (Model 1), the coefficient for *MP_INFRACTION* is significant, but the coefficient is in the opposite direction ($p < 0.05$). Consistent with more proximate national office's being able to monitor managing partners, the differences in coefficients across subsamples are also statistically significant based on the Chi-squared test.

Next, I drop the clients served by large offices from my sample since prior research indicates that large offices are associated with higher audit quality (Francis and Yu 2009), which may be driven by systematic differences in their quality controls and client base. I follow Beck et al. (2019a) to define large offices by the top decile within audit firm each year. After dropping all large offices, I bisect the remaining offices into offices that are closer to versus more distant from the most proximate large office within the same audit firm. Beck et al. (2019a) document the geographic proximity to a large office provides additional monitoring. The results in Panel C reveal that *MP_INFRACTION* remains significant in all regressions using the subsample of small offices located further away from the most adjacent large office. In contrast, the coefficients for *MP_INFRACTION* are insignificant in subsamples of offices located close to a nearby large office with the

exception of a marginally negative coefficient in the audit fee regression. The Chi-squared test of coefficient differences is statistically significant in each of the F-score models but is insignificant for the audit fee model.

[Insert Table 6 here]

Additional Test: Auditor Pricing of Misstatement Risk

In an additional test, I examine whether managing partners with prior infractions are associated with a weakened relationship between audit pricing and engagement-level misstatement risk. Specifically, I estimate the following model based on the approach in Beck et al. (2019a) and Amir et al. (2014):

$$\begin{aligned}
 LN_AUDFEES_{it} = & \beta_0 + \beta_1 MP_INFRACTION_j + \beta_2 FSCORE_{it} \\
 & + \beta_3 MP_INFRACTION_j \times FSCORE_{it} + \beta_4 MP_AGE_{jt} + \beta_5 MP_FEMALE_j \\
 & + \beta_6 MP_MASTERS_j + \beta_7 MP_SERVICE_AUDIT_j + \beta_8 MP_SHORT_TERNURE_{jt} \\
 & + \beta_9 AUDOFFICE_SIZE_{it} + \beta_{10} AUDOFFICE_EXPERT_{it} + \beta_{11} AUDFIRM_CHG_{it} \\
 & + \beta_{12} SIZE_{it} + \beta_{13} ROA_{it} + \beta_{14} LOSS_{it} + \beta_{15} LEVERAGE_{it} + \beta_{16} MB_{it} + \beta_{17} CFO_{it} \\
 & + \beta_{18} VOLATILITY_{it} + \beta_{19} GROWTH_{it} + \beta_{20} SEGMENTS_{it} + \beta_{21} DELAY_{it} + \beta_{22} MW_{it} \\
 & + \beta_{23} LITRISK_{it} + \beta_{24} RECINV_{it} + \beta_{25} FOREIGN_{it} + \beta_{26} BUSY_{it} \\
 & + \text{Audit Firm, Industry, and Year Fixed Effects} + \varepsilon_{it}
 \end{aligned}
 \tag{3}$$

where the variables are the same as equation (2) with the exception of adding misstatement risk (*FSCORE*) from equation (1). If managing partners with prior infractions reflect an office tone more tolerant of audit risk then I predict the degree to which incremental misstatement risk is priced on an engagement (i.e., engagement pricing decisions), then I expect a negative value for β_3 . Table 6 reports the results of this test, which shows a negative and significant coefficient ($p < 0.05$) for the $MP_INFRACTION \times FSCORE$ interaction. In terms of economic significance, managing partners with infractions weaken

the relationship between misstatement risk and audit fees by 29% relative to engagements from offices with non-infraction managing partners.²⁸

[Insert Table 7 here]

Robustness Tests

I perform several tests to evaluate whether my results are robust to different design choices and/or model specifications. First, prior research acknowledges the inherent challenges to controlling for client's underlying financial reporting processes and quality (Lawrence et al. 2011; Minutti-Meza 2013). Therefore, I re-estimate my regression models relying on entropy balancing to achieve covariate balance between engagements in offices with and without infraction managing partners (Hainmueller 2012). An advantage to entropy balancing as opposed to propensity score matching is that it retains all observations in the full sample.²⁹ Following recommendations in McMullin and Schonberger (2020, 2021), I require covariate balance on the first, second, and third moments of the distributions of all covariates. I find that doing so results in a maximum weight of 2.411 (2.488) and weight ratio of 0.114 (0.119) for the risk of misstatement (auditor effort) model.³⁰ Panel A of Table 8 shows the mean, variance, and skewness across the treatment and control groups after requiring covariate balance on the first, second, and third moments

²⁸ Consistent with prior literature, a 1% increase in the risk of misstatement (F-score) increases audit fees by 14% [$\exp(0.134)-1$]; however in offices with infraction managing partners, audit fees only increases by 10% [$\exp(0.134 + (-0.041))-1$]. Thus, the decrease in the sensitivity of engagement pricing to incremental misstatement risk is 29% on average [(14%-10%)/14%].

²⁹ Untabulated, I also re-estimate my main regression models using propensity score matching (PSM) techniques with (1:3) and without (1:1) replacement and the results hold across all five models.

³⁰ The maximum weight represents the largest weight assigned to a control observation for the respective entropy balancing regression. The weight ratio represents the number of control observations receiving above equal weight in the entropy-balancing regression divided by the number of observations appearing in a one-to-one match without replacement (McMullin and Schonberger 2020). For example, in the F-score sample, 843 observations receive a weight above 1 indicating that only 11.4% of my sample has greater influence than other observations (843/7,382).

of all covariates for the corresponding model. Panel B of Table 8 reports the core evidence holds ($p < 0.05$) after applying this entropy balancing technique.

[Insert Table 8 here]

In additional (untabulated) tests, I evaluate whether my results are sensitive to alternative measures of managing partner infractions. Given that I am interested in a characteristic of managing partners likely to be observed during their appointment, I require the managing partner to have an infraction *before* their appointment. Next, although research from criminology and psychology empirically validates the cross-situational behavior of individuals who commit even less severe traffic tickets, I redefine managing partners with infractions based on the type and frequency of infractions as well as the age and amount of time since the last infraction as follows: (1) excluding all nonmoving infractions (i.e., parking tickets and sport and leisure); (2) using a continuous measure of total infractions defined as the natural logarithm of one plus the number of infractions reported by LexisNexis; (3) requiring the last infraction to be recent (i.e., within 7 years of appointment); (4) requiring at least one infraction to occur as an adult (i.e., after reaching 21 years of age). I find that my core results continue to hold using each of these alternative measures of managing partner infractions.

