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journal homepage: [www.journals.elsevier.com/journal-of-accounting-and-economics](http://www.journals.elsevier.com/journal-of-accounting-and-economics)Delegated leadership at public accounting firms<sup>☆</sup>Clive Lennox<sup>a,\*</sup>, Chunfei Wang<sup>b</sup>, Xi Wu<sup>b</sup><sup>a</sup> Leventhal School of Accounting, University of Southern California, USA<sup>b</sup> School of Accountancy, Central University of Finance and Economics, China

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## ABSTRACT

Public accounting firms are owned by all equity partners, but day-to-day management is generally delegated to a team of leaders. Using data from China, this study examines which equity partners are selected to the firm's national leadership team, and whether firmwide audit quality is related to leadership attributes. We find that a partner is more likely to be selected as a leader if the partner is more experienced in public company auditing and has attracted more new clients to the firm. Firmwide audit quality is higher when leaders are more experienced in public company audits or have a past record of larger audit adjustments, and is lower when leaders have attracted more high-risk new clients to the firm. Leadership attributes exhibit a relatively strong (weak) association with audit quality at the headquarters (branch offices). Moreover, audit quality is higher when a firm has more leaders in an audit-quality role.

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## 1. Introduction

Public accounting firms face a trade-off between short-term profit maximization and long-run survival because a firm that compromises on audit quality to increase its profits could eventually fail as a result of regulatory sanctions or reputation impairment. Public accounting firms are also exposed to agency problems because an individual partner may not act in the best interests of the firm as a whole. For example, an individual partner may compromise on audit quality in order to retain a client even though doing so could expose the entire firm to the risk of regulatory sanctions or reputation impairment. It is the responsibility of the firm's leadership to institute firm policies aimed at mitigating such agency problems to safeguard the firm's future.

Executive control of an accounting firm's policies, operations, and administrative matters is generally delegated to a leadership team of senior managing partners. Leaders influence the trade-off between short-term profit maximization and long-run survival in a number of ways. Leaders influence the selection of partners and the recruitment of employees. Leaders

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communicate the firm's priorities in its training programs and in its policies on remuneration and disciplinary procedures. Leaders also play a role in screening clients to manage audit risks. They institute policies that require engagement partners to consult with the firm's risk control department regarding contentious accounting issues, the recording of audit adjustments, and the issuance of qualified audit opinions. Given the considerable influence of leaders, we posit that leaders can have a significant impact on audit quality throughout the firm.

Standard setters and regulators have speculated that the leaders of accounting firms might prioritize short-term profit maximization to the detriment of audit quality (IAASB, 2014; CAQ, 2014; PCAOB, 2015; IFIAR, 2015; FRC, 2018; IAASB, 2019; PCAOB, 2019). However, very little is known about the partners who are selected as leaders or whether audit quality varies with the attributes of the firm's leadership team. We provide this evidence by examining which partners are selected (not selected) as national leaders, and by examining whether audit quality varies with the attributes of the firm's national leadership.

We predict that a partner is more likely to be selected as a leader if the partner: 1) has more experience in public company auditing, 2) performed high-quality audits in the past, and 3) previously attracted more new clients to the firm. While these predictions are intuitive, they are not without tension. For example, the first prediction may not be true if firms select leaders from non-audit backgrounds (e.g., tax, consulting). The second prediction may not hold because accounting firms may prioritize short-term profit maximization over audit quality. Conversely, the third prediction may not hold if firms prioritize audit quality over short-term profits.

Next, we examine whether audit quality varies with the attributes of the firm's leaders. We expect a firm to provide higher quality audits when its leaders are more experienced in public company auditing and have past track records of high-quality audits. We make these predictions for a couple of reasons. First, leaders can draw on their past audit experiences to make improvements to firmwide audit quality. For example, experienced leaders can require engagement partners to consult with the firm's risk control department to deal with contentious audit adjustments or to issue qualified audit opinions. Second, we expect that a firm would select experienced leaders with a history of high-quality audits if the firm has audit quality as one of its top priorities.

Conversely, we expect lower audit quality when leaders have a past record of attracting more new clients to the firm, particularly if the new clients were high risk. Leaders who emphasized client acquisition when they were engagement partners may continue to emphasize revenue growth once they are elected as firm leaders. The emphasis on short-term revenue growth (i.e., keeping audit clients happy) could have a deleterious impact on firmwide audit quality. Second, a firm is likely to select leaders with a strong track record of attracting new clients if the firm considers short-term profits to be a bigger priority than audit quality. Given these arguments, we expect audit quality to be lower when the firm's leaders have a past record of attracting more new clients to the firm.

Prior research on accounting firm leadership has proved difficult due to a lack of publicly available data. We use data from China, where firms have been required to disclose the identities of leaders to the regulator since 2013. We have additional data on the past audits of every partner during their career (as far back as 1991), which allows us to compare the past work history of partners before they were selected (not selected) as leaders. In addition, the China setting provides detailed information on each partner (e.g., their equity ownership, age, and gender), allowing us to examine the determinants and consequences of leadership selection. Our sample comprises 35 accounting firms licensed by the China Securities Regulatory Commission (CSRC) to audit public companies (2013–2018). In total, the firms have 3714 equity partners of which 12% serve on the firm's national leadership team at some point during the sample period.<sup>1</sup>

As predicted, we find that a partner is more likely to be selected as a leader if the partner has more experience in public company auditing. On the other hand, approximately one quarter of leaders have no experience in public company auditing whatsoever (e.g., they come from non-audit or administrative backgrounds such as tax, advisory, human resources, or technological support). As predicted, we find a partner is more likely to be selected as a leader if the partner has a stronger track record of introducing new clients to the firm. This finding suggests that firms value commercial acumen as well as audit experience when selecting leaders.

We further examine whether the selection of national leaders is related to the partner's past audit adjustments. DeAngelo (1981) defines an audit as being of higher quality if it has a higher probability of detecting and correcting an existing misstatement. Audit adjustments fit naturally with this definition because an adjustment signifies that a misstatement was discovered and corrected during the audit before the financial statements were issued to investors. Leaders are able to directly influence audit adjustments through their authority over the firm's risk control department which consults with engagement partners about contentious audit adjustments. We therefore follow prior studies by using audit adjustments as our primary measure of audit quality (e.g., Lennox et al., 2014, 2016, 2018, 2020; He et al., 2018; Lennox and Wu, 2022; Choudhary et al., 2022).

In univariate tests, we find that a partner is more likely to be selected as a leader if the partner required larger audit adjustments on his or her past engagements. However, these results become insignificant or borderline significant in the regression analyses, depending on the specification that is estimated. Other partner characteristics are found to be more important in explaining the selection of leaders. We find that a partner is more likely to be selected if the partner is an older

<sup>1</sup> Consistent with the leadership role taking up much of the partner's time, we find a significant drop in the number of public company clients served by a partner after the partner is selected as a leader.

male with a larger equity stake in the firm. On average, the leadership team owns 34.3% of the firm's equity, which suggests that leaders have strong equity-based incentives to increase firm value.

Next, we examine whether audit quality varies with the attributes of the leadership team. We find that audit adjustments are significantly larger when leaders are more experienced in public company auditing. This finding continues to hold when we control for the past experience of the signatory auditors and the past experience of other (non-leader) partners at the same firm. We find that audit adjustments are not strongly related to the adjustments that occurred on the past audits of leaders. However, audit adjustments are significantly smaller when leaders have a past record of attracting more new clients to the firm, particularly if the new clients were risky. These results suggest that audit quality is lower when leaders have a past history of prioritizing revenue growth through acquiring high-risk clients.

We perform several supplementary analyses that serve to strengthen and extend our main findings. First, we conduct long-form interviews with 9 national leaders (including 3 chief managing partners) and 2 other equity partners. The interviewees told us that leaders at their firms balance the trade-off between profit-making and audit quality in several ways: 1) client screening and selection, 2) selecting partners who possess the firm's desired qualities, 3) communicating to employees the leadership's emphasis on professionalism versus commercialism, 4) employee recruitment and training, 5) assigning experienced partners to high-risk clients, 6) managing the risk control department to deal with contentious accounting issues, the recording of audit adjustments, and the issuance of qualified audit opinions, and 7) establishing firmwide policies on partner remuneration and disciplinary procedures.

Second, the interviewees told us that a lack of integration has made it difficult for firm leaders at the headquarters to control audit quality at the local branch offices. In contrast, it is relatively easy for leaders to control audit quality at the headquarters. We therefore expect leadership attributes to have a strong impact on audits by the headquarters and a relatively weak impact on audits by the branch offices. Consistent with this expectation, we find that audit adjustments in headquarter audits are significantly larger when leaders have more past experience in public company audits or a past record of larger audit adjustments. Further, audit adjustments in headquarter audits are significantly smaller when leaders have a past record of introducing high-risk clients to the firm. In contrast, these leadership attributes are insignificant in explaining audit adjustments at the branch office audits. We conclude that leadership attributes are strongly associated with audit quality at the headquarters and insignificantly associated with audit quality at the branch offices.

Third, the interviewees told us that leaders have significant influence over the firm's acceptance of new audit clients. We therefore examine whether client acceptance decisions are related to leadership characteristics. We find that firms are more conservative in accepting new clients when their leaders are more experienced in public company auditing and when their leaders have a past history of larger adjustments on their own audit engagements.

Fourth, we examine the roles to which partners are assigned on the leadership teams. We distinguish between leaders who perform audit quality (AQ) roles versus leaders that perform other roles.<sup>2</sup> We expect past audit experience to be more important for leaders in the AQ role. Consistent with this expectation, we find that a partner is more likely to be appointed to an AQ leadership role if the partner is more experienced in public company auditing. Moreover, we find that audit adjustments are significantly larger when the firm has more leaders in an AQ role.

Fifth, we use qualified audit opinions and material accounting misstatements as alternative measures of audit quality. We find that auditors issue qualified opinions more often whereas material accounting misstatements occur less often when leaders are more experienced in public company auditing or when they have a past record of larger audit adjustments.

Finally, our main findings remain robust when we examine the sub-sample of audits in which the engagement auditors are non-leaders. This evidence is consistent with leaders having an impact on the quality of audits performed by other (non-leader) auditors in the firm.

Our study contributes to the prior literature in two ways. First, it contributes to the audit literature by examining how accounting firms are managed at the top. Prior studies focus on the individual auditors who lead audit engagements (e.g., audit supervisors, managers, or engagement partners) rather than the firm's national leaders. In a recent survey of the literature, [Andiola et al. \(2020\)](#) observe that "audit literature examining leadership climate is fairly restricted, focusing almost exclusively on leadership factors at the engagement level with very few examining other leadership levels, including national and global levels." Our study fills this void by providing the first large-sample examination of leadership selection and how leadership attributes correlate with audit quality. Our results indicate that audit quality is higher when leaders are more experienced in public company auditing or have a past record of larger audit adjustments, whereas audit quality is lower when leaders have a past record of attracting new high-risk clients to the firm.

Second, our study contributes to a large literature on business leadership. There is a wealth of evidence on the leaders of public corporations but very little evidence on the leaders of accounting firms.<sup>3</sup> The findings of the corporate literature are not readily applicable to accounting firms because the agency issues and leadership arrangements at accounting firms are

<sup>2</sup> AQ roles are risk management, quality control, professional standards, code of ethics, and discipline, whereas non-AQ roles include strategy, tax, consulting, advisory, financial officer, human resources, and technology.

<sup>3</sup> Surveys of the corporate governance literatures include [Shleifer and Vishny \(1997\)](#), [John and Senbet \(1998\)](#), [Adams et al. \(2010\)](#), and [Busenbark et al. \(2016\)](#).

different from those at public corporations. For instance, there is no significant separation of ownership and control at accounting firms because accounting firms are fully owned and controlled by equity partners.<sup>4</sup> Moreover, corporate leaders are always expected to be rain makers for their firms, whereas accounting partnerships face a trade-off between commercialism and professionalism. Another important difference between our setting and the research on corporate leadership is that the leaders of accounting firms are chosen internally from the firm's own equity partners. In contrast, the leaders of public corporations (e.g., CEOs) are often appointed through the external labor market. Consequently, studies of corporate leadership have not been able to identify a pool of candidates from which leaders are chosen. An advantage of our setting is that the pool of leadership candidates is more narrowly defined because accounting firms select leaders from among their own equity partners rather than external candidates.

## 2. Background

### 2.1. Audit regulators and accounting firm leadership

Regulators have suggested that accounting firm leaders could be a key driver of audit quality. The Center for Audit Quality (CAQ) – whose stated mission is to enhance investor confidence by fostering high-quality auditing – has said that:

*“The audit firm's leadership, through its tone at the top, emphasizes the importance of audit quality, adherence to professional standards, independence and objectivity, and holds itself accountable for the effectiveness of the audit firm's system of quality control.”* (CAQ, 2014: page 3).

The Public Company Accounting Oversight Board (PCAOB) shares the CAQ's view that leaders influence the quality of work carried out by auditors lower down in the firm's hierarchy. The PCAOB explains its reasoning as follows:

*“the audit firm's overall commitment to quality can shape the engagement team, which does not operate in isolation; tone at the top, the incentive system, recruiting, retention, training, technology, tools, and knowledge bases all affect the strength of the engagement team's work. The culture of the audit firm, and not just the engagement team, is likely to influence audit performance.”* (PCAOB, 2015: page 20).

