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THE PARTNERSHIP STRUCTURE OF THE AUDIT FIRM: GOVERNANCE OF AUDIT FIRMS AND ITS IMPLICATIONS ON THE AUDIT FIRM AND AUDIT QUALITY[1]

The relationship between the client and the auditor could explain variance in audit quality. We propose a complimentary explanation, with a focus on the governance of the audit firm. Audit firms are governed by partners and its partnership structure. We explore theoretically how the number of partners and especially, how the partnership concentration, i.e., number of partners/number of auditors and experts in an audit firm, influence the audit firm and the audit quality. We find that both number of partners and partnership concentration influence the partners and the organisation towards more commercial actions and reduce the audit quality, but only to a certain level. Our policy recommendation is that regulators should not only focus on the relationship between the client and the auditor, for example NAS and rotation of auditors, but also on the governance of the audit firms.

Key words: Governance, partnership structure, audit quality.

Коллін Свен Олоф. **Структура партнерства аудиторської фірми: управління аудиторськими фірмами та вплив на якість аудиту.**

На якість аудиту впливають відносини між клієнтом та аудитором. У статті висувається гіпотеза про залежність якості аудиту від способу управління аудиторською фірмою. Управління аудиторською фірмою здійснюється стейхолдерами, що мають різну структуру. Проведено теоретичне дослідження того, як кількість партнерів та всіх тих, хто входить до складу аудиторської фірми – кількість партнерів, аудиторів та експертів – впливають на її роботу та якість аудиту. Було виявлено, що кількість стейхолдерів впливає на рівень якості аудиту та зростання комерціалізації фірми. Регуляторним органам рекомендується зосередити увагу не лише на відносинах між клієнтом

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та аудитором (наприклад, на NAS, ротації аудиторів), але також й на управлінні аудиторськими фірмами.

Ключові слова: управління, структура партнерства, якість аудиту/.

Коллин Свен Олоф. **Структура партнерства аудиторской фирмы: управление аудиторскими фирмами и влияние на качество аудита.**

На качество аудита влияют отношения между клиентом и аудитором. В статье выдвигается гипотеза о зависимости качества аудита от способа управления аудиторской фирмой. Управление аудиторской фирмой осуществляется стейкхолдерами, имеющими различную структуру. Проведено теоретическое исследование того, как количество партнеров и всех тех, кто входит в состав аудиторской фирмы – количество партнеров, аудиторов и экспертов – влияют на ее работу и качество аудита. Было выявлено, что количество стейкхолдеров влияет на уровень качества аудита и рост коммерциализации фирмы. Регуляторным органам рекомендуется уделить внимание не только на отношениях между клиентом и аудитором (например, на NAS, ротации аудиторов), но также и на управлении аудиторскими фирмами.

Ключевые слова: управление, структура партнерства, качество аудита

INTRODUCTION

Traditionally, less based on empirical proof, Big-N, i.e., the large audit firms, where n depends on year of observation, have been interpreted as a proxy of audit quality. Choi, Kim, Liu & Simunic (2008) argue that Big 4 have higher audit quality, which they price in the Big 4 audit fee premium, since they have higher litigation risks, due to ‘big pockets’, i.e, due to their size they can pay more if they have made an audit error, and because of their size, they have higher reputational capital to loose. While Lennox (1999) found that the large audit firms in Britain had more accurate reports than small firms, recent studies, (Sundgren & Svanstrцm, 2014; Tagesson, & Öhman, 2015), have indicated that there is a variance of audit quality in today’s audit firms that do not follow the categorization of Big-4. Proxies, such as capacity to give proper going concern warning, has shown that the Big-4 vary in their success of making a correct reported prediction, which can be interpreted as an indication of variance of audit quality. It has also been found that commercial attitude, observed as attitude towards importance of marketing, which could be interpreted as a sign of lower audit quality, vary between audit firms, where Big 4 do not have less, but appears to have higher commercial attitude (Broberg, Umans & Gerlofstig, 2013).

Audit quality could be driven by threat of independence, where the relationship between the auditor and the auditee is at focus. Regulators have taken this conception of independence to their hearts. In US the extent of Non Audit Service is regulated and auditor rotation is compulsory (Knechel, 2015). Today the EU regulation contains demands on rotation of auditors and firms. It is argued that there is a threat to independence since the auditor is financially dependent, and the auditor and the audit firm has a long relationship with the firm and the client. Thus, financial dependency has to be broken, and the long-term relationship, that is presumed to reduce independence, has to be broken through rotation.