Although I am careful to control for all available personal characteristics of the managing partner, I perform several robustness tests to ensure my results are not sensitive to alternative design specifications or environmental characteristics unique to the audit setting. First, during hand-collection, I noted some (100/601) of the listed managing partners are physically located at a nearby office. The results remain unchanged when I drop these “satellite” offices where the managing partners’ risk-seeking tone may be less

influential. Second, I consider that certain managing partners might have a “local” advantage if they were born in the surrounding state where they with presumably deeper connections established within the office and surrounding community (Carter and Spence 2014). Using information on the birth state of each managing partner from LexisNexis, I identify and control for instances when the managing partner is from the surrounding state. After doing so, I continue to find that my core evidence holds. Third, I focus on the latter half of my sample—2011 to 2019—where I am able to retain almost the complete universe (96%) of managing partner-office-years in my initial sample (and before attrition from hand-collecting the identities of managing partners) and my main results are noticeably stronger (i.e., significant at $p < 0.01$) with the exception of the additional analysis on the pricing of misstatement which remains unchanged.

Next, since female audit partners are associated with risk-averse behavior (Lennox and Wu 2018; Meyers-Levy 1986) as well as audit fee premiums (Lee et al. 2019), I drop female managing partners and further examine only the subset of male managing partners. After dropping 117 female managing partners, my sample includes 20,892 client-year observations. I find that my core results are consistent if not statistically stronger. Further, during hand-collection, I identified 29 managing partners for which the start date was not determinable. Therefore, I drop engagements where the managing partner’s tenure is censored, and my results stay the same.

Next, although I could not identify a reason why unobservable variation in law enforcement or expungement across different locations could confound the interpretation of the results, I nonetheless explore the possibility in a couple ways. In particular, I control for the population of the Metropolitan Statistical Area (MSA) based on the 2010 census

and continue to find my results hold across all tests. In a separate test, I drop the client-year observations in each state one by one and find that no one state is driving my results. Collectively, these additional tests reinforce my results are driven by a personal characteristic of the managing partner and not related to the level of law enforcement across the geographic location of the office.

Form AP Disclosures and the Lead Engagement Partner

I exploit the mandatory partner disclosure towards the latter part of my sample to extend my analysis to include the lead engagement partner and his/her history of prior infractions. Specifically, the PCAOB began requiring disclosure of the lead engagement partner in a separate document called Form AP for audit reports issued on or after January 31, 2017 (PCAOB 2015). I merge the corresponding Form AP with my office managing partner dataset and LexisNexis, which reduces my sample to 4,877 client-year observations representing 1,492 unique engagement partners. Overall, managing partners with infractions appear to attract partners that exhibit similar behavior and personality traits; specifically, 40% of audit partners have a prior infraction when serving clients from offices with infraction managing partners compared to only 20% at other offices. In addition, I consider only the 714 new partners assigned in my sample. Consistent with the overall sample, new infraction partners are assigned to new public client engagements 36% (70/193) of the time by infraction managing partners compared to only 21% (112/521) by non-infraction managing partners. Given the findings in Pittman et al. (2022) that partners with prior infractions compromise audit quality on engagements, infraction managing partner's propensity to assign partners with prior infractions provides at least one plausible explanation for how the managing partner may influence engagement-level outcomes.

Finally, I drop client-year observations with engagement partners that have prior infractions. In the remaining sample, I continue to find that managing partners with prior infractions influence auditor behavior on engagements for all measures of misstatement risk in equation (1) as well as the analysis on the incremental pricing of misstatement risk in equation (3). However, the levels result for audit fees in equation (2) is no longer significant at conventional levels when using this restricted sample.

CHAPTER 6: CONCLUSION

This study examines whether partners in office-level leadership positions with a history of legal infractions reflect a tone at the top that weaken audit firm quality controls. Using extensive hand-collection, I identify and interpret managing partners appointed to lead the U.S. Big 4 offices in the post-SOX period. Importantly, I rely on revealed preference theory and their history of legal infractions to identify leaders with impulsive, risk-taking, and present-oriented personalities (e.g., Davidson et al. 2015, 2020; Pittman et al. 2022; Wright et al. 2004). I find managing partners with prior infractions are associated with increased audit risk measured by a higher risk of misstatement and lower overall auditor effort. Moreover, I also find managing partners with prior infractions weaken the relationship between engagement pricing and the risk of misstatement. In cross-sectional analysis, my results indicate that the influence of these managers is mitigated in certain settings when alternative governance mechanisms within the same audit firm are present.

My analysis is subject to several caveats. First, since I cannot directly observe the leadership of the managing partner, I rely on their history of legal infractions to capture their preference or propensity to break the rules. This design choice is similar to other research on off-the-job behavior of executives and audit partners (Davidson et al. 2015;

2020; Pittman et al. 2022). In addition, I measure managing partners' "rule-breaking" behavior several ways and verify my results are not sensitive to any particular design choice. However, I recognize that it remains plausible that my measure of leadership captures an alternative characteristic of the managing partner. Next, I acknowledge that the very nature of the audit process is unobservable rendering it difficult to identify the exact causal mechanism by which the managing partners' legal infractions influence audit risk on engagements. Grounded in theoretical links from practitioner and regulator standards and communications, I provide several plausible explanations for managing partners' preferences and behaviors to influence auditors in ways that would increase audit risk at the engagement-level.

Next, I cannot fully dispel the threat coming from potential selection bias and correlated omitted variables (Lennox et al. 2012; Lennox and Wu 2018). I confront this concern by controlling for observable differences across managing partners that might be correlated with their leadership style (e.g., gender, age, and education) using entropy balancing and PSM techniques. However, given my inability to find a suitable instrumental variable that satisfy the exclusion restrictions (Lennox et al. 2012), I am unable to fully address the non-random assignment of managers to offices. Finally, my sample is restricted to the Big 4 audit firms. Although this approach allows me to focus on audit firms of similar size with similar quality control structures, my findings may not generalize to a full population of managing partners at particularly smaller audit firms.