Current audit standards contain very limited references to the leadership of accounting firms (PCAOB, 2019). Regulators have therefore been considering whether new standards might be needed. In 2019, the International Auditing and Assurance Standards Board (IAASB) proposed a new quality control (QC) standard (ED-ISQM 1) for firm leadership. The IAASB argued that the new standard was necessary to promote a firmwide culture of high-quality auditing:

*“a new approach to quality control at the firm level is needed that emphasizes the responsibility of firm leadership for proactively managing quality [...] The firm's culture and the tone set by leadership should promote the importance of quality, and the need to exercise professional skepticism when performing audit, review or other assurance engagements [...] This standard requires that the firm's leadership demonstrate a commitment to quality through their actions and behaviors and establish the expected behavior of personnel within the firm.”* (IAASB, 2019: pages 6, 10, and 36).<sup>5</sup>

The proposed standard (ED-ISQM 1) would require firms to establish: 1) a culture that promotes a commitment to quality, 2) a leadership team that is responsible and accountable for quality, and 3) an organizational structure that supports the firm's quality control system. The PCAOB has indicated that it may introduce a similar QC standard for U.S. accounting firms and the PCAOB is also contemplating whether more concrete requirements might be needed to supplement the subjective criteria in the IAASB's proposed standard. For example, the PCAOB has suggested that a future standard might encompass the procedures that accounting firms must use to select leaders (PCAOB, 2019). Regulators have announced these initiatives despite a lack of scholarly evidence on leadership selection or on the leadership characteristics that are relevant to audit quality.

### 2.2. Prior literature

Our study is related to recent research by Aobdia (2020) and Mowchan et al. (2021). Aobdia (2020) finds that firms with PCAOB-identified quality control (QC) deficiencies provide lower quality audits. Moreover, large firms with organizational QC deficiencies have less profitable audits. Our study is different from Aobdia (2020) because we focus on a firm's national leaders rather than firm-level QC deficiencies.

A recent working paper by Mowchan et al. (2021) also considers issues related to accounting firm leadership. Their study shows that leaders generate higher audit fees than non-leaders, but the clients of leaders are more likely to restate their

<sup>4</sup> For example, public corporations appoint independent directors to act on behalf of outside shareholders. In contrast, there are (usually) no independent directors at public accounting firms because there are no outside shareholders.

<sup>5</sup> Chinese regulators have voiced similar concerns. Before the start of the 2012 annual audit season, Yugui Chen, the then General-secretary of the CICPA, stressed that accounting firms should “consider their business development from the angle of engagement quality rather than short-term commercial benefits” (Chen, 2013). More recently, Wenqin Jia, the then Chief Accountant of the CSRC, stated that “some CSRC-licensed accounting firms still base their internal governance on fee revenues, which has compromised engagement quality” (Jia, 2017).

financial statements. They conclude that leaders emphasize revenue growth and business development to the detriment of audit quality. Our study differs from Mowchan et al. (2021) in several ways. First, we examine which partners are selected (not selected) as leaders whereas Mowchan et al. (2021) do not model leadership selection. Second, we investigate whether audit quality (by non-leader as well as leader partners) varies with the attributes of the leadership team. In contrast, Mowchan et al. (2021) test whether audit quality at the engagement level is a function of whether the engagement partner is a leader or non-leader. Third, our sample includes all equity partners, including those without any experience in public company audits (e.g., partners with non-audit backgrounds), whereas Mowchan et al. (2021) only examine the partners who conduct public company audits. Finally, most leaders in the Mowchan et al. (2021) study hold office or regional leadership positions, whereas the leaders in our study all hold national positions.

### 2.3. The China setting

In 2011, the Chinese Institute of Certified Public Accountants (CICPA) issued guidance to public company audit firms on how they should be internally governed as partnerships.<sup>6</sup> Section 5.1 of the guidance states that firmwide decisions should be put to a vote of all equity partners in a general meeting.<sup>7</sup> The number of votes needed for a proposal to pass depends on the nature of the proposal. A 'routine' proposal – such as assigning duties to partners, departmental re-organizations, and profit-sharing rules – is passed if it receives agreement from at least half the partners. A 'material' proposal – such as an amendment to the partnership agreement, mergers or splits, and changes in the scope of business services – is passed if it receives agreement from at least two thirds of partners. (A proposal is deemed material if at least half the partners agree that it is material.) Finally, a proposal to terminate a partner's employment is passed if it receives agreement from all partners at the meeting (except the partner whose future is being decided).

Control of an accounting firm is, in principle, exercised by the entire body of equity partners. However, the responsibility for day-to-day management is typically delegated to a smaller leadership team of senior managing partners. In China, the leadership team is known as the *Partnership Management Committee* (PMC). Section 5.2 of the CICPA guidance states that the PMC is responsible for submitting proposals to the general partner meeting (e.g., business development strategies, financial budgets, assignments of duties among partners, firm mergers), and executing the decisions of past partner meetings. A partner's election to the PMC must receive agreement from at least two thirds of all partners. Each PMC member is elected to a three-year term and can be re-elected at the end of the term.<sup>8</sup>

Similar to the senior executives of a public corporation, the PMC manages the daily operations and administration of the partnership. For instance, the PMC decides how to deal with significant disputes with clients (e.g., audit adjustments) and it determines which new clients can be accepted. The leadership team holds regular meetings that must be attended by at least two thirds of PMC members in order to be quorate. Decisions reached in PMC meetings must receive agreement from at least half of all PMC members before being put to a vote of all equity partners in a periodic general meeting.<sup>9</sup>

## 3. Hypotheses and research design

### 3.1. Hypotheses

Audit firms face a trade-off between short-term profit maximization versus long-term survival. The trade-off exists because a firm may increase its short-term profits by compromising on audit quality but doing so can jeopardize the firm's long-term future due to an elevated risk of future regulatory sanctions or reputation impairment. The way firms balance this trade-off is likely to depend on the priorities of the firm's leaders. A firm will select leaders with more auditing experience and with a stronger track record of high-quality audits if the firm is prioritizing audit quality over commercial considerations. On the other hand, a firm will choose leaders with more non-audit experience and a stronger track record of finding new clients if

<sup>6</sup> Prior to 2011, most audit firms in China were organized as corporations whereas few firms were organized as partnerships (Firth et al., 2012). Economic theory suggests that partnerships have stronger incentives than corporations to provide high quality services (Greenwood and Empson, 2003; Huddart and Liang, 2003; Levin and Tadelis, 2005). China's Ministry of Finance (MOF) decided in 2010 that all of China's public company audit firms would have to become limited liability partnerships (LLPs). The MOF originally planned for the firms to re-organize as LLPs by 2011, but most firms completed their transformations in 2013. Appendix A provides relevant excerpts from the CICPA guidance.

<sup>7</sup> The voting protocol is usually on the basis of equal representation (i.e., one partner = one vote). The principle of equal representation applies to many partnerships around the world including partnerships in the United States. The democratic model helps to promote open discussion among all partners, including the new partners who own less equity. The democratic model also helps ensure that the firm is careful about who it promotes to the partnership level given that a partner with a small equity stake has the same voting rights as a more senior partner. That said, control over firmwide policies is largely delegated to managing partners (i.e., the national leadership team) whose equity stakes are relatively large. Delegating decision rights to the managing partners helps resolve coordination problems as it is more efficient to have decisions made by a committee when the firm has many equity partners.

<sup>8</sup> In our sample, most leaders are re-elected after the end of their initial three-year term. Among 441 leaders in our sample, 348 (78.9%) serve as leaders in every year of the six-year sample period (2013–2018). Another 33 (7.5%) begin their tenure as leaders during our sample period and are still serving on the leadership team at the end of 2018. Only 60 (13.6%) stop serving as leaders during our sample period.

<sup>9</sup> In China (and the U.S.), the individuals selected as leaders are always equity partners. In a few other countries, accounting firms are also required to appoint independent (non-partner) directors to the leadership team. For example, the U.K.'s Financial Reporting Council (FRC) and Japan's Financial Services Agency have introduced Audit Firm Governance Codes that recommend the appointments of independent directors. Currently, the PCAOB is considering whether U.S. accounting firms should appoint independent directors (PCAOB, 2019) but it is not a requirement at the moment.

the firm is putting more emphasis on short-term profits. We focus on these characteristics because they closely match the leadership attributes that regulators care about (CAQ, 2014; PCAOB, 2015; IAASB, 2019; PCAOB, 2019). In particular, the first two characteristics (past experience and past audit adjustments) are intended to capture the partner's competence and audit quality, whereas the third characteristic (past record of introducing new clients to the firm) is intended to capture the partner's commercial acumen.

### 3.1.1. A partner's past experience in auditing public companies (H1a and H1b)

Public company auditing is subject to demanding ethical and quality control requirements as well as complex technical standards and stringent regulatory scrutiny (IFAC, 2005; DeFond and Francis, 2005; MOF, 2006; CSRC, 2010). Experience in public company auditing is therefore an important attribute for auditors. Experience is likely to be an important pre-requisite for accounting firm leaders as well, especially if the leadership role is directly related to the monitoring of audit quality. We therefore predict that a partner is more likely to be selected as a leader if the partner is more experienced in public company auditing.

**H1a.** *A partner is more likely to be appointed to the firm's leadership team if the partner has relatively more past experience in public company auditing.*

While H1a is intuitive, it has tension because a firm could select a partner without any audit experience if the leadership position is unrelated to audit quality. Such appointments are more likely among firms that prioritize non-audit services. For example, a firm may select leaders with experience in tax or consulting if the firm is prioritizing tax and consulting services over auditing and assurance services.

Next, we consider the implications of H1a for firmwide audit adjustments. We expect a positive association between audit adjustments and the leadership team's past experience in public company auditing for a couple of reasons. First, when leaders have more personal experience with public company audits, they will better understand the threats to audit quality that confront auditors in their day-to-day tasks. An experienced leadership team can ensure that the firm's centralized risk committee emphasizes audit quality when it communicates with engagement partners about contentious audit adjustments. Second, we expect that a firm will select leaders with more public company audit experience if the firm regards audit quality as one of its top priorities. Given these arguments, we formulate the following hypothesis:

**H1b.** *Audit adjustments are positively related to the public company audit experience of the firm's leadership team.*

The prediction in H1b has tension for a few reasons. First, the power delegated to the leadership team is limited because control over a firm's policies is partly exercised by the entire body of equity partners (see Section 2.3 and Appendix A). Leadership attributes may have no bearing on audit quality to the extent that firmwide policies are determined by all equity partners rather than just the firm's leaders. Second, the control exercised by leaders is limited insofar as individual offices and individual partners are granted autonomy in their decision-making. Third, appointing leaders with little or no past experience in public company audits may not impair audit quality. It may even improve audit quality if leaders from non-audit backgrounds are less resistant to novel ideas that would improve the firm's existing audit methodology. For example, non-audit partners may be more receptive to the introduction of new technologies compared to audit partners who are comfortable with the firm's existing technology.

### 3.1.2. A partner's past record of audit adjustments (H1a and H2b)

Accounting firms monitor audit quality using internal audit quality reviews (Aobdia, 2019, 2020). Internal reviewers pay special attention to audit adjustments, which can in turn affect the engagement partner's annual performance evaluation.<sup>10</sup> If the reviewers find that the partner's audit adjustments were appropriate, the partner is more likely to receive a favorable evaluation. On the other hand, if the reviewers believe that the engagement partner did not require sufficient audit adjustments, the performance evaluation is likely to be less favorable. Low-quality audits can damage the reputation of the entire firm and can result in regulatory sanctions or reputation damage. To the extent that leaders are able to influence audit quality, firms would want to appoint high quality leaders in order to mitigate the risk of low-quality audits. We therefore expect that firms select leaders with past records of large audit adjustments on their own past audit engagements.

**H2a.** *A partner is more likely to be appointed as a leader if the partner has a past track record of relatively large audit adjustments.*

Next, we consider the implications of H2a for a firm's current audit adjustments. We expect a positive association between a firm's current audit adjustments and the past audit adjustments of its leaders. For one thing, a partner who performed high quality audits in the past may continue to regard audit quality as important when the partner becomes a leader. In addition, a firm's tone at the top can filter down to auditors at lower levels in the firm's hierarchy. Therefore, a focus on audit quality by

<sup>10</sup> For example, we received the following comments from three interviewed partners: "we have a quality control department with over 160 staff members to conduct frequent quality monitoring ... quality managers are responsible for rating public company audits and engagement partners. I am the person who assigns work to the quality managers and to whom the quality managers report"; "The quality control department in our firm is responsible for reviewing the documentations of all public company audits, including audit adjustments made"; "Our firm identifies material accounting and auditing issues at the engagement level both through engagement partner reporting and quality control review teams. No matter through which channel, the leadership team requires the headquarters to be involved in the audit adjustments or audit reporting decision process."

the firm's leadership can have positive spillover effects on other auditors in the firm (e.g., junior partners, audit managers, and audit staff). Finally, leaders have significant influence over the firm's risk control department which deals with contentious accounting issues, including the recording of audit adjustments. Given these arguments, we formulate the following hypothesis:

**H2b.** *A firm's current audit adjustments are positively related to the leadership team's past record of audit adjustments.*

The H2b prediction has tension for a couple of reasons. First, a partner who performed high quality audits in the past may not continue to emphasize audit quality when he or she assumes a leadership position. Instead, the leader may turn her attention to commercial considerations. Second, leaders may have limited influence over audit adjustments to the extent that individual offices and partners act as autonomous units.