In this paper we will focus on conclusions made by empirical studies that shows that audit firms vary in audit quality. But we will offer a complementary explanation of audit quality variance. It will neither focus on the traditional separation between Big 4 and Non-Big 4, nor will it focus on the relationship between the auditor and the auditee. We will enter the organization and focus on the governance of the audit firm. Our understanding will be derived from a focus on the governance of the audit firm. We will claim that audit quality varies between audit firms because of differences in the audit firm's corporate governance structure, and more specifically, in their partnership structure.

Some empirical indications have been found to support the view that audit quality could vary with partnership structure. Dominance of female CPAs in the partnership structure showed a negative correlation with abnormal accruals as an indicator of the quality of the financial statement in Spanish firms (Montenegro & Bras, 2015). In a Swedish context, it has been found that Big-4 firms vary in partnership concentration, defined as number of partners/number of employees in the audit firm (Lexander & Öggesjö, 2011). Another Swedish study found that partnership concentration in an audit firm was positively correlated with probability that the audited listed firm deviated from the Swedish code of corporate governance

(Tagesson & Collin, 2015). While these are empirical correlations, we will develop a model in order to understand these correlations.

Recently, Francis (2011) noticed: “We would also like to know more about the structure of partner compensation contracts, and how compensation affects the partner’s incentives and behaviour…” (p. 138). He concluded, as did Knechel, Krishnan, Pevzner, Shefchik & Velury (2013) in an extensive review of the audit quality literature, that there is limited research in this field.

In this paper, we claim that due to differences in the governance of the audit firms, more specifically, differences in the partnership concentration, partners and potential partners will have different incentives and power reasons that influence the auditor’s approach and actions when performing an audit, and therefore influence audit quality.

A MODEL OF PARTNERSHIP STRUCTURE

Assumptions of the model

The model contains some specific conceptualizations and assumptions. We conceptualize the partnership as a governance structure, implying that not only the partners are considered but also the partnership structures influence on the organization.

Partnership as a governance structure

There is a literature about partnership, using rather advanced modelling (i.e., Narayanan, 1995; Miller,1997; Huddart, & Liang, 2005), based on Holmstroms (1982) development of team ideas from Alchian & Demsetz (1972). This literature is, however, solely focused on partners. They assume a firm consisting of only partners, where the functions and the interest of the principal and the agent is located in the same person. We are interested in audit firms that consist of partners and potential partners since audit quality is a consequence of a production performed by partners, potential partners and other employees. In our conception, partnership is not a characteristic of the firm, but a characteristic of the governance of the firm, i.e., partnership is a governance structure.

In this governance structure one could, as indeed the literature of partnership is doing, focus on the partners and their incentives, especially the financial incentives (Burrows, 1998; Huddart & Liang, 2005; Knechel, Niemi & Mikko, 2013). We believe, however, that the output of an audit firm is created by the organization subject to the governance structure. While the partners are important as managers of the production of the audit firm, we believe that their governance of the firm, and how the governance structure is organized is conducive to the quantity and quality of the output of the firm. Our question is: What is the outcome of an audit firm being organised with partnership as the governance structure?

The partnership models have another specific characteristic, well expressed in this motivation of a study: "The service sector forms a large and growing portion of the economy; therefore, accounting research on control issues in professional partnerships is particularly relevant." (Narayanan, 1995:897). The focus in the research is on how to control, i.e., how to divide the pie created, ignoring the issue of how to produce it, i.e., how to bake the pie, or how to develop the firm, i.e., to create a new or a larger pie (cf. Ponomareva, 2015). In our model we will focus on the disciplining part, but also include entrepreneurial aspects of an audit firm.

Our model is based on the conception that partners influence the audit firm, in which the audit quality is produced. Audit quality of the firm is probably strongly influenced directly by the partners, through their decision making power, their monitoring of the audit teams and them directing the teams. But the audit quality is produced in everyday actions by everyone at the audit firm. Here, routines of the firm and the culture of the audit firm, including culture of billing, i.e., to strive to perform actions that can be billed (Alvehus & Spicer, 2012), guide auditors and other workers of the audit firm which influence the audit quality. This view is consistent to IFACs view (as cited by Montenegro & Bras, 2015:266): "The partners provide leadership at many levels: technical leadership, leadership in the production and commercial aspects of the firm's operation, and shaping the culture and atmosphere within the office. " (IFAC, 2011:26)

We have to understand the drivers of partners actions and how it influences the daily activities of the organization through influencing audit firm workers, especially those conducting the main part of the audit, where many of them are potential partners.