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APPENDIX A

Variable Definitions

Dependent Variables:

<i>FSCORE</i>	the predicted probability of accounting misstatements from model 1 in Table 7, Panel A of Dechow et al. (2011), scaled by the unconditional probability of having accounting misstatements. Values greater than (less than) one indicate a higher (lower) probability of misstatement than the unconditional expectation.
<i>FSCORE_ONE</i>	1 if the predicted probability of accounting misstatements from model 1 in Table 7, Panel A of Dechow et al. (2011), scaled by the unconditional probability of having accounting misstatements is greater than 1, and 0 otherwise. Values greater than 1 are considered “above normal risk.”
<i>FSCORE_SUBST</i>	1 if the predicted probability of accounting misstatements from model 1 in Table 7, Panel A of Dechow et al. (2011), scaled by the unconditional probability of having accounting misstatements is greater than 1.85, and 0 otherwise. Values greater than 1.85 are considered “substantially above normal risk.”
<i>LN_AUDFEES</i>	the natural logarithm of audit fees in year <i>t</i> .

Test Variable:

<i>MP_INFRACTION</i>	1 if the managing partner has an infraction reported by LexisNexis, and 0 otherwise.
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MP Control Variables:

<i>MP_AGE_START</i>	the managing partner’s age calculated as of the date of the appointment as manager of the audit office.
<i>MP_AGE_END</i>	the managing partner’s age calculated as of the date of the end of their appointment as manager of the audit office.
<i>MP_AGE</i>	the managing partner’s age calculated as of the date of the client’s financial statements in year <i>t</i> .
<i>MP_FEMALE</i>	1 if the managing partner is a female, and 0 otherwise.
<i>MP_MASTERS</i>	1 if the managing partner has a master's or law degree, and 0 otherwise.
<i>MP_SERVICE_AUDIT</i>	1 if the managing partner was from the audit service line (as opposed to tax or advisory), following Mowchan (2016).
<i>MP_SHORT_TENURE</i>	1 if the managing partner has served for two years or less as manager of the audit office.
<i>MP_TENURE</i>	the length of time (in years) the managing partner served as manager of the audit office.

Other Auditor Control Variables:

<i>AUDITFIRM_CHANGE</i>	1 if the client changes audit firms in year t , and 0 otherwise.
<i>AUDOFFICE_EXPERT</i>	1 if the audit office has the largest audit fees in an MSA-year for a two-digit SIC industry and is at least ten percent above the next closest competitor following Definition 1 of Reichelt and Wang (2010), and 0 otherwise.
<i>AUDOFFICE_SIZE</i>	measure of audit office size based on aggregated client audit fees (in \$ millions) of an audit office in year t .

Client Control Variables:

<i>BUSY</i>	1 when fiscal year t ends in the months of December through March, and 0 otherwise.
<i>CFO</i>	cash flow from operations (OANCF) in year t divided by total assets (AT) in year $t-1$.
<i>DELAY</i>	the number of days between the issuance of the audit report and the client's year end in year t .
<i>FOREIGN</i>	1 if the company has foreign sales in the Compustat Segments file in year t , and 0 otherwise.
<i>GROWTH</i>	sales growth from year $t-1$ to year t , scaled by sales in year $t-1$ (SALE).
<i>LEVERAGE</i>	total debt (DLC + DLTT) divided by total assets (AT) in year t .
<i>LITRISK</i>	1 if the client operates in a high litigation industry (SIC codes of 2833-2836, 3570-3577, 3600-3674, 5200-5961, 7370-7374 and 8731-8734), and 0 otherwise following Francis et al. (1994).
<i>LOSS</i>	1 if operating income after depreciation (OIADP) in year t is less than zero, and 0 otherwise.
<i>MB</i>	market value of assets (AT + (PRCC_F*CSHO) - CEQ) divided by book value of assets (AT) in year t .
<i>MW</i>	1 if the company reports a material weakness in year t , and 0 otherwise.
<i>RECINV</i>	the ratio of accounts receivable (RECT) and inventories (INVT) to total assets (AT).
<i>ROA</i>	earnings before extraordinary items (IB) in year t divided by total assets (AT) in year t .
<i>SEGMENTS</i>	natural logarithm of 1 plus the number of business segments in year t as obtained from the Compustat Segments file.
<i>SIZE</i>	natural logarithm of total assets (AT) in year t .
<i>VOLATILITY</i>	standard deviation of operating cash flows (OANCF/AT) over the past three years ($t-3$ to t).

APPENDIX B

Description of Data Collection Steps

Step 1: Obtain identities of the office managing partners:

- ✓ Obtain list of active audit offices for the Big 4 accounting firms from Audit Analytics for the sample date range of 1/1/2003 through 12/31/2019.
- ✓ Perform an iterative Google search for common words in audit firm, local business, and other press releases such as office location (city and state) and year, starting with the first year in the sample (2003). Once the first managing partner in an office is identified, I use his/her name in subsequent searches to increase the accuracy to identify replacement managing partners in later years. The following detail provides an example of the type of press release that I use to collect office managing partner identities.

Press release example

[Date] | [City], US

[Audit Firm A] announces [Partner] as new [City] Office Managing Partner

Succeeds [Outgoing Partner] after [Length of Time] as [City] Leader

[Audit Firm A] has appointed [Service Line] Partner [First and Last Name] to serve as [City] Office Managing Partner, effective [Month, Day]. [Partner] succeeds [Outgoing Partner], who has assumed a new leadership role with [New Role] after [Length of Time] as Office Managing Partner.

As Office Managing Partner, [Partner] is responsible for leading [Specific Number of] professionals while continuing to drive growth and advancing the firm's inclusive, people-focused culture. The [Audit Firm A City] office, which celebrated its [Relevant Office Milestone], will be overseen by [Partner].

[Additional quotes from Firm Leadership along with further detail about the new Office Managing Partner]

Step 2: Use the managing partner's name in LexisNexis Public Records search function along with additional information available from other public sources to narrow potential matches (i.e., LinkedIn or firm biographies). See screen shot below for an example of the search function in LexisNexis.

Public Records > SmartLinux® Comprehensive Person Report

Welcome back Della Valentine. Last Sign In: Monday, October 11, 2021 at 9:41:21 PM. [View sign-in history](#)

[View Alerts](#) | [Coverage](#)

Form Search

Enter information in at least one field below.

Basic Information

SSN LexID(sm)

First Name Middle Name/Initial Last Name

Street Address

City State Zip Code

Telephone Date of Birth

Advanced

☐ Strict Search (Find only exact names and addresses)

☐ Find similar sounding last names

☐ Find nicknames of first name

Address Radius

Age Range (18 - 120)

Note: For more common names, I limit the potential matches based on office city and state and an estimated age range from information available on professional websites such as LinkedIn and firm websites.