### 3.1.3. A partner's past record of attracting new clients to the firm (H3a and H3b)

Audit partnerships are commercial enterprises. Although accounting firms have professional responsibilities to provide high-quality audits, their ultimate aim is to make profits. Introducing new clients to the firm is one dimension on which firms evaluate a partner's commercial performance (Burrows and Black, 1998; Coram and Robinson, 2017). To the extent that firms prioritize commercial acumen when choosing their leaders, we expect that firms would appoint partners with a strong past record of attracting new clients to the firm. We therefore test the following hypothesis:

**H3a.** *A partner is more likely to be appointed to the firm's leadership team if the partner has a relatively strong past record of introducing new clients to the firm.*

Finally, we consider the implications of H3a for a firm's current audit adjustments. We expect a negative association between current audit adjustments and the leadership team's past success in attracting new clients to the firm. A partner who previously introduced more new clients to the firm may continue to emphasize revenue growth when the partner is promoted to a leadership position at the firm. When leaders prioritize commercial objectives over audit quality, this message can filter down to auditors at a lower level, resulting in lower quality auditing. This is supposedly what happened at Arthur Andersen, whose leadership team put more emphasis on commercial considerations during the 1990s which created a culture of low-quality auditing and ultimately the firm's demise (Gendron and Spira, 2009). We expect lower quality audits when leaders emphasize commercial considerations. Therefore, we hypothesize that audit adjustments are smaller when a firm's leadership is comprised of partners who were previously more successful in introducing new clients to the firm.

**H3b.** *Audit adjustments are negatively related to the leadership team's past success in introducing new clients to the firm.*

Once again, the prediction in H3b has tension. A partner could be successful at attracting new clients to the firm but still competent and professional when executing audits. Such a partner might be good at attracting low-risk clients and less concerned about losing high-risk clients. In contrast, a partner that is not good at attracting clients might be more worried about losing clients, resulting in that partner being more dependent on the clients he or she already has.

## 3.2. Research design

### 3.2.1. The selection of partners to leadership positions (H1a, H2a, H3a)

We examine which equity partners are selected as national leaders by estimating the regression model in eq. (1).

$$AFLEAD = \alpha_0 + \alpha_1 EXP_{PAST} + \alpha_2 ADJ_{PAST} + \alpha_3 NEW_{PAST} + X + FE + u \quad (1)$$

The dependent variable (*AFLEAD*) equals one if the partner is selected as a national leader at the accounting firm (zero if not selected). We view the selection of leaders as a form of tournament. Tournament theory proposes that firms promote employees who have exhibited relatively strong performance in the past (Lazear and Rosen, 1981). Therefore, we use measures of relative past performance for our independent variables in eq. (1).

The first variable of interest captures the partner's relative audit experience ( $EXP_{PAST}$ ). This variable is measured as the percentile ranking of the total number of public company audits by the partner up to the end of the previous year among all equity partners of the same firm in the same year. A higher percentile ranking indicates that the partner is more experienced in public company auditing relative to other partners at the same firm.<sup>11</sup> Under H1a, a partner is more likely to be selected as a leader if the partner is more experienced. We therefore predict a positive coefficient on  $EXP_{PAST}$  (i.e.,  $\alpha_1 > 0$ ).

The second variable of interest ( $ADJ_{PAST}$ ) uses a partner's past audit adjustments as a measure of the partner's past audit quality. An adjustment's percentage impact on reported earnings ( $ADJ_{MAG}$ ) is calculated using the ratio of the absolute magnitude of the audit adjustment divided by absolute pre-audit earnings. For example, if pre-audit earnings are \$10 million and audited earnings are \$9 million, the adjustment percentage would be 10% (= (10 - 9)/10). An issue with this ratio is that there are important outliers. To address this issue, we follow prior literature (e.g., Lennox et al., 2020) by taking a log

<sup>11</sup> We code  $EXP_{PAST}$  as zero if the partner has no prior experience in public company audits. Similarly, we code other ranked variables (e.g.,  $ADJ_{PAST}$ ,  $NEW_{PAST}$ ,  $OWN$ ) as zero when their raw values equal zero.

transformation of  $ADJMAG$  and winsorizing the logged variable at the 99th percentile.<sup>12</sup> The  $ADJ_{PAST}$  variable is measured using the partner's percentile ranking of past audit adjustments among all equity partners of the same audit firm in the same year. It is therefore a measure of the partner's relative performance on past audits. Under H2a, a partner is more likely to be selected as a leader if the partner has a past track record of larger audit adjustments. We therefore predict a positive coefficient on  $ADJ_{PAST}$  in eq. (1) (i.e.,  $\alpha_2 > 0$ ).

The third variable of interest ( $NEW_{PAST}$ ) captures the partner's relative success in introducing new clients to the firm. This variable is measured as the percentile ranking of the number of clients introduced to the firm by the partner up to the end of the previous year among all equity partners of the same audit firm in the same year.<sup>13</sup> Under H3a, a partner is more likely to be selected as a leader if the partner was more successful in attracting new clients to the firm. We therefore predict a positive coefficient on  $NEW_{PAST}$  (i.e.,  $\alpha_3 > 0$ ).

Eq. (1) controls for other partner characteristics ( $X$ ), including the partner's equity ownership ( $OWN$ ), the partner's age ( $AGE$ ), and gender ( $FEMALE$ ). Consistent with our variables of interest, we use percentile rankings to measure equity ownership ( $OWN$ ) and age ( $AGE$ ), while we use a dummy variable to capture the partner's gender ( $FEMALE$ ). Eq. (1) also includes audit firm fixed effects and year fixed effects to control for unobserved heterogeneity across audit firms and to control for time-varying factors that affect leadership appointments.<sup>14</sup> We cluster the standard errors on each partner because the independent variables of interest ( $EXP_{PAST}$ ,  $ADJ_{PAST}$ , and  $NEW_{PAST}$ ) are measured at the partner level.<sup>15</sup>

### 3.2.2. Firmwide audit adjustments and the attributes of firm leaders (H1b, H2b, H3b)

Next, we examine whether firmwide audit adjustments vary with the leadership team's past experience (H1b), past audit quality (H2b), and past success in attracting new clients (H3b).

$$\ln ADJMAG = \beta_0 + \beta_1 AFLEAD\_EXP + \beta_2 AFLEAD\_ADJ + \beta_3 AFLEAD\_NEW + X + FE + v \quad (2)$$

The dependent variable in eq. (2) ( $\ln ADJMAG$ ) is the natural log of (one plus)  $ADJMAG$ , where  $ADJMAG$  is the absolute magnitude of the audit adjustment (as a proportion of absolute pre-audit earnings). The first independent variable ( $AFLEAD\_EXP$ ) is the leadership team's past experience in public company audits. Under H1b, we expect larger adjustments when the firm's leaders are more experienced in public company auditing. We therefore predict a positive coefficient on  $AFLEAD\_EXP$  ( $\beta_1 > 0$ ). The second variable of interest is the leadership team's past audit adjustments ( $AFLEAD\_ADJ$ ). Under H2b, we expect current audit adjustments to be positively related to the past adjustments of the firm's leaders. We therefore predict a positive coefficient on  $AFLEAD\_ADJ$  ( $\beta_2 > 0$ ). The third variable of interest is the leadership team's past record of introducing new clients to the firm ( $AFLEAD\_NEW$ ). Under H3b, we expect smaller audit adjustments if the leadership team attracted more new clients to the firm in the past. We therefore predict a negative coefficient on  $AFLEAD\_NEW$  in eq. (2) ( $\beta_3 < 0$ ).

Eq. (2) includes a number of control variables ( $X$ ). First, we control for other characteristics of the firm's leadership team, including the size of the team ( $AFLEAD\#$ ), the team's aggregate equity ownership ( $AFLEAD\_OWN$ ), the average age of leaders ( $AFLEAD\_AGE$ ), and their gender composition ( $AFLEAD\_FEM$ ). Eq. (2) also controls for other characteristics of the accounting firm. Specifically, we control for the average experience of the firm's non-leader partners ( $NonAFLEAD\_EXP$ ), an indicator for Big 4 firms ( $BIG4$ ), and an indicator for large local accounting firms ( $BIGLOCAL$ ). In addition, we control for the characteristics of engagement partners and offices, including whether the engagement partner is a national leader ( $ENG\_LEADER$ ), the engagement partner's past experience in auditing public companies ( $ENG\_EXP$ ), the engagement partner's age ( $ENG\_AGE$ ), the engagement partner's gender ( $ENG\_FEM$ ), the engagement partner's equity ownership ( $ENG\_OWN$ ), and whether the audit is done by the branch office or the headquarters ( $BRANCH$ ). Finally, eq. (2) follows prior research on the determinants of audit adjustments by controlling for the characteristics of audit clients (e.g., Lennox et al., 2014; Lennox and Wu, 2022). The client control variables include: company size ( $\ln TA$ ), the number of subsidiaries ( $\ln SUBS$ ), leverage ( $LEV$ ), an indicator for net losses ( $LOSS$ ), the current ratio ( $CURRATIO$ ), an indicator for state-owned enterprises ( $SOE$ ), the percentage of independent directors on the client's board ( $INDDIRP$ ), an indicator for accounting firm switches ( $SWITCH$ ), and the length of tenure between the client and audit firm ( $TENURE$ ).

Eq. (2) includes year fixed effects to control for unobserved time-varying factors. We alternately include industry fixed effects or company fixed effects to control for unobserved heterogeneity across companies. The specification with company fixed effects helps to mitigate the risk that our inferences are contaminated by unobservable time-invariant client characteristics.<sup>16</sup> However, a limitation is that the company fixed effects absorb much of the variation in our independent variables

<sup>12</sup> Alternatively, the outlier issue can be addressed using a rank transformation of the audit adjustments variable (e.g., see Lennox et al., 2020). In untabulated tests, we obtain similar results using a rank transformation instead of the log transformation.

<sup>13</sup> We assume a partner introduced a client to the firm if the partner performed the firm's first audit of the new client. Consistent with this assumption, our interviewees told us that the first engagement partner is usually the same partner who initially introduced the client to the firm.

<sup>14</sup> Untabulated analyses show that the audit firm fixed effects absorb only 5.7% of the variation in  $EXP_{PAST}$ , only 9.9% of the variation in  $ADJ_{PAST}$ , and only 3.6% of the variation in  $NEW_{PAST}$ . Thus, there remains plenty of variation in these variables after controlling for audit firm fixed effects.

<sup>15</sup> Our inferences are similar when we cluster on audit firm instead of partner or when we cluster on both audit firm and partner.

<sup>16</sup> We acknowledge that fixed effects are not a perfect solution to the causation issue because there could be time-varying unobservables that influence how clients are matched to firms and how partners are matched to firms. Therefore, we avoid drawing strong causal inferences from the documented associations in eq. (2).

of interest.<sup>17</sup> We cluster the standard errors on each audit firm because the independent variables of interest (*AFLEAD\_EXP*, *AFLEAD\_ADJ*, and *AFLEAD\_NEW*) are measured at the audit firm level.<sup>18</sup>

#### 4. Which partners are selected as leaders (H1a, H2a, H3a)?

##### 4.1. Sample accounting firms

Our sample period is 2013–2018. We begin in 2013 because this was the first year that China's accounting firms started filing leadership information to the CSRC. During the sample period, 40 accounting firms were licensed to conduct public company audits but two firms have not disclosed the identities of their leaders and three firms have not disclosed the leadership roles. After dropping these five firms, our sample comprises 35 accounting firms (see Table 1).<sup>19</sup> The 35 firms have a total of 3714 equity partners (hereafter, we refer to equity partners simply as 'partners').<sup>20</sup> We identify partner characteristics and whether partners conduct public company audits using data from the MOF, CSRC, and CSMAR databases (the former two data sources are proprietary, whereas the CSMAR database is public). Our sample includes partners with public company audit clients and partners without such clients.

**Table 1**  
Sample description.

Panel A. Sample of audit firms					
	No.				
CSRC-licensed accounting firms (2013–2018)	40				
Less: Firms that did not disclose a national leadership team or the roles of individual leaders	5				
Remaining accounting firms	35				
Equity partners at the 35 accounting firms	3714				
Panel B. Composition of national leadership teams					
	No.				
Equity partners who belong to the firm's national leadership team in at least one year from 2013 to 2018	441				
Equity partners who do not belong to the firm's national leadership team from 2013 to 2018	3273				
Equity partners who join the firm's national leadership team in 2013	402				
Plus: Equity partners who join the firm's national leadership team after 2013	39				
Less: Equity partners who exit the firm's national leadership team no later than 2018	72				
Equity partners who belong to the firm's national leadership team by the end of 2018	369				
Panel C. The number of leaders and the percentage of leaders with experience in public company auditing (N = 210 accounting firm-years)					
	Mean	SD	P10	Median	P90
Number of leaders on the team ( <i>AFLEAD#</i> )	11.1	8.1	6	9	19
Percentage of leaders with experience in public company auditing	76.3%	19.1%	47.7%	75.0%	100.0%
Panel D. Change in the number of public company audits in the years surrounding a partner's election to the firm's national leadership team					
	Mean number of public company audits			(2) vs. (1)	
	(1)	(2)	t-stat.		
The year before election					
Partners who join the firm's national leadership team (N = 441)	1.401	1.116		−3.97***	
Partners with prior public company audit experience who join the firm's national leadership team (N = 328)	1.951	1.537		−4.34***	

\*\*\* denotes significance at the 1% level (two-tailed).