Partner's motivations and influence on the organization

Partners act due to their incentive system (Knechel, Niemi & Mikko, 2013) and in accordance to their professional norms, and in accordance to the standards (Knechel, 2013). Partners experience status through partnership, and they have power in the firm through their ownership stakes. They have financial incentives through a base salary, but also through profit sharing schemes, were some parts can be divided equally to each partner and one part divided to individual partners, dependent on the partners performance, competence and the clients the partner serve (Holmes & Zimmer, 1998; Knechel, Niemi & Mikko, 2013).

The audit firm, including all auditors and experts that belong to the group of potential partners, is influenced by the partners through the decisions made by partners, through partners being role models in the firm, especially for the potential partners, and through partners signalling proper behaviour of auditors through their own actions and through selecting partners.

Time horizon of the partner

Partnership is a form that makes a selected part of the employees owners of the audit firm, implying the right "…1) to be a residual claimant; 2) to observe input behavior; 3) to be the central party common to all contracts with inputs; 4) to alter the membership of the team; and 5) to sell these rights…" Alchian & Demsetz, 1972:783). The deviation from this definition of the classical capitalist firm is that the fifth condition, to sell these rights, is restricted, where often the owner, i.e., the partner, has to sell the shares back to the firm, to a price that do not reflect its potential market value. The limitation of transferable rights creates the problem of partner's incentives of investing the profit in the firm. Investments will be made out of current profit, but will not be reflected in the current value of the firm through the shares, but in the cash flow in the future, thus reducing the current wealth of the partner.

This investment problem is stronger the shorter time horizon the partner has since the reduction in profit today could create larger profit in the future or at least, will defend the profit levels of today. The longer horizon, the higher probability that the investment will influence the expected profit of the partner, thus creating incentives of investments. Hence, an old partner will have weaker investment incentives than younger partners.

Additionally, a partner will have less incentives of effort when the horizon becomes shorter since less effort will influence the profit in the future. Facing this risk, a partnership structure focused on financial incentives will distribute a higher share of the profit to the older partners, in order to counteract this loosening of effort incentives.

The partner's profit, power and monitoring

The profit is typically distributed, either with an equality system or with a performance system (Holmes & Zimmer, 1998). It is hard to measure each individual partner's contribution since, for example in large audit firms, one can expect that large clients, presumably profitable ones, are attracted by the audit firm brand and not by any single auditor. However, an auditor that do not treat the client well could be a reason for the client to change audit firm. Thus, to retain a client could be one reason for strong individual correlation between a client's profit contribution to the audit firm and the incentive compensation to the partner that handle the client.

The owner of the firm has power over the firm, which in the Alchian and Demsetz (1972) list is the right to be a central party and to change the membership. This power is functional in securing effects of monitoring, i.e., to have right to select partners and to sanction existing partners (which we soon will discuss). The power is also a mean to secure investments, so they create profit in the future. Since we found earlier that due to time horizon, older partners have less incentives of investments, a rational form of structure would be to reduce their power over investments, creating the form where older partners receive more profit, in order to stimulate them to effort, and less power, in order to keep them from reducing investments.

Concerning power, we can also leave the financially oriented individual and assume that individuals are motivated by status and by needs of making good. These motivations needs to be canalised through power usage, where the individual can decide of development that makes the audit firm more attractive, thus increasing the status of the partner, or being better in a sense judged by the individual partner, thus creating the feeling of making something good. It should be noted that with this assumption of human motivation, there are no reasons to have increasing profit distributed to the older auditors. There could, however, be reasons to give less power to these since they could overinvest for the sake of the good and not for the profit, especially not the long-term profit, which could be more attractive for the younger partners.

Thus, power is needed in order to secure the firm through monitoring effects such as selection, but also to make it possible for partners to develop the firm, for the sake of profit, status or to create something they consider good. It has to be noted that development due to profit and status is aligned with the economic assumptions of individual motivation. Power for the sake of creating something good is however not in accordance to this assumption. For example, Legros & Matthews (1993) argue that "…some partner will shirk because he must share the marginal benefit of his effort, but he alone bears its costs." (p. 599). This is the rather unrealistic assumption of economics, where individuals are hindered in engagement due to them focusing on the division of the pie instead of making the pie. In a more realistic theory of human action, one has to consider the existence of more generous individuals or individuals that act out of a sense of duty, to do the right thing (Collin, 2020), to develop the audit firm, even at the full costs of doing it while sharing the benefits to others. The power explanation open the theoretical categories to firm development where individuals acts out of other motivation than pure financial egoism.

Finally, monitoring, where the partner system is a monitoring system through peer review. In fact, it can be shown under the assumption of auditor effort avoidance, financial interest and absence of professionalism, the agency costs effects of mutual monitoring is one reason to create an audit firm (Balachandran & Ramakrishnan, 1987). Since the partner's wealth depend on the reputation of the firm, each partner has incentives to monitor the other partners.