Step 3: Obtain the comprehensive person report which includes a table of contents along with an example of the legal history reported by individual infraction in LexisNexis. The screenshot below shows an example of the types of information available in LexisNexis. The screenshot on the following page shows an example of the Subject Summary (page 2 of the LexisNexis report) that includes information such as the partner's date of birth, address, and state in which the social security card was issued (i.e., where s/he was born). Note that gender is included in other sections of the report if not provided in the Subject Summary.

Table of Contents

Subject Summary	2
Others Using SSN - 2 records found	3
Address Summary - 13 records found	3
Voter Registrations - 6 records found	7
Professional Licenses - 5 records found	9
Health Care Providers - 0 records found	10
Health Care Sanctions - 0 records found	10
Pilot Licenses - 0 records found	10
Sport Licenses - 0 records found	10
Weapon Permits - 0 records found	10
Real Property - 7 records found	10
Boats - 0 records found	13
Aircraft - 0 records found	13
Bankruptcy Information - 0 records found	13
Judgments/Liens - 1 records found	13
UCC Liens - 0 records found	14
Fictitious Businesses - 0 records found	14
Notice Of Defaults - 0 records found	14
Potential Relatives - 10 records found	14
Business Associates - 0 records found	16
Person Associates - 5 records found	16
Neighbors - 5 records found	18
Employment Locator - 0 records found	18
Criminal Filings - 3 records found	18
Sexual Offenders - 0 records found	19
Cellular & Alternate Phones - 3 records found	19
Utility Information - 0 records found	20
Possible Education - 1 records found	20
Sources - 174 records found	20

Criminal Filings - 3 records found

1: Ohio Court Report

Name:	[REDACTED]	Offender information
Address:	[REDACTED]	
Case Number:	[REDACTED]	
Case Filing Date:	[REDACTED]	
County:	[REDACTED]	
DOB:	[REDACTED]	
SSN:	[REDACTED]	
Case Filing Date:	[REDACTED]	Offenses
Offense Date:	[REDACTED]	
Arresting Agency:	[REDACTED]	
Case Number:	[REDACTED]	
Court Offense:	[REDACTED]	SPEED - INTERSTATE 84/65
Court Disposition:	[REDACTED]	
Court Fine:	[REDACTED]	
Court Level/Degree:	[REDACTED]	



1 OF 1 RECORD(S)

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Date: 5/15/2020
Report processed by:
Virginia Polytechnic Institute and State University

Full Name	Address	County	Phone
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

ADDITIONAL PERSONAL INFORMATION

SSN	DOB	Gender	LexID(sm)	Email
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Subject Summary

Name Variations

1:	[REDACTED]
2:	[REDACTED]
3:	[REDACTED]
4:	[REDACTED]
5:	[REDACTED]
6:	[REDACTED]
7:	[REDACTED]
8:	[REDACTED]
9:	[REDACTED]
10:	[REDACTED]

SSNs Summary

No.	SSN	State Iss.	Date Iss.	Warnings
1:	[REDACTED]	[REDACTED]	[REDACTED]	Most frequent SSN attributed to subject:

DOBs

Reported DOBs:

[REDACTED]

TABLE 1
Sample Selection

Panel A: Sample selection for active Big 4 offices	
Observations with assets in Compustat for FY 2003-2018	142,997
Less: Financial and Utility Clients (SIC 4400-4999; 6000-6999)	(41,290)
Observations with missing CIK	(12,771)
Observations with missing audit fee or auditor information	(28,047)
Observations with Non-Big 4 auditors	<u>(24,781)</u>
Initial sample of client-year observations	36,108
Less: Observations with missing control variables for auditor behavior analysis	(3,846)
Observations with unidentifiable managing partners	<u>(6,369)</u>
Total client-year observations in final sample	25,893
Total number of managing partners in final sample	601

Panel A presents the sample selection from merging available data from Audit Analytics, Compustat, and various public sources with information for on the managing partner and their work history (e.g., audit firm press releases, audit firm websites, and partner bios on LinkedIn). “FY” represents the Compustat definition of fiscal year (i.e., FY 2018 represents fiscal years ending between June 1, 2018, and May 31, 2019).

TABLE 1 (continued)
Sample Selection

Panel B: Number of Big 4 offices by audit firm and year															
Year	PwC	EY	Deloitte	KPMG	No			Total	Year	PwC	EY	Deloitte	KPMG	No	
					Offices	MP	Total							Offices	MP
2003	45	58	47	46	196	(112)	84	2011	56	64	54	70	244	(18)	226
2004	64	74	65	77	280	(139)	141	2012	56	64	54	69	243	(12)	231
2005	63	73	62	76	274	(121)	153	2013	56	64	53	67	240	(9)	231
2006	62	67	57	71	257	(96)	161	2014	55	62	52	67	236	(8)	228
2007	59	67	58	69	253	(89)	164	2015	55	62	51	67	235	(5)	230
2008	57	66	56	66	245	(67)	178	2016	55	60	52	69	236	(7)	229
2009	57	65	56	68	246	(43)	203	2017	54	60	53	64	231	(5)	226
2010	57	66	57	67	247	(30)	217	2018	53	61	53	63	230	(4)	226
								2019	52	57	51	60	220	(7)	213
													4,113	(776)	3,364

Panel B presents the number of audit offices by calendar year over the sample period. The identity of the managing partner (MP) was available for 81.8% (3,364/4,113) of the active audit office-years in my sample. An audit office is active if it administers at least one audit engagement following Francis and Yu (2009).

TABLE 2
Details of Managing Partner Legal Infractions

Panel A: Types of infractions committed by managing partner			
<u>Infraction Description</u>	<u>Count</u>	<u>%Total</u>	
Severe - felony	8	1.9%	
Severe - traffic	11	2.7%	
Speeding charges	231	55.7%	
Minor - nonmoving traffic	152	36.6%	
Other - sport and leisure charges	<u>13</u>	<u>3.1%</u>	
Total infractions	415	100%	

Panel B: Number of infractions committed by each managing partner			
	<u>Managing Partners</u>	<u>%</u>	<u>Infractions</u>
Number of managing partners with 0 infractions	401	66.7%	0
Number of managing partners with 1 infraction	116	19.3%	116
Number of managing partners with 2 infractions	31	5.2%	62
Number of managing partners with 3 infractions	25	4.2%	81
Number of managing partners with 4 infractions	12	1.50%	36
Number of managing partners with 5 infractions	7	1.00%	30
Number of managing partners with 6 infractions	1	0.17%	6
Number of managing partners with 7 infractions	2	0.3%	14
Number of managing partners with 8 infractions	1	0.2%	8
Number of managing partners with 9 infractions	3	0.5%	27
Number of managing partners with 11 infractions	1	0.2%	11
Number of managing partners with 13 infractions	<u>1</u>	<u>0.2%</u>	<u>13</u>
Total	601	100%	415

Table 2 presents details of the legal infractions committed by managing partners. Panel A classifies infractions by type and severity. More severe felony infractions (Severe - felony) include charges such as obstruction of justice, probation violation, domestic violence, and prostitution. More severe traffic infractions include reckless driving and driving under the influence. Minor - nonmoving traffic infractions include expired registrations or licenses. Other – sport and leisure infractions include fishing without a license and failure to put out a fire at camp. Panel B presents the number of infractions for each managing partner in the final sample as identified by LexisNexis.