<sup>17</sup> Untabulated analyses show that the company fixed effects absorb 88.2% of the variation in *AFLEAD\_EXP*, 81.6% of the variation in *AFLEAD\_ADJ*, and 83.7% of the variation in *AFLEAD\_NEW*. In contrast, industry fixed effects absorb only 0.9% of the variation in *AFLEAD\_EXP*, 1.3% of the variation in *AFLEAD\_ADJ*, and 1.9% of the variation in *AFLEAD\_NEW*.

<sup>18</sup> Our inferences are similar when we cluster the standard errors on each company instead of audit firm.

<sup>19</sup> The 35 audit firms include all the Big 4 affiliates plus 31 non-Big 4 firms. The 35 firms account for 95.0% (73.5%) of the total market share based on aggregate assets (number of clients) during our sample period.

<sup>20</sup> Non-equity partners are never appointed to national leadership teams. We therefore restrict the sample to equity partners when we examine which partners are selected (not selected) as leaders in eq. (1).

**Table 2**  
Attributes of the national leadership teams of public accounting firms.

Panel A. Comparing the attributes of partners who belong (do not belong) to the firm's national leadership team			
	(1)	(2)	(1) vs. (2)
	Partners who belong to the accounting firm's national leadership team ( <i>AFLEAD</i> = 1; <i>N</i> = 2327)	Partners who do not belong to the accounting firm's national leadership team ( <i>AFLEAD</i> = 0; <i>N</i> = 13336)	
	Mean	Mean	t-stat.
<i>EXP<sub>PAST</sub></i>	0.484	0.257	11.62***
<i>AGE</i>	0.671	0.478	14.15***
<i>FEM</i>	0.222	0.332	-4.93***
<i>OWN</i>	0.586	0.163	24.17***

  

Panel B. Comparing the attributes of partners who belong (do not belong) to the firm's national leadership team (the sample is restricted to partners with prior experience of auditing public companies; i.e., <i>EXP<sub>PAST</sub></i> > 0; <i>N</i> = 8725 partner-year observations).			
	(1)	(2)	(1) vs. (2)
	Partners who belong to the accounting firm's national leadership team ( <i>AFLEAD</i> = 1; <i>N</i> = 1707)	Partners who do not belong to the accounting firm's national leadership team ( <i>AFLEAD</i> = 0; <i>N</i> = 7018)	
	Mean	Mean	t-stat.
<i>EXP<sub>PAST</sub></i>	0.647	0.480	9.06***
<i>ADJ<sub>PAST</sub></i>	0.526	0.383	7.24***
<i>NEW<sub>PAST</sub></i>	0.371	0.184	8.11***
<i>NEW_LR<sub>PAST</sub></i>	0.222	0.097	6.18***
<i>NEW_HR<sub>PAST</sub></i>	0.237	0.106	6.40***
<i>AGE</i>	0.666	0.457	13.09***
<i>FEM</i>	0.196	0.316	-4.58***
<i>OWN</i>	0.600	0.165	20.98***

  

Panel C. Correlation matrix of equity partner attributes (the sample is restricted to partners with prior experience of auditing public companies; i.e., <i>EXP<sub>PAST</sub></i> > 0; <i>N</i> = 8725 partner-year observations).										
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	
<i>AFLEAD</i>	(1)	1.00								
<i>EXP<sub>PAST</sub></i>	(2)	<b>0.23</b>	1.00							
<i>ADJ<sub>PAST</sub></i>	(3)	<b>0.17</b>	<b>0.39</b>	1.00						
<i>NEW<sub>PAST</sub></i>	(4)	<b>0.23</b>	<b>0.50</b>	<b>0.23</b>	1.00					
<i>NEW_LR<sub>PAST</sub></i>	(5)	<b>0.19</b>	<b>0.37</b>	<b>0.17</b>	<b>0.72</b>	1.00				
<i>NEW_HR<sub>PAST</sub></i>	(6)	<b>0.19</b>	<b>0.39</b>	<b>0.21</b>	<b>0.75</b>	<b>0.33</b>	1.00			
<i>AGE</i>	(7)	<b>0.30</b>	<b>0.24</b>	<b>0.19</b>	<b>0.21</b>	<b>0.15</b>	<b>0.17</b>	1.00		
<i>FEM</i>	(8)	<b>-0.10</b>	<b>-0.05</b>	-0.02	<b>-0.08</b>	<b>-0.07</b>	<b>-0.07</b>	0.01	1.00	
<i>OWN</i>	(9)	<b>0.52</b>	<b>0.26</b>	<b>0.13</b>	<b>0.23</b>	<b>0.15</b>	<b>0.23</b>	<b>0.36</b>	<b>-0.06</b>	1.00

The variables are defined in Appendix B. The t-statistics are based on standard errors clustered on each partner because each partner has multiple yearly observations in this partner-year sample. \*\*\* denotes significance at the 1% level (two-tailed). Bold letters in Panel C denote significance at the 5% level or better (two-tailed).

#### 4.2. Descriptive statistics on individual partners

Of the 3714 partners in our sample, 441 (11.9%) serve on their firm's national leadership team at least once from 2013 to 2018 (Panel B of Table 1). The remaining 3273 partners (88.1%) do not serve as national leaders (i.e., they are 'non-leader' partners). There are 402 national leaders in 2013. In subsequent years, 39 partners join the leadership teams while 72 partners exit, leaving a total of 369 leaders (= 402 + 39 - 72) in 2018. Panel C shows that the number of leaders per firm (*AFLEAD*#) averages 11.1 and ranges from 6 (at the 10th percentile) to 19 (at the 90th percentile). Nearly a quarter of leaders have zero experience in public company auditing, whereas 76.3% have audited at least one public company in the past.

Panel D reports the change in the number of public company audits surrounding a partner's selection to the national leadership team. We find that (soon-to-be) leaders conduct an average of 1.40 public company audits in the year immediately before their selection, whereas they conduct only 1.12 public company audits one year later.<sup>21</sup> The drop from 1.40 to 1.12 is statistically significant (t-stat. = -3.97) as well as large in magnitude (-20%), suggesting that partners have less time to do audits after they are appointed as leaders.<sup>22</sup>

<sup>21</sup> An average partner's number of public company audit engagements is similar to the U.S. setting. For example, Gipper et al. (2021) report that the average U.S. partner audits 1.7 SEC issuers and 5.3 non-issuers per year. The average number of audits in our sample is slightly smaller because our sample includes partners with no experience of auditing public companies.

<sup>22</sup> The leaders without past experience could not see a drop in the number of public company audits following their appointment so we also report descriptive statistics after dropping these observations. In the sub-sample of 328 leaders with past experience of public company auditing, the number of public company audits drops from 1.95 in the year before election to 1.54 one year later. The drop is highly significant (t-stat. = -4.34) and large in magnitude (-21.2%).

**Table 3**  
Regression model explaining the firm's selection of national leaders.

Dep. var. = AFLEAD		All partners		Partners with prior experience of auditing public companies ( $EXP_{PAST} > 0$ )			
		(1) Coeff. (z-stat.)	(2) Coeff. (z-stat.)	(3) Coeff. (z-stat.)	(4) Coeff. (z-stat.)	(5) Coeff. (z-stat.)	(6) Coeff. (z-stat.)
$EXP_{PAST}$	H1a (+)	2.134*** (11.94)	1.572*** (7.89)	1.158*** (3.46)	0.703* (1.89)	1.207*** (3.67)	0.778** (2.13)
$ADJ_{PAST}$	H2a (+)			0.341 (1.28)	0.605* (1.91)	0.342 (1.28)	0.624** (1.97)
$NEW_{PAST}$	H3a (+)			1.062*** (4.50)	0.588** (2.25)		
$NEW\_LR_{PAST}$						0.899*** (3.24)	0.693** (2.23)
$NEW\_HR_{PAST}$						0.702*** (2.69)	0.069 (0.23)
AGE		2.945*** (11.90)	1.508*** (5.48)	3.130*** (9.36)	1.618*** (4.27)	3.131*** (9.40)	1.616*** (4.28)
FEM		-0.619*** (-4.21)	-0.640*** (-3.93)	-0.674*** (-3.52)	-0.771*** (-3.51)	-0.666*** (-3.47)	-0.764*** (-3.48)
OWN			6.182*** (17.89)		6.325*** (12.88)		6.344*** (12.95)
Audit firm FE?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Partner-year observations		15,663	15,663	8725	8725	8725	8725
Pseudo R <sup>2</sup>		0.274	0.479	0.310	0.500	0.311	0.501

The variables are defined in Appendix B. The z-statistics are based on standard errors clustered on each partner because each partner has multiple yearly observations in this partner-year sample. \*\*\*, \*\*, and \* denote significance at the 1%, 5% and 10% levels, respectively (two-tailed).

#### 4.3. Univariate results (H1a, H2a, and H3a)

Table 2 presents the univariate results for H1a, H2a, and H3a. Panel A shows results for the full sample of 15,663 partner-year observations, whereas Panel B shows results for the sub-sample of 8725 partner-years that pertain to partners who conducted at least one public company audit in the past (i.e.,  $EXP_{PAST} \geq 1$ ). We report results for the two samples separately because the  $ADJ_{PAST}$  and  $NEW_{PAST}$  variables are only observable for partners with a history of public company audits. Panels A and B show that leaders have significantly more audit experience than non-leader partners ( $t$ -stats. = 11.62, 9.06). This is consistent with our prediction in H1a that an experienced partner is more likely to be selected as a leader.

Consistent with H2a, Panel B shows that past adjustments ( $ADJ_{PAST}$ ) are significantly larger for partners who are subsequently selected as leaders ( $t$ -stat. = 7.24). Consistent with H3a, Panel B shows that leaders have a stronger track record of introducing new clients to the firm ( $NEW_{PAST}$ ). The difference in  $NEW_{PAST}$  between leaders and non-leaders is highly significant ( $t$ -stat. = 8.11). To determine whether this result is different for low-risk and high-risk clients, we define a new client as risky if the client in the pre-switch year was subject to a regulatory sanction, investigation, or a lawsuit, or received a modified audit opinion, or was in financial distress, where financial distress is defined as negative net income, negative working capital, or negative stockholder equity (Carcello et al., 2009). We find that the coefficients are statistically significant for both low-risk new clients ( $NEW\_LR_{PAST}$ ) and high-risk new clients ( $NEW\_HR_{PAST}$ ).

Turning to the control variables, Panels A and B show that the partners who are selected as leaders are significantly older (AGE) and own larger equity stakes (OWN). We find that 22.2% of leaders are female whereas 33.2% of non-leader partners are female, indicating that females have a lower likelihood of being selected as leaders ( $t$ -stat. = -4.93). This finding is consistent with evidence that females are less likely to occupy leadership positions at their firms (Lazear and Rosen, 1990; Niederle and Vesterlund, 2007; Bertrand et al., 2010).

Panel C reports a correlation matrix for the attributes of equity partners. We find that a partner's past experience ( $EXP_{PAST}$ ) is positively correlated with the partner's past record of introducing new clients to the firm ( $NEW_{PAST}$ ).<sup>23</sup> More experienced partners ( $EXP_{PAST}$ ) also have a past record of making larger audit adjustments ( $ADJ_{PAST}$ ). The partners who previously introduced more new clients to the firm ( $NEW_{PAST}$ ) have larger equity ownership stakes (OWN) as do the partners who are more experienced ( $EXP_{PAST}$ ).<sup>24</sup> The latter correlations suggest that partners are awarded larger equity stakes when they perform well by being rain-makers for their firms and when they rise up the firm to more senior positions.

#### 4.4. Regression results (H1a, H2a, and H3a)

Table 3 presents the regression results for H1a, H2a, and H3a. Results for the full sample of partners (including those without any experience in public company auditing) are shown in Cols. (1) and (2). Consistent with H1a, Col. (1) shows a highly significant positive coefficient on  $EXP_{PAST}$ , implying that a partner is more likely to be selected as a leader if the partner is more experienced in public company audits ( $z$ -stat. = 11.94). In Col. (2) we add a control for the partner's equity ownership (OWN). Controlling for ownership carries the risk of throwing the baby out with the bathwater because partners tend to

<sup>23</sup> The pairwise correlation between  $NEW\_LR_{PAST}$  and  $NEW\_HR_{PAST}$  is just 0.33, indicating that some partners tend to attract low-risk clients to their firms whereas other partners tend to attract high-risk clients.