ANALYSING THE PARTNERSHIP STRUCTURE

We start our analyses of the partnership structure by noticing some important consequences of the number of partners in the partnership. Then we focus on partnership concentration and its consequences on the audit firm and the audit quality.

Number of partners

We start our analysis of partnership structure by focusing on the number of partners in an audit firm.

Concerning financial incentives, when there is an equal sharing of profit, the partners have financial reasons to limit the number of partners. The more individual sharing, for example due to performance (vulgarly expressed as ‘eat-what-you-kill’), the number of partners will not influence the wealth of the individual partner. Thus, one can assume that, due to financial incentives, equal sharing will restrain the number of partners, while individual sharing makes it possible to enlarge the number of partners. Then one would ask, why have partners when profit sharing is dependent on individual performance? One reason is tradition, that partners are defined as those receiving the profit. Another reason is that it is hard to individualize performance, thus some part has to be divided due to some formula, where equal distribution among a restricted set of partners is preferred. Finally, they need potential performers to become partners, where the performers can have the individual incentive to perform, but at the same time create value for the firm. Thus, we can summarize this discussion in a hypothesis:

H_1: The more partners, the lower equal sharing of profit

Concerning power, the more partners, implying more sharing of power, the less every partner will investment in knowledge about the firm and developing strategies for the firm. This is similar to the shareholders weakening incentives to invest in competence of the firm due to low power and therefor a low capacity to implement and defend the strategy chosen. In partnership this is accentuated by the partnership tending to have democratic rules of influence. Thus, number of partners attenuate the motive to use power.

H_2: The more partners, the lower the individual partner’s investment in governance of the audit firm

H_3: The more partners, the lower the individual partner’s usage of power

Concerning monitoring, the capacity to monitor each partner will be reduced with increasing number of partners. The implications could be that efforts will decrease since effort is individual but effects are collective through the profit sharing scheme. It could also increase the risk of the firm, especially when there are elements of individual profit sharing. Then the positive outcome of an increasing risk will go to the acting partner, while the downturn risk first hit the partner and then hit all partners.

Knechel, Niemi & Mikko (2013) suggest that with increasing number of partners, the monitoring system will be harder to keep up. Then the audit firm will use incentive systems in order to direct the auditor. That is, however, debatable since peer review monitoring is hardly interchangeable with compensation systems. When we use compensation system here, we have to assume that it implies performance based compensation since equal pay cannot be supplementary to monitoring. If we assume performance compensation, the compensation system will tend to rely on measurable factors, in contrast to the monitoring, where peer review contains also, and maybe foremost, qualitative factors. Thus, with increasing number of partners one could instead expect that monitoring will be supplemented with evaluations based on more easily measurable factors, which pave the way for compensation schemes based on performance.

An alternative to easy measurable metrics in order to use compensation system, and in order to avoid the risk with attenuated monitoring when increasing the number of partners, the audit firm could reduce the need of monitoring. This could be made through reducing the audit risk. It implies that the audit firm will accept only large clients with low audit risk, or accept many small clients, with a high level of audit risk diversification, or preferably rather similar clients, reducing the audit risk through competence specialization, which have the benefits of producing higher audit fees (Numan & Willekens, 2012). Therefore, one would expect that with many partners comes preference for low audit risk, which will be reached through low-risk clients, small clients, or audit specialization. Thus, we hypotheses:

H_4: The more partners, the lower audit risk of the client firms

H_5: The more partners, the smaller the clients

H_6: The more partners, the higher level of auditor specialization.

Partnership concentration

We now turn to the relative share of partners through introducing the concept *partnership concentration*, which indicates to which extent the benefits and costs of partners are concentrated to specific members of the organization. These members are termed partners. The formal definition of partnership concentration is: 1 - (number of partners/auditors and experts in the audit firm). Thus, a high concentration imply that there are few partners compared to the number of employees, thus indicating that the benefits of partnership is concentrated to few partners.

The immediate financial motives behind a concentration of a partnership structure is that the profit for each partner increase with partnership concentration. It also implies that the power becomes concentrated, inducing partners to invest in knowledge about the firm in order to develop the firm since there are fewer partners that share the power of the firm. And finally, monitoring of partners becomes easier in terms of number of partners to monitor. With the logic of the above reasoning, it would imply that the drive to implement performance compensation becomes less with increasing partnership concentration, and more equal distribution of the residual would be expected.

Thus, we formulate the following hypotheses

H_7: With increasing partnership concentration the use of equal division of profit will increase.

