Audit Quality and Audit Partners’ Behavior: Insights into Audit Firms’ Incentive Structures
Empirical Evidence of Audit Partner Compensation and Audit Firm Equity Structures

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Abstract

This study investigates audit firms’ incentive structures and their effect on audit quality through the analysis of (1) audit partner compensation schemes and (2) audit firm ownership. The Belgian audit market is used as the research setting. Audit firms can incentivize auditors to operate in alignment with the firms’ strategy and objectives. Thus, the incentive structures reflect the embodiment of the professional and the commercial logic and reveal how audit firms manage the inherent tension between both logics. As individuals are responsive to incentives, the incentive structures influence audit partners’ behavior and decisions. Hence, the incentive structures might eventually have an impact on the quality of the audit work as auditors’ behavior is a critical aspect in the production of audit quality.

First, this study aims to answer the question to which extent audit firms compensate equity partners equally or based upon their individual performance. Additionally, it addresses the relative importance given to individual professional performance versus commercial performance in the compensation calculation and seeks to answer as such the question how committed audit firms are towards the professional and commercial logic. Second, this study examines whether and how the total level and the functional form of equity partner compensation influences audit quality. Specifically, it addresses the question whether commercial (professional) incentives have a negative (positive) effect on audit quality. Third, this study analyzes the effect of equity incentives on audit quality. It examines whether owning shares of the audit firm or not is likely to incentivize audit engagement partners differently.

Results of regression analyses lead to the following conclusions. First, larger audit firms predominantly use performance based compensation. Moreover, partner compensation is to a larger extent based on commercial performance than on professional performance in firms of all sizes. Second, audit quality increases with the total level of compensation. This study shows that an excessive use of commercial incentives may reverse the initial positive effects on audit quality. Professional incentives are found to be counterproductive as they negatively influence the quality of audits. Third, this study provides evidence that auditors provide higher audit quality in case they own shares of the audit firm.

This study adds to our understanding of incentive structures used in audit firms to shape auditors’ behavior. Our results demonstrate that regulators, professional bodies, and audit firms should take decisions on incentives structures with some caution in order to prevent unintended or counterproductive consequences. Ongoing monitoring of incentives remains indispensable.