<sup>24</sup> The variance-inflation-factors in our leadership selection models are all below ten.

accumulate larger equity stakes as they become more experienced. Therefore, we expect the coefficient on partner experience ( $EXP_{PAST}$ ) to become smaller after controlling for ownership ( $OWN$ ). Consistent with this expectation, the  $EXP_{PAST}$  coefficient drops from 2.134 in Col. (1) to 1.572 in Col. (2) but it remains highly significant ( $z\text{-stat.} = 7.89$ ). Thus, a partner's past experience has a significant incremental association with leadership selection even after controlling for the partner's equity ownership.<sup>25</sup>

Cols. (3) to (6) of Table 3 report results for the sub-sample of partners with prior experience of public company audits ( $EXP_{PAST} \geq 1$ ;  $N = 8725$ ). Consistent with the univariate results for H2a, we find positive coefficients on past audit adjustments ( $ADJ_{PAST}$ ), suggesting that a partner is more likely to be chosen as a leader if the partner had larger adjustments on her past audit engagements. However, the  $ADJ_{PAST}$  coefficients are either insignificant (Cols. (3) and (5)) or borderline significant (Cols. (4) and (6)). Consistent with H3a, we find significant positive coefficients for  $NEW_{PAST}$ , indicating that a partner is more likely to be selected as a leader if the partner introduced more new clients to the firm in the past ( $z\text{-stats.} = 4.50, 2.25$ ).<sup>26</sup> Turning to the control variables, we find that a partner is more likely to be selected as a leader if the partner is older ( $AGE$ ), is not female ( $FEMALE$ ), and has a larger ownership stake ( $OWN$ ).

## 5. Firmwide audit quality (H1b, H2b, and H3b)

### 5.1. Company-year sample and descriptive statistics

Panel A of Table 4 shows how we assemble the company-year sample to estimate eq. (2). We begin by merging the CSMAR and MOF databases, which yields 8882 company-year observations. Consistent with Lennox et al. (2018), we drop 489 observations where there are inconsistencies between the CSMAR and MOF databases in their values of audited earnings.<sup>27</sup> We drop another 195 observations where the control variables have missing data. This leaves a final sample of 8198 company-year observations.

Panel B of Table 4 reports descriptive statistics for the variables in eq. (2). Consistent with prior research, we find that audit adjustments occur in 55.6% of audits and the average absolute magnitude of audit adjustments ( $ADJ_{MAG\%}$ ) is 7.5%. Leaders are more experienced ( $AFLEAD\_EXP$ ) than non-leader partners ( $NonAFLEAD\_EXP$ ). We find that 52% of audits are conducted by branch offices ( $BRANCH$ ) and 48% are by the firm's headquarters. Only 7.6% of audits are by the Big 4 firms, reflecting that the Big 4 have small market shares in China. Turning to client characteristics, we find that 37.2% of companies are SOEs and 37.6% of corporate board members are independent directors.

Panel C of Table 4 reports a correlation matrix for the attributes of a firm's leadership team. There is a positive correlation between  $AFLEAD\_EXP$  and  $AFLEAD\_OWN$ , indicating that experienced leadership teams own more equity. Experienced leadership teams also have a past record of larger audit adjustments ( $AFLEAD\_ADJ$ ) and a stronger track record of attracting new clients to the firm ( $AFLEAD\_NEW$ ).

### 5.2. Regression results (H1b, H2b, and H3b)

Table 5 reports the regression results for the audit adjustments model in eq. (2). Cols. (1) and (2) show the results after controlling for industry fixed effects, while Cols. (3) and (4) present the results after controlling for company fixed effects. Consistent with H1b, we find that audit adjustments are significantly larger when the leadership team is more experienced in auditing public companies ( $AFLEAD\_EXP$ ). Results for H2b are mixed as the  $AFLEAD\_ADJ$  coefficients are consistently positive but they are either insignificant or borderline significant. Consistent with H3b, we find that audit adjustments are negatively related to the leadership team's past record of introducing new clients to the firm ( $AFLEAD\_NEW$ ). This finding suggests that audit quality suffers when leaders have a past history of attracting more new clients.

It could be argued that the negative coefficients on  $AFLEAD\_NEW$  are consistent with leaders carefully choosing high-quality clients that are likely to warrant smaller audit adjustments. To distinguish between this alternative explanation and ours, we examine whether leaders were previously introducing high-risk or low-risk clients to the firm. We aggregate the values of  $NEW\_HR_{PAST}$  across each member of the leadership team to measure the past record of leaders in introducing high-risk clients to the firm. Similarly, we aggregate the values of  $NEW\_LR_{PAST}$  for each leader to measure the team's past record of introducing low-risk clients to the firm. If the coefficients on  $AFLEAD\_NEW$  are significantly negative because leaders were choosing high-quality clients that deserved smaller audit adjustments, we would expect significant negative coefficients on  $AFLEAD\_NEW\_LR$ . On the other hand, if the coefficients on  $AFLEAD\_NEW$  are significantly negative because leaders were aggressively seeking out high-risk clients, we would expect to find significant negative coefficients on  $AFLEAD\_NEW\_HR$ . The results are shown in Cols. (2) and (4) of Table 5. We find significant negative coefficients on  $AFLEAD\_NEW\_HR$  ( $t\text{-stats.} = -2.41$ ,

<sup>25</sup> In untabulated tests, we continue to find significant results when using an alternative measure of past experience ( $EXP_{PAST}$ ) based on the aggregate size of the partner's past clients.

<sup>26</sup> In an untabulated analysis, we test whether a partner is more likely to be selected as a leader if the partner's new clients were large ( $NEWSIZE_{PAST}$ ). Consistent with our results for  $NEW_{PAST}$ , we find positive coefficients on  $NEWSIZE_{PAST}$  ( $t\text{-stats.} = 3.51, 1.75$ ).

<sup>27</sup> The inconsistencies are largely due to a data entry person using the accounts of the parent company rather than the group accounts when entering data into the MOF database (Lennox et al., 2016). We define the two databases as being inconsistent when the reported difference in audited earnings is at least  $\pm 1\%$ .

**Table 4**  
Summary statistics of audit adjustments analysis.

Panel A: sample of audit engagements										
	Company-year observations									
Initial sample (for the 35 accounting firms of Table 1) after merging the CSMAR and MOF databases (2013–2018)	8882									
Less: Observations where there are inconsistencies between the two databases	(489)									
Less: Observations with missing data	(195)									
Final sample	8198									
Panel B: descriptive statistics for the regression variables (N = 8198 company-year observations).										
	Mean	SD	P25	P50	P75					
<i>LnADJMAG</i>	0.937	1.252	0.000	0.255	1.633					
<i>AFLEAD_EXP</i>	0.502	0.149	0.374	0.503	0.630					
<i>AFLEAD_ADJ</i>	0.538	0.127	0.474	0.590	0.621					
<i>AFLEAD_NEW</i>	0.329	0.108	0.286	0.337	0.380					
<i>AFLEAD_NEW_HR</i>	0.205	0.093	0.164	0.211	0.235					
<i>AFLEAD_NEW_LR</i>	0.206	0.106	0.125	0.210	0.273					
<i>AFLEAD_AGE</i>	0.747	0.132	0.672	0.784	0.865					
<i>AFLEAD_FEM</i>	0.138	0.152	0.000	0.125	0.286					
<i>AFLEAD_OWN</i>	0.554	0.384	0.043	0.704	0.907					
<i>AFLEAD#</i>	15.037	13.071	7.000	11.000	15.000					
<i>NonAFLEAD_EXP</i>	0.322	0.089	0.272	0.321	0.382					
<i>ENG_LEADER</i>	0.198	0.398	0.000	0.000	0.000					
<i>ENG_EXP</i>	3.222	0.949	2.708	3.332	3.871					
<i>ENG_AGE</i>	41.992	4.850	38.445	41.616	45.177					
<i>ENG_FEM</i>	0.532	0.499	0.000	1.000	1.000					
<i>ENG_OWN</i>	0.016	0.020	0.004	0.008	0.020					
<i>BIG4</i>	0.076	0.265	0.000	0.000	0.000					
<i>BIGLOCAL</i>	0.535	0.499	0.000	1.000	1.000					
<i>SWITCH</i>	0.069	0.254	0.000	0.000	0.000					
<i>TENURE</i>	6.737	5.481	3.000	5.000	9.000					
<i>BRANCH</i>	0.520	0.500	0.000	1.000	1.000					
<i>LnTA</i>	12.968	1.383	12.013	12.796	13.730					
<i>LnSUBS</i>	2.468	0.998	1.792	2.485	3.091					
<i>LEV</i>	0.433	0.213	0.257	0.421	0.592					
<i>LOSS</i>	0.106	0.308	0.000	0.000	0.000					
<i>CURRATIO</i>	2.375	2.388	1.106	1.636	2.670					
<i>SOE</i>	0.372	0.483	0.000	0.000	1.000					
<i>INDDIRP</i>	0.376	0.055	0.333	0.364	0.429					
Panel C: correlation matrix of leadership attributes (N = 8198 company-year observations).										
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	
<i>AFLEAD_EXP</i>	(1)	1.00								
<i>AFLEAD_ADJ</i>	(2)	<b>0.22</b>	1.00							
<i>AFLEAD_NEW</i>	(3)	<b>0.34</b>	<b>-0.10</b>	1.00						
<i>AFLEAD_NEW_HR</i>	(4)	<b>0.33</b>	-0.01	<b>0.68</b>	1.00					
<i>AFLEAD_NEW_LR</i>	(5)	<b>-0.17</b>	<b>-0.19</b>	<b>0.76</b>	<b>0.34</b>	1.00				
<i>AFLEAD_AGE</i>	(6)	<b>0.15</b>	<b>0.04</b>	<b>0.30</b>	<b>0.05</b>	<b>0.21</b>	1.00			
<i>AFLEAD_FEM</i>	(7)	<b>0.13</b>	<b>-0.19</b>	<b>-0.23</b>	<b>-0.15</b>	<b>-0.28</b>	<b>-0.29</b>	1.00		
<i>AFLEAD_OWN</i>	(8)	<b>0.55</b>	<b>0.10</b>	<b>0.08</b>	<b>0.03</b>	<b>-0.18</b>	<b>0.13</b>	<b>0.10</b>	1.00	
<i>AFLEAD#</i>	(9)	<b>-0.04</b>	<b>0.18</b>	<b>-0.14</b>	<b>-0.10</b>	<b>-0.04</b>	<b>-0.58</b>	-0.01	<b>-0.10</b>	1.00

The variables are defined in Appendix B. The *LnADJMAG*, *LEV*, and *CURRATIO* variables are winsorized at the top and bottom 1 percentiles to address outlier issues. Bold letters in Panel C denote significance at the 5% level or better (two-tailed).

-3.23), whereas the results are either insignificant or weakly significant for *AFLEAD\_NEW\_LR* (t-stats. = -0.53, -1.72). These findings suggest that the leaders who introduced high-risk clients to the firm put less emphasis on audit quality and therefore had smaller audit adjustments. The findings are inconsistent with the alternative argument that leaders had a past history of larger adjustments because they had introduced high risk-clients to the firm.

Turning to the control variables, we find that audit adjustments are unrelated to leadership age (*AFLEAD\_AGE*), gender (*AFLEAD\_FEM*), equity ownership (*AFLEAD\_OWN*), or number of leaders (*AFLEAD#*). Audit adjustments are unrelated to the experience of non-leader partners (*NonAFLEAD\_EXP*) or the experience of engagement partners (*ENG\_EXP*). Audit adjustments are unrelated to whether the engagement partner is a leader or non-leader (*ENG\_LEADER*), the engagement partner's age (*ENG\_AGE*), gender (*ENG\_FEM*), and equity ownership (*ENG\_OWN*). Audit adjustments are smaller at Big 4 clients (*BIG4*) and at larger clients (*LnTA*) whereas audit adjustments are larger when companies change auditor (*SWITCH*). Audit adjustments are larger for loss-making companies (*LOSS*), companies with less liquidity (*CURRATIO*), companies with greater