Commercial attitude, defined as marketing oriented (Broberg et al, 2013), with pre-client acquisition through advertising and solicitation (Hay & Knechel, 2010), and post-client acquisition, such as client interaction where client orientation, service and even adjustment have been claimed to imply the loss of professional audit attitude. While client adjustment appear to be hard to accept when the norm of independence is hailed, it can be argued that it is to miss the point. If we assume that auditors have independence as a mean to perform an audit that creates audit quality, client orientation does not necessarily intrude in audit quality, at least not to the level of creating scandals. While, for example, support to the client to find ways to avoid the corporate governance code, could indicate a loss of independence, it will not necessarily influence audit quality, defined in the traditional way, as the probability of an auditor to discover and to report errors in the accounting system (DeAngelo, 1981).

Audit quality, as probability of reporting, could be assumed to be more influenced by fee dependency, although research has shown mixed results (Craswell, Stokes & Laughton, 2002). The argument would be that if the client has a large share of the audit firm's sales, which pays salaries, and therefor involves the whole organization, and especially a large share in the audit firm profit, which pays the profit to the partners, and therefor involves the partners, those signing the audit report, the probability of defective reporting will increase.

The commercial attitude will probably be more influential on audit quality as probability of finding errors. The interaction between the client and the audit firm and its auditors imply that the auditor will try to manage the expectations of the client. Grey (1998) showed that managing the client was part of the evaluation of the auditors. Thus, to become successful, one has to be able to interact with the client and to influence the client, but at the same time, let the client influence the audit firm. Auditors have reasons to spend time on client adjustment and client service since it is experienced by the client and creates a sense of value for money, thus increasing client satisfaction. The time consumed with client adjustment and service, if not possible to be billed as a Non Audit Service (NAS) or to increase the bill of auditing, will reduce the time spent with actual audit. Hence, a commercial attitude with client adjustments and service outside NAS consume time that otherwise would have been spent on detecting errors.

An auditor with a will to keep up with professional norms and audit standards (Knechel, 2013), thus creating acceptable audit quality, and keep up the reputation of the audit firm, will conduct audit to the level of reaching an acceptable level of audit effort, that will, given the level of audit risk, create an acceptable level of probability to find substantial errors.

We therefor expect to find a reduction of audit quality with increasing concentration due to commercial attitude, but the decrease will level off at an acceptable level of audit quality.

H_8: With increasing partnership concentration the audit quality will decrease to a certain level.

It has, however, been argued that more client interaction will increase the knowledge by the auditor of the client (Knechel, Sharma & Sharma, 2012; Svanström, 2013). This knowledge spillover could imply higher capacity to detect errors (Pott, Mock & Watrin, 2009). The total effect could very well be that the less time spent on detecting errors will be fully compensated by the higher capacity through knowledge of the client to detect the errors. Or, at least, it will lower the downturn speed of decreasing capacity to detect errors, i.e., a slower reduction of audit quality.

Another objection could be that in the pre-client phase, the audit firm could, through advertising but maybe even more, through solicitation activities, manage client expectations of activities such as client interaction in the audit phase, which could motivate higher audit fees. Thus, our assumption above, that interaction will not be reflected in the audit fee, could be wrong, and therefore our hypothesis of a decrease would not hold for empirical tests. Hay & Knechel (2010) found indications in New Zealand, that advertising increase audit fees, while soliciting reduce audit fees. The increase of audit fees can be explained by successful differentiation, which Numan & Willekens (2012) found in a study of US audit firms. However, the solicitation results is harder to understand. Solicitation imply that not only the buyer of the product can express their demand, but also the supplier can enter the market and express their supply, i.e., improving the market capacity to create a fit between demand and supply. Solicitation imply a client interaction that would be superior in its capacity to manage client expectations, thus being able to not only produce a well fitted product, but also to motivate the price of the product, i.e., the audit fee. Thus, one would expect that solicitation would imply higher audit fees and that those with a strong commercial attitude, i.e., those with high partnership concentration, prefer solicitation.

Increasing partnership concentration will also influence, indirectly and directly the audit firm organisation below the partnership structure. For example, it will influence the selection of the partners, therefor it will influence the pool of potential partners.

With higher level of partnership concentration, it will become more important to have an accurate process of selecting a new partner. If one partner leaves and a new partner will be selected, it will not influence the short-term profit sharing since the partnership concentration will be the same. But a new partner will influence through power since the new partner have ideas and ambitions that have to be aligned with the other partners. Additionally, the new partner could have competences and ambitions in auditing that increase or decrease the audit risk and influence the strategy of the audit firm, therefor the monitoring effort could be influenced. Less monitoring would be preferred since it reduces costs. However, initial increased monitoring could be expected, before the partner has been well adjusted to the norms and strategies of the other partners. Thus, selection of a partner becomes a very important process in an audit firm with high level of partnership structure concentration.