TABLE 3
Descriptive Statistics for Managing Partners

Panel A: Descriptive statistics for all managing partners

Variable	N	Mean	Median	Std. Dev.	Min	Max
<i>MP_INFRACTION</i>	601	0.333	0.000	0.472	0.000	1.000
<i>MP_AGE_START</i>	601	47.095	47.000	5.467	31.000	61.000
<i>MP_AGE_END</i>	601	53.484	53.000	5.243	37.000	64.000
<i>MP_FEMALE</i>	601	0.195	0.000	0.396	0.000	1.000
<i>MP_MASTERS</i>	601	0.203	0.000	0.403	0.000	1.000
<i>MP_SERVICE_AUDIT</i>	601	0.596	1.000	0.491	0.000	1.000
<i>MP_TENURE</i>	601	6.864	5.916	4.232	0.583	25.084

Panel B: Comparison of managing partners by legal infraction

Variable	<i>INFRACTION</i> = 0	<i>INFRACTION</i> = 1	Test of Mean Difference (p-value)
	Mean	Mean	
<i>MP_AGE_START</i>	46.955	47.375	0.375
<i>MP_AGE_END</i>	53.372	53.710	0.456
<i>MP_FEMALE</i>	0.225	0.140	0.017**
<i>MP_MASTERS</i>	0.207	0.195	0.731
<i>MP_SERVICE_AUDIT</i>	0.586	0.615	0.496
<i>MP_TENURE</i>	6.898	6.794	0.778
N = 601	401	200	

Panel A presents descriptive statistics of all managing partners (MP) in the sample. Since *MP_AGE* varies by year over their tenure, this partner-level statistic is reported as the age at the start and end of the managing partner appointment. Similarly, *MP_TENURE* is reported as the total length in tenure. Panel B presents the mean difference by infraction of the managing partner, where infraction is an indicator variable equal to one if the managing partner has an infraction reported by LexisNexis.

TABLE 3 (continued)
Descriptive Statistics for Managing Partners

Panel C: Managing partner appointments by calendar year

<i>MP_INFRACTION</i>					<i>MP_INFRACTION</i>				
Year	= 0	= 1	Total	% Total	Year	= 0	= 1	Total	% Total
< 2003	54	36	90	40%	2011	29	9	38	24%
2003	38	5	43	11.6%	2012	26	6	32	19%
2004	22	1	23	4.3%	2013	16	17	33	52%
2005	8	13	21	62%	2014	20	14	34	41%
2006	26	6	32	19%	2015	22	7	29	24%
2007	11	10	21	48%	2016	17	4	21	19%
2008	26	19	45	42%	2017	26	10	36	28%
2009	19	16	35	46%	2018	16	10	26	38%
2010	19	11	30	37%	<u>2019</u>	<u>6</u>	<u>6</u>	<u>12</u>	<u>50%</u>
Total						401	200	601	33%

Panel C presents managing partner appointments by infraction and calendar year. The sample period starts in 2003, following the passage of the Sarbanes Oxley Act and includes 90 total managing partners appointed before 2003 for those still active during calendar year 2003. Variable definitions are provided in Appendix A.

Panel D: Legal infractions by state and audit firm

<i>MP_INFRACTION = 1</i>					
	MP	% Total	% During	% Recent	% Severe
All	601	33%	13%	22%	2%
<u>State (Avg.)</u>					
Mean	13.36	27%	9%	19%	9%
Std. Dev.	13.47	29%	12%	24%	12%
<u>Audit Firm</u>					
PwC	133	35%	13%	26%	3%
EY	159	36%	14%	21%	1%
Deloitte	153	31%	15%	21%	3%
KPMG	156	31%	10%	22%	3%

Panel D presents details of the sample distribution of managing partners (*MP*) with infractions by state within the U.S. and by audit firm. I present the number of partners with an infraction (*MP_INFRACTION = 1*) as a percentage of total partners (*%Total*). I also report the percent of managing partners incurring an infraction during the appointment (*%During*) or within 7 years of their appointment (*%Recent*). Finally, I present the percentage of total partners with a severe infraction (e.g., felony, reckless, or driving under the influence infraction) (*%Severe*).

TABLE 4
Descriptive Statistics for Client-Year Observations

Panel A: Full sample

Variable	N	Mean	S.D.	Min	25%	Median	75%	Max
<i>FSCORE</i>	25,893	1.008	0.583	0.143	0.553	0.915	1.347	3.153
<i>FSCORE_ONE</i>	25,893	0.445	0.497	0.000	0.000	0.000	1.000	1.000
<i>FSCORE_SUBS</i>	25,893	0.080	0.272	0.000	0.000	0.000	0.000	1.000
<i>LN_AUDFEES</i>	25,893	14.196	1.053	11.376	13.504	14.151	14.869	16.909
<i>AUDOFFICE_SIZE</i>	25,893	17.650	1.192	10.933	16.933	17.810	18.561	20.389
<i>AUDOFFICE_EXPERT</i>	25,893	0.532	0.499	0.000	0.000	1.000	1.000	1.000
<i>AUDFIRM_CHANGE</i>	25,893	0.027	0.162	0.000	0.000	0.000	0.000	1.000
<i>SIZE</i>	25,893	6.811	1.819	2.170	5.557	6.778	8.019	11.142
<i>ROA</i>	25,893	-0.025	0.223	-1.366	-0.030	0.036	0.076	0.280
<i>LOSS</i>	25,893	0.235	0.424	0.000	0.000	0.000	0.000	1.000
<i>LEVERAGE</i>	25,893	0.234	0.233	0.000	0.019	0.194	0.358	1.234
<i>MB</i>	25,893	2.168	1.510	0.698	1.236	1.665	2.504	9.308
<i>CFO</i>	25,893	0.048	0.184	-1.072	0.031	0.083	0.132	0.341
<i>VOLATILITY</i>	25,893	0.061	0.091	0.003	0.018	0.034	0.065	0.702
<i>GROWTH</i>	25,893	0.150	0.487	-0.734	-0.019	0.071	0.196	3.605
<i>SEGMENTS</i>	25,893	0.563	0.635	0.000	0.000	0.693	0.693	3.045
<i>DELAY</i>	25,893	62.221	18.170	26.000	54.000	59.000	70.000	210.000
<i>MW</i>	25,893	0.055	0.229	0.000	0.000	0.000	0.000	1.000
<i>LITRISK</i>	25,893	0.412	0.492	0.000	0.000	0.000	1.000	1.000
<i>RECINV</i>	25,893	0.240	0.173	0.000	0.103	0.213	0.337	0.764
<i>FOREIGN</i>	25,893	0.257	0.437	0.000	0.000	0.000	1.000	1.000
<i>BUSY</i>	25,893	0.806	0.395	0.000	1.000	1.000	1.000	1.000