**Table 5**  
Audit adjustments and the attributes of the firm's national leadership team.

Dependent variable = LnADJ/MAG		Controlling for industry FE		Controlling for company FE	
		(1) Coeff. (t-stat.)	(2) Coeff. (t-stat.)	(3) Coeff. (t-stat.)	(4) Coeff. (t-stat.)
AFLEAD_EXP	H1b (+)	1.048*** (3.00)	0.994*** (3.10)	1.071** (2.66)	0.851** (2.67)
AFLEAD_ADJ	H2b (+)	0.486 (1.68)	0.466* (1.79)	0.294 (0.73)	0.384 (1.04)
AFLEAD_NEW	H3b (-)	-1.173** (-2.16)		-1.649*** (-3.30)	
AFLEAD_NEW_HR	H3b (-)		-1.163** (-2.41)		-1.298*** (-3.23)
AFLEAD_NEW_LR			-0.277 (-0.53)		-0.950* (-1.72)
AFLEAD_AGE		0.254 (0.40)	0.533 (0.84)	-0.781 (-1.20)	-0.641 (-1.03)
AFLEAD_FEM		0.265 (0.46)	0.319 (0.56)	0.088 (0.21)	-0.003 (-0.01)
AFLEAD_OWEN		0.119 (0.87)	0.083 (0.62)	0.011 (0.12)	-0.047 (-0.46)
AFLEAD#		-0.001 (-0.09)	0.003 (0.36)	-0.004 (-0.53)	-0.002 (-0.30)
NonAFLEAD_EXP		0.496 (1.01)	0.711 (1.36)	0.368 (0.69)	0.673 (1.32)
ENG_LEADER		-0.031 (-0.50)	-0.034 (-0.56)	-0.066 (-0.96)	-0.057 (-0.82)
ENG_EXP		0.037 (1.02)	0.035 (0.99)	-0.024 (-0.55)	-0.027 (-0.63)
ENG_AGE		-0.003 (-0.66)	-0.002 (-0.41)	0.006 (1.10)	0.006 (1.19)
ENG_FEM		0.012 (0.32)	0.009 (0.26)	-0.009 (-0.23)	-0.006 (-0.16)
ENG_OWEN		0.831 (0.57)	1.073 (0.70)	0.282 (0.22)	0.365 (0.28)
BIG4		-0.404*** (-3.55)	-0.590 *** (-4.24)	-0.301 (-1.44)	-0.399* (-1.96)
BIGLOCAL		0.244 (1.08)	0.133(0.55)	0.027 (0.13)	-0.092 (-0.41)
SWITCH		0.202*** (3.27)	0.206*** (3.25)	0.191** (2.22)	0.190** (2.18)
TENURE		0.017** (2.75)	0.018*** (2.86)	0.036*** (5.84)	0.034*** (5.89)
BRANCH		0.032 (0.39)	0.036 (0.42)	0.103 (0.98)	0.100 (0.93)
LnTA		-0.138*** (-6.21)	-0.139*** (-6.11)	-0.053 (-0.94)	-0.049 (-0.89)
LnSUBS		0.090*** (4.59)	0.089*** (4.54)	0.044 (1.62)	0.040 (1.47)
LEV		0.258* (1.86)	0.268* (1.97)	-0.142 (-0.61)	-0.143 (-0.63)
LOSS		0.447*** (5.65)	0.449*** (5.70)	0.219** (2.57)	0.218** (2.55)
CURRATIO		-0.026*** (-3.41)	-0.026*** (-3.43)	-0.046*** (-3.08)	-0.047*** (-3.14)
SOE		-0.243*** (-6.17)	-0.243*** (-5.88)	0.055 (0.36)	0.050 (0.34)
INDDIRP		0.769*** (4.27)	0.759*** (4.24)	-0.353 (-0.65)	-0.379 (-0.70)
Year FE?	Yes	Yes	Yes	Yes	Yes
Industry FE?	Yes	Yes	No	No	No
Company FE?	No	No	Yes	Yes	Yes
Company-year observations		8198	8198	8198	8198
Adj. R <sup>2</sup>		0.132	0.132	0.349	0.350

All variables are defined in Appendix B. The t-statistics are based on standard errors clustered on each audit firm because the leadership variables have multiple yearly observations for each audit firm. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% levels (two-tailed), respectively.

complexity (*LnSUBS*), and companies with more independent directors on the board (*INDDIRP*), whereas audit adjustments are smaller for SOEs.<sup>28</sup>

### 5.3. Partner interviews

We conduct long-form open-ended interviews with senior partners to learn more about how leadership practices operate at Chinese accounting firms. We interview 9 national leaders (including 3 chief managing partners) and 2 equity partners who are not on the national leadership team. The interviewees are from 11 (31.4%) of the 35 audit firms, including two Big 4 firms, three top-10 firms, and six other firms. The average interview lasted 46 min.

We assume in our hypothesis development that firms face a trade-off between short-term profit maximization versus providing high quality audits. We begin by asking our interviews about this trade-off. All 11 interviewees told us there is a trade-off between maximizing short-term profits versus providing high-quality audits.<sup>29</sup> All 11 interviewees mentioned that their firms balance the trade-off by carefully screening new clients and rejecting potential clients on the grounds that they are too risky.

Next, we asked the interviewees whether firm leaders have a causal impact on audit quality and, if so, how this influence is manifest. All 11 interviewees told us that leaders have a causal impact on audit quality. They identified several ways in which

<sup>28</sup> In untabulated analyses, we interact the *ENG\_LEADER* variable with the firm's leadership attributes (*AFLEAD\_EXP*, *AFLEAD\_ADJ*, *AFLEAD\_NEW\_HR*, and *AFLEAD\_NEW\_LR*) using the full sample of audit engagements, and we also estimate the effects of leadership attributes within the sub-sample of engagements performed by non-leaders. Our main results remain robust, suggesting that our findings are not driven by the audits of firm leaders. Rather, our results are consistent with leaders having an impact on the quality of audits performed by non-leader auditors in the firm.

<sup>29</sup> For example, interviewee #2 stated: "I believe the goal of profit maximization doesn't work long for the public accounting profession, because this profession is based on credence and professional competence. These elements cannot be equivalent to economic profits in many circumstances [...] If one believes in profit maximization and issues the audit report to clients regardless the risk, it is hopeless and the firm would soon meet its demise. It's obvious that conflicts exist between profit maximization and quality maintenance."

leaders impact audit quality: 1) rigorous client acceptance procedures to screen out high-risk clients, 2) selecting partners who possess the firm's desired qualities, 3) employee recruitment and training, 4) communicating to employees the firm's emphasis on professionalism versus commercialism, 5) assigning experienced partners to high-risk clients, 6) partner remuneration and disciplinary policies, and 7) an effective risk control department to deal with contentious accounting issues, including the recording of audit adjustments and the issuance of qualified audit opinions. For example, interviewee #1 told us:

*"I believe the leadership team plays a critical role in maintaining the firm's audit quality. The leadership determines the firm culture. The emphasis on audit quality by the leadership determines the sustainability of a firm. Whether the management treats the client acceptance as a 'deal' or as a responsibility means the outcome would be very different. In our screening of partners from engagement partner, to a senior partner, and then to a managing partner, we care about their past audit quality, and in their past audits, there cannot be problematic engagements or risk exposures. The risk and quality control departments will evaluate the engagement risks to ensure the leadership's emphasis on audit quality. If problems occur, we impose monetary and career penalties on involved partners, or even expel them. We as the leadership team enforce our impact on audit quality in three ways: (1) Through controlling the client acceptance process. We require the engagement partners carefully assess engagement risks before accepting the clients. Engagement partners need to report to the managing partner at the branch office any noticeable risks, and the managing partner at the branch office would get involved in the acceptance decision process. (2) Through dealing with difficult accounting issues. Engagement partners need to report significant accounting issues to the managing partner at the branch office, and the managing partner at the branch office would get involved in addressing these issues. (3) Through issuing appropriate audit opinions. Sometimes we cannot persuade the clients over significant accounting issues. Then we have to decide to issue qualified audit opinions via the discussion with the risk control committee."*

We also asked the interviewees about potential impediments to audit quality.<sup>30</sup> A common theme emerged that leaders have difficulty controlling the quality of audits at the branch offices. We received the following comments from four interviewees:

*"Although some local firms rank very high in the CICPA national ranking, I know they have poor internal governance. They cannot integrate various branch offices because the branch offices were acquired and are basically autonomous units. It seems that little can be done for this generation of partners because most of the founding partners have not retired yet. They are too old to initiate the reform. Hopefully the next generation of partners can make a difference."*

*"[A] major area to improve in our firm is the integration between the headquarters office and branch offices. The integration is a key issue with extreme importance. [...] the accounting firm is a 'people-based' entity, and once people are involved, it is very difficult to touch people's vested interests given the evolving history of our firm."*

*"Although we have been improving in integrating our branch offices during the past few years, I think we have room to improve in this regard. In particular, when the branch offices get larger in size, it becomes a problem whether they are still willing to accept the guidance or rules of the headquarters office when audit disputes arise."*

*"From an internal governance view, I think our biggest problem is we still cannot make a common profit pool for all of our equity partners. Each branch office shares profits within the office. I don't think this situation is easy to change because disparity exists in terms of regional development, operation history, and revenue size among our 16 offices."*

Given these comments, the next section examines whether leaders have more influence over audits performed by the headquarters than audits performed by the branch offices.

#### 5.4. Audits by branch offices versus audits by the firm's headquarters

Table 6 shows the results when eq. (2) is estimated separately for audits by the headquarters (N = 3932; Col. (1)) and audits by the branch offices (N = 4266; Col. (2)). Col. (1) shows that audit adjustments at the headquarters are significantly larger when the leadership team is more experienced in public company audits (*AFLEAD\_EXP*; *t-stat.* = 4.90) and when leaders have a past record of larger audit adjustments on their own engagements (*AFLEAD\_ADJ*; *t-stat.* = 3.19), whereas audit adjustments are significantly smaller when leaders have a past record of introducing high-risk new clients to the firm (*AFLEAD\_NEW\_HR*; *t-stat.* = -3.36). In contrast, Col. (2) shows that these leadership attributes are statistically insignificant for

<sup>30</sup> In addition, we asked the interviewees about similarities and differences in leadership practices among audit firms in China. The non-Big 4 interviewees told us that local firms still have some way to go to catch up with the practices of the Big 4 firms. As the Big 4 firms have a small share of public company audits in China, we do not run our analyses separately for the Big 4 and non-Big 4 samples. Instead, we include interactions between our variables of interest and *BIG4*. In the leadership selection analysis, we find that Big 4 firms put more weight on age (i.e., a significantly positive coefficient on *AGE* × *BIG4*) and gender diversity (i.e., a significantly positive coefficient on *FEM* × *BIG4*) when selecting national leaders. We do not find distinguishable differences between Big 4 and non-Big 4 firms in the relation between leadership selection and other partner attributes. In the audit adjustments analysis, the coefficients on leadership attributes are not significantly different between Big 4 and non-Big 4 firms.

**Table 6**  
Cross-sectional tests.

Dependent variable = $\ln ADJ/MAG$	Headquarters' audits	Branch-office audits
	(1) Coeff. (t-stat.)	(2) Coeff. (t-stat.)
<i>AFLEAD_EXP</i>	1.341*** (4.90)	0.717 (1.38)
<i>AFLEAD_ADJ</i>	0.994*** (3.19)	0.095 (0.27)
<i>AFLEAD_NEW_HR</i>	-1.594*** (-3.36)	-0.353 (-0.81)
<i>AFLEAD_NEW_LR</i>	-0.117 (-0.35)	-0.646 (-0.87)
Control variables?	Yes	Yes
Year FE?	Yes	Yes
Industry FE?	Yes	Yes
Company-year observations	3932	4266
Adj. R <sup>2</sup>	0.186	0.113

All variables are defined in [Appendix B](#). Control variables are the same as those shown in [Table 5](#). The t-statistics are based on standard errors clustered on each audit firm because the leadership variables have multiple yearly observations for each audit firm. \*\*\* denotes significance at the 1% level (two-tailed).

the audits of branch offices.<sup>31</sup> The fact that leadership characteristics are significantly related to audit quality only when audits are conducted by the headquarters helps to increase confidence that the estimated relations may be causal. That is, a firm's leadership characteristics only impact audit quality in the headquarter audits because the leaders are unable to effectively control audit quality at the branch offices. Nevertheless, we cannot rule out the alternative explanation that partners are chosen for leadership positions when their values reflect the prevailing culture of the firm's headquarters. Therefore, we are still not able to draw strong causal inferences from [Table 6](#) results.

### 5.5. Client acceptance decisions

The interviewees in our survey told us that firm leaders influence audit quality by exerting authority over the firm's decisions to accept new audit clients. The client acceptance decision is an important quality control procedure that firms employ to manage the risk and quality of their audits ([Johnstone and Bedard, 2003, 2004](#)). Therefore, we examine whether client acceptance decisions are related to the characteristics of the firm's leadership team. We construct a dummy variable (*ACCEPT*) that takes the value one if the audit engagement corresponds to a newly accepted client (zero otherwise). We also construct a trichotomous variable (*ACCEPTR*) that equals one if a newly accepted client is high-risk, two if a newly accepted client is low-risk, and zero if the client is a continuing engagement.<sup>32</sup> We then estimate regressions in which *ACCEPT* and *ACCEPTR* are alternate dependent variables.<sup>33</sup>

There are three main findings from the client acceptance results in [Table 7](#). First, firms accept fewer new clients when leaders are more experienced in public company audits (*AFLEAD\_EXP*; *z-stats.* = -3.42, -2.39). Second, firms accept fewer new clients, particularly high-risk clients, when leaders have a past history of larger adjustments on their own audits (*AFLEAD\_ADJ*; *z-stats.* = -2.64, -2.79). This finding is consistent with conservative partners having had larger adjustments on their past audit engagements and with such partners continuing to be more conservative in client acceptance decisions when they assume leadership positions at their firms. It is inconsistent with partners having had large adjustments on their past audits because they previously accepted more high-risk clients. Finally, we find that firms accept more clients when leaders have a past history of introducing low-risk clients to the firm (*AFLEAD\_NEW\_LR*; *z-stats.* = 2.48, 2.12, 2.14).

### 5.6. Leaders who are assigned to audit quality roles

Some leaders are assigned to audit quality (AQ) roles (e.g., risk management, quality control, professional standards, code of ethics, or discipline), whereas other leaders are assigned to roles that are not directly related to audit quality (e.g., market development, administration, non-audit services, human resources). Of the leader-year observations in our sample, 612 (26.3%) pertain to AQ roles and 1714 (73.7%) pertain to non-AQ roles. In this section, we examine which partners are

<sup>31</sup> The coefficients are statistically different between Col. (1) and Col. (2) for the *AFLEAD\_ADJ* variable (F-stat. = 3.60,  $p = 0.058$ ) and the *AFLEAD\_NEW\_HR* variable (F-stat. = 5.90,  $p = 0.015$ ), but not the *AFLEAD\_EXP* variable (F-stat. = 1.76,  $p = 0.184$ ) and *AFLEAD\_NEW\_LR* (F-stat. = 0.80,  $p = 0.372$ ).