H_9: With increasing partnership concentration the importance and therefor the resources spent on selecting a new partner will increase.

The partnership concentration influence both partners and how they influence the organization through their actions, but it also influence directly the organization through those processes known from the tournament theory (Rosenbaum, 1979; Connelly, Tihanyi, Crook, and Gangloff, 2014). Tagesson & Collin (2015) claims that with increasing partnership concentration, through the process of tournament, adherence to the norms and values of the partners will be stronger. Audit firms tend to use the "up-or-out" career system (Greenwood and Empson, 2003). The norms signalled by the partners, both the commercial norms and the professional norms will be sought for by the potential partners. Those that accept those signals will be in the pool of potential partners (cf. Connelly, Tihanyi, Crook, and Gangloff, 2014). Those that do not accept them will leave the firm, due to the tradition of "up-or-out" or some will stay, only incentivized by their own norms.

Acceptance of the signals given by the partners have to be shown by the potential partners in order to be considered to be in the pool of potential partners. These potential partners can create signals of adherence or, even stronger, copy the preferred behaviour.

The strongest signal is to copy and replicate the behaviour. For example, when Tagesson & Collin (2015) found a correlation between partnership concentration and the audited corporation's adherence to the corporate governance code, it was interpreted as a more commercial attitude (Suddaby, Gendron & Lam, 2009) among partners. The actual process could be that the team that interact daily with the client experience a client's need of deviation. The team reports the client needs to the signing auditor and suggest, as a signal of adherence, a solution that is in line with a commercial attitude of client adjustment and service. By this actual behavior, the potential partner show an understanding of the commercial strategy, and can express it through a closer client relationship, listening and understanding the needs of the client, in this example, a need to deviate from the code. In contrast, an auditor of the team with a very strong professional attitude void of commercial attitude and not being in the pool of potential partners, could, at first not even be able to perceive the client need, and if it would have been recognized, have no reason to report it to the signing auditor, and finally, have not spent any valuable audit time on finding a solution to the client need.

Thus, we would expect that the tournament behaviour of adhering to the norms of the winners of the tournament game, the partners, becomes stronger with increasing partnership concentration. Since we have hypothesised that the commercial attitude will increase at the partner level with increasing partnership concentration, that is the norm that will be supported and signalled.

H_{10}: With increasing partnership concentration the commercial attitude of potential partners will increase

The partnership concentration influences the pool of potential partners and the motivation of the potential partners, as we indicate in diagram 1.

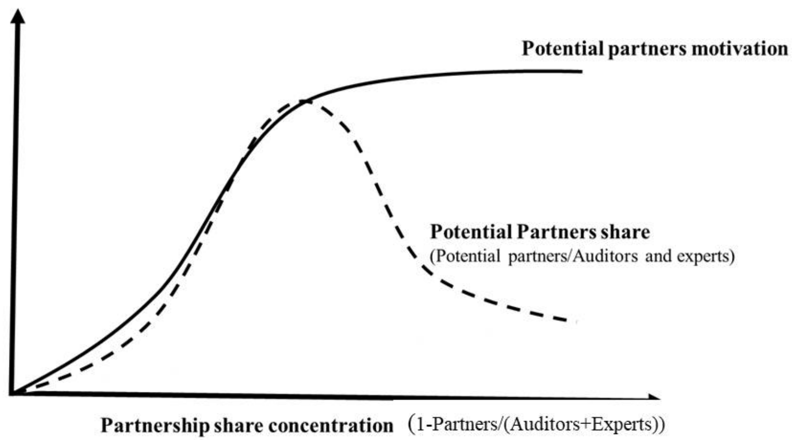

Diagram 1. Pool of potential partners and their motivation

In diagram 1, with the dotted line, we show how the pool of potential partners will vary due to partnership concentration. Beginning at the left end, everyone becomes partners, without any selection. In this case, no-one has an interest in becoming partners since everyone becomes partners and the profit is distributed to everyone. This is a case when there is no difference between being employee and partner. But when there is a selection, there is profit sharing that is not distributed to everyone, thus creating financial incentives to be partner. The pool increases with partnership concentration to a certain level. The increase can be explained by the individuals experience the financial opportunities through profit sharing increasing more than the costs, presumably potential loss of professional pride that the demands to adhere to the commercial attitude put on auditors. The competition is also rather weak, since the concentration is still on moderate level, which makes the effort needed to be part of the competition to become partner on a moderate level.