Panel A provides the descriptive statistics on client characteristics for the control variables used in the regression models based on the full sample. Variable definitions are provided in Appendix A. All continuous variable winsorized at 1% and 99%.

TABLE 4 (continued)
Descriptive Statistics for Client-Year Observations

Panel B: Subsamples for managing partners with (without) a history of legal infraction

Variable	<i>MP_INFRACTION</i> = 0				<i>MP_INFRACTION</i> = 1			
	N	Mean	Median	S.D.	N	Mean	Median	S.D.
<i>FSCORE</i>	18,511	0.995	0.897	0.580	7,382	1.042***	0.958***	0.589
<i>FSCORE_ONE</i>	18,511	0.432	0.000	0.495	7,382	0.476***	0.000***	0.499
<i>FSCORE_SUBS</i>	18,511	0.077	0.000	0.266	7,382	0.088***	0.000***	0.284
<i>LN_AUDFEES</i>	18,511	14.225	14.176	1.066	7,382	14.123***	14.096***	1.015
<i>AUDOFFICE_SIZE</i>	18,511	17.801	17.977	1.199	7,382	17.270***	17.312***	1.085
<i>AUDOFFICE_EXPERT</i>	18,511	0.510	1.000	0.500	7,382	0.589***	1.000***	0.492
<i>AUDFIRM_CHANGE</i>	18,511	0.027	0.000	0.162	7,382	0.027	0.000	0.163
<i>SIZE</i>	18,511	6.816	6.747	1.844	7,382	6.799	6.860	1.755
<i>ROA</i>	18,511	-0.032	0.034	0.229	7,382	-0.009	0.040***	0.204
<i>LOSS</i>	18,511	0.251	0.000	0.434	7,382	0.194***	0.000***	0.396
<i>LEVERAGE</i>	18,511	0.235	0.192	0.237	7,382	0.232	0.198	0.224
<i>MB</i>	18,511	2.214	1.684	1.563	7,382	2.055***	1.620***	1.362
<i>CFO</i>	18,511	0.043	0.082	0.191	7,382	0.062***	0.089***	0.165
<i>VOLATILITY</i>	18,511	0.063	0.035	0.094	7,382	0.056***	0.032***	0.083
<i>GROWTH</i>	18,511	0.160	0.074	0.513	7,382	0.126***	0.064***	0.413
<i>SEGMENTS</i>	18,511	0.578	0.693	0.629	7,382	0.528***	0.000***	0.647
<i>DELAY</i>	18,511	62.098	59.000	18.173	7,382	62.530*	59.000	18.324
<i>MW</i>	18,511	0.055	0.000	0.228	7,382	0.057	0.000	0.231
<i>LITRISK</i>	18,511	0.430	0.000	0.495	7,382	0.366***	0.000***	0.482
<i>RECINV</i>	18,511	0.232	0.204	0.172	7,382	0.260***	0.235***	0.175
<i>FOREIGN</i>	18,511	0.269	0.000	0.444	7,382	0.227***	0.000***	0.419
<i>BUSY</i>	18,511	0.813	1.000	0.390	7,382	0.789***	1.000***	0.408

Panel B provides the descriptive statistics on client characteristics for the control variables used in the regression model based on separate subsamples by the existence of managing partner infractions. *MP_INFRACTION* represents instances in which the managing partner has an infraction reported by LexisNexis. Variable definitions are provided in Appendix A. ***, **, * denote significance at the 0.01, 0.05, and 0.10 levels, respectively, for the two-sample t-test of the difference in mean values or the Wilcoxon rank-sum test for median values.

TABLE 5
Managing Partner Infractions and Audit Risk on Engagements

Dependent Variable:	Model (1): <i>FSCORE</i>		Model (2): <i>FSCORE_ONE</i>		Model (3): <i>FSCORE_SUBST</i>		Model (4): <i>LN_AUDFEES</i>	
Variable	Coeff.	S.E.	Coeff.	S.E.	Coeff.	S.E.	Coeff.	S.E.
<i>MP_INFRACTION</i>	0.025**	0.015	0.121**	0.060	0.151**	0.081	-0.038**	0.016
<i>MP_AGE</i>	-0.002*	0.001	-0.006	0.005	-0.009	0.007	-0.001	0.001
<i>MP_FEMALE</i>	-0.028*	0.016	-0.139**	0.065	-0.111	0.096	0.042***	0.016
<i>MP_MASTERS</i>	-0.024	0.015	-0.125**	0.061	-0.105	0.093	0.016	0.016
<i>MP_SERVICE_AUDIT</i>	0.005	0.013	0.024	0.052	-0.018	0.079	-0.019	0.013
<i>MP_SHORT_TENURE</i>	0.001	0.009	-0.001	0.035	-0.018	0.061	-0.004	0.008
<i>AUDOFFICE_SIZE</i>	0.004	0.007	0.009	0.028	0.016	0.039	0.089***	0.007
<i>AUDOFFICE_EXPERT</i>	0.012	0.014	0.014	0.056	0.077	0.078	0.067***	0.013
<i>AUDFIRM_CHANGE</i>	0.058**	0.023	0.166*	0.086	0.051	0.147	-0.059***	0.020
<i>SIZE</i>	0.031***	0.019	0.117***	0.023	0.009	0.030	0.510***	0.006
<i>ROA</i>	0.453***	0.006	2.370***	0.242	3.652***	0.480	-0.390***	0.037
<i>LOSS</i>	-0.257***	0.037	-0.981***	0.070	-1.020***	0.135	0.029*	0.016
<i>LEVERAGE</i>	0.000	0.016	0.038	0.138	0.070	0.165	0.006	0.033
<i>MB</i>	-0.016***	0.033	-0.065***	0.018	-0.088***	0.029	0.023***	0.004
<i>CFO</i>	-0.798***	0.004	-3.709***	0.278	-5.406***	0.530	-0.068	0.049
<i>VOLATILITY</i>	-0.301***	0.048	-1.954***	0.326	-0.232	0.468	0.293***	0.064
<i>GROWTH</i>	0.267***	0.063	0.666***	0.041	1.039***	0.054	-0.025***	0.008
<i>SEGMENTS</i>	0.080***	0.008	0.305***	0.075	0.138	0.105	0.105***	0.017
<i>DELAY</i>	0.001***	0.017	0.002	0.001	0.005***	0.001	0.006***	0.001
<i>MW</i>	0.032*	0.019	0.175**	0.073	0.073	0.118	0.321***	0.018
<i>LITRISK</i>	-0.094***	0.018	-0.396***	0.071	-0.327***	0.104	0.026	0.019
<i>RECINV</i>							0.636***	0.057
<i>FOREIGN</i>							0.223***	0.019
<i>BUSY</i>							0.051**	0.021
Intercept	0.644***	0.166	-1.095	0.729	-2.437**	1.317	8.071***	0.197
Year FE	Yes		Yes		Yes		Yes	
Industry FE	Yes		Yes		Yes		Yes	
Audit Firm FE	Yes		Yes		Yes		Yes	
Model	OLS		LOGIT		LOGIT		OLS	
N	25,893		25,893		25,893		25,893	
Adj./Pseudo R2	0.183		0.117		0.122		0.795	