<sup>32</sup> Consistent with our earlier analysis, we define a client as high-risk if the client was subject to a regulatory sanction, investigation, or a lawsuit, received a modified audit opinion, or was in financial distress in the pre-switch year.

<sup>33</sup> Our analysis focuses on client acceptance decisions rather than auditor resignations for a couple of reasons. First, unlike the U.S. setting, regulators in China do not require firms to disclose whether an auditor change is prompted by a client dismissal or an auditor resignation. Second, all the interviewees in our survey mentioned that the client acceptance decision is a major area over which the firm's leadership has significant authority. The interviewees regard the resignation vs continuation decision as less important because they said it would be more effective for the firm to not accept risky clients in the first place.

**Table 7**  
 Acceptances of new clients and the attributes of the firm's national leadership team.

Dependent variable	Logit		Multinomial logit	Multinomial logit
	ACCEPT	ACCEPT	ACCEPTR = 1 (Accepting risky clients)	ACCEPTR = 2 (Accepting less risky clients)
	(1)	(2)	(3)	(4)
	Coeff. (z-stat.)		Coeff. (z-stat.)	
AFLEAD_EXP	-2.218*** (-3.42)	-1.615** (-2.39)	-1.644** (-2.44)	-1.733* (-1.67)
AFLEAD_ADJ	-1.001*** (-2.64)	-1.038*** (-2.79)	-1.087** (-2.54)	-0.696 (-1.60)
AFLEAD_NEW	2.131** (2.32)			
AFLEAD_NEW_HR		0.535 (0.59)	1.272 (1.25)	-0.257 (-0.23)
AFLEAD_NEW_LR		2.267** (2.48)	2.479** (2.12)	1.950** (2.14)
Control variables?	Yes	Yes	Yes	Yes
Year FE?	Yes	Yes	Yes	Yes
Industry FE?	Yes	Yes	Yes	Yes
Company-year observations	7712	7712	7712	7712
Pseudo R <sup>2</sup>	0.107	0.109	0.143	0.143

All variables are defined in [Appendix B](#). The z-statistics are based on standard errors clustered on each audit firm because the leadership variables have multiple yearly observations for each audit firm. The sample size is smaller than in other tables because we require prior year data for company-level control variables. In the multinomial logit regressions (Cols. (3) and (4)), observations with continuing audit engagements ( $ACCEPTR = 0$ ) are used as the baseline group. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% levels (two-tailed), respectively.

assigned to AQ and non-AQ leadership roles, and we examine whether audit quality varies with the fraction of leaders assigned to an AQ role.

Results for the selection of leaders to AQ and non-AQ roles are reported in Panel A of [Table 8](#). We find a partner is more likely to be selected to an AQ leadership role if the partner is more experienced in public company auditing ( $EXP_{PAST}$ ). In contrast, we find that  $EXP_{PAST}$  does not strongly explain the appointments of partners to non-AQ leadership roles. Consistent with [Table 5](#), the results for H2a are statistically insignificant for both AQ and non-AQ roles. Finally, a partner is more likely to be selected to either an AQ or non-AQ leadership role if the partner has a past record of introducing low-risk new clients to the firm ( $NEW\_LR_{PAST}$ ). Therefore, a partner's past success in attracting new low-risk clients to the firm increases the probability of the partner being selected as a leader to either an AQ role or a non-AQ role.

Next, we examine whether audit adjustments are larger when the firm assigns a higher proportion of leaders to an AQ role ( $AFLEAD\_AQ$ ). We expect a firm to have more leaders in an AQ role if the firm makes audit quality one of its top priorities. We therefore predict a positive association between audit adjustments and  $AFLEAD\_AQ$ . Panel B of [Table 8](#) presents the results. We find significant positive coefficients on  $AFLEAD\_AQ$ , indicating that audit adjustments are larger when the firm has a higher percentage of its leaders in an AQ role.

### 5.7. Alternative measures of audit quality

We believe audit adjustments are the best measure of audit quality for our research questions. First, accounting firms have internal engagement quality reviews, which pay special attention to audit adjustments and which are an important input to the engagement partner's annual performance evaluation. Internal quality reviews are capable of distinguishing subtle variations in audit quality. This is important because most clients do not resort to acts so egregious that they lead to material restatements or qualified audit opinions. Second, accounting misstatements are sometimes discovered as a result of regulatory investigations, which are not timely indicators of audit quality because they often take a long time to produce an outcome.<sup>34</sup> Accordingly, we may not observe some misstatements that occurred during our sample period (2013–2018) because they have not yet culminated in a regulatory sanction. Moreover, Chinese partners often leave their firms when they are under investigation by regulators ([Chen et al., 2022](#)), and such partners would no longer be in our sample. Third, audit adjustments occur frequently whereas restatements and qualified audit opinions are relatively infrequent. In addition, data on the magnitudes of accounting misstatements are generally not available.

Despite these limitations, we re-run our tests using audit opinions and accounting misstatements as alternative measures of audit quality. The interviewees told us that their firms sometimes issue qualified audit opinions (or opinion disclaimers) because the auditors disagree with the client's preferred accounting treatment but the client refused to make the proposed audit adjustments. We therefore create an alternative audit quality measure ( $QUAL$ ) equal to one if the auditor issues a qualified opinion (or opinion disclaimer) due to accounting-related issues (zero otherwise).<sup>35</sup> In our sample, there are 103 audit reports where  $QUAL$  equals one, which corresponds to 1.26% of audits.<sup>36</sup> We re-run eq. (2) using  $QUAL$  as an alternative

<sup>34</sup> For example, one interviewee told us that his firm was sanctioned in 2019 for a misstatement that occurred eight years earlier in 2011. [Wu and Zhang \(2014\)](#) document a mean (median) of 734 (715) days between regulatory investigations into public company misstatements and CSRC sanction outcomes.

<sup>35</sup> Consistent with [Lennox et al. \(2018\)](#),  $QUAL$  is coded zero if auditors disclose going-concern uncertainties but without referencing accounting issues.

<sup>36</sup> The sample in which  $QUAL$  equals one includes 78 qualified audit opinions and 25 opinion disclaimers. Auditors have not issued any adverse audit opinions in our sample.

**Table 8**  
Selection of partners to the audit quality (AQ) role or other leadership roles.

Panel A. Selection of partners into AQ vs. non-AQ leadership roles.				
Dependent variable	ROLE=1	ROLE=2	ROLE=1	ROLE=2
	(AQ)	(Non-AQ)	(AQ)	(Non-AQ)
	(1)	(2)	(3)	(4)
	Coeff. (z-stat.)	Coeff. (z-stat.)	Coeff. (z-stat.)	Coeff. (z-stat.)
<i>EXP<sub>PAST</sub></i>	1.870*** (3.25)	0.917** (2.49)	1.358** (2.37)	0.506 (1.24)
<i>ADJ<sub>PAST</sub></i>	0.462 (1.07)	0.291 (0.96)	0.984** (2.18)	0.471 (1.32)
<i>NEW_LR<sub>PAST</sub></i>	1.167*** (2.72)	0.825*** (2.65)	0.999** (2.17)	0.604* (1.77)
<i>NEW_HR<sub>PAST</sub></i>	0.391 (0.97)	0.842*** (2.85)	-0.209 (-0.48)	0.203 (0.62)
<i>OWN</i>			5.775*** (9.01)	6.652*** (12.49)
Control variables?	Yes	Yes	Yes	Yes
Audit firm FE?	Yes	Yes	Yes	Yes
Year FE?	Yes	Yes	Yes	Yes

  

Panel B: audit adjustment analyses		
Dependent variable = LnADJ <sub>MAG</sub>	(1)	(2)
	Coeff. (t-stat.)	Coeff. (t-stat.)
<i>AFLEAD_AQ</i>	0.547*** (3.79)	0.667*** (3.60)
<i>AFLEAD_EXP</i>	0.324 (0.84)	0.477 (1.34)
<i>AFLEAD_ADJ</i>	0.834*** (3.06)	0.860*** (3.85)
<i>AFLEAD_NEW</i>	-0.208 (-0.33)	
<i>AFLEAD_NEW_HR</i>		-0.916*** (-2.75)
<i>AFLEAD_NEW_LR</i>		0.740 (1.31)
Control variables?	Yes	Yes
Year FE?	Yes	Yes
Industry FE?	Yes	Yes
Company-year observations	8198	8198
Adj. R <sup>2</sup>	0.137	0.140

The variables are defined in Appendix B. Panel A of Table 8 estimates multinomial regressions because the dependent variable (ROLE) takes three categorical values. Panel A uses non-leader partners as the baseline group. Control variables for Panel A are the same as those shown in Panel A of Table 3. The z-statistics reported in Panel A are based on standard errors clustered on each partner because each partner has multiple yearly observations in this partner-year sample. Control variables for Panel B are the same as those shown in Table 5. The t-statistics reported in Panel B are based on standard errors clustered on each audit firm because the leadership variables have multiple yearly observations for each audit firm. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% levels, respectively (two-tailed).

dependent variable and the logit estimation results are reported in Col. (1) of Table 9. We find significant positive coefficients for *AFLEAD\_EXP* (z-stat. = 2.19) and *AFLEAD\_ADJ* (z-stat. = 2.38). Therefore, auditors are more likely to issue qualified opinions when leaders have more audit experience and a past track record of larger audit adjustments.

Next, we use accounting misstatements as an alternative measure of audit quality. The *MISST* variable equals one if the client's audited financial statements are subsequently restated or are revealed by the regulator to have been misstated (zero otherwise). In China, accounting restatements are disclosed in the "Material Accounting Errors" section of the financial

**Table 9**  
Alternative proxies for audit quality: qualified audit opinions and accounting misstatements.

Dependent variable	Full sample	Head-quarters	Branch	Full sample	Head-quarters	Branch
	<i>QUAL</i>	<i>QUAL</i>	<i>QUAL</i>	<i>MISST</i>	<i>MISST</i>	<i>MISST</i>
	(1)	(2)	(3)	(4)	(5)	(6)
	Coeff.(z-stat.)	Coeff. (z-stat.)	Coeff. (z-stat.)	Coeff. (z-stat.)	Coeff. (z-stat.)	Coeff. (z-stat.)
<i>AFLEAD_EXP</i>	1.675** (2.19)	3.678*** (3.07)	0.132 (0.13)	-1.599*** (-2.91)	-2.279** (-2.17)	-0.524 (-0.56)
<i>AFLEAD_ADJ</i>	1.273** (2.38)	4.869** (1.98)	-0.459 (-0.55)	-1.265** (-2.28)	-2.932*** (-2.78)	0.037 (0.05)
<i>AFLEAD_NEW_HR</i>	1.071 (0.73)	2.806 (1.00)	2.020 (1.38)	-0.236 (-0.22)	-1.795 (-1.15)	1.136 (0.70)
<i>AFLEAD_NEW_LR</i>	-1.641 (-1.14)	-3.582 (-1.26)	-2.447 (-1.23)	-2.123* (-1.89)	-4.546** (-2.28)	-1.073 (-0.82)
Control variables?	Yes	Yes	Yes	Yes	Yes	Yes
Year FE?	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE?	Yes	Yes	Yes	Yes	Yes	Yes
Company-year observations	8198	3932	4266	8198	3932	4266
%(Dep. var. = 1)	1.26%	0.99%	1.50%	2.61%	1.98%	3.19%
Pseudo R <sup>2</sup>	0.284	0.435	0.255	0.085	0.147	0.072

All variables are defined in Appendix B. Control variables are the same as those shown in Table 5. The z-statistics are based on standard errors clustered on each audit firm. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% levels (two-tailed), respectively.

statement footnotes (He et al., 2022). Following He et al. (2022), we identify material misstatements of the audited financial statements by collecting subsequent restatements from the footnotes contained in the WIND and CSMAR databases. We supplement these restatement data with CSRC regulatory actions in which auditors were sanctioned for failing to identify material accounting misstatements. In our sample, 214 audits have *MISST* equal to one, which corresponds to a frequency of 2.61%.<sup>37</sup> Results for the *MISST* model are shown in Col. (4) of Table 9. We find significant negative coefficients for *AFLEAD\_EXP* (z-stat. = -2.91) and *AFLEAD\_ADJ* (z-stat. = -2.28). Therefore, material accounting misstatements occur less often when leaders have more audit experience and a past track record of larger audit adjustments. Table 9 also shows that the *QUAL* and *MISST* results in Cols. (1) and (4) are driven by headquarter audits (Cols. (2) and (5)) rather than branch office audits (Cols. (3) and (6)).

## 6. Conclusion

The governance arrangements and agency problems at public accounting firms are different from those at public corporations. Nevertheless, public accounting firms are similar to public corporations in the sense that day-to-day management decisions are delegated to a small team of leaders (i.e., managing partners). While the prior literature has provided a wealth of evidence on the leaders of public corporations, scant research exists on the leaders of public accounting firms. This study seeks to provide the first large-sample archival evidence on how accounting firms select their leaders and the relevance of leadership attributes to firmwide audit quality.