At a certain level the competition to become partner is so stiff, and the demands to adhere to the norms in order to be selected are so strong, that some individuals, those stressing professional norms very hard and those that do not have an interest in using energy in a hard competition, loose interest in the tournament (Connelly, Tihanyi, Crook, and Gangloff, 2014). After that optimum, the pool of potential partners are being reduced. Still, the selection forces are strong on adhering to the norms, but the competition becomes less hard since the pool is smaller.

H_{11}: With increasing partnership concentration the pool of potential partners increase, to an optimum, and then decrease

At the right side of the optimum, one could note that the diversity of potential partners decreases, and left are strongly competitive commercial-oriented individuals. While lower diversity is good for implementing established strategies, studies of diversity indicates that developmental capacity will be reduced (Umans, 2012).

With the solid line we show the development of motivation intensity among those that stay in the pool of potential partners. Their motivation increase with concentration, but after the optimum, they stay in the pool, attracted by the profit share, by the power and the status of becoming a partner. While these utilities would increase the motivation, the competition becomes less hard since the pool of potential partners becomes less and less, thus reducing the need of motivating for the potential successful selection to become partner. All in all, it could very well be the effect that the motivation increase of financial and intrinsic rewards are levelled out by the less competitive stance, making the total motivation of an individual rather stable during the increase of the concentration.

H_{12}: With increasing partnership concentration the motivation of the potential partners increase, but level off when reached the optimal level of the pool of potential partners

Our reasoning leads to a conclusion that due to the tournament process, the audit firms can have an optimum partnership structure where the pool of potential partners are as large as possible, with possibilities of creating a diverse partnership structure, and keeping the motivation as high as possible.

We have hypothesised that with increasing partnership concentration comes equal distribution of profit among the partners. But at the same time, higher partnership concentration implies a strong tournament effect of unequal distribution between partners and non-partners. An important question is how to establish equal distribution among those that have been attracted and accustomed to high unequal distribution? If the tournament effect is driving their motivation, i.e., more motivation with more inequality, what happens to the motivation when entering into an environment of equality? One could imagine, under assumption of effort avoidance, that monitoring costs will be very high since when entering partnership, the goal has been reached and the tournament incentive has ceased to exist, and therefor do not drive motivation.

It could be claimed that those selected have so strong intrinsic driving force that they cannot stop being hard working, therefor no extra monitoring is needed. These individuals have not been motivated during their work in the audit firm by the tournament signals, but they have selected the audit firm with the high partnership concentration in order to reach the wealth of the partners. Thus, the high partnership concentration is established in order to attract highly motivated individuals. With this, economic based understanding, we formulate a hypothesis similar to H_9:

H_{13}: With increasing partnership concentration the selection process of individuals entering the audit firm will be stressed

An alternative understanding would be to leave the assumptions of economics, and enter an assumption made in sociology, that of socialisation. Individuals are being socialised into the hard working norms during the career in the firm, so when entering into the cadre of partners, they have no preferences for effort avoidance available. Training to accept the norms of the tournament and legitimization of the tournament will therefore be stressed during the individual's career.

H_{14}: With increasing partnership concentration the socialization into tournament selection will be stressed

Finally, one could adopt the Perrow argument (1993), that individuals adjust to the control system. An individual in a control system based on opportunism will behave opportunistic. An individual in a tournament system, will act in accordance to that system. When promoted to partner, with equal sharing, the individual is so flexible in behaviour and becomes a worker in the partner system, subordinated to monitoring and sharing the profit. With the Perrow argument, the flexible individuals adjust to the control system, making the question of changing control system a non-issue.

Another implication of the tournament process in high concentrated partnership is the risk distribution. While those that are partners have strong incentives of monitoring the other partners, the partners could run the firm with very high risk. Those that are potential partners are doing a very high investment in the firm, and since the probability of becoming partner reduces with increasing concentration, there are many potential partners making high investments. If we then enter the specific condition of the audit industry, that every larger audit firm tend to be an internal labour market, where transfers between audit firms are highly unlikely, many potential partners are looked in to the specific tournament in the specific audit firm. There is a moral hazard problem of large magnitude where the potential partners make huge investments, but are being subject to the partner's power to implement whatever risky strategy they want. Thus, potential partners have reasons to monitor the partners in order to get information of the risk of the audit firm. If they find the risk to be unacceptable, they have to look for alternatives outside the audit industry, to try to break the tradition of enclosed labour market in audit firms or to influence the partners. Realizing this hold-up condition of potential partners, the present partners, with their interest to keep up the tournament process, signal the riskiness of the strategy to the potential partners. Thus, to keep the trust in the firm and the tournament, with increasing partnership concentration comes more intense information about the development of the firm.