This table presents the regression results for the association between managing partners with prior infractions and engagement-level misstatement risk and auditor effort. I measure misstatement in models (1)-(3) using the continuous *FSCORE* as well as indicators *FSCORE_ONE* and *FSCORE_SUBST* following Dechow et al. (2011). *FSCORE_ONE* equals 1 when the *FSCORE* is categorized as “above normal” risk of misstatement (>1.00) and *FSCORE_SUBST* equals 1 when the *FSCORE* is categorized as “substantial risk” of misstatement (>1.85). Model (4) presents the regression results for the association between managing partners with prior infractions and auditor effort where *LN_AUDFEES* is the natural logarithm of audit fees earned for the client engagement in a given year. For brevity, coefficients on audit firm, industry, and year fixed effects (FE) are not reported. Robust standard errors clustered by client firm are included. ***, **, and * represent significance at the 0.01, 0.05, and 0.10 levels, respectively. The significance of the coefficient for *MP_INFRACTION* is based on a one-tailed test given the directional prediction in my hypotheses, while the significance of coefficients for the control variables is based on a two-tailed test. Variable definitions are provided in Appendix A.

TABLE 6
Alternative Governance Mechanisms

Panel A: Analysis of managing partners at offices closer to versus further away from the national office

Dependent Variable:	(1): <i>FSCORE</i>	(2): <i>FSCORE_ONE</i>	(3): <i>FSCORE_SUBS</i>	(4): <i>LN_AUDFEES</i>				
<i>MP_INFRACTION</i>	-0.033** (0.095)	0.058*** (0.023)	-0.020 (0.020)	0.054*** (0.019)	-0.009 (0.008)	0.019** (0.009)	-0.017 (0.021)	-0.072*** (0.024)
Model	OLS		LOGIT		LOGIT		OLS	
Subsample	Close	Far	Close	Far	Close	Far	Close	Far
Control Variables	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	13,190	12,703	13,190	12,703	13,190	12,703	13,190	12,703
Adj./Pseudo R2	0.191	0.185	0.146	0.137	0.084	0.069	0.820	0.772
χ^2 Test of Coeff. Diff. between Close and Far	9.36***		7.93***		5.58***		3.03**	

This table presents the subsample results for audit offices that are closer (Close) versus further away (Far) from the audit firm's national office. Close (Far) is defined if the office is less (more) than the median distance from the national office or within the same city as national office. For brevity, coefficients on the control variables as well as audit firm, industry, and year fixed effects are not reported. Robust standard errors clustered by client firm are included in parentheses. ***, **, and * represent significance at the 0.01, 0.05, and 0.10 levels, respectively. The significance of the coefficients and Chi-squared test are based on a one-tailed test given the directional predictions in my hypotheses. Variable definitions are provided in Appendix A.

TABLE 6 (continued)
Alternative Governance Mechanisms

Panel B: Analysis of MP at small offices closer to versus further away from a nearby large office

Dependent Variable:	(1): <i>FSCORE</i>	(2): <i>FSCORE_ONE</i>	(3): <i>FSCORE_SUBS</i>	(4): <i>LN_AUDFEES</i>				
<i>MP_INFRACTION</i>	-0.018 (0.021)	0.046** (0.022)	-0.012 (0.019)	0.043*** (0.018)	-0.001 (0.008)	0.144** (0.009)	-0.031* (0.023)	-0.050*** (0.022)
Model	OLS		LOGIT		LOGIT		OLS	
Subsample	Close	Far	Close	Far	Close	Far	Close	Far
Control Variables	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	11,057	12,195	11,057	12,195	11,057	12,195	11,150	12,330
Adj./Pseudo R2	0.184	0.189	0.144	0.145	0.069	0.074	0.802	0.781
χ^2 Test of Coeff. Diff. between Close and Far	4.82***		4.57**		1.64*		0.54	

This table presents the subsample results for small audit offices that are closer (Close) versus further away (Far) to the closest large office within the same audit firm. Following Beck et al. (2019a), I measure large offices by the top decile within audit firm and year. For brevity, coefficients on the control variables as well as audit firm, industry, and year fixed effects are not reported. Robust standard errors clustered by client firm are included in parentheses. ***, **, and * represent significance at the 0.01, 0.05, and 0.10 levels, respectively. The significance of the coefficients and Chi-squared test are based on a one-tailed test given the directional predictions in my hypotheses. Variable definitions are provided in Appendix A.

TABLE 7
Managing Partner Infractions and the Pricing of Audit Risk

Dependent Variable:	Model (5): <i>LN_AUDFEES</i>	
Variable	Coeff.	S.E.
<i>FSCORE</i>	0.134***	0.014
<i>MP_INFRACTION</i>	0.003	0.025
<i>MP_INFRACTION</i> × <i>FSCORE</i>	-0.041**	0.019
<i>MP_AGE</i>	-0.001	0.001
<i>MP_FEMALE</i>	0.044***	0.016
<i>MP_MASTERS</i>	0.016	0.016
<i>MP_SERVICE_AUDIT</i>	-0.020	0.013
<i>MP_SHORT_TENURE</i>	-0.004	0.008
<i>AUDOFFICE_SIZE</i>	0.088***	0.007
<i>AUDOFFICE_EXPERT</i>	0.068***	0.013
<i>AUDFIRM_CHANGE</i>	-0.062***	0.020
<i>SIZE</i>	0.507***	0.006
<i>ROA</i>	-0.405***	0.038
<i>LOSS</i>	0.040***	0.016
<i>LEVERAGE</i>	0.001	0.033
<i>MB</i>	0.023***	0.004
<i>CFO</i>	-0.033	0.049
<i>VOLATILITY</i>	0.308***	0.064
<i>GROWTH</i>	-0.041***	0.009
<i>SEGMENTS</i>	0.103***	0.017
<i>DELAY</i>	0.005***	0.000
<i>MW</i>	0.321***	0.018
<i>LITRISK</i>	0.025	0.019
<i>RECINV</i>	0.557***	0.060
<i>FOREIGN</i>	0.222***	0.019
<i>BUSY</i>	0.052***	0.021
Intercept	8.077***	0.192
Year FE		Yes
Industry FE		Yes
Audit Firm FE		Yes
Model		OLS
N		25,893
Adjusted R2		0.796

This table presents the regression results for auditor pricing of misstatement risk. *FSCORE* is the as previously defined and the significance of the coefficient of interest (*MP_INFRACTION* × *FSCORE*) is based on a one-tailed test given the directional prediction in my hypothesis, while the significant coefficients on the control variables is based on a two-tailed test. For brevity, coefficients on audit industry, and year fixed effects are suppressed. Robust standard errors clustered by client firm included. ***, **, and * represent significance at the 0.01, 0.05, and 0.10 levels, respectively. Appendix A provides the variable definitions.

TABLE 8
Entropy Balanced Analysis

Panel A: Descriptive statistics for the entropy balanced sample

	<i>MP_INFRACTION = 1</i>			<i>MP_INFRACTION = 0</i>		
<u>Variables</u>	<u>Mean</u>	<u>Variance</u>	<u>Skewness</u>	<u>Mean</u>	<u>Variance</u>	<u>Skewness</u>
<i>MP_AGE</i>	50.910	24.380	-0.044	50.910	24.380	-0.044
<i>MP_FEMALE</i>	0.104	0.093	2.591	0.104	0.093	2.591
<i>MP_MASTERS</i>	0.250	0.188	1.153	0.250	0.188	1.153
<i>MP_SERVICE_AUDIT</i>	0.571	0.245	-0.286	0.571	0.245	-0.286
<i>MP_SHORT_TENURE</i>	0.278	0.201	0.994	0.278	0.201	0.993
<i>AUDOFFICE_SIZE</i>	17.270	1.177	-0.267	17.270	1.177	-0.267
<i>AUDOFFICE_EXPERT</i>	0.589	0.242	-0.361	0.589	0.242	-0.361
<i>AUDFIRM_CHANGE</i>	0.027	0.026	5.810	0.027	0.026	5.810
<i>SIZE</i>	6.799	3.079	-0.096	6.799	3.079	-0.096
<i>ROA</i>	-0.009	0.042	-3.599	-0.009	0.042	-3.599
<i>LOSS</i>	0.194	0.157	1.545	0.194	0.157	1.544
<i>LEVERAGE</i>	0.232	0.050	1.298	0.232	0.050	1.298
<i>MB</i>	2.055	1.855	2.520	2.055	1.855	2.520
<i>CFO</i>	0.062	0.027	-3.527	0.062	0.027	-3.527
<i>VOLATILITY</i>	0.055	0.007	4.711	0.055	0.007	4.711
<i>GROWTH</i>	0.126	0.171	5.035	0.126	0.171	5.035
<i>SEGMENTS</i>	0.528	0.418	0.902	0.528	0.418	0.902
<i>DELAY</i>	62.530	334.000	3.893	62.530	334.000	3.893
<i>MW</i>	0.057	0.054	3.831	0.057	0.054	3.831
<i>LITRISK</i>	0.366	0.232	0.556	0.366	0.232	0.556
N	7,382	7,382	7,382	18,511	18,511	18,511

This table presents descriptive statistics for the entropy balanced samples. This technique assigns weights to observations in the treated (*MP_INFRACTION* = 1) and control (*MP_INFRACTION* = 0) until the means, variance, and skewness of the covariates are balanced. Variable definitions are provided in Appendix A.

TABLE 8 (continued)
Entropy Balanced Analysis

Panel B: Regression results using the entropy balanced sample

Dependent Variable:		Model (1):		Model (2):		Model (3):		Model (4):		Model (5):	
		<i>FSCORE</i>		<i>FSCORE_ONE</i>		<i>FSCORE_SUBST</i>		<i>LN_AUDFEES</i>		<i>LN_AUDFEES</i>	
Variable		Coeff.	S.E.	Coeff.	S.E.	Coeff.	S.E.	Coeff.	S.E.	Coeff.	S.E.
<i>MP_INFRACTION</i>		0.020***	0.008	0.018***	0.007	0.011***	0.004	-0.040***	0.007	-0.024**	0.013
<i>MP_INFRACTION</i> × <i>FSCORE</i>											
Control Variables	Yes			Yes		Yes		Yes		Yes	
Model	OLS			OLS		Logit		OLS		OLS	
N	25,893			25,893		25,893		25,893		25,893	
Adj./Pseudo R2	0.186			0.140		0.086		0.780		0.781	
Maximum Weight	2.410			2.410		2.410		2.488		2.488	
Weight Ratio	0.114			0.114		0.114		0.119		0.119	

Panel B presents the results using entropy balancing samples after requiring covariate balance on the first, second, and third moments of the distributions of all covariates for the corresponding model. The maximum weight represents the largest weight assigned to a control observation for the respective entropy balancing regression. The weight ratio represents the number of control observations receiving above equal weight in the entropy-balancing regression divided by the number of observations appearing in a one-to-one match without replacement (McMullin and Schonberger 2020). For brevity, coefficients on controls are suppressed. Robust standard errors clustered by client firm are included. ***, **, and * represent significance at the 0.01, 0.05, and 0.10 levels, respectively. The significance of the coefficients is based on a one-tailed test given the directional predictions in my hypotheses. Appendix A provides the variable definitions.