Our findings are noteworthy for regulators who are contemplating new standards to address how accounting firms should select their leaders (CAQ, 2014; PCAOB, 2015; IAASB, 2019; PCAOB, 2019). Consistent with regulatory concerns that accounting firms put significant weight on commercial considerations, we find that partners are more likely to be appointed as leaders if they have a track record of attracting more new clients to the firm. Moreover, firms appear to provide lower quality audits when leaders have a past history of attracting more high-risk new clients to the firm. We also find that partners are more likely to be appointed as leaders when they have a wealth of audit experience; and, firms provide higher quality audits when their leaders are more experienced or when their leaders had superior audit quality in the past. Given that regulators are interested in the mapping of audit quality to accounting firm leadership, our results suggest that past experience, past audit quality, and commercial success are key leadership attributes that regulators might want to consider.

## Appendix A

Excerpts of Guidance from the CICPA relating to the national leadership teams of public accounting firms.

Appendix A includes excerpts from Chapter 5 of *The Chinese Institute of Certified Public Accountants' Guidance on Partnership Agreements for Limited-Liability-Partnership Audit Firms* (the Guidance hereafter). The Guidance was released in November 2011 in anticipation of CSRC-licensed audit firms' impending transformation to limited liability partnerships by the end of 2013. Section 5.1 covers the Partner Meeting, and Section 5.2 discusses the "Partnership Management Committee", which is the name given to a Chinese firm's national leadership team.

### Section 5.1: The Partner Meeting

Article 61. The Partner Meeting, comprised of all partners, is the supreme power institution in the audit firm. The Partner Meeting undertakes the following duties:

1. Approving operating strategies and business development plans;
2. Approving duty division of partners, department settings and duties;
3. Deciding chief executive partner;
4. Electing a Partnership Management Committee (PMC);
5. Approving the PMC's annual plans and reports;
6. Approving the firm's annual financial budgets, financial report, and profit distribution;
7. Deciding whether to revise the Partner Agreement, and approving the revisions to the Partner Agreement;
8. Deciding whether to extend the duration of firm operations;
9. Approving capital additions or reductions;
10. Approving audit firm merger, divestment, partnership dissolution, and liquidation;
11. Deciding whether to change the audit firm name;
12. Deciding whether to change the scope of business services or registered business site;
13. Approving partner entry, exit, and property share transfer;
14. Deciding whether to dispose the audit firm's intellectual properties and real estate;

<sup>37</sup> For each company-year observation, we use restatement data up to May 2022 to identify whether the previously-issued financial statements are subsequently restated. The 2.61% misstatement rate in our sample is similar to the 2.59% misstatement rate for a comparable period in He et al. (2022).

15. Deciding whether to agree with a partner's external guarantee with collateral on her share of the firm, or the transfer of her share of the firm; and deciding whether to agree with the firm's external guarantee;
16. Deciding whether to join international associations, establish an audit firm group, unify a brand name, and make investments;
17. Overseeing the performance and duty delivery of the PMC;
18. Approving proposals to monitor the partners, the PMC, or the functional departments;
19. Other affairs that warrant approval by the Partner Meeting.

Article 65. The Partner Meeting votes on the basis of "one partner one vote", or otherwise specified.

For a common proposal to pass, agreement needs to be received from more than half of all partners. For material proposals (including items 7 to 16 of Article 61, other than involuntary partner terminations, along with other proposals deemed as material), agreement needs to be received from more than two thirds of all partners (or 100 percent if otherwise specified). For a proposal to terminate a partner's employment, agreement needs to be received from 100 percent of all other partners.

A proposal shall be deemed as material if more than half of all partners agree that the proposal has a material impact upon the accounting firm.

### *Section 5.2: The Partnership Management Committee*

Article 67. The audit firm establishes a Partnership Management Committee (PMC). A PMC member can be titled as a managing partner for the purpose of external communication, executing her duties as authorized by the PMC.

Article 68. An agreement has to be reached by more than two thirds of all partners for a PMC member to be elected. Each PMC member has a three-year term, and can be consecutively elected.

Article 69. The PMC is responsible for implementing the following duties:

1. Reporting to the Partner Meeting;
2. Executing decisions made during the Partner Meeting;
3. Submitting the following proposals to the Partner Meeting:
  - 3.1. Business development strategies;
  - 3.2. The firm's annual plans, financial budgets, financial report, and profit distribution;
  - 3.3. Draft of revisions to the Partner Agreement;
  - 3.4. Duty division of partners, department settings and duties;
  - 3.5. Any change in the expected duration of firm operations;
  - 3.6. Capital additions or reductions;
  - 3.7. Audit firm merger, divestment, partnership dissolution, and liquidation;
  - 3.8. Change in the audit firm name;
  - 3.9. Change in the scope of business services or registered business site;
  - 3.10. Partner entry, exit, and property share transfer;
  - 3.11. Disposal of the audit firm's intellectual properties and real estate;
  - 3.12. Joining international associations, establishing an audit firm group, unifying a brand name, and making investments.
4. Discussing and approving policies drafted by functional departments;
5. Discussing and approving the setting up and closure of branch offices, and routine administration policies;
6. Deciding the purchase and disposal of assets for deals above a specified monetary amount;
7. Deciding material contracts and agreements;
8. Overseeing the operation and administration of the audit firm, along with short-term business development objectives and plans;
9. Nominating the chief partner, and deciding the persons in charge of each functional department;
10. Deciding how to deal with engagements where there are significant disputes;
11. Suing partners who break the law, regulations, or the firm's Partnership Agreement, or other people who infringe the rights and interests of the audit firm;
12. Other affairs that warrant the approval of the PMC, or other duties authorized by the Partner Meeting.

Article 71. For a PMC meeting to be effective, more than two thirds of the PMC members need to attend the meeting. Each PMC member has one vote. Any decision made by the PMC needs to receive agreement from more than half of all PMC members.

## Appendix B

## Variable Definitions.

Variable name	Definition
AFLEAD	Indicator variable equal to one if the partner belongs to the accounting firm's national leadership team, and zero otherwise.
EXP <sub>PAST</sub>	The percentile ranking of the total number of public company audits by the partner up to the end of the previous year relative to all equity partners of the same audit firm in the same year. A higher percentile ranking indicates greater past experience. EXP <sub>PAST</sub> is coded as zero if the partner has no prior experience in public company audits.
E <sub>PRE</sub>	Pre-audit earnings.
E <sub>AUD</sub>	Audited earnings.
ADJMAG	The absolute magnitude of the audit adjustment as a proportion of absolute pre-audit earnings; i.e., $ADJMAG = 100 \times ( E_{PRE} - E_{AUD} / E_{PRE} )$ .
LnADJMAG	Natural log of (one plus) <i>ADJMAG</i> .
ADJ <sub>PAST</sub>	The percentile ranking of past audit adjustments by the partner relative to all equity partners of the same audit firm in the same year, based on the mean absolute magnitude of audit adjustments to pre-audit earnings (measured using <i>LnADJMAG</i> ) among the partner's past audits up to the end of the previous year. <i>ADJ<sub>PAST</sub></i> is coded as zero if the mean absolute magnitude of past audit adjustments is zero. This variable covers audits where audit adjustment data are available.
QUAL	Indicator variable equal to one if the auditor issues a qualified audit opinion or an opinion disclaimer due to accounting-related issues, and zero otherwise.
MISST	Indicator variable equal to one if the annual audited financial report is subsequently restated or revealed by the regulator to have involved a material misstatement, and zero otherwise. To identify misstatements in the audited financial statements, we follow He et al. (2022) by collecting restatement data from the "Material Accounting Errors" section of the financial statement footnotes in the WIND and CSMAR databases. We supplement these restatement data with CSRC regulatory actions in which auditors were sanctioned for failing to identify material accounting misstatements. For each company-year observation, we use restatement data up to May 2022 to identify whether the previously-issued financial statements were materially misstated.
ACCEPT	Indicator variable equal to one if the audit engagement corresponds to a newly accepted audit client, and zero otherwise.
ACCEPTR	Trichotomous variable equal to one if a newly accepted client is high-risk, two if a newly accepted client is low-risk, and zero if the client is a continuing engagement. We define a client as high-risk risk if the client in the pre-switch year was subject to a regulatory sanction, investigation, or a lawsuit, received a modified audit opinion, or was in financial distress. Financial distress is defined as negative net income, negative working capital, or negative stockholders' equity (Carcello et al., 2009). We define a client as low-risk if it does not meet any of the above criteria for risky clients.
NEW <sub>PAST</sub>	The percentile ranking of the number of public company clients introduced to the firm by the partner up to the end of the previous year relative to all equity partners of the same audit firm in the same year. We assume a partner introduced the client to the firm if the partner performed the firm's first audit of the client. <i>NEW<sub>PAST</sub></i> is coded as zero if the partner introduced no public company clients to the firm.
NEW <sub>HRPAST</sub>	The percentile ranking of the number of high-risk public company clients introduced to the firm by the partner relative to all equity partners of the same audit firm in the same year. <i>NEW<sub>HRPAST</sub></i> is coded as zero if the partner introduced no high-risk public company clients to the firm. We define a client as risky if the client in the pre-switch year was subject to a regulatory sanction, investigation, or a lawsuit, received a modified audit opinion, or was in financial distress. Financial distress is defined as negative net income, negative working capital, or negative stockholders' equity (Carcello et al., 2009).
NEW <sub>LRPAST</sub>	The percentile ranking of the number of low-risk public company clients introduced to the firm by the partner relative to all equity partners of the same audit firm in the same year. <i>NEW<sub>LRPAST</sub></i> is coded as zero if the partner introduced no low-risk public company clients to the firm. We define a client as low-risk if it does not meet any of the criteria for risky clients (see above).
AGE	The percentile ranking of the partner's age relative to all equity partners of the same audit firm in the same year.
FEM	Indicator variable equal to one if the partner is female, and zero otherwise.
OWN	The percentile ranking of the partner's ownership percentage at the beginning of the year relative to all equity partners of the same audit firm in the same year. <i>OWN</i> is coded as zero if the partner's ownership percentage at the beginning of the year is zero.
AFLEAD <sub>EXP</sub>	The average value of <i>EXP<sub>PAST</sub></i> among the accounting firm's national leadership team members in a given year.
AFLEAD <sub>ADJ</sub>	The average value of <i>ADJ<sub>PAST</sub></i> among members of the accounting firm's national leadership team in a given year. This variable is measured as the average value of <i>ADJ<sub>PAST</sub></i> among members of the national leadership team that have audited at least one public company in the past.
AFLEAD <sub>NEW</sub>	The average value of <i>NEW<sub>PAST</sub></i> among members of the accounting firm's national leadership team in a given year.
AFLEAD <sub>NEWHR</sub>	The average value of <i>NEW<sub>HRPAST</sub></i> among members of the accounting firm's national leadership team in a given year.
AFLEAD <sub>NEWLR</sub>	The average value of <i>NEW<sub>LRPAST</sub></i> among members of the accounting firm's national leadership team in a given year.
AFLEAD <sub>AGE</sub>	Mean <i>AGE</i> of the accounting firm's national leadership team in a given year.
AFLEAD <sub>FEM</sub>	The percentage of female members of the accounting firm's national leadership team in a given year.
AFLEAD <sub>OWN</sub>	The average value of <i>OWN</i> among members of the accounting firm's national leadership team in a given year.
AFLEAD <sub>#</sub>	Total number of partners on the accounting firm's national leadership team in a given year.
ROLE	Indicator variable equal to zero if the partner does not belong to the firm's national leadership team, one if the partner belongs to the firm's national leadership team and is assigned to an audit quality-related role (i.e., risk management, quality control, professional standards, code of ethics, or discipline), and two if the partner belongs to the firm's national leadership team and is assigned to a leadership role other than audit quality.
AFLEAD <sub>AQ</sub>	The percentage of the accounting firm's national leadership team members who are assigned to an audit quality-related role.
NonAFLEAD <sub>EXP</sub>	The average value of <i>EXP<sub>PAST</sub></i> among all non-leader partners at the firm in a given year.
ENG <sub>LEADER</sub>	Indicator variable equal to one if either of the two engagement auditors belong to the firm's national leadership team, and zero otherwise.
ENG <sub>EXP</sub>	The natural log of (one plus) the total number of public company audits by the two engagement auditors up to the end of the previous year.
ENG <sub>AGE</sub>	Average age of the two engagement auditors.
ENG <sub>FEM</sub>	Indicator variable equal to one if either of the two engagement auditors is female, and zero otherwise.

(continued on next page)

(continued)

Variable name	Definition
ENG_OWN	Equity shares owned by the two engagement auditors.
BIG4	Indicator variable equal to one if the audit is conducted by one of the Big Four audit firms (PwC, KPMG, EY, and DTT), and zero otherwise.
BIGLOCAL	Indicator variable equal to one if the audit is conducted by one of the top-10 audit firms based on the CICPA's annual revenue ranking (but not a Big Four firm), and zero otherwise.
SWITCH	Indicator variable equal to one if the company switches audit firm during the year under audit, and zero otherwise.
TENURE	The length of tenure (in years) between the company and its audit firm.
BRANCH	Indicator variable equal to one if the audit is conducted by a branch office, and zero if the audit is conducted by a headquarter office.
LnTA	Natural log of the company's total assets.
LnSUBS	Natural log of (one plus) the number of subsidiaries.
LEV	Ratio of total liabilities to total assets.
LOSS	Indicator variable equal to one if the company reports a net loss, and zero otherwise.
CURRATIO	The ratio of current assets to current liabilities.
SOE	Indicator variable equal to one if the company's ultimate owner is the government or a state-owned entity, and zero otherwise.
INDDIRP	The fraction of independent directors on the board.

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