H_{15}: With increasing partnership concentration the information effort in the organization concerning the development of the audit firm will increase

CONCLUSIONS

A few studies have studied the governance of the audit firm, where the partnership structure is in focus. Montenegro & Bras (2015) found that gender distribution in the partnership structure correlated with abnormal accruals in Spain. Inspired by Lexander & Öggesjö (2011), Tagesson & Collin (2015) found a correlation between partnership concentration and the audited firm's propensity to follow the corporate governance code in Sweden. Our task in this paper has been to explore the partnership structure, and specifically, the partnership concentration and find theoretical reasons that could indicate how the partnership structure influence the audit firm and the product of the audit firm.

We have found, based on mainly economic logic, but also on sociological logic, that partnership structure influence behaviour of the partners and the organization.

We have derived hypotheses concerning number of partners that propose that with more partners we expect less use of equal sharing of profit, lower partner investment in governance and development of the audit firm, lower partner usage of power, lower audit risk exposure, smaller clients and higher level of auditor specialization.

Turning to partnership concentration, we expect more use of equal division of profit among partners, the selection of new partners will be an important and costly process, the commercial attitude of potential partners will increase, the pool of potential partners will have an inverted U-shape, the socialization into tournament selection will be stressed, the information effort in the organization concerning the development of the audit firm will increase and there will be a decrease in audit quality to a specific level.

The findings of Tagesson & Collin (2015), that with increasing partnership concentration, the client firm tend to deviate more from the corporate governance code, can be explained by our hypotheses. We believe that the client orientation will increase with the partnership concentration since the partners are more inclined to try to satisfy the clients, in order to profit from clients satisfaction. This client orientation will be signalled strongly to the organizations, especially to those in the organisation that is still in the pool of potential partners. The potential partners have, however, undergone a hard selection process and a socialization process where they learn to use the client orientation.

We have found that audit quality will be lower, but only to a certain level. Thus, we find no strong reasons to worry about the audit quality per see. This is probably also the case when trying to understand the Spanish study (Montenegro & Bras (2015) since their dependent variable was abnormal accruals, which could be interpreted to show the auditors acceptance of a client interest, and not necessarily imply lower audit quality, in terms of errors found and reported.

Higher partnership concentration appears to transform the audit firm into a more commercial firm. Is that so bad? Both professionalism and reputation set the lower limit of audit quality, while the commercial attitude, so strongly promoted in the tournament system of highly concentrated partnership structure, makes the auditor and audit firm more prone to service.

With the focus on the governance of audit firms, we get an interesting conclusion concerning regulation. Regulation today, for example, auditor rotation, tend to focus on the relationship between the client and the auditor. The regulation through corporate governance codes do also focus on this relationship through demanding the presence of an audit committee, which partly has the responsibility to guard audit quality. We believe that it is as important to focus on the other side, that the threat on audit quality can be situated in the governance structure. While the concentration of partnership has certain advantages, such as client orientation, and presumably more of business development within the audit firm, it has its drawbacks concerning monitoring. Today the actual monitoring of audit firms is mostly internalized when it concerns the large audit firms, which are the ones we have been discussing in this paper. In extreme cases the monitoring is externalised to the state and the courts, as Choi, Kim, Liu & Simunic (2008) show in their test of institutional legal differences. In US, PCAOB is a federal agency, governed by the SEC through them appointing the board of PCAOB, and financed by the audit firms.

In between, in order to manage audit quality before it has turned into a scandal and a failure that puts the audit firm to court and subject to the scandal press and the scandal researchers, one could imagine non-state external monitoring. Our policy conclusion could be, that given the strong forces through partnership concentration, monitoring of the auditors and the firm could preferably be external. Since the audit is performed in the interest of the stakeholders, they are the ones that should direct the monitoring agency. The stakeholders, mostly the creditors, such as banks with interest through loans, government with taxes and labour with wages and employment, could establish a monitoring organization, governed by them, and, similar to US PCAOB, financed by those that create the monitoring problem, i.e., the audit firms.

Regulations tend, however, to be forced and based on prejudice and formal models, and less on strong empirical evidence. The main implication of our explanation of partnership concentration is therefore less that of regulation, and more call on research that focus on the governance side of audit firms, and test some or all of our hypotheses. Indeed, it is fascinating to experience the enormous energy spent in studying the corporate governance of corporations, and the negligence of studying those governance forces that influence those that are they final guardians of the market economy, the auditors.